FRAUD AND ABUSE BY INSIDERS, BORROWERS, AND APPRAISERS IN THE CALIFORNIA THRIFT INDUSTRY

HEARING

BEFORE A

SUBCOMMITTEE OF THE

COMMITTEE ON

GOVERNMENT OPERATIONS

HOUSE OF REPRESENTATIVES

ONE HUNDREDTH CONGRESS

FIRST SESSION

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Printed for the use of the Committee on Government Operations

U.S. GOVERNMENT PRINTING OFFICE

76-791 WASHINGTON : 1987

For sale by the Superintendent of Documents, Congressional Sales Office
U.S. Government Printing Office, Washington, DC 20402

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FRAUD AND ABUSE BY INSIDERS, BORROWERS, AND APPRAISERS IN THE CALIFORNIA THRIFT INDUSTRY

SATURDAY, JUNE 13, 1987

HOUSE OF REPRESENTATIVES,
COMMERCE, CONSUMER,
AND MONETARY AFFAIRS SUBCOMMITTEE
OF THE COMMITTEE ON GOVERNMENT OPERATIONS,
Los Angeles, CA.

The subcommittee met, pursuant to notice, at 9:40 a.m., in room 350, Los Angeles City Hall, Los Angeles, CA, Hon. Doug Barnard, Jr. (chairman of the subcommittee) presiding.

Present: Representatives Doug Barnard, Jr., Albert G. Bustamante, and Matthew G. Martinez.

Also present: Peter S. Barash, staff director; Stephen R. McSpadden, counsel; and Russell J. Mathews, minority professional staff, Committee on Government Operations.

OPENING STATEMENT OF CHAIRMAN BARNARD

Mr. BARNARD. The hearing will be in order.

Today, the Commerce, Consumer, and Monetary Affairs Subcommittee of the Government Operations Committee is pleased to be in Los Angeles this beautiful sunny Saturday morning to continue our investigation and hearings on a very important subject.

At the outset, I want to thank Mayor Bradley and the city administration for making available this morning this fine facility for our hearing. It is certainly ideal, and we appreciate the courtesy and the hospitality of the city in this regard.

You might think it is sort of unusual that we hold a hearing on Saturday morning, but really it is not. It is a time when we can get more witnesses to appear because of their schedules, and although we don't have all of our committee members here this morning, we do have present a good complement of the committee.

My name is Doug Barnard. I represent the 10th Congressional District of Georgia, and I am the chairman of this subcommittee. I have been chairman of this subcommittee now for 3 terms. On my left is Albert Bustamante. Mr. Bustamante is a Representative from Texas, the 23d Congressional District of Texas, and he is serving his second term on this subcommittee. One of our new members of this subcommittee, but a very welcome member, and one who has already contributed much toward our ongoing information gathering and prior hearings is Mr. Matthew G. Martinez, who is from the 30th Congressional District of California.

This morning, we will be examining evidence of severe problems in the California savings and loan industry, the largest in the Nation in the terms of asset size. The hearing will be seeking detailed information on, first, the nature and the extent of misconduct by California thrift industry insiders, officers, directors, and principal stockholders, and by certain affiliated outsiders (major borrowers and appraisers). Second, we will look into the role of abusive appraisal practices in such misconduct; third, the relationship between misconduct and the insolvencies or problem status of California savings institutions, including the costs to the Federal savings and loan insurance fund; fourth, the effectiveness of the Federal Home Loan Bank Board's policies for detecting criminality and making referrals on such misconduct to Federal law enforcement agencies; fifth, the adequacy of the responses of those agencies, namely, the FBI, the U.S. attorneys' offices, the Justice Department's Fraud Division, in investigating and prosecuting insider, borrower and appraiser misconduct; and then, lastly, we will be looking for some specific recommendations for solving the financial fraud problem.

Why is this subcommittee holding this hearing? And, yes, why are we in Los Angeles? And, yes, why are we focusing on the savings and loan industry?

Under the Rules of the House of Representatives, the subcommittee is charged with responsibility for overseeing the operations of financial institutions and the Federal bank regulatory agencies and for advising Congress on whether the industry and those agencies are performing responsibly.

In attempting to fulfill this mandate, the subcommittee has held many hearings and has issued numerous reports that are relevant to today's proceedings. Two are of particular importance: In October 1984, the subcommittee issued a report entitled, "Federal Response to Criminal Misconduct and Insider Abuse in the Nation's Financial Institutions." That report was based on a very comprehensive investigation of the role of misconduct in 150 financial institution failures. The report concluded that:

> Misconduct was a principal factor in 50 percent of the commercial bank failures studied and 25 to 30 percent of thrift insolvencies; that bank regulatory agencies were lax in searching for criminal misconduct and slow to make criminal referrals; and that the criminal justice agencies frequently lacked the commitment, the resources, and the occasional expertise to prosecute complex financial institution fraud cases.

In September 1986, the subcommittee issued another report relevant to this hearing entitled, "The Impact of Appraisal Problems on Real Estate Lending, Mortgage Insurance, and Investments in the Secondary Market." And that report found that:

> Faulty and fraudulent real estate appraisals have become an increasingly serious national problem; that their harmful effects are widespread, pervasive, and costly; that they have contributed directly to the insolvency or problem status of hundreds of the Nation's financial institutions and are at least partially responsible for billions of dollars in losses to federally insured lenders, private mortgage insurers, investors in mortgage-backed securities, and Federal mortgage guarantee funds.

Today's hearings and the hearings planned for later this summer in Washington, are a logical, and—I would argue—a necessary followup to the "criminal misconduct" and "appraisal abuse reports."

The hearing is being held in Los Angeles, not because financial institution misconduct and appraisal abuse are unique to California, but, rather, because California's thrift industry problems are representative of what seems to be happening across the country, although on a scale sufficiently large and dramatic to focus needed public attention. Nor are insider abuse and appraisal misconduct unique to the thrift industry. Last weekend, the FDIC, which insures deposits in commercial banks, announced that it was closing its 85th bank for 1987, barely 5 months into this year. The Chairman of the FDIC has readily acknowledged that insider abuse is as frequently to blame for commercial bank failures as economic conditions in the oil patch, trouble in the farm belt, or loan defaults by Third World countries.

The results of today's hearing will also be relevant to important public policy debates currently taking place in Congress over what to do about the FSLIC recapitalization problem, whether financial institutions should have expanded powers, and whether the FSLIC should continue to exist as a deposit insurance agency separate from the FDIC. Frankly, there is serious concern in Washington that if Government and the private sector fail to take speedy and dramatic action against unscrupulous operators in the vulnerable thrift industry, an undercapitalized FSLIC fund may give way to a nonexistent thrift industry.

The subcommittee's investigation of the thrift industry's problems strongly suggests that misconduct by S&L insiders, by major borrowers and by appraisers has become the leading cause of thrift insolvencies here and has reached epidemic proportions. There is evidence to show that serious insider misconduct is implicated in most of California's 31 thrift failures over the past 3 years, that appraisals were used to facilitate much of this misconduct, and that fraud is responsible for a large percentage of the $3.7 billion in accompanying losses to the FSLIC, just a few days ago revised upwards to $5.6 billion. Two extremely disturbing patterns appear to exist in California in connection with the misconduct issue:

First, it appears that many individuals who are engaged in financial institution misconduct have been able to move from financial institution to financial institution with virtual impunity, to the detriment of all the institutions that they touch; and we need to get a handle on this issue—and quickly.

Second, the common practice of institutions participating in each other's loans, with little or no independent underwriting is fraught with great risk. When loans are fraudulently made or involve unsafe and unsound ventures, defaults have a devastating rippling effect on all participating institutions. This appears to have happened time and time again on improper loans made by certain California S&L's. We need to get a handle on this issue, as well.

This subcommittee is concerned that the responses of the regulators and the criminal justice system to this epidemic of misconduct are not adequate and that more resources and a greater commitment are required. Today, we are searching for information, for explanations, and for solutions. But this is an issue that should be of interest, not just to the Congress, not just to the bank regulators, not just to the criminal justice agencies. It is an issue that needs to be addressed by the financial community itself. Our hearings in

Washington later this summer will provide the thrift and banking industries with an opportunity to do so.

This morning, we have a very large number of witnesses to hear from, and all of them bring very important information on the subject at hand. In order that we might adequately hear from all witnesses to the fullest extent possible, we are going to ask that those testifying summarize their testimony as much as possible and as practical; but we want you to be careful not to exclude some of your essential points.

I am now going to see if either of my colleagues would like to have an introductory statement. I will first turn to Congressman Bustamante.

Mr. BUSTAMANTE. Thank you, Mr. Chairman.

I am happy to join you and our colleague, Mr. Martinez, at this hearing in which we will examine misconduct by owners and senior officials of savings and loans, and the role of real estate appraisal fraud in facilitating misconduct and the effectiveness of the criminal justice system in prosecuting those responsible for financial institution fraud.

Misconduct in the savings and loan industry in California by major borrowers and by appraisers has become the leading cause of thrift insolvency in California over the past several years; and you, Mr. Chairman, have pointed to the fact that this situation has California leading the Nation in white-collar crime.

Fraud and incompetency within the S&L industry has made Congress reluctant to approve large sums of money to recapitalize the FSLIC fund. Additionally, unsound thrift purchases undermine efforts by Congress to expand the powers of financial institutions so that they can compete more effectively in a domestic and international financial marketplace.

I look forward to the individuals who will testify this morning to provide some further information and also to try to see if we can get recommendations to resolve this problem. Thank you very much.

Mr. BARNARD. Congressman Martinez.

Mr. MARTINEZ. Mr. Chairman, I have a statement that I would like to have entered into the record in its entirety, and I'll be brief because I know that there are important witnesses here today that can give us some insight into the problems involved here.

Mr. BARNARD. Without objection, it will be.

Mr. MARTINEZ. But just let me say that, as I read the reports, I am appalled that there hasn't been a greater interest and desire on the part of the industry itself to police itself, and to work with other agencies to ensure that culprits in the financial industries are thwarted and prosecuted.

Certainly, we all know that, if it was a simple bank robber, or a bank clerk committing some kind of a crime that we would with great diligence, not hesitate to condemn, pursue, and prosecute. I think this is something that we have to scrutinize since we expect that people entrusted with stewardship over the financial institutions in which so many of us entrust our money to be safeguarded—we expect that individuals in that position are of the highest integrity, and are people who are worthy of that trust that we have bestowed on them.

It seems that that is not the case in so many instances. I know that we have to expect, in the current economy, that there would be failures of financial institutions throughout the country, especially in the farm areas; and we know that they are failing there because of severe downturns in the economy. And that's something that is hard for anyone really to control.

But certainly, insider theft, fraud, and abuse should be able to be controlled. Those of us who have for years put our trust into financial institutions have reason to be alarmed. We have become worried that there isn't that kind of integrity, and we certainly cannot understand the needless loss caused by insider fraud in the thrift industry.

I think that the Government agencies that are responsible for the oversight have to move and move quickly to overcome this crisis. Thank you, Mr. Chairman.

Mr. BARNARD. Thank you, sir.

[Mr. Martinez' prepared statement follows:]

OPENING STATEMENT BEFORE
THE SUBCOMITTEE ON COMMERCE, CONSUMER, AND MONETARY AFFAIRS
COMMITTEE ON GOVERNMENT OPERATIONS
JUNE 13, 1987

Mr. Chairman:

Night-after-night television network news carries the stories of financial insitutions in the farm and energy belts that are failing as a result of severe downturns in those sectors of our economy. Unfortunately, the economic forces which have caused these downturns are difficult for anyone to control and consequently, more financial institutions in states like Iowa and Oklahoma may fail. While agriculture and energy in California are no better off than other parts of the country, our state is enjoying relative prosperity since business and industry is more diversified. Nevertheless, California s Savings and Loan Associations are also failing in record numbers, but most of these failures have not been caused by economic downturns. Rather, they have been needlessly caused by fraud inside the thrift industry. And, to make matters worse, federal government agencies responsible for overseeing the thrift industry have ineffectively combated internal misconduct.

As all of us are aware, thrift failures are not solely an internal problem of the Savings and Loan industry. Such failures prevent taxpayers from retrieving their deposits. Moreover, the California thrift failures has exasperated the nation-wide thrift crisis, by draining $3.75 billion from the Federal Savings and Loan Insurance fund.

In order to solve this problem, severe bureaucratic pathologies inside the various federal agencies involved in this crisis must be remedied. Agency representatives should tell us today how they plan to:

(1) prioritize efforts against insider misconduct;

(2) improve interagency coordination.

(3) make thorough investigations and follow-up on those investigations when they are referred to another agency;

(4) provide more adequate training to personnel investigating these cases; and

(5) accept caseload assistance when provided by headquaters or other regional offices.

If nothing else, I am hopeful that today's hearing will demonstrate how serious Congress feels about this problem. With this in mind, I look forward to discussing these issues with the witnesses that will appear before us.

Thank you, Mr. Chairman.

Mr. BARNARD. I think it is very appropriate this morning that we have as our first witness the savings and loan commissioner of the State of California, Mr. William J. Crawford.

Mr. Crawford is accompanied by Mr. William Davis, the deputy commissioner of the savings and loan department. Mr. Crawford has made frequent visits to Washington, DC. And, Mr. Crawford, on each visit we have appreciated your interest in visiting with us on the subcommittee, to talk about the problems of California; and I don't know of anybody in California who is a more appropriate witness than you, to talk about the subject this morning; and we welcome you to this panel.

As I have already indicated, your entire testimony will be included in the record, and we will leave it up to you as to how you might want to summarize it all. So, now, we are pleased to hear from you, Mr. Crawford.

STATEMENT OF WILLIAM J. CRAWFORD, SAVINGS AND LOAN COMMISSIONER, STATE OF CALIFORNIA, ACCOMPANIED BY WILLIAM DAVIS, DEPUTY COMMISSIONER

Mr. CRAWFORD. First, I would like to start off by saying that whatever I express here is my own personal opinion, and it is not the opinion of the department; it is not the opinion of the State of California. I am expressing my own personal opinion.

I think the problems of the savings and loan industry were almost to be expected. The industry has historically rented money short, and loaned it long; and when I started in the industry, the average loan was 139 months, on a conventional loan—11 years and 7 months. If you borrowed $2,500, you paid it back $25 a month, and that would pay it off at 6 percent in 11 years and 7 months.

We stretched out loans to 30 years, and maybe even sometimes 40 years. We continued to attract money in short term, and we paid market rates. You could pay anything you want to pay for money. That's where your problem starts, with what you pay for the money, because you must add to that overhead and risk of loss on the assets. And when you start paying too much for money, you must put it out at high rates; and when you don't leave something on the table for the other guy, you are inviting trouble; and if you are a gouger, you are inviting trouble. If a guy comes in and offers you a deal that's better than any deal you have ever been offered, you had better look carefully at that deal. Why is this guy willing to pay me so much for this deal? And you become a skeptic.

And also, you must review everything. People get pieces of paper to justify what they do, and they may have policies and procedures, but they may not be following the policies and procedures, so you have to make sure that they are following those.

But, basically, it starts with paying too much for money, and getting a deal that you can't refuse. And, generally, that thing is supported by an appraisal. You must have an appraisal. An appraisal is a very powerful tool. If the client is the guy that's borrowing the money, if the appraiser's client is the fellow that's borrowing the money, or the loan broker that's charged to get the loan for the man, you've got a potential problem right from day one. If you

don't have a smart loan officer, and if he doesn't go out and see the property, and if he doesn't do all of the credit checking and the like, and use the five C's of credit, and document the file, and challenge everything that he gets, he can either be a fool, or he can be tied in with the guy and accommodating the guy that is getting the money.

These white-collar criminals are experts at penetrating financial institutions; they penetrate banks, they penetrate savings and loans, they penetrate thrift and loans. Anybody that's got money. We mentioned that California is leading in white-collar crime. I want to say that California has 27 million people, and the average income is high, and with affluent people, someone wants to separate them from their money.

So, if you want to go into business, you wouldn't go into business in a place that was a depressed area, you would go to where people have the money that you want to separate from their nest egg.

The appraisal, every major white-collar crime has an appraisal to validate the property value, to validate the crime, and also it holds off the auditors, and it holds off the examiners.

An auditor comes in to audit the books, and if you have a good MAI appraisal in the file, that's the value of the asset. He is not an expert in that, and he should, if it's a major asset, maybe hire an appraiser, or order an appraisal, to have the company ordering the appraisal before he would certify the financial statement that it fairly presents the true financial condition of that company.

But it also holds off the examiners. If you go into an institution and everything is rosy, and all the loans are current, you know, this is a pretty good outfit. They have a high return on assets; they have a high return on net worth. In fact, I worry about the manager that has the highest return on assets and the highest return on net worth, because he may be taking risks that he doesn't know he's taking.

Also, I would like to make a point that there is a risk beyond which you can't take, no matter what the borrower gives you. If he'll pay you so much, and he'll pay you so much more to go another 10 percent, you probably bought the project. I always thought of myself, when I was functioning as a loan officer, and I always told my loan officers to think of themselves as a purchasing agent.

When that borrower comes in, he may sell you that property, and you didn't know it; and so, be very careful. If you loan too much, or if you invest too much with a joint venture, you bought the property. All he has to do is to milk his money out on the front end and dump it to you.

There's another important factor in this fraud; it is greed. We used to say as auditors, or anybody who was taking an audit course: if you put temptation and the opportunity, and the need in the same place, you are asking for trouble. An employer doesn't pay an employee enough; gives him a large amount of cash to handle, and is looking out the window while he's handling it, the employee has that need, and he may borrow it. Usually they start borrowing funds.

The controls, historically, were set out to protect the cash and securities in a financial institution. They always wanted to protect against the officers stealing the cash, and the tellers stealing the

cash; somebody converting securities, bearer securities to their personal use. We build thick vaults; we have cameras; we have time clocks on the vaults; we have dual control—all these controls were to protect against somebody stealing the cash.

Well, you can steal far more money, and take it out the back door. The best way to rob a bank is to own one. If you have 100 percent control, you can make yourself the chairman of the audit committee, the chairman of all committees. And you can be the chairman of the committee with people not knowing that you are the chairman of the committee.

If you hire a man and you pay him three times what he has ever made before—let's say he made $50,000; you pay him $150,000, he'll sign almost anything over a period of time, you know—just a little bit here, a little bit there; sign this, sign that. And you fire a few people around him. The first thing you know you have got a loyal friend.

The system of internal control doesn't work. We've gone upscale where we have got temptation, opportunity, and *greed*; we are handling much larger sums of money. They are making much larger deals. They forget the name of the game is to cut the risk up into small pieces and use the law of large numbers, to take small risks.

Equity is the only thing that the borrower really protects. If you have a trust deed, you can't get a deficiency judgment, so you have a choice between chasing this guy; and if he has hidden his net worth, you don't chase him, you take the property.

If you take the property in California under the terms of the deed of trust, you have to be satisfied with the proceeds of the sale. There is no deficiency judgment available in California if you foreclose on a deed of trust. The borrower's equity is all you get as a cushion against loss.

If an association develops problems and you are losing money, you have to get greater earnings on the next deal. You have to keep feeding this machine. One of our large problem association loan agents were paid commission based on the volume of business they brought in, not the profitability of the business, but the volume of business. They brought in losses all day long, and they were paid commissions, and they are terminated. But the poor assets are stuck on the books.

If the work product of the appraiser never gets checked, he can fool a lot of people for a long time; and I can tell you that there are members of appraisal societies that, unless they are hauled before them, their ethics committee with a complaint (usually, the complaints come from their own members, but if you don't get complaints and you do things and nobody complains) you can be an appraiser for 20 years, and not have any peers check your work product. They just accept it.

So that is the big problem with appraisers. I will give you a couple of examples here, and these are anonymous.

A piece of property that probably cost $1,400,000 to build in the late seventies, it couldn't be sold as a condominium project, so they converted it to a timeshare project, and it wound up on the books of a financial institution 3 months after it opened, for slightly under $15 million.

The initial capital of that company was $3 million.

Now, we've heard Dr. Benston testify on direct investment that if the Federal Home Loan Bank would just close savings and loans when they hit zero net worth, the investor would lose all his investment and FSLIC would lose nothing. The stockholders would lose everything; FSLIC would lose nothing—an ideal situation; they should face up and do that.

Now, we hear people talking about forbearance. This institution was insolvent by $9,200,000 the day they bought that asset in 1983, 90 days after they opened. But we didn't know it, and the Federal Home Loan Bank didn't know it; and we appraised the property about 4 months later for $5 million.

The Federal Home Loan Bank appraised it about 6 months later for about $10.4, but there were differences in the appraisal assumptions. I think maybe ours says, well, it is not a timeshare; it's a condominium; and theirs says it's a timeshare.

Well, to cover this, because we regulators want them to put up the difference in the loss reserve and write the asset down, they sold it for over $20 million, with $2 million down; and then when we took over the institution, we found the association had taken a deed to the property and that the property was in escrow, sold with no contingencies for $33 million.

The board of directors were told that everything's rosy, but Mr. Davis here found a letter of commitment in a desk drawer to buy it back for $40 million within 2 years.

And also, in a closet, he found an appraisal for $72 million that was 104 pages long and very official and had lots of pedigrees and MAI and all that on it.

So, I sent my old chief appraiser to this property to appraise it, and he appraised it for $2,400,000. He said you might list it for $2.5 million, but be prepared to accept, a lesser price.

That is a classic example of the fiction that could be written, and of the documentation that can look very official.

It had a gold seal on it. I forget whether it had ribbons or not, but it had an embossed gold seal on it.

I had another example property bought in 1983 for $1.5 million, with $750,000 down and a $750,000 first trust deed back to seller. It was manipulated from April to June to borrow $3.2 million from a bank. I think they penetrated that bank, frankly; but, anyway, in December 1984, for a $44,000 fee, they were able to obtain an appraisal for $25.5 million on this property. The property's only access is through a gate at the end of a freeway culvert; it has a 35-percent grade; it has many easements across it. It has a 14-acre floating life estate that is not described. The property never was worth over $500,000, and this property was used to try to gain control of a savings and loan. It was to be contributed as capital for not less than $16 million.

We turned the acquisition down in about August; in November 1985, this property was foreclosed for the balance owing on the first-trust deed of $750,000 wiping out. That's a classic.

I'll give you one more appraisal example. This was appraised at 47 finished lots for $18,300,000. The financial institution, I believe, loaned $6 million on it. It's in a coastal zone; it's adjacent to a regrowth city; it's in a green belt; you have to cross other people's property to get to it; they have a hillside ordinance in the city; the

appraiser never went to the city departments at all; he did no research. He said in his appraisal he did no research and he accepted the representations of his client. This was a loan broker by profession who now was the borrower. The property is worth $500,000. We now find that you can make two lots out of that property. Obviously, that appraisal was delivered to a loan officer with the intention that he would use it for some purpose. I know you could never develop those lots. They didn't have a sewer, water—engineering or geological report.

I'll give you two examples that came to me just in the last few days. Two appraisals of single-family dwellings by the same appraisers in prestige neighborhoods in West Los Angeles—my appraisal of those two properties are $9.6 million less than those two appraisals.

I had two appraisals of commercial properties by another appraiser, that my appraiser's value of those properties is $6.3 million less.

An MAI appraiser that was my chief appraiser on the National Ethics Committee was asked to tell what it would cost to appraise a condominium project. He quoted a price of $6,500; and, the client said, if you can come up with an appraisal value of this amount or more, send me a bill for $21,000.

We do definitely need more professionalism and ethics not only in the appraisal profession, and ethics, we need it in the savings and loan business, too.

We have some very fine appraisers; we have some very fine savings and loans, but, believe me, if you don't have good ethics at the top of the business you've got problems.

In summary of the savings and loan industry in the State of California, we have the cream of the crop in California.

I took this Los Angeles time study from a week or so ago, and I gave you a little 1-page analysis, of 19 California-based savings and loans that made only $1,933,600,000. The entire industry in the United States made $2 billion last year.

Thirteen of the best savings and loans on there were historic State-chartered savings and loans. I would like to summarize how the State of California developed its volume of problems. Basically, it happened when you passed Garn-St Germain, and your deregulation act, perhaps it was an FHLB regulation arising from that that said you could loan or invest up to 100 percent of value.

The State of California, on emergency basis, for State associations, adopted that same regulation. California was the finest State regulator in the Nation. We had a uniform chart of accounts; we had an early-warning computer system where all the loan registers from each association came in every month. We had 41 appraisers on duty in the department. We had the premier savings and loans in the United States, and we had a hook on them. And that hook was that there were State-chartered stock companies and Federal mutuals. If you wanted to build an estate for your family, you had to be a State-chartered stock company. And so, we beat these people up pretty good, and they had to stand there and take it. We had discipline.

But when Congress passed the law and permitted Federal stock companies under the guise that they needed to get capital into the

Federal companies, we lost our hook, and we lost 50 of our 93 savings and loans, in 1980 and 1982—I think there were 22 conversions to Federals and there were 28 merged with Federals.

So we lost 50 of our 93 associations. We support the department by assessments on the industry, so we lost our assessment basis. Each year we'd figure what it cost to run the department and bill the industry based on assessments. We cut our staff from 172 employees in July 1978 to 55 employees in July 1983, and that really decimated the department.

So, naturally, when you are losing your employment, you say, well, what are we going to do; so we responded by telling people, we'll be very lenient in granting some new charters. So some of the analysts went around, and attorneys, and they conducted seminars, "Own a bank or savings and loan. Own your own money machine."

Financial advisers working tax shelters and syndications and developments could have their own checking account here, they wanted a charter, so we got them. When their applications come in, their profiles look great. Their financial statements are all doctored up; they look real good. If a guy doesn't have a criminal record, how are you going to keep him out? If he's successful, and he's got a good net worth, it's hard to sort out, who's good, and who's bad.

We got a lot of new entrants, and they like to grow fast; and rapid growth is the cause of one of the worst ailments in a savings and loan business. If you have got a lot of money, high-cost money pushing you, and you have to make profits, you have to put it out awful fast; and some of these people had big egos, and some of them got their contributing property for capital.

If you get property appraised high enough, and it looks good enough, and you know when it comes in as capital, then you can leverage it 33 to 1. We used to have 6 percent net worth as a guideline. It was always a capital based regulated industry. When the industry lost half their net worth, and we lost 1,000 associations in 1981 and 1982, we cut the net worth requirements to 3 percent, so you could leverage 33 to 1.

I made a 1-page summary exhibit here of the things that I think cause the problem, and things that might lend to a solution, but I can tell you that one thing that will not lead to a solution is forbearance. We endeavor to buy time all the time; that is something that we completely endeavor to do. We took an institution out of the bad management's hands in 1984, and it has been in good management's hands for the last 3 years. It still has severe problems.

If you leave any association in the hands of the management that got it in trouble, you'll never solve the problem.

I have got one last statement. There is a "Handy, Dandy Guide for Examiners" to Garn-St Germain, dated September 1983. They had a meeting or seminar on the new law. I want to read the final statement to you.

"Because the old-time examiners said institutions are going to get in trouble—people in the industry that knew the industry thought that they were going to get in trouble."

It says: "Finally, the examiner should not be overly pessimistic about these new regulatory changes. Examiners have a natural tendency to speculate on how associations will get themselves into

trouble using these new powers. Keep in mind that there are many well-run associations out there who can and will use these powers effectively."

I believe that that happened; there were a lot of them out there that used those powers effectively, but there were also a lot of new entrants who came and used them most ineffectively. The losses are huge. Thank you.

Mr. BARNARD. Thank you, Mr. Crawford.

[Mr. Crawford's prepared statement follows:]

PROPOSED TESTIMONY OF
WILLIAM J. CRAWFORD, SAVINGS AND LOAN COMMISSIONER
BEFORE THE CONGRESS OF THE UNITED STATES
HOUSE OF REPRESENTATIVES
COMMERCE, CONSUMER AND MONETARY AFFAIRS SUBCOMMITTEE
OF THE HOUSE GOVERNMENT OPERATIONS COMMITTEE
LOS ANGELES, CALIFORNIA - JUNE 13, 1987

A. Profile of California Thrift Industry and Savings and Loan Department

1. Provide a brief profile of today's California thrift industry, including the following: (a) the number of state-chartered associations; (b) the number of federally chartered associations; (c) the aggregated assets, market value, and profits of these associations (and how these numbers compare with those for the entire country); and (d) the number of state-chartered associations that are in "problem" status.

The savings and loan industry in the United States had only $10 billion in assets in 1946. Today it has well over a trillion dollars in assets, or a one-hundredfold growth. California is a leading state in the savings and loan industry, due to a tremendous growth. It recently passed 27 million in total population. The migration to California created a huge demand for housing capital, which was mostly provided by an aggressive savings and loan industry. At December 31, 1986, the total assets of the California savings and loan industry ($311 billion) exceeded those of the California banking industry ($293 billion).

To understand the problems of the California thrift industry, we need to review some history.

The savings and loan industry in the 1950's and early 1960's was well-controlled. The federal institutions were mutuals and the state associations were stock. The laws were strict for both. The enforcement actions were aggressive, and entry into the field was tightly controlled. (The tax laws prior to 1963 favored the owners of stock companies, allowing retention of association profits because of the tax advantage. The tax advantage was gradually reduced and by 1969 the industry was paying substantial taxes.) Lending and investment authorities were slowly and gradually expanded, and, although many poor investments were made, the inflationary experience in the 1950's and 1960's tended to cure most problems. In 1967 the then Savings and Loan Commissioner, Preston Martin, hired Price Waterhouse to devise an Early Warning System to detect institutions that had a propensity for getting into trouble. The overbuilding in 1963 and 1964 had created the need for such a System and the 1966 credit crunch brought home the vulnerability of savings and loans to changes in interest rates and the need for adjustable rate mortgages. This Early Warning System utilized a number of financial ratios which had been identified in the Price Waterhouse study as effective in discriminating between strong and weak associations, and produced a score for each association. Associations were then ranked, worst to best, on the basis of the assigned scores.

The two oil shocks of 1973 and 1979 brought great inflationary forces and illustrated the need for deregulating the liability side of the balance sheet in order to provide sufficient funds to avoid starving the housing market. However, controls were maintained over the asset side of the balance sheet and the industry was ill-positioned for the restrictive monetary policy of 1980-81 which was used to cool the double digit inflation. Congress responded by passing the Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn-St Germain Depository Institutions Act of 1982, which liberalized the powers to help the industry to respond to the depletion of its net worth. The new federal laws expanded lending powers and provided for federal stock associations. In addition, the federals, on April 12, 1982, amended a regulation which they had imposed in 1957 requiring 400 local stockholders and allowing no one to own more than 10% of the stock and no family or control group to own more than 25% of the stock. At the same time there was a free enterprise movement at the federal level which stated that what this industry needs is a free enterprise entrepreneur with expertise and capital to recapitalize the industry and use creative methods to restructure the balance sheets of the savings and loan industry. California, having no hook to hold them and seeing the conversions of state associations to federal charters,

responded in 1983 with a very liberal law of its own to woo the institutions back to the state.

Between April 12, 1982, and the fall of 1984, seminars were conducted by consultants and attorneys who obtained charters for banks and savings and loans and told developers and homebuilders that they should own their own moneymaking machines. A flood of applications totaling 235 were received by the California Department of Savings and Loan. Many new institutions were opened. At this time, forty-nine applications approved by our Department are still pending for insurance of accounts in Washington. Sixty-eight were awaiting action of the Commissioner when I took office, of which one has been approved and 67 were denied. Also, there was a group of entrepreneurs who did not wish to wait for the new application process who came forward to buy existing institutions to gain quick entry into the industry. Many of these acquirors donated properties, at inflated appraised values, to provide the capital required for the acquisition. Many of the institutions that they were attempting to acquire were in difficulty and the existing stockholders looked upon the acquiror as a saviour. The combination of the two waves I have just described has created a backlog of institutions which are either insolvent or have substantial problems.

There are 212 federally-insured savings and loans operating in California. Of these, 140 are state associations and 72 are federally-chartered. The industry profits in the United States for 1986 were $2.0 billion and the net profit for the associations operating in California was $1.2 billion. The market value of all associations cannot be determined because most associations are not publicly traded. Approximately 24% of the state savings and loan associations in California have significant problems.

I have available to you a series of charts that clearly shows the impact these changes have had on the California savings and loan industry.

Chart 1 shows population change. Chart 2 shows historic changes in the number of associations serving the California public. Chart 3 shows the change in assets from 1955 to 1987. Chart 4 shows the changes in number of facilities over that period. Chart 5 shows the number of new state associations approved. Chart 6 shows the number of savings and loan offices over that period of time. Chart 7 shows the number of Department of Savings and Loan employees. Chart 8 shows the employees per billion of assets. Chart 9 is DSL expenditures. Chart 10 shows the net worth of the industry, and Chart 11 shows commercial bank prime rate.

A
2. **Provide a brief profile of the California Savings and Loan Department, including the following: (a) the number of thrifts supervised by your department as of June 1980, June 1985 and June 1987; (b) the number of ceiling and filled positions in your department as of January 1978, January 1983, and June 1987. How many vacant positions currently exist within the Department's examination staff and its appraisal staff? What are the prospects for filling any vacancies?**

The Department of Savings and Loan of the State of California and the law under which it operated was the national model through 1978. It had had a Uniform Chart of Accounts, a very disciplined accounting system, a loan register system which monitored current loans recorded, a state of the art early warning computer system for monitoring the institutions, and a well-trained appraisal and examination staff. The California industry was financially strong, highly profitable, and closely regulated. The mid-seventies saw important changes in social responsibility for associations with the enactment of tough fair lending laws and regulations in California. When the impact of double digit inflation in the late '70's came to bear on the institutions at the same time they were encountering the added substantial operating burdens associated with the new fair lending legislation, Public Law 96-221 enabled institutions to switch to federal stock charter. Twenty-two California savings and loans that converted in 1981-1982 were the cream of the crop institutions of the Department of Savings and Loan. The Department of Savings and Loan historically has been

operated by assessment against the industry that it regulates. Conversion to federal charters of 22 of the 93 associations regulated by this Department and the merger of 28 associations with federal institutions during 1981 and 1982 (50 of 93) resulted in the loss of 68% of the assessment funds necessary to run the Department. As a result, much of our early warning and regulatory systems had to be modified for the limited amount of the industry that remained to be regulated. The law was recodified and there was discussion that the whole department would be abolished.

In 1983 the California Legislature passed a bill that also allowed state associations to make 100% loans and greatly liberalized investments in real estate, service corporations and in other assets. By January of 1984 all discipline for the savings and loan industry was pretty well removed. At the same time that new entrepreneurs were coming into the industry, bringing property for capital, acquiring control of existing institutions, obtaining new charters at a rapid rate and using the expanded powers with great gusto, the experienced examiners visiting institutions were shocked at the lack of competence of the new arrivals. The old, experienced managers were also concerned about the inexperience of the new examining staff as we attempted to rebuild the Department. When you matched inexperienced examiners against incompetent

managers, the FSLIC Fund was in jeopardy. The results are clear. The GAO says that FSLIC is $6.3 billion insolvent, and the Secondary Reserve Fund has been depleted, leaving an additional $800 million net worth loss to be booked by the industry in 1987.

The Department supervised 126 associations in June 1980, 154 in June 1985 and 140 as of June 1987. The number of ceiling and filled positions for the Department as of January 1978 had 186 as a ceiling and 172 filled positions. By January 1983 there were 66 as a ceiling and filled was 55. By June of 1987 the ceiling is back up to 143 with 136 positions filled. The seven unfilled positions consist of one appraiser, four examiners and two clerical. We anticipate filling these positions prior to June 30, 1987.

Since 1984 the Department has been instrumental in adopting legislation to provide controls on the described abuses.

A
3.a **Describe briefly the general responsibilities of the Savings and Loan Department for state-chartered/FSLIC insured thrifts.**

The responsibilities of the Department of Savings and Loan include:

1. Approvals as required by law, which include new charters, changes of control, new branches and agency offices, mergers, consolidations, conversions, de novo

managing officers only, business plans, and changes of name, changes of location, investments in service corporations and sale of stock.

2. Supervising the operations of associations through a reporting and monitoring system.

3. Examining books and records of institutions for compliance with laws and regulations.

4. Promulgating regulations to implement the Savings Association Law and making legislative proposals to change the law.

5. Supervising and enforcing the laws and regulations and disciplining institutions that fail to comply, Cease and Desist Orders and Court actions, which may include receiverships or conservatorships and closing insolvent institutions, and other legal remedies.

A
3.b **How is examination, supervisory, and civil enforcement authority shared between your department and the Federal Home Loan Bank of San Francisco/FSLIC with respect to (i) solvent thrifts and (ii) thrifts in conservatorship because they are in danger of becoming insolvent or in receivership because they are determined to be insolvent?**

This Department by law has the power to enforce any federal law or regulation on a California state institution. We, as much as practical, provide dual examinations and share

the work with the federal examiners. We also exchange workpapers and information with the Federal Home Loan Bank to assist one another in monitoring and supervision. We take action to enforce the state law and regulations and they take action to enforce the federal law and regulations. We have a free exchange of information between the two departments. When an institution becomes insolvent an agreement is reached with the Federal Home Loan Bank that they will accept a conservatorship or receivership appointment from the Department of Savings and Loan. We jointly go to the State Court to ratify closure of the institution and appointment of the Federal Savings and Loan Insurance Corporation as conservator or receiver. They must testify that they agree to accept it if we tender it. In the past we have had some restrictions on our ability to cooperate with state regulatory agencies investigating unsafe and unsound business practices. However, recently we have been able to obtain changes in the California law that permit us to share information with other state regulatory agencies as well as the Federal Home Loan Bank without requiring a subpoena. Our relationship has long been a cooperative and compatible one.

A
4. **There are approximately 2 1/2 times as many state chartered as federally chartered thrifts in California. Are there any overriding reasons for the larger number of state-chartered thrifts?**

An important reason why there are 2 1/2 times as many state associations as federally chartered thrifts in California may be that the Commissioner is geographically closer so he can be more responsive to an association's concerns and give approvals more rapidly. In addition, state associations are authorized to invest directly in real estate and real estate developments. California law also permits more flexible investments in service corporations and has no prescribed activities. All these factors contribute to more state associations.

B. Nature, Extent and Consequences of Misconduct in California Thrift Industry

5.a **Provide an overview of the nature, extent and consequences of abusive behavior and criminal misconduct by thrift industry (i) insiders, (ii) borrowers and (iii) appraisers in California.**

Expanded powers and deregulation provide an opportunity for insiders to fund assets to 100% of value. This meant that you could accommodate your friends, relatives and associates to the benefit of owning real estate without the burdens of the loss. Any aggressive entrepreneur would recognized that benefit.

As an overview of the 29 institutions on which we tendered conservatorship or receivership to the Federal Savings and Loan Insurance Corporation for California state-licensed associations, most of them included self-dealing, dealing with affiliates, dealing with friends, either as borrowers

or as joint ventures. Appraisal abuse was present in most cases, as you need an inflated appraisal to validate the amount of money loaned or invested.

B
5.b **Utilizing those institutions on the attached list, provide the subcommittee with actual case studies illustrating abusive and criminal misconduct (including the role of faulty and fraudulent appraisals in facilitating that abuse and misconduct) and the impact of such misconduct on the safety and soundness of the California thrift industry.**

Because of the limitations of the California law, actual case studies will have to be obtained from the Federal Home Loan Bank of San Francisco. Of the 29 institutions which I discussed, nearly all 29 contained some form of self-dealing or dealing with fraudulent appraisals. Since the entire basis of strength in real estate investing or lending depends upon the equity that the borrower or joint venturer has in the project, inflated appraisals result in negative equity and huge losses. The true impact of this has been highlighted by the GAO report on the $6.3 billion negative net worth of the FSLIC and the huge number of unresolved cases nationwide. I estimate that the losses on the 29 institutions will approximate $3.5 billion to date.

The industry as a whole is not able to obtain adequate economical directors' and officers' liability insurance or blanket bond coverage. Because of the tort liability laws, neither the savings and loan industry nor the appraisal societies are able to discipline their members to conform to ethical standards of performance. Our system of justice

works slowly in prosecuting offenders, and has failed to transmit a strong message that integrity pays. In fact, the real public message is that white collar crime has high rewards and little risk.

B
5.c **To what extent has the safety and soundness of the thrift industry, in California and elsewhere, been jeopardized by the movement of dishonest insiders and affiliated outsiders from financial institution to financial institution? Is it your supervisory experience that a relatively small number of "hard core" white-collar criminals commit a disproportionately high number of the crimes in S&Ls and other financial institutions? Please provide actual examples. How can the movement of these individuals be more effectively monitored; and how can they be prevented from damaging financial institutions?**

Since an individual's rights to a livelihood are held in such high esteem by the laws and the courts, an effective system banning white collar criminals from any industry is impossible. Evidence must be so conclusive and the time for gathering evidence, bringing a case to trial and obtaining a conviction is long and difficult to achieve. To prove that they knowingly and wilfully broke a law and did not just violate regulations and ethical business practice norms or prudent man rules is a difficult task. A convicted felon, if he makes a complete disclosure, may be banned from being an officer or director of an institution. However, we believe he may be hired as an employee. There is not in place an effective means of censuring and disciplining officers, directors and appraisers if they are not convicted of wrongdoing. Sections 6151 and 6152 (a) of the law states:

> 6151. No person shall be eligible for election or shall serve as a director or officer of an association who has been convicted of a criminal offense involving dishonesty or a breach of trust.
>
> 6152 (a) A director shall automatically cease to be a director upon being adjudicated as bankrupt or upon conviction of a criminal offense involving dishonesty or a breach of trust.

The proposed director of a new savings and loan is checked with the Justice Department. Prior to 1985 there was no review of new directors being elected to the Board of an existing institution. However, we have issued a Commissioner's directive dated April 19, 1985, providing:

> The Department of Savings and Loan, pursuant to California Financial Code Section 8151, has determined that all associations upon election of a new director must submit to the Commissioner a confidential biographical statement using a format similar to the form used by proposed directors of new associations but without financial statements.
>
> The Department of Savings and Loan believes that current information on all new directors is necessary because of numerous problems that have become evident from the exercise of new powers granted to associations through deregulation, which makes the position of director even more important than in past years. The responsibility and potential liability that a director now faces in making policy decisions makes it imperative that a director have experience and character to assure that the association will be operated in a safe and sound manner.

I have not found that there is a limited number of hard core criminals. There are many people involved where temptation, opportunity and greed help them across the line into marginally white collar crime activity. Stopping the movement of white collar criminals with the Right to Privacy Act and all individual rights is nearly an

impossible task. While new legislation permits sharing of information between departments, tracking individuals in any form of blacklist is prohibited by law. The potential for deep pocket lawsuits from individuals who allege abuse of their rights to employment prohibited effective monitoring in addition to limiting your ability to prohibit them from employment activities. Removal and prohibition of individuals is an expensive, time-consuming legal process.

C. Adequacy of Criminal Justice Response to Insider Misconduct

6. **Utilizing specific case studies as examples, please describe the adequacy of the cooperation and responsiveness of both federal and state criminal law enforcement agencies when your department reports evidence of criminal misconduct in California thrifts. If responsiveness and cooperation have been unsatisfactory, please explain why and set forth your recommendations on how criminal enforcement agencies could be made more responsive to crimes taking place in financial institutions.**

When we initially attempted to take action in response to white collar crimes in this state, we visited the Los Angeles District Attorney, the Orange County District Attorney, two Orange County police departments and the FBI in Santa Ana, and found that white collar crime not only was out of control, there was not adequate personnel to take on new cases in a timely manner. In fact, we were told it would be two years before they could get around to the type of cases we were trying to refer. We attempted to pursue that across jurisdictional lines and the California Business, Transportation and Housing Agency established a

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White Collar Crime Task Force. Included on the task force was the State Banking Department and the Departments of Insurance, Corporations and Real Estate as well as our own Department. Also, this Department is organizing a special "enforcement team" to deal with white collar crime cases.

What reforms in state law or federal law and procedures would you recommend to make the criminal justice system more effective with respect to financial institution insider and affiliated outsider misconduct? For example, does the federal Right to Financial Privacy Act impair the reasonable exercise of your responsibilities to provide information to and assist criminal justice agencies in investigating and prosecuting criminal misconduct? If so, how should the Act be changed?

We would like to see greater cooperation between federal and state law enforcement agencies to bring economic crime under reasonable control. We do not believe that adequate information has been brought to the surface to show the true economic loss from these types of crimes. Since the transactions involved in these crimes may be complicated and exotic, prosecutors, judges and even juries may have difficulty following the transaction to obtain a conviction. The Federal Right to Privacy Act is used by educated white collar criminals to hide the transactions. This cover-up makes it difficult to determine exactly what the extent of the crime that has been committed really is.

D. Adequacy of Supervisory Coordination and Cooperation Between Federal and State Thrift Agencies

8. Please describe the nature and extent of cooperation and coordination, and the overall adequacy of your relationship with the Federal Home Loan Bank of San Francisco and the Federal Savings and Loan Insurance Corporation. Is the coordination, cooperation and sharing of information between your department and the federal bank regulatory agencies adequate? Please be specific. If the relationship could be improved, please set forth how.

We believe that we now have a high degree of cooperation between the Department of Savings and Loan and the Federal Home Loan Bank of San Francisco as well as the Federal Home Loan Bank Board and the Federal Savings and Loan Insurance Corporation in Washington. We have a full exchange of information and we attempt to provide equal staffing on examinations within budgetary constraints. The Department is supported by assessments on the industry which it regulates. If that industry is not making sufficient profits and we place too great an assessment burden on them, they can freely convert to a federal charter.

D

9. What other comments or recommendations do you have with respect to preventing or minimizing misconduct within the thrift industry and for improving the responses of both supervisory agencies and criminal enforcement agencies, when misconduct is discovered? Your comments would be particularly welcome on the need for changes in your authority over the appointment of thrift officers; over your ability to investigate and bring civil enforcement actions for unsafe and unsound conduct; over the adequacy of state resources in the Office of Attorney General, etc.

Preventing misconduct requires discipline and balance. We can never achieve that if the various vestees in the individual institutions do not have something to lose. Internal control is intended to put checks and balances inside the institution. The prevention must come from the Board of Directors that employs the management and monitors their progress monthly. Only when the people who help run the institution on a day-to-day basis have integrity and standards of ethical behavior that are implemented with wise policies and detailed procedures will an institution function as an independent unit where knowing people inside the institution will blow the whistle and stop misconduct. Another integral part of stopping misconduct is a fishbowl, clear water full disclosure reporting system for public scrutiny. The institution should be able to write a prospectus at the end of any quarter telling why it is a sound institution and the public should invest its money there in stock or savings accounts. They should report in detail to their stockholders and savers. Challenging internal auditors with job security should be monitoring the controls daily and the challenging independent auditors should be rendering audit reports on an annual basis. Institutions should not be permitted to issue financial statements that do not fairly reflect financial condition and the results of operations, and the regulator must closely monitor audit reports.

This oversight can be implemented by a career-type, consistent, politically independent regulator on an annual basis. However, the regulator in sending experienced or inexperienced personnel to discover in a limited period of the time, exactly what is going on inside an institution and to take effective remedial action is placing too much stress on a limited resource. The Federal Home Loan Bank has over 3,200 institutions nationwide and the Department of Savings and Loan has 150 institutions. There is a tendency to look to regulators who are only on duty for a limited period of time for miraculous cures. We need consistent, career, non-political, streetwise regulators.

I believe that this Congressional committee wants a solution and some indication of what to avoid. To set this forth I would like to present the following that I believe to be axioms:

A. The root of the problem is in renting money short-term and subrenting it long-term. This has been encouraged by Congress, the legislators, realtors, borrowers and developers. The objective of fulfilling the American dream of economical homeownership has squelched the profit margins of the savings and loan industry that was the only compulsory real estate lender. The consumer was given to believe that he needed no equity. In fact, we have passed a law on the federal level that

you can loan up to 100% of value. We passed a law on the state level that you can loan up to 100% and can invest 100% of your assets in almost anything with the permission of the Commissioner. Misuse of this authority has bankrupted many in the savings and loan industry and its Insurance Fund.

B. The idea of federal deposit insurance because of the way it has been amended does not make any sense. The original insurance required a one-quarter of one percent premium for $2,500 insurance. It was amended to one-eighth of one percent for $5,000 insurance and then in 1950 it was amended to one-twelfth of one percent for $10,000 insurance and it has ultimately increased to $100,000, keeping the one-twelfth of one percent premium. The insurance completely ignored the fact that the losses were taken on the assets and the lending powers were expanded from 33% on vacant land to 100% of value on vacant land. The single family dwelling loan was expanded from 80% to 100% of the value. The premiums are totally disproportionate to the actual exposure. In the early 1950's the term of the loans generally was 15 years on conventional loans. Now they are extended to as much as 40 years.

C. We deregulated the interest rates on the liability side of the balance sheet much too rapidly. It was supposed

to be done over six or seven years and effectively it was done in less than a year after the committee that was supposed to oversee it was appointed.

D. Tne industry realized in the 1960's the problems of the mismatch on savings compared to loans and wanted to deregulate the asset side of the balance sheet first. However, it was done in the reverse and between 1980 and 1982 we lost half the net worth of the industry and over 1,000 institutions nationwide.

E. The impact of this was that the industry became so weak and everyone wanted to buy time, including the industry, the regulators, the administration and the legislators. So we got forbearance in the form of creative accounting principles. You could sell loans, bonds or other securities and defer the loss over the remaining life of the asset which was gone. You could take an office building that you had on your books for years and was not for sale, appraise it and write up the value for appraised equity capital. You could take IOU's from the Federal Savings and Loan Insurance Corporation and put them on the books as assets and net worth. You could buy an institution and pay too much for it and book the overpayment as goodwill and net worth. Generally Accepted Accounting Principles allows this goodwill to be written off over as much as 40

years. Forty-seven percent of the total net worth of the industry is in this form. There are many other creative accounting practices that conflict with fishbowl, clear water, accurate reporting and complete disclosure to the public. Even GAAP accounting can be embarrassing. Marked to market accounting is impossible to employ in the savings and loan industry as long as fixed-rate, long-term investments are permitted in a global, sensitive financial market.

SUGGESTED SOLUTION: My personal opinion is that having the GAO release a statement that you have an insolvent Insurance Fund with a $6.3 billion negative net worth serves no useful purpose. It is also my belief that you should abolish both federal deposit insurance funds and establish a federal deposit guarantee corporation. Examine institutions annually and establish an actuarially sound, risk-related assessment to be paid monthly to maintain the guarantee. Establish a 90-10 co-insurance (Federal guarantee 90%, saver 10%) so that the savers will bring some discipline to the management of the institution in which they entrust savings for reinvestment. Maybe they will get to know the manager's name and even look him in the eye and ask him what he is doing with their money. The saver that is earning high deregulated interest should certainly have something at risk in loaning his money at such high rates without knowing what they are doing with it. The saver has too good a deal right now and it is a deal he cannot refuse. It is a Ponzi deal. Give me your

money at high rates and do not ask me what I do with it. I am deregulated and you are protected against loss by the full faith and credit of the United States Government.

After hearing what I have just said, it is no wonder that insurance companies do not want to write directors' and officers' liability insurance, that bonding companies do not want to write bond coverage, with appraisers providing accommodating appraisals to officers who must loan money that they have paid too much for. It is also no wonder that lawyers have a field day suing everyone for the wrongdoing and defending the wrongdoers. The root of the whole problem is that associations are paying too much for their money, to persons who do not have to worry what is done with the money. Since they are permitted to do almost anything with it, it is no wonder that we have developed a large segment of the industry that is floundering and have an insolvent FSLIC insurance corporation.

If we want to improve the quality of the human resources and the integrity of the human resources, we must require professional organizations to establish norms of behavior and standards of performance for their members and to discipline or remove the incompetent and unethical members who misuse the professional designations they hold. You must modify the tort system to improve professionalism. The Society of Residential Appraisers has 203 complaints awaiting action of their Ethics Committee, a tremendous increase of 200 in the number over the last three

years. Money will buy you almost any appraisal you want to validate a transaction so long as the unethical can keep their professional designations and licenses. Because of our tort system, the professional appraisal societies cannot effectively police their members. Therefore, I believe we must look to establishing government qualifications and testing of their ability and review of their work product. Disciplinary or removal action must be taken against the incompetent and fraudulent-prone appraisers.

My recommendations would be best summarized by the article from Outlook Magazine which has been submitted to you.

CHART 1

POPULATION FOR CALIFORNIA AND UNITED STATES

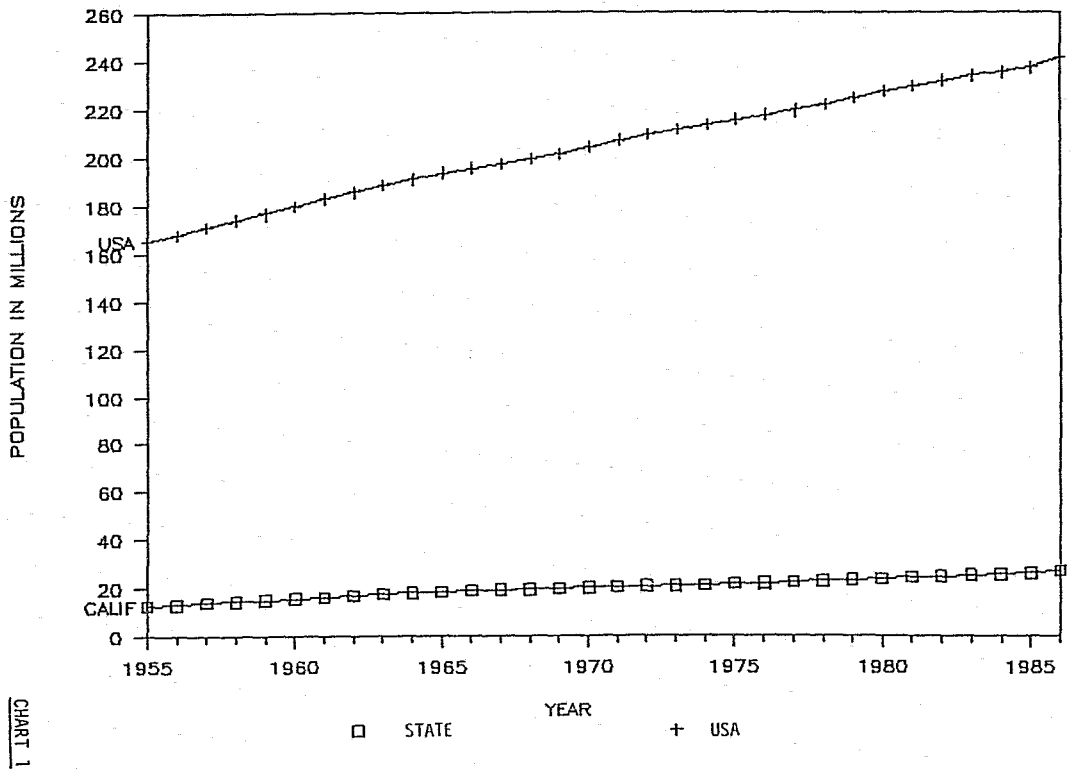


CHART 1

CHART 2

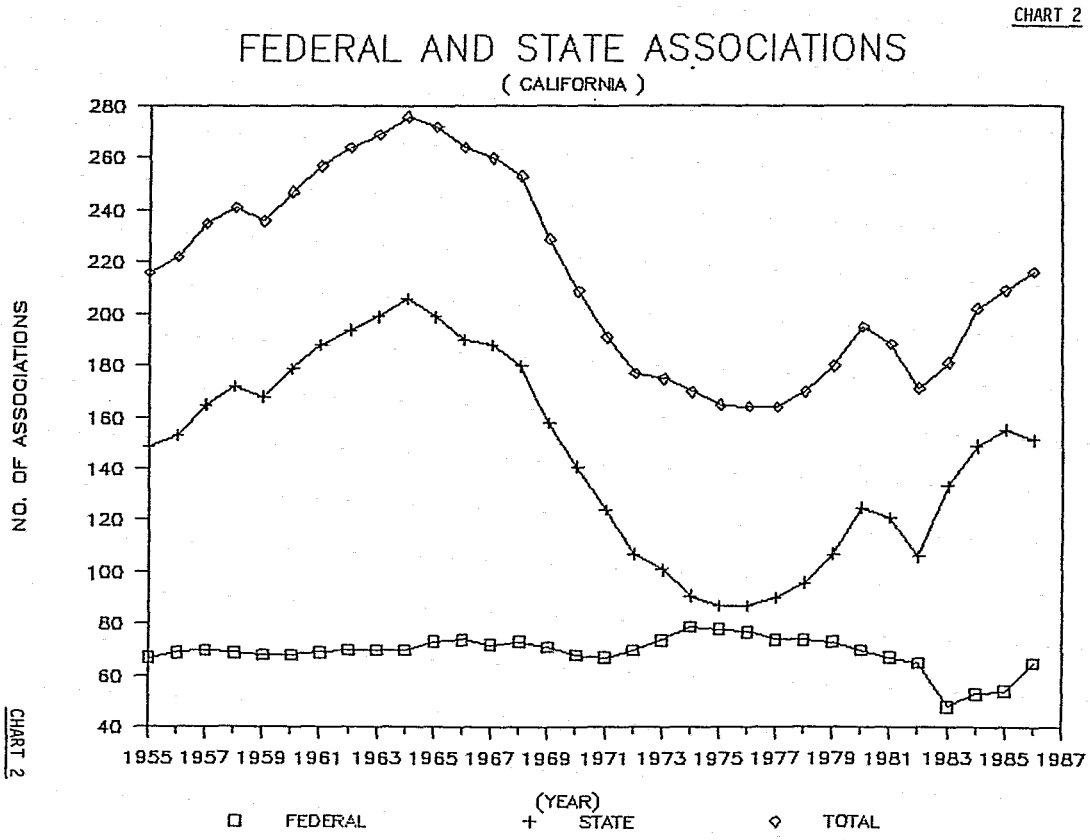


CHART 2

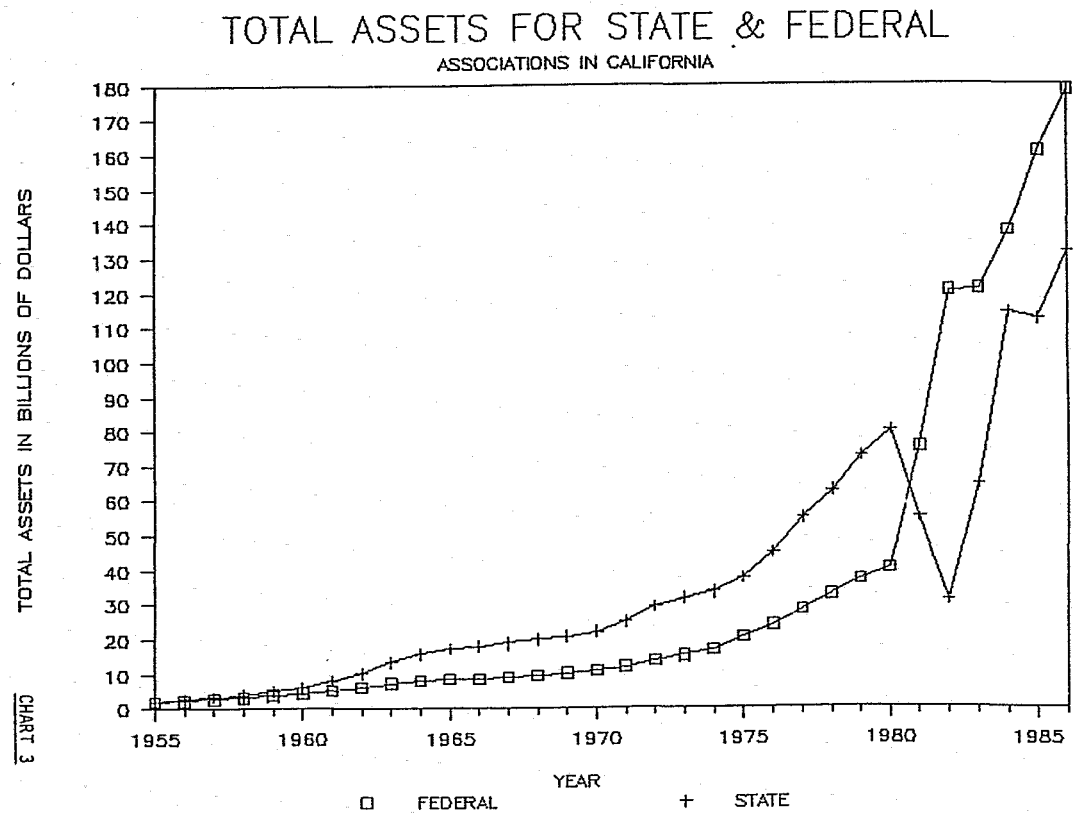

TOTAL ASSETS FOR STATE & FEDERAL
ASSOCIATIONS IN CALIFORNIA
TOTAL ASSETS IN BILLIONS OF DOLLARS
180
170
160
150
140
130
120
110
100
90
80
70
60
50
40
30
20
10
0
1955
1960
1965
1970
1975
1980
1985
YEAR
FEDERAL
STATE

CHART 3

CHART 4

NUMBER OF BRANCHES FOR STATE & FEDERAL

ASSOCIATIONS IN CALIFORNIA

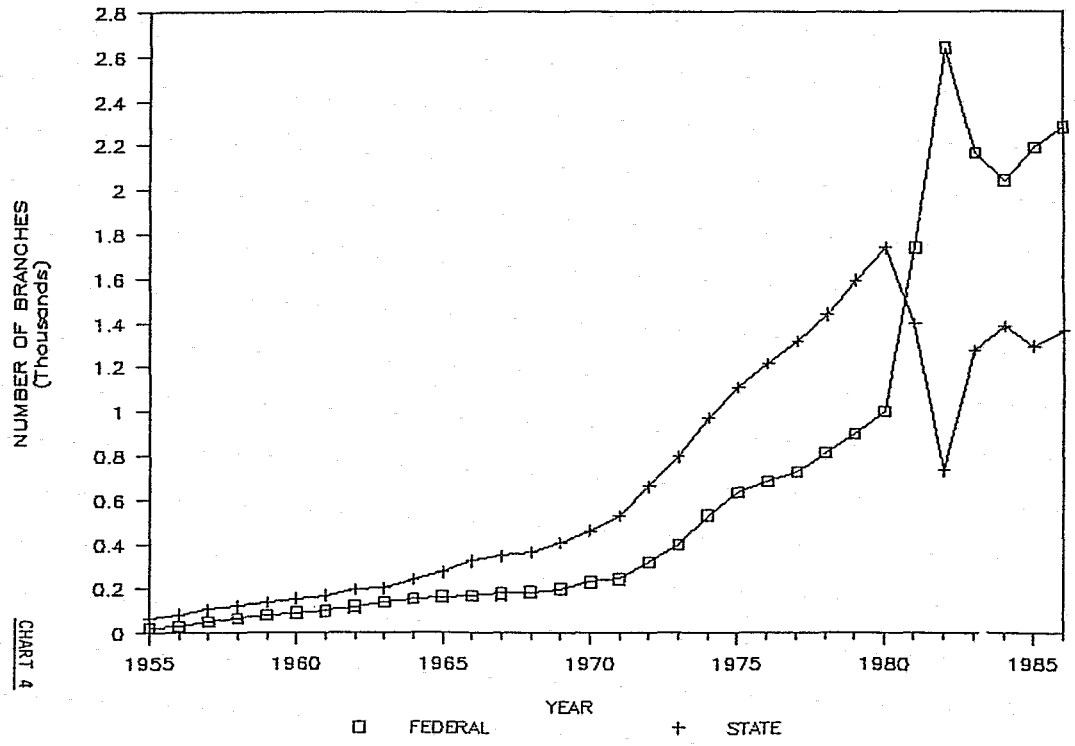


CHART 4

NEW STATE OF CALIFORNIA ASSOCIATIONS

APPROVED BY DEPT. OF SAVINGS & LOANS

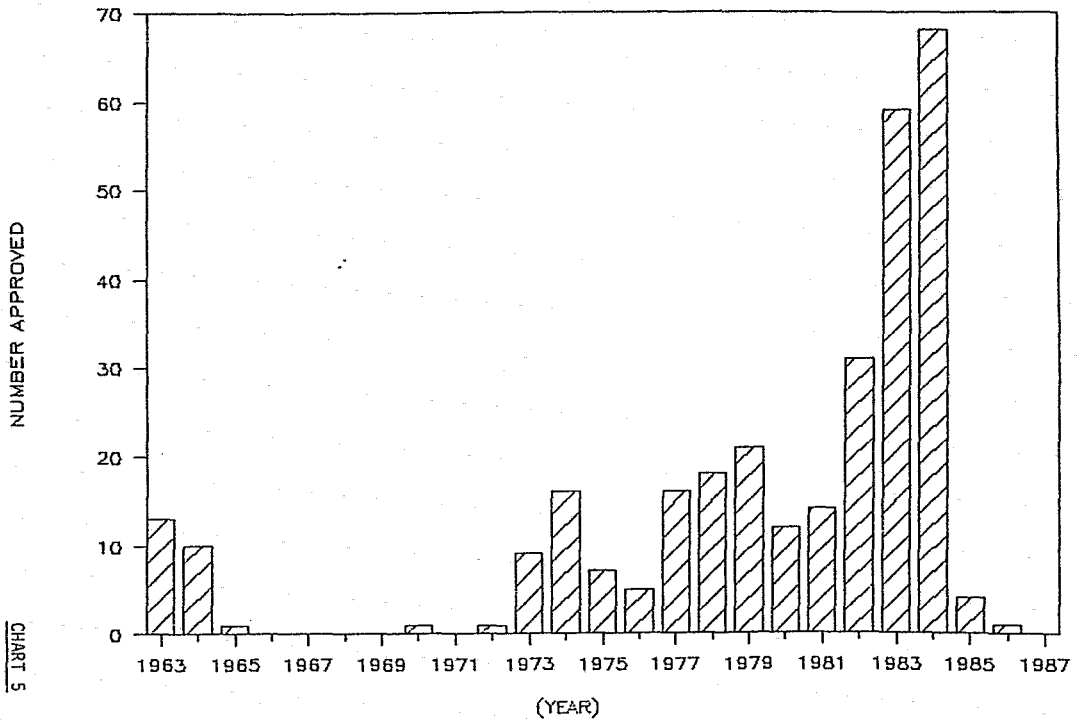


CHART 5

CHART 6

NUMBER OF S&L OFFICES IN CALIFORNIA

PER MILLION OF POPULATION

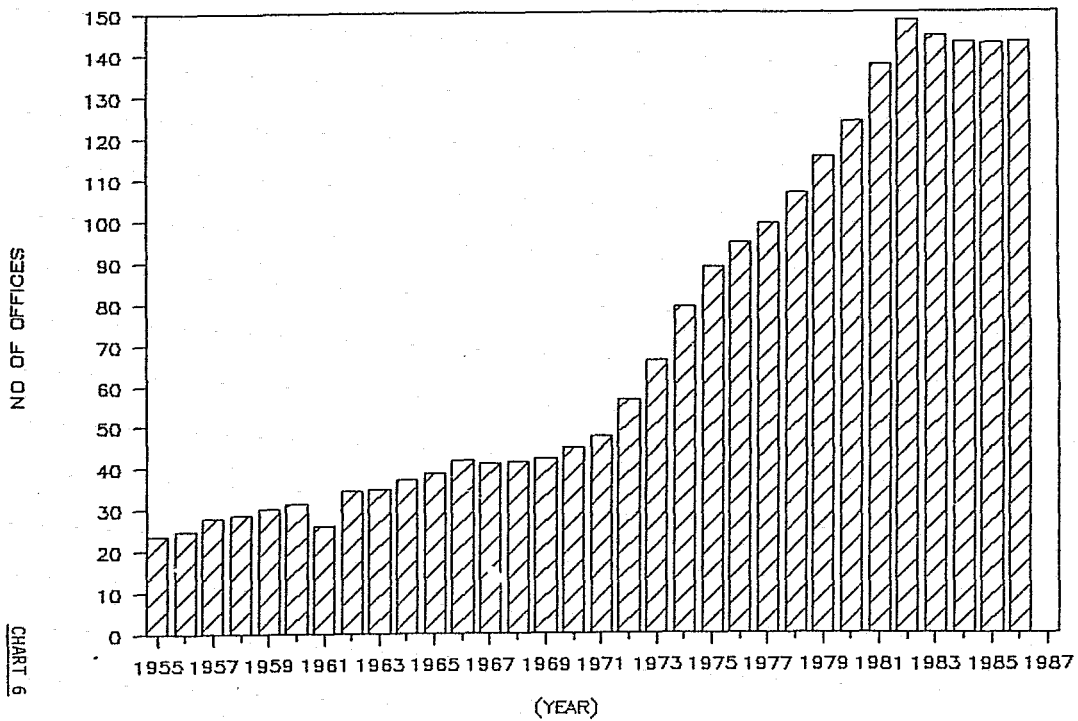


CHART 6

NO. OF DSL EMPLOYEES PER ASSOCIATION

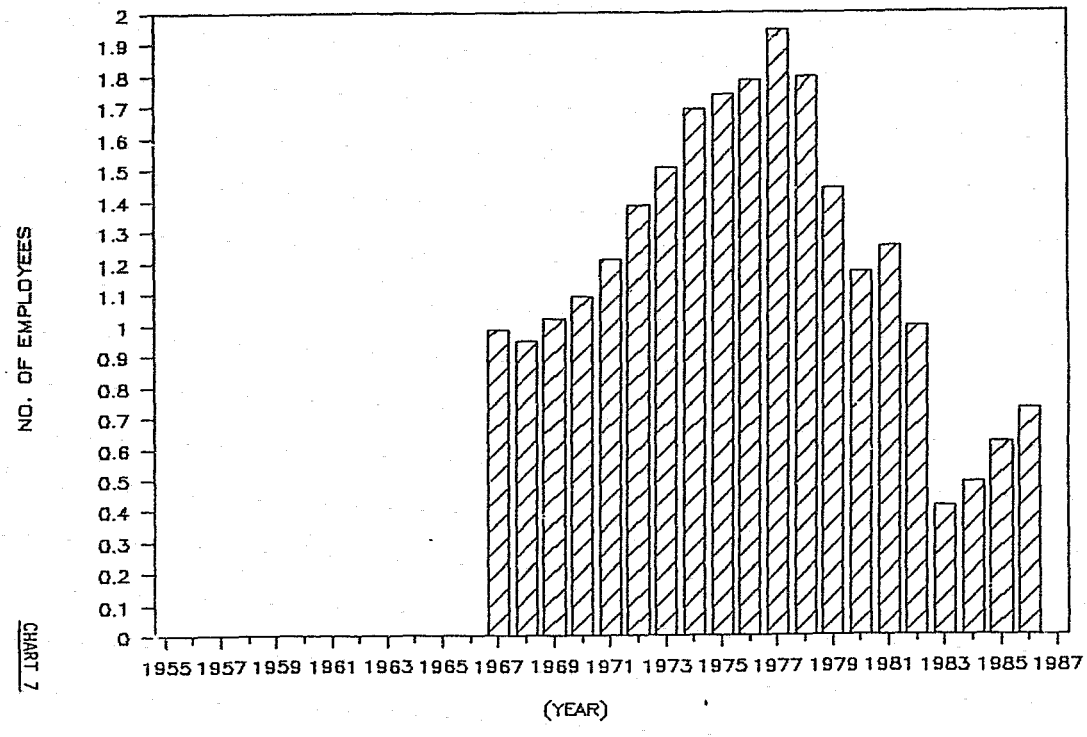


CHART 7

CHART 8

DSL EMPLOYEES PER BILLION OF ASSETS

ADJUSTED FOR INFLATION (1967=100)

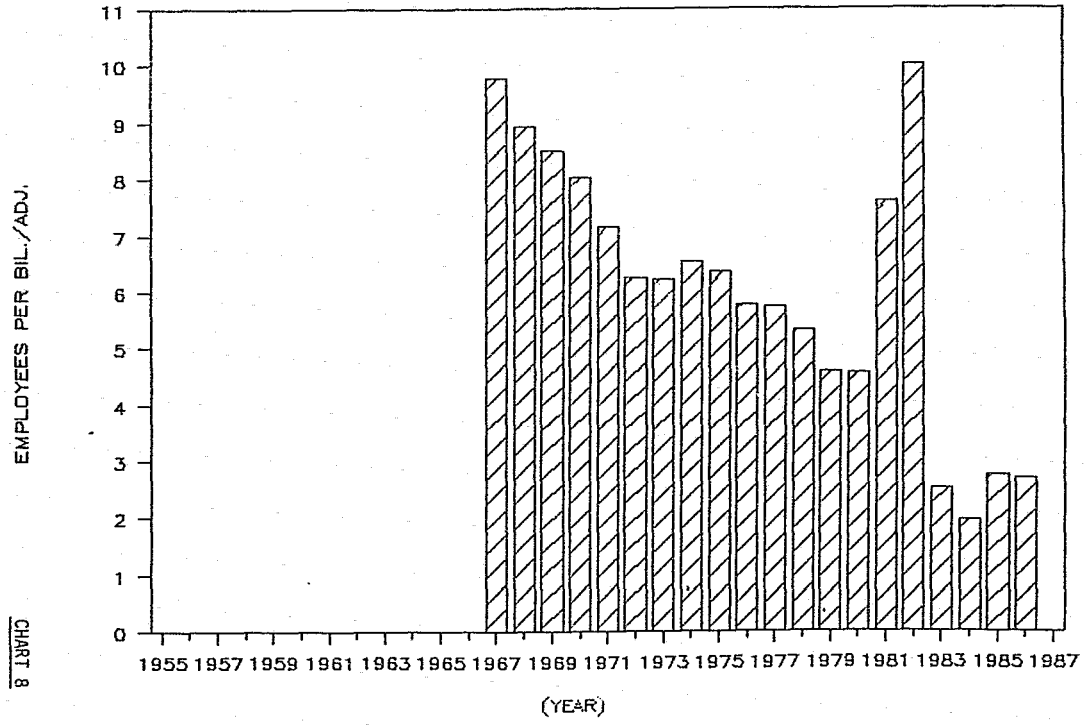


CHART 8

DSL EXPENDITURES ($000) PER BILLION

OF ASSETS (ADJ. FOR INFLATION)

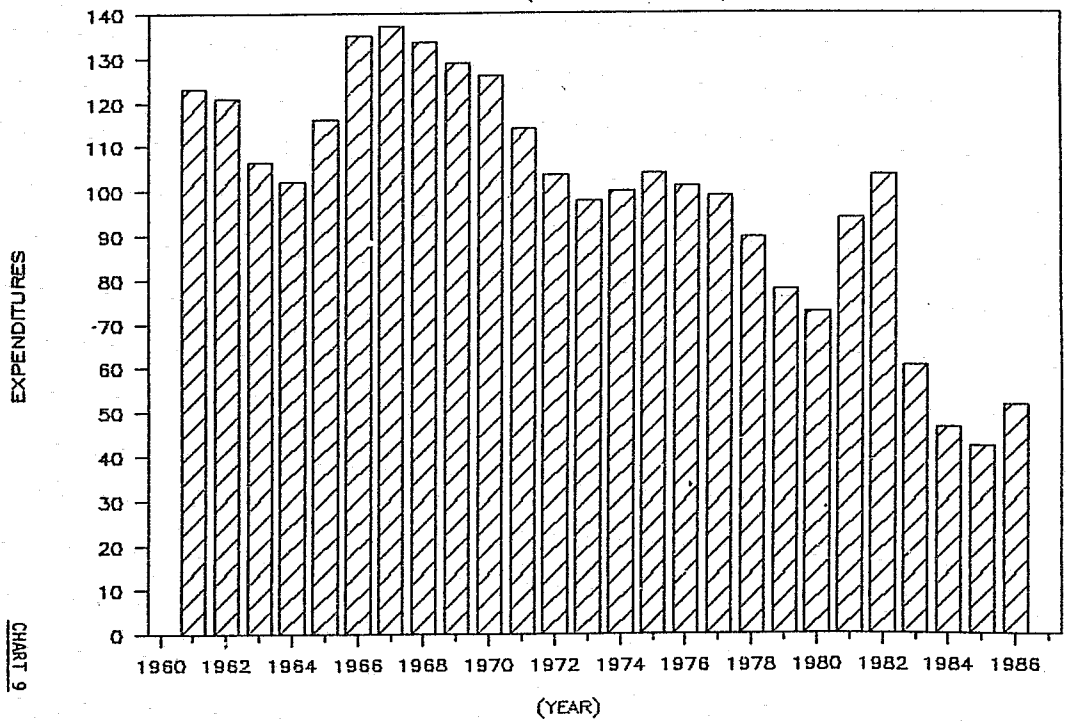


CHART 9

RAP, GAAP, AND TAP NET WORTH

ALL FSLIC–INSURED INSTITUTIONS

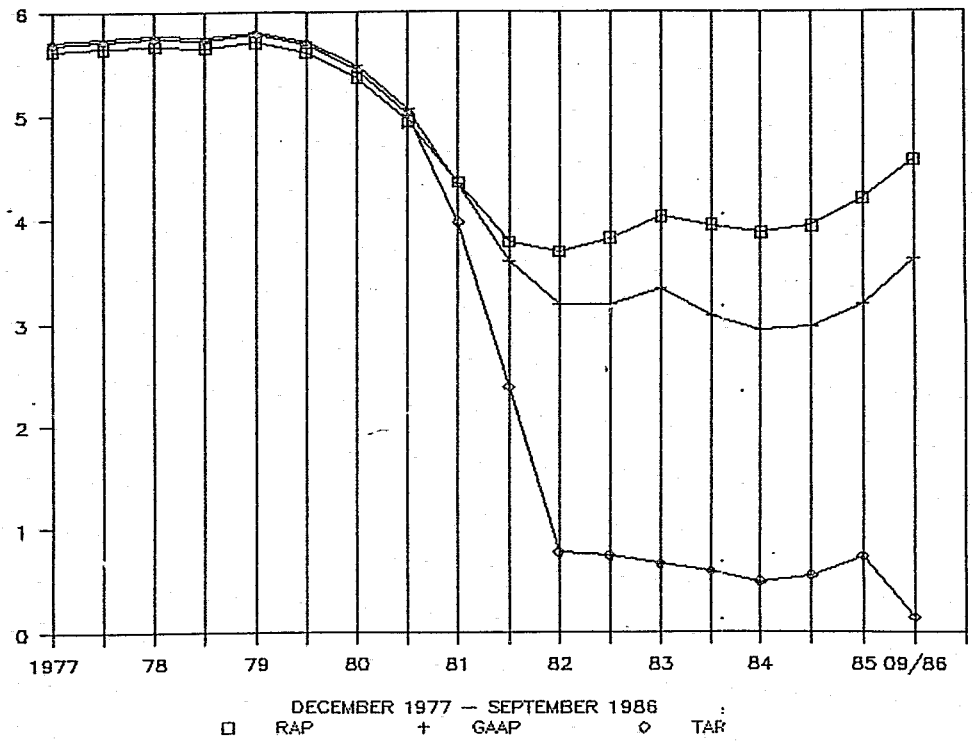


CHART 10

COMMERCIAL PRIME RATE

(High Low)

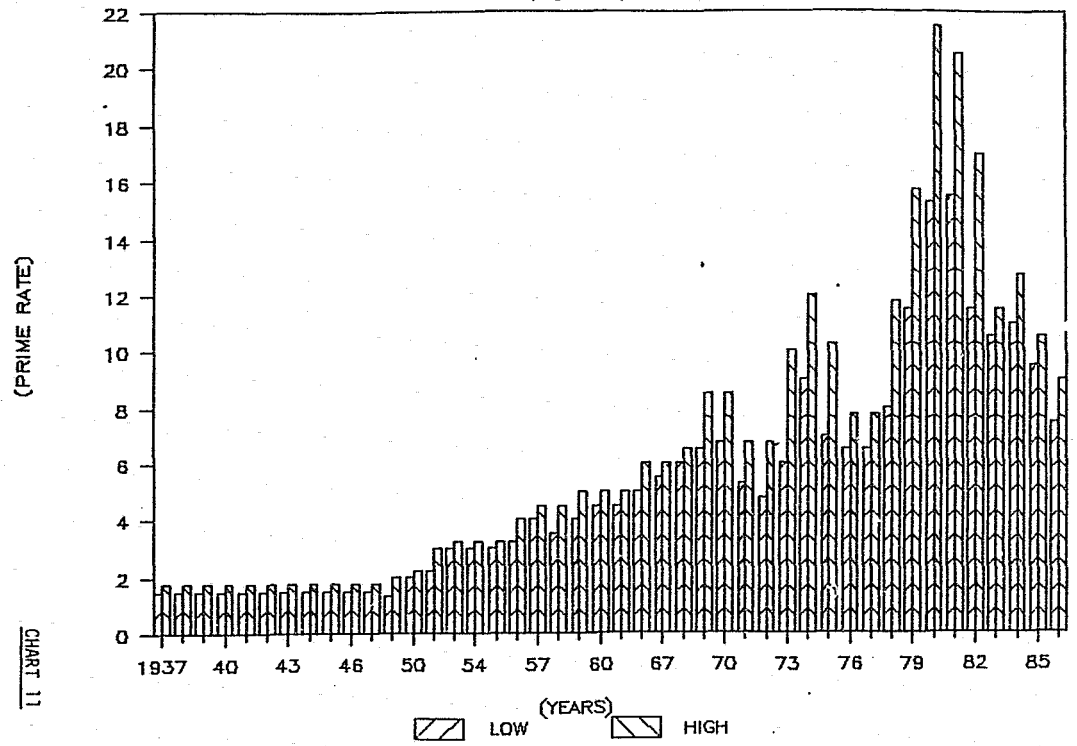


CHART 11

Source: 1st Interstate Bank

Mr. BARNARD. Mr. Crawford, in your oral testimony this morning, you touched on primarily the appraisal situation which we are very much concerned about and interested in. As you know, our committee has done considerable work in this particular area, even to the degree of working with a task force of appraisal organizations, including the Society of Real Estate Appraisers. We hope to structure for this Congress, a self-regulatory operation which Congress would recognize, but it would definitely be a self-regulatory organization. Hopefully, that is going to be one of the results of these hearings, some type of regulation on the appraisal industry. And from your testimony, I think that you have very well brought out that it needs it.

Let me ask you this question: As to these irregular appraisals that you have discovered, did you report the irregularity to the certifying agency, such as the American Institute of Real Estate Appraisals?

Mr. CRAWFORD. To my knowledge, most of them have been referred by appraisers who were employed and appraised the property at the lower figures. They are extremely interested in getting rid of their bad apples.

Mr. BARNARD. Well, what were the results of it? Do you know of any results?

Mr. CRAWFORD. Well, I've looked at tables that show the results, and it is not very good, but they are working on it.

Mr. BARNARD. Well, let me ask you this question: We are talking about the fact that we have failures today because of past appraisals, and I would hasten to say that, from what you are telling me this morning, that the appraisal associations, those who were giving out the professional certificates, didn't really take much action when an abuse was reported. Is that right?

Mr. CRAWFORD. Well, I think you have to look at it from their standpoint, and if you're on an ethics committee, and you have a group of people that you are investigating, and you have all gone through the chairs of a society, and what goes around, comes around, and so when I get on you, then you get on me, and so——

Mr. BARNARD. OK, I can go with that. Well, let me ask you this: Did your office, or did the savings and loans that were having the losses, did they bring any legal action against the appraisers for these irregular appraisals?

Mr. CRAWFORD. There are more actions being brought now, yes, but I want to go back to—the ethics committees. Those committees, they have tort. When you take an appraiser's livelihood away, and you take his designation with which he can earn that livelihood, and you can't prove everything on grounds, and you didn't follow your bylaws, and procedures, he'll sue you. And I understand that it cost them about a million dollars a year, one society, in legal fees. The society members don't like that.

Mr. BARNARD. Mr. Crawford, you also indicated, I thought you said that "The best way to rob a bank was to own one"?

Mr. CRAWFORD. Yes.

Mr. BARNARD. Well, let me ask you this, why is it that it is so easy to own a bank? I thought in the days gone by that banks and savings and loans were supposed to be pseudopublic institutions, whereby that the ownership was widely distributed in the commu-

nity, nobody owned more than 2, or 3, or 4 percent—no one particular individual; how all of a sudden has it become so easy for individuals to own institutions?

Mr. CRAWFORD. Well, briefly——

Mr. BARNARD. I mean, just think, Mr. Bustamante and myself and Mr. Martinez, we all walk into your office and say, OK, Mr. Crawford, here's our financial statements; let's say that they are better than they ought to be, and say, we want to charter a State S&L. We want a State S&L charter, and it's just three of us. I mean, what would be your response from that?

Mr. CRAWFORD. Well, my response would be, probably you are wasting your time if you look at the industry, and if you look at——

Mr. BARNARD. Oh, I'm not talking about from that standpoint—I'm talking about——

Mr. CRAWFORD. I know.

Mr. BARNARD [continuing]. The fact is that an S&L is available for us three to file for.

Mr. CRAWFORD. Oh, I'd accept your application if you wanted to file.

Mr. BARNARD. But somebody must be getting them, buying them, though.

Mr. CRAWFORD. No.

Mr. BARNARD. I mean you just said that the best way to rob a bank is to own one, it must be free and easy for some of these folks to get one.

Mr. CRAWFORD. Well, I've only approved one of 68 pending applications in the 2 years.

Mr. BARNARD. And did one individual own it?

Mr. CRAWFORD. No, this one approved was a group. There were 68 applications laying there for action when I came to work, and I turned 67, all but one, down. I'll tell you where this one owner came from. There was a very bright gentleman who was on the Federal Home Loan Bank Board, and he was the head of the insurance corporation. In 1957 he says, we are not going to have any one guy owning the stock. So, he put in a regulation that said for a condition for insurance of accounts, there must be at least 400 stockholders; I think most all of them had to be local. The maximum one person could own would be 10 percent of the stock; the maximum any control group could own was 25 percent, and that was in effect from 1957 to April 1982, when that was dropped because they thought they needed new capital in this industry, and, frankly, I would like to see that requirement put back on a Federal level. I can't do that just on a State level.

Mr. BARNARD. Let me ask you this: For an institution that is insured by FSLIC, the Federal Savings and Loan Insurance Corporation, even though it is a State-chartered institution, when there is a change in management, who has that responsibility to review it? Is it you or is it FSLIC?

Mr. CRAWFORD. We have a right, and I think they reserve a right, for the first 3 years that the institution is open, and that is in our guidelines, but after 3 years, I have no right; I can approve the managing officer for 3 years, and I believe I might have the right to approve the chief loan officer for that period of time. But

we have denied people from being a managing officer, but they will still have them there as president, or executive vice president, and they just won't have a managing officer.

Mr. BARNARD. Well, what has been your observation and critique of the FSLIC? I mean, have they done a good job or a lousy job, as far as watching the change in management occur when some of these good old boys get in there, who are going to rob the institution? What kind of a job have they done?

Mr. CRAWFORD. Well, I think they have done as good a job as they can do. Basically, you are not going to let a crook get in there. If you know a guy is a crook, and he has been convicted of a felony, there is no way he is going to get into that financial institution.

But if the guy looks good, you don't forget you have lawyers and you have analysts, consultants that draw these applications up, and they read the law, and maybe they were there and helped promulgate the law, and a guy comes in and he looks squeaky clean—there are very few people that have a criminal record— if they are clean, until they get in there and do something wrong, even if people do something wrong and are not convicted of a crime, you can't do anything about it. He's innocent until he's proven guilty.

Mr. BARNARD. But isn't there a lot of—I'm taking too much time from my colleagues—the point I'm trying to say is it looks like to me that we are discovering these situations far, far too late; and I am a little bit appalled at that. First of all, I am appalled at it now, because we're just letting any small group or one individual own an institution. Maybe we ought to have some firm prohibitions against that. But the second thing about it is, it seems like the checks and balances that we are supposed to have in place are just not working as far as the examiners are concerned. I mean, is the examination process falling down in this situation? Do you mean to tell me these folks are so smart that there is no way in the world for an examiner to catch this business?

Mr. CRAWFORD. The controls in a financial institution have to be internal, and they have to be working 365 days a year, and if the guy at the top is a crook, unethical, it tends to permeate the whole organization; but, until you find bad assets and an indication of losses, and poor policies and procedures, you only go in there once a year.

Mr. BARNARD. OK, well, let's go back. What is the place, then, of the certified public accountant? I mean what is his role in an institution? Why shouldn't we require—why shouldn't the bank examiner, why shouldn't a regulatory agency, be it State or Federal—why shouldn't it require that an institution have a certified public audit, that the audit be certified, and that a copy of it be deposited with the regulator?

Mr. CRAWFORD. Well, we do.

Mr. BARNARD. What would be wrong with that?

Mr. CRAWFORD. We do that. We do that.

Mr. BARNARD. But they—the Federal banking agencies—still don't. OK, let's get back now. Do we prosecute the CPA when he certifies that everything is great in that institution?

Mr. CRAWFORD. We have a CPA we are looking for right now. He's disappeared. But we'd like to send him where he can't do it again.

Mr. BARNARD. Well, I am building up, as you probably know, to the statement in your testimony, that 24 percent of the California's 140 open State-chartered S&L's have significant problems. I mean such time is of the essence. Is that right?

Mr. CRAWFORD. Yes.

Mr. BARNARD. Well, Mr. Crawford, how many of these 33 or 34 associations are capable of being nursed to health, and how many are likely to go over the edge into insolvency?

Mr. CRAWFORD. Well, I really am not good at predicting. But when they get sick, they usually don't get well. It is unusual to have turn-around situations.

Mr. BARNARD. I'm listening to you loud and clear. The word "forbearance" has come up several times. And it is a very controversial subject, it's in the new FSLIC legislation. But you are telling us then that this 24 percent, or 33 of the 140, is not due to the economic condition, because California is in a booming area; the State has less than 5 percent unemployment. Everything seems to be going strong. This problem is not because of economic conditions, right?

Mr. CRAWFORD. I would be glad to accept all the facts that California is a great State, but we do have problems in the State of California. We do have areas that are overbuilt; California is the largest farm State in the Union, and California is an energy State, too. People say farming and energy cause all our problems.

In States across the country, and California, in financial institutions, there were crooks, greedy, and stupid people in there. You can't blame it on economics, you have got to blame it on the directors, officers, and owners.

Mr. BARNARD. You would rather deal with the stupid ones than the crooked ones, wouldn't you?

Mr. CRAWFORD. Well, it's hard to tell the difference.

Mr. BARNARD. Oh, I see. But, anyway, however you categorize it, it seems like the insolvent or troubled thrifts which you are talking about are losing $53 million per month, or $636 million a year, is that correct?

[SUBCOMMITTEE NOTE.—The figures are from the FSLIC's Deputy Director's testimony, reprinted later in this transcript.]

Mr. CRAWFORD. Well, I guess if you have got that figure, I think it is probably a good figure. I think it's almost predictable. In 1955, in California, we had 24 savings and loan offices per million population. Now, we've got about 142 offices per million of California population; and we had rate control in 1955 where convenience was the major factor in deciding where to say we took the rate control off now, and the money will go down the street to another association that offers a 2-percent bonus for 6 months, and they shift all the money; they get $40 million overnight, out of a number of associations into one association. So, what I'm saying is that we don't need all the brick and mortar of 142 facilities per million of population any more.

Mr. BARNARD. Well, let me ask you this question: When you see one of those high-flying organizations that's located in an office building someplace and playing 200 basis points over the prevailing interest rates, and let's say, you're the regulator, and you notice this situation, what would be your inclination?

Mr. CRAWFORD. Well, I wish I could shut them down, but that's not what the law says I can do.

Mr. BARNARD. Well, do you examine them?

Mr. CRAWFORD. Oh, yes, we send examiners out, we have an early warning system where employees call up and complain, where they can blow the whistle; and heck, we've got the examiners out there the next day.

Mr. BARNARD. Mr. Crawford, are you chartering any new thrifts, or approving any takeovers these days?

Mr. CRAWFORD. I have not chartered but one, and I'll stand on the one that I did approve in Paso Robles. Takeovers, we have some attempted takeovers. I do not accept any property for equity—I only accept cash. If anybody wants to take over a California financial institution, there was one in the hopper for change of control where the sale agreement was signed, that I accepted—because I had to go through with it, accepting property as equity. I have not accepted anything but cash for stock since February 11, 1985. No more property.

Mr. BARNARD. Mr. Crawford, what additional powers, if any, do you think that you or the Federal regulators need to keep out unscrupulous people?

Mr. CRAWFORD. Well, I think the best thing that could happen to keep unscrupulous people out, we don't need as many as we've got today, and, if somebody would figure out how to give the wedding presents that are necessary to merge these unprofitable or insolvent institutions that are in incompetent hands or improper hands or don't have adequate net worth, and can't win, if we could get the wedding presents to get somebody to take them, that's what's needed. We do have maybe 1,600 sets of management that are competent; and maybe there are 1,500 sets of management that we ought to get rid of by merger.

Mr. BARNARD. All right, let me ask you this: As far as Congress is concerned, should Congress consider passing a bill which in some way would put some teeth into the appraisal industry?

Mr. CRAWFORD. Oh, definitely. Definitely—it's needed. It should be just like the CPA's that we think are not very good. They are just better than anything that's second. If you didn't have CPA's, and you didn't have generally accepted accounting principles, and you didn't have a Financial Accounting Standards Board, you would have a terrible mess, so I think we need the same thing. It ought to be patterned just the way the CPA's are.

Mr. BARNARD. What else do you think we need to do?

Mr. CRAWFORD. Well, I got all——

Mr. BARNARD. I've got a suggestion.

Mr. CRAWFORD [continuing]. I've got it all on one page, but the first thing we need to do is to get many stockholders. It is hard to be a fiduciary when you are the only beneficiary. So, the first thing we need to get is a lot of stockholders, and the second thing is, we should not be able to loan 100 percent of value. That is the stupidest thing there is, if the guy doesn't have equity.

Mr. BARNARD. It makes no difference, if you go get the inflated appraisal.

Mr. CRAWFORD. That's right. And the next thing we need is we need 90-10 coinsurance—deposit insurance. For a creditor to give

$100,000 to a financial institution that pays the highest rate, 3,000 miles away, and not have to worry, that's silly, because he's going to do something unusual with that money. The most insolvent institutions pay the highest rates.

Mr. BARNARD. Please summarize—what else have you got?

Mr. CRAWFORD. Well, I got it there on one page.

[Analysis referred to follows:]

ONE PAGE ANALYSIS OF S&L PROBLEM AND SOLUTION

Rapid Changes in S&L Requirements & Environment From Equity
to Lack of Equity and 400 Stockholders to 1 Owner

For a Simple Business of Housing the Public by (1) Making Good Loans and Investments
(2) Providing a Convenient Safe Place to Save
(3) Perpetuating the Business by Balancing the Benefits and Burdens Among Vestees
(4) Making a Clear Complete Disclosure

FACTORS	1. Stability	2. Sheltered	3. Loans Investment Control	4. Loan Diversity	5. Ownership Diversity	6. Creditor Saver Discipline	7. Basic Mismatch	8. Best Economic Climate	9. Laws & Regs	10. Appraisals	11. Regulators
Healthy S&L Environment	Slow steady growth stable interest rates local and economy	Filed no Inc. tax return until 1951 No tax if NW less than 12% (1951-1963) Light tax 1963-1969	Borrower must have equity something to lose Lender must know the territory and underwrite the loan carefully	Small loans many borrowers	Minimim 400 stock-holders Max 1 person 10% of stock Max control group 25% 1957 to 4/1982	Recommend 90%-10% coinsurance so some saver creditor discipline	Need All Arm Loans illegal to mismatch and hedge	Mild Inflation	Simple tabular European road sign graphics for equity integrity balanced discipline	NATL standards like CPA's & GAAP State Lic.	Professional continuity nonpolitical street wise
Unhealthy S&L Environment	Fast uneven growth in assets and decline in loan economy World wide sensitive linkage	Full Tax & Social Burdens	Law says can loan 100% of value and can loan anywhere in USA Don't know territory sloppy underwriting	Risk concentra-tion large loans risky types of property	4/12/82 Fed regula-tion dropped to one stockholder can own 100% "Own your own money machine using the public's insured nesteggs get rich quick wizards with cash or property for capital. It will save the industry."	Worst $100,000 insurance with full faith & credit of US Govt. tax payer & decontrolled rates	Rent short subrent long at fixed rate then hedge	Disinflation	Complicated misunder-stood invite uneven playing field and cheating	Buy your own value opinion to facilitate fraud scheme	Opposite of above Looking for connection for future

REMEDY

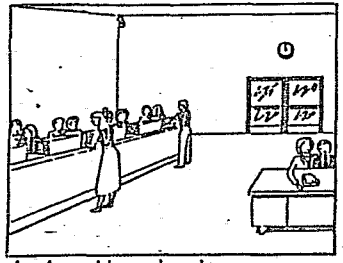
Buy the wedding presents to merge the incompetent, insolvent and below 3% net worth consolidate into 1500 competent - integrity hands then enact laws that are simple and actuarially sound and enforceable.

Analysis of Nineteen Leading Savings and Loan Companies in California
Who Participates in Los Angeles Times Special Section 6/7/87

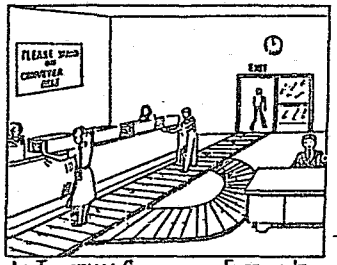
Association	Year Opened	Rank Assets	USA Savings	No. of Savings	Offices Loan	12/31 Assets Billions '86	'85	12/31 Savings Billions '86	'85	Net Income Calendar Yr Millions '86	'85	Employees Calif	USA	Name of Holding Co. States	
American	1922	1	3	172	32	$33.9	$27.4	$17.0	$17.4	HS $95.4	$53.3	5700	5700	1	FCA
Home	1888	2	1	312	98	27.4	26.5	21.8	19.5	HS 323.4	226.6	6750	9140	18	BEAUMAMSON
Great Western	1887	3	2	(889 Nationwide) 260	28	27.2	25.1	18.2	17.7	HS 300.2	203.9	7430	11540	2	GWFI
Calif. Federal	1925	4	4	188		20.5	18.2	15.5	13.1	163.4	115.4	5160	6090	6	Cal Fed INC.
Glendale Fed	1934	5	5	176		17.5	14.2	12.7	11.0	111.2	69.2	2510	3800	2	Glen Fed INC.
World	1912	6	11	196		12.4	12.1	7.7	7.6	HS 183.0	159.4	2000	2610	4	Golden West
1st Nationwide	1885	7	7	253		15.2	11.6	11.1	9.0	HS 104.2	75.1	1990	3220		Ford Motor
Home Fed	1934	8	10	167		12.1	10.0	8.6	7.4	103.4	72.8	3500	3600		
Gibraltar	1886	9	17	118	10	11.4	9.5	5.7	6.1	HS 40.6	46.1	2060	2140	2	GIB FIN
Great American	1885	10	9	188		13.1	8.8	8.9	6.5	93.7	63.1	2760	3390		
Coast	1935	11	16	93		9.7	7.5	5.9	4.5	50.6	31.4	1750	1750	1	
Imperial	1920	12	18	89		8.9	7.3	6.8	5.5	HS 47.5	(14.3)	1800	1800	3	FCA
Sears	1928	13	21	81		6.8	7.1	5.1	4.9	HS 6.5	24.2	1300	1200	1	Sears, Roebuck & Co.
Columbia	1958	14	19	35		10.2	7.1	5.2	4.7	HS 103.5	122.2	840	840	3	
Citicorp	1921	15	47	93		5.0	4.4	3.1	3.1	HS 59.9	44.8	1700	1700	1	Citicorp
Fidelity Fed	1983	Missing or Skipped 17		30		3.3	3.1	2.4	2.2	29.0	26.0	720	720		Citadel
Santa Barbara	1963	18		44		4.6	3.1	2.0	2.1	HS 19.1	4.2	810	810		Fmc. SB
Guarantee	1973	19		41		2.9	2.9	2.2	2.0	HS 8.0	14.1	1700	1700		Guar Fin
Far West	1889	Missing or Skipped 21		26		3.0	2.4	2.1	1.7	HS 23.2	16.1	700	750		Far West Fin
Total		19		2554		$245.1	$208.3	$157.0	$145.0	$1833.6	(1) $1323.6	51240	62580		
Historic State Assns.		13		1722		168.9	146.5	103.8	100.3	1402.5	975.7	34760	43230		
Federal Assns.		6		832		76.2	61.8	54.0	44.7	531.1	347.9	16480	19350		

HS - Historic State Assn. Source LA Times 6/7/87 (1) Entire USA Industry Earned $7.8 Billion in 1986

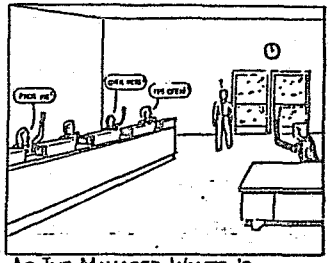
THE IDEAL LOBBY ....



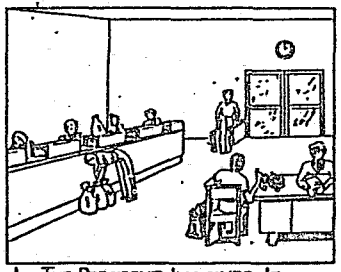
AS AUDIT WOULD LIKE IT



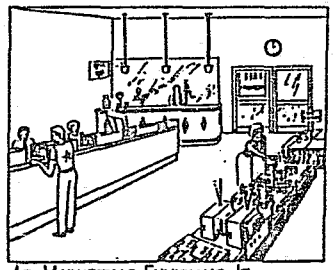
AS INTERNAL CONSULTING EXPECTS IT



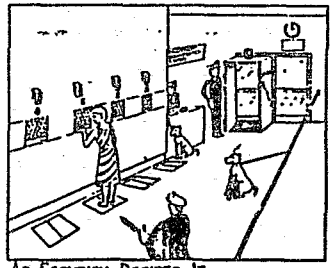
AS THE MANAGER WANTS IT



AS THE PRESIDENT IMAGINES IT



AS MARKETING ENVISIONS IT



AS SECURITY DESIRES IT

Rich Swartz

Mr. BARNARD. Well, let me ask you this—let's take it beyond this stage now—let's say that we have a referral. A referral then goes to the proper law enforcement agency. Don't you believe that we need to beef up one way or another the law enforcement agencies and even the criminal justice system?

You know it just appalls me that we see people out here that are going scot free; we know that they have robbed banks; we know that they are living like kings, and yet we see instances where the Justice Department hasn't been effective. In one particular case, which I won't mention, it was just flagrant insider abuse.

Mr. CRAWFORD. No question.

Mr. BARNARD. The fellow was tried on 25 accounts, and acquitted on 25. Now, you see this is what concerns me. I mean, not only do we have it happening, but we are not doing anything after it is discovered.

Mr. CRAWFORD. All right, I would rather have Mr. Davis address that, but before you do, just pretend that I'm the judge, and the guy has $5 million in net worth, and he puts $3 million in; he gets a savings and loan, and he steals 10. The judge is sitting there, and a guy comes up, and you say, "Well, first give me back the 10 million." Now, we ought to have some punitive penalty on you for this, so, give me 2 million of your money. And then send a message to the other people: "We'd like to have you go to the penitentiary for 10 years." Now, you've punished the guy.

Mr. BARNARD. Yeah, but that's not what happens.

Mr. CRAWFORD. That's right, and——

Mr. BARNARD. I thought you were giving me an actual experience.

Mr. CRAWFORD. But what I'm talking about is—we'll give you an experience right here. Mr. Davis will summarize it for you, and this will tell you why the law enforcement agencies take 2 years to prepare a case, and why they are still driving around in their Rolls Royce and living high on the hog with the money they stole.

Go ahead, Bill.

Mr. DAVIS. Well, this is just one example of a case that has pretty much been through the system.

Letha and Jay Soderling, brothers, opened Golden Pacific Savings and Loan in Windsor, CA, in April 1984. These were young entrepreneurs, successful. They also jointly owned a construction company. Each owned 50 percent of the stock of the savings and loan. After the institution was operating, for about 3 weeks, the California Department of Savings and Loan came into Golden Pacific and issued a cease and desist order for violating direct real estate investment regs, and also inadequate recordkeeping. At the same time, the Federal Home Loan Bank had meetings with the board of directors and officers of the institution, and subsequently ordered them to sign a supervisory agreement which put severe restrictions on the institution. Another cease and desist order was issued by the California Department of Savings and Loan in December when they violated the first cease-and-desist order. So, this is an example, where 3 weeks after the institution opened, we started with some kind of regulatory process.

During 1984, they expanded into major construction lending, real estate development activities, and they violated the loans to one

borrower and affiliated transaction regulations. They operated without adequate books and records, and they had absolutely no control.

Mr. BARNARD. What's the end result—where are we now?

Mr. DAVIS. This is on February 19, 1985, Lee Soderling was removed as the chairman of the board of the association.

Mr. BARNARD. Why do they wait so long? If the violations started 3 weeks after these brothers started the business, why did the regulators wait so long?

Mr. DAVIS. Well, they agreed to these things; it appears on the surface that they are reacting to the supervision, and the control that the regulators are placing on them, but, in fact, that wasn't happening. A lot has to do with the collusion that they had with the appraiser. A lot has to do with the things that were going on behind the scenes. Despite the removal and prohibition of the chairman of the board, there was still—he still exerted influence over the institution. As a consequence, the savings and loan suffered a loss of approximately $10 million; it was insolvent, and it was put into receivership in September 1985.

The brothers were subsequently charged in March 1986 with bank fraud. They pleaded guilty in June. In June, earlier this month, they were both sentenced to a year in prison, and I just want to get to the public perception here, because I have a——

Mr. BUSTAMANTE. Mr. Chairman, may I ask: What did they start out the S&L with? How much capital?

Mr. DAVIS. I think they capitalized with $2 million.

Mr. CRAWFORD. Two or three.

Mr. DAVIS. Here's a copy of a press headline that I received just this week, and it says, "One Year Prison Term for the Soderlings."

In it, there is a statement from his lawyer to the judge that says: "It was not an intentional act of thievery or stealing, Your Honor. It was manipulation of funds; and I hope you see the difference." [Laughter.]

They end up with 1 year in prison, and ironically the same day that I read this, there was an article in the Wall Street Journal that says, "White-Collar Inmates Find Tennis and Good Food in Prison," and it talks about where the white-collar criminal goes when he goes to prison, and——

Mr. BARNARD. If they have any who go——

Mr. DAVIS. And one more thing, today, this morning, in talking to a reporter from this town where this happened—she happens to be a reporter for the Crest Democrat—she told me that there was another headline in that same paper, and the headline says: "Man Sentenced to Three-Year Prison Term for Stealing a Macaw"—which is a parrot. So, to me, the public perception is that there are tremendous rewards in economic crime; there's a message going to the white-collar criminal element that says the rewards are there, and the risk is very, very minimal.

So, somehow—and we appreciate what your committee is endeavoring to do, because I think you are going to raise the profile of what's happening in the savings and loan industry, and send a different message.

Mr. BARNARD. Looking at the Southeast, we held hearings on the United American Bank failures in Tennessee, and those people are not suffering greatly but they're suffering a little bit.

Mr. Crawford, another aspect of this, of course, are proper and timely investigations and prosecutions. Would you care to tell us now the problems that you had with the FBI in investigating the North American Savings and Loan Association?

Mr. CRAWFORD. I'm not talking about the specific institution; I'm talking about my contact with the FBI.

We did have difficulty with the FBI. We did have difficulty, and we experienced difficulty from the first time we came to work, but we found out why we had the difficulty, and it is basically that the FBI has so much work that they have to screen their cases, so they challenge you to—how can you prove this? How can you show this? So, on the day that I called when Mr. Davis took over the institution as conservator on Friday, by Monday, we knew we had much evidence.

So, we called the FBI, and it took 17 phone calls in 8 days to get an FBI agent on the case. The Santa Ana office was swamped with cases; I think they had 12 agents. We found out that the LA office has 450 bank fraud cases, and I think they have 32 agents. Sometimes it takes 2 years to prepare a case, and if the same result happens that happened in the *Soderling* case, we spent months working on this *Soderling* case. When we gave it to the district attorney, it was ready for almost a conviction. In fact, he pled guilty.

But it took many phone calls to Washington, to San Francisco, and finally they got an agent, and transferred an agent from Long Beach. And, once the FBI got on the case, they have done an excellent job, but we didn't see, a lot of times, regulatory agencies don't know what the other agencies' problems are. But we finally got to the bottom, and we understand that they just have more white-collar crime than they can handle.

Mr. BARNARD. I wasn't intending to be critical of the FBI this morning—I mean in asking that question, but that's the point I want you to bring out, the fact is, in our national priority, we are not giving the FBI sufficient manpower and resources to do a good job.

Mr. DAVIS. No question. The blue collar comes in the front door with a gun, and he gets a thousand dollars——

Mr. BARNARD. Well, we can do one thing to heighten, as this gentleman has just said, the awareness with these hearings. Now, I'm against drugs as much as anybody in this world, but, brother, we are giving that problem a lot of attention, and yet—and we deserve to give it, not only what attention we are giving it, but all the more attention that we can give it because I'm concerned about the youth of our country and so forth. But, let me say this: The fact that we don't have an adequate deterrent today, it's causing us to lose one of our financial industries; and that's the savings and loan industry.

Mr. DAVIS. That's right.

Mr. BARNARD. And, in this North America case, as I understand it, the FSLIC lost $25 million. Now, you know, you can say, "Just $25 million?"

Mr. DAVIS. I don't think that's the end of the line.

Mr. BARNARD. But it's absolutely unreal. Well, I've taken up too much time, Mr. Bustamante.

Mr. BUSTAMANTE. Mr. Chairman, you just about covered everything, but let me ask real quickly, in reference to the FBI.

Have you found in dealing with them that they are really prepared to go in these financial institutions and really get to the source of the problem, the data that they need to understand, and——

Mr. CRAWFORD. I think that FSLIC hires very professional attorneys who gather evidence. I think the evidence outside the institution, I think the FBI has gotten after it finally—after we got them on it, and I understand that they are doing an excellent job.

Mr. BUSTAMANTE. I just heard this woman talking to some people that sometimes what happens once an FBI agent is assigned to a case, he is soon transferred somewhere else, say, to North Dakota, where there's not that many vacancies, or some other area of the country; and this has become a problem for many of our FBI agents, you know.

Mr. CRAWFORD. Yes, if you load an agent with too much work, and he's got too many cases, he can't do a good job anyhow.

Mr. DAVIS. I just wanted to say that right now we are just learning better how to prepare—and I mean from the examination level, to properly document and get the file ready. This is a learning process for us, too; and I think we can help the FBI move these cases along a lot faster as we gain experience.

Mr. BUSTAMANTE. Let me ask you: Do we have any type of network to deal with those in all the institutions, and also in the appraisal area, where they do business outside the State, and, of course, here in the State with the appraiser. Do we have any type of network for those abusers, for those that are constantly involved in wrongdoing in this area?

Mr. DAVIS. I think we are learning a lot more about networking. There is no system in place, presently, that will allow a red light to go on, and you have different people working from bank to savings and loan, to thrift and loan. However, I think this is coming. I think it's going to be computerized. But it's not here at the moment.

Mr. BUSTAMANTE. I know that we have had some of the people that have come in California and in the San Antonio area. I was wondering how we are matching information, to see what they are using here in the Texas area. Say, not only in San Antonio, but in other parts of the country. I was just wondering as to what our intelligence level was, in——

Mr. CRAWFORD. Basically, word of mouth, telling somebody about something—you are telling one person, one person communicating. It needs to be almost with Social Security number, and computerized as to where it is in a staging area, and could be called up on a screen where somebody could check them. We probably should have access to police department and FBI screening.

Mr. BUSTAMANTE. How do you become an appraiser in California? Just like in Texas?

Mr. CRAWFORD. That's right—be a real estate broker, and know the territory and submit your knowledge of real estate to a finan-

cial institution, and their board of directors says, "Fine, you are our appraiser."

Mr. BUSTAMANTE. Who has oversight over this, the State?

Mr. CRAWFORD. Pardon me?

Mr. BUSTAMANTE. Does the State have oversight?

Mr. CRAWFORD. We used to have an oversight, and we are getting back to it. We used to rate appraisers and approve them, but the board of directors—it's the responsibility of the board of directors of the individual financial institutions at this time.

Mr. BUSTAMANTE. Thank you, Mr. Chairman.

Mr. BARNARD. Mr. Martinez.

Mr. MARTINEZ. Well, as Mr. Bustamante has said, Mr. Chairman, you pretty well covered it. I think you've, in the colloquy that you had with Mr. Crawford, you have pretty well outlined the problems as they exist as well as some of the remedies that have to be considered to rectify the problem.

There's something that keeps sticking in my mind, though. Imagine what happens when there is a fire. At the fire department the bells go off, and everybody goes into high gear, and they slide down poles; and they rush out at high speeds. They get to the fire, and they put it out.

And it seems to me like this situation is similar to a fire. The bells going off in the fire department, and the fire department says, "Oh, gee, that's another fire. I wonder if I should get up and go worry about it now. Aah, it'll burn down, burn itself out. We'll just leave it alone."

And sometimes it seems like in what we've heard here that there is a fire, but no one wants to fight the fire.

There's going to be testimony and a little later we are going to ask about the 10 vacancies in the White-Collar Crime Division of the FBI, which they have the personnel; all they need is to devote the funds to transfer them here so that they can help in the investigation here in an ultimate prosecution.

Mr. CRAWFORD. We've gone from 55 employees in July 1983 to 136 employees now, so we're gearing back up.

Mr. MARTINEZ. But the California——

Mr. BUSTAMANTE. Excuse me, will the gentleman yield?

Mr. MARTINEZ. Yes.

Mr. BUSTAMANTE. But you were saying that before this, we had 180 some-odd?

Mr. CRAWFORD. Well, we had 172——

Mr. BUSTAMANTE. It went to 55, and now we're up to——

Mr. CRAWFORD. We went down to 55, and now we are back up to 136, going up to 143.

Mr. BUSTAMANTE. Thank you.

Mr. MARTINEZ. Well, we are going to have to do something to get that personnel into the FBI so that they can work with you, and attack these problems, or find some way that maybe under some jurisdiction some personnel can be set under your jurisdiction to go after these people.

Mr. CRAWFORD. Well, the amount of money involved is so huge that somebody should be going to the penitentiary on a regular basis.

Mr. MARTINEZ. I'm sure if they robbed a thousand dollars at a clerk's station, and were caught, they'd go to 5 years, under a mandatory——

Mr. CRAWFORD. That's the point that I was trying to make. This gentleman that was the chairman of the board of a financial institution owned 100 percent of the stock. He had a son that had been in the penitentiary, and was tried for murder and stuff, and he robbed a bank six times. If I had called the FBI, and said, "This son is down on the first floor robbing this financial institution," we would have had them there.

Mr. MARTINEZ. Yes.

Mr. CRAWFORD. But the old man was up on the fifth floor, and he got $25 to $40 million bucks, and it took 17 phone calls in 8 days to get them.

A white-collar criminal is called a con man, a confidence man. He has to gain confidence to get your money, and when he goes before the judge, he gains the judge's confidence, the jury's confidence, everybody's confidence. He's a smooth cookie.

Mr. MARTINEZ. It's interesting that you draw that analogy, because people have an admiration for people that are able to outfox other people. I wonder if somehow there isn't a little too much admiration for these people, and too much respect, and not enough concern that they are just criminals?

Mr. CRAWFORD. Listen, if they talk to you, you might want to invest money with them. I tell you, they are very good.

Mr. MARTINEZ. The other aspect of that is that if you are an honest man, you can't be taken. I think that is baloney.

Mr. CRAWFORD. That's right.

Mr. MARTINEZ. Like you say, they are smooth.

Let me ask you on the appraisal situation, because that's something I'm concerned about. I've bought and sold several pieces of property and had to have appraisals on them—well, they are as tough as hell on me.

I mean, they come after me, and I say, "Listen, I was offered this much money for this property; you're appraising it way down here."

I said the guy's willing—"No, that's all the property is worth."

How do these other people get away with this?

Mr. CRAWFORD. Well, I never thought of trying to get a financial institution to make a loan based on an appraisal that I furnished to them. That is the most stupid arrangement to have the borrower furnish the appraisals.

Mr. MARTINEZ. Absolutely. Let me ask you, isn't there a State law that attempts to regulate appraisals?

Mr. CRAWFORD. No, but we are going to have a law, I think, in 1989. When you try to eliminate the agents that are out there earning their living as a local real estate broker, that votes, and you are saying he can't be an appraiser any more, that's not very popular, and, if you grandfather them all in under a licensing, you'll have them around for the next 20 years.

Mr. MARTINEZ. My next question was: Have you looked at that law, and is that law adequate? And it seems like you have just answered the question that it is not adequate if you grandfather them all in.

Mr. CRAWFORD. That's right. We need to certify appraisers, and we need to have a standard national board that an appraiser can appraise across State lines; but the individual State maybe should have licensing and certification and enforcing.

Mr. MARTINEZ. I agree with you. You know, there are so many other services that we require to have a license—even a barber who cuts a person's hair has got to be licensed.

Mr. CRAWFORD. That's right.

Mr. MARTINEZ. He's got to pass State examinations.

One other thing about appraisers. You talked about the association that is leery of taking action because they might end up being sued. How about a bonding system where when the person has been so bad they can't get bonded, nobody is going to use them; they are not in the business any more then.

Mr. CRAWFORD. That's right. I think bonding would be a very good thing.

Mr. MARTINEZ. I just have to commend you, Mr. Crawford; it seems like you've got your finger on the situation. You know what it is; you know what it is going to take. You need a lot of cooperation. I hope we can find some way to give it to you. Thank you.

Mr. CRAWFORD. Thank you.

Mr. BARNARD. Well, thank you very much, Mr. Crawford, you and Mr. Davis; we appreciate your testimony. We may be submitting further questions for you—and we would appreciate your cooperation in those answers if we do.

Mr. CRAWFORD. Thank you very much.

Mr. BARNARD. Our next witness this morning is Mr. Steve Adler, who is the assistant attorney general and chief, major fraud unit of the California State Attorney General's Office.

Mr. Adler, after that very stern testimony, we can't wait to hear what you have got to say about all this; and we do appreciate your being with us this morning, this Saturday morning. I'm sure you probably could find it more to your liking to be on the golf course, or the tennis courts, or somewhere, but this is important, also. So, with that—your entire testimony will be included in the record, without objection, and if you care to summarize, that's up to you. We'll hear from you at this time.

STATEMENT OF STEVEN ADLER, ASSISTANT ATTORNEY GENERAL AND CHIEF, MAJOR FRAUD UNIT, CALIFORNIA STATE ATTORNEY GENERAL'S OFFICE, ON BEHALF OF JOHN K. VAN DE KAMP, ATTORNEY GENERAL OF CALIFORNIA

Mr. ADLER. Thank you, Mr. Chairman.

On behalf of John Van de Kamp, attorney general of California, I appreciate the opportunity to testify.

I noticed from the previous witness that it seems to be your custom to let the witness talk, and then you ask questions. I would much prefer it if you stop me as I go along and ask me questions.

Mr. BARNARD. Well, you start off, and then we will ask questions—we are not timid about that kind of procedure.

Mr. ADLER. I appreciate that.

The major fraud unit in the attorney general's office is a very new organization. We are in the bank fraud business, as a side-

line—I thought I'd say "hobby," but it's not a hobby. We were founded in the middle of 1984, and the reason that we came into existence was to help district attorneys in California handle big investment fraud cases. Investment frauds, are, as you know, cases where individuals invest money and then promptly lose it.

California seems to be the world capital of those things, as it is many other areas. I have heard the stories that is because the State was populated by tilting the United States, and everything that was loose rolled to California. I don't know if that's true. I was born here myself.

Mr. BARNARD. It's collected some very valuable assets that way, though, I'll say. I wish they would tilt the other way, you know, to Georgia.

Mr. ADLER. I'm sure that there are many other States that would appreciate having our problems if our assets went along with them.

The role that our unit has had in bank fraud cases is not great, not only because that's not really why we were brought into existence, but also because of our size. We have recently had our budget doubled by the bipartisan effort of a democratically controlled legislature and a Republican Governor, and we have now ended up with a truly enormous army. We have 6 prosecutors, 10 investigators, 3 to 4 auditors, and 3 paralegals; and that's it.

We do—we presently have about 40 cases under investigation, 10 cases in court; losses on our cases are about $650 million.

From that, you can see that I am not going to sit here and volunteer to take on everybody's spare bank fraud cases. We have got plenty of other work to do.

When I talked to your staff people, I had some ideas about some things we might do; and I did want to share those with you.

I was glad the commissioner talked about the *Golden Pacific Savings and Loan* case, because that was our case; and I was going to tell you what a good deal it was, and what a good case it was; and if it weren't for the sentence, I could still do that. The sentence was ridiculous; but let me just spend a little time on it, and show you maybe as an example of what we the State of California could do to help the Federal agencies, where that help is needed. Golden Pacific came to us from the commissioner of savings and loan. They have a statutorily imposed duty to report any possibility of criminal misconduct that they come across as a part of an examination, to the attorney general.

So, we had a report from them. Now, when they came to us, they were not yet finished doing their thing; and what we tell regulatory agencies in every case is "Thank you very much, goodbye, we haven't told you to do anything; we don't want you to become our agent; we don't want you to do anything but what the law requires you as regulator to do. When you get finished, give us a call; we'll come back and see you." And, in fact they got finished, and got to the point where they could start turning stuff over to us. They gave us a call. They had done an outstanding job. They had a literal army of examiners descend on these people, and do their books and records.

Now, I don't know what——

Mr. BARNARD. Let me interrupt you at that point.

Mr. ADLER. Yes, sir.

Mr. BARNARD. Now, are you telling me that is your usual practice, or that was your practice?

Mr. ADLER. Which practice is that, sir?

Mr. BARNARD. Waiting until they do their thing? Is that your practice today?

Mr. ADLER. Yes, sir.

Mr. BARNARD. Well, then, what happens? Bankers or bank agents, bank regulators or savings and loan regulators, are they trained sufficiently that they can discover and maintain and protect evidence when there is a criminal matter, when there is a crime?

This is one of the things that we found out, that they may have all good intentions, and they may have a real case, but not having that know-how to put the evidence together, to save the evidence. By the time you come in, all the evidence could have been gone, and I think that is what has happened in many, many cases: That between the closing of the institution of the referral and the time that the attorney general gets in, or rather the FBI, the case is lost. I mean, I just——

Mr. ADLER. Well, a couple of things on that question: Number one, in our experience—now, we've worked with both departments, savings and loan and the State banking department. That hasn't happened.

Our response to that problem is to, at the invitation of the commissioner, have our prosecutors and investigators go to the examiners, and, you know, spend 8 hours with them talking about how we do our cases. I don't want to tell them: This is what we want you to do. We tell them: "This is what we need. When we do a case, we do it this way, and we have a protocol that we go through that is only common sense, it is not written down anywhere. This is what we are looking for." Basically, we are telling them, we want you to do all of our financial work for us, because with this cast of thousands, in our unit, only three auditors, we aren't going to be able to dispatch an auditor to do all the books and records.

Mr. BARNARD. Is this a continuing program that you have, or just a course of study? What kind of communications do you have with the regulatory agency now in that regard?

Mr. ADLER. Well, I hesitate to call anything a program. You have got to remember our staff size. Most of these programs that I'm talking about, you are looking at the program. I'm it. So, I, I and an investigator, or one of our other prosecutors, goes to the department of savings and loan. They ask us: Will you please come and talk to our examiners; we have a quarterly meeting, or once every 6 month's meeting; we get all of our examiners together. Why don't you come and tell us about loan fraud, about what you need, about how typical real estate fraud works.

And so we do. But when we are giving that lecture, I'm telling them, now, what—this is what we want, but you do what you are supposed to do, because you can get into this trouble real easily; you turn them into your agent, and pretty soon, some bright defense attorney is going to start accusing me of going out and creating 153 stalking horses that can run around and grab evidence without having to go through the due process hoops that I have to jump through to get it.

Mr. BARNARD. Well, isn't the experience that you have with that case you just cited, was the preliminary work done by the regulatory agencies? Was it good, bad, indifferent?

Mr. ADLER. It was the department of savings and loan; the work was outstanding. It formed the basis for our investigation.

Mr. BARNARD. And you think that came about because of the communications that your department has had with the department, on how to assemble evidence, and how to maintain evidence and be sure the things are not destroyed.

Mr. ADLER. Well, they did an excellent job before they had a chance to talk to us; so, everything worked real well. Again, remember we're talking about a few cases, and in the few cases we've done, it has worked real great.

Mr. BARNARD. And this has been since 1984?

Mr. ADLER. Yes, sir, the middle of 1984. And we really only started getting into these bank cases maybe a year after that.

Anyway, we are going through this program of talking about how we do our cases, and what we do now for the State banking department. We have also started to go out and talk to the savings and loan people themselves.

Mr. BARNARD. Is this a part of what you call your major fraud index?

Mr. ADLER. No, sir. That major fraud index is a program that—another infant program that we put together with the intelligence component of our department. They have massive files on organized crime-type people, and other criminal groups, biker groups, what-have-you. We——

Mr. BUSTAMANTE. Mr. Chairman?

Who is that, your office?

Mr. ADLER. This is in our department of justice. It is a State operation. And we thought that it might be a good idea to provide a place where law enforcement agencies could apply for knowledge, and also could put information that they had that they thought should be available to other law enforcement agencies. We didn't see that one of those existed, so with the organized crime people, the intelligence people, we got together and made up a little card that I gave you a copy of, and that's working OK. We haven't been deluged with a flood of information, but these things take time. Not everybody knows about it; not everybody trusts it; various people have privacy problems, et cetera. But it's working OK.

That information, of course, isn't available to, you know, the Smith State Savings and Loan, because it would be privileged information.

Mr. BARNARD. Well, from what you are saying—and I certainly want to compliment you, and compliment the State for acknowledging the fact that there is a problem here, that it is part of your responsibilities ultimately, and that therefore you are gearing up to handle it.

Based upon this system, even though it may be in its infancy, what do you see at this point that you could recommend on a national scale?

Mr. ADLER. Oh, I think it would be an excellent idea, and you will have exactly the same problems on a national scale that we do, except that they will be magnified many times.

If California regulatory agencies would feel a little nervous about contributing to this data base because of State privacy law problems, Federal agencies will be chary of letting go of their Federal privileges by contributing information into a data base like this—and these are all legitimate concerns; I am not trying to pooh-pooh them. The bigger, the agency, the more lawyers to go through to get things done.

Mr. BARNARD. Well, we have a group looking into this. It's the Attorney General's Bank Fraud Task Force.

Mr. ADLER. Yes.

Mr. BARNARD. This task force includes the regulators, the FBI, the Attorney General's Office, and a number of others; but it is also in its infancy. I think it acknowledges the problems, but it's having some problem, I think, getting the resources necessary to do the job that is going to have to be done if we are going to bring this matter under control.

We've been talking this morning about the lack of laws having to do with appraisals, and what that's doing to foster insider abuse and fraud and crime. We also have some laws on the books which are doing the same thing. I have two questions on problems that I understand you have uncovered with the Right to Financial Privacy Act. First, you suggest that clarifying language is needed to make clear that victims may turn over files without compulsion of violating the act. What precisely would you have Congress write in the way of an amendment to handle this problem?

Mr. ADLER. Well, this is one of those things where it is kind of hard to tell you to write an amendment when, as far as I'm concerned, the law already provides what we need. I don't know that you are in the business of knuckling bank house counsel, but I think that is what we are talking about, because a bank house counsel, financial institution house counsel, say we want to report a bank fraud. We say, OK, give us the loan files.

They say, "No, no. You've got to get a subpoena. Because of financial privacy."

"That's nonsense. You, the bank are a victim; you can give us that stuff." We are not asking for third-party bank records of some citizen whom we are investigating for some other conduct.

Mr. BARNARD. So, under the Right to Privacy Act, the bank believes it cannot give you this information?

Mr. ADLER. That's their position. Our position is they can.

Mr. BARNARD. Yes.

Mr. ADLER. Now, of course, we can't go anywhere without the information, so we give them a paper; we give them a subpoena or a search warrant.

Mr. BARNARD. What about when the FSLIC or another supervisory agency takes over the bank, will they then provide you with that information?

Mr. ADLER. Yes, generally. They have asked us to come in.

Mr. BARNARD. Yes.

Mr. ADLER. So they will provide us with all that information. But more important than the information is their summary and analysis of it. That's what's key about going in after a regulatory agency.

Mr. BARNARD. A related issue: Do you suggest that the act be modified to remove the threat of liability to the financial institu-

tions? Could you also give us a specific proposal as to how you would like to see that act amended?

Mr. ADLER. I don't know how you would draft the language, but what house counsels were telling these banks was based on not wanting to be sued disclosing the stuff. So, the bank is covering its tail by getting a piece of paper to justify that. If you could remove that problem by simply providing disclosure of a loan file when the financial institution is a victim, based upon that loan, shall not be a basis for tort liability.

Mr. BARNARD. Have you had any experience with insiders trying to take advantage of the Right to Financial Privacy Act?

Mr. ADLER. No, sir.

Mr. BARNARD. As far as their own selves and the crimes that they have committed?

Mr. ADLER. No.

Mr. BARNARD. That has happened. We have found problems where insiders accused of crimes have used the Right to Financial Privacy Act to alter or destroy documents—and I think we've got that changed, have we?

Mr. BARASH. Yes, it has changed slightly.

Mr. BARNARD. It has been changed slightly. We are trying to pursue that, so that an insider cannot use this law to protect himself or his crime.

Mr. ADLER. Well, these folks manage to steal enough money to be able to hire themselves fancy lawyers.

Mr. BARNARD. Oh, yeah.

Mr. ADLER. You know—that's what is going to happen. They are going to take advantage of every legitimate thing they can come up with.

Mr. BARNARD. Mr. Bustamante.

Mr. BUSTAMANTE. Well, I'd like for him to continue. We're just——

Mr. BARNARD. Oh, excuse me. OK.

Mr. ADLER. No problem.

I just want to continue talking about the Golden Pacific Savings and Loan thing for a minute, because I think it is a good example of a whole bunch of things. We took that case. We saw that that was a federally insured institution, so we went to the U.S. attorney in the Northern District of California, and asked to cross-designate on the case.

In the major fraud unit, all six of our prosecutors are cross-designated special assistant U.S. attorneys; and we went into cross-designation because California State laws and criminal procedures are disastrous for prosecuting white-collar crime, for a whole number of reasons, which I can go into for a moment.

Mr. BUSTAMANTE. Can I just stop you? Mr. Chairman, I want to ask a question.

Mr. BARNARD. Yes, sir. Go right ahead.

Mr. BUSTAMANTE. I understand that they are behind about 3,000 cases in this area.

Mr. ADLER. Who's behind?

Mr. BUSTAMANTE. The U.S. attorneys' offices.

Mr. BARNARD. 300 cases, in the Central District of California and it also involves the FBI.

Mr. BUSTAMANTE. 300 cases?

Mr. BARNARD. It's 3,000 cases in the entire Nation.

Mr. BUSTAMANTE. In the Nation. They are about 3,000 cases behind.

Mr. ADLER. That wouldn't surprise me in the least.

Mr. BUSTAMANTE. They can't even get going on any one of them, because they feel that they don't have the personnel to adequately address these cases.

Mr. ADLER. Well, the U.S. attorney really is the main-line prosecutor in these cases. And, of course, I am not proposing that we supplant them because we don't have the resources; it is not our business. We are more than willing to help them, to the extent that they deem it appropriate; and we have set ourselves up so that we can help them, if they deem it appropriate.

These are all complex fraud cases, and I would imagine that California, the most populous State in the country, and I understand the sixth richest country in the world, has maybe 40 prosecutors, maybe 40 or 50 prosecutors in the whole State who do white-collar crime, and are capable of handling, have the training and experience to handle this kind of crime. Most of them are in the U.S. attorneys' offices. Some are in our office, and a few are in district attorneys' offices, and they are mostly scattered in the very biggest ones, like Los Angeles, Alameda, San Francisco, and the like.

So, there aren't very many people anywhere to do these kind of cases. Those 300 cases could keep all those prosecutors busy, and, again, for us and the district attorneys, financial institutions failure, we don't do that most of the time. We're trying to take care of investment frauds, and all the other kinds of stuff that people dream up to steal money in California.

On Golden Pacific, we cross-designated—were assigned an FBI agent, and the FBI did a good job following up the leads that were exposed by the regulatory examination and gathering evidence. As to the chronology, you've heard from the commissioner. This was a real "express" case. It doesn't sound like an express case, but in our experience, as far as the criminal end of it goes, this one just went lickety-split. Everything was going great; the two crooks pled to 7 years' worth of crimes, and everything was going fine until we came to sentencing.

Let me talk about plea bargaining. We do our cases; we focus our entire investigation and our prosecution efforts on getting people to plead guilty. If you think about our resources, if you think about the number of cases that we have assigned to us, and what we are trying to do, we've got no choice. The prosecutor working on cases that are going to result in a guilty plea can handle six to eight cases; a prosecutor trying a case can handle, of course, only one. And, of course, the prosecutor will drag with him or her an investigator or two, an auditor or two, a paralegal, et cetera. That person is lost to us; that person's caseload stagnates, and we've got no place to put it. We don't have other line prosecutors to handle the balance of those cases.

We have, since we were founded in August 1984, not gone to trial—ever. All our cases have been resolved by plea, about 80 percent of them with a prison sentence.

We have the biggest problem with prison sentences in financial institution cases. The reason for that is very simple. When we do an investment fraud case, we have victims "who are real people" old ladies, widows, orphans, the whole nine yards. And these people have lost real money. They have lost their life savings. They have been kicked out of their houses, and they come in and they talk to the court, and the court listens. The court doesn't often listen as well as we would like, but they listen; and in almost all of those cases, the principal, the head guys go to prison.

Financial institution insider cases are more difficult. The background for the Golden Pacific was very well done. It was very thorough. It was a classic real estate scam using straw buyers, inflating the value of the property; and, since you own your own bank, you can loan yourself money, based on the inflated appraisals. Once you get the money based on the inflated appraisal, then you have a party where you divide the money up, and everybody goes home happy, and dreams up another piece of property that you can run the scam on.

This is all crystal clear. And we wrote a big, long sentencing memorandum, like all good prosecutors will do when they have a fraud conviction based on a guilty plea; and the court gave the sentence that you see.

This is not a recommendation for legislation, but rather a plea. I'm not asking necessarily for more time for these people; I'm asking that more of them get time. Every principal in a big fraud case should go to prison. I don't—I'm not saying that they should go for 100 years, because I know they won't, but they should go; and the court should realize that they carry part of the load. The courts must shoulder part of the blame, if there is no deterrence, because we can charge them, and we can argue our tails off, but unless these crooks actually go and do some time, the word isn't going to get out.

Mr. BARNARD. Just briefly, how about telling us what your experience has been as far as the adequacy of the FBI, their expertise and their resources?

Mr. ADLER. Well, our experience with resources, I'll take that first, is that the FBI doesn't have what it needs in California as a whole.

I was back in New York the first part of this year. As a State employee I don't get to travel around the country all that much, so while I was back there I visited with the DA's, the U.S. attorneys, and the FBI; and visited the head of their white-collar operation there in Manhattan.

He told me how many agents he had. You could have knocked me over with a feather. I think he had 150 agents assigned to white-collar crime in Manhattan.

Now, I don't know what the Bureau has here, but I know it is not 150. I know it's not even close to that. I don't think that that is justifiable. It may be that New York is more important, or has taller buildings, but it can't be that much more important to have maybe twice as many white-collar agents. From talking to the prosecutors that handle the cases I know they have insider trading, but they don't have the investment problems that we do here, and they don't have the fancy schemes, people losing millions and

millions and millions. They don't have oil wells that we have here, and they don't have this financial institution crunch that we do here.

We've got a lot of work to do out here, and the prosecutors can't do it unless the cases get investigated; and it is just that simple. The FBI needs to put more white-collar crime people out here. The people that are here are doing a good job. They are overworked, unloved and underpaid; but they are doing a good job. They handle the cases well, and they do a good job on their investigations.

Unfortunately, there are so many cases that they get assigned to agents who don't have a white-collar-crime background or training. Anytime that happens, the investigation is going to slow down because the agent is learning while they are doing, and we all have to do that with white-collar crime; it just takes longer.

Another problem was alluded to by the commissioner, and that is transfer. Now, that is going to happen, a transfer of an agent with case responsibilities. That's going to happen in any agency like the FBI. It doesn't happen too much in our organization, but we are specialized and our investigators are dedicated just to doing fraud work, and work for the Unit. And I am not going to tell the Bureau that it can't transfer its people, because obviously that would be ridiculous. You need to move people, for advancement, because you have other problems.

What is important, though, is to have a cadre of people in the outfit who know what's going on, who know fraud real well, and if you get a new kid on the block, you can groove that person in. They can train the new agent, and help the agent do those cases while that person is learning. That way, the case doesn't slow down quite as much.

We have had the experience of having cases come to a complete halt when one of these shifts occur, and that tends to be frustrating.

Mr. BARNARD. This *Golden State* case, that was strictly a State case?

Mr. ADLER. Well, we don't do anything by ourselves.

Mr. BARNARD. Well, did the U.S. attorney from San Francisco participate with you in that case?

Mr. ADLER. In that case, the U.S. attorney participated in that they oversaw the conduct of the investigation and the court proceedings by our prosecutor, who was a cross-designated special assistant. Our prosecutor did most of the work.

Mr. BARNARD. Are you in a position to appraise the U.S. attorneys' offices, as far as their expertise and adequacy is concerned?

Mr. ADLER. I believe I am. As far as expertise, the expertise is outstanding. Again, in the white-collar units, and again, in the management of the offices, the U.S. attorneys, their chief deputies, and the people who run the fraud units know their business. They are outstanding prosecutors. They are experts in all phases of this kind of work. We work with each U.S. attorney in California. We've got cases going with each U.S. attorney in California. Our program would not have succeeded without the U.S. attorneys.

And this is as good a time as any to give you a short lecture on why we don't do stuff in State court.

You have no problems whatsoever on the Federal side because you have got a decent court system. We in California, in terms of white-collar crime, have a system that really penalizes you for prosecuting a case in State court. It is not too bad if you are going to run a violent crime, if you are going to do a murder case—although, if you want to get the death penalty, it is a real nightmare.

But for white-collar cases, it is ludicrous. Feature, if you will, not being able to issue a subpoena for somebody's bank records. When we are practicing as Federal prosecutors, and we get a case in, the first thing we do is round everything up. We use grand jury subpoenas to do that. It is perfectly appropriate. You can't do that and have the evidence be admissible in California State court. You have to use a search warrant. A search warrant requires a higher level of evidence. In order to justify it, you basically have to have an insider. You have to have somebody coming to you saying, I want to tell you what happened here, and what was done.

Mr. BUSTAMANTE. Is this under California law?

Mr. ADLER. Yes, sir.

Mr. BUSTAMANTE. And is this the reason then you go into the Federal court?

Mr. ADLER. Absolutely.

Mr. BUSTAMANTE. You as a State attorney?

Mr. ADLER. Yes, sir. Yes, sir. We are doing—well, you know, the people of California, when they set up this major fraud unit, want prosecution, they want deterrence; they want protection from major frauds. If we did all of our cases in State courts——

Mr. BUSTAMANTE. Well, is the code so bad——

Mr. ADLER. Yes.

Mr. BUSTAMANTE [continuing]. That you have to then forget about California State law and go into the Federal court in order to prosecute or get expediency in a case?

Mr. ADLER. Yes, sir. Yes, it is not just the code; it is also court-made procedures, you know. Criminal practice is a combination of substantive statutes, procedural statutes, and then, of course, court-made law.

Mr. BUSTAMANTE. Well, though, is the State doing something about that?

Mr. ADLER. Well, yes. The voters, I think, recognize this problem when they voted out three members of the California Supreme Court in the last election. The voters have passed a number of constitutional initiatives which had, with varying degrees of efficiency, in my view, had the goal of streamlining or——

Mr. BUSTAMANTE. Was this the real reason for turning off those three justices?

Mr. ADLER. Well, not white-collar crime, per se.

Mr. BUSTAMANTE. I was going to say, I didn't think so.

Mr. ADLER. No, no, sir. Not at all.

But I think when you asked is something being done? The answer is one of the things that was done was done by the voters, because insofar as some of these problems are created by the courts, I would imagine that these justices that were voted out would have underwritten the approach.

So, we've got a search warrant problem. You can run a grand jury in California in a State case, but you are doing it for your own

amusement, because after you indict the person, the court has mandated that everybody gets a post-indictment preliminary hearing. The last post-indictment preliminary hearing in a major investment fraud case in California took 6 months. Again, this is why I, given the option that the U.S. attorneys have allowed us, cross-designate and go into Federal court in appropriate cases.

I have got to have rocks in my head to send my prosecutors in the State court, when I have the option to go into Federal court. Now, we are not taking just any cases in the Federal court. They have to be obviously a Federal violation. They have to be an offense of some magnitude; otherwise, it is not going to be acceptable to the U.S. attorney, and, more importantly, to the U.S. district court judge.

And that's the ultimate audience that we have to make sure that they feel that our efforts are appropriate, and we have to make sure we cover the U.S. attorneys, and make sure that their generosity and consideration of us is rewarded.

There was one thing that I wanted to cover since I don't have a question, and that is this: This arises out of the experience in the *Golden Pacific* case, and it is a suggestion that I want to make. I don't think it is a suggestion that would be answered by legislation, but it is a suggestion that might be answered by policy; and, of course, I feel free to ask the commissioner and the U.S. attorneys and the Federal Home Loan Bank and everybody else who might have an opinion on it.

In Golden Pacific Savings & Loan, because the referral came directly from State savings and loan to us, there was a prosecutor on that case at a relatively early point. I mean, even before a prosecutor had to be involved, there was a prosecutor on that case, thinking about what are we going to do with this; how are we going to set this up? How are we going to run this investigation?

I am not an expert on this by any means, but just from appearances, what I've seen happen in the Federal referrals is that a case goes into the Bureau [FBI] from the regulator. The regulators are overworked; the Bureau is overworked, and it may be that you don't have the opportunity of having a case come to the attention of a prosecutor, or be assigned to a Bureau agent that can actually handle the case. Cases that sit are cases that are going to get you in trouble, and to the extent that it is possible, it is good not to have cases sit.

The suggestion that I would make is that in the case where the institution is State-chartered, we would certainly be willing to contribute our resources to a prosecution of that case, even if the case is one involving the federally insured institution. We can't take all of Mr. Bonner's spare cases, or Mr. Nunez's spare cases, or the spare cases of the other two U.S. attorneys—we just don't have the staff, and that is not our primary role. But I know that the department of savings and loan is vigorously going after criminal referrals, and they want prosecution; and I can't commit Commissioner Crawford's resources, but he might be willing to commit them to such an effort.

Under this proposal, things could go like this: A State-chartered S&L is going to be referred for criminal investigation or prosecution. If that case is brought to the attention of the U.S. attorney it

would be perfectly all right with me if the U.S. attorney called me up and said, "We've got one of these that is going to be referred. It's State-chartered; we are full up." Do you folks have a prosecutor that you can assign? This would be up to the U.S. attorney; I have no problem with that. I don't want to make the decision for them because it is not mine to make.

Mr. MARTINEZ. Can I interrupt you right there?

In a State-chartered federally insured savings and loan, it sounds like you are saying that the primary responsibility is with the Federal Government?

Mr. ADLER. I'm not saying legally whose responsibility it is, because I don't know.

Mr. MARTINEZ. It has never been designated or determined?

Mr. BARNARD. Oh, yes. Yes, it can be either/or.

Mr. BARASH. It can be either/or.

Mr. BARNARD. I mean, because of Federal insurance, Federal criminal laws apply, and the U.S. attorney could have it, as I understand it. But if it is a State-chartered institution, it looks like to me—if you are going to try one under Federal law, and you are going to try the other one under State law, aren't you?

Mr. ADLER. No.

Mr. BARNARD. You're not?

Mr. ADLER. We probably would take it to Federal court. What I'm trying to do is——

Mr. MARTINEZ. Well, what I am trying to get at is——

Mr. ADLER [continuing]. If you want Federal prosecutors available to you, or semi-Federal prosecutors, because that's all we are.

Mr. MARTINEZ. What I am getting at is, any ambiguity delays things, and there ought to be some policy established to prevent it. It may be necessary to set a policy that gives either the State or Federal Government, primary responsibility over State-chartered federally insured thrifts. That is not to say that the State and Federal governments couldn't do what you say—cooperate, and ask you to come in and assist them since resources are limited at both levels of government. However, there ought to be, rather than this ambiguous situation you have described, a method where you determine which level of government has jurisdiction.

Mr. ADLER. Well, let me just say that what appears to be the ambiguity that I'm proposing might be better than what you have at present, because at present there is no ambiguity. They all go to the Home Loan Bank, thence to the FBI, and then you run into resource problems.

These are not regulations that—or policies that I can make. I'm just saying that we would be willing to help out if the people with the primary responsibility, the Federal insurance people, the FBI, and the U.S. attorney, want some help.

Mr. MARTINEZ. See, now, we have established from your statement just then that the Federal Government has primary responsibility over State-chartered, federally insured thrifts.

Mr. ADLER. I think that what the chairman said is probably correct. I am just talking about what I've seen.

Mr. MARTINEZ. As it works?

Mr. ADLER. Yes, as it works. And if you'll look at that chart on the back of your, I guess, press release, it shows what happened to

all of those institutions and there's only one where the State commissioner of savings and loan got into a conservatorship. All the rest of them went into receivership, and it was FSLIC receivership.

That's what I'm talking about. Because that means that it is going to go to FSLIC, the Federal Home Loan Bank, and then to the FBI, and then to the U.S. attorney, and that's where your logjam is.

Mr. BUSTAMANTE. In the closing of all these institutions in the State of California, how much have we lost as far as, in money, Mr. Chairman? Do you know?

Mr. BARNARD. Oh, yes.

Mr. ADLER. Beats me, a lot.

Mr. BUSTAMANTE. We have lost, I understand, over $5 billion. Yet, we are not willing to commit moneys to provide proper staffing in many of these areas?

Mr. BARNARD. Well, it hasn't been one of the priority things.

Mr. ADLER. Well, it doesn't appear that way.

Mr. BUSTAMANTE. The U.S. attorneys—the FBI has 10 vacancies? The FBI [Los Angeles Division] has 10 vacancies that have not been filled? The U.S. attorneys understaffed? And the citizens of California in this Nation, just in this area have lost over $5 billion?

Mr. ADLER. True.

Mr. BUSTAMANTE. Then, it's terrible.

Mr. ADLER. I agree.

Mr. BARNARD. Mr. Adler, I think your testimony has been outstanding, and both your written statement and your answers to questions that we asked. We could probably spend the rest of the morning with you, and the afternoon, too. However, we have got some others we have got to move on along.

But I want to thank you very much for coming. As we get our hearing record completed, I am sure that we are going to need to have some additional information from you, and we would certainly appreciate you and your department cooperating with us in that, and we are just going to thank you very much.

Mr. ADLER. Thank you, sir.

Mr. BARNARD. Before you go, though, let me say—have you got a question, too?

Mr. MARTINEZ. Yes, I think we are developing one right here.

Mr. BARNARD. Well.

Mr. MARTINEZ. It goes back to what we were just talking about.

Mr. BARNARD. Well, let's develop it fast.

Mr. MARTINEZ. OK.

In the processes that you described, that it goes to FSLIC first, the FBI, and then they subsequently may come to you?

Mr. ADLER. Yes.

Mr. MARTINEZ. There is another agency involved here, or another person involved here—the commissioner. How soon does the commissioner know when there is some investigation going on?

Mr. ADLER. I couldn't answer how long. I'm sure the commissioner could give you that in a second.

Mr. MARTINEZ. How soon do you find out?

Mr. CRAWFORD. I'm sorry—I can't hear you.

Mr. MARTINEZ. How soon do you find out when there has been a complaint against——

Mr. CRAWFORD. Filed?

Mr. MARTINEZ. Filed.

Mr. CRAWFORD. Generally, the complaints, they have been filed by the Federal Home Loan Bank.

Mr. MARTINEZ. And so you can't find out right away?

Mr. CRAWFORD. Well, if they want to notify me. They are now, I believe, giving us a copy of it when it goes to—we have now set up an enforcement bureau where they are now furnishing us with copies of it. Before we didn't know.

Mr. MARTINEZ. Do they always tell you when they are making a criminal referral? Do they always tell you?

Mr. CRAWFORD. They are telling us now. Before, we didn't know.

Mr. MARTINEZ. Well, before you didn't but now they are. So, upon the notification that there is a criminal referral, do you have the jurisdiction then to bring the State attorney in?

Mr. CRAWFORD. Right—that's right.

Mr. MARTINEZ. That may be the key to getting you on when they need the resources and when you feel that——

Mr. CRAWFORD. That's right. They furnish us with copies of all of them now.

Mr. ADLER. Thank you very much for your time, and the opportunity to testify. I appreciate it.

Mr. MARTINEZ. Thank you, sir.

Mr. BARNARD. Thank you very much. I wish we could spend more time with Mr. Adler.

[Mr. Adler's prepared statement follows:]

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June 8, 1987

Honorable Doug Barnard, Jr.
Chairman, Commerce, Consumer, and
Monetary Affairs Subcommittee on
Government Operations
Rayburn House Office Building, Rm. B-377
Washington, D.C. 20515

Dear Chairman Barnard:

Testimony at Hearing, June 13, 1987

On behalf of John K. Van de Kamp, Attorney General of California, I appreciate the opportunity to testify on the subject of bank fraud in California.

The California Attorney General receives referrals from California regulatory agencies (Department of Savings & Loan, State Banking Department) in situations where regulatory examinations reveal irregularities. One of these cases involved an institution on the list of failed associations, Golden Pacific Savings and Loan. The Major Fraud Unit has been involved in other bank fraud cases which are concluded, as well as some pending matters.

1. Background:

   The cases in our experience have involved loan frauds on financial institutions generally based upon real estate as security. All are variations on the basic real estate/bank fraud theme: misrepresentations as to value of the property and/or misrepresentations as to the credit-worthiness of the borrower.

2. Reasons for Appointment as Special Assistant United States Attorney: Greater Efficiency and Lack of Appropriate Penalties in the California state System

   All prosecutors in the Major Fraud Unit, including myself, are cross-designated as Special Assistant United States Attorneys in the four districts in California. Three of our prosecutors are former Assistant United States Attorneys; the other three come from local or state prosecuting backgrounds. All are prosecutors with more than 10 years experience in prosecution.

When the Major Fraud Unit was founded in mid-1984, it was clear investigation and prosecution of major investment and bank fraud cases had overwhelmed the resources of local prosecutors. In addition, the Major Fraud Unit is a small one. It was evident that unless the unit were organized to work efficiently, it would immediately be overwhelmed by its caseload.

One major step toward efficient handling of big paper cases was the Unit's creation as an integrated team of prosecutors, investigators, auditors and paralegal professionals. This composition was a key feature of Attorney General Van de Kamp's proposal for a specialized Major Fraud Unit. In addition, an analysis of fraud investigations and prosecutions showed they consumed an incredible amount of time and resources. Further investigation showed that at least part of this delay was due to California criminal law and criminal procedure.

a. Search Warrants for Third Party Bank Records

California law requires a search warrant to obtain bank records of a bank client. In contrast, such records can be obtained by grand jury subpoena when the investigation is conducted at the direction of a federal grand jury. A much greater quantum of evidence is required before a search warrant may be issued.

b. Grand Jury Indictment Versus Preliminary Hearing

Under California criminal procedure mandated by the State Supreme Court, all defendants are entitled to a post-indictment preliminary hearing. At these hearings, the prosecution case is presented by direct evidence, and hearsay is prohibited or greatly circumscribed. All defendants are represented by counsel, and preliminary hearing proceedings can be be quite lengthy in major fraud cases. As an example, a recent major fraud case took six months in preliminary hearing and approximately 14 months in jury trial. In contrast, a matter may be presented to a federal grand jury for indictment in much less time.

c. Penalties

Under California state law, the maximum punishment for any white collar crime, or crimes, irrespective of the amount of taking, is a total of 10 years in state prison. The Penal Code also mandates a reduction of sentence by

one-half for good behavior and work while in prison. Credits may not be denied if work is unavailable. In contrast, no limitations are placed upon federal sentence maxima.

As recently as last year, an effort to raise the maximum sentence for state violations to 12 years was defeated in the Legislature.

d. Statute of Limitations

The California state law statute of limitations for most financial crimes is three years from the date of discovery. In contrast, federal law provides a flat five-year statute of limitations from the date the offense was committed.

e. Speedy Trial Act

Although California state courts are attempting to address the problem, there is still no state equivalent of the Federal Speedy Trial Act which mandates all cases be tried within 60 days. Unfortunately, the federal process is not as expeditious as it sounds, for all Unit cases to date have been declared complex, thus exempt from the time requirements of the Speedy Trial Act.

3. General Overview and Examples

In the experience of the Major Fraud Unit, real estate frauds are the most common vehicles used by both insiders and outsiders in defrauding financial institutions in California. As noted, real estate frauds are consummated via two misrepresentations: lies involving the value of the property and lies involving the credit-worthiness of the borrower.

a. Value of the Propety

In order to steal money using real estate, it is essential that the value of the property involved be inflated. In our experience, this inflation is usually double or triple the market value of the property. In some cases, the value can be inflated by as much as twenty-fold. Property values are typically inflated using the "double escrow" or by purchase by "straw buyers." In a double escrow, the same piece of property is sold simultaneously to two entities controlled by the fraudster.

One transaction is from the bona fide seller to the first entity controlled by the trickster; this sale is for a reasonable market price. The second sale is from the first entity to the second entity controlled by the fraudster, and this is typically for double or triple the bona fide seller's original asking price.

If a straw buyer is used, the straw buyer purchases the property from the bona fide seller, then sells it to the "Q", or "qualifier", the individual in whose name a fraudulent financial package (which will qualify for a large loan) has been prepared.

b. Misrepresentations as to Credit-Worthiness of the Borrower:

Real estate is rarely inflated in value for its own sake. Rather, the goal is to borrow money using the property's inflated valuation as security. In Major Fraud Unit cases, money has been borrowed from limited partnerships as well as from financial institutions. In either case, the borrower, though a fraudster or associate, must be made to appear credit-worthy. This is accomplished with false income tax returns and false financial statements which reflect large imaginery incomes. Often, "loan packages" are presented to victim financial institutions by mortgage brokers or others pretending to be independent and objective third parties who have analyzed the loan and the loan package and found it satisfactory.

c. Appraisals

No discussion of California real estate fraud would be complete without a review of the role of appraisals and appraisers. No real estate-based loan fraud can be committed without an appraisal supporting the valuation the fraudster is seeking. However, our cases have not featured bribes to appraisers or other undue influence situations. It is important to recall appraisers are paid no more than $200 to $300 for each residential appraisal. Fraudsters obtain the desired figures by calling in appraisers from afar with no experience in the area where the target property is to be found. Also, the fraudster will present the appraiser with "comparables" (properties of purported comparable worth) that have already been the subject of value

fraud offender. In our experience, appraisers are generally satisfied with information that is spoon-fed to them. Financial institutions which accept appraisals from outside sources without independent review tend to be victimized much more frequently than those institutions which employ their own appraisers and accept appraisals from no other source.

4. Movement of Major Borrowers, Appraisers, Insiders, and Others Between Financial Institutions: In some cases, a few escrow companies are used by different fraudsters in their schemes.

a. In the Major Fraud Unit's experience, we have not handled cases where insiders, borrowers, or appraisers have moved from one institution to another. However, we have handled cases where different fraudsters in unrelated cases have used a common escrow company to conduct both double escrow activity and rent-skimming scams.

b. Detention/Prevention of Such Movement

Based upon conversations with both those in the industry and regulators, a number of problems make information sharing difficult. First, there is no agency or forum with responsibility to receive and disseminate such information. Government agencies could not appropriately handle much of this information because it often involves employees who have been terminated without any referral to a law enforcement agency. If institution security personnel are effective, terminations may occur in situations where there would be insufficient evidence for a criminal investigation or prosecution. In addition, where no conviction resulted, a criminal justice agency could not disseminate "intelligence" information or arrest information to private parties without violating confidentiality laws.

Another obstacle to the free flow of this information seems to result from the privacy law and advice from financial institution house counsel. Apparently, it is often the position of house counsel that institutions must not share such information among themselves because privacy-based law suits by affected individuals could result.

Suggestions for Improvement:

Since not all cases of termination for suspicion of criminal involvement will necessarily be referred for investigation or prosecution, better sharing of intelligence between government agencies will not do much to address this problem. In any event, such intelligence cannot be shared with private entities because of California privacy legislation. It might be most appropriate and efficient for information on possible loan scam artists to be shared by those in the industry. However, modification of privacy legislation might be required to remove the threat of liability to the financial institutions.

Intelligence Sharing:

At the state level, the Major Fraud Unit and the Bureau of Organized Crime and Criminal Intelligence in the Department of Justice have set up a Major Fraud Index to facilitate the interchange of intelligence information on fraud schemes and subjects. However, use of this system is restricted to government agencies. Although the system is still quite new, a number of agencies are contributing. The efficiency of the system will, of course, increase in direct proportion to the number of agencies which utilize it.

A blank entry card for the Index is attached.

5. Adequacy of Coordination, Dissemination of Information, and Assistance Between and Among Financial Institutions, Bank Regulatory Agencies and Federal/State Prosecutors:

a.(i) Detection and reporting of criminal misconduct in financial institutions by banking agency examiners.

Reports of misconduct by the California Department of Savings and Loan and the Banking Department have been adequate and timely in our experience. Since the Major Fraud Unit does not receive reports from federal regulatory agencies at this time, no comment on the timeliness or sufficiency of such reports is appropriate.

a.(ii) Detection and Reporting of Bank Fraud Problems By Financial Institutions

In our limited experience, most of the cases reported had been reported by state agencies. However, we have had a few matters referred by financial institutions. In those few cases, the reports were timely and the institutions were helpful. In fact, the report made by one institution has resulted in an agreement beteween the Major Fraud Unit and that institution to provide training for loan officers and other institution employees on how to detect, avoid and report possible bank frauds.

b. Additional Views on Improved Coordination

The Major Fraud Unit suggests a variation in regulatory agency reporting of policies in California. In cases where the association which fails has been chartered by the State of California, it might be appropriate for the federal regulatory agency to consider having examinations done by the Department of Savings and Loan in some cases. As a result the responsibility for regulatory examinations could be shared between federal and state regulators. Likewise, prosecutorial responsibility might then be shared between federal prosecutors and our office.

In order to make such a proposal work, it would be necessary to bring criminal referrals to the attention of the United States Attorney immediately, at the point of referral by the regulatory agency to law enforcement. At this time, if the association involved were state-chartered, the federal prosecutor could opt to request the involvement of the Department of Savings and Loan and the Major Fraud Unit in the matter. At present, all matters are routinely referred to the Federal Bureau of Investigation for eventual prosecution by the United States Attorney. Of course, we have no objection to this system, as these matters are a federal responsibility. However, it is evident the combination of the complexity of the cases and the number of cases being referred has resulted in significant delays in investigation and prosecution. If these delays can be lessened by our involvement in appropriate cases, this proposed change in policy might have beneficial results with little added cost. Naturally, the state agencies

will also reach a saturation point at some time since state resources are not unlimited. However, our experience in investment frauds shows that sharing those cases between federal and state prosecutors results in more expeditious and efficient prosecution of a higher number of cases. The same might well be true in the bank fraud area.

6. Adequacy of FBI Expertise and Resources:

The limited experience of the Major Fraud Unit in these cases, again, prohibits a general response. In the Golden Pacific Savings and Loan case, the FBI agents assigned (from the Santa Rosa office) did an efficient and effective job conducting the investigation. In another matter, where further identification is precluded by rule 6(e) of the Federal Rules of Criminal Procedure, some difficulties were encountered when the case agent originally assigned was reassigned and other agent had to be brought up to speed. However, the newly assigned agent is presently working with a Major Fraud Unit Special Agent, and the investigation is proceeding satisfactorily.

Generally, we have observed the same variance in expertise and skill among FBI agents as among Special Agents in the Major Fraud Unit. FBI agents assigned to bank fraud teams in Los Angeles, for example, are quite good at handling these cases. However, case volume often results in assigning the cases to inexperienced agents or agents with less training in handling white collar cases. In those situations, obviously, the quality of investigation may decline.

FBI manpower resources in California are inadequate. To prove this point, it is necessary only to compare the number of FBI agents assigned to the Los Angeles and Manhattan offices. Almost twice as many agents in the Manhattan office serve the same population -- about 14 million citizens. This disparity does not seem appropriate.

Besides staffing, agent rotation sometimes creates problems. In the Major Fraud Unit, although Special Agents rotate into the unit as well as leave it, we try to maintain a core of experienced Agents who can work with new Agents on complex financial crimes. In addition, we employ a full-time Consultant Investigative Specialist in white-collar crime to train and assist all our agents in handling these cases. White-collar crime investigations are a specialized field,

and it is important for large police agencies such as the FBI to recognize this. Agencies must provide mechanisms which will allow for investigative continuity when investigators assigned to particular major cases are reassigned. Such situations are predictable in white-collar cases which often take two years to investigate.

In addition, the FBI appears to set priorities which order its caseload and the attention given classes of cases. White-collar crime often finds a place in this hierarchy, but its rank in the hierarchy is often changed. Consequently, the staffing assigned to white-collar crime and its institutional importance seems to be in a constant state of flux. As financial crimes are long term investigations requiring a significant commitment of agent personnel and time, the results of this priority change are not always beneficial.

7. Adequacy and Expertise of Federal Prosecutorial Resources:

As is the case with the FBI, manpower resources of United States Attorneys offices in California are inadequate to address white-collar crime in California's four federal districts. The problem is most pronounced in Southern California where major fraud is endemic. However, frauds are found in wealthy urban areas, and such areas may be found in all four of California's districts.

Staffing problems are particularly acute in the specialized fraud units in the four offices. The Assistants assigned to the specialized units are the most experienced prosecutors in the U.S. Attorney's Office. Without exception, these prosecutors do fine work. However, the white-collar crime experience they gain as prosecutors makes them highly desirable candidates for employment as partners in major law firms all over the state. Often, these private sector jobs offer pay scales two or three times that available to a government prosecutor. The result is relatively rapid turnover of the best and most exprienced federal prosecutors. This is probably unavoidable, but creates a constant problem of case reassignment and the need to train new fraud prosecutors.

A number of improvements might increase the length of prosecutorial tenure in U.S. Attorneys offices. First, of course, is more money. No government agency can or should compete with the big firms of Los Angeles, but there might be some effort to at least equal the pay scale of the Los Angeles

District Attorney's office. In addition, federal fraud prosecutors must handle non-fraud trials involving bank robbery, alien smuggling and minor narcotics cases. These cases are assigned to attorneys throughout many United States Attorneys offices because there are simply too many cases for the "line" prosecutors to handle. If major frauds are to receive the attention they deserve, the attention must be undivided. To achieve this, there must be more prosecutors assigned to the four United States Attorneys offices in California.

8. Right to Financial Privacy Act (RFPA) Problems and Adequacy of Sentences Imposed in Bank Fraud Cases:

a. RFPA Problems

Only one salient problem recurs with respect to interpretation of the right to Financial Privacy Act. Although banks are victims in bank fraud cases and may turn over copies of loan packages to law enforcement agencies upon request, financial institutions invariably require a subpoena or search warrant before turning over these materials. In our experience, these policies are generally due to advice of house counsel who are doubtless giving their clients conservative advice. Although the Right to Financial Privacy Act already provides victims may turn over files without compulsion or violation of the Act, perhaps clarifying language to make the point clearer yet would be useful.

b. Adequacy of Sentences:

Sentences imposed in state and federal courts are inadequate to deter criminal misconduct in bank fraud cases. In a June 1985, CBS-New York Times poll, 65% of the respondents believed punishment was too lenient for white-collar criminals. 68% of those surveyed felt government was not making enough of an effort to catch white-collar criminals. 85% of the public said most white-collar criminals get away with their crimes. In light of these public attitudes, the response of the criminal law should be clear.

Principals in major white-collar crime schemes, including bank frauds, should receive a term of imprisonment, if convicted. In our experience, prison terms imposed are generally in the 2 to 5-year range in both the state and federal systems, and mandatory reductions of the sentences for good behavior or work occur.

Some criminologists have observed that while deterrence is of questionable value in the area of violent crimes, it has great value in convincing the white-collar offender that a criminal course of action does not pay. There is no question this country's prison and jail facilities are jammed. Sentences for white-collar offenders will generally be relatively short because these offenders rarely have criminal histories. However, imprisonment for principals in major white-collar schemes should be routine. In addition, the terms of incarceration should be more than a few months in a light custody "country club" environment.

In summary, deterrence and protection of the public require principals in major white-collar crimes, including bank frauds, be sentenced to terms of imprisonment upon conviction. These terms should be more substantial than those presently imposed, and terms of imprisonment should be imposed in a higher percentage of cases.

9. Role of the Attorney General's Office in These Matters:

The California Attorney General's Major Fraud Unit is willing to investigate and prosecute bank frauds, using the same format we have developed in investment fraud cases. As a "secondary" law enforcement agency, that is, one which accepts referrals of cases from other agencies, the Major Fraud Unit will work financial institution frauds when requested by appropriate authorities.

In the case of federally insured associations, our involvement would be at the request of the federal prosecutor. The only exception to this will occur in situations where a referral is made by a state regulatory agency. However, since we generally prosecute our cases in federal court as cross-designated Special Assistant United States Attorneys, federal prosecutor assent will also be required before we become involved in these situations as well.

Although we cannot volunteer the resources of the California Department of Savings and Loan, our experience in the Golden Pacific Savings and Loan case demonstrates that the Department did an outstanding job in its examination and summarization of the Association's books and records. That analysis formed the basis of our investigation (jointly conducted with the FBI),

and outlined the charges to which the defendants, Leif and Jay Soderling eventually admitted guilt. As noted, we believe some of the federal workload could be relieved if federal prosecutors requested involvement by the Department of Savings and Loan and the Major Fraud Unit in some cases involving federally insured associations.

As shown by the attached Major Fraud Unit Fact Sheet, our Unit is still not large -- we have only six prosecutors and ten special agent investigators. In addition, our primary caseload will continue to consist of investment fraud matters. Therefore, we will not be able to absorb a large number of bank frauds. We certainly cannot replace the additional federal prosecutors so desperately needed by the United States Attorneys of California.

Obviously, this proposal cannot succeed without coordination and cooperation between state and federal investigators. However, the Major Fraud Unit has enjoyed an outstanding relationship with federal prosecutors and law enforcement agencies, and we are positive this relationship will continue.

I have attached a copy of a Fact Sheet, outling the composition, history and tactics of the Major Fraud Unit. In addition, a brief summary of the Golden Pacific Savings and Loan case is included to demonstrate how one bank fraud was consummated and what investigation steps resulted.

Again, I deeply appreciate the opportunity to testify before this Subcommittee and the opportunity to work with you towards a solution of the problem of bank fraud in California.

Very truly yours,

JOHN K. VAN DE KAMP
Attorney General

STEVEN V. ADLER
Assistant Attorney General
Chief, Major Fraud Unit

SVA:ejl

Encls.

	Attachment
Major Fraud Unit Fact Sheet	1
U.S. v. Soderling, Leif D. and Jay S.	
Information - filed /2/87	2
Newsclipping - Press Democrat 3/3/87	3
Sentencing - 6/2/87	4
Fraud Index Card	5

May 1987

MAJOR FRAUD UNIT FACT SHEET

BACKGROUND:

The Major Fraud Unit, Criminal Division, Office of the Attorney General of California, was first funded July 1, 1984. The Unit was approved by the Legislature at a funding level of $2.1 million; the Governor reduced funding to $900,000. In 1986, Senator Robert Beverly sponsored SB 2457, which provided increased funding for the Major Fraud Unit. On September 26, 1986, Governor Deukmejian signed the bill into law, approving a higher funding level. The Department of Finance has approved continuation of the new funding level for FY 1987-1988.

The Unit's mission is to handle complex multijurisdictional white collar criminal cases. In addition, the Unit coordinates anti-fraud law enforcement efforts by local, state, and federal agencies and offers assistance when requested in appropriate cases. The Unit also trains local and state peace officers in investigation techniques for complex fraud cases.

The Unit has been enthusiastically accepted by law enforcement, and major cases are constantly being referred to us by other agencies. Cases with losses totaling more than $650 million involving thousands of victims are being investigated or prosecuted by MFU.

PRESENT STAFFING:		SB 2457: (1/1/87)
Prosecutors	4	6
Special Agents	9	10
Auditors and Analysts	5	7

CASE HANDLING PROCEDURES:

The Major Fraud Unit's aim is to efficiently investigate and prosecute multijurisdictional investment fraud in California. We seek to deter those who would commit such crimes by arguing for (and in most cases obtaining) sentences involving imprisonment for defendants we prosecute.

We pursue our investigations and prosecutions in both state and federal courts, choosing the forum which allows for the most efficient prosecution with the most appropriate statutes and the punishment most suited to the criminal enterprise. We investigate our cases jointly with local, state and federal regulatory and/or law enforcement agencies. We prosecute in tandem with District Attorneys and United States Attorneys.

We have increased fraud prosecution in California by filing cases, by assisting other agencies, and by coordinating multi-agency efforts. Working together, we intend to move the fraud capital of the U.S. -- elsewhere.

MAJOR FRAUD UNIT WORKLOAD STATISTICS

Since the Unit was founded in August, 1984 (and fully staffed by November, 1984) no case handled by Unit prosecutors has gone to trial. Disposition data for Unit cases is shown by the figures below.

One case investigated by MFU Special Agents has gone to trial - the case was prosecuted by Sierra County's District Attorney. The case involved a loss of about $100,000, and the defendant was sentenced to five years in state prison. The defendant had run a check-kiting scheme, and sold the same part interest in a mold for a fiberglass car body to a number of different investors.

All cases reflected in these statistics were investigated and prosecuted using the MFU task force approach -- other agencies were almost always involved, usually in the investigation of the case.

The "assessment" category reflects cases which meet MFU criteria, but are not being actively worked for any reason. For example, MFU may lack resources to handle the matter alone, and we are searching for assistance; the matter has been referred to another agency and we are awaiting a reply; or preliminary investigation is underway to determine whether criminal prosecution is appropriate.

These statistics also reflect cases in which Unit personnel have assisted other agencies in investigations: these cases usually involve a Unit auditor analyzing complex financial transactions at the request of a local prosecuting or police agency. MFU does not assume primary responsibility for investigation or prosecution of these cases.

			Total
I.	COMPLETED: (number of defendants)		
	Convictions:		34
	Prison:	15	
	County Jail	5	
	Probation:	7	
	Sentencing Pending:	7	
II.	PENDING: (number of cases)		41
	Prosecutions (charges filed in court):	8	
	Investigations:	25	
	Assessments:	11	
III.	ASSISTANCE: (MFU renders auditor, investigative or legal help in cases being handled by other agencies.	17	17

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RONALD D. SMETANA
Assistant Attorney General and
Special Assistant United States Attorney
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Assistant United States Attorney
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(707) 525-4279

IN THE UNITED STATES DISTRICT COURT

FOR THE NORTHERN DISTRICT OF CALIFORNIA

UNITED STATES OF AMERICA, Plaintiff, v. LEIF D. SODERLING and JAY S. SODERLING, Defendants.	CR NO. 87 0149 RHS Violation: Title 18, United States Code, section 657--Misapplication of Funds; Title 18, United States Code, section 1014--Overvaluing Securities to a Bank

I N F O R M A T I O N

COUNT ONE: (18 U.S.C. 657)

The United States Attorney charges: T H A T

Beginning on or about April 15, 1984 and continuing to on or about July 16, 1984, in the City of Windsor, County of Sonoma, in the State and Northern District of California,

LEIF D. SODERLING, and
JAY S. SODERLING,

defendants herein, being owners and directors of Golden Pacific Savings and Loan Association, the deposits of which were insured by the Federal Savings and Loan Insurance Corporation, did, with reckless disregard for the interests of the Association, misapply

funds of the Association in excess of $100 by expending funds of the Association for the benefit of themselves and their related business entities on transactions such as the financing of purchase of property on Holman Lane in Cotati, California.

COUNT TWO: (18 U.S.C. 1014)

The United States Attorney further charges: T H A T

On or about June 15, 1984, in the City of Windsor, County of Sonoma, in the State and Northern District of California,

LEIF D. SODERLING and
JAY S. SODERLING,

defendants herein, being owners and directors of Golden Pacific Savings and Loan Association, the deposits of which were insured by the Federal Savings and Loan Insurance Corporation, did overvalue certain property in Vacaville, California for the purpose of influencing the action of the Association.

DATED: 2/24/87

Joseph P. Russoniello

JOSEPH P. RUSSONIELLO
United States Attorney

(Mount Clipping in Space Below)

Press Democrat
425 Mendocino Ave.
Santa Rosa, Ca. 95401
Date: 3/3/87
Edition:

Title:

Character: SF29A-0652
or
Classification:
Submitting Office: SF

Santa Rosa, California, Tuesday, March 3, 1987

Soderlings charged in S&L deals

Brothers accused of inflating values

By BOB ELOISE
Staff Writer

Leif and Jay Soderling, the Sonoma County brothers whose brief foray into the banking industry ended 18 months ago with insolvency and takeover, were charged in federal court Monday with criminal self-dealing and misrepresenting property values.

U.S. Attorney Joseph Russoniello said the pair's activities caused losses of several million dollars to Golden Pacific Savings and Loan, the one-time Soderling thrift that is now owned by Empire of America-California.

Leif Soderling, 34, and his 28-year-old brother are accused of turning over property to inflate the values and finagling the transactions through their own savings and loan for their own benefit.

Conviction of the felony charges, which were filed in U.S. District Court in San Francisco, carried carries a maximum prison term of seven years and $500,000 fines.

The brothers were notified of the federal charges last week. They will be arraigned Wednesday at 1:30 p.m. before Magistrate Ivan Brennan in San Francisco.

See Charges, Page A6

Leif Soderling

Jay Soderling

FBI/DOJ

Attachment 3

Charges

Continued from Page A1

The Soderlings are the eighth and ninth persons to be charged with federal crimes since authorities began investigating Golden Pacific Savings and Loan and three other troubled Bay Area thrifts.

Assistant U.S. attorney Peter Robinson said the investigation into Golden Pacific continues.

"It is possible that other persons connected with the savings and loan will be charged," he said. "I can't say who might be the targets."

The Soderlings could not be reached for comment Monday.

Their attorney, Richard Freeman, Santa Rosa, declined to discuss the charges but said the Soderlings may be prepared to discuss the case in a week or so.

The two are accused of approving loans to themselves or to business entities they owned. Robinson said the self-dealing occurred in 1984 and involved two properties in Cotati and one in Vacaville. The case was developed by Robinson, the FBI and deputy state attorney general Ronald Smetana.

The charges against the brothers said they acted in reckless disregard for the interests of the thrift to benefit themselves.

"Audits performed by the California Department of Savings and Loan were instrumental in uncovering the fraud," said Robinson.

Smetana said titles to the three parcels were traded back and forth between Golden Pacific Savings and Loan, Landco West, another Soderling company, and Michael Rosen, a Rohnert Park developer and brother-in-law of the Soderlings.

All the financing was provided by Golden Pacific, Smetana said.

He said value of the Cotati property was inflated almost four-fold.

"They had the right to buy it for $600,000 and, instead, paid $2,275 million," said Smetana.

"The net result to (the Soderlings) was a gain of $1.6 million," he said.

The Vacaville property was inflated from $230,000 to $825,000, however the deal fell through when the Department of Savings and Loan stepped in and blocked the transactions, Smetana said.

Robinson said the exact amount of money lost by the Savings and Loan is not known.

Rosen declined to comment. He referred inquiries to his attorney Tom Kelly who was unavailable on Monday.

Golden Pacific, which the Soderlings started in 1983, was declared insolvent and taken over by federal authorities in September 1985, five weeks after similar action against Santa Rosa-based Centennial Savings and Loan, Columbus-Marin Savings of San Rafael and Atlas Savings and Loan of San Francisco came under similar regulatory action shortly thereafter.

Golden Pacific Savings and Loan was formed in 1983 and received Federal Savings and Loan Insurance Corp. coverage a year later.

About the same time, the Soderlings formed a development company, Golden Pacific Financial, Inc., successor to Soderling Land and Cattle Co.

The brothers became snarled in regulatory problems within months of opening the savings and loan. The thrift was the target of two cease and desist orders by the state and federal authorities seized control in September 1985.

The Soderlings currently own about $9 million in property under the corporate title of Golden Pacific Builders.

United States v. Leif Soderling
United States v. Jay Soderling
Northern District
DAG Smetana

On June 2, 1987, Judge Peckham committed Leif and Jay Soderling to the Attorney General or his designee; they were committed for five years on the 657, two years on the 1014, all but six months of each sentence stayed with the two six month terms to run consecutively; each was additionally placed on probation for five years on each offense, ordered to make restitution to FSLIC (using a set formula and based on the losses in seven separate transactions; amount will be around $2,000,000 or more) and to perform 2,000 hours of community service. The defendants will be starting to perform the service immediately by building a housing project in Kelseyville for the California Human Development Corporation; they start serving their jail term on January 5, 1988. They were also ordered to disclose assets to FSLIC.

BUREAU OF ORGANIZED CRIME AND CRIMINAL INTELLIGENCE
FRAUD INDEX CARD

NAME	FRAUD TYPE
ALIAS	
ADDRESS	

SEX	RACE	HGT	WGT	HAIR	EYES	DOB
SCARS/MARKS						

FBI	CII	SS#
CDL	ADDL INFO	

ASSOCIATE:	DOB:	ASSOCIATE RELATIONSHIP:
ASSOCIATE:	DOB:	ASSOCIATE RELATIONSHIP:
ASSOCIATE:	DOB:	ASSOCIATE RELATIONSHIP:
ASSOCIATE:	DOB:	ASSOCIATE RELATIONSHIP:

DATE OF PHOTO:

BUSINESS NAME:	BUSINESS RELATIONSHIP, I.E., OWNER/MANAGER:
BUSINESS ADDRESS:	
BUSINESS NAME:	BUSINESS RELATIONSHIP, I.E., OWNER/MANAGER:
BUSINESS ADDRESS:	

M.O. AND COMMENTS (SEE REVERSE SIDE FOR ADDITIONAL INFORMATION)

OC-115

M.O. AND SPECIFICS CONTINUED

ADDITIONAL ASSOCIATE INFORMATION

ASSOCIATE:	DOB:	ASSOCIATE RELATIONSHIP
ASSOCIATE:	DOB:	ASSOCIATE RELATIONSHIP
ASSOCIATE:	DOB:	ASSOCIATE RELATIONSHIP
ASSOCIATE:	DOB:	ASSOCIATE RELATIONSHIP

LAW ENFORCEMENT AGENCY: _____

INVESTIGATOR NAME: _____ TELEPHONE NUMBER: _____

DISSEMINATION INSTRUCTIONS: ☐ RELEASE INFORMATION, ☐ RELEASE AGENCY NAME ONLY, ☐ DO NOT RELEASE

MAILING ADDRESS:
DEPARTMENT OF JUSTICE
BUREAU OF ORGANIZED CRIME AND CRIMINAL INTELLIGENCE
FRAUD UNIT
4949 BROADWAY
P.O. BOX 903357
SACRAMENTO, CA 94203-3570
(916)739-5746

Mr. BARNARD. I am going to ask staff to see if it is possible to get five people around that table. If it is, I think we would like to have a panel of all of our Home Loan Bank Board witnesses. For the next panel, I would like to call Mr. Charles Deardorff, Mr. William Black. Mr. Black, I believe you have got Mr. James Lauer and Mark Gabrellian with you. If we could have all of you gentlemen to appear on that panel.

[Pause.]

Mr. BARNARD. The little ones get on the end, and the big ones get in the middle.

[Pause.]

Mr. BARNARD. Well, I appreciate your cooperation in this. I think this will expedite the hearing a little bit.

Our first witness this morning on this panel will be Mr. Charles A. Deardorff. Mr. Deardorff is Deputy Director, Supervision, of the Federal Home Loan Bank in San Francisco. I will ask—Mr. Deardorff, we will hear from you at this time, and then I will introduce the rest of the panel, and then our questions will be consolidated. Thank you, sir.

STATEMENT OF CHARLES A. DEARDORFF, DEPUTY DIRECTOR, SUPERVISION, FEDERAL HOME LOAN BANK, SAN FRANCISCO, CA

Mr. DEARDORFF. Thank you, Mr. Chairman.

Mr. Chairman, members of the subcommittee, thank you for this opportunity to provide testimony on misconduct of S&L insiders in real estate appraisals in the California thrift industry.

For the subcommittee's information, I have been a supervisory agent for the Federal Home Loan Bank Board since September 1983 with day-to-day supervisory responsibilities for the 240 savings and loan institutions in the 11th district, which includes Arizona, California, and Nevada. On March 1, 1987, I became Deputy Director of the Agency Group in charge of the Special Surveillance Section consisting of problem institutions in the 11th district.

I will draw on these experiences in providing testimony and in answering the subcommittee's questions.

The Agency Group of the Federal Home Loan Bank in San Francisco, headed by the principal supervisory agent, is FSLIC's designated agent for the purpose of examining, monitoring, supervising federally insured and federally chartered, State-chartered savings institutions in the 11th district. Employees of the Agency Group are responsible for front-line examination and performance of regulatory functions on behalf of FSLIC and the Federal Home Loan Bank Board. Through onsite inspections and computer-assisted reviews of thrifts' financial data, the staff reviews the financial safety and soundness of insured institutions and attempts to identify those thrifts posing a potential risk to the FSLIC fund.

With respect to suspected criminal misconduct of insiders—directors, officers, shareholders, or affiliated companies of an institution—or outsiders who receive preferential or advantageous treatment from an institution due to their business or personal relationships with insiders, it is the responsibility of the Agency Group, California Department of Savings and Loan, and the institution to

try to detect such misconduct and to ensure that referrals to the criminal enforcement agencies are promptly made.

The nature, extent, and consequences of misconduct by insiders, borrowers, and appraisers in the thrift industry in California over the past several years has been extensive, costing the shareholders—FSLIC principally—and other creditors hundreds of millions of dollars. In a review of 35 failed or failing institutions since year-end 1984, insider misconduct was noted to some extent in 27 institutions, or in 77 percent of the sample. Unfortunately, this percentage is only marginally above the national average.

Clearly, the criminal law process is not effectively deterring such abuse in California, or nationwide. Based upon our experience, two things are certain: First, the recognized examples of misconduct in California thrift institutions have increased in recent years; and second, the consequence of such abusive practices have harmed the affected institutions and the Federal Savings and Loan Insurance Corporation, and contributed to the failures of many of those insured institutions. Moreover, this misconduct is not limited to insiders, borrowers, and appraisers, but also encompasses lawyers, accountants, consultants, and other persons involved in the affairs of FSLIC-insured institutions. Misconduct in the thrift industry ranges from minor teller defalcations to sophisticated and intricate schemes, often involving numerous transactions and interrelated parties which materially benefit insiders and their associates at the expense of the insured institutions.

Certain of these types of misconduct are evidenced over and over again in problem institutions. Typically, misconduct includes:

(1) Misapplication of funds through the payment of exorbitant personal expenses totally unrelated to the institution's business;

(2) Inordinately large loan concentrations to insiders or affiliated companies, granted with little or no underwriting and/or in violation of the limitations on loans to one borrower;

(3) Purchase or lease of assets from affiliates at inflated prices or provision of services by affiliates at inflated costs;

(4) Land flips, whereby the value of land is artificially inflated through multiple sales to persons not dealing at arm's length, resulting in an acquisition or financing of that land by the institution above the actual fair market value;

(5) Embezzlement;

(6) Extension of credit by an institution in exchange for payment of personal fees to an insider;

(7) Fraudulent appraisals greatly overvaluing real property, resulting in the extension of funds by institutions in excess of the market value and of the land offered as collateral;

(8) Inaccurate audited financial reports resulting in misrepresentation of an institution's financial condition; and

(9) False information submitted by borrowers resulting in an extension of imprudent loans.

As previously noted, the extent of misconduct by persons participating in the affairs of an institution ranges from the single isolated incident with minimal adverse effect on an institution, or as it too often happens, to an overall pervasive pattern of self-dealing, which results in causing the failure of an institution.

However, insider misconduct is not limited to failed institutions or institutions clearly operating in an unsafe and unsound condition. Rather, many institutions having a superficially healthy appearance, upon examination, reveal insider transactions, often masked by poor documentation and inaccurate appraisals. A recurring characteristic of the institutions evidencing some type of misconduct is that, in some part, the institutions are owned by one individual, or a few individuals, and have passive management and board of directors. Additionally, these institutions, as compared to the total population of institutions regulated in this district, are the most uncooperative during an examination process.

Institutions engaged in the worst insider abuse often cause catastrophic failures to the FSLIC by growing extremely rapidly and investing in highly risky assets, particularly acquisition, development, and construction loans, and direct investments. Such investments have proved a far more fertile area for fraud than mortgage loans. Rapid growth allows for more generous rewards to abusive insiders.

The FSLIC, shareholders, savings account holders, and creditors all suffer because of misconduct committed by persons participating in the affairs of insured institutions. Too often, such conduct results in the failure of the affected institutions. And, in cases where other institutions participate in questionable loans originated by a failed institution, these participants may be as drastically affected as the failed institution.

Finally, the consequences of misconduct, which has occurred through the thrift system, and not just in California, affects even the well-run, healthy institutions because of the resulting higher FSLIC insurance premiums, higher cost of funds, and the negative publicity. Such misconduct not only drains the insurance fund, but also drains the personnel and other resources of the FSLIC. It is essential to FSLIC's survival that our abilities to fight insider abuse and fraud be enhanced, not drastically curtailed.

The Bank Board and the Agency Group in San Francisco have taken positive steps to address the growing number of incidents of insider abuse. The Bank Board, among other items, has developed various policies and procedures to work for the sharing of information among various regulators. They have developed a systemwide data base for detection of movement of individuals subject to enforcement and/or criminal activities; spun out the examination's functions to the district banks to provide for increased examination staff. They have directed FSLIC to file civil suits against individuals whose abusive conduct or criminal activities have contributed to the failure of insured institutions, and resulted in FSLIC loss. And they have directed district banks to use aggressive enforcement action to curb and punish abusive behavior.

The Agency Group in San Francisco has also worked in this area, by dramatically increasing its examination and supervisory staffs including technical specialists, and the bank has significantly increased the size of its legal department; restructured the Agency Group to provide for specialization and identification of high-risk institutions, and increased flow of information within the Agency Group in a more timely and proactive supervisory approach.

Jointly with the bank's legal department, the bank has established a criminal referral task force with the involvement and participation of the California Department of Savings and Loan in order to improve staff training, information systems, communication, and to provide for the timely detection in reporting criminal activity.

It is our hope that these measures will be responsive to the widespread egregious, abusive behavior of insiders and to the criminal activity prevalent in the California thrift industry.

Thank you for the opportunity to address the subcommittee.

[Mr. Deardorff's prepared statement follows:]

STATEMENT OF

CHARLES A. DEARDORFF

DEPUTY DIRECTOR, AGENCY GROUP

FEDERAL HOME LOAN BANK OF SAN FRANCISCO

BEFORE THE

COMMERCE, CONSUMER, AND MONETARY AFFAIRS SUBCOMMITTEE

OF THE

COMMITTEE ON GOVERNMENT OPERATIONS

UNITED STATES HOUSE OF REPRESENTATIVES

JUNE 13, 1987

Mr. Chairman, members of Subcommittee, thank you for this opportunity to provide testimony. Your invitation requests that I address specific questions regarding problems in the California thrift industry. I note that some of the questions addressed to me have also been addressed to William K. Black, Deputy Director, FSLIC, who is also providing both written and oral testimony to the Subcommittee. I have formatted my testimony in response to those questions, setting out the inquiry, then providing my answer.

A. Profile of California Thrift Industry and Federal Home Loan Bank of San Francisco.

1.a. Please set forth the number of (i) federally-chartered thrifts and (ii) state-chartered/FSLIC-insured thrifts currently operating in California. Of these, what number are in conservatorship and what number are otherwise in problem status?

As of March 31, 1987, there were 70 federally-chartered and 144 state-chartered thrifts operating in the state of California. Of these, 39 institutions are currently considered as "Significant Supervisory Cases." The Significant Supervisory Cases include 17 institutions in the Federal Home Loan Bank Board's (FHLBB) Management Consignment Program (MCP).

The MCP was established in April 1985, as an interim step in the permanent resolution of failing institutions. In general, the MCP is designed: (1) to enable the FHLBB and the FSLIC to replace deficient management and directors; (2) to stabilize the institution's operations, once control is established; (3) to evaluate assets, as well as the risk posed by such assets to the FSLIC; and (4) to facilitate the development of alternative resolutions to cases. Institutions are placed into the MCP either through the appointment of a conservator or a receiver by the FHLBB. In the case of conservatorships, the FHLBB has appointed the FSLIC as conservator, which, with the support of an advisory management team, an advisory board of directors, and fee counsel, directs the institution's operations. In the case of receiverships, the FHLBB has appointed the FSLIC as receiver, which has transferred the failed institution's assets and liabilities to a newly-chartered federal mutual institution (hereafter, a "pass-through" institution). The boards and managements of these federal mutual institutions are selected by and operate under the supervision of the FSLIC.

At present, conservatorships account for 6 of the 17 MCP institutions and the balance are pass-through institutions. All of the 6 institutions in conservatorship are state-chartered. Of the

11 pass-through institutions, 10 were created as the result of the FHLBB's appointment of receivers for state-chartered institutions and one resulted from the receivership of a federally-chartered institution.

In addition to the 17 MCP institutions, there are 22 other California thrift institutions that may be categorized as Significant Supervisory Cases. Of these 22 institutions, 19 are state-chartered, while 3 have federal charters.

b. For associations in conservatorship or otherwise in problem status, please estimate their aggregate monthly loss.

The aggregate monthly net operating loss for institutions in receivership, conservatorship, or otherwise a Significant Supervisory Case is $53 million. This number is derived from the current period net operating income for the quarter ending March 31, 1987, for the 39 such institutions in existence as of May 30, 1987.

2. Beginning with the receivership for San Marino S&L on February 3, 1984:

a. List each state-chartered and, separately, each federally-chartered thrift institution that has been placed into receivership or conservatorship; provide the date of the action; and provide the most recent estimate of the FSLIC losses for each of

these institutions.

Pursuant to conversation with the subcommittee's staff, we are providing the aggregate estimate of FSLIC loss for these institutions. The latest estimate of FSLIC's aggregate losses is $5.6 billion. Of these losses, 96.1 percent are from institutions that were state-chartered when they failed.

State-chartered Thrift	Type of Action_1/	Date of Action_2/
San Marino S&LA	C	2/3/84
San Marino, CA	R	12/6/84
Western Community SB	R	3/8/85
Walnut Creek, CA		
Beverly Hills S&LA	R	4/23/85
Mission Viejo, CA		
Bell S&LA	R	7/25/85
San Mateo, CA		
Butterfield S&LA	R	8/7/85
Santa Ana, CA		
Centennial S&LA	R	8/20/85
Santa Rosa, CA	R	4/24/87
Presidio S&LA	R	8/28/85
Porterville, CA	R	8/8/86
Golden Pacific S&LA	R	9/27/85
Windsor, CA		
Farmers SB	R	10/11/85
Davis, CA		

_1/ The type of action taken by the FHLBB is designated as either "C" (conservatorship) or "R" (receivership).

_2/ Where two dates are shown, the institution was originally placed into conservatorship or a pass-through receivership, on the first indicated date, and subsequently was liquidated on the second indicated date.

Manhattan Beach S&LA Manhattan Beach, CA	C	1/9/86
Mt. Whitney S&LA Visalia, CA	C	2/12/86
American Diversified SB Costa Mesa, CA	C	2/14/86
Westwood S&LA Los Angeles, CA	C	3/27/86
United Bank, SSB San Francisco, CA	R	3/28/86
Columbus S&LA San Rafael, CA	C	4/14/86
Gateway SB Oakland, CA	C	4/14/86
Consolidated SB Irvine, CA	C R	5/22/86 8/29/86
Seapointe S&LA Carlsbad, CA	R	5/30/86
Atlas S&LA San Francisco, CA	R	7/14/86
Sun S&LA San Diego, CA	R	7/18/86
Ramona S&LA Orange, CA	R	9/12/86
Cal America S&LA Walnut Creek, CA	R	9/19/86
Unified SB Northridge, CA	R	10/10/86
North America S&LA Santa Ana, CA	R	1/23/87
South Bay S&LA Newport Beach, CA	R	3/6/87
Perpetual SB Santa Ana, CA	R	3/18/87
Equitable S&LA San Mateo, CA	R	3/27/87
Tahoe S&LA South Lake Tahoe, CA	R	4/3/87

Central S&LA San Diego, CA	R	4/10/87

Federally-chartered Thrift	Type of Action	Date of Action
First Federal S&LA Redding, CA	C	6/29/84
Southern California FS&LA Beverly Hills, CA	R	6/6/85

b. For each such institution (i) indicate whether a FSLIC complaint seeking restitution and/or other damages has been filed against any insider or affiliated outsider of that institution; (ii) provide a brief summary of the wrongful acts alleged; (iii) identify the parties sued and their position with or relationship to the institution; and, (iv) set forth the total amount of damages and penalties being sought.

Please refer to the testimony submitted by William K. Black.

3. Please describe briefly the functions and responsibilities of the San Francisco Bank including the detection and referral to the appropriate law enforcement agencies, of evidence of criminal misconduct by insiders and affiliated outsiders (a) while the institution is open and (b) after it has been placed into conservatorship or receivership.

The Agency Group of the Federal Home Loan Bank of San Francisco (Bank), headed by the Principal Supervisory Agent, is the FSLIC's designated agent for purpose of

examining, monitoring, and supervising federally-chartered and FSLIC-insured, state-chartered savings institutions in the Eleventh District, which includes California, Arizona, and Nevada. In this role, employees of the Agency Group are responsible for "front-line" examination and performance of regulatory functions on behalf of the FSLIC and the FHLBB. Through on-site inspections and computer-assisted reviews of thrifts' financial data, the staff reviews the financial safety and soundness of insured institutions and attempts to identify those thrifts posing a potential risk to the FSLIC fund. Agency Group examiners also review insured institutions' compliance with applicable federal laws and FHLBB regulations, and the supervisory staff help prescribe and ensure that appropriate corrective actions are carried out, as required, for individual troubled thrifts.

With respect to suspected criminal misconduct of insiders (directors, officers, shareholders, or affiliated companies of an institution) or outsiders who receive preferential or advantageous treatment from an institution due to their business or personal relationships with insiders, it is the responsibility of the Agency Group, California Department of Savings and Loan (CDSL), and the institution to try to detect such misconduct and to ensure that referrals to the criminal enforcement agencies are promptly made. However, in the case of pervasive insider or affiliated

outsider criminal activity, the Agency Group knows that the institution will not make criminal referrals while such insiders remain in control of the institution. Rather, in those instances, the Agency Group considers itself primarily responsible for notifying the enforcement agencies as soon as possible upon discovery of such conduct, whether such discovery is made onsite by the examiners or offsite by analysts, in their review of documents, reports, or applications. By removing insiders engaged in the abuse of their institutions, future losses can be avoided and the new management can assist the Agency Group in making effective criminal referrals. This responsibility continues, whether an institution is being independently operated or has been placed into conservatorship or receivership. The Agency Group also coordinates with various departments of the FHLBB, including the Office of Enforcement and the Office of General Counsel, and with FSLIC fee counsel in the case of receiverships and conservatorships, in the preparation of criminal referrals. The Agency Group also works with the (CDSL), as appropriate, in developing referrals regarding state-chartered institutions.

The Agency Group is now creating a central coordination unit for oversight of all criminal referral activity, whether initiated by the Agency Group, the CDSL, or by the institution. The purpose of this unit is to ensure

the quality of referrals and to monitor ongoing communications with investigative and prosecutorial agencies, the FHLBB, and state authorities regarding those referrals. It will also serve as the record-keeping section for the Agency Group in connection with all referrals.

The FHLBB regulation governing criminal referrals is found at 12 CFR Section 563.18(d). FHLBB Form No. 366 is the document by which referrals are made either by the institution or by the Agency Group. If the referral is completed by the institution, a copy must be sent to the FBI, the United States Attorney's Office, and the Agency Group, which forwards a copy to the FHLBB's Office of Enforcement. If it is completed by the Agency Group, it is responsible for making the same distribution of referrals.

The Agency Group is also responsible for providing ongoing information and cooperation to the law enforcement authorities to the extent permitted by law.

B. Nature, Extent, and Consequences of Misconduct in California Thrift Industry:

4.a. Please provide an overview of the nature, extent and consequences of misconduct by insiders, by borrowers, and by appraisers in the thrift industry in California over the past several

years. Has the misconduct in the California thrift industry been worse than or about the same as misconduct in the Home Loan Banks of other Districts?

The nature, extent, and consequences of misconduct by insiders, borrowers, and appraisers in the thrift industry in California over the past several years has been extensive, costing the shareholders, FSLIC (principally), and other creditors hundreds of millions of dollars. In a review of 35 failed or failing institutions since yearend 1984, insider misconduct was noted to some extent in 27 institutions, or in 77 percent of the sample. Unfortunately, this percentage is only marginally above the national average (See the statement of William K. Black.). Clearly, the criminal law process is not effectively deterring such abuse in California, or nationwide. Based upon our experience, two things are certain. First, the recognized examples of misconduct in California thrift institutions have increased in recent years, and, second, the consequences of such abusive practices have harmed the affected institutions and the FSLIC, and contributed to the failures of many of those insured institutions. Moreover, this misconduct is not limited to insiders, borrowers, and appraisers, but also encompasses lawyers, accountants, consultants, and other persons involved in the affairs of FSLIC-insured institutions.

Misconduct in the thrift industry ranges from minor

teller defalcations to sophisticated and intricate schemes, often involving numerous transactions and inter-related parties, which materially benefit insiders and their associates at the expense of the insured institution. Certain of these types of misconduct are evidenced over and over again in problem institutions. Typically, misconduct includes: (1) misapplication of funds through the payment of exorbitant personal expenses totally unrelated to the institution's business; (2) inordinately large loan concentrations to insiders or affiliated companies, granted with little or no underwriting and/or in violation of the limitations on loans to one borrower set forth at 12 CFR Section 563.9-3; (3) purchase or lease of assets from affiliates at inflated prices or provision of services by affiliates at inflated costs; (4) "land flips," whereby the value of land is artificially inflated through multiple sales to persons not dealing at arms-length (resulting in acquisition or financing of the land by institutions above the actual fair market value); (5) embezzlement; (6) extension of credit by an institution in exchange for payment of personal fees to an insider; (7) fraudulent appraisals greatly overvaluing real property (resulting in the extension of funds by institutions in excess of the market value of the land offered as collateral); (8) inaccurate audited financial reports resulting in the misrepresentation of an institution's financial condition; and (9) false information submitted by

borrowers resulting in the extension of imprudent loans.

Examples of misconduct in the thrift industry are not hard to come by. For instance, listed below are just a few samples of the cases involving misconduct at insured institutions discovered in this District in recent years.

(1) In one instance, an institution claimed to have received payment by check in the amount of $23.0 million on a delinquent loan on the last day of the quarter. The institution made its independent auditors aware of this payment, which was then included in its financial statements without the auditors having verified the existence of funds. Three days later the check was returned due to insufficient funds, thereby rendering the institution's certified financial statements grossly inaccurate. Additionally, the institution never made the proper adjustments to their books until requested to do so by the regulators.

(2) An institution, which is now in receivership, made a $16.5 million loan to its sole shareholder, secured by a 157-acre parcel of raw land that was used as a toxic waste dump. The property was purportedly "donated" to the

institution by the sole shareholder. The "donation" was accomplished through a highly questionable Trust Agreement used by the institution to assert that it had a "beneficial interest" in the property, even though a corporation and partnership controlled by the sole shareholder and his business associates retained their interest in the property. A legal opinion issued by the institution's General Counsel supported the propriety of the transaction. At least $2.0 million of the loan proceeds directly benefited the insiders. As further documentary support for the 'economic' merits of this donation, an appraisal was submitted showing the market value to be $117.0 million. A later appraisal revealed the actual market value to be $6.2 million. The receiver has chosen not to foreclose on this loan due to the unknown liability of owning a toxic waste dump. The loss on the transaction is estimated to total in excess of $10.0 million.

(3) In yet another instance, a third party agreed to purchase from an insolvent institution a large nonearning asset for $30.0 million. The asset, which had an appraised value of only $10.2 million, had been purchased two years earlier for $14.7 million from a company formerly owned, in part, by the institution's chairman of

the board. Subsequent to the receivership action by the FSLIC, a forged appraisal valuing the property at $70.0 million was discovered, as well as an agreement requiring the institution to repurchase the property three years later for $40.0 million. The CDSL recently reappraised the property at $2.5 million. The conservatorship action by the CDSL and subsequent receivership action by the FSLIC precluded this transaction from being consummated, preventing a substantial loss to the institution.

(4) In one instance of borrower misconduct, a borrower grossly misstated his financial condition and omitted material facts such as existing loans, previous defaults, and bankruptcies, on a loan application. The extension of credit based on misrepresentations by this borrower, who later defaulted on the loan, severely impacted the association's capital position.

(5) In an example of insider abuse in a holding company-controlled institution, the holding company contrived, with the aid of various misstatements, including a legal opinion, representations, and warranties, to exchange essentially valueless holding company assets for cash from the controlled institution, with the

resulting loss to the institution aggregating more than $13.0 million dollars and contributing to the institution's failure.

(6) In connection with a change in control application, three potential acquirors of an institution made misrepresentations to the FHLBB during the application process. These misrepresentations involved: (1) the manner in which the acquisition would be financed - the acquirors claimed they had extensive personal resources to infuse into the institution - the acquirors actually borrowed all the money to acquire the institution and secured the borrowings by pledging stock of a shell holding company formed to acquire the institution; (2) the extent of capital to be contributed to the institution - the acquirors proposed a $2.4 million contribution to the institution consisting of four completed and leased apartment buildings - only one apartment building was contributed (this building was subsequently sold by the institution at no gain); (3) the willingness of the acquirors to comply with an Operating Plan approved by the Supervisory Agent - in fact, the acquirors materially deviated from the plan they agreed to abide by; and (4) a service corporation that was to invest in multi-family properties and rehabilitate them for

resale - no plans for "flip" transactions were disclosed - however, the service corporation was involved in at least eight flip transactions, financed largely by the institution, resulting in material losses to the institution.

(7) Appraisal abuse is typified in the example where an appraiser valued 123 acres of land in California at $69.4 million, ignoring 3 sales of the subject property that occurred 10 days prior. The first sale of the property was for about $30.0 million less than the appraised value. The insured institution that purchased the property in early 1984 was placed in conservatorship within days after the purchase. After 3 years, FSLIC was able to sell this property for $37.0 million, with the probable loss to FSLIC in excess of $30.0 million.

(8) In one instance, in an attempt to bolster the institution's net worth, the two owners of a savings and loan holding company structured a series of transactions with major borrowers in which institution cash was contributed to a number of joint ventures (made up of major borrowers and the institution) and then subsequently loaned by the joint venturers to the same major borrowers/joint venture partners (collateralized by overvalued real estate). The

> borrowed money was then invested by the major borrowers/joint venture partners in the stock of the holding company that owned the insured institution. The holding company ultimately reinvested the money in the stock of the institution. In effect, the institution financed its own "capital infusion," which was purported to increase its net worth.

As previously noted, the extent of misconduct by persons participating in the affairs of an institution ranges from the single isolated incident with minimal adverse impact on an insured institution, or, as it too often happens, to an overall pervasive pattern of self-dealing, which results in causing the failure of an institution. However, insider misconduct is not limited to failed institutions or institutions clearly operating in an unsafe and unsound condition. Rather, many institutions having a superficially healthy appearance, upon examination, reveal insider transactions, often masked by poor documentation, and inaccurate appraisals. A recurring characteristic of the institutions evidencing some type of misconduct is that, in large part, the institutions are owned by one individual or a few individuals and have a passive management and board of directors. Additionally, these institutions, as compared to the total population of institutions regulated in this District, are the most uncooperative during the examination process.

Institutions engaged in the worst insider abuse often cause catastrophic failures to the FSLIC by growing extremely rapidly and investing in highly risky assets, particularly acquisition, development, and construction (ADC) loans and direct investments. Such investments have proved a far more fertile area for fraud than mortgage loans. Rapid growth allows for more generous rewards to abusive insiders.

The FSLIC, shareholders, savings account holders, and creditors all suffer because of misconduct committed by persons participating in the affairs of insured institutions. Too often such conduct results in the failure of the affected institutions. And, in cases where other institutions participate in questionable loans originated by a failed institution, these participants may be as drastically affected as the failed institution. Finally, the consequences of misconduct, which has occurred throughout the thrift system, and not just in California, affects even the well run and healthy institutions because of the resulting higher FSLIC insurance premiums, higher cost of funds, and negative publicity. Such misconduct not only drains the insurance fund, but also drains the personnel and other resources of the FSLIC. It is essential to FSLIC's survival that our abilities to fight insider abuse and fraud be enhanced, not drastically curtailed.

b. For all the institutions listed in response to question "2" above, please state the aggregate number of criminal referrals made by the San Francisco Bank to criminal law enforcement agencies. Are additional referrals anticipated and, if so, how many are likely?

For the institutions listed in response to question two above, the Bank has made criminal referrals on 22 individuals previously involved in some manner in the affairs of the subject institutions. This figure includes 6 referrals made by the FHLBB's Office of Enforcement. In addition, another 2 referrals have been made by MCP management teams upon the recommendation of this Bank. Further, to the extent permitted by law, the Agency Group has provided information to the FBI and the grand juries in their investigation of open cases, including an investigation of criminal activity at 4 inter-related institutions, which, although no formal criminal referrals were made before the investigation began, to date, has resulted in guilty pleas by 5 individuals.

This Bank continually assesses the need for additional criminal referrals based upon information discovered by FSLIC fee counsel and MCP management teams as they identify wrongdoing on the part of individuals previously involved at the institution. In this regard, we anticipate the possibility of making an additional 50 criminal referrals on individuals previously involved in some manner in the affairs of

the institutions listed in response to question "2."

c. The subcommittee's investigations of financial institution failures and the misconduct issue, strongly suggest that insiders and affiliated outsiders who are involved in abusive behavior or criminal misconduct in one federally insured institution are frequently involved, at the same or at a subsequent time, in similar conduct at other federally insured financial institutions. Please comment on this observation and describe in detail, systems and arrangements presently in place or planned for the sharing of information on the identities of thrift institution insiders and affiliated outsiders who are the subjects of civil or criminal enforcement actions (a) among the 12 district Federal Home Loan Banks; (b) between the district banks and the Federal Home Loan Bank Board/FSLIC in Washington; and (c) between the Home Loan Bank of San Francisco and the California Department of Savings and Loan. If such exchanges of information are accomplished only on an informal basis, has this been sufficient to deter the movement of dishonest insiders and outsiders from institution to institution? What reforms are necessary in this area?

Certain individuals involved in misconduct or abusive behavior at a federally-insured institution sometimes do circulate to other federally-insured institutions. Procedures have been implemented to allow for the exchange of supervisory information between the Bank, the FHLBB, CDSL, and the other federal financial institution regulators, to permit the more effective assessment of potentially troublesome situations and to

coordinate supervisory actions, if necessary.

The FHLBB recently initiated a Confidential Individual Information System ("CIIS") pursuant to the Privacy Act of 1974. CIIS is a computerized system that contains summaries of enforcement actions against individuals, criminal referrals or referrals to professional organizations naming individuals, applications for FSLIC insurance or for federal charters, change in control notices filed, and significant business between an insured institution and an individual. This information is accessed by the name of the individual involved in such matters.

The CIIS system was designed to assist the Federal Home Loan Banks and the FHLBB in carrying out examination, supervisory, and enforcement responsibilities, in preparing criminal referrals or recommendations for enforcement action, and in reviewing applications. Instructions and training on the system have been provided to key Bank and FHLBB personnel. The data currently in the CIIS system have been provided by the FHLBB offices, the Federal Home Loan Banks, and some information from Federal Reserve Board, Office of the Comptroller of the Currency, and Federal Deposit Insurance Corporation. Once the CIIS system's data-base is loaded, it will be a valuable tool for spotting multi-institution problems.

FHLBB Memorandum SP-40, dated May 23, 1984, provides for the exchange of information between the FHLBB and other financial institution regulators in three areas: enforcement activities, transfers of sub-quality assets, and change in control actions.

FHLBB Memorandum SP 42, dated May 29, 1984, establishes procedures for inter-agency notification of enforcement action. For Supervisory Agreements, the following information would be gathered: (1) name and location of the institution; (2) institution personnel involved in agreement; (3) whether such persons are personally involved in the wrongdoing from which the supervisory agreement stemmed or whether they are mere signatories to the agreement; and (4) brief description of the infraction and the corrective action.

Copies of such information are to be forwarded from the District Bank to the: (1) state savings and loan supervisor, if a state-chartered institution is involved; (2) regional offices of the OCC, FRB, and the FDIC if the wrongdoing is known or suspected to be in some way connected to any of the institutions that the banking agencies regulate; (3) appropriate FHLBB Assistant Director for Regional Operations in Washington, D.C. office; and (4) Office of Enforcement, FHLBB.

The exchange of information with regard to orders to

cease and desist and other enforcement proceedings is the responsibility of the Office of Enforcement, and the FHLBB. The Office of Enforcement provides each of the banking agencies with a letter noting the enforcement action taken and the thrift institution against which it is initiated.

The agencies agreed on a policy to exchange the information discussed in SP 42 on October 2, 1984. It was determined that an agreement would be completed and signed before initiating the exchange of regulatory or supervisory information relating to sub-quality assets, change-in-control applications, enforcement actions, and criminal referrals. The agreement provides that the agencies recognize the privileged nature of the information and will maintain the confidentiality of the information. Yet another means of coordination in the process of obtaining Supervisory Agreements from state-chartered institutions is the FHLBB's standard policy of asking the state regulator to also sign the Supervisory Agreement. Additionally, frequent discussions are held with state regulators on the status of problem state-chartered institutions and any proposed enforcement action.

While the above-mentioned procedures assist in preventing the movement of certain individuals subject to criminal or administrative sanctions from one institution to another, the procedures do not address

the broader spectrum of persons participating in the affairs of an insured institution, such as appraisers, consultants, accountants, and borrowers. The procedures also do not cover persons who have engaged in misconduct, but are not yet subject to criminal or administrative sanctions. And, as a final matter, even with procedures in place, it is often difficult to track insiders subject to previous enforcement action, when such individuals use aliases or engage in other schemes to deceive the regulators.

Examples of the movement within the industry of insiders and affiliated outsiders involved in abusive or criminal misconduct in more than one federally-insured institution follow:

(1) One individual owned two FSLIC-insured institutions, one in California and another in a neighboring state. Unsafe and unsound practices, including insider abuse, were identified by the Agency Group and CDSL in the California institution. The Agency Group shared this information with the Federal Home Loan Bank with supervisory jurisdiction over the second institution (Sister Bank). Based on this sharing of information, the second institution's operations were reviewed, similar insider abuse and unsafe and unsound practices were noted, and both institutions were eventually placed into

conservatorships.

(2) One individual was a major borrower at a now-failed California institution. The loan transactions engaged in between the borrower and the institution resulted in material losses and directly contributed to the institution's failure. Prior to our knowledge of this, the borrower acquired a controlling interest in a new California institution. Subsequent to this purchase, and shortly after assuming control of the new institution, similar lending practices and relationships with the owner were discovered, resulting in loss to the institution, the removal and prohibition of the owner, and the eventual failure of the institution.

(3) One individual left the employment, a number of years ago, of a now-failed institution. Functioning as Chief Lending Officer, his activities were not thought to have been a factor in the institution's eventual failure. This individual assumed the president's responsibilities at an out-of-state institution, where he was involved in unsafe and unsound activities that led to its failure. He resigned from that institution prior to failure and before the FHLBB initiated administrative removal and prohibition proceedings. Four months later, he

resurfaced as the proposed Chief Lending Officer in a then-troubled, now-failed institution in California. Operating under restrictions requiring Supervisory Agent prior approval of senior management, the institution requested approval of his appointment. Discussion by the AgencyGroup with a Sister Bank and the FHLBB's Office of Enforcement led to the eventual removal and prohibition of this individual.

(4) An individual was proposed as president of a then-troubled, now-failed institution. Because of his prior banking experience, the Agency Group obtained information as to his past performance at his financial services employer, which indicated that he demonstrated a disregard for safety and soundness. The Bank contacted the local FDIC office for further information and received confirming information that, based upon poor past performance and the near failure of the bank in which he worked, the individual was not qualified to serve as a chief executive officer. The FDIC's relevant, candid comments and excellent cooperation assisted the Agency Group in preventing the individual's employment in the troubled institution.

(5) Another individual, an appraiser, while not an insider or affiliated outsider, is worthy of

mention. This appraiser has appeared in three failed California institutions. Within a two-year period of time, the individual performed 3 faulty and highly optimistic appraisals, each of which facilitated an unsafe and unsound investment, which contributed to the failure of each of the 3 California institutions. This individual remains an active appraiser with his professional designation as MAI (Member of the American Institute), despite 3 referrals (2 from the Agency Group) to the American Institute of Real Estate Appraisers. To date, and to our knowledge, there have been no published actions regarding these referrals.

In order to deter the movement of dishonest insiders and outsiders from institution to institution, certain reforms are necessary, including: (1) a dramatic increase in criminal investigations, prosecutions, convictions, and jail sentences; (2) improved communication between financial regulatory agencies and other federal agencies such as the FBI and Internal Revenue Service (IRS); (3) increased penalties and de-licensing for dishonest appraisers, accountants, consultants and other professionals; (4) broadened definitions of those who can be removed and prohibited from participating in the industry; (5) improved means of limiting control of an institution by more than just one or a few dominant shareholders; (6) means of

insuring the appointment of independent and competent directors', and (7) ability to seek civil money penalties for violations of law and regulation, similar to the powers of other financial institution regulators.

C. Adequacy of Criminal Justice Response to Financial Institution Misconduct:

5. Please describe the specific policies and procedures of the San Francisco Bank for monitoring the status and progress of Justice Department/U.S. Attorney/FBI action on criminal referrals you make. In this regard, who in the San Francisco Bank is directly responsible for monitoring and advocating prospective action on such referrals? What specific recommendation, if any, do you have for assuring that criminal referrals by the San Francisco Bank are properly monitored?

Currently, two individuals, a Deputy General Counsel and an Assistant Director and Supervisory Agent, have responsibility for monitoring and advocating action on criminal referrals. These two individuals, along with 13 other employees within the Agency Group of the Bank, are part of a Criminal Referral Task Force ("Task Force") that has been established to accomplish at least four goals.

First, the Task Force is currently developing a comprehensive program for training Agency Group staff,

including Supervisory Agents, managers, examiners, and analysts to detect and recognize criminal activity and to prepare criminal referrals. This training will provide an increased awareness among the employees of their responsibility to take an active and continuing interest in the actual detection and referral of criminal acts for prosecution.

A second goal of the Task Force is to improve the existing data base so that, at any point in time, we will be able to determine the status of a case and to document the extent of our monitoring efforts. Ideally, this computerized information system, when fully enhanced, will allow us to manage a referral from detection to conviction.

A third goal of the Task Force is to establish and maintain a liaison with various criminal law enforcement and other regulatory agencies, including the United States Justice Department and the FBI, the CDSL, the California Department of Real Estate, the Nevada Gaming Commission, the IRS, and the United States Customs Service.

Finally, it is an important goal of the Task Force to identify and prepare timely referrals in all instances where criminal activity has been observed but previously unreported.

Specific activities undertaken to date include the holding a training seminar in our offices in San Francisco on criminal referrals. Instructors included local employees of the United States Justice Department and the FBI. Students in this first class included five employees from the CDSL and 30 Bank employees, including Supervisory Agents, managers, examiners, analysts, and attorneys of the Bank. Policies and procedures are being developed by the Agency Group and are expected to be finalized shortly. Further, the Agency Group has recently reviewed the Investigative Units established at the Federal Home Loan Banks of Chicago and of Dallas. We have established liaison with the two District Banks, which seem to share similar problems, including problem participation loans, appraisal abuse, creative financing techniques, and volume of criminal activity.

Initial composition of the Criminal Referral Task Force included Supervisory Agents and managers from each of the functional line units within the Agency Group, managers, accountants, and appraisers from the Technical Support Unit of the Agency Group, and attorneys from the Legal Department of the Bank. However, it is anticipated that the composition of this Task Force will change in the near future into a more permanent structure, staffed by employees with specialized expertise needed to accomplish the goals of the criminal referral program. The criminal referral

unit will consult with experts such as accountants and appraisers so that special attention can be brought to bear on those individuals, employed by, or contracting with, the institutions, who, at times give fraudulent transactions the appearance of legitimacy. Concurrent with our criminal referrals, we will also expend every effort to ensure timely and effective referrals to ethics committees and other professional disciplinary bodies.

We believe that with these major efforts we have remedied many of the deficiencies that we have identified within the criminal referral process, and have taken great strides in establishing a program that will be both timely and effective. Moreover, we believe the program that we are creating will assure that criminal misconduct will be properly dealt with.

6. Utilizing specific case studies as examples, please describe the adequacy of the cooperation and responsiveness of federal criminal law enforcement agencies when your department reports possibly criminal misconduct in California thrifts. If responsiveness and cooperation have been unsatisfactory, please explain why and set forth your recommendations on how criminal enforcement agencies could be made more responsive to crimes taking place in financial institutions.

Federal criminal law enforcement agencies have generally been cooperative and relatively responsive

when the Bank's Agency Group has reported criminal misconduct in California thrifts. Of course, as might be expected, there are some cases where the cooperation between the Agency Group and those agencies resulted in less than satisfactory results. However, as some of the following case studies demonstrate, with improvements in the procedures of the Agency Group and the law enforcement agencies, the criminal referral process can be made more effective.

Institution A

A joint examination commenced in 1985 illustrates the extent and nature of cooperation obtained with other agencies, specifically the CDSL, the California Attorney General's Office ("Attorney General"), and the FBI. Working closely together, the federal and state examiners discovered numerous instances of insider abuse, which were substantiated through the use of subpoenas authorized and issued by the CDSL. As the circumstances became clearer and the facts accumulated, it became evident that the Attorney General or the United States Justice Department should become involved. As the CDSL was the issuing authority for the subpoenas, it was mutually decided that referrals should be made to the Attorney General. An attorney from the Attorney General's Office was cross-designated as an Assistant United States Attorney and detailed to work the case through the federal courts. Investigative efforts were provided by the FBI. Thus

far, prosecutorial efforts have resulted in the guilty pleas of the two principal stockholders of criminal fraud. Each has been sentenced.

Except for the absence of a formal criminal referral, the relationship of state and federal agencies working together in this instance was ideal. Actions were authorized and taken to investigate fully the matters disclosed by the examination. Subpoenas issued by California authorities allowed the examiners to obtain escrow, appraisal, loan, and demand deposit information, which was not available from the institution's records. This more complete information was used to convince the Attorney General of the seriousness of the case and to justify the assignment of an attorney to assist in prosecution. FBI agents became involved through their investigation of the affairs of another local institution, which investigation indicated a linkage to Institution A through lending activities of stockholders, certain directors and officers, and common borrowers. With the issuance of a grand jury subpoena, virtually all essential information obtained by the examination staffs was transferred to the FBI. Further, numerous conferences were held with both of the FBI agents to advance their understanding of the circumstances and facts, and to assist them in understanding the regulatory process.

Institution B

On May 20, 1986, Bank staff made criminal referrals on two individuals involved in this institution's operations.

The suspected violation related to the sole shareholder's apparent systematic efforts, with the assistance of other related parties, to misapply the assets of the institution. Due to a lack of sufficient detail in the referral and the lack of follow-up communication between the Agency Group and law enforcement authorities, it is only recently that an investigation has commenced. I believe that the deficiencies illustrated by this referral will be remedied under the coordination of the Criminal Referral Task Force (see Section C.5.)

Additional referrals on individuals in this institution will soon be filed with the Department of Justice.

Institution C

Cooperation with the FBI in the investigation of the affairs of this institution has, at least thus far, produced less than satisfactory results. The FBI became concerned with the institution with the publication in a local newspaper of the difficulties being experienced by the chairman of the board/CEO in attempting to effect a change of control through utilization of the institution's ESOP, and the decision

of the institution's auditors to disallow the structure of the transaction. Upon presentation of subpoenas, detailed information was provided to the grand jury via its assigned FBI Special Agent regarding various insider transactions, including so-called "dirt-for-stock" swap transactions, and insiders' abuse of position, including the CEO's receipt of loan fees and utilization of a helicopter.

In this instance, there was a lack of adequate feedback from law enforcement officials as the investigation progressed, as well as no results to date from the investigation into what we believed to be a very gross instance of insider abuse.

The FBI and the Department of Justice need more resources. They need a clear indication from Congress of what degree of priority such insider abuses of federally-insured financial institutions should receive. They need local, regional, and national task forces that will allow the development of cadres of experts in uncovering and prosecuting such often sophisticated insider abuses. A national task force is especially necessary because the same scams, and sometimes the same participants, may be present in many different jurisdictions. We also need to convince, or direct by legislation, judges to impose significant jail sentences on those found guilty of such abuses. The FBI and the Department of Justice suffer from

terrible personnel restraints. Congress could act to resolve such "penny wise and pound foolish" limits.

7. What reforms in state law or federal law and procedures would you recommend to make the criminal justice system more effective with respect to financial institution insider and affiliated outsider misconduct? For example, does the federal Right to Financial Privacy Act impair the reasonable exercise of your responsibilities to provide information to and assist criminal justice agencies in investigating and prosecuting criminal misconduct? If so, how would the Act be changed?

Please refer to the testimony submitted by William K. Black.

8. a. Please set forth the specific policy of the San Francisco Bank with respect to the question of who has lead or primary responsibility for the detection and reporting of unsafe and unsound practices and criminal misconduct by insiders and affiliated outsiders - the thrift itself or the San Francisco Bank's supervisory staff. That is, does the San Francisco Bank believe that the financial institution itself and the Home Loan Bank share equal responsibility (practical not legal) for the detection and referral of such abusive behavior and misconduct? What is the San Francisco Bank's present "confidence level" that thrifts themselves aggressively identify and report misconduct by insiders and affiliated outsiders? Are any policy changes necessary in this area?

The Bank's Agency Group and the institutions that it

regulates have equal practical responsibility for the detection and reporting of unsafe and unsound practices and criminal misconduct of insiders and affiliated outsiders. It is important to remember that directorates and managements are closer to and more completely aware of their respective institutions' operations, including criminal misconduct. To the extent that members of management and the directorate are not participants in such criminal misconduct, it is not unreasonable to expect them to detect and report such activities. Indeed, this expectation is reflected in the FHLBB's regulations (See 12 CFR. Section 563.18) and is consistent with concepts of fiduciary duty.

Of course, in cases of pervasive misconduct by controlling persons, it is not realistic to expect insiders to report their own criminal misconduct, or that of their associates, and the Agency Group does not suggest that financial institutions have equal practical responsibility for doing so in these cases. In fact, experience has shown that serious insider abuse typically has not been reported by institutions in such cases.

The Agency Group believes that it must detect and attack this latter form of serious insider abuse where it occurs, through the examination and supervision process and criminal referrals, where appropriate. We

intend to transmit a bulletin to the industry describing our Criminal Referral Task Force and the parallel responsibilities of the institutions to detect and report insider abuse and other criminal activities. Additionally, we have already begun talking to industry trade organizations about our concerns in this area and our actions and plans to deal with them. Our ultimate goal and greatest need are the timely detection, investigation, and effective prosecution of insider abuse and criminal activity. As a deterrent to such future activity, we plan to publicize any convictions to the fullest extent possible.

b. How many criminal referrals involving senior insiders or affiliated outsiders have California thrifts made themselves in 1985 to date?

With the exception of institutions in the MCP or under supervisory control, we are not aware of any criminal referrals involving senior insiders or affiliated outsiders made by the California thrifts themselves since 1985.

9. Please discuss the Bank Board's responsibilities vis-a-vis FSLIC and/or FSLIC fee counsel when a thrift has become insolvent. In this regard, what are your views as to any real or perceived conflicts between FSLIC's restitution function and its responsibility to assist law enforcement agencies in the prosecution of criminal misconduct? How should any such real or perceived conflicts be

resolved?

Please see the testimony of William K. Black. I agree with the views he expresses there.

Mr. BARNARD. Thank you, Mr. Deardorff. We are going to reserve questions until we have this entire panel testify.

The next one to testify is Mr. William K. Black. Mr. Black is former Director, Litigation Division, Office of the General Counsel, Federal Home Loan Bank Board. What do you do now, Mr. Black?

Mr. BLACK. I am the Deputy Director of FSLIC; I am on detail from the Federal Home Loan Bank of San Francisco, where I am their general counsel.

Mr. BARNARD. I just wanted to get that into the record. I knew what you were doing.

Mr. Black is accompanied by Mr. James Lauer and Mr. Mark Gabrellian, attorneys with the Federal Savings and Loan Insurance Corporation.

Well, Mr. Black, I see you have come well fortified this morning, so we'll hear from you at this particular time.

STATEMENT OF WILLIAM K. BLACK, DEPUTY DIRECTOR, FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION, FORMERLY DIRECTOR, LITIGATION DIVISION, OFFICE OF GENERAL COUNSEL, FEDERAL HOME LOAN BANK BOARD, ACCOMPANIED BY JAMES LAUER AND MARK GABRELLIAN, ATTORNEYS, LITIGATION DIVISION, OGC FEDERAL HOME LOAN BANK BOARD

Mr. BLACK. Thank you, Mr. Chairman, and distinguished members of the subcommittee, for this opportunity to talk to you this morning.

In addition to that collection of titles, I have in my former life been a what we call fee counsel to the Federal Home Loan Bank Board and a Department of Justice attorney. So, I cover a number of the segments that your questions to me asked about.

I wanted to repeat again what we have seen as the value of past hearings that this subcommittee has held. The Interagency Working Group, I believe, exists in large part due to the efforts of this committee, and it has been of substantial benefit in improving cooperation and the effectiveness of the criminal justice process.

Chairman Barnard's opening statement, I think, accurately summarized a number of the problems and issues facing us. Mr. Deardorff's statement has gone through a number of them, so I will do it very briefly.

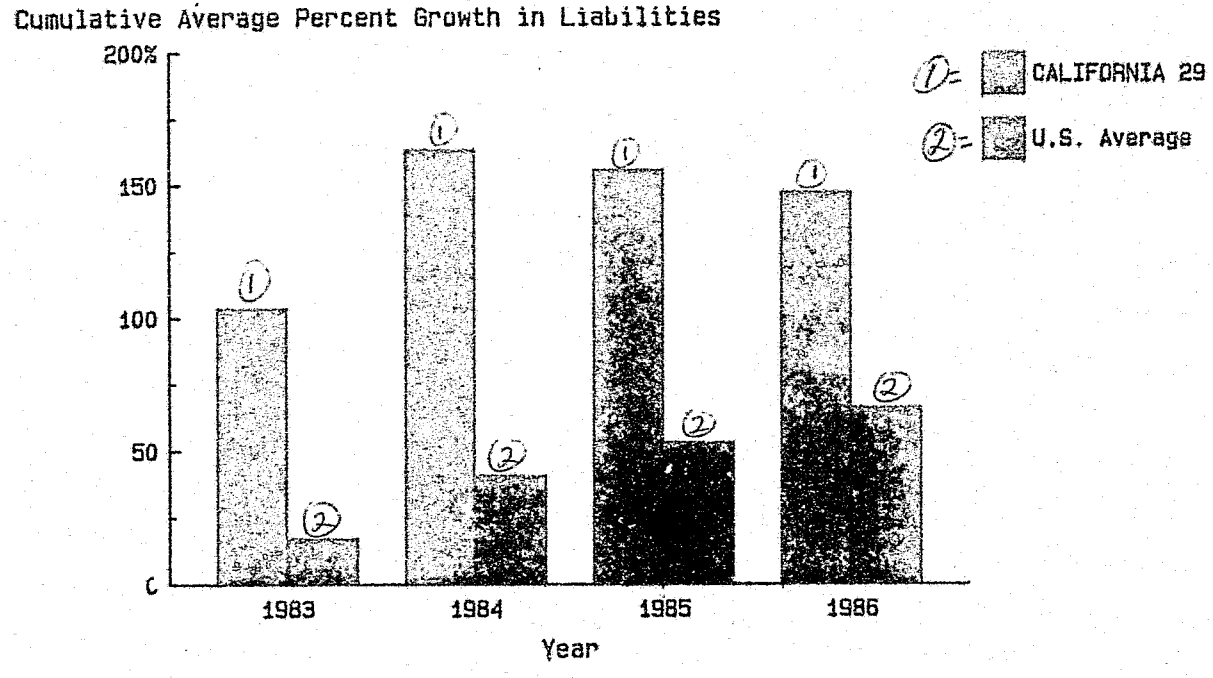
The insider abuse has occurred in most thrift failures, not simply some. California is not unique in this. Indeed, it is representative of those States that had broad and very liberal investment powers. As the chairman noted in his opening statement, the issue of those banking powers is relevant; what we have seen is a pattern, not in all of these institutions, but in certainly far too many. And the pattern was basically somewhere around 1982 to 1984, coming out of the interest rate crisis. You got either a new S&L started, or you got a change of control. And you often brought in a real estate developer. Here in California there was a law firm that went around to all kinds of groups—real estate developers, and gave that package that is attached as an exhibit in my testimony, that encouraged people, the real estate developers to start a State-chartered thrift because it was the perfect way, really, to mint money. And it

even went to such levels as talking about financing the flips, referring to land flips, truly incredible things.

They went after the change of control into extremely rapid growth. One of the color charts—I hope the top one in the package you have shows some idea of the differential of the group of 29 institutions that are State chartered that you asked us about.

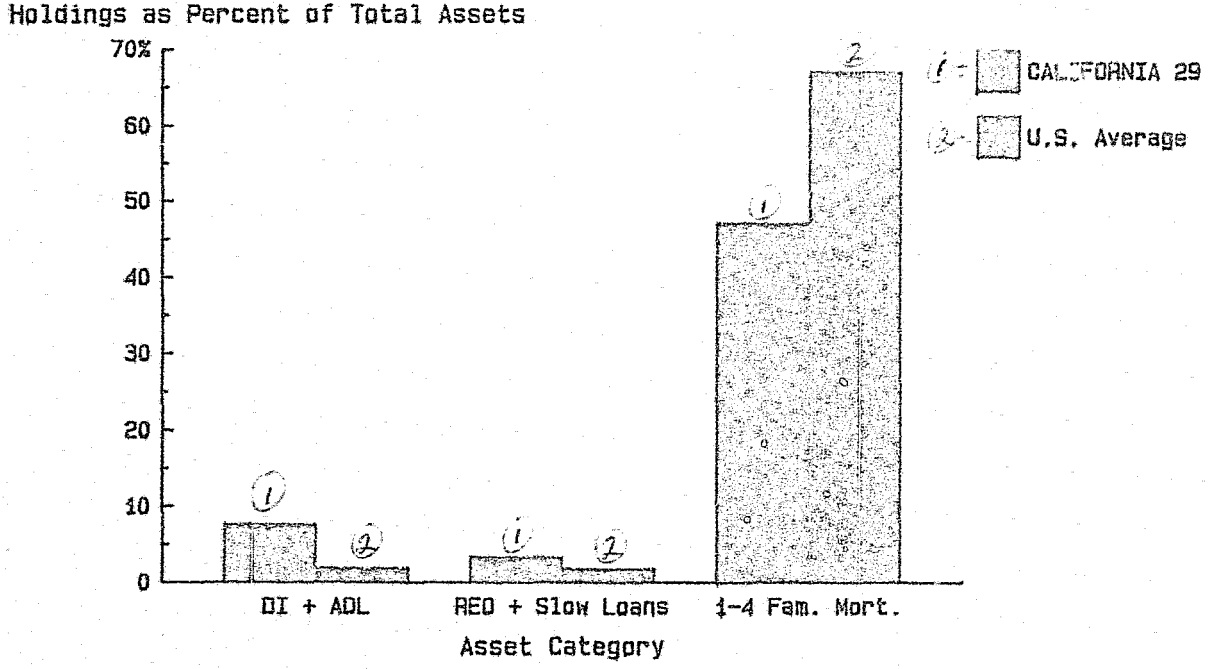
[The charts referred to follow:]

Cumulative Average Annual Growth
The CALIFORNIA 29 and the U.S. Average
1983 - 1986



Based on year-end reports

Comparison of Asset Holdings
The CALIFORNIA 29 and the U.S. Average
1982



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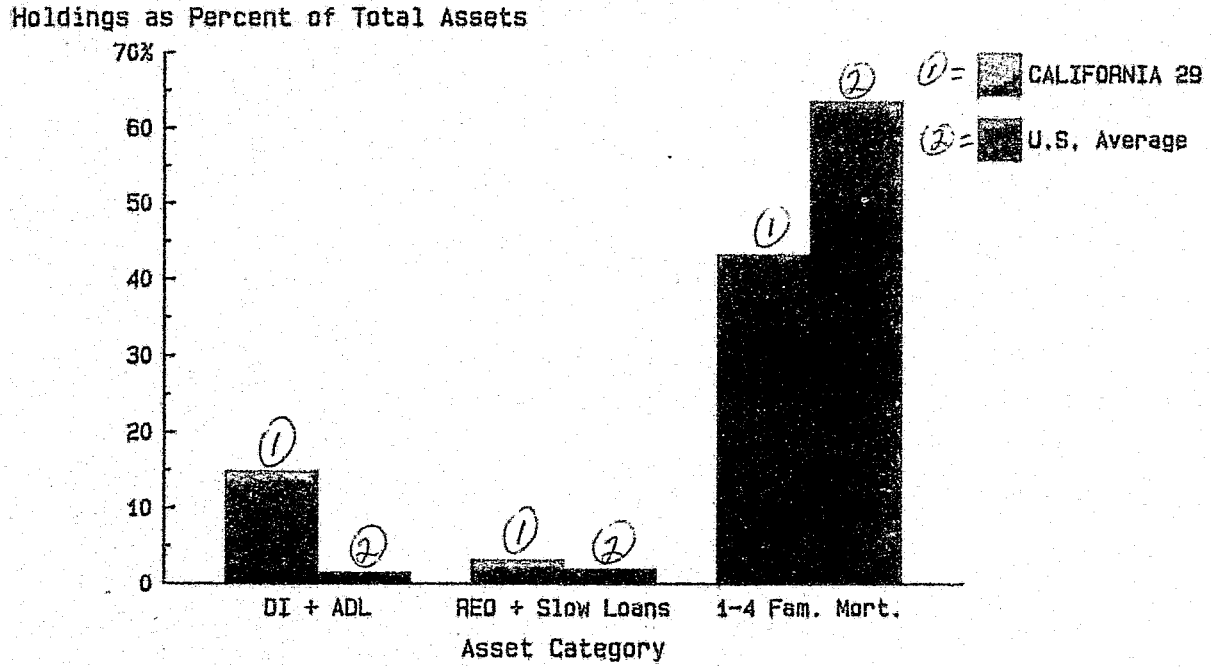

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Comparison of Asset Holdings
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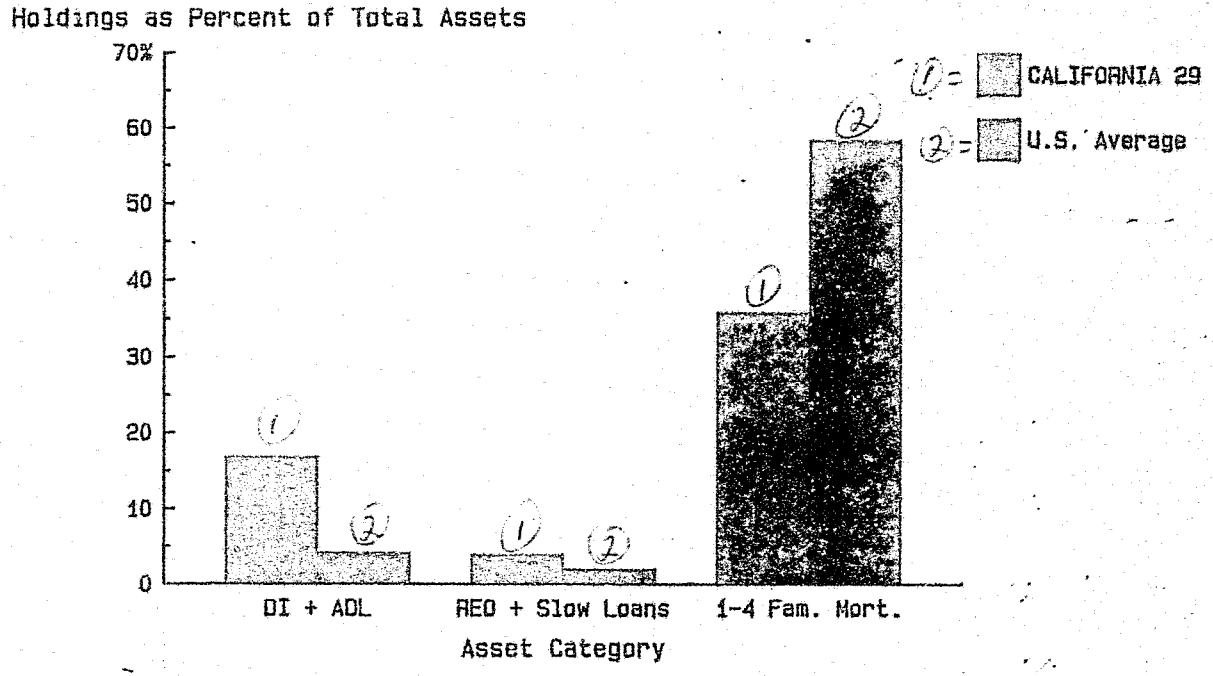
1984



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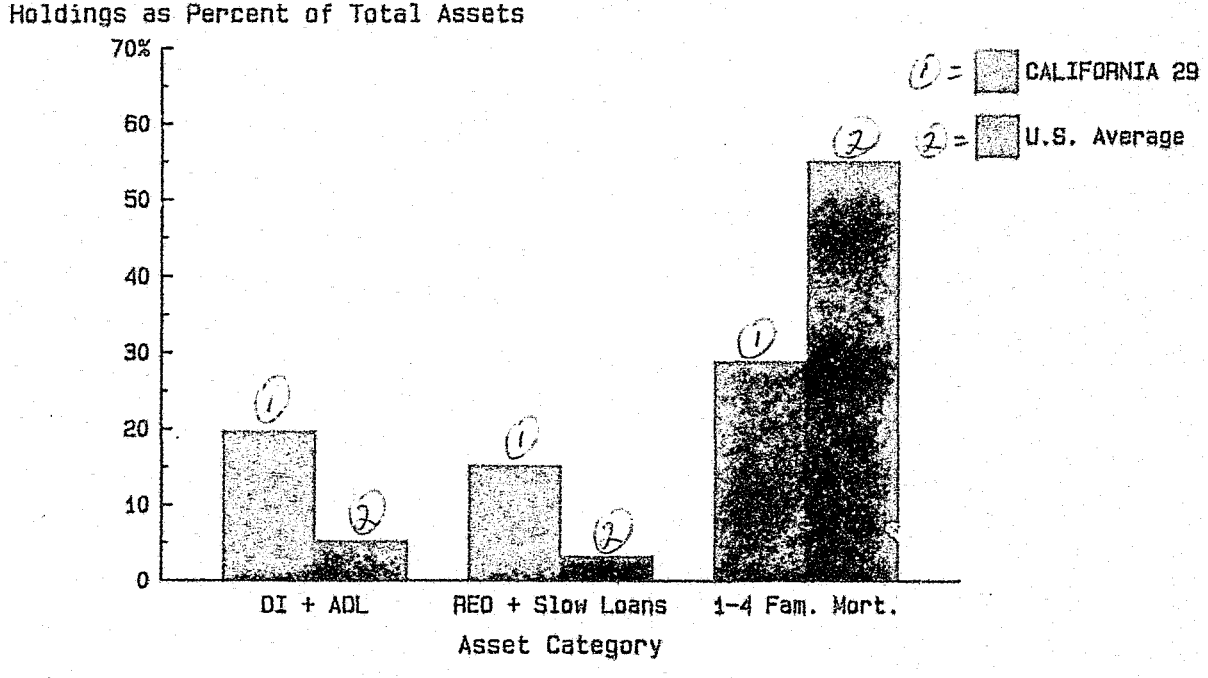

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Comparison of Asset Holdings
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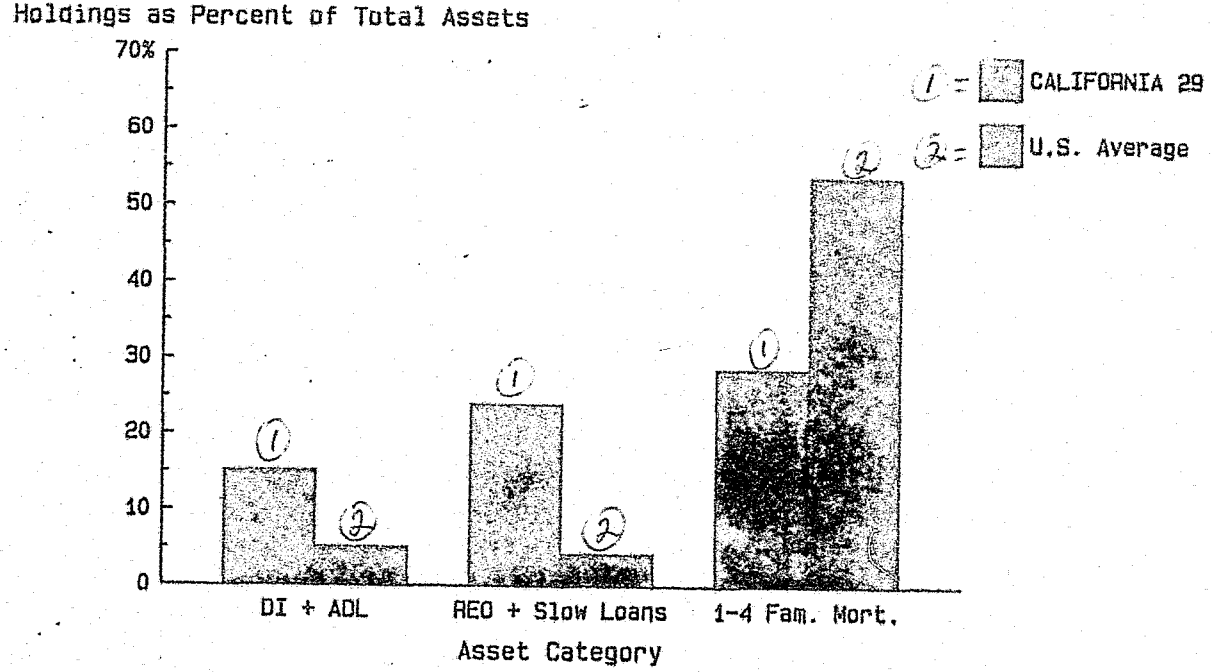
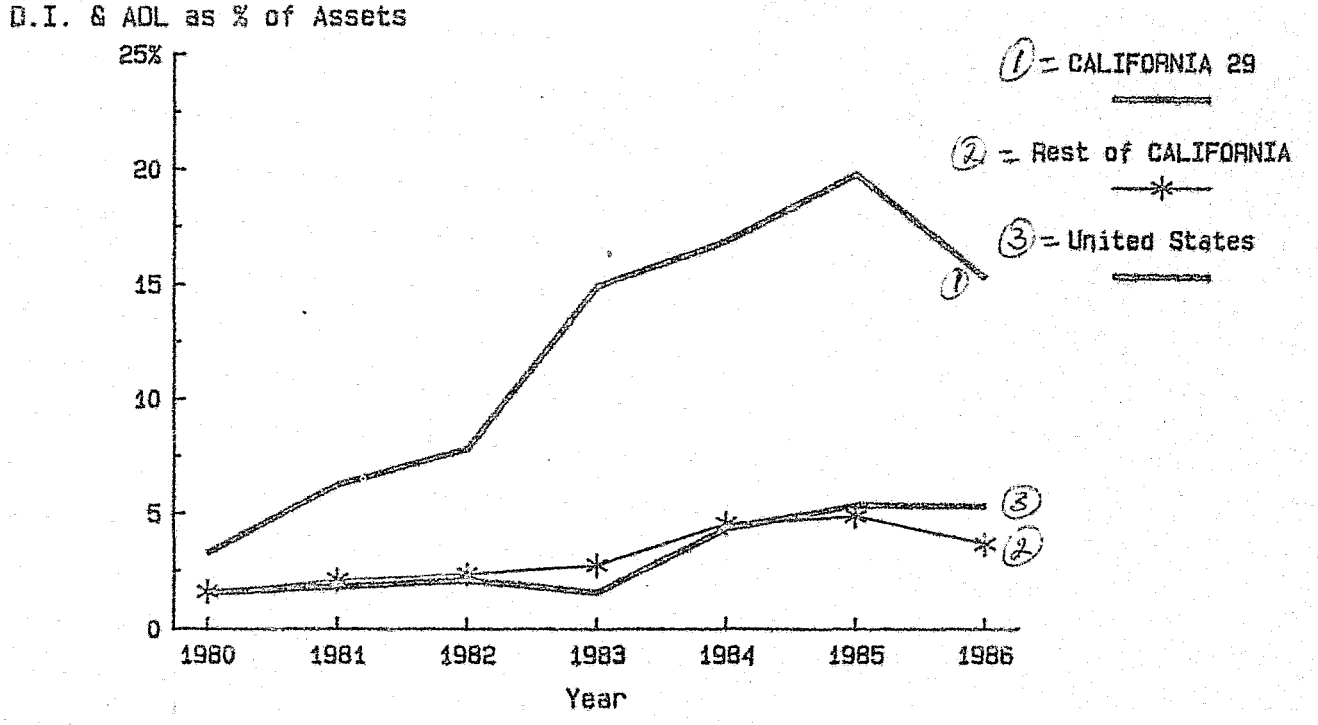
1986

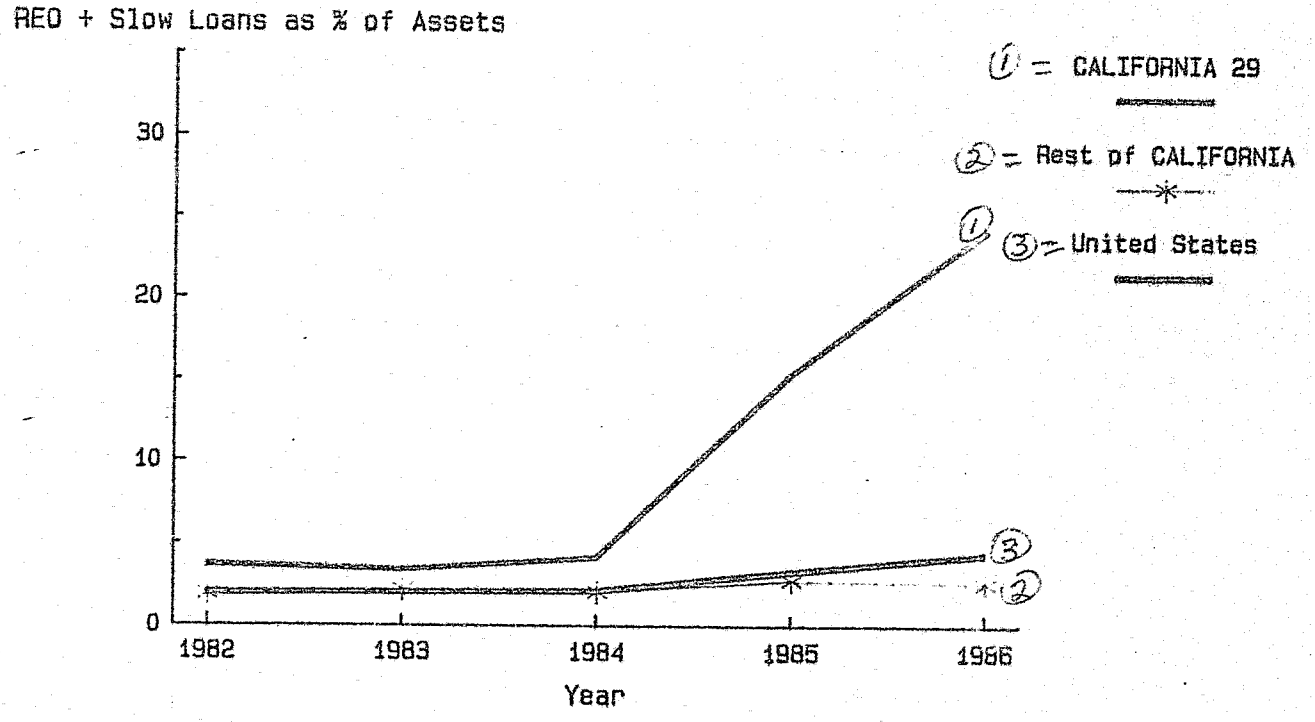


Based on year-end reports

Direct Investment, (D.I.) & Acquisition, Development and Land Loans (ADL)



Problem Loans as a Percentage of Assets



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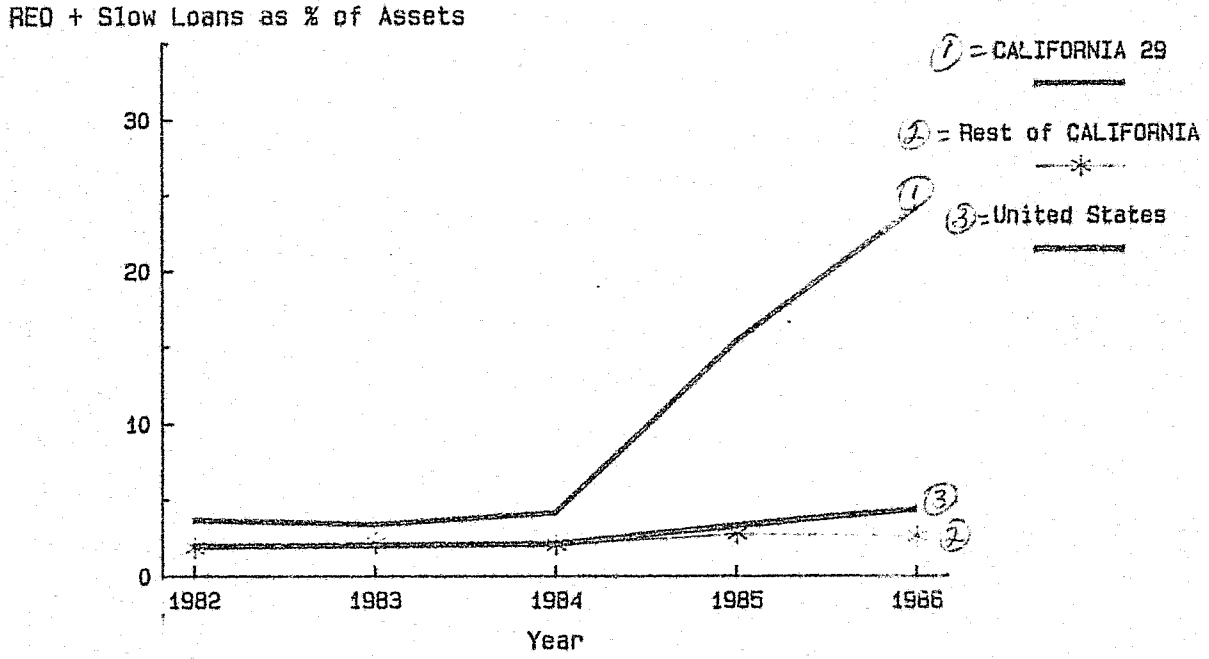

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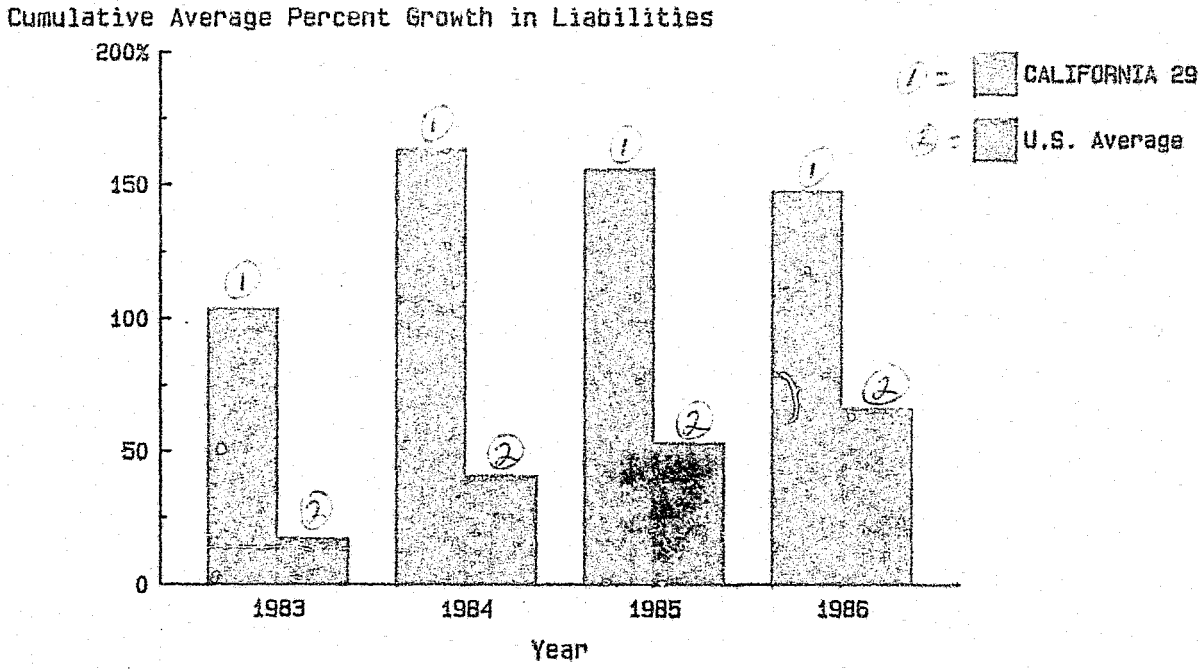

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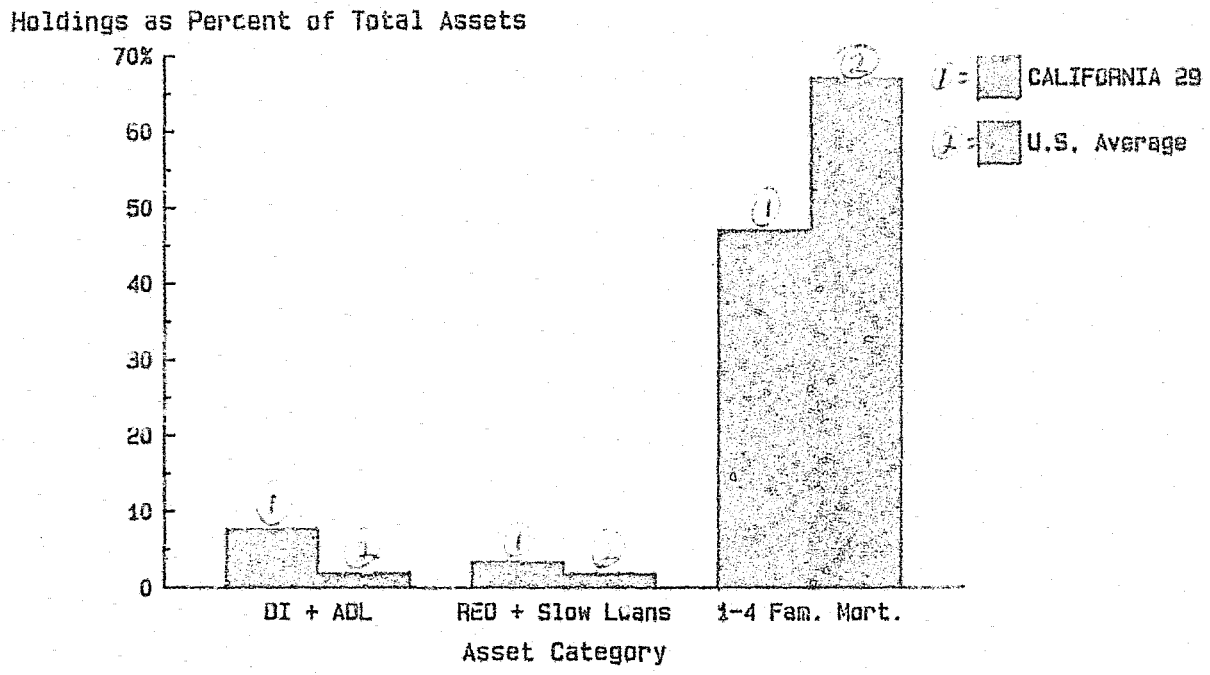
1982



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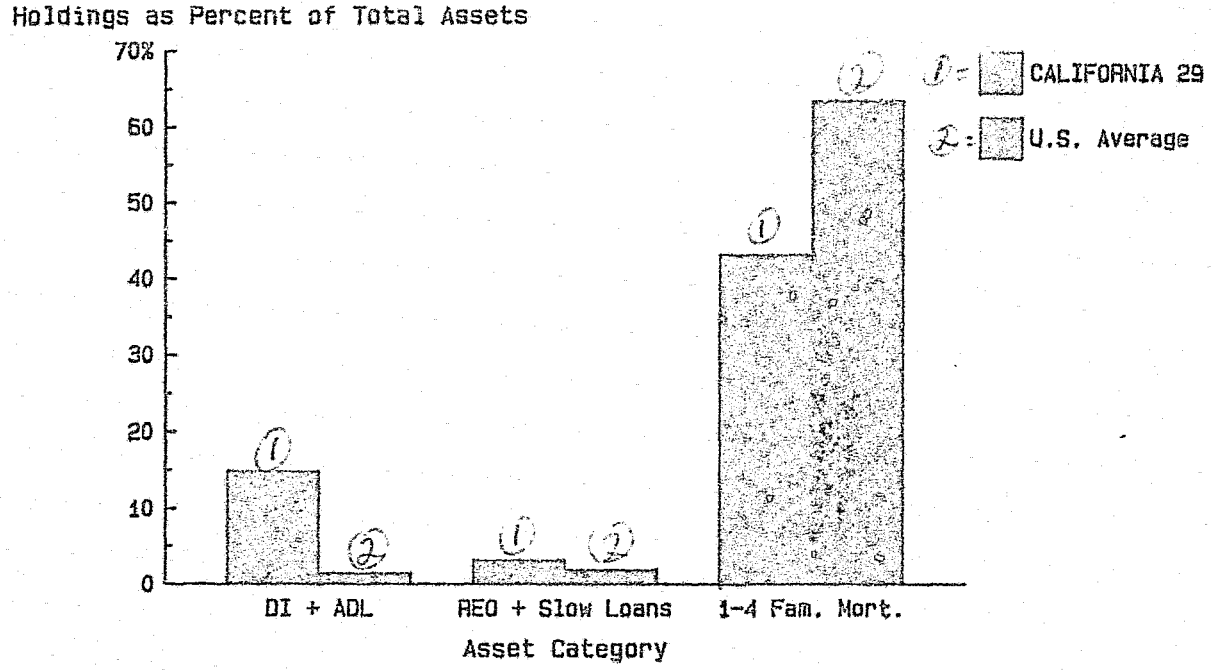

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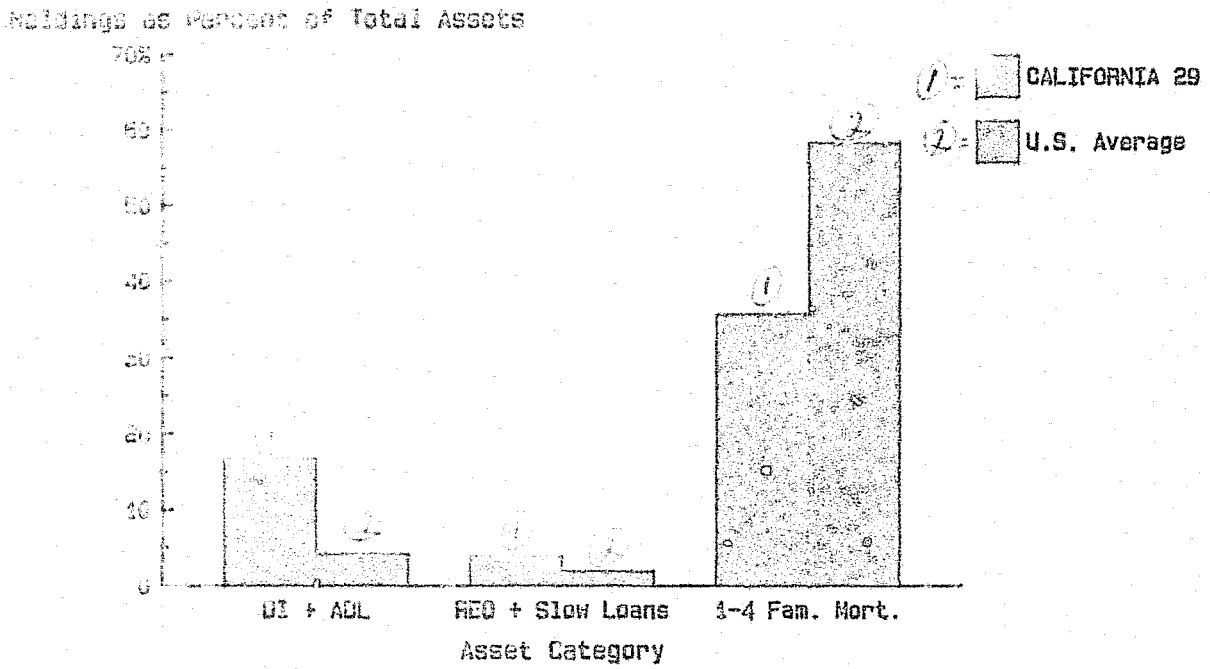

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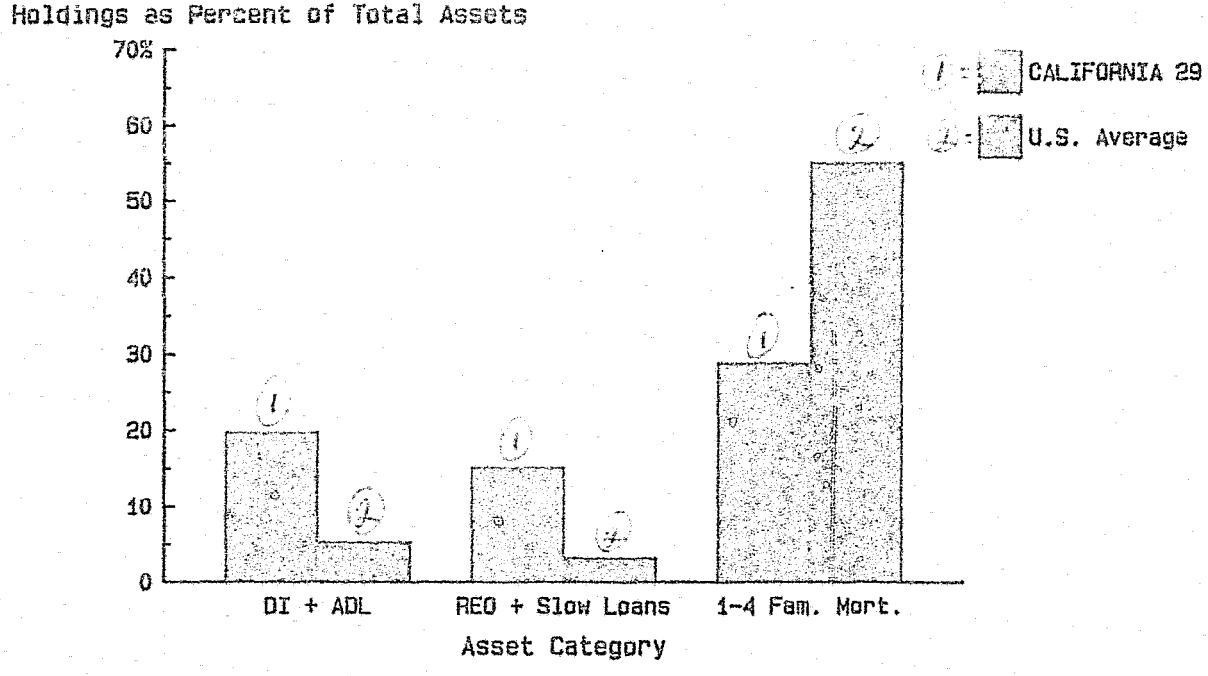

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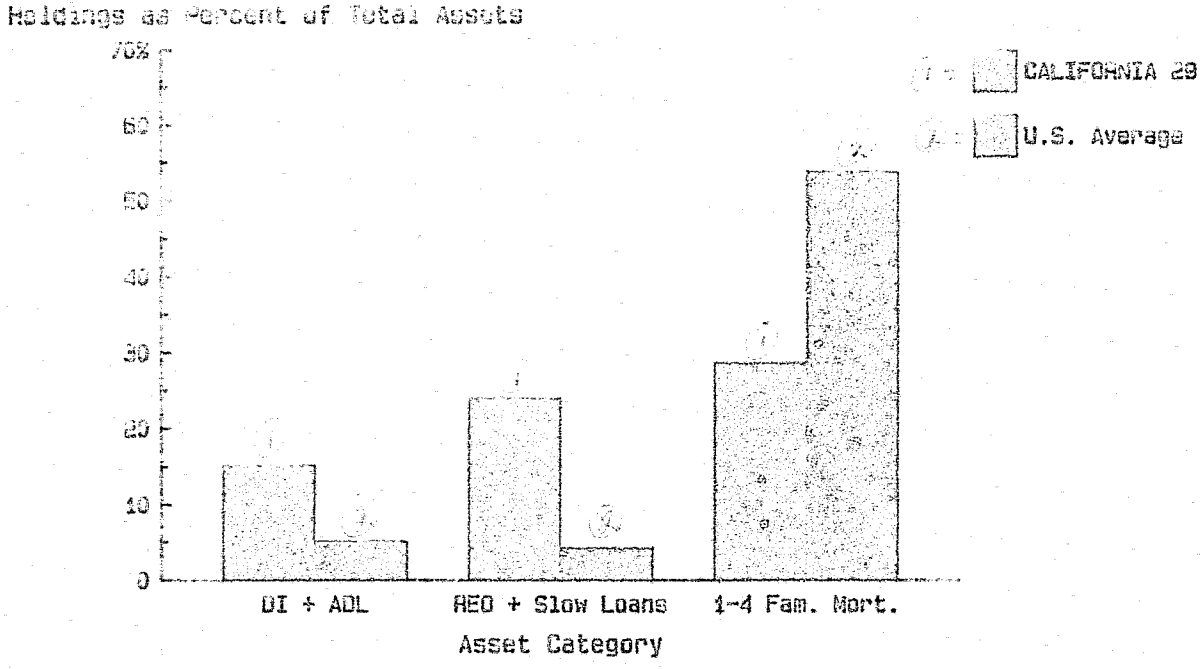

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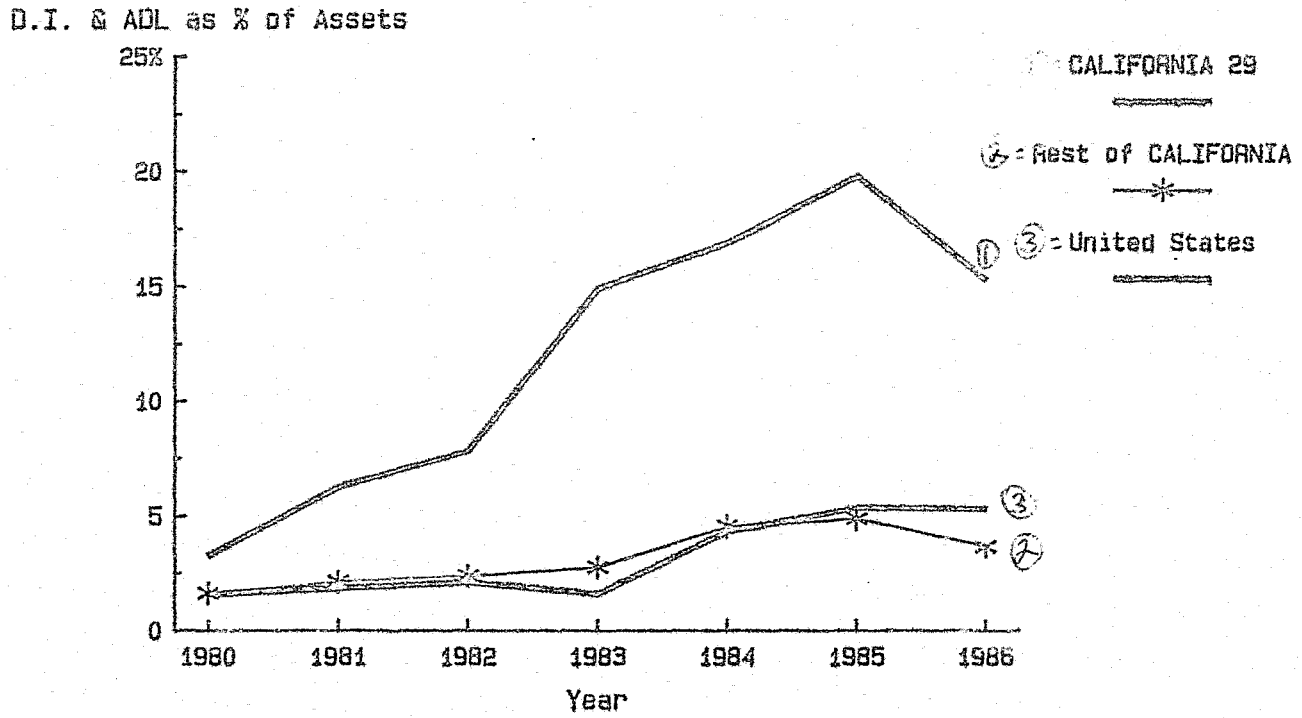

Mr. BLACK. You can see that in 1983, the average one of these 29 institutions grew more than 100 percent, more than doubled in 1 year. I mean, we are talking about truly phenomenal growth. You can also see in 1985 and 1986 after the growth regulation went into effect, that you started actually to get a decline in the size of these institutions. Of course, a number of them also started entering receivership, and their assets declined for that reason as well.

In addition to the growth, they went into extremely different asset portfolios in other institutions. The next chart, I think, that you have in front of you, shows what happened in 1982, 1983, 1984, et cetera, through 1986; and you will see that the percentage of home loans they made declined steadily; the percentage of direct investment and acquisition development and land loans—that's what the DI and the ADL stand for at the bottom of those bar charts—increased dramatically; and then, with a lag, but very significant, you can see what happened to the troubled loans.

And that REO stands for "Real Estate Owned," and that basically means foreclosures; and slow loans—the loans delinquent 60 days or more. And you can see, it just kept on growing and growing and growing.

Two other ways of looking at it are the last two charts, where we put all the years together. Those are the charts with the lines, and you can see the degree of difference. For example, in 1985, you are talking about nearly 20 percent of the assets of this group of 29 institutions were in direct investment in ADL, two of the asset categories carrying the highest variability and risk, and that you are talking on the national average, and, indeed, the California average in that same year, as about 5 percent.

Mr. BARNARD. What does ADL mean?

Mr. BLACK. Acquisition, development, and land loan—it is very much like an acquisition and development construction loan.

Let me just—are those types of loans immediately familiar? Because they are really amazing creatures. I could do it fairly briefly.

Mr. BARNARD. Yes, do that. I think that would be helpful for the record.

Mr. BLACK. All right. The land loan simply means that you are only buying the land typically and doing some of the initial clearing. The ADC adds the C, the construction part, where you start putting up the building where you have the land and you have done some site improvements.

The typical bad ADC and ADL loan—and I am not saying that all ADC and ADL loans are bad; I hope that's clear—but the typical bad one that we're suffering from, you financed 100 percent of the loan. In other words, no money down for these folks; you financed all their points and fees, and those points and fees were typically very high because these were very risky loans, and they would have to pay you, say, three to five points, in many cases, to make these loans.

In addition, you did something, you created something called an interest reserve. And that's a concept that has to be explained to have its full import really understood. You create an obligation—say, it was a million-dollar loan with 10 percent interest, and say that you had interest-only payments for the first few years, and then a big balloon with the principal due. So, you really were

making a loan of $1.2 million. Let's say it was 10 percent interest. You distributed, gave the real estate developer a million dollars; you made him sign a note—we hope. Many of these didn't even have obligations; they were personal. They had no personal guarantee. But, say, you got the note for $1.2 million. The other $200,000 you kept in your S&L, and then every month you made a bookkeeping entry in which you credited an interest payment; and what all of this together meant is this: You booked extraordinary income when you made these ADC and ADL loans, because you took up front as income all the points and all the fees.

On top of that, you booked these very high interest rates. These are typical, variable, you know, prime plus two, three type loans—you booked the next 2 years out of your interest reserve as income.

Now, note, all of this is money going out the door; zero money has come in the door, but now I am recording record profitability, and that is particularly true if I grow like crazy and I harken back to the first chart. These folks were growing at an incredible rate, and so they looked like many of the most profitable institutions in the country. I know the chairman has had experience with our bad experience at Empire. Empire was such a case, which until relatively close to its failure, reported one of the highest rates of profitability in the entire country.

Now, these things then were also added an important thing because of the interest reserve. They couldn't go delinquent while the interest reserve existed. By definition you were paying yourself for the first 2 years, so the examiner had very limited ways of proving that this was a bad loan.

And even if the interest reserve finally ran out, there were a series of scams that were done. The clumsy one was simply to refinance it yourself; and, of course, when you refinanced it, it had to be a bigger loan, because by now more was due, and you booked new points to these, and you reported new profitability.

If that one seemed too clumsy, you'd do what one magazine has called the I'll give you my dead cow for your dead horse routine. You found another savings and loan in a similar problem, with the examiners getting too close to their bad loans, and you would either purchase or refinance their bad loans, and they would do the same thing for you; and you would both again report new income and new profitability and you would laugh at the foolish examiner who had ever claimed that this was a bad asset.

A third variant of it was the nominee or strawman, or shill—whatever phrase you want to use—sale, where you would give somebody who purchased it, again, typically a profit, and book a new profit. But, of course, the purchaser, you'd give him or her 100 percent loan, and you would often make it what is called a nonrecourse loan, which is to say they had no personal guarantee, which meant they had no real responsibility.

Now, at the worst thrifts, they combined this course with insider abuse; but, even before the level of insider abuse, you simply had outrageously poor underwriting because you are growing so fast and hard, nobody has time to underwrite at these growth rates, and many of them had unbelievably poor disbursement practices as well, where you didn't look at where the money went. So, for example, FSLIC is now the not very proud owner of a $22 million, five-

story, block-long hole in the ground in Dallas, because folks didn't even make sure in their disbursement that productive things were being done with this money they gave away.

So, again, as I think the chairman concluded, these things were really direct investments; they were really equity risks. The accountants were in on the scam, typically, so that they wouldn't account for them as direct investments. because if they did, you couldn't book all this up-front income and you couldn't book the income from the interest reserves, as well.

So, that's a story on something that Commissioner Crawford alluded to when he talked about the financing, but I think, you know, fleshed in, you can see just how effective these kind of bad loans are in destroying institutions, first; but, second, you can also see why these are the perfect device for fraud and insider abuse. And that's why you get the high fraud and insider abuse at this kind of shop that is heavy into this kind of investment, not somebody that is running a traditional S&L. It's much harder to run the scam with one- to four-family mortgages; and our experience is very similar.

There's a couple of ways of looking at it. Here in California, 29 of the 31 institutions you are looking at are State-chartered institutions that took advantage of the more liberal investment powers granted by the State.

I mean, you have run an empirical test, in one sense, of what it meant. Now, I don't mean to say that there aren't people making very good use of those liberal powers, but there is a bottom downside, too, and this downside, I submit, has been an unconscionable price, that's the over-$5 billion figure that you've looked at, which is not—again, our message is—this is not simply fraud. These people, even on the loans where they were not engaged in fraud, were not engaged in any conscious insider abuse, but typically made a series of acquisition, development, and construction loans, and very poor direct investments as well, and they created significant losses.

Another way of looking at it is Texas, another State with very liberal investment powers. Of the FSLIC caseload, of which there are approximately 40 institutions in Texas—and to me, the FSLIC caseload means that it is going to cost FSLIC money to resolve the problems at the institution; and, as a practical matter, pretty much means that they are deeply insolvent. Ninety-eight percent of the insolvency, the gross insolvency at those 40 shops, is in the State-chartered institutions.

A third way of looking at it is simply by taking a group that one of the strongest proponents of direct investment, Professor Bensten, cited originally back in 1985, as a demonstration of why these newer powers were producing successes.

He looked at a group—I think his group was actually something like 35—there were really 37 we found that met his characteristics—institutions that had put more than 10 percent of their assets into direct investments by the end of 1984. And he looked at them in 1985, and said, these guys are doing above normal. They are more profitable than other folks, et cetera. Well, indeed, they were. Not simply from direct investments; they also did huge numbers of acquisition, development, and construction loans, did a lot of that

up-front booking of income. But, again, when you looked at them, most of those were really direct investments.

Well, we looked at them, at the end of 1986, or ballpark, near the end, like third-quarter 1986 again; and 21 of those 37 institutions that were his demonstration of why this was a good idea and very successful in practice—21 of them were either already dead, or had fallen to a level of being on our significant supervisory caseload, which indicates that you are a deeply distressed institution, and many of them that have not formally been put in receivership or conservatorship are on that sort of next-worst level in our FSLIC caseload, which is, as I said, a subset of the significant supervisory caseload.

There have been tremendous downsides, and one of the messages that we give you is that people combine the two. You know, it's a double-whammy. It's the folks that do insider abuse plus significant growth and high risky investment that show up at our shops that we lose the 300 million, 500 million, 700 million of dollars on. So, if you look at the catastrophic, the truly catastrophic failures, you will find in virtually every single one of them the combination of these highly risky assets, plus insider abuse.

Mr. BARNARD. Mr. Black, how long does it take to discover those situations? I mean, from what I'm listening to, and of course, from our hearings on direct investments, this is like what Yogi Berra said, this is deja vu all over again. But, how long does it take to discover these horrendous situations on the misuse of direct investments, and these other fraudulent practices?

Mr. BLACK. It depends on the time. Back in 1983, 1984, as you know, from some of your prior hearings, we had fewer than 750 examiners, and there were a large number of shops that people simply could not go to, because if you went to them, you didn't go to somebody else.

And, as you also know, the people—we were subject to the OMB and OPM limits that the FDIC was either exempt from, or largely exempt from, so when our folks got more experienced, a number of them would walk across the street, and make 25 percent more.

Mr. BARNARD. Well, now that you have transferred examiners to the original home loan banks, are you finding and discovering these situations more quickly than you did during that period of time?

Mr. BLACK. Absolutely. What we are discovering, I think there is more—I think it is a little misleading, I think what most people think is coming out of this hearing is that there are, you know, hundreds of these people right now actively committing these frauds. Most of what you are really seeing is folks who did frauds in 1984 and 1985; and there is much less of it going on. I think that is absolutely true. Let me tie it to California. The commissioner has done a tremendous job, given his resources; but, at the same time, that, again, the industry was taking off with its massive growth, and the same time that one-third of the savings and loan industry, by asset size, is in this State alone, California cut its number of professionals in its examination and supervision force from, I think the number was, one——

Mr. BARNARD. Down from 100 plus to something around 50.

Mr. BLACK. 126 to 40—I thought it was lower than 50 at one time.

Mr. BUSTAMANTE. It was 172 to 55, if I remember correctly.

Mr. BLACK. I think there was actually a year when they were even lower than that. Their number of professional appraisers went from 40 to 8, you know. You can guarantee that, if you don't put even remotely enough examiners and supervisory agents out there, what is going to happen, and it did happen; and, you know, we can yell and kick, and we certainly didn't do things perfect, even with the number of folks we had. But that's the biggest story of what was happening.

Mr. BARNARD. Can you tell us, what has been your experience recently? When did the original banks take on the examination responsibility?

Mr. BLACK. I think it was August 1985, and by December 1986, we had gone—in that time period I've given—from 750 to slightly over 1,500 examiners, and we had nearly tripled our supervisory agent force, as well.

Mr. BARNARD. Well, can you tell us, then, is there enough information to go on as to what that record has been on direct investments and——

Mr. BLACK. Well——

Mr. BARNARD [continuing]. See, when we go back there in time, when we talked about direct investments in 1985—I guess it was 1985, wasn't it, when we had our hearings on direct investment—the big problem that was developing then is why we were not able to discover the fraudulent abuses in direct investment early on. Of course, it was somewhat of a problem for me as a former bank examiner. And, of course, I think it is very obvious that you didn't have enough examiners in the field, and evidently, we did not have enough foresight at that time to know how to target those institutions which were offering, you know, 150 and 200 and 300 basis points more for their money. So, we had a problem as far as that was concerned.

But really that was, wasn't it, one of the main problems?

Mr. BLACK. That was one of the main problems. In addition, in Texas, for example—the whole Dallas district—there was a 30-percent turnover rate. And they were bringing folks in at starting salaries of $14,000 to deal with what was now no longer sort of a sleepy industry that did one- to four-family mortgages, but was doing these incredibly—sophisticated may be the wrong word—risky might be the right word, but they were very different, very complex transactions with multiple parties, and all these scams going on. It was ridiculous.

Mr. BARNARD. I'm going to throw you a soft pitch, and then we will go to Mr. Martinez, a very soft pitch.

Where did this primarily take place?

Mr. BLACK. I'm checking my wallet.

[Laughter.]

Mr. BARNARD. Where did this primarily take place?

Mr. BLACK. It primarily took place in the States that liberalized their asset powers. The worst States in terms of losses, fraud, and insider abuse, which are the areas you are talking about are California, first—California, Oklahoma, Louisiana, and Texas.

Mr. BARNARD. In those States, what did the Home Loan Bank Board do to increase its cease and desist powers and its other supervisory powers that it had, to improve conditions in those institutions? Did that number increase as well?

Mr. BLACK. The number, I'm sorry, of cease and desist orders?

Mr. BARNARD. Yes.

Mr. BLACK. Yes. The number of cease and desist orders and other enforcement actions has dramatically increased. And it is a good question because your first question was detection. That is a huge problem but then stopping is the next problem; and precisely the scams I've discussed were aimed at, OK, even if you detect me, you can't prove a loss.

And our enforcement statutes, generally speaking, are tied to the existence of a loss. So, if we can't prove you've lost anything because you keep the ball moving, we are in deep trouble, first.

Second, again, with your hearings, I think you were—maybe we even testified—in the Dallas district, the average time to get an appraisal back that conformed was when we set out to do a reappraisal because we thought it was a problem loan, was 9 months.

Well, that's ridiculous; these institutions are growing 100 percent a year. It's 2X.

Mr. BARNARD. Who did those appraisals?

Mr. BLACK. Those appraisals were done by some of the best folks in the industry; and part of the reason it took so long is that, as you have well documented, there are significant problems in this industry. We know when we do the reappraisal we are going to get challenged in court, and it has to be a first-class job. Again, that is exactly what you are asking, I think, from your banking background. I assume one of the questions you are asking is what in God's name is going on if the banking examiner saw this, they would classify these assets.

Well, we had no classification of asset powers. We had no classification of assets regulation until 1985. In fact, it wasn't effective, I think, until January 1986, and it was done over tremendous opposition from this industry.

Mr. BARNARD. Do you mean to tell me that there is no classification of powers?

Mr. BLACK. Not until January 1986, was such a regulation put into place by the chairman.

Mr. BARNARD. Well, that's something new to me.

Mr. BLACK. Well, that—that is one of the real keys. That is one of the things that people don't understand, especially that have seen the other industry; and, frankly, we have now stolen a number of the top regulators, as you may or may not know, from banking agencies, and the first thing each of them does is to get into our system, and get—what in God's name is going on? What do you mean we can't impose, for example, civil money penalties? What do you mean that I can't classify this asset? What do you mean that I can't just go on, and say, this is ludicrous?

Mr. BARNARD. Has all of that——

Mr. BLACK. We can't do anything on these 100 percent loans.

Mr. BARNARD. Has all of that been changed now?

Mr. BLACK. The classification of assets regulation has been changed, but it has run into, you know, pick your cliche about political fire storms, and, in particular, in Texas. And——

Mr. BARNARD. Well, you know that's amazing to me. And I say this is amazing, sitting on the Banking Committee, because, as you know, we've heard a lot of proposals from the Home Loan Bank Board, from the standpoint of new legislation, including some on direct investment, which I'm looking at in a new light. I am going to be open-minded anyhow, and I don't want some folks in the audience to keel over and faint when I say that. But I would like to say that we have had various proposals from the Home Loan Bank Board for legislation, but we have never had one that permits you to classify loans.

Mr. BLACK. Well, maybe we didn't need that. Now, I think we have statutory power—the problem, and we have a regulation doing it, but the problem for us, with legislation now, is that the House recap bill has two things in——

Mr. BARNARD. I know.

Mr. BLACK [continuing]. That are going to gut our classification of assets power. One of them says that we cannot require additional reserves for substandard assets.

Mr. BARNARD. Why didn't you take advantage of this before now?

Mr. BLACK. Well, the regulation should certainly have been put in in an earlier year.

Mr. BARNARD. Absolutely.

Mr. BLACK. That's absolutely true, but you have to remember if you look back to the statistics on acquisition, development and construction loans, for example, there were tiny amounts of it before 1982, and then suddenly in particular in Texas and some in California, you start getting a progression where it's doubling and tripling each year.

It takes people time to do it, and people used to—our system was traditionally driven by, as I say, default, delinquencies. The loan was 60 days late. Well, that works great with a home loan. That's a good indication of when a home loan is in trouble if you miss the 2 month's payment. But with these interest reserves, they targeted it in such a way as to perfectly negate our usual system for detecting the problem loan.

And, then, frankly, the industry fought like all heck against our classification of asset regulation and stalled it considerably. And I think that's irrational. I think the good folks in the industry ought to be realizing that the worst burden they bear is when we can't stop these kinds of practices, because there are only two places the $5.3 billion is going to come from: It's either the taxpayers or this industry. And it is just irrational to restrict our powers when it's clear to everybody that looks at it, your subcommittee, that the problem is a lack of effective supervision in the past to stop some of these problems.

Why in God's name, in light of that, would you pass legislation restricting our powers instead of expanding it?

Mr. BARNARD. I think you are correct logically, but politically I think you know why.

Mr. BLACK. Yes, politically, I know why. But that's part of the answer as well. Not only was the classification of assets regulation

fought before it was put into effect, but as soon as it was put into effect and was used against ADC loans——

Mr. BARNARD. Do you think there is a national understanding across the board? You've got 435 Members of Congress, and you've got 100 Senators. Across the board, do you think that there is a clear understanding of this problem?

Mr. BLACK. No. Nobody got—I mean——

Mr. BARNARD. I mean I say that for this reason——

Mr. BLACK [continuing]. Very few people understand what an ADC loan is, what in God's name that means in terms of enforcement.

Mr. BARNARD. But I mean, when you get down to understanding the situation, when Members of Congress talk to one another and they compare illustrations—now, we have one Member of Congress here from California, and another here from Texas, and I brought them purposely because I wanted them to see what is going on in their States.

Mr. BLACK. I thought you needed a quorum.

Mr. BARNARD. But the problem is, the problem that I'm saying is that the Home Loan Bank Board feels very insecure that they are not, that they are about to get legislation, which they don't deserve; and I can understand that. But the point I'm saying is that that understanding is not—there is not a general understanding of that across the board, and the industry, I guess this is heresy to say this, in a way, but I'm not a part of the industry, I'm a part of Congress—the industry is not helping you in that regard.

Mr. BLACK. No, they certainly aren't, they are hurting us.

Mr. BARNARD. Well, anyway, we—you know, we can go on and on with this, and I have taken up too much time, so I'll go to Mr. Bustamante, and then I'll come back.

Mr. BUSTAMANTE. Mr. Chairman, of course, for Members that are not only the Banking Committee, and I know that Mr. Martinez and I are not on the Banking Committee but I have been involved on this subcommittee—and it is very, very difficult really to understand. So I can understand how difficult it would be for other Members of Congress that are not involved at all in this area.

I've been looking at some of the testimony with interest, and simply because it applies to some of the parochial areas that I represent—in my area, San Antonio in south Texas; and Mr. Gabrellian, is that——

Mr. GABRELLIAN. Yes.

Mr. BUSTAMANTE. Can you tell me a little bit about South Bay Savings & Loan and some of their involvement, and some of their procedures as they went through, not only South Bay, but I think San Marino——

Mr. BLACK. I can answer with regard to San Marino——

Mr. BUSTAMANTE. Actually, did you have anything against Mr. Bona, and Mr. Dominguez was involved, since they are mentioned here.

Mr. GABRELLIAN. South Bay, Congressman, South Bay Savings & Loan Association is one of the institutions that I in my capacity as a trial attorney in the Litigation Division, I'm responsible for. In April of this year, South Bay Savings & Loan Association, which is located in Gardena, CA, was placed into FSLIC receivership.

South Bay was a relatively young association. I mean, received its insurance of accounts, in May 1983, I believe, and started up business at that time.

Frankly, Dominguez and Jack Bona entered South Bay and acquired in the aggregate a majority of South Bay's outstanding stock, and provided the needed capitalization was South Bay's against credits.

It is the FSLIC's practice whenever an institution is placed into receivership to conduct an investigation into the circumstances of the association's insolvency and failure. That investigation is currently taking place at this time.

A number of South Bay's loans and investments were centered around properties and projects located in Texas.

Mr. BUSTAMANTE. Dallas—the Dallas area?

Mr. GABRELLIAN. In the Dallas area. That's correct.

Mr. BUSTAMANTE. And Corpus Christi?

Mr. GABRELLIAN. And Corpus Christi.

The three largest projects were know by various names, but in the testimony that I provided, they are known as Briarcliff Department Project, Biscayne Project, and the Greenway Gardens.

The first two were located in Dallas, the last, in Corpus Christi. These were condominium conversion projects and the funding for the loans was provided, based upon appraisals that value the projects on the basis of their conversion value, that is, their value as condominiums.

Mr. BUSTAMANTE. Did they use the same scheme, saying that they would put up 80 percent on a 100-percent loan on the property in other areas of investment, and the other 20 percent was to repay the loan interest for a number of years?

Mr. GABRELLIAN. Mr. Congressman, I hestitate to speak specifically about each project and the various loans that were made on each project, in part, because the information isn't available to me; and, also, in part, because our investigation is still continuing. However, as a generality, that was the case.

Briarcliff and Biscayne were loans, whereas Greenway was a direct investment of South Bay's. We anticipate, Congressman, that losses will be borne on all the projects, losses have already been borne on all three projects. The nature of the transaction with South Bay, in which it was placed in receivership, was called a purchase and assumption transaction so that another institution has acquired substantially all the assets and liabilities.

Mr. BUSTAMANTE. So, can we say that the real estate transactions alone for these two individuals contributed to the failures of both institutions?

Mr. GABRELLIAN. Both institutions?

Mr. BUSTAMANTE. Well, the South Bay and Ramona?

Mr. GABRELLIAN. Ramona Savings & Loan?

Mr. BUSTAMANTE. Yes.

Mr. GABRELLIAN. As far as we know, Frank Dominguez and Jack Bona were not involved in the Ramona Savings & Loan.

Mr. BUSTAMANTE. San Marino?

Mr. GABRELLIAN. San Marino.

Mr. BUSTAMANTE. Both of these institutions participated in these loans? Am I correct?

Mr. GABRELLIAN. No, that's not correct.

Mr. BUSTAMANTE. Just South Bay?

Mr. GABRELLIAN. South Bay participated in these loans. It is possible, but we have not disclosed that.

Mr. BUSTAMANTE. But it was the same channel, in other words? It was used in both of these S&L's?

Mr. BLACK. With your indulgence, there is not a lawsuit at this time on this institution, and I know we have briefed your staff fully. If we could—if we are going to go into those kind of specifics, if it would be possible to either do it confidentially, or we would really appreciate it in terms of not jeopardizing——

Mr. BARNARD. We are going to have further hearings on this, so why don't we defer that until the further hearings. We are going to be doing that in Washington.

Mr. BUSTAMANTE. Thank you very much.

Mr. GABRELLIAN. Thank you.

[SUBCOMMITTEE NOTE.—See appendix 1 for subcommittee staff memorandum concerning these individuals alleging misconduct by them in San Marino S&L and South Bay S&L.]

Mr. BARNARD. I didn't mean to interrupt, but we are going to——

Mr. BUSTAMANTE. Well, I just wanted to find out the patterns that were used. One of the individuals, Mr. Chairman, Mr. Dominguez is supposed to have been a very prominent name in the San Antonio area with investments and different real estate transactions, and I wanted to find out a little more, because it is an area that I represent—it is an area that I represented as town judge, and I was the county judge in the early eighties; he had come in and was paraded around town as a substantial investor in our area, and this is one of the reasons that I wanted to get a little more.

Mr. BLACK. We would be happy, as well, if it meets your desires, to brief you at any time prior to such hearings.

Mr. BUSTAMANTE. OK.

Let me ask you, Mr. Black; Mr. Lundin is going to recommend in his testimony establishment of a system or informal network in which fee counsel and the enforcement agency, so that fee counsel could, for example, easily identify persons within this enforcement agency, and also, in my opinion, get a feel for which type of misconduct violates the Federal criminal statutes. How could such a system be implemented? How can fee counsel be better educated?

Mr. BLACK. Well, there is a computer system that the Bank Board adopted by regulation, the Bank Board would like to fully implement it. Well, the Chairman would like to have adopted it earlier; he had to wait for a new Board to get positive results. That computer system goes by the delectable acronym "CIIS," and it is being loaded in now. Our fee counsel will be able to draw on that. So, it's in operation. There is a lot of data that needs to be loaded, so it takes time.

Mr. BUSTAMANTE. Thank you, sir.

Mr. BARNARD. Mr. Martinez.

Mr. MARTINEZ. Thank you, Mr. Chairman.

Earlier—and I had wanted to ask the question at the time because it gave me a queazy feeling—you started out to say that most of the situations that we are talking about happened a long time ago. And it almost sounded as if you were inferring that it wasn't

happening anymore. And then you did clarify it by saying that there were instances, but you seemed to indicate that they had diminished.

And what I would be more concerned about in relation to what you said is even though they have diminished because there is a certain awareness now, and there are certain actions that are being taken by the different agencies now; one, to try to stay on top of it there, to expedite reporting when it needs to be reported; and two, to promote interagency cooperation and all, which is very good. But also, after reading the report, I got the idea that even though some of this had been done, it wasn't nearly enough. Further, I got the impression, that it wasn't even scratching the surface. The other inference I got was that a lot of the situations that allow these things to occur, still existed and that there needs to be some correction.

Would you amplify on that?

Mr. BLACK. Well, OK. I agree with some of what you say, and I have perhaps a slightly different view on other things. In terms of the causes, as we see them in what has been done—the change of control, procedures, and regulations that we had back in 1983 were not effective—period. Those have been changed, and we have, frankly, a new commissioner in California. And that has changed things dramatically, in terms of who has gotten charters.

Mr. MARTINEZ. And he has been there, for what—3 years?

Mr. BLACK. Two years.

[SUBCOMMITTEE NOTE.—Mr. Crawford became California S&L commissioner in early 1984.]

Mr. MARTINEZ. And so he is really new.

Mr. BLACK. That's right.

But that has been a dramatic change, our Change of Control Act is a dramatic change—our Change of Control Act regulations were a dramatic change.

But, more than that, it was just plain things that could have been done but weren't, and are done now. We always check now on enforcement. We always do NEXUS runs, and other investigative techniques to find out; with the CIIS system that's going in, that ability will be enhanced further.

So, something has been done about that element that I think everybody agrees is a big problem. The growth problem, which I think again, most every—I don't think there is much controversy, that, at an absolute minimum, it made the losses dramatically worse, and that, in addition it was probably one of the causes itself because of its effect on underwriting. We put in a growth regulation, and a capital regulation, and have dramatically reduced growth in this industry, and have stopped the excessive growth at the weak institutions.

If I can digress for just a second on what we inherited. People always deal with the problem that they are facing, and the Bank Board before Chairman Gray was facing the interest rate crisis, and it was felt that what was needed by that Bank Board was to get away from home loans and to grow like crazy so that these low-interest home loans that were on their books would become a smaller and smaller percentage of their asset portfolio.

So, they, the prior Bank Board—three Board members—reduced our capital requirements from 5 to 3 percent; they debased our definition of capital such that the newspapers used to make jokes about it was "creative regulatory accounting principles," using the first initials as an acronym.

We had something called 5-year averaging and 20-year phase-in, which meant you had 20 years to get up to this very low 3 percent requirement—and, of course, the 3 percent wasn't real anyway because of our accounting changes; and the 5-year averaging was particularly preposterous, because it meant that you didn't need 3 percent of your liabilities that you have now grown up to, you needed an average of what you had had over 5 years. And it created an absolutely perverse incentive to grow rapidly. Your percentage net worth requirement went down the faster you grew, and so you could meet your capital requirement. If you grew rapidly enough with less than 1 percent capital—and, as I said, even that capital wasn't real, because of the accounting changes.

It was a prescription for disaster on the asset quality side. It was a felt need to—I mean, they thought it was hopeless almost on the interest rate side unless they grew that rapidly, and that's why they did it, but it obviously turned out disastrous.

So that we had done something about the growth component, and the risk component. We've got our direct investment regulations, and our new acquisition, development, and construction regulations. We have changed our capital requirements to increase them, and we've gone back to something much cleaner in terms of the definition of capital.

We've put dramatically more examiners out; we make many more criminal referrals. Frankly, we are to the point in California, for example, the numbers you have seen, that when we make each new criminal referral, in essence, we are bumping one that we have already made, down in priority, because people in the U.S. attorneys' offices and the FBI offices here have absolutely the best intentions; they work with us in general very, very constructively; and they don't have the people to do it.

And, I mean—we've been there. When we had 750 examiners, there was no way to do a decent job. You tried to do the best you could, but by definition you were going to suffer massive losses; and by definition, as long as OPM and OMB keep the fist tight around the Justice Department budget and the FBI budget, we are going to have this situation; and it is so incredibly pennywise and pound foolish as to be ludicrous.

But, hey, a true story that the chairman always likes to tell. Of course, OMB hates it when you take folks outside their jurisdiction, as any good bureaucrat would; so when they heard we were going to send our examination force out, their Assistant Director came over to me personally with Chairman Gray, and said, "Hey, such a deal I have for you. If you will agree not to put the examiners out, we will give you 40 new examiners."

Mr. BUSTAMANTE. Who said that?

Mr. BLACK. Jim—I'll get the exact name from our testimony but——

Mr. BUSTAMANTE. No, but what agency?

Mr. BLACK. OMB.

Chairman Dingell has used extraordinarily tough words to describe precisely what they did to us; and it's cost literally billions of dollars to save a couple of hundred thousand—maybe it's a million—in salaries. I mean, what can I say?

So, things are dramatically different now, and they could be even dramatically better if the FBI and U.S. attorneys could get more resources, if nationally the Justice Department could get more resources, because a lot of our problems involve people who do it in six different States. Well, you are always hampered as an assistant U.S. attorney, trying to deal with that. There are reasons to have national task forces as well.

In the offices of the U.S. attorneys that have established special task forces to deal with thrift and bank failures, and people get really expert in them, we have had particularly good results.

And, then, when you deal with that problem, then the problem is, you need real jail time, because right now the message is too close to "Crime pays."

We have people who take these shops. Here's a real example. It was $82 million when they purchased it for a million dollars in cash, took out, grew it like crazy, went into these very risky assets, booked it all as up-front income, used the income to justify huge dividends, huge bonuses, huge salaries; and took out $22 million in 3 years, and that doesn't count all the stuff he took indirectly, the benefit of the Air Force he had—five planes, six pilots; the sistership to the Presidential yacht Sequoia.

Mr. BARNARD. Who are you talking about?

Mr. BLACK. This is Vernon. And the three beach houses here at California, and one of them was $2 million. The three——

Mr. BARNARD. In this case, the fellow has pleaded guilty?

Mr. BLACK. No.

Mr. BARNARD. He has not? This is an ongoing case?

Mr. BLACK. There is no prosecution yet; the receivership was just imposed 2 months ago.

Mr. BARNARD. OK.

Mr. BLACK. The three beach houses, one for $2 million, with three-quarters of a million in entertainment expenses, paid for by the association, and the Beaver Creek Ski Chalet, because, you know, the seasons change, and you want to be in appropriate places at different times of the year.

Mr. BARNARD. OK.

Mr. MARTINEZ. And all that was a very low investment, to begin with, using——

Mr. BLACK. Well, it was worse. It is real insider stuff, friends, maybe kickbacks directly. I mean, Mr. Chairman, you asked in terms of detection, and the difference—is it a simply bad underwriting? or is it fraud? Well, we often really do not know.

You get a situation where the loan is stupid. I mean, it is just an obvious stupid loan, and you have got three choices: The guy who made the loan is just stupid, or he was just doing things so quickly that he couldn't check, or he is getting a kickback, because what else could explain something that there was a guaranteed loss?

But proving a kickback, if people are at all clever—they do it through third parties, fourth parties, indirectly.

Mr. BARNARD. But now, with your—excuse me for interrupting but, if the gentleman would yield—but with your classification system, the FDIC has announced that it's going to go to disclosure.

Mr. BLACK. Yes.

Mr. BARNARD. What is the Home Loan Bank Board—is it considering disclosure?

Mr. BLACK. I don't—the FDIC, I thought, was backing off its disclosure, last I heard.

Mr. BARNARD. Do what?

Mr. BLACK. Backing off—that was—Isaacs was proposing——

Mr. BARNARD. They had a proposal at one time that they were going to disclose the CAMEL rating, right?

Mr. BLACK. Yes, that was the last——

Mr. BARNARD. That was the last you have heard from them?

Mr BLACK. Yes, that was the last head, the new head, I think, has largely reduced that.

But, you know, as a practical matter, anybody can get our quarterlies. I'm sorry—that's our quarterly reports, are available through the Freedom of Information Act.

Mr. BARNARD. Yes, but what about your Bank Board's confidential, individual information system?

Mr. BLACK. Well, I hope that's not available under FOIA.

Mr. BARNARD. But can the FBI get to it?

Mr. BLACK. Yes.

Mr. BARNARD. Can the U.S. attorney's office get to it?

Mr. BLACK. My understanding is yes, and that the sister regulatory agencies—now, if there are some——

Mr. BARNARD. You might want to check into that.

Mr. BLACK. I will check into that, whether they have the restrictions that the State AG was talking about, in terms of you have to be very careful about not abusing civil discovery and such.

Mr. MARTINEZ. You know, then, Mr. Chairman, let me ask you a question, Mr. Black.

You know we as elected officials and elected officials throughout local government—State and local government—are all required to make financial disclosures once a year, and so that the world knows exactly what we are doing. Why aren't savings and loans' officers, especially those that are federally insured required to do the same annually so that it would be a matter of public record, so that we know. In many cases, wouldn't that be a way of determining, hey, all of a sudden this man has recorded all these assets, at whose expense?

Mr. BLACK. I don't have a real answer. I know that nobody does it now. I don't know whether we would have the regulatory, the authority to do it by regulation. We would be pleased to talk with you if that is a legislative concept that you would like to work with us on, and——

Mr. MARTINEZ. One other thing is that in your ability to gain information when you need it, I understand the Privacy Act has you inhibited as to how much information you get in certain cases, and how you can use it. And I would imagine that an investigation is going to be considered confidential, anyway. Have you some thoughts on how you could, or what we could do to expedite your ability to get that information?

Mr. BLACK. We have made officially—the Bank Board has made proposed amendments to the Right to Financial Privacy Act, and we have worked through the working group, which again, has official proposals, which were before Congress last year, and I believe are before Congress again. My statement addresses in part our position—I'm sorry, Mr. Deardorff's statement does—and the attachment of Mr. Robertson and my testimony that was to be given before Chairman St Germain, has, I think, even more extensive discussion of our proposed amendments to the Right to Financial Privacy Act.

We agree with you that amendment is desirable. That is the position of all of the agencies concerned. I think I also agree with what other people have said, that that isn't the biggest problem in the world; by far, the biggest problem in the world is resources for Justice and FBI and sentencing.

Mr. MARTINEZ. Well, I think that in everything you have said, Mr. Crawford referred to temptation and greed. Unfortunately, the need to exercise the greed would lead to continued abuse. However, you have eliminated a lot of this need in the procedures you have set up. At least, the temptation part of it.

What I would say, however, is that there still is a great potential for people in that position of responsibility to take advantage of their position to perpetrate some of these frauds.

Mr. BLACK. I agree absolutely, and one of our messages that we always try to get across is the usual—if you're sitting there, in an S&L that has no capital, it's insolvent—what are you risking?

You have got no money to lose. Why not gut the store? And people use different phrases. The usual one is: "Heads I win, tails FSLIC loses." If I gain, maybe I turn the place around, and I take the money in bonuses; if I lose, FSLIC loses instead. I don't like that phrase, though, because it's inaccurate. When you do these acquisition, development and construction loans, it's, you know, it's "Heads I win, tails I win."

Mr. MARTINEZ. Yes.

Mr. BLACK. By definition, I book a profit, and by definition I pay myself while I'm losing, so I win and FSLIC loses simultaneously. It's a crazy world.

Now, again, by regulation, we have dealt with part of that aspect, but the broader problem of the incentive of insolvent institutions to gamble remains with us, and, frankly, it gets worse, when the perception is that there is not much we can do about it, because we are broke; the FSLIC fund is insolvent by well over $6 billion, as of the end of the year, and it is, you know, it's worse since then; and you don't want the perception to grow that I've got that incentive that the commissioner talked about, and I'm not very much sure that when I look at the world there is much that you can do to me. You don't have the money to liquidate me. The odds of getting prosecuted seem to remain low. Probably when most folks view it. And the odds of doing any significant jail time—I'm sorry.

Mr. MARTINEZ. Mr. Black, just let me say this, Mr. Chairman, if you would, in closing—the chairman asked you a question which you really didn't get a chance to answer, and he pretty much answered it for you, and so did Congressman Bustamante—the fact is,

that until this trip, I was very little aware of all these situations; and there are probably 420—how many are not on the committee? 400 Members of the Congress that are not aware either. And then when you multiply that by the number of people in all of our constituencies that are not aware, it is clear that this thing needs to be publicized more so that public pressure can be put on us to do something about it.

Thank you.

Mr. BARNARD. The only problem there, though, is then you may cause a run on the savings and loan industry.

Mr. MARTINEZ. Well, that's true, too. Yes, like Maryland.

Mr. BARNARD. Let me just—we've got to go to two other minor subjects, but I want them to be very, very brief, and, Mr. Deardorff, not that we didn't come back to you time and time again, but I think that you are all getting paid out of the same payroll, I believe, is that true?

Mr. DEARDORFF. I think we are.

Mr. BARNARD. Do you feel like that the Board, and FSLIC, are doing a better job in being able to identify criminal misconduct? I don't want to have a long answer. I just want a short answer.

Mr. DEARDORFF. Yes.

Mr. BARNARD. You feel like that you are doing a better job now—OK, that's important. You know, we are going to ask a followup question in our further written questions. But do you feel that you are all making an effort now, to train the examiners, so that they can better identify criminal misconduct?

Mr. DEARDORFF. That is absolutely correct. We have had meetings with the FBI with the sole purpose of helping our staff, with the analytical stuff, and examiners be trained in identification of fraud, how to make referrals, how to work closely with them, and how to come to a successful conclusion with some of these investigations.

Mr. BARNARD. Good.

Mr. Black, you are familiar with the Attorney General's task force. Up to this point, has it been effective?

Mr. BLACK. It's been a dramatic improvement over——

Mr. BARNARD. Yes, but I mean, 1 over 0 is a dramatic improvement, but on a score of 0 to 10 it isn't. I will be honest with you. This task force was set up in 1985. You know, to me, it was given a big fanfare—and also, it was interesting that it was the biggest idea of the Attorney General although it was based on our committee's recommendation; you know, great I don't care who gets the credit—but what have they really done? I mean really significantly? A task force, to me, is a body that gets in there and gets the job done; and I will be very honest with you, I am very disappointed. I don't see the meetings taking place like they should be. I just wonder if it's nothing but window dressing.

Mr. BLACK. The things that it can do are better. The problem is it can't do the things that are most important to do. It can't get more people, and it can't get more jail time. What it can do——

Mr. BARNARD. Why can't—why couldn't the task force go to OMB, or go to the administration, or go to Congress, and say, "we need more FBI agents; we need more U.S. attorneys"? The task force is the legitimate source that that information should come

from. That's exactly what I'm talking about. We haven't seen any dramatic actions, even in the changes in the laws. What little change in the laws that have come about to strengthen the criminal prosecution system and detecting crime has come from, really from, Congress.

Mr. BLACK. Well, you, frankly, that's where it has—there are two places that it can come from.

Mr. BARNARD. No, no, no, no.

Mr. BLACK. It can come from the White House.

Mr. BARNARD. It's not supposed to come from us—we are not the experts; we are just laymen in the field.

Mr. BLACK. Well, I understand, I understand, sir, but we are both—at least, I am still resident in Washington for a little while—OMB is a very powerful group. You can either win by getting the White House to referee the battle in your favor, or you can win because Congress directs that the staffing will be X, you know, and you will increase this, that, and the other thing; and you will be able to pay people enough to keep them retained when they can make twice as much doing something else.

Mr. BARNARD. Well, this has been a very interesting panel, and I appreciate all of the testimony that you have brought to us. We will be asking further questions that we would like to have in writing to complete the record, and we would appreciate that very much.

Mr. BLACK. With your permission, could I ask whether it will be acceptable to have those graphs that I prepared added to the record?

Mr. BARNARD. Oh, absolutely, without objection. They will be included in the record.

Mr. BLACK. I appreciate it. Thank you.

[The prepared statements of Messrs. Black, Lauer, Blair, and Gabrellian and their joint supplemental statement follow:]

STATEMENT OF

WILLIAM K. BLACK OF THE

FEDERAL HOME LOAN BANK BOARD

BEFORE THE

COMMERCE, CONSUMER, AND MONETARY AFFAIRS SUBCOMMITTEE

OF THE

COMMITTEE ON GOVERNMENT OPERATIONS

UNITED STATES HOUSE OF REPRESENTATIVES

JUNE 13, 1987

Mr. Chairman, distinguished members of the Subcommittee, I am pleased to respond to your request for testimony on problems in the California thrift industry. Those of us involved in the regulation of this industry appreciate your continued attention and vigilance, particularly in these trying times for the Federal Savings and Loan Insurance Corporation ("FSLIC"). Your 1985-1986 hearings concerning the impact of appraisal problems on real estate lending helped focus attention on a severe problem involving the appraisal profession that had produced serious losses for the FSLIC. Some of the observations and conclusions in the Committee Report proved most helpful to the Federal Home Loan Bank Board in enhancing our already comprehensive system regarding appraisal policies, practices, and procedures.

The misconduct by thrift industry insiders and affiliated outsiders is certainly one of the major reasons for the FSLIC's current insolvent condition. Grossly imprudent operations -- generally involving excessive growth, woefully inadequate underwriting, and excessive concentrations of riskier assets, particularly acquisition, development, and construction (ADC) loans and direct investments-- have also produced massive FSLIC losses. Indeed, our most costly failures usually involve both characteristics. I urge the Subcommittee to read the document

attached as Exhibit 1. It was prepared by a law firm for the purpose of encouraging real estate firms to acquire or start a thrift. It is an incredible document, particularly its "Financing the Flips" section. As the operating head of the FSLIC, the Bank Board must be able to act decisively against insider abuse and imprudent operations if we are to prevent future massive losses. We also need, however, a very substantial commitment of the FBI's and Department of Justice's scarce resources to bring to bear truly effective deterrence of criminal insider misconduct, through criminal conviction and incarceration.

Today, I will address a wide range of subjects pertaining to thrift misconduct, as you have requested in your invitation. For the Subcommittee's information, I was the Director of Litigation in the Bank Board's Office of General Counsel during the period from early 1984 to 1986, until I was appointed Deputy Director, FSLIC, last January. I am currently on detail to the FSLIC in that capacity and expect to begin a new full-time role as General Counsel to the Federal Home Loan Bank of San Francisco in the near future. I hope to draw upon all of these experiences in answering the Subcommittee's questions.

You have also asked us to provide you with responses to a number of specific questions, in order to assist the Subcommittee in its analysis.

Question 1:

(a) Briefly describe the role of the FSLIC and its staff attorneys with respect to federally insured thrifts that are insolvent or in danger of becoming insolvent.

The role of the FSLIC with respect to insolvent or nearly insolvent thrifts is to coordinate with the supervisory agents and examiners to determine the cause and extent of the problems, the prospects for recovery, factors concerning its marketability and cost, to determine whether the thrift will enter the FSLIC caseload, and aid the estimation of alternative costs of resolution; to recommend the best alternative available under FSLIC's extremely limited financial constraints; to determine the relative priority of resolving each case; and to implement the Board's chosen alternative, e.g., marketing the thrift, arranging a management consignment team, or devising an asset backed transfer. The general goal is finding the least-cost solution, consistent with congressional priorities.

The role of FSLIC's staff attorneys with regard to such problem thrifts is to provide legal support to the business decision makers, to bring administrative and civil litigation where appropriate, to defend against

lawsuits and to aid the criminal law process. Staff attorneys provide legal support for negotiating assisted acquisitions, setting up receiverships and chartering new Management Consignment Program ("MCP") thrifts, and negotiating FSLIC assistance agreements. Staff attorneys make an initial judgment as to whether the statutory grounds to appoint a receiver or conservator exist. Other attorneys in the Board's Office of Enforcement ("OE"), conduct investigations and administrative enforcement actions. They may already have made criminal referrals prior to the appointment of a receiver or a conservator.

Staff attorneys in the Litigation Division first review a new potential case for issues that may be critically time sensitive. They check whether a statute of limitations or insurance policy is about to expire. The litigation attorney coordinates with OE and determines whether criminal referrals have been made. They then determine whether a receivership or conservatorship challenge or potential freeze action against the assets of those involved in insider abuse is likely. Huge preparatory work is required in either event, because we have to be ready to defend or bring a lawsuit on the day we put a receiver or conservator in place. The litigation attorney determines the probable scope of the legal work that will be entailed, conducts a confidential request for bids from several law firms, checks them for conflicts, and retains fee

counsel. The litigation attorney, particularly if the fee counsel has not previously done FSLIC work, explains the role of FSLIC fee counsel in the particular institution they are hired to assist. Generally, the Litigation Division has no right to bring suit against insiders until a receiver or conservator is appointed. Once appointed, however, the litigation attorney provides the legal direction for all affirmative and defensive litigation of the receiver, conservator, or FSLIC in its corporate capacity.

(b) Describe the role of FSLIC fee counsel with respect to such institutions.

The role of FSLIC fee counsel is to assist the Litigation attorney in any affirmative or defensive litigation assigned to the fee counsel, to recommend the retention of other fee counsel where appropriate, and to provide legal advice to business decision makers of the receiver or conservator. In pass through receiverships, i.e., receiverships where the FSLIC places the "old" thrift into receivership and transfers virtually all of its assets to a newly chartered federal mutual association. The role of the Litigation Division and fee counsel is limited to bringing suit against former officers, directors, and professionals, and defending any legal challenge to the appointment of the receiver. In conservatorships and liquidating receiverships, the

role of the Litigation Division and fee counsel is much broader, requiring advice on commercial law and the conduct or defense of what can be hundreds of lawsuits pending when the receiver or conservator is appointed. Counsel may also have to bring a large number of suits to recover collateral from defaulting borrowers.

Litigation and fee counsel also assist the administrative claims procedure in institutions with liquidating receiverships. By statute and regulation, the receiver must marshal the assets, e.g., through foreclosure actions; determine the validity and priority of claims against the receiver through our administrative claims procedure (with judicial review under the Administrative Procedure Act), and liquidate the receivership assets so that valid claims can be paid in accordance with applicable priorities. Litigation counsel and fee counsel provide legal support to the receiver in the conduct of this longstanding administrative claims procedure that allows a much prompter, less expensive, and fairer (because it avoids preferential recoveries) resolution of many hundreds of claims against FSLIC receivers. This administrative claims procedure is also essential if any FSLIC recapitalization plan is to succeed, because the FSLIC Fund generally cannot be replenished for its massive expenses of paying insurance until

enough contingent claims have been resolved to allow the receiver to begin making distributions to receivership claimants. FSLIC is by far the largest receivership claimant.

(c) Set forth the numbers of fee counsel currently employed by FSLIC (i) in California and (ii) elsewhere. Also set forth FSLIC's total expenditures for fee counsel (i) in California and (ii) elsewhere in 1986 and, if available, for the first quarter of 1987.

The FSLIC currently employs 12 law firms in California, and a total of 43 nationwide. (An additional 29 firms are employed by the receiverships themselves.) In 1986, fee counsel cost in excess of $6 million for California and $20 million nationwide. Through June 8, 1987, FSLIC's expenditures for fee counsel are over $5 million for California and $19 million nationwide.

Question 2

(a) Provide an overview of the nature, extent and consequences of misconduct by insiders, by borrowers and by appraisers in the thrift institutions on the attached list.

Generally, misconduct by insiders has been a significant problem with the thrifts that you have asked us to review. Of the institutions we reviewed approximately three-quarters had problems with insider misconduct. This misconduct often led to the filing of a civil complaint and was usually an important factor contributing to the failure of the association in question. In this regard, FSLIC has filed or is involved in 19 complaints that have named over 175 insiders as defendants and are seeking an aggregate of approximately $1.2 billion in damages.

The insider abuses took various forms but included loans to the insiders in excess of that allowed by regulation; payment of exorbitant dividends at times when the institutions were at or near insolvency; payment for personal trips to Europe and the Far East as well as automobiles, clothing, and art; payment of unwarranted commissions and fees to companies owned by the sole shareholder; payment of "consulting fees" to insiders or their companies; use of insiders' companies for association business; and putting friends and relatives on the payroll of the institutions.

A classic example of this type of insider abuse occurred at Manhattan Beach Savings and Loan Association, whose sole shareholder is Peter Sajovich. A little over a year prior to its closing, Sajovich decided to "contribute" a subsidiary company called National Home Equity Corporation

("NEHC"), wholly owned by himself, to the institution. The day before the "contribution", Sajovich received a check for $3 million from NHEC: $2.515 million characterized as a "dividend" (the entire purported net worth of NHEC at the time) and $485,000 characterized as an unsecured, non-interest bearing loan to Sajovich. Because of this payment of Sajovich, at the time of the "contribution" to Manhattan Beach, NHEC had a net worth of $0 or less. Further, this "contribution" was expressly conditioned upon Manhattan Beach's Agreement immediately to recapitalize NHEC with an infusion or $4.5 million in cash. At Sajovich's urging, Manhattan Beach agreed to do so, even though at the time this sum was more than the entire net worth of the institution. NHEC is currently in bankruptcy.

Appraisal abuse has also been a problem at these institutions. In the institutions on your list, at least 10 had appraisal problems. We have brought suits naming eight appraisers, and others are being investigated. Nationally, too, we are looking seriously at the appraisal problems at failed institutions, and FSLIC has brought numerous complaints against appraisers. Copies of complaints filed against appraisers, involving institutions inside and outside of California, have been supplied to the Subcommittee staff. As you know, the use of

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inflated appraisals aids insiders in completing transactions that might otherwise be prevented. These actions by unscrupulous appraisers have been, and continue to be, a serious problem in the thrift industry.

An example of the appraisal abuse problem arose in Butterfield Savings and Loan Association. When the net worth of that institution began to fall dramatically, the management at Butterfield devised a scheme whereby its parent holding company issued new stock and contributed the stock to Butterfield, which in turn used this newly-issued stock along with some cash, to purchase 40 different parcels of real property at a cost in excess of $80 million. The scheme was structured so that the higher the purchase price, the better for management, since the purpose was to increase the book net worth figure as much as possible to relieve the pressure from the regulators. Many of the appraisals obtained on these properties stated grossly inflated values and did not comply with industry standards and the Board's Memorandum R-41b. For example, one of the parcels purchased for development turned out to be largely a swamp and another was mostly a forest preserve. A suit has been filed seeking in excess of $20 million from appraisers and realtors involved in this case. Additional examples of appraisal abuses were found at Sun, Bell, United, Equitable, San Marino, and Consolidated, among others.

In addition, the misconduct of certain borrowers has been a problem in at least nine of the institutions you listed. A prime example of borrower misconduct was discovered at Consolidated, where the former management made a loan and participated in advances in the amount of $9 million to a corporation owned by a convicted felon by the name of Charles Bazarian. These advances were made without any loan application and financial information, and they were made with only cursory, one-page letter opinions from the appraisers as to the value of the secured property. Not one payment was made on these loans and they appear to be substantial -- if not total -- losses. Mr. Bazarian, his company, and its chief officer have been named in the suit the FSLIC has filed with respect to Consolidated.

In summary, the record reflects that the misconduct of insiders, appraisers, and borrowers has played an important part in the failure of many California thrifts. I would also note that other professionals, particularly accountants and attorneys, have played on integral role in facilitating insider abuse and fraud.

(b) Has the misconduct in the California thrift industry been worse than or about the same as misconduct in other states?

Based upon a staff review of some FSLIC cases (i.e., those cases in which FSLIC assistance or intervention was necessary to resolve the problems of a FSLIC-insured institution) over the past two years, it appears that the incidence of insider abuse in the California thrift industry may be slightly but not significantly higher that the national average. I have attached a copy of recent testimony of the Bank Board in which we were asked to focus on insider abuse and fraud in Texas and Oklahoma as Exhibit 2. That testimony illustrates that California is far from unique.

(c) Describe (and provide actual examples of) the extent to which these insiders and affiliated outsiders have been or are presently involved with other closed or open federally insured financial institutions. Is such movement, from institution to institution, a phenomenon limited to California?

Mr. Deardorff's statement gives specific examples of insiders, affiliated outsiders, and professionals who have been involved in causing losses at more than one FSLIC-insured institution. Such practices are not limited to California. Loan brokers and "professionals" engaged in futures trading have caused losses at multiple institutions. An unscrupulous loan broker appears to have acted as a "match maker" for two thrift insiders in New Orleans and the State of Washington to facilitate illegal acts by them. The former manager of the New Orleans thrift was recently

convicted. Mr. Bazarian has caused severe losses at institutions in Oklahoma, as well as Consolidated in California. "Daisy chains" involving some of the worst managed thrifts in Texas, Oklahoma and Louisiana appear to have been devised to facilitate insider abuse and prevent an effective regulatory response.

Question 3

(a) Provide FSLIC's current best estimate of its likely losses for the institutions on the attached list. (Provided as an aggregate, by prior agreement.)

The FSLIC's current estimate of the cost to resolve the California associations in conservatorship or receivership is $5.6 billion.

Question 4

(a) Discuss FSLIC's responsibilities and its policies with respect to: (i) seeking monetary recovery for losses due to the acts of insiders, of affiliated outsiders and of others; and ii) identifying possible criminal wrongdoing by such individuals and assisting the Justice Department and state law enforcement agencies in prosecuting such wrongdoing.

Where the FSLIC is acting as conservator or receiver, its litigation responsibility is to maximize the net value of the receivership. Therefore, the FSLIC receivers and conservators do not bring suits they know will not be cost-effective. If a suit is deemed essential by the FSLIC for deterrent reasons, the FSLIC in its corporate capacity will acquire the lawsuit from the receiver on terms requiring the Corporation to pay any judgment recovered in excess of our costs to the receiver. With regard to the defense of lawsuits, the receiver has a responsibility to maintain the integrity of the administrative claims procedure described in my answer to question 1(b), by avoiding preferential recoveries. Receivers frequently settle claims involving disputed facts as a routine part of the administrative claims procedure.

The FSLIC's deterrence policy is that cases of severe insider abuse should normally be pursued through civil litigation even if they are unlikely to be cost-effective. Where a successful criminal prosecution occurs, a civil suit will not normally be pursued if it is not expected to be cost-effective.

The FSLIC's policy towards criminal referrals is that a successful prosecution resulting in a substantial jail sentence is the critical deterrent essential to bring a halt to possible future losses to FSLIC

from insider abuse and fraud. All insured institutions are required to make criminal referrals. Obviously, we know that thrifts will not refer their controlling insiders for criminal prosecution while the insiders remain in control. One of our key jobs is to remove such insiders.

Our examiners are instructed to look for insider abuse and fraud and to refer such evidence to the Department of Justice and/or state authorities. The same is true of OE and litigation attorneys and fee counsel. Our personnel are instructed to encourage and provide lawful assistance to criminal investigations and prosecutions of insider abuse.

(b) Discuss any real or perceived conflicts between FSLIC's restitution function and its responsibility to assist other agencies in the prosecution of criminal misconduct. How should any such conflicts be resolved? Is it the clear policy of FSLIC that FSLIC attorneys and FSLIC fee counsel are required to make criminal referrals and provide assistance, irrespective of the effects of such actions on the restitution function? Is there a written policy? Are fee counsel formally notified of FSLIC's policy and, if so, how?

We do not believe that there is any real conflict between our restitution function and assisting law enforcement. Indeed, we believe that Congress

intends them to be complementary. We hope you will encourage prosecutors to make greater use of restitution as a condition of virtually all plea arrangements with insiders and in making sentencing recommendations.

Any conflict should be resolved in favor of law enforcement. In the unusual case where fee counsel has perceived (I believe erroneously) that such a conflict might exist, we have always resolved the matter in favor of assisting law enforcement.

That policy has always been our policy. Our litigation attorneys are trained to move aggressively on criminal referrals and we have consistently instructed fee counsel in that fashion. My successor, Dorothy Nichols, has put that policy in writing to each fee counsel. (See Exhibit 3.)

Question 5

(a) Describe briefly (1) Federal Home Loan Bank Board/FSLIC requirements, if any, for insurance by thrift officers, directors and other insiders and affiliated outsiders. (2) The type of insurance that these individuals typically carry. (3) The types of acts and practices that are traditionally covered by those policies and the types typically excluded? (4) How easy or difficult is it currently for affected persons to obtain such insurance?

There is no requirement that individuals carry any type of insurance in order to serve as a director, officer, or affiliate of an insured institution. Federally-chartered thrifts are permitted to purchase insurance for their directors and officers with respect to claims of negligence. 12 C.F.R. § 545.121(d). Most States permit state-chartered institutions to purchase insurance for their directors and officers. Federal regulations require all FSLIC-insured institutions to maintain fidelity bond coverage to protect the institution against losses attributable to dishonest acts of officers and employees. 12 C.F.R. § 563.19.

Individuals typically do not carry any type of insurance relating to their conduct as directors, officers, or affiliates of insured institutions. Savings and loan associations typically carry both director and officer ("D&O) liability insurance and fidelity bond coverage when such coverage is available.

D&O insurance generally covers losses attributable to "wrongful acts" of insured directors and officers, i.e., branch of fiduciary duty and negligence. Coverage also typically extends to the association itself for any indemnification it is legally obligated to pay to its directors and officers. D&O policies typically exclude coverage for losses

attributable to dishonest acts. Fidelity bonds generally cover losses caused by the dishonesty of the officers and employees of the insured.

In recent years, D&O insurance and fidelity bond coverage have become difficult to obtain. When coverage is available at all, premiums and deductibles are very high and coverage is very limited. In some instances, riders to existing policies attempt to eliminate or severely limit the carrier's exposure to suits brought by the institution itself, suits by stockholders, and suits brought by the FSLIC. Several FSLIC-insured institutions have been unable to obtain fidelity bond coverage despite the regulatory requirement. In response to this insurance situation (which is affecting corporate America in general, not just the financial institutions industry), many individual financial institutions and industry trade groups have been exploring alternative methods of obtaining coverage. The U.S. League recently formed a captive insurer that will be capitalized by and provide coverage to qualified members. Some institutions have investigated the possibility of self-insurance through a wholly-owned subsidiary. Insurance through a captive or self-insurance may be feasible alternatives for healthy, well-capitalized financial institutions, but offer little chance of success for smaller struggling institutions.

(b) Provide an overview and some actual examples of how easy or difficult it is to reach the personal or business assets of individuals found to owe monetary damages to FSLIC.

The FSLIC's experience in reaching the personal or business assets of individuals found to owe monetary damages to the FSLIC is similar to the experiences of any other litigant. As you know, obtaining a judgment against a particular individual does not necessarily ensure collectibility of that judgment. For example, in FSLIC v. Williams, which arose from the failure of a Maryland thrift, the FSLIC obtained a jury verdict awarding damages against several individuals who were directors and officers of the defunct Community Federal S&LA of Rockville, Maryland, in the amount of approximately $10,000,000. The FSLIC is still attempting to collect that judgment from the various defendants, but because their personal estates appear to be insufficient to pay the full judgment, it is unlikely that the judgment will be satisfied in full. Dissipation of assets through highly hedonistic life styles, and perhaps Swiss bank accounts, bankruptcy law protections, homestead exemptions, trust arrangements, placing the property in the spouse's name or holding it jointly with the spouse, and the costs of litigation are all factors limiting net recoveries.

As a result, very few cases actually proceed to trial in the United States; most are settled. This is also true of the FSLIC's suits. Defendants who desire to settle a claim brought against them by the FSLIC are almost always required to provide the FSLIC with certified financial statements of their assets. Settlement agreements are structured so that misrepresentations about assets can be used to set aside the voluntary dismissal of a claim.

In the FSLIC's efforts to maximize its ability to recover assets from defendants, the FSLIC has had a great deal of success securing temporary and preliminary injunctive relief freezing an individual's assets and even attaching assets prior to obtaining a judgment. Indeed, on several occasions, the FSLIC has been granted temporary restraining orders freezing individuals' assets within 24 hours of filing suit. Such suits can reduce the dissipation of assets and serve as a deterrent against future misconduct. Given the nature of this remedy, its use has been limited to situations where the facts available to the FSLIC demonstrate fraud and self-dealing. The courts are reluctant to impose such restraints in the absence of persuasive evidence not only supporting the FSLIC's claims but also demonstrating the defendant's proclivity to hide or waste assets. Even where the FSLIC has obtained preliminary injunctive relief, the truly bad actors frequently will have secreted

their assets before the suit can be brought. Others have violated even a court imposed freeze order, requiring us to bring a contempt action. The FSLIC often discovers that some defendants have vacationed over the years in places such as Switzerland and the Cayman Islands. Tracing assets in such places is very difficult. Discovery into assets is generally very restricted in the United States prior to securing a judgment.

Question 6

(a) For the institutions on the attached list, please set forth the aggregate numbers of criminal referrals made by FSLIC to date; and provide examples of actions giving rise to such referrals. Are additional criminal referrals anticipated? If so, approximately how many? Who within FSLIC is charged with monitoring the progress of referrals or investigations initiated independently by Justice/FBI?

A total of 22 criminal referrals have been made by either the FSLIC or the FHLBank of San Francisco. Additional criminal referrals are under consideration.

Litigation attorneys in the Office of General Counsel monitor any ongoing criminal investigations and prosecutions related to associations to which

they are assigned. Criminal proceedings often have a significant bearing on civil suits filed or contemplated. Moreover, litigation attorneys try to convince the criminal law process to require restitution as part of any plea bargin or sentence. Therefore, monitoring criminal prosecutions is viewed as an important aspect of the job.

Similarly, attorneys within the Board's Office Enforcement (OE) make criminal referrals, or assist the district banks to make such referrals where their investigations turn up evidence warranting such action. The OE attorney handling the institution monitors, and, as appropriate, assists the FBI's and Department of Justice's efforts.

As the Subcommittee is probably aware, the Board -- along with the other four federal financial institution supervisory agencies -- entered into an agreement on April 2, 1985, with the Federal Bureau of Investigation and the Department of Justice to form a "Working Group" to improve the referral, investigation, and prosecution of bank fraud and insider abuse cases. High among the goals of the Working Group has been seeking an amendment to the Right to Financial Privacy Act that would remove the current impediments in the statute that limit or complicate the sharing of information among and between the named agencies and the departments. The Working Group has supported a clarifying amendment to the Right to Financial Privacy Act to permit the transfer of fiancial information

lawfully in the possession of one government agency (such as the Bank Board) to another government agency (such as the Justice Department) for a law enforcement purpose within the jurisdiction of the receiving agency without notice to the customer. This amendment is broader than the exemption contained in the omnibus drug bill of last year and the Board continues to support adoption of the Working Group's broader exemption.

Another important goal of the Working Group relates to the inability of the supervisory agencies to receive information that the Department of Justice may have as a result of Grand Jury proceedings. Our inability to obtain this information prevents us from most effectively performing some of our responsibilities, such as our duty to process Change-in-Control applications. The Anti-Drug Abuse Act of 1986 amended the Change in Control Act to require prior notice of at least 60 days to the Board of a proposed acquisition to allow the Board time to investigate the acquirors. However, one potentially important source of information on acquirors -- that developed from Grand Jury proceedings -- is currently beyond the access of the Board and all of the federal financial institutions regulatory agencies. Presently, the federal financial institutions regulatory agencies may seek grand jury information only if the agency has on ongoing "judicial proceeding" to which the information is relevant. Unfortunately, a change in control application does not

qualify as a "judicial proceeding" and a prosecutor would be unable to share with the agency pertinent information on the fitness of those individuals attempting to gain control of an insured institution. The Working Group supports amendment of the grand jury secrecy rule to permit the sharing with an agency of information or documents obtained through a grand jury for matters within that agency's jurisdiction, such as a change in control application.

(b) For each institution on the attached list, please set forth whether a FSLIC civil complaint has been filed, identify the individuals (and their relationship to the institution) being sued, and state the total amount of civil money damages claimed in each suit. Are additional complaints anticipated? If so, please estimate the additional dollars likely to be requested in these complaints.

Information on the complaints has been separately provided to the Subcommittee. Additional complaints are under consideration, but we cannot provide a reliable estimate of requested relief at this time.

Again, let me thank you, Mr. Chairman, and this Subcommittee for your past and on-going efforts to bring attention to the critical problems posed by fraud, insider abuse, appraisal abuses, and the lack of an

effective criminal deterrence mechanism. Your past efforts have already produced important advances. Cooperation between the FSLIC and law enforcement agencies is greatly improved. We make more referrals, make them at an earlier date, in better detail, and in a standardized format worked out with the Department of Justice. Your efforts, our encouragement, and the awful carnage of billions of dollars in losses from insider abuse and fraud have convinced all law enforcement agencies of the seriousness of these problems.

The professional appraisal societies are making efforts to come to greater consistency in their standards. The Bank Board has sought public comment on improving its appraisal standards. We understand that you intend to make legislative proposals to improve further the quality of the appraisal profession.

Your current hearing has already had the salutary effect of improving cooperation and communication here in California. Thank you for the opportunity to address the Subcommittee.

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NARRATIVE OUTLINE

JAMES R. BUTLER, JR.
Chairman
Financial Institutions Department

WHY DOES IT SEEM EVERYONE IS BUYING OR STARTING A CALIFORNIA S&L?

The New S&L Powers

Under sweeping legislation enacted in the past two years by the federal and California legislatures, S&Ls have broadened their range of activities. The following is the result of a survey of 200 S&Ls reported in the Los Angeles Times on February 19, 1984:

Activity	Percentage of Surveyed Associations Engaged in Activity
Joint Ventures	86%
Mortgage Banking	69%
Real Estate Development	51%
Real Estate Syndication	26%

The new California S&L powers were contained primarily in the Nolan Bill, enacted in the S&L "depression" of 1982 (the bill became effective on January 1, 1983) and the

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Grateful acknowledgement is made for the assistance contributed by Bruce L. Ashton and Arne T. Swensson, both lawyers with Jeffer, Mangels & Butler.

Exhibit 1

Garn-St. Germain Bill enacted on October 15, 1982. Supplemented by other laws and rule changes, S&Ls were given sweeping new powers, including the following:

- Direct or Indirect Real Estate Investment (including development, holding for income, syndication, etc.) -- up to 100% of assets (subject to a 10% limit for the first three years of operation of a new S&L).

- Commercial Real Estate Lending (as opposed to residential mortgage lending) -- up to 40% of assets.

- Consumer Lending -- up to 30% of assets.

- Commercial Lending -- up to 20% of assets.

- Investment in a Service Corporation which can engage in any activity lawful for a normal business corporation -- up to 100% of assets (subject to a 10% limit for the first three years of operation of a new S&L).

Under recently promulgated standards, new California S&Ls receiving insurance of accounts after November, 1983, must limit the combined amount of investment in real estate and service corporations to 10% of assets for the first three years. After three years of operation, there is no limitation on the amount of investment, although prudent man standards must still be observed. The 10% limitation presently does not apply to S&Ls which were insured prior to November, 1983, or "grandfathered" S&Ls acquired after November, 1983. However, many expect that the so-called "de novo" 10% limitation on investment in real estate and service corporations may be extended to existing S&Ls upon acquisition by new owners, and perhaps to existing S&Ls even absent any such acquisition.

Excepted from the 10% of assets limitation are the following:

a. Any real property owned by an S&L and used for its offices or branches (even if the office or branch represents a small percentage of the square footage);

b. REO (real estate owned as a result of foreclosure of defaulted mortgages);

c. Any loan from unrelated parties to a service corporation and certain loans from the parent S&L which are "conforming loans";

d. Accrued profits earned on the original permitted investment; and

e. Equity participating loans which provide for both a fixed or floating rate of interest and a percentage of equity ownership or a percentage of profits from the project or business.

The profit potential of participating loans has been a major incentive for many deciding to enter the S&L arena. In a currently popular format, the S&L will make a loan at a fixed interest rate of 10 or 11 percent, and will receive additional interest equal to half of the profits derived from the project.

Power of Readily Available Cash

Through its branch network (and as supplemented by brokered deposits, a money desk, or advertised jumbo CD programs), a California savings and loan has the ability to raise virtually unlimited amounts of capital in the form of deposits. (See the discussion of brokered funds below.) An S&L's cost of funds depends upon many factors. At this writing, with the prime interest rate generally around 11%, institutions with a strong retail deposit base are experiencing a cost of funds in the 9 to 9-1/2% range. Institutions relying on jumbo CD accounts for substantial portions of their deposit base are experiencing a higher cost of funds, generally in the the 10 to 12% range, depending upon the deposit mix, maturity and other factors. It is significant, however, that the cost of funds to an S&L engaging in mortgage banking, real estate development or real estate syndication activities is probably considerably less than the cost of funds to those engaged in such activities outside a savings and loan context.

As experienced mortgage bankers, syndicators and developers may best appreciate, ready availability of relatively low cost funds can provide a tremendous advantage over the competition. In the mortgage banking context, the

S&L can fund loans which may be arbitraged through pre-existing puts into mortgage pools or the secondary market. In the syndication and development context, the availability of cash solves three classic problems:

1. Tying up the "Steals".

Every developer and syndicator has faced the need to instantly raise cash to take advantage of an opportunity which will not wait for ordinary financing cycles or a syndication effort. A developer or syndicator operating under the umbrella of a savings and loan association has the ability to tap cash resources and seize a favorable deal while other potential buyers are still trying to acquire financing.

2. Financing the "Flips".

In the course of extensive development or syndication activities, many people encounter situations, often several times a year, where property can be acquired and quickly resold or "flipped" for a substantial profit. In fact, the attractiveness of flips is often so great that there is no benefit to syndicating the project if capital can be raised by another method. This is particularly true when flips can be executed in a short period of time, such as 30-90 days. Unfortunately, syndicators and developers are frequently unable to take advantage of flips because they do not have enough liquid capital available.

Through an S&L, a developer or syndicator has financial resources readily at hand on very favorable terms. Indeed, funds from an S&L are, in all probability, the cheapest source of capital available for accomplishing the quick turn-arounds which flip opportunities require.

3. Staying Power.

Every developer or syndicator is subject to the vagaries of interest rate cycles. There are many instances when the most brilliant businessman is hard pressed for cash to make up for an unexpected negative cash flow. Going back to investors for additional capital under such circumstances can often prove embarrassing and significantly diminish the investors' confidence in the project.

Raising more than the required amount of capital at the outset of a project may be uneconomic and

competitively disadvantageous in view of the simple fact that investors want the highest yield available in any given marketplace and market time.

The conduct of real estate syndication and development projects in an S&L can be an effective way to solve this problem. The S&L is able, by its very nature, to deliver badly needed liquidity at a reasonable price to fund a project's short term negative cash flow.

Unparalleled Leveraging of Funds.

One of the outstanding features of a California S&L is its exceptionally favorable leverage. With $3.0 million in capital -- the amount of capitalization required for a new savings and loan in California -- an S&L can take in approximately $42 million of deposits from the public, which may be insured by the Federal Savings and Loan Insurance Corporation. In other words, in its first year of business, an S&L can take in deposits equal to approximately 14 times its initial capital base. For new S&Ls, up to 10% of this amount ($4.2 million) can be directly invested in real estate in the first year. After three years there is no limitation on the amount of assets which can be invested directly or indirectly in real estate. S&Ls approved prior to November 1983 are also presently free of any percentage limit on real estate or service corporation investment.

The amount of leverage permitted increases during the first three years of a new S&L's operations so that after three years, an S&L can accept deposits equal to 33-1/3 times its capital base. On capitalization of $3.0 million, an S&L could raise more than $100 million. As noted above, in theory at least, after three years, a new S&L could invest 100% of its assets in real estate. All investments of an S&L are, however, subject to general prudent man standards of diversification of investment by category as well as specific investment. But, if even a relatively conservative 10% to 25% of an S&L's assets were invested in real estate, a $3.0 million investment in the S&L could provide a $10 to $25 million working line of credit for real estate investments after only 3 years operations.

In contrast to the leverage available to California S&Ls, banks are generally limited to leveraging their capital 12 times or less. Industrial loan companies (frequently called "thrift and loans" in California) are initially

limited in leverage to 3 times initial capital, and after five years, with regulatory approvals, may ultimately go to a statutory maximum of 20 times.

A few cautions on leverage: Statutory or theoretical "maximum leverage" is the outer limit, and should be cautiously approached. Leverage magnifies profit potential on the up-side, but also magnifies losses on the down-side.

Flexible and Profitable Loan Opportunities.

Historically, S&Ls were limited by statute and regulations to making primarily residential mortgage loans. Under the new powers, up to 40% of assets can now be invested in mortgage loans secured by commercial property. Up to 30% of assets can be put in consumer loans. Up to 20% of assets can be put in commercial loans on a phased-in basis. (In 1984 7-1/2% of assets can be invested in direct commercial loans with an additional 10% by participation with or purchase from a commercial bank for an aggregate maximum of 17.5% of assets; and, in 1985, these limits will be raised to 10% in direct origination and an additional 10% through participation or purchase for an aggregate of 20% of assets).

In addition to having new types of lending capacity, an S&L has considerable latitude in structuring its loans. For example, some real estate syndication-oriented S&Ls have made loans to real estate limited partnerships which they sponsor with a coupon rate of interest reflecting market rates, but with only a portion of the interest payable currently out of the real property's net income, and with the balance of the interest payable on sale or refinance. If you become active with such loans, you will need to devote attention to maximum loan size limits, loan to one borrower limitations, related-party restrictions, and the difficultly of selling non-traditional loans in the secondary market.

The participating mortgage discussed above in connection with the new powers is quite similar. In this variation, the S&L extends a market or below market rate loan to a borrower, usually at a fixed rate of interest, and in addition, gets a percentage (up to 50%) of the profits from the project. Many industry observers feel that this type of loan is the inevitable result of associations' past experience. For years, S&Ls and other lenders took all of the risk on real estate development projects but enjoyed none of

the upside profit potential. If the project or economy went sour, the S&L typically ended up with the property in its REO portfolio. If the project went well, however, the S&L only got a fixed rate of interest while the developer got substantial profits.

Other Attractive Features.

S&Ls have begun a dramatic return to profitability. There are a number of reasons for this, including lower interest rates, expanded powers, new techniques for matching duration and cost of funds with investment opportunities, and better management. A recent study shows that of the 69 California S&Ls opened between January 1, 1978 and June 30, 1983, only 10 operated at a loss while the remaining 59 experienced profitability. In fact, almost 10% of the S&Ls had a return on beginning net worth of 50% or more.

While the stocks of the large chain S&Ls have generally traded at half of book value or less, and S&Ls with assets over $1 billion have tended to be bought or sold at approximately book value, sales of small independent S&L's occurring in the last year have been at multiples ranging between 2-1/2 to 3-1/2 times book value.

Many business people find the ability to operate with all the prestige and credibility of an independent financial institution to be a significant advantage. The S&L charter may open many doors in mortgage banking. It may create instant credibility for real estate investors, and with consumers of other financial services provided by the S&L. The people closely associated with S&Ls are "members of the financial institution club". In addition to the prestige, however, this membership carries tremendous responsibility to discharge the public trust.

One person or company can now own 100% of a California S&L. A California S&L can be owned by non-US citizens or other out-of-state investors. It can make loans or investments outside California and can draw deposits to its licensed California offices from anywhere in the world.

If an S&L has sufficient qualifying assets (generally cash, Ginnie Mae and Fannie Mae Certificates, and residential mortgage loans) it enjoys a favorable tax rate of approximately 38% on its income (combined Federal and California) as compared to the approximate 50% marginal tax

rate (combined Federal and California) applicable to ordinary business corporations.

Based upon appropriate credit, correspondent banks have traditionally loaned an association's organizers 50% to 75% of the funds needed to capitalize the association. Banks may also lend on the purchase of existing savings and loans. These loans are typically for five years' duration, at an interest rate of prime plus 1%, interest only for one year, principal amortized over the remaining four years. The loans are unsecured to qualifying borrowers, and there are certain restrictions on the pledge of an S&L's stock during the first three years of its operation. Persons starting or buying an S&L may not strip the S&L of cash generated by operations to repay their loans. Persons borrowing the initial capitalization for an S&L or the purchase price for an existing S&L should also be mindful of the IRS limitations on investment interest.

S&L stock is "freely tradable" stock. It is generally exempt from registration requirements of federal and state securities laws, and subject only to regulations administered by S&L regulators. S&L stock is not "letter stock", nor is it subject to Rule 144 restrictions. The securities exemptions available for S&L stock do not apply to an S&L's holding company's stock. The stock of holding companies is subject to state and federal securities laws.

HOW TO ACQUIRE AN S&L

If the advantages of owning a California S&L seem attractive, you make wish to consider the following three basic ways to take advantage of the opportunity:

1. Buy an existing savings and loan.

2. Buy a state or national bank and convert it to a savings and loan.

3. Start a new or de novo S&L.

Because there are different considerations for each of these alternatives, we will examine each in turn.

Buying An Existing S&L.

As of the first quarter of 1984, it appears that small, healthy, independent S&Ls are being acquired at prices which equate to approximately 2-1/2 to 3-1/2 times book value. The S&Ls tend to be fairly small (generally under $100 million in assets). Many have a negligible earnings history. Relatively new and undeveloped associations are attractive to many purchasers who wish to avoid large portfolios with below-market rate mortgages, or other problems with existing loans.

An acquisition of an existing S&L might theoretically be concluded in as little as three to four months in the case of a private transaction or seven to nine months in the case of a public tender offer. In addition to saving time in getting into the business, an acquisition is attractive because S&Ls which received their insurance of accounts prior to November, 1983, are not presently subject to certain restrictions applicable to "de novo" S&Ls formed after that date. Many predict, however that the de novo restrictions will soon be applied to existing S&L's upon their acquisition by new owners and perhaps to existing S&L's even absent an acquisition.

The prices at which small independent S&Ls are bought have traditionally been expressed as multiples of book value, but the trend now is to place greater emphasis on the amount, nature and consistency of earnings (as opposed to book value). A number of consultants believe S&Ls will be valued in a range of 6 to 12 times earnings. Present multiples (however calculated) are probably at a peak and likely to decline over the coming months unless the demand for charters continues.

Acquiring an existing operation can certainly save a tremendous amount of the time and effort that goes into organizing a new S&L, but a potential buyer must evaluate the relative cost/benefit ratio of acquiring an existing facility and deposit base.

While "sick" or troubled S&Ls may be acquired at a fraction of the cost of a clean, healthy one, turn-around efforts can be perilous, costly and time consuming.

There are interesting possibilities of building the book value and capitalization of an S&L (and thereby

increasing leverage potential) with regulatorily approved contributions of appreciated realty or other assets.

It is imperative in any acquisition to observe proper regulatory procedures, including registration with state and federal authorities who must approve of the character and financial capacity of the acquiror, the acquiror's business plan, and other aspects of the acquisition.

Purchase Of A Bank And Conversion To An S&L.

Because state and national banks presently appear to be out of vogue in certain investment circles, many independent banks can be acquired at lower multiples of book value or earnings than comparably sized S&Ls. As of this writing, the author knows of several "clean" bank acquisitions completed at a price in the one to two times book range, substantially less than the price for a comparable S&L.

A bank acquisition, followed by a conversion to an S&L charter, presents problems absent from a straight S&L acquisition. The bank's portfolio may have to meet the regulatory constraints for an S&L upon conversion. The conversion process is subject to considerable regulatory discretion and troubled banks would probably not be permitted to convert to S&Ls. Regulatory approval procedures similar to those for S&L acquisitions must be followed for bank acquisitions.

Starting A De Novo S&L.

Timing. Compared to other financial institutions, a California S&L may be organized relatively quickly and easily. In 1983, a number of new S&Ls opened their doors approximately nine to twelve months after commencement of the chartering process.

Delays which occurred while new regulations were being adopted by federal and state regulatory agencies in the summer and fall of 1983 increased the time required for a new S&L to open its doors to the 18 to 24 month range and a backlog of applications developed. The backlog now seems to be clearing.

Many predict that the time required to start a new S&L will soon be cut in half. We project that the time to

commence business with a new S&L will soon be in the 12 to 18 month range.

Expense. The "risk capital" in starting an S&L is only $50,000 to $60,000; this amount may be repaid out of the S&L's profits after opening. This sum is called "risk capital" because, if the application is denied by the Department of Savings and Loan, the $50,000 to $60,000 cannot be recovered. The funds should be raised with a prelicensing funds agreement. Although all funds will be expended quickly at the outset of the process, careful accounting for these and all other funds is imperative. Fortunately, California is in a very favorable chartering mode and most properly structured groups are obtaining charters.

If you get your first approval, there are other regulatory and business hurdles to overcome (becoming a member of the Federal Home Loan Bank system, obtaining FSLIC insurance, selling your stock, hiring your professional staff, selecting and improving your site, etc.), but generally speaking the subjective element of whether you will have an S&L has been resolved. During the second, or organizational phase, preopening expenses will probably total at least $200,000 to $400,000 more (over and above the risk capital). This amount, however, is usually paid with an organizational loan obtained by the organizers from a correspondent bank, and the organizational loan is paid off from the initial $3.0 million capitalization.

Three Things Needed To Start The Process.

In order to start a de novo savings and loan, there are three basic requirements:

1. Site - a new S&L application must designate an "at or near the intersection of" site which is not preempted by other new charters or branches opened in the last year or two. The site should be in a community where there is a "need" for additional S&L services. Preferably, the site will be in a "natural" market with strong demographics. Your attorney, economist and other advisors can assist you in selecting appropriate sites.

2. The Organizing Group and Initial Board of Directors. You must have at least five directors to file an application to start an S&L with the Department of Savings and Loan. More directors are acceptable, but not necessary

for the filing. Later, when you file for FSLIC insurance, you must have at least seven directors. Your CEO will be a director. You do not need a CEO at the time of filing.

Under recent changes in regulatory procedures, the makeup of the organizing group has become the most important factor in obtaining a new S&L charter. This factor is now more important than the economic study or demographics of the area where the S&L is to be located.

Standards for entry into the S&L industry are already high and continue to be raised. The Department's major consideration in approving an organizing group is its "success profile" -- the track record and net worth of its members. Even if the organizers have had no prior experience with banks or savings and loans, the regulators believe that people successful in their chosen field of endeavor will use the same techniques or skills to make the savings and loan association successful. There may be many routes to success, such as native intelligence, hard work, ability to attract excellent support staff, ability to delegate, etc. The human traits that make the "Midas Touch" work in real estate syndication or manufacturing should likewise make a savings and loan successful.

The following are a few guidelines for evaluating whether or not your group meets the "success profile" sought by the regulators:

The average net worth of the directors should be at least $1 million (including home, automobile and household furnishings); the larger the net worth, the better. Some individuals with modest net worth can be strong board members if their knowledge or business contacts are particularly strong, e.g. a retired banker of great experience. If such an individual has a modest net worth, say $200,000, someone else on the board should have a proportionately higher net worth, say $3 million. Generally, having two or more directors from one company (except in a holding company context) or one family is undesirable.

Directors should have the financial depth or contacts to raise additional capital if problems develop. At least one person other than the CEO should have depository institution experience. Real estate experience is generally highly regarded by the regulators, and it is acceptable to have several of the directors involved in various aspects of real estate. However, there should be

some diversification of real estate experience in various areas, such as syndication, brokerage, development, investment, and mortgage lending. Other directors should have sound business or financial experience -- as executives, certified public accountants, investment bankers, etc. Representatives from the community (e.g. a mayor, commissioner, chamber of commerce leader, planning commissioner, civic or religious leader or similar person) is desirable. A minority or a woman, successful in his or her own right, is a valuable addition.

If a single individual intends to own all of the stock of a savings and loan association, he should have a net worth of at least $10 million or more.

A FEW FINAL CONSIDERATIONS

Given the many opportunities offered by an S&L, should everyone form a savings and loan association? Emphatically, the answer is "No!"

1. Regulatory Environment. S&Ls are subject to extensive regulation by federal and state agencies. Many successful business people simply lack the patience needed to tolerate a highly regulated environment. Moreover, regulators can react sharply if they believe their regulations have been intentionally violated. Although financial institutions are generally going through a rapid deregulation, the threat of reregulation is constantly present, especially if the regulators perceive abuses. Any attempt to predict the course of regulatory developments is speculative at best.

2. Competition and Management Shortage. With large numbers of new applications and expansion of existing associations, there is strong competition for business and a shortage of top quality, experienced management. If you are not prepared to operate an S&L in a competitive environment, you should not become involved with one. It must be run in a businesslike manner with carefully laid business plans. First-rate management will be more important than ever and in relatively short supply.

At present, however, such talent is certainly available. Experienced "superstar" managers from the industry and allied fields (banking, mortgage banking, etc.) can typically be lured away from relatively large institutional settings for salaries in the $80,000 to $100,000

range, plus stock options and incentives. The business plan of the organizing group must convincingly prove to the regulators that your S&L can afford such expensive talent. It is the author's experience that the superstar managers usually pay for themselves very quickly many times over, but many people have a short-sighted philosophy and refuse to pay a premium wage for a proven performer. If you are not willing to hire the best management available, you probably should not enter the field.

3. Common Sense -- Avoiding The Appearance Of Impropriety. However technically correct something seems by the strict letter of the law, test the concept to see if it seems prudent and sound for a financial institution using public funds and FSLIC insurance. Is there diversity of investment? It is generally better to have several relatively small investments, than just a few large ones. Similarly, the association's investment portfolio should be diversified by category of investment. While it is theoretically possible to invest all of an association's assets in real estate, to do so would be unwise. Does management have sufficient knowledge and experience and a proven track record of success in this particular activity?

How will this activity look when scrutinized by the press? If it wouldn't look good on the front page of the newspapers, don't do it! How will it look when scrutinized by the regulators? Are there any related-party problems? Is there even the appearance of impropriety?

Do the intended activities permit the S&L to match maturities of the sources of its funds (deposits, debt instruments) with its investments? In other words, is daily passbook money being used to repeat the past mistake of making 30 year fixed rate mortgages, or is money taken in on 1-year CDs being used to make sound 6 month construction loans that really will be paid when due?

Remember that in the S&L context, investments in conventional mortgages, equity participating mortgages, real estate development or syndication projects, mortgage pools, or other lawful investments are made with Federally insured money raised from the public. The association's professional, full time staff should insulate non-industry owners from most of the administrative headaches; and, while investments described above are clearly lawful and appropriate, a "captive" S&L cannot be used as an "alter ego" for making "sweetheart loans" to friends and relatives, nor

purchasing "white elephant" projects from related parties. The savings and loan association and its affiliated businesses must be run in accordance with prudent business standards.

4. Brokered Funds Limitation. A major issue now raging in regulatory circles and in Congress is the extent to which banks, S&Ls and other depository institutions should be permitted to accept deposits (typically jumbo CD's) raised by stockbrokers and others (who are generally unlicensed). Many S&Ls (and other depository institutions) want the freedom to access brokered deposits, claiming that there is an ample supply of good investments for such funds at rates which will provide significant profits. They claim that despite high interest rates on brokered deposits, the cost of collecting these funds is actually less than raising funds via a branch network, which is intensive in people and equipment. On the other hand, regulators fear that brokered funds will enable poorly managed associations to raise and squander large sums which must then be replaced by the FSLIC. The regulators also fear that brokered deposits subject S&L's to the influence of brokers, are more expensive than retail deposits, and cannot be profitably deployed. The regulators note that the percentage of brokered deposits tends to rise as institutions get into financial trouble.

The various political and economic interests are still sorting out the brokered deposit issue. At present, it appears that even if limitations are put on brokered deposits (such as limiting the insurability of such deposits), in-house money desks and advertised jumbo CD programs will continue to be permissible.

It is interesting to note that of the top performing California S&Ls (those earning more than 50% on beginning net worth), all but one of the associations had jumbo CDs comprising over 69% of their deposits. Half of all high performing associations had jumbo CDs compromising over 90% of their deposits.

5. Commitment To Economical Home Financing. There is strong sentiment in certain influential corners in the United States Congress, and in State and federal regulatory circles that S&Ls must have some significant commitment to economical home financing and the purposes of the National Housing Act. There is presently no clear indication of what such a commitment requires in any operating

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sense for new or existing S&L's, but many questions are being raised. How much of an investment, measured in dollars or in percent of assets, is "significant"? What does "economical home financing" mean? Does it mean low interest residential mortgages, market-rate residential mortgages, construction loans to developers of single family residences ("SFRs"), condos, apartment houses, office buildings and shopping centers? Is the concept limited to loan origination or is the test satisfied by an "ultra-wholesale" secondary market broker-trader operation? Does real estate syndication meet the test? What if the syndication develops or purchases low cost housing units or multi-residential housing? Is pre-fab low cost SFR construction a "good" activity? Are such activities within the express purposes of the National Housing Act, which are:

> "to improve Nation-wide housing standards, provide employment, and stimulate industry; to improve conditions with respect to home-mortgage financing; to prevent speculative excesses in new-mortgage investment, and to eliminate the necessity for costly second-mortgage financing, by creating a system of mutual mortgage insurance and by making provision for the organization of additional institutions to handle home financing; to promote thrift and protect savings..."?

There are no clear answers to the foregoing questions. Certain interest groups argue that the purposes of the National Housing Act would be best served by limiting S&L's to their traditional activities. Other observers note that if S&L's are to survive in a deregulated environment, they must be permitted to engage in non-traditional activities. The current laws and regulations seem to indicate that the California and federal legislatures, and the respective regulatory agencies, understand that a balance must be maintained. Associations now have the investment authority needed to be profitable, but are still regulated enough to insure continued contribution to the housing and related industries. The precise nature of this balance between the need for profitability and the goal of "economic home financing" will undoubtedly evolve as the industry makes use of its new investment powers.

STATEMENT OF

WILLIAM K. BLACK, DEPUTY DIRECTOR, FSLIC

AND

WILLIAM L. ROBERTSON, DIRECTOR

OFFICE OF REGULATORY POLICY, OVERSIGHT AND SUPERVISION

FEDERAL HOME LOAN BANK BOARD

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS

SUPERVISION, REGULATION AND INSURANCE

OF THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

UNITED STATES HOUSE OF REPRESENTATIVES

JUNE 9, 1987

EXHIBIT 2

Mr. Chairman, distinguished members of the Subcommittee, we are pleased to respond to your request that the Federal Home Loan Bank Board ("Bank Board" or "Board") testify concerning problems incurred by insured institutions as a result of bank fraud and insider abuse, and concerning Bank Secrecy and Change of Control Act reforms that were enacted, in substantial part, due to this Subcommittee's efforts. With regard to thrift failures, you have asked us to address the causes of failures -- particularly the correlation between fraud and insider abuse and thrift failures; the impact of such abuses; what the Bank Board has done to combat such failures; and how Congress can aid the Bank Board in preventing future abuses and thrift failures.

By way of overview, insider abuse and fraud are very significant contributors to thrift losses and failures. Risky investment strategies, usually including excessive growth and grossly inadequate underwriting practices are also major causes of thrift losses and failures. Worse, both of these primary contributors to the losses of the Federal Savings and Loan Insurance Corporation ("FSLIC") are often present simultaneously in our most expensive thrift failures. Combined, these two causes of losses are overwhelmingly responsible for virtually all recent failures, FSLIC's growing insolvency, and the huge coming losses that we have already identified.

As we will explain at some length, FSLIC and the Bank Board have taken tremendous regulatory and personnel steps to combat fraud, insider abuse, and imprudent investment strategies. Congress can help by enacting proposed statutory language that the Bank Board has proposed to enhance the fight against insider abuse and fraud; by increasing the resources the Department of Justice brings to bear against criminal misconduct involving thrifts; and by deleting the so-called forbearance language in the House recapitalization bill -- which would be used by those engaged in fraud and insider abuse to delay the Bank Board from ending their misconduct.

Too often, the cases involving FSLIC's largest losses have borne an uncanny resemblance to each other. The general pattern was a state-chartered association that underwent a change of control in 1982 or 1983, massive growth, adoption of a risky investment strategy emphasizing acquisition, development, and construction ("ADC") loans, acquisition, development, and land ("ADL") loans, and direct investments. Underwriting was often extremely poor. Insider abuse was usually present, and actual fraud was far from rare.

The change of control often brought a real estate developer into control of the thrift. For the unscrupulous developer, owning a thrift was a dream come true -- a virtual printing press to provide money to develop his real estate. Typically,

the new manager put minimal capital into the acquisition. Indeed, some changes of control were funded by overappraised real property, without any cash infusion.

The growth rate of many of these thrifts skyrocketed after the changes of control. Growth rates of 100 percent a year became common. Exhibits 1 and 2 are charts that show the difference in growth rates among 40 of the weaker Texas thrift, the remainder of Texas thrifts, and the U.S. average. As you can see, the difference was phenomenal. In one year, the average growth of the "Texas 40" was nearly 100 percent. Prudent underwriting is almost impossible when a thrift grows extremely rapidly. The pressure is immense to get the huge cash inflow obtained from massive deposit growth invested quickly so that it can start earning a return.

The regulatory system that Chairman Gray inherited created a perverse incentive for massive growth. His predecessors reduced the capital requirement from 5 to 3 percent, allowed five year averaging and 20 year phase-in, and debased even the minimal capital requirement that remained by creating regulatory capital definitions that materially overstated thrifts' financial health. The result was that a thrift's percentage capital requirement declined if it grew more quickly. By growing fast enough, and taking advantage of five year averaging, some thrifts had net worth requirements of one percent or less. Even that minimal net worth was often the product of bad accounting.

This massive growth went largely into highly risky investments, particularly ADC and ADL loans, and direct investments. Exhibit 3 demonstrates a much higher concentration of the "Texas 40" and other Texas thrifts in these highly risky assets compared to the U.S. average. This pattern has been repeated by many state-chartered thrifts in states with liberal investment powers. The bad ADC and ADL loans that have caused FSLIC its most severe losses involved the thrift's making an investment that is structured as a loan, but bears an equity risk. The thrift would often fund 100 percent of the loan amount (i.e., no "downpayment" was required), plus all points and fees, plus the first 2 to 3 years interest (retained as an interest reserve), and often an "equity kicker" that gave the thrift a percentage of the net profits of the project if it succeeded. Because these loans are extremely risky, they typically carried high interest rates, 3-5 points, and significant equity kickers. The loans generally required interest-only payments in the early years, and were sometimes made "without recourse" (i.e., without a personal guarantee by the borrower). Because the points and fees were booked immediately as income, the thrifts looked extremely profitable. Because of the high interest rate and the interest reserve, the thrift also looked profitable in the early years of the loan. The "interest reserve" was an important device. For example, for a two year $1 million principal amount loan at 10 percent interest, the borrower would sign a note for $1.2 million, the

thrift would disburse $1 million to the borrower, and create an interest reserve on its books of $200,000. Each month, the thrift would make a bookkeeping entry "paying" itself the interest the borrower owed that month. This entry allowed the thrift to book the interest as income. The interest reserve also meant that the loan could not become delinquent as long as the reserve was not exhausted. This meant that our prior system of identifying nonperforming loans -- delinquency of 60 days or more -- was useless for bad ADC and ADL loans.

The overall impact of bad ADC and ADL loans was that the thrift booked tremendous income from paying itself points and interest, while making highly risky loans with a tremendous danger of default, covered up the risk of default through an interest reserve, and created strong incentives for the borrower to walk away from the project if any problems developed. When combined with poor underwriting, appraisal and disbursement practices -- or outright fraud -- such loans were a prescription for disaster. An example of poor disbursement controls was Guaranty Savings of Arkansas, which was the lead lender on what was supposed to be a massive urban country club. Instead, Guaranty disbursed $22 million and ended up with (actually, FSLIC has ended up with) a 5 story hole in the ground occupying virtually a city block in downtown Dallas, Texas.

Empire Savings of Mesquite, Texas reported that it was one of the most profitable thrifts in the country -- and then failed catastrophically. It combined direct investments, structured as ADC and ADL loans, with fraud to produce massive losses.

Even when the interest reserve ran out, thrifts were often able to disguise their ADC and ADL losses through several devices. First, the thrifts often refinanced their own loans just before the interest reserve would have run out. Second, groups of thrifts would develop "back scratching" arrangements whereby they would refinance or purchase each others' bad loans if the supervisory agent was preventing self refinancing or the examiners were looking too closely at such practices. These refinancings allowed the thrifts to book additional income and avoid any loan defaults. They also caused the thrifts' risk exposure to grow even larger. Third, even if the earlier loans began to default after the interest reserves were exhausted, a thrift could continue to report high net profitability if it grew quickly enough and the new income outweighed the, by now, relatively much smaller, old nonperforming loans. This was a variant of the old pyramid scheme.

Examiners and supervisory agents had very limited means of preventing such abuses before 1985. Reappraisals ordered by the Principal Supervisory Agent ("PSA") of our ninth district, which includes Texas, took an average of nine months to complete. By the time the reappraisal was complete, the thrift often had

already doubled in size. Once the reappraisal came in indicating a serious loss, the property could be refinanced or purchased by another thrift or a shill in a backscratching deal at a purported profit. The shills who purchased such properties generally received a non-recourse loan for the full purchase price and interest. They had no risk, and were happy to "purchase" the property at an inflated price. The examiners were left to start all over again trying to prove the existence of losses. Virtually all of our enforcement powers are triggered by existence of such losses.

The typical problem ADC and ADL "loan" we have described is really a direct investment -- it poses an equity risk to the thrift. The thrifts that have made the largest number of such ADC and ADL loans and direct investments have fared disastrously. Exhibit 4 shows the problem loan ratios of the "Texas 40" as compared to the U.S. average and all other Texas thrifts. The differences are dramatic, and reflect the different investment strategies these three groups employed. (See Exhibit 3.) Similarly, of the 37 thrifts that placed more than 10 percent of their assets in direct investments in 1983, 21 of these thrifts had been placed into receivership or conservatorship or are currently of significant supervisory concern.

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These ADC and ADL problems were abetted by many professionals. Appraisers provided the inflated valuations and participated in, or blinked at, "land flips" designed to overstate the value of property through sham sales. Accountants failed to require that the ADC and ADL loans that were really direct investments be properly accounted for under generally accepted accounting principles ("GAAP"). The phony ADC and ADL income could not have been booked without such improper accounting. Attorneys provided the "creativity" necessary for sham transactions. "Shopping" for the professionals who were willing to "blink" at such improprieties, or even to plan them, became endemic among the worse managed thrifts. Similarly, borrowers learned to shop for the worst managed thrifts.

On its surface, these problem ADC and ADL loans are so insane that it seems irrational for any thrift manager to engage in such practices. From some thrift managers' perspectives, however, it could pay to make such loans. By booking high income the managers could justify awarding themselves high salaries, bonuses, and dividends. They also increased their reported net worth, which in turn, allowed them to make still larger loans and book still larger profits. Some managers also gained from loans because they were giving money to themselves through conflicts of interests or through kickbacks from borrowers. Until our growth regulation brought the pyramid scheme to a halt, the massive growth of the worst managed thrifts allowed most of these thrifts to continue to report

profitability. This was a sham. The worst managed thrifts were able to report as "profits" the act of essentially giving away their money and making themselves insolvent. These problem loans never made any sense. The decline of the regional economy merely exacerbated losses. For example, on average the "Texas 40" were insolvent on a tangible capital basis by the end of 1984 -- well before the steep 1986 drop in oil prices.

The carnage that such risky investment and growth strategies and insider abuse and fraud have left is staggering. Virtually all FSLIC's recent and pending major losses are explained by such practices. They account for the fact that FSLIC was insolvent by $6.3 billion by the end of 1986 and is now down to well under $1 billion in cash and securities. That insolvency, in turn, is not simply "technical." It has had real and painful results for the FSLIC and the thrift industry. It has exhausted the secondary reserve and thereby reduced the thrift industry's net worth by $823 million. It may also lead the accounting profession to require thrifts to "write-off" $4.8 billion in FSLIC notes held by thrifts.

FSLIC's insolvency also caused the outside accountants of the Federal Home Loan Bank of Dallas to question the value of FSLIC's guarantee of loans the Dallas Bank had made to problem thrifts. This led to the Dallas Bank "calling" our guarantee, and required FSLIC to send over $1 billion in cash to the Dallas Bank. It has also meant that very substantial FSLIC guarantees

are unlikely to be made in the future until FSLIC is restored to financial health. FSLIC guaranteed loans used to be an effective means of "leveraging" our very limited cash. Without such guarantees, many problem thrifts must increase their deposit rates to maintain their liquidity. This, in turn, increases their net operating losses, which are already running at $3.8 billion annually (approximately $1.68 billion at Texas significant supervisory cases). It also causes healthy thrifts to have to bid up their deposit rates to compete for deposits. This increases their expenses and reduces their profitability or increases their losses. Nationwide, the difference in deposit rates between FSLIC insured and FDIC insured institutions is running at more than $4 billion a year. Well-managed Texas thrifts are the worst victims of these "high rate junkies." Exhibit 5 shows the precipitous decline in Texas mortgage spreads from the end of 1985 to 1986 -- at a time when the U.S. average was improving. FSLIC has now suffered 7 consecutive months of net new deposit declines, with much of that loss suffered in Texas. Until FSLIC can resolve the problem of the high rate junkies, well-managed Texas thrifts will be forced to carry them like a heavy ball and chain. Absent the $15 billion recapitalization, FSLIC will not be able to resolve many hopelessly insolvent thrifts. Over $2.5 billion in net operating losses have occurred since the FSLIC recapitalization bill was first put on hold in October 1986.

Agency Initiatives to Address Problems

The Bank Board has been working to address these problems in numerous ways. We have testified before the Congress that budget and staffing constraints on FSLIC by the Office of Management and Budget ("OMB") and by the Office of Personnel Management ("OPM") have severely impaired our ability over time to attract, hire, and retain high quality agency staff in the numbers required. The past response by OMB and OPM to our critical needs in this regard has been grossly inadequate, to say the least.

In order to protect the safety and soundness of the thrift industry in the face of OMB's and OPM's unresponsiveness the Board has taken positive and aggressive action to strengthen its examination and supervisory efforts. As of July 6, 1985, the Board transferred its field examination function to the Federal Home Loan Banks ("FHLBanks") in order to build a well-trained, effective, and efficient field examination force. By December 31, 1985, the number of professional examiners on the staffs of the FHLBanks grew from 747 to 1,003, an increase of 34.3 percent. The Board established a goal of at least 1,500 examiners for the FHLBanks by the end of 1986; there were 1,524 professional examiners as of December 31, 1986. Many of these new examiners have advanced degrees in business or finance and/or have professional designations, such as Certified Public Accountant.

These Board initiatives have resulted in a doubling of the professional field examination staff in just a year and a half, and a tripling of the professional supervisory staff since 1984. The professional supervisory staffing levels were increased by 62.2 percent to 550 nationwide during calendar year 1986. Training of both examination and supervisory personnel was conducted at an all-time high level during 1986.

The Board determined that its purpose of improving the effectiveness of its examination and supervisory functions would be best served by establishing within the FHLBank System a new Office of Regulatory Policy, Oversight, and Supervision ("OFPOS") through which to exercise its statutory responsibility to oversee, control, and, where necessary, improve those functions. On July 24, 1986, the Board voted to establish ORPOS, and this was done effective September 27, 1986.

Another significant response undertaken by the Board to deal with the real causes of FSLIC losses was the expansion of our enforcement program. In late 1985, the Office of Enforcement ("OE") was created by the transfer of personnel and responsibilities from within the Office of General Counsel to an independent office. OE was created to increase the number of enforcement personnel to keep pace with the increase in supervisory staff at the FHLBanks, to expand the independence and effectiveness of enforcement personnel, and to enable the

staff to address better and more quickly the referrals for formal enforcement action against violations of laws and regulations and unsafe and unsound practices in the thrift industry.

During calendar year 1986, OE obtained 58 cease-and-desist orders and 48 removal and prohibition orders, and completed 15 securities cases. This represents a substantial increase over the number of actions during 1985, thereby aiding preservation of the FSLIC insurance fund.

Additionally, both OE and the Office of General Counsel have been working with the U.S. Department of Justice. Since part of the cause of FSLIC losses has involved suspected criminal conduct such as insider abuse and fraud, the Board had more than quadrupled its number of criminal referrals in 1986 over 1985, and is currently proceeding at a pace that could well exceed that number in 1987.

In addition, to underscore the full commitment to the Board's enforcement efforts, the Chairman has issued a series of supervisory directives, beginning April 12, 1984, and culminating as recently as May 22, 1987, to ensure that, despite any staffing or other constraints, the FHLBanks and the Board's staff respond decisively to all material violations, and to highlight particular areas of concern.

Another tool related to an effective enforcement program is civil litigation in the federal courts. Over the last four years the Board has nearly quadrupled the size of its litigation staff, thereby substantially increasing suits against officers, directors, and professionals who have caused losses to the FSLIC. As a result, damage recoveries for FSLIC are on a steady increase. In recent years, we have begun to concentrate our litigation efforts at obtaining injunctive relief as soon as it is legally possible, in order to maximize deterrence and minimize the dissipation of assets by insiders who have looted insured institutions. FSLIC has met with considerable success in the courts in obtaining "freeze" orders --effectively preventing continued abuse of the institution or its assets by directors or officers named in our complaints.

THE BOARD'S REGULATORY RESPONSE

During the last several years, the Board has undertaken a comprehensive regulatory program designed to promote capital adequacy in the thrift industry; limit risky investments; especially by undercapitalized or insolvent institutions; prescribe more realistic recordkeeping and reporting in the industry; and encourage allocation of adequate allowances for loan losses when assets have been identified as posing problems of collectibility. Each of these regulations should be viewed as part of the larger program and that the larger program is guided by two key principles. First, we must recognize that

FSLIC is an insurance company and its safety and soundness are imperative. Second, such regulations should generally give greater latitude to well capitalized, well managed thrifts.

The Board's regulatory initiatives have been comprehensive. We have attached a description of these initiatives as Exhibit 6.

BARRIERS TO PRUDENT REGULATION

The regulatory achievements of the Board during the past four years have, all too often, come in spite of tremendous industry opposition, and often the opposition of key state regulators. For example, in a letter received by the Board dated July 12, 1984, the Texas Savings and Loan League opposed the direct investment regulation, noting that the Dallas and San Francisco districts had booked record profits in 1982 and 1983, arguing that "risk management techniques have evolved so as to reduce the potential exposure of associations engaged in these activities." A year later, the Texas League opposed the proposed regulation on classification of assets, and on June 30, 1986, the Texas League assailed the Board's "sweeping round" of regulatory changes (net worth, liquidity, and nationwide lending) for discouraging the entry of new capital into the thrift industry:

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> The commerce of this country must be financed. We cannot have riskless financing and economic growth . . . with good industry managers, with cooperation, patience and understandings (sic) from the regulators and with the advantages and natural functions of an open market place, the savings and loan industry will continue to be a viable component in the financial institution industry.

A now troubled thrift opposed the direct investment regulation in its December 27, 1984, letter with the comment that ". . . unless we are allowed to compete and grow as fast as sound business judgment requires and supports, we cannot long survive." (Emphasis in the original.) By January 24, 1986, its letter regarding the classification of assets regulation reflected the improvements in the Board's examination and supervision process:

> Indeed, this regulation could result in the death of the Savings and Loan industry. During a period in which the industry and regulatory sectors need to come closer together, this regulation causes the industry to become more defensive and antagonized by the examiners.

The permissive investment powers of some states for state-chartered, but federally-insured, thrifts has also helped create incentives for certain thrifts to utilize these powers for high risk investments, under the philosophy "heads I win, tails the FSLIC loses." The December 26, 1984, comment letter from Texas Savings and Loan Commissioner L.L. Bowman III, regulator of a state with some of the most liberal direct investment authority in the nation, opposed the Board's proposals on direct investments, net worth, and ADC loans:

> My primary concern over the proposed definition of acquisition, development and construction loans stems primarily from the hazard of allowing an examiner to interpret complicated accounting principles and arrive at an arbitrary conclusion. I have long espoused the philosophy that this responsibility rests solely with the private audit firm which performs the association's annual audit. . . .

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> The new proposed net worth regulation (anti-growth) is by far the most damaging of the three regulatory proposals. Our industry is replete with associations whose background has been steeped in the traditional purposes of thrifts and homeownership. Their portfolios bulge with long-term fixed-rate mortgages. The majority of these mortgages are well below current yields and represent the sword of Damocles to the boards of directors of these associations. Because of this asset mix, these associations are moving irrevocably toward failure, unless they can institute a program of rapid growth in rate-sensitive transactions . . . The growth necessary to offset such sub-standard portfolios would, of necessity, be far in excess of the limitations placed on the industry in this regulation.

NEEDED CONGRESSIONAL SUPPORT

Legislative action is essential to aid the Bank Board in its efforts to stop fraud and insider abuse. The most important legislative need is to eliminate the so-called forbearance provisions of the House recapitalization bill. As we have explained, the critical need for the thrift industry is higher capital, honest accounting, quicker regulatory response, and higher levels of compliance with law and regulations. Unfortunately, Congress has been unable to pass any expansion of

our enforcement powers in the past four years. Worse, the House and Senate recapitalization bills contain not a single provision designed to aid the Bank Board in stopping fraud, insider abuse, and risky investments. Instead, the House bill, in particular, contains a panoply of provisions that will constrain the Bank Board's efforts to stop such losses.

We have already explained how our enforcement powers are generally tied to the existence of losses. The House and Senate bills would drastically curtail our ability to require thrifts to recognize the existence of losses by limiting our reappraisal and classification of asset powers to require thrifts to recognize the full extent of their losses. By purporting to limit losses to "GAAP" losses, these bills would further encourage accounting "shopping".

The House bill bars FSLIC from requiring a thrift to increase its general loss reserves regardless of the amount of its assets classified "substandard" -- which indicates an unusual danger of loss. That provision is indefensible.

The House bill creates an elaborate appeal and arbitration mechanism that can be used whenever a supervisory agent requires a thrift to recognize a loss. This is a perfect device for those engaged in insider abuse and fraud to delay any enforcement action that would stop such abuses. Those abusing a

thrift have the strongest incentive to use the arbitration mechanism. The fact that the thrift has to pay the arbiters' costs is plainly irrelevant to such insiders.

If the House truly believed that these provisions were desirable, it would have applied them to our sister banking regulatory agencies -- who also use market value appraisals and asset classifications, require additional general loss reserves for substandard assets and have no arbitration/appeal mechanism. Our sister regulatory agencies unanimously oppose such "forbearance" provisions as destructive of safety and soundness.

These provisions cannot be justified on the basis of alleged regulatory abuses by the Bank Board. This Subcommittee held hearings on these allegations and received testimony on no such abuse of any thrift in Texas or elsewhere. The testimony included rhetoric and an anonymous "whisper" campaign attacking the Bank Board, but not a single example of an abused institution. This whisper campaign sunk to its lowest level when it was alleged that the absence of a demonstration of abuse constituted proof that all thrifts were too intimidated to complain. By definition, it is logically impossible to refute such an allegation.

There is such a thing as rational forbearance, and the Bank Board's practice and policy statement provide for it. We temporarily forbear on our capital requirements for well-managed

thrifts that have a real possibility of recover, have a sound plan for returning to adequate capital, and have made enforceable commitments to follow the plan.

Other thrifts, however, are hopelessly insolvent and losing more money every day they are unresolved. Such thrifts have a tremendous incentive to engage in risky or fraudulent behavior because they are in a "heads I win, tails FSLIC loses" situation. The vital legislative initiative needed to stop this incentive is a $15 billion FSLIC recapitalization plan that would allow us to resolve these cases.

For several years, the Bank Board has sought amendment of the Home Owners' Loan Act and of Title IV of the National Housing Act to clarify and strengthen its civil enforcement powers, as explained in Chairman Gray's testimony to this Subcommittee on May 8, 1986. Some of the Bank Board's proposals have been introduced by the full Committee (see, e.g., H.R. 4998, 99th Cong., 2d Sess, and H.R. 1680, 99th Cong., 1st Sess.); however, the Congress has not acted on these vital proposals.

Having failed on its own to elicit sufficient support for the amendment, the Board is now working with the other federal financial institutions regulatory agencies to develop a joint legislative package for the enhancement of the civil enforcement authorities of all the agencies.

We would, however, like to take this opportunity to reiterate a few of those key enforcement areas in need of legislative revision. First is an amendment to permit the Board to issue a temporary cease-and-desist order on the grounds of disarray or lack of books and records. Deficient or non-existent recordkeeping has been a recurrent problem in many of the serious difficulties encountered in resolving supervisory cases. When it is clear that an institution is in severe financial straits, the Bank Board must be able to halt new business activities to prevent further losses and insolvency. However, we are hampered in doing so under our current authority if our examiners cannot determine the financial condition of the institution when its books and records are woefully inadequate. This amendment would extricate the Board from its dilemma by permitting the Board to halt certain business activities of an institution immediately when its financial condition cannot be determined because of a disarray or lack of records. This would be an invaluable tool for preventing serious problems hidden by inadequate or nonexistent records from expanding into disasters during the time needed to reconstruct and identify the problems. Similarly, the Board should be expressly authorized to require the immediate termination of any violation of law or rule through issuance of a temporary cease and desist order.

Secondly, legislative amendment is needed to clarify that the Board's and the other federal financial institutions regulatory agencies' authority to halt violations of law or regulation includes the right to require affirmative corrective action in the form of restitution, rescission, guarantees against loss, etc. by the institution or its management officials.

A further necessary clarification to the Board's enforcement authority concerns its removal and prohibition powers. For example, the grounds for removal of an officer from an institution for misconduct at another institution should be consistent with the grounds for a direct removal from the first institution. Moreover, the pertinent statutes should be amended to clarify that the agencies' removal authority is not affected by a director's or officer's resignation or other separation from the institution. The Board also has requested Congressional expansion of the industry-wide ban that presently exists for individuals who have been removed to cover not only FSLIC-insured thrifts, but all federally-insured financial institutions. Currently, a thrift official removed from one FSLIC-insured institution may not serve as a director, officer or employee at another FSLIC-insured institution; however, he or she may work for a FDIC-insured bank or a NCUA-insured credit union without penalty. The Board's suggested amendment would not only prohibit a removed individual from working at another FSLIC-insured institution, but also prohibit an individual

removed by an agency from employment at any type of federally-insured financial institution from serving at any other without prior approval of the appropriate regulatory agency.

The new interagency draft of enforcement legislation also will include a desired expansion of the agencies' civil money penalty authority and increase certain of the existing penalty provisions in current law.

Moreover, the Bank Board is likely to seek in future legislative proposals the authority presently held by the federal banking agencies to mandate capital adequacy requirements for thrift institutions in the same manner as the banking regulators have for commercial banks. See 12 U.S.C. § 3907. Among other things, the authority would assist in the prevention of insiders from dissipating the assets of an institution before corrective action could be initiated.

The grounds for appointing a receiver or conservator for a state chartered thrift should be expanded to be identical with federally chartered thrifts. Currently, a conservator or receiver can be appointed for a federally chartered thrift that willfully violates a cease and desist order, but not a state chartered association.

It would be scandalous to reduce the effectiveness of the Bank Board's tools against fraud, insider abuse, and imprudent investments. We cannot state too strongly our conclusion that the House recapitalization bill, because of its forbearance provisions, would increase FSLIC's losses and provide a shield for renewed insider abuse and fraud. We need your held to avoid this result.

BANK SECRECY ACT

You have also asked us to address the Board's efforts to implement Subtitle H of the Anti-Drug Abuse Act of 1986 and to ensure full compliance with the Bank Secrecy Act. In addition, you have asked for the Board's views on recent changes -- and additional recommendations for change -- to the Right to Financial Privacy Act. Finally, you have requested our views on the effectiveness of the 1986 changes to the Change in Savings and Loan Control Act, and on any additional legislative actions that may be necessary. 1/

1/ Last year, on April 17, 1986, the Bank Board testified before this Subcommittee on its efforts to combat money laundering, and it presented a detailed report, which we note has been included in the Report on the Hearings of Subcommittee on Tax Evasion, Drug Trafficking and Money Laundering as they Involve Financial Institutions (Serial No. 99-80). Because the agency's report of April 17, 1986, is quite detailed, we will concentrate on subsequent actions taken by the Bank Board to enhance its enforcement of the anti-money laundering statutes and to protect the financial integrity of FSLIC-insured institutions against insider abuse and fraud.

26

Implementation of the Requirements of Section 1359 of the 1986 Act

On January 27, 1987, the Bank Board, along with the Federal Reserve Board, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the National Credit Union Administration adopted comparable final regulations directing financial institutions within their respective jurisdictions to establish and maintain procedures designed to assure compliance with the Bank Secrecy Act and the implementing regulations of the Department of the Treasury (see Exhibit 7). The agencies promulgated these regulations in response to the requirements of section 1359 of the Money Laundering Control Act of 1986.

The Board's regulation requires an institution's board of directors to adopt a written compliance program that must, at a minimum, include four elements: (i) a system of internal controls; (ii) independent testing for compliance by in-house personnel or others; (iii) designation of individual(s) to be responsible for day-to-day compliance; and (iv) provision for training of personnel.

Pursuant to the regulation, institutions under the jurisdiction of the Bank Board were required to have their programs implemented by April 27, 1987.

Other Regulatory Efforts on BSA

On May 8, 1987, the Board published in the Federal Register a proposed rule that clarifies and expands the existing rule to set forth in greater detail the necessary elements of a Bank Secrecy Act compliance program (see Exhibit 8). The proposal focuses on three areas: testing, training, and board of director action.

First, the proposed rule clarifies that the testing of the Bank Secrecy Act compliance program is to be conducted semiannually on a random schedule in order to provide an accurate examination of the compliance program. Testing may be performed by the thrift's auditors or by management personnel not directly involved in the day-to-day Bank Secrecy Act compliance process. Each test of an institution's compliance program would involve six minimum steps: (i) a review of any prior test results; (ii) a review of the institution's written operating procedures for compliance with the Treasury Bank Secrecy Act regulations and whether the procedures are designed to enable an institution's personnel to identify transactions subject to the Bank Secrecy Act and the Money Laundering Control Act; (iii) a check of a sampling of the records that Treasury requires to ascertain compliance with the Treasury regulations and completeness; (iv) a check of a sampling of the currency reports required to be filed to ascertain their completeness and accuracy; (v) a review of the institution's exemption list to

verify the continuing appropriateness of the exemptions and whether the records supporting the exemptions are current and complete; and (vi) submission of the results of the Bank Secrecy Act compliance testing to the institution's auditors for incorporation in the annual audit report for presentation to the institution's board of directors.

Upon receipt of the annual audit report including the results of the independent testing of the thrift's Bank Secrecy Act compliance program, the thrift's board is directed by the proposed rule to take those steps necessary to remedy any deficiencies discovered by the testing program. Any such actions to remedy deficiencies are to be reflected in the minutes of the board of directors.

The Board's proposed rule also clarifies the existing rule on training for Bank Secrecy Act compliance. The proposal specifies that the existing training requirement extends to all employees, not just those newly-hired, and that documentation of actual training must be maintained. In addition, institutions are directed to focus their training efforts on all personnel who have duties relating to the reporting or recordkeeping requirements of the Bank Secrecy Act, particularly those who accept deposits or otherwise handle cash.

29

Improvements in the BSA Examination Process

As the Board noted in its April 1986 testimony, during the period from 1982 through mid-year 1986, examiners were granted discretion as to whether their regular examinations of thrift institutions would include testing for the institutions compliance with the requirements of the BSA. Although the Bank Board would have preferred to require every regular examination to include such testing, the inadequate numbers of examiners made that goal impossible at the time. Nevertheless, during our testimony to this Subcommittee, the Bank Board indicated its commitment to ensuring compliance with the law and pledged to improve examinations for BSA compliance.

Due to the reorganization of the examinations function of the agency, discussed previously, the examinations staff has increased substantially. Accordingly, on May 12, 1986, ORPOS informed the examinations staff that every regular examination is to include testing for compliance with BSA requirements in accordance with procedures now set forth in the revised manual for examiners, the Examination Objectives and Procedures Manual ("EOP").

Under the revised EOP, examiners are to perform certain tests to ascertain whether the subject institution is complying with the BSA requirements. If upon application of the tests the

examiner detects deficiencies the examiner must conduct an expanded scope examination.

Examiner Education and Training

ORPOS has revised the EOP to reflect the latest interagency Bank Secrecy Act examination guidelines and procedures. ORPOS also has issued a chapter on the Bank Secrecy Act for inclusion in the Board's Supervisory Objectives and Procedures Manual in order to provide further guidance to the Board's supervisory agents on their responsibilities under the Act.

Additional guidance has been provided to supervisory and examination personnel and to the industry on the compliance requirements of the Bank Secrecy Act through use of the Board's Technical Series Memoranda which have been updated in the last year to reflect changes in Treasury's regulations and revisions in the currency transaction reporting forms or instructions. These memoranda include suggestions on features thrifts should consider including in their Bank Secrecy Act compliance programs.

The Bank Board also has expanded its requirements for the annual independent audit of insured institutions. Following consultation with the American Institute of Certified Public Accountants ("AICPA"), the Bank Board now requires an institution's audit to include testing the institution's

procedures for compliance with the Bank Secrecy Act and the Board's guidelines on the Act, and the auditors are to issue a special purpose report on its findings.

The Bank Board also has educated thrifts on the Bank Secrecy Act and its requirements through publication of an article in the July/August 1986 issue of the thrift industry magazine, "Outlook on the Federal Home Loan Bank System". (See Exhibit 9).

Right to Financial Privacy Act Issues

The Subcommittee also has requested that the Board comment on last year's proposed amendment to the Right to Financial Privacy Act of 1978. We note that Title V of the Omnibus Drug Enforcement, Education, and Control Act of 1986 (H.R. 5484, 99th Cong., 2d Sess), as reported by the full committee on September 11, 1986, proposed revisions to the Right to Financial Privacy Act; regrettably, the proposals were not enacted into law. Title V of H.R. 5484 would have provided an exemption from the requirement of customer notices under limited circumstances. The Bank Board supports the proposal, but we believe it does not go far enough.

As the Subcommittee is aware, the Board -- along with the other four federal financial institution supervisory agencies -- entered into an agreement on April 2, 1985, with the Federal

Bureau of Investigation and the Department of Justice to form a "Working Group" to improve the referral, investigation, and prosecution of bank fraud and insider abuse cases. High among the goals of the Working Group has been seeking an amendment to the Right to Financial Privacy Act that would remove the current impediments in the statute that limit or complicate the sharing of information among and between the named agencies and the departments. The Working Group has supported a clarifying amendment to the Right to Financial Privacy Act to permit the transfer of financial information lawfully in the possession of one government agency (such as the Bank Board) to another government agency (such as the Justice Department) for a law enforcement purpose within the jurisdiction of the receiving agency without notice to the customer. This amendment is broader than the exemption contained in the omnibus drug bill of last year and the Board continues to support adoption of the Working Group's broader exemption.

Another important goal of the Working Group relates to the inability of the supervisory agencies to receive information that the Department of Justice may have as a result of Grand Jury proceedings. Our inability to obtain this information prevents us from most effectively performing some of our responsibilities, such as our duty to process Change-in-Control applications. The Anti-Drug Abuse Act of 1986 amended the Change in Control Act to require prior notice of at least 60 days to the Board of a proposed acquisition to allow the Board

time to investigate the acquirors. However, one potentially important source of information on acquirors -- that developed from Grand Jury proceedings -- is currently beyond the access of the Board and all of the federal financial institutions regulatory agencies. Presently, the federal financial institutions regulatory agencies may seek grand jury information only if the agency has an ongoing "judicial proceeding" to which the information is relevant. Unfortunately, a change in control application does not qualify as a "judicial proceeding" and a prosecutor would be unable to share with the agency pertinent information on the fitness of those individuals attempting to gain control of an insured institution. The Working Group supports amendment of the grand jury secrecy rule to permit the sharing with an agency of information or documents obtained through a grand jury for matters within that agency's jurisdiction, such as a change in control application.

CHANGE IN SAVINGS AND LOAN CONTROL ACT

Finally, you have requested that the Bank Board provide the Subcommittee with its assessment of the effectiveness of the amendments to the Control Act set forth at Section 1361 of Title I of the Anti-Drug Abuse Act and that the Bank Board advise the Subcommittee of any additional legislative actions that may be necessary or appropriate in this area. In general, the Bank Board applauds the changes made by the amendments. We also note

that in many ways, the Bank Board, on its own initiative, had already made changes in its own procedures to address the very areas with which the Amendments were concerned.

The investigative authority granted by the Anti-Drug Abuse Act has been particularly helpful to the Bank Board; this authority is currently being used by the Bank Board in its formal examinations and investigations of institutions. In addition, the amendments have been useful in specifically giving to the Bank Board authorization (and, with respect to certain provisions, the responsibility) to verify information, seek comment on applications, and compel publication of Notices.

The Bank Board welcomed the clarification of the Bank Board's authority to seek injunctive relief. The Bank Board had previously taken the position that it had the authority to seek such a remedy, but the clear statement in the amendments removes any questions of the Bank Board's authority to seek such relief.

The amendments also require, among other things, that the Bank Board make an independent determination of the accuracy and completeness of information provided by an applicant concerning such areas as the applicant's identity, background, and experience; his or her assets, liabilities and income; any criminal indictments or convictions; and the identity, source, and amount of funds or other consideration to be used in making

the acquisition. The amendments direct the Bank Board to prepare a written report of the investigation -- including, at a minimum, a summary of the results of the investigation.

Prior to the enactment of the amendments, the Bank Board, on its own initiative, had in fact initiated procedures to verify significant information in the material submitted to the Bank Board. An FBI name check is conducted for every applicant. Computerized data systems also are used to check the background of applicants. These data bases include the Bank Board's own computer information system and commercially available data bases maintained by third parties. Applicants are required, pursuant to forms promulgated under the Control Act, to submit financial statements that have been certified by an independent public accountaht. The staff also may contact credit agencies and verify the credit history of an applicant. Where a proposed acquisition of control has involved the incurrence of debt, applicants have been required to submit copies of the underlying documents for review. Information obtained as a result of these inquiries is included, along with other pertinent information obtained from the applicant, in a worksheet style report used to evaluate the application and to record the steps taken in the review process.

The amendments also provided for public comment regarding change-in-control notices. The statute provides for the publication of the name of the insured institution to be

acquired and the persons identified in the notice as a person by whom or for whom such acquisition is to be made. In addition, the statute provides for the solicitation of public comment on the proposed acquisition, particularly in the geographic area where the institutions proposed to be acquired is located.2/

Again, the Bank Board, on its own initiative, in 1985 had promulgated regulations requiring public notice of proposed acquisitions in the area of the institution to be acquired, and the solicitation of comments. A specific procedure also was provided for notice to the "target" institution. In promulgating these regulations, the Bank Board noted that it "finds that public participation in the applications process can be helpful in the execution of its duties, particularly in bringing to its attention information that would prevent acquisitions of control of insured institutions by unqualified or dishonest acquirors."3/

With regard to legislative changes that may be necessary or appropriate, we direct your attention to 12 U.S.C. § 1730(q)(16), which provides, in part, that any person who willfully violates the Control Act, or any regulation or order issued by the Corporation pursuant thereto, shall forfeit and

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2/ The statute includes an exception from the publication and comment process if the Corporation determines in writing that such disclosure or solicitation would seriously threaten the safety or soundness of the institution to be acquired.

3/ Board Resolution No. 85-1005 (November 8, 1985), 50 FR 48686 (November 26, 1985).

pay a civil penalty of not more than $10,000 per day for each day during which such violation continues. The statute provides the Corporation with authority to assess such a civil penalty, after notice and an opportunity to submit various types of information is given, and after giving consideration to certain enumerated factors. The Bank Board, however, must bring an action in the appropriate United States district court to collect the penalty.

The Bank Board and the other agencies participating in the Working Group believe that it would be extremely useful to amend the Control Act to provide for the imposition of penalties through use of an administrative proceeding in the same manner that the agencies have the authority to impose penalties for violation of other statutes. In addition, the Working Group advocates the deletion of the need to demonstrate "willfulness" in all cases in order to assess such penalties. The "willfulness" requirement is difficult to prove, and 12 U.S.C. § 1730(q)(16) already incorporates the state of mind of the offender by requiring the Bank Board to consider the "good faith of the person charged." A range of remedies, similar to that contained in the Savings and Loan Holding Company Act, would give the Bank Board valuable flexibility to deal with various types and degrees of violations of the Control Act. The Working Group is presently drafting proposed language regarding these concerns.

EXHIBIT 1

CUMULATIVE AVERAGE ANNUAL GROWTH OF THE TEXAS 40
AND THE UNITED STATES AVERAGE
1983 - 1986

Cumulative Average Annual Growth of the TEXAS 40 and the United States Average, 1983 - 1986

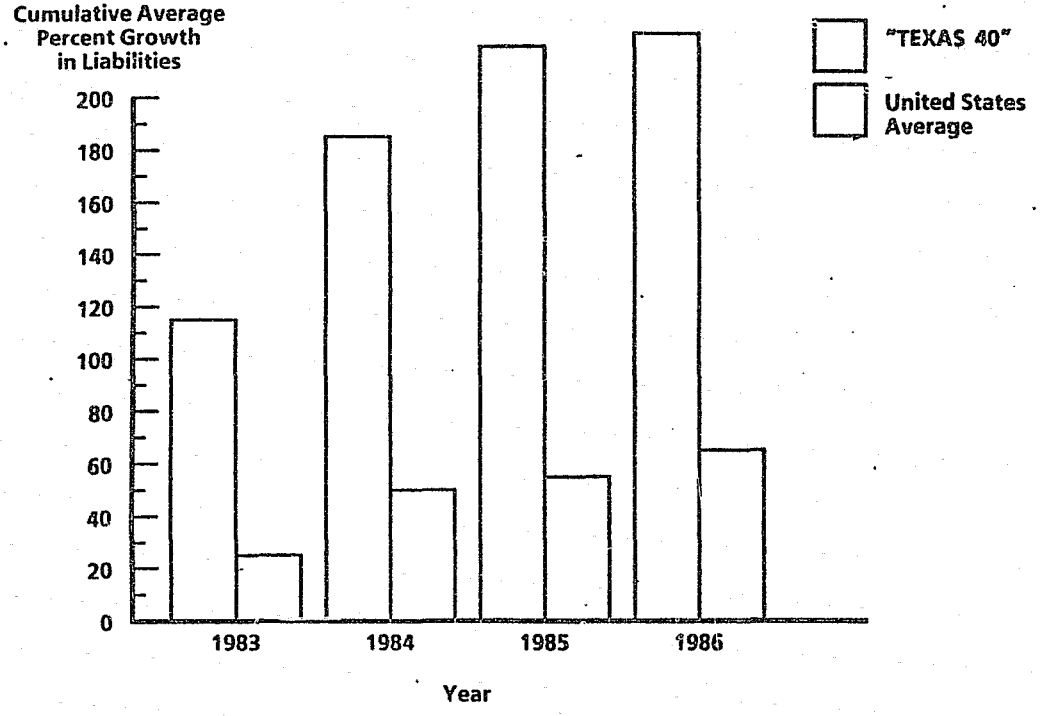

EXHIBIT 2

EXTRAORDINARY GROWTH OF TEXAS THRIFTS
BETWEEN DECEMBER 1982 AND DECEMBER 1986

Extraordinary Growth of Texas Thrifts Between December 1982 and December 1986

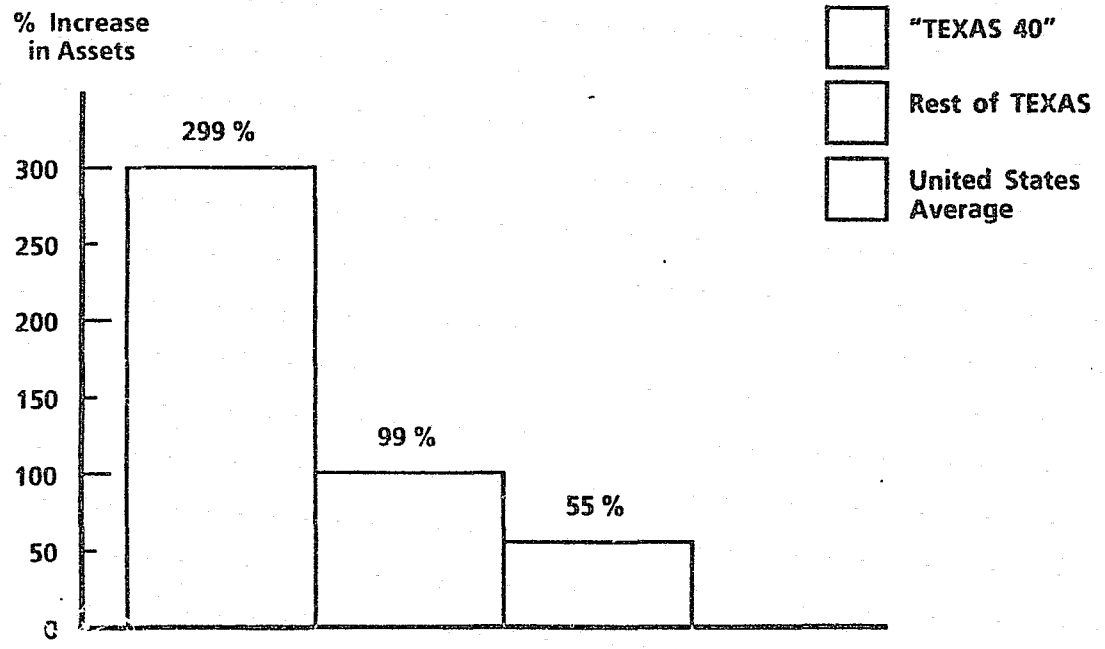

EXHIBIT 3

DIRECT INVESTMENT LOANS & ACQUISITION, DEVELOPMENT, AND LAND LOANS

Direct Investment, (D.I.) & Acquisition, Development and Land Loans (ADL)

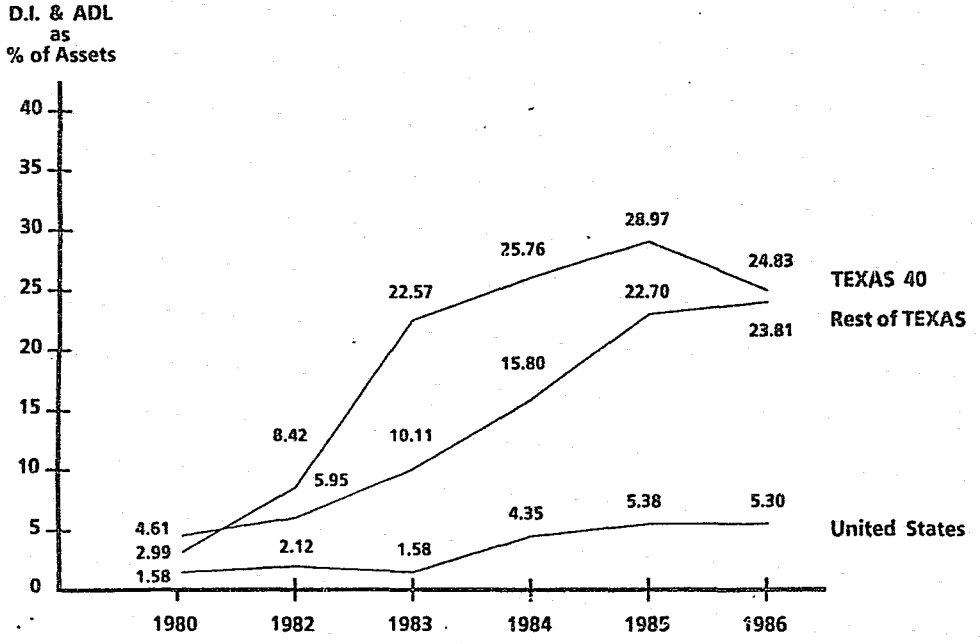

EXHIBIT 4

PROBLEM LOANS AS A PERCENTAGE OF ASSETS

Problem Loans as a Percentage of Assets

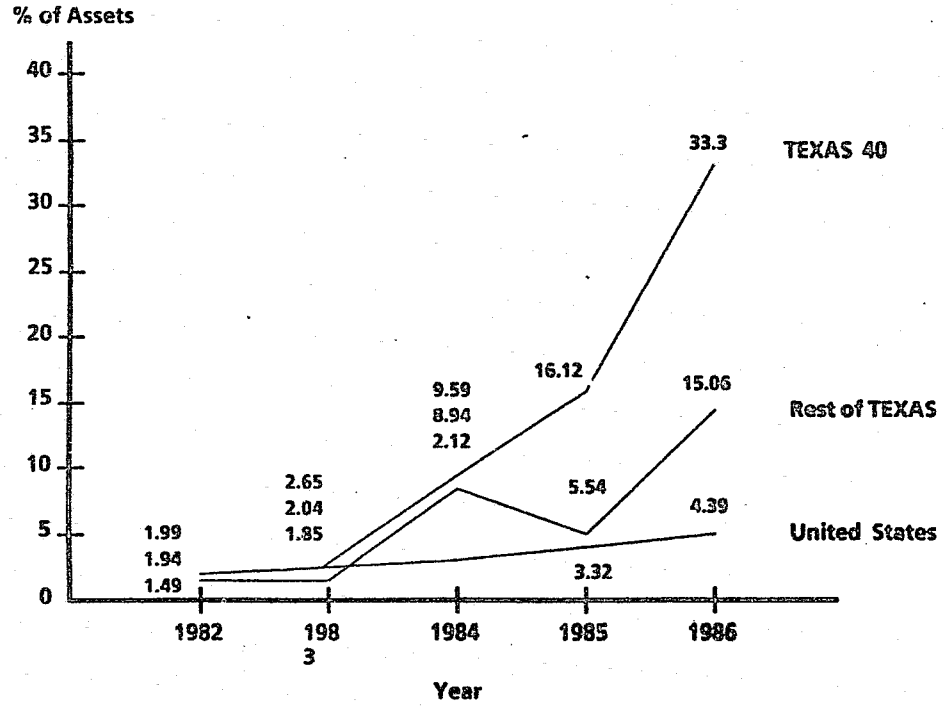

EXHIBIT 5

MORTGAGE YIELD SPREADS

APPENDIX 23

MORTGAGE YIELD SPREADS
(BASIS POINTS)

	84-04	85-01	85-02	85-03	85-04	86-01	86-02	86-03	86-04
Arkansas	221	175	212	221	224	250	166	92	182
Louisiana	88	152	185	196	209	194	210	198	178
Mississippi	194	223	230	266	285	257	262	286	329
New Mexico	145	218	222	247	302	259	277	232	211
Texas	149	206	242	241	277	234	183	121	110
District 9	147	197	231	235	265	231	191	139	136
United States	161	218	245	264	275	279	280	276	288

Source: Federal Home Loan Bank of Dallas

EXHIBIT 6

THE BOARD'S REGULATORY RESPONSE

Capital Regulation; Liability Growth Regulation

The net worth and liability growth regulations were developed by the Board in consultation with its field staff, and were formally adopted by the Board in January 1985. They curtail overleveraged deposit growth and require institutions to increase their capital as they increase their deposits. On August 15, 1986, the Board -- again in close consultation with senior supervisory agents in the field -- amended its net worth and growth regulations by building upon their basic frameworks.

The minimum capital requirements for thrift institutions adopted on August 15, 1986, and effective January 1, 1987, can be divided into three components: a liability component, a contingency component, and a maturity-matching credit. The liability component requires institutions to hold capital equal to six percent of their liabilities in excess of the level on their books on January 1, 1987. The capital requirement for the liability level on their books on January 1, 1987, will initially equal approximately three percent and will increase each year (until it reaches six percent) by a fraction of the average profitability in the industry during the preceding year. An institution's specific initial requirement will depend on its base requirement under the regulation in effect prior to January 1, 1987.

The contingency component requires institutions to hold incremental capital against certain assets. The contingency component includes a two percent requirement on recourse liabilities, a two percent requirement on standby letters of credit, and a 20 percent requirement on scheduled items. It also contains a variable component for which the incremental capital requirement depends on an institution's actual capital level and its concentration in a specific asset category. These variable incremental requirements apply to direct investments, under the Board's proposed Equity Risk Investment rule, direct investments, including, land loans and nonresidential construction loans.

The maturity-matching credit allows institutions to reduce their capital requirement by up to two percent of liabilities for one-year and three-year cumulative hedged maturity gaps of less than 15 percent and 25 percent receive credit on a declining scale and gaps above 25 percent received no credit. Institutions cannot use this credit to bring their overall requirement below three percent for the first three years of the regulation and not below four percent thereafter.

On January 31, 1985, the Board adopted, in conjunction with its final rule pertaining to net worth requirements for insured institutions, a new regulation, section 563.13-1, to prohibit any insured institution having assets in excess of $100,000,000 from increasing its total liabilities during any two consecutive

quarters at an annual rate in excess of 25 percent unless a growth plan had been approved in advance by the institution's PSA. In order to obtain such approval, an institution was required to submit to its PSA a detailed growth plan containing information necessary for the PSA to determine the institution's ability to manage the resulting increase in size, whether the investments contemplated by such growth would be appropriately diversified, the stability of the funding sources and the risk of potential runs, and the interest rate and credit risk posed by the planned uses of funds.

The most recent amendment to this growth regulation, adopted at the same time as the capital regulation in August of 1986, clarified that institutions may not increase their total liabilities within any two-quarter period at a rate greater than 12.50 percent (still an annualized rate of 25 percent) without prior PSA approval. This growth limitation applies to every insured institution unless it is exempt because it meets or exceeds its current regulatory capital requirement.

4

Definition of Regulatory Capital Regulation; Proposed Policy Statement on Accounting for Acquisition, Development and Construction ("ADC" Loans)

The Board is moving steadily in the direction of requiring insured institutions to report in compliance with Generally Accepted Accounting Principles ("GAAP"). In May of 1987, the Board issued a final rule on the Definition of Regulatory Capital. That rule requires that for periods beginning on or after January 1, 1988, insured institutions prepare in accordance with GAAP all financial statements, all audited financial statements, and reports, all financial reports required to be filed with the Board, and all counterstatements. In addition, these statements and reports must include a footnote reconciliation of GAAP equity capital to regulatory capital.

The definition of regulatory capital includes equity capital, computed under GAAP, and items based on risk analysis reporting ("RAR") that are not part of GAAP equity capital. Mutual insured institutions can only obtain external capital through the sale of subordinated debt, which would not qualify as GAAP capital, but is generally treated as capital for RAR purposes.

In keeping with this policy of applying GAAP accounting standards to insured institutions to the extent it is reasonable and possible to do so, the Board has proposed to amend its statements of policy relating to accounting for acquisition development, and construction loans to comport with the position taken by the American Institute of Certified Public Accountants and by the Chief Accountant of the Securities and Exchange Commission on determining whether a transaction characterized as an ADC loans is truly a loan or is, in substance, a real estate investment or participation in a joint venture.

Direct Investment Regulation

The new direct-investment rule significantly revised the investment thresholds beyond which institutions must obtain prior supervisory approval for their direct-investment activities. Institutions that fail their minimum capital requirement must still receive prior approval for all direct investments. Institutions that meet their minimum capital requirement but have less than six percent tangible capital may hold the greater of three percent of assets or two and one-half times their tangible capital in direct investments without supervisory review or approval. Beyond this threshold, supervisory review and approval is required. Finally, institutions meeting their minimum capital requirement and

having at least six percent tangible capital may hold up to three times their tangible capital in direct investments before supervisory review and approval is required.

The new rule significantly strengthens the former rule by linking review thresholds to an institution's tangible capital, rather than regulatory capital, which includes such intangible assets as goodwill and deferred loan losses.

As was true with the previous regulation, the new rule retains the waiver provisions. That is, institutions that wish to engage in direct investments beyond their established thresholds may apply for a waiver from the PSA in their respective districts if the institution has the proper controls to limit its risk exposure.

The Board also issued a proposal that would define an "equity-risk investment" to include all direct investments as currently defined by the direct-investment regulation, as well as land loans and nonresidential construction loans with loan-to-value ratios greater than 80 percent or loan-to-cost ratios greater than 100 percent. These loans also would be subject to incremental capital requirements of up to ten percent as established by the regulatory capital rule.

7

Proposed Rules On Classification Of Assets And Appraisal Standards

In May 1987, the Board issued a proposal to amend its classification of assets regulation to ensure the use of broader, but judicious, examiner discretion in the classification of assets, consistent with the examination practices of the bank regulatory agencies. Heretofore, the Board's appraisal standards were published as supervisory memorandum R41c issued by its Office of Regulatory Policy, Oversight, and Supervision. The standards contained in R41c were substantially the same as those contained in its predecessor memorandum, R41b, praised as "highly developed and comprehensive" by the House Committee on Government Operations. The Board's current proposed regulation clarifies and simplifies its existing appraisal standards. The standards themselves, however, would continue to require derivation of a market value for properties in accordance with methodology accepted and in use by the appraisal industry.

EXHIBIT 7

PROCEDURES FOR MONITORING BANK SECRECY ACT COMPLIANCE

DEPARTMENT OF THE TREASURY

Comptroller of the Currency

12 CFR Part 21

[Docket No. 87-2]

FEDERAL RESERVE SYSTEM

12 CFR Part 208

[Docket No. R-0594]

FEDERAL DEPOSIT INSURANCE CORPORATION

12 CFR Part 326

FEDERAL HOME LOAN BANK BOARD

12 CFR Part 563

[Docket No. 87-1]

NATIONAL CREDIT UNION ADMINISTRATION

12 CFR Part 748

Procedures for Monitoring Bank Secrecy Act Compliance

AGENCIES: Office of the Comptroller of the Currency, Treasury; Board of Governors of the Federal Reserve System; Federal Deposit Insurance Corporation; Federal Home Loan Bank Board; and National Credit Union Administration.

ACTION: Final rule.

SUMMARY: The Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Federal Home Loan Bank Board, and National Credit Union Administration (collectively referred to as the "agencies") are amending their respective regulations to require the financial institutions that they regulate ("regulated institutions") to establish and maintain procedures to assure and monitor compliance with the requirements of subchapter II of chapter 53 of Title 31, United States Code. In its original form, subchapter II was part of Pub. L. 91-508 which requires recordkeeping for and reporting of currency transactions by banks and others and is commonly known as the "Bank Secrecy Act." This action is necessary for the agencies to comply with the requirements of section 1359 of the Anti-Drug Abuse Act of 1986, Pub. L. 99-570. This final rule is effective on January 27, 1987, and is intended to assure that regulated institutions establish and maintain procedures to comply with the requirements of the Bank Secrecy Act. Because the agencies are acting under a three-month statutory deadline, this final rule establishes only those requirements that we consider to be the minimum necessary for any compliance procedure. The agencies, however, are considering whether to establish more detailed compliance procedures in the near future.

DATE: This final rule is effective January 27, 1987.

ADDRESSES: Office of the Comptroller of the Currency, 490 L'Enfant Plaza East, SW., Washington, DC 20219.

Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue NW., Washington, DC 20551.

Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, DC 20429.

Federal Home Loan Bank Board, 1700 G Street, NW., Washington, DC 20552.

National Credit Union Administration, 1776 G Street, NW., Washington, DC 20456.

FOR FURTHER INFORMATION CONTACT: Thomas C. Lehmkuhl, National Bank Examiner, Commercial Activities Division, (202) 447-1164 or Yvonne D. McIntire, Attorney, Legislative and Regulatory Analysis Division, (202) 447-1177, Office of the Comptroller of the Currency.

Sara A. Kelsey, Senior Attorney Legal Division, (202) 452-3236, Conrad G. Bahlke, Attorney, Legal Division, (202) 452-3707, or Richard Schriber, Senior Financial Analyst, (202) 452-2733, Division of Bank Supervision and Regulation, Board of Governors of the Federal Reserve System.

R. Eugene Seitz, Review Examiner, Division of Bank Supervision, (202) 898-6783 or Katharine H. Haygood, Senior Attorney, Legal Division (202) 898-3732, Federal Deposit Insurance Corporation.

John Downing, Attorney, Office of Enforcement, (202) 653-2604, C. Dawn Causey, Attorney, Office of Enforcement, (202) 653-2624, or Francis Raue, Policy Analyst, Office of Regulatory Policy, Oversight, and Supervision, (202) 778-2517, Federal Home Loan Bank Board.

Martin Kushner, Examiner, Office of Examination and Insurance, (202) 357-1065 or John K. Ianno, Staff Attorney, Litigation Division, (202) 357-1030, National Credit Union Administration.

SUPPLEMENTARY INFORMATION:

Background

Section 1359 of the Anti-Drug Abuse Act of 1986 ("Act"), contains a number of provisions amending section 8 of the Federal Deposit Insurance Act (12 U.S.C. 1818), section 5(d) of the Home Owners' Loan Act of 1933 (12 U.S.C. 1464(d)), section 407 of the National Housing Act (12 U.S.C. 1730) and section 206 of the Federal Credit Union Act (12 U.S.C. 1786). Specifically, these provisions require the agencies to: (1) Prescribe regulations requiring regulated institutions to establish and maintain procedures reasonably designed to assure and monitor compliance with the Bank Secrecy Act; and (2) review such procedures during the course of their examinations. The regulations requiring regulated institutions to establish procedures are to take effect within three months after enactment—by January 27, 1987. The Act also authorizes the agencies to issue civil money penalties and cease and desist orders in the event that a regulated institution fails to establish such procedures or to correct problems with regard to its procedures after an agency has notified the institution that problems exist.

Agency Action

The agencies are issuing this final rule to require regulated institutions to establish and maintain a program designed to assure and monitor compliance with the requirements of the Bank Secrecy Act and the implementing regulations promulgated thereunder by the Department of the Treasury established at 31 CFR Part 103. An institution's compliance program must, at a minimum, consist of a system of internal controls to assure ongoing compliance and provide for independent testing of compliance by the institution's personnel or by an outside party. The institution shall also designate an individual or individuals responsible for coordinating and monitoring day-to-day compliance and provide training for appropriate personnel.

This final rule becomes effective on January 27, 1987. Institutions must have developed and implemented their compliance programs by April 27, 1987. The Department of the Treasury has advised the agencies that institutions should recognize that compliance with the requirements of this rule, standing alone, will not be considered to be a defense in any criminal prosecution or civil action involving a violation of the Bank Secrecy Act or regulations promulgated thereunder.

Reason for Adoption Without Prior Notice and Comment

Immediate adoption of this final rule is necessary to comply with the requirements of section 1359 of the Anti-Drug Abuse Act of 1986, Pub. L. 99-570, which requires the agencies to

promulgate regulations to take effect by January 27, 1987.

Due to the time constraint, we find that application of the notice and public participation provisions of the Administrative Procedure Act (5 U.S.C. 553) to this action would be impracticable and that good cause exists for making this action effective immediately. Since we have had to move so rapidly to implement the requirements of the Act, we have established only those requirements that we consider to be the minimum necessary for any compliance procedure. Consequently, the agencies are considering whether to establish more detailed compliance procedures in the near future.

Regulatory Flexibility Analysis

Because no notice of proposed rulemaking is required under section 553 of the Administrative Procedure Act or any other law, the Regulatory Flexibility Act (5 U.S.C. 601-602) does not apply.

Executive Order 12291

The Office of the Comptroller of the Currency has determined that this final rule is not a "major rule" and, therefore, does not require a regulatory impact analysis.

Paperwork Reduction Act

12 CFR Part 21

Pursuant to the Paperwork Reduction Act of 1980, the recordkeeping requirements of 12 CFR 21.21 were submitted to and approved by the Office of Management and Budget under control number 1557-0180.

12 CFR Part 208

Pursuant to the Paperwork Reduction Act of 1980 and the regulations promulgated thereunder, the recordkeeping requirements of 12 CFR 208.14 have been approved by the Board of Governors of the Federal Reserve System under delegated authority from the Office of Management and Budget and have been assigned control number 7100-0196.

12 CFR Part 326

Pursuant to the Paperwork Reduction Act of 1980, the recordkeeping requirements of 12 CFR Part 326 were submitted to and approved by the Office of Management and Budget under control number 3064-0087.

12 CFR Part 563

Pursuant to the Paperwork Reduction Act of 1980; the recordkeeping requirements of 12 CFR Part 563 were submitted to and approved by the Office of Management and Budget under control number 3068-__.

12 CFR Part 748

Pursuant to the Paperwork Reduction Act of 1980, the recordkeeping requirements of 12 CFR Part 748 were submitted to and approved by the Office of Management and Budget Under control number 3133-0094.

List of Subjects

12 CFR Part 21

National banks, Criminal referrals, Insider abuse, Theft, Embezzlement, Check kiting, Defalcations, Currency, Foreign currency, Reporting and recordkeeping requirements.

12 CFR Part 208

Banks, Banking, Currency, Federal Reserve System, Foreign currency, Reporting and recordkeeping requirements, Securities.

12 CFR Part 326

Banks, Banking, Currency, Federal Deposit Insurance Corporation, Foreign currency, Reporting and recordkeeping requirements, Security measures, State nonmember bank.

12 CFR Part 563

Bank deposit insurance, Investments, Reporting and recordkeeping requirements, Savings and loan associations.

12 CFR Part 748

Report of crime or catastrophic act, Currency, Reporting and recordkeeping requirements.

COMPTROLLER OF THE CURRENCY

Authority and Issuance

For the reasons set forth in the preamble, 12 CFR Part 21 is amended as follows:

1. The authority citation for 12 CFR Part 21 is revised to read as follows:

Authority: 12 U.S.C. *et seq.*, 93a, 1818, as amended, 1881-1884 and 31 U.S.C. 5311 *et seq.*

2. The title of Part 21 is revised to read as follows:

PART 21—MINIMUM SECURITY DEVICES AND PROCEDURES, REPORTS OF CRIMES AND SUSPECTED CRIMES AND BANK SECRECY ACT COMPLIANCE.[1]

3. New Subpart C consisting of § 21.21 is added to read as follows:

[1] In its original form, subchapter II of chapter 53 of title 31, United States Code was part of Pub. L. 91-508 which requires recordkeeping for and reporting of currency transactions by banks and others and is commonly known as the "Bank Secrecy Act."

Subpart C—Procedures for Monitoring Bank Secrecy Act Compliance

§ 21.21 Bank Secrecy Act compliance.

(a) *Purpose.* This subpart is issued to assure that all national banks establish, and maintain procedures reasonably designed to assure and monitor their compliance with the requirements of subchapter II of chapter 53 of title 31, United States Code, and the implementing regulations promulgated thereunder by the Department of Treasury at 31 CFR Part 103.

(b) *Compliance procedures.* On or before April 27, 1987, each bank shall develop and provide for the continued administration of a program reasonably designed to assure and monitor compliance with the recordkeeping and reporting requirements set forth in subchapter II of chapter 53 of title 31, United States Code, and the implementing regulations promulgated thereunder by the Department of Treasury at 31 CFR Part 103. The compliance program shall be reduced to writing, approved by the board of directors and noted in the minutes.

(c) *Contents of compliance program.* The compliance program shall, at a minimum:

(1) Provide for a system of internal controls to assure ongoing compliance;

(2) Provide for independent testing for compliance to be conducted by bank personnel or by an outside party;

(3) Designate an individual or individuals responsible for coordinating and monitoring day-to-day compliance; and

(4) Provide training for appropriate personnel.

(Approved by the Office of Management and Budget under control number 1557-0180)

Dated: December 22, 1986.

Robert L. Clarke,

Comptroller of the Currency.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Authority and Issuance

For the reasons set forth in the preamble, 12 CFR Part 208 is amended as follows:

PART 208—[AMENDED]

1. The authority citation for 12 CFR Part 208 is revised to read as follows:

Authority: 12 U.S.C. 248, 321-338, 486, 1814, 1816, as amended; 3907, 3909, and 31 U.S.C. 5311 *et seq.*, unless otherwise noted.

2. A new § 208.14 is added to read as follows:

§ 208.14 Procedures for monitoring Bank Secrecy Act compliance.

(a) *Purpose.* This section is issued to assure that all state member banks establish and maintain procedures reasonably designed to assure and monitor their compliance with the provisions of subchapter II of chapter 53 of title 31, United States Code, the Bank Secrecy Act, and the implementing regulations promulgated thereunder by the Department of Treasury at 31 CFR Part 103, requiring recordkeeping and reporting of currency transactions.

(b) *Establishment of compliance program.* On or before April 27, 1987, each bank shall develop and provide for the continued administration of a program reasonably designed to assure and monitor compliance with the recordkeeping and reporting requirements set forth in subchapter II of chapter 53 of title 31, United States Code, the Bank Secrecy Act, and the implementing regulations promulgated thereunder by the Department of Treasury at 31 CFR Part 103. The compliance program shall be reduced to writing, approved by the board of directors, and noted in the minutes.

(c) *Contents of compliance program.* The compliance program shall, at a minimum:

(1) Provide for a system of internal controls to assure ongoing compliance;

(2) Provide for independent testing for compliance to be conducted by bank personnel or by an outside party;

(3) Designate an individual or individuals responsible for coordinating and monitoring day-to-day compliance; and

(4) Provide training for appropriate personnel.

(Approved by the Office of Management and Budget under control No. 7100-0186)

Board of Governors of the Federal Reserve System, January 21, 1987.

James McAfee,

Associate Secretary of the Board.

FEDERAL DEPOSIT INSURANCE CORPORATION

Authority and Issuance

For the reasons set forth in the preamble, 12 CFR Part 326 is amended as follows:

1. The authority citation for 12 CFR Part 326 is revised to read as follows:

Authority: 12 U.S.C. 1819 [Tenth], 1881–1884; 31 U.S.C. 5311 *et seq.*

2. The title of Part 326 is revised to read as follows:

PART 326—MINIMUM SECURITY DEVICES AND PROCEDURES AND BANK SECRECY ACT [1] COMPLIANCE FOR INSURED STATE NONMEMBER BANKS

3. Part 326 is amended by designating §§ 326.0 through 326.7 as Subpart A:

Subpart A—Minimum Security Devices and Procedures

4. The heading of § 326.0 is revised to read as follows:

§ 326.0 Scope of subpart.

5. New Subpart B consisting of § 326.8 is added to read as follows:

Subpart B—Procedures for Monitoring Bank Secrecy Act Compliance

§ 326.8 Bank Secrecy Act compliance.

(a) *Purpose.* This subpart is issued to assure that all insured state nonmember banks establish and maintain procedures reasonably designed to assure and monitor their compliance with the requirements of subchapter II of chapter 53 of title 31, United States Code, and the implementing regulations promulgated thereunder by the Department of Treasury at 31 CFR Part 103.

(b) *Compliance procedures.* On or before April 27, 1987, each bank shall develop and provide for the continued administration of a program reasonably designed to assure and monitor compliance with recordkeeping and reporting requirements set forth in subchapter II of chapter 53 of title 31, United States Code, and the implementing regulations promulgated thereunder by the Department of Treasury at 31 CFR Part 103. The compliance program shall be reduced to writing, approved by the board of directors and noted in the minutes.

(c) *Contents of compliance program.* The compliance program shall, at a minimum:

(1) Provide for a system of internal controls to assure ongoing compliance;

(2) Provide for independent testing for compliance to be conducted by bank personnel or by an outside party;

(3) Designate an individual or individuals responsible for coordinating and monitoring day-to-day compliance; and

(4) Provide training for appropriate personnel.

[1] In its original form, subchapter II of chapter 53 of title 31, United States Code was part of Pub. L. 91-508 which requires recordkeeping for and reporting of currency transactions by banks and others and is commonly known as the "Bank Secrecy Act."

(Approved by the Office of Management and Budget under control number 3064-0087)

By order of the Board of Directors.

Dated at Washington, D.C. this 6th day of January, 1987.

Federal Deposit Insurance Corporation.

Hoyle L. Robinson,

Executive Secretary.

FEDERAL HOME LOAN BANK BOARD

The Federal Home Loan Bank Board hereby amends Part 563, Subchapter D, Chapter V, Title 12, Code of Federal Regulations, as set forth below.

SUBCHAPTER D—FEDERAL SAVINGS AND LOAN INSURANCE CORPORATIONS

PART 563—OPERATIONS

1. The authority citation for Part 563 continues to read as follows:

Authority: Sec. 1, 47 Stat. 725, as amended (12 U.S.C. 1421 *et seq.*); sec. 6A, 47 Stat. 727, as added by sec. 1, 64 Stat. 256, as amended (12 U.S.C. 1425a); sec. 6B, 47 Stat. 727, as added by sec. 4, 80 Stat. 824, as amended (12 U.S.C. 1425b); sec. 17, 47 Stat. 736, as amended (12 U.S.C. 1437); sec. 2, 48 Stat. 128, as amended (12 U.S.C. 1462); sec. 5, 48 Stat. 132, as amended (12 U.S.C. 1464); secs. 401–407, 48 Stat. 1255–1260, as amended (12 U.S.C. 1724–1730); sec. 408, 82 Stat. 5, as amended (12 U.S.C. 1730a); Reorg. Plan No. 3 of 1947, 12 FR 4981, 3 CFR, 1943–1948 Comp., p. 1071.

2. Part 563 is amended by adding a new § 563.17-7 to read as follows:

§ 563.17-7 Procedures for monitoring Bank Secrecy Act compliance.

(a) *Purpose.* The purpose of this regulation is to require insured institutions (as defined by § 561.1 of this subchapter) to establish and maintain procedures reasonably designed to assure and monitor compliance with the requirements of subchapter II of chapter 53 of title 31, United States Code, and the implementing regulations promulgated thereunder by the U.S. Department of Treasury, 31 CFR Part 103.

(b) *Compliance procedures.* On or before April 27, 1987, each insured institution shall develop and provide for the continued administration of a program reasonably designed to assure and monitor compliance with the recordkeeping and reporting requirements set forth in subchapter II of chapter 53 of title 31, United States Code, and the implementing regulations promulgated thereunder by the Department of Treasury, 31 CFR Part 103. The compliance program shall be reduced to writing, approved by the insured institution's board of directors,

and reflected in the minutes of the institution.

(c) *Contents of compliance program.* The compliance program shall, at a minimum:

(1) Provide for a system of internal controls to assure ongoing compliance;

(2) Provide for independent testing for compliance to be conducted by an insured institution's in-house personnel or by an outside party;

(3) Designate individual(s) responsible for coordinating and monitoring day-to-day compliance; and

(4) Provide training for appropriate personnel.

By the Federal Home Loan Bank Board

Jeff Sconyers,

Secretary.

NATIONAL CREDIT UNION ADMINISTRATION

12 CFR Part 748 is amended as follows:

1. The authority citation for 12 CFR Part 748 is revised to read as follows:

Authority: 12 U.S.C. 1766(a); 12 U.S.C. 1786(q); 31 U.S.C. 5311.

2. The title of Part 748 is revised to read as follows:

PART 748—REPORT OF CRIME OR CATASTROPHIC ACT AND BANK SECRECY ACT COMPLIANCE

3. Part 748 is amended by adding § 748.2 to read as follows:

§ 748.2 Bank Secrecy Act compliance programs and procedures.

(a) *Purpose.* This section is issued to ensure that all federally-insured credit unions establish and maintain procedures reasonably designed to assure and monitor compliance with the requirements of subchapter II of chapter 53 of title 31, United States Code, the Financial Recordkeeping and Reporting of Currency and Foreign Transactions Act, and the implementing regulations promulgated thereunder by the Department of Treasury, 31 CFR Part 103.

(b) *Compliance procedures.* On or before April 27, 1987, each federally-insured credit union shall develop and provide for the continued administration of a program reasonably designed to assure and monitor compliance with recordkeeping and reporting requirements set forth in subchapter II of chapter 53 of title 31, United States Code, the Financial Recordkeeping and Reporting of Currency and Foreign Transactions Act and the implementing regulations promulgated thereunder by the Department of Treasury, 31 CFR Part 103. This program shall be reduced to writing, approved by the board of directors of the institution, and noted in the minutes.

(c) *Contents of compliance program.* Such compliance program shall at a minimum—

(1) Provide for a system of internal controls to assure ongoing compliance;

(2) Provide for independent testing for compliance to be conducted by credit union personnel or outside parties;

(3) Designate an individual responsible for coordinating and monitoring day-to-day compliance; and

(4) Provide training for appropriate personnel.

(Approved by the Office of Management and Budget under control No. 3133–0094.)

By the National Credit Union Administration Board on the 14th day of January 1987.

Rosemary Brady,

Secretary of the Board.

[FR Doc. 87–1731 Filed 1–26–87; 8:45 am]

BILLING CODE 4810-33-M; 6210-01-M; 6714-01-M; 6720-01-M; 7535-01-M

EXHIBIT 8

FEDERAL HOME LOAN BANK BOARD'S PROPOSED RULE ON BANK SECRECY ACT COMPLIANCE PROCEDURES

[6720]

Proposed Rules

Federal Register
Vol. 52, No. 83
Friday, May 8, 1987

This section of the FEDERAL REGISTER contains notices to the public of the proposed issuance of rules and regulations. The purpose of these notices is to give interested persons an opportunity to participate in the rule making prior to the adoption of the final rules.

FEDERAL HOME LOAN BANK BOARD

12 CFR Part 563

[No. 87-617]

Bank Secrecy Act Compliance Procedures

Dated: April 30, 1987.

AGENCY: Federal Home Loan Bank Board.

ACTION: Proposed rule.

SUMMARY: The Federal Home Loan Bank Board ("Board"), as the operating head of the Federal Savings and Loan Insurance Corporation ("FSLIC"), is proposed to amend for purposes of clarification, its recently adopted regulation which requires insured institution to establish and maintain procedures to assure and monitor compliance with the requirements of the Bank Secrecy Act (including the Currency and Foreign Transactions Reporting Act), Subchapter II of Chapter 53 of Title 31, United States Code ("BSA"). The proposed rule sets forth in greater detail the elements required to be in a BSA compliance program, in particular, the requirements of BSA compliance testing and continuing education.

DATE: Comments must be received on or before July 7, 1987.

ADDRESS: Send comments to Director, Information Services Section, Office of the Secretariat, Federal Home Loan Bank Board, 1700 G Street, NW., Washington, DC 20552. Comments will be available for public inspection at this address.

FOR FURTHER INFORMATION CONTACT: Francis Raus, Policy Analyst, (202) 777-3517, Cynthia Grasa, Manager, Operations Standards, (202) 778-2363, Office of Regulatory Policy, Oversight, and Supervision, Federal Home Loan Bank System, 900 Ninetoenth Street, NW., Washington, DC 20006; C. Dawn Causey, Attorney, Office of Enforcement, (202) 653-2924, or John Downing, Attorney, Office of Enforcement, (202) 653-2604, Federal Home Loan Bank Board, 1700 G Street, NW., Washington, DC 20552.

SUPPLEMENTARY INFORMATION:

A. Background of the Rule

On January 27, 1987, the Comptroller of the Currency, the Federal Reserve Board, the Federal Deposit Insurance Corporation, the Board, and the National Credit Union Administration jointly published a regulation to implement to implement section 1359 of Subtitle H of the Anti-Drug Abuse Act of 1988, Pub. L. 99-570 ("final rule"). The Anti-Drug Abuse Act charged each agency to prescribe regulations requiring financial institutions to establish and maintain procedures reasonably designed to assure and monitor compliance with the BSA and to review such procedures during the course of their examinations of such institutions.[1]

The final rule adopted by the Board and the other agencies requires the establishment and maintainance of a program designed to assure and monitor compliance with the requirements of the BSA and the implementing regulations of the U.S. Department of the Treasury, 12 CFR Part 103 ("Treasury BSA regulations"). As set forth in the final rule, an insured institution's compliance program must, at a minimum, (1) provide for a system of internal controls to assure ongoing compliance, (2) provide for independent testing by in-house personnel of others, (3) designate individual(s) responsible for coordinating and monitoring day-to-day compliance, and (4) provide for training of personnel. While the final rule became effective January 27, 1987, insured institutions were granted a three month period in which to develop and adopt written compliance programs.

B. The Proposed Rule

The Board proposes to clarify its existing rule requiring a BSA compliance program to set forth in greater detail the requirements for testing the compliance program; to clarify that the results of the independent testing are to be attached to or otherwise incorporated in the report of the auditor to the board of directors, and that upon receipt of the report, the board is required to address the problems identified through the testing process; and to clarify that the training requirement applies to both newly hired and continuing employees whose participation in the program must be documented.

As promulgated, the final rule requires independent testing of the BSA compliance program by in-house or outside personnel. The proposed rule clarifies that the testing is to be conducted semiannually on a random schedule in order to accurately examine the insured institution's BSA compliance program. Testing may be performed by the institution's auditors or by management personnel not directly involved in the day-to-day BSA compliance process. In addition, the requirement for independent testing is clarified by setting forth in greater detail what elements are to be tested.

As proposed, the testing of BSA compliance would consist of six minimum steps: (1) A review of prior test results, if any; (2) a comparison of the institution's written operating procedures to determine whether they set forth the requirements of the Treasury BSA regulations and whether the procedures enable management and other responsible personnel to identify the currency and monetary transactions subject to the Treasury BSA regulations; (3) a check of a sampling of the institution's records that are required to be maintained by the Treasury BSA regulations[2] to ascertain whether records are maintained for the prescribed length of time, contain the required information, and include lists of exempt customers and transactions; (4) a review of sampling of the reports required to be filed pursuant to the Treasury BSA regulations[3] to ascertain

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[1] 52 FR 2858 (January 27, 1987). The fundamental purpose of the BSA, which includes the Currency and Foreign Transactions Act, is to provide a paper trail of the activities of money launderers serving the interests of drug traffickers and other elements of white collar and organized crime.

[2] The Treasury BSA regulations list the records that must be kept and their period of retention. Insured institutions are required to maintain a list of each BSA exemption granted and to retain a signed statement from each customer added to its BSA exemption list. 51 FR 47326 (Dec. 17, 1986) (to be codified at 31 CFR 103.22). Insured institutions are specifically included in the definitions of financial institutions and banks for purposes of the Treasury BSA regulations.

[3] Reports required to be filed pursuant to the Treasury's BSA regulations include the following: (1) Form 4789 for currency transactions of more than $10,000 with a financial institution (§ 103.22(b)(1)); (2) Form 4790 for currency in excess of $10,000

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their accuracy and completeness; (3) a review of the institution's exemption list to verify the continuing appropriateness of the exemptions and whether the records supporting the exemptions are current and complete; and (4) submission of the results of BSA compliance testing to the institution's auditors so that they may be attached to or incorporated in the annual audit report for presentation to the institution's board of directors.

Because the board of directors will receive the results of the independent testing, the board is directed to take those steps necessary to remedy any deficiencies discovered in its BSA compliance program. Any such actions are to be reflected in the minutes of the board of directors.

Pursuant to the proposal and the final rule, independent testing may be performed by either management personnel or outside parties. Use of an institution's outside auditors for this purpose would satisfy the proposed rule, but is not required. However, the Board has long believed that the employment of outside auditors is useful in achieving full compliance with the BSA, and thus furthers Congress' goal of preventing money laundering.[4] To this end the independent testing required does not replace or preempt the existing auditing requirements for BSA compliance, rather the results of the BSA testing are to be attached or otherwise incorporated in the audit report in accordance with the Board's existing auditing requirements.[5] The Board invites comment on the scope of review encompassed by the independent testing and the interaction, if any, between an institution's management personnel and its outside auditors.

The proposal also clarifies the existing training requirement by specifying that the BSA educational program applies to all employees, not just those newly-hired, and that documentation of participation in the training programs must be maintained. Training should be focused on all institution personnel who have duties relating to the reporting or recordkeeping requirements of the BSA, particularly those who accept deposits and otherwise handle cash. Acceptable documentation of participation in training programs would include a report of attendance at a seminar, training session, or meeting.

The Board also invites comment on the provisions of the final rule establishing the BSA compliance program. Because of the Congressionally-mandated deadline of January 27, 1987, prior notice and comment on the final rule was not possible. Therefore, commenters are urged to address the entire regulation, not just the amendments proposed herein.

Effective Date

The final rule required establishment of a BSA compliance program by April 27, 1987. Commenters are urged to address the issue of the amount of additional time needed for compliance if the final rule is amended as proposed.

Initial Regulatory Flexibility Analysis

Pursuant to section 3 of the Regulatory Flexibility Act, 5 U.S.C. 603, the Board is providing the following regulatory flexibility analysis:

1. *Reasons, objectives, and legal basis underlying the proposed rule.* These elements are discussed above in SUPPLEMENTARY INFORMATION.

2. *Small entities to which the proposed rule would apply.* The proposed rule would apply to all institutions whose accounts are insured by the FSLIC.

3. *Impact of the proposed rule on small entities.* The proposed rule would not have a substantial impact on small insured institutions.

4. *Overlapping or conflicting federal rules.* There are no known federal rules that duplicate, overlap, or conflict with this proposal.

5. *Alternatives to the proposed rule.* The above requirements for Bank Secrecy Act compliance programs establishes a minimum system for verifying and encouraging compliance with the Bank Secrecy Act in accordance with Congressional concern. Alternatively, the Board could have required an in-depth audit of insured institutions' compliance by independent auditors. The Board believes that such an alternative would have been less flexible and more restrictive for insured institutions.

List of Subjects in 12 CFR Part 563

Bank deposit insurance, Investments, Reporting and recordkeeping requirements, Savings and loan associations.

Accordingly, the Federal Home Loan Bank Board hereby proposes to amend Part 563, Subchapter D, Chapter V, Title 12, Code of Federal Regulations, as set forth below.

SUBCHAPTER D—FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION

PART 563—OPERATIONS

1. The authority citation for Part 563 continues to read as follows:

Authority: Sec. 1, 47 Stat. 725, as amended (12 U.S.C. 1462 *et seq.*); sec. 5A, 47 Stat. 727, as added by sec. 1, 49 Stat. 293, as amended (12 U.S.C. 1425a); sec. 5B, 47 Stat. 727, as added by sec. 4, 49 Stat. 684, as amended (12 U.S.C. 1425b); sec. 17, 47 Stat. 736, as amended (12 U.S.C. 1437); sec. 2, 48 Stat. 128, as amended (12 U.S.C. 1462); sec. 8, 48 Stat. 132, as amended (12 U.S.C. 1464); secs. 401–407, 48 Stat. 1256–1268, as amended (12 U.S.C. 1724–1730); sec. 408, 82 Stat. 5, as amended (12 U.S.C. 1730a); Reorg. Plan No. 3 of 1947, 12 FR 4981, 3 CFR, 1943–1948 Comp., p. 1071.

2. Revised § 563.17–7 by revising paragraph (c) and by adding a new paragraph (d) to read as follows:

§ 563.17–7 Procedures for monitoring Bank Secrecy Act compliance.

* * * * *

(c) *Contents of compliance program.* The compliance program shall, at a minimum:

(1) Provide for a system of internal controls to assure ongoing compliance with the Bank Secrecy Act and the regulations promulgated thereunder at 31 CFR Part 103, which include the proper filing of required reports, the granting of exemptions, and retention of records.

(2) Designate individual(s) responsible for coordinating and monitoring day-to-day compliance.

(3) Provide for independent testing for BSA compliance at least semi-annually on a random basis to be conducted either by an insured institution's auditors or by management personnel not directly involved in the area of operations being tested or responsible for coordinating and maintaining day to day compliance pursuant to paragraph (c)(2) of § 563.17–7, which shall at a minimum include the following:

(i) Review of the results of any prior testing to determine whether there are continuing deficiencies;

(ii) Review of an insured institution's written operating procedures to ascertain whether such procedures set forth the requirements of 31 CFR Part 103 and to determine whether the institution's operating policies, procedures, and practices are adequate

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transported or attempted to be transported from or to the United States, or if not filed by the customs receipt of currency in excess of $5,000 from any place outside of the United States (§ 103.23) and (3) Form TD–F 90–22.1 for each account held in a foreign country over which the financial institution has signature authority or in which it has a financial interest (§ 103.24).

[4] See, Office of Regulatory Policy, Oversight, and Supervision ("OSPOS") T-Memorandum 85–7 issued May 13, 1985. OSPOS (and its predecessor, the Office of Examinations and Supervision) has regularly provided guidance to the industry on compliance with the BSA in the form of its T-memoranda Series 85.

[5] See, OSPOS Public Accounting Bulletin PA–7A–3 Revised (April 17, 1986).

reasonable management or responsible personnel pursuant to paragraph (c)(2) of § 563.17-7 to identify the currency and monetary transactions subject to the referenced regulations.

(iii) A test check of the records an institution is required to maintain by 31 CFR Part 103 to determine whether the records (A) are maintained for the prescribed length of time, (B) contain mandated information, and (C) include lists of exempt customers and transactions.

(iv) A test check of the reports required to be submitted pursuant to 31 CFR Part 103 to determine whether they were properly completed and filed, and whether additional action is needed to correct or complete the reports.

(v) Review of the institution's exemption list for continuing appropriateness of each exemption, whether the records supporting the exemption are current and complete and include a detailed statement of reasons supporting the appropriateness of the exemption submitted by the requesting customer, the customer's personal signature along with his or her title and position, and his or her attestation as to the accuracy of the information furnished; and

(vi) The results of the testing of the compliance procedures shall be provided to the institution's auditors so that they may be attached to or incorporated in the annual audit report required by § 563.17-1(a)(2) of this chapter and shall also be available for review by persons performing examination or supervisory functions on behalf of the Board.

(4) Provide an ongoing employee education program for appropriate personnel, both newly hired and continuing, that informs employees of their individual compliance responsibilities. The program shall include training in the reporting and recordkeeping requirements. Participation in the education program shall be documented.

(d) *Review of Compliance Program Report.* Upon receipt of the report of the auditors together with the results of the independent testing of the compliance program, as required by paragraph (d)(3) of the section, the board of directors of the insured institution shall take such steps as necessary to remedy any deficiencies found in its compliance program and such actions shall be reflected in its minutes.

By the Federal Home Loan Bank Board.

[FR Doc. 87-10573 Filed 5-7-87; 8:45 am]

BILLING CODE 6720-01-M

12 CFR Part 563

[No. 87-603]

Insurance Termination Provisions

Dated: April 27, 1987.

AGENCY: Federal Home Loan Bank Board.

ACTION: Advance notice of proposed rulemaking.

SUMMARY: The Federal Home Loan Bank Board ("Board") is currently reviewing a number of issues relating to the extent to which institutions insured by the Federal Savings and Loan Insurance Corporation ("FSLIC") that terminate their insured status in connection with transfers by operation of law must pay a final insurance premium to the FSLIC. As part of its review, the Board is soliciting public comment to ascertain whether to issue a proposal in this area.

DATE: Comments must be received on or before July 7, 1987.

ADDRESSES: Send comments to Director, Information Services Section, Office of the Secretariat, Federal Home Loan Bank Board, 1700 G Street, NW., Washington, DC 20552. Comments will be available for public inspection at the above address.

FOR FURTHER INFORMATION CONTACT: John A. Buchman, Assistant Deputy Director, (202) 377-6383; or Julie L. Williams, Deputy General Counsel for Securities and Corporate Structure, (202) 377-6459; Corporate and Securities Division, Office of General Counsel, Federal Home Loan Bank Board, 1700 G Street, NW., Washington, DC 20552.

SUPPLEMENTARY INFORMATION:

Background

During the past twelve months, a number of FSLIC-insured institutions have proposed, and in some cases consummated, transactions in which all or a substantial portion of their assets and savings account liabilities would be transferred to a commercial bank or a savings bank insured by the Federal Deposit Insurance Corporation ("FDIC"). These types of transfers have raised significant legal and policy issues, including the initial question of whether bulk transfers of assets and liabilities by operation of law, such as in "thrift-to-bank" conversions, are subject to the application and approval requirements of the Board's regulations governing bulk transfers of assets, 12 CFR 563.22(b). In an effort to resolve uncertainty that may have existed concerning the proper interpretation of its asset transfer regulations, on October 7, 1986, the Board adopted a clarifying amendment to the definition of "transfers" set forth in its statement of policy regarding mergers and transfers of assets. The revised definition made clear that "all transfers of assets or account liabilities not in the ordinary course of business from an [FSLIC-] insured institution to a different corporate entity, whether effected by conventional transfer, operation of law, or otherwise" fall within the scope of 12 CFR 563.22(b).[1]

However, as the preamble to the clarification indicates, the interpretation did not specifically address the separate issues of whether an insured institution undertaking a transfer of assets and liabilities by operation of law in which the surviving entity is not FSLIC-insured must pay a final insurance premium to the FSLIC, and if so, the amount of such payment.[2] The Board has been reviewing this so-called "exit premium" issue on an ongoing basis and as yet has made no final determination with respect to this matter. In view of the continued importance of this issue as it relates to the financial condition of the FSLIC insurance fund and the recapitalization proposals now before the Congress, the Board is hereby soliciting public comment on this subject.

Discussion

It has long been the position of the Board and its staff that when an insured institution transfers all of its assets and liabilities by operation of law to an entity not insured by the FSLIC (e.g., a commercial bank), the FSLIC-insured status of the institution is terminated.[3] In a series of legal opinions dating back to May, 1963,[4] the Office of General

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[1] Board Resolution No. 86-1024, 51 FR 39833 (Oct. 10, 1986) (to be codified at 12 CFR 571.5(a)). The clarification was subsequently challenged by an insured institution contemplating a transfer by operation of law pursuant to a conversion into a state-chartered commercial bank, and in an order dated December 18, 1986, a U.S. District Court in Florida issued a preliminary injunction to prevent the Board from enforcing its interpretation to require Board approval of the institution's proposed conversion. *See United First Federal Savings and Loan Ass'n et al. v. Federal Home Loan Bank Board*, No. 86-431-Civ-J-16 (M.D. Fla., Dec. 18, 1986). The Board is currently pursuing an appeal from the district court's decision and has recently had published for comment a proposed rule substantially similar to the October 7, 1986 clarification. See Board Resolution No. 87-178, 52 FR 3763 (Feb. 26, 1987).

[2] *See id.* n.1.

[3] See, e.g., Letter dated October 10, 1984, from Kenneth J. Scott, General Counsel, to John H. Rydin, at 3.

[4] See, e.g., Letter dated May 13, 1963, from Harry W. Quillian, Acting General Counsel, to Thomas P. Vartanian.

EXHIBIT 9

ARTICLE, "WHAT'S SO SECRECT ABOUT
THE BANK SECRECY ACT?"

What's So Secret About the Bank Secrecy Act?

by Margery Waxman and Linda Madrid

The Currency and Foreign Transactions Reporting Act—commonly known as the Bank Secrecy Act—has recently haunted many commercial banks. Violations of the act have resulted in the prosecution of bank officers and other employees and the imposition of stiff criminal fines and civil penalties. The time has come when savings institutions will be subjected to similar scrutiny, especially thrifts located in regions known to harbor serious drug trafficking.

The Federal Home Loan Bank Board has provided thrifts with guidance on how to comply with the Bank Secrecy Act, and this is a good time for thrift managers to review those guidelines to ensure that their institutions are prepared to comply quickly with the act and its implementing regulations. The importance of compliance is clear.

Congress enacted the Bank Secrecy Act in 1970 in response to widespread concern that criminals were turning to financial institutions to "launder" large amounts of cash received as a result of increased drug traffic. Law enforcement officials argued that appropriate records by financial institutions—including banks, savings and loan associations, credit unions, and others—would provide a paper trail of money launderers who served the interests of drug traffickers and organized crime. Curiously, the act of laundering money was not itself included as a crime under the Bank Secrecy Act.

The requirements of the act and applicable U.S. Treasury Department regulations fall into three basic categories:

- Reporting of certain domestic cash transactions;
- Reporting of international transportation of currency or certain monetary instruments; and
- Recordkeeping of certain transactions resulting in the transfer of funds, extensions of credit, or similar transactions.

Margery Waxman, a former deputy general counsel of the U.S. Department of the Treasury, is chief of the financial services department at Sidley & Austin, Washington, D.C. Linda Madrid is an associate at the firm.

Domestic Transactions

The most basic requirement of the Treasury regulations demands that a financial institution file a Currency Transaction Report (CTR) with the Internal Revenue Service (IRS) when currency transactions of more than $10,000 occur. A transaction that transfers funds by means of a bank check, bank draft, wire transfer, or other written order, and does not include the physical transfer of currency, is not a transaction in currency. When a CTR is necessary, it must be filed within 15 days of the transaction, and a copy must be retained by the financial institution for a period of five years from the date of the report.

The CTR requires a financial institution to provide detailed information about each currency transaction of more than $10,000, including the name, address, and account identification number of both the person making the transaction and the one for whom the transaction is conducted; the amount of currency involved; the nature of the transaction; the denomination of currency; certain bank account information; and the identity of the bank employee filing the report. A recently revised CTR form (IRS Form 4789), which can be obtained from IRS form distribution centers, must now be used by all financial institutions.

Although filing a CTR appears to be a fairly simple procedure, there is confusion among industry regulators and the judiciary over what transactions actually have to be reported—specifically, whether smaller amounts that total $10,000 or more in the aggregate must be reported.

Although the statute itself does not mandate the aggregation of transactions —and Treasury regulations do not explicitly include multiple transactions— the CTR form itself indicates that a financial institution must aggregate any multiple transactions *of which it is aware*. This is consistent with the position of the IRS, the U.S. Department of the Treasury, and the U.S. Department of Justice that multiple transactions by the same person on the same day exceeding $10,000 must be aggregated and reported by institutions that took the deposits. Given this apparent consensus—along with proposed changes in Treasury regulations that would specifically require aggregated reporting—institutions should equip themselves to account for such transactions.

Treasury regulations provide that thrifts may exempt some established customers who deal regularly in large amounts of cash from filing CTRs. Such customers include sports arenas, racetracks, amusement parks, bars, restaurants, hotels, check-cashing services, vending machine companies, theatres, state and local governments, and certain retail establishments. An institution also may request a special exemption from the Treasury for other types of customers. But individual, nonbusiness customers and transactions with nonbank financial institutions, such as Western Union and foreign currency brokers, are never exempted under any circumstances.

Any exemptions must be recorded and kept on a master list that contains all the information required of those who do file a CTR. A thrift must be ready to deliver the list to the Secretary of the Treasury. Regulators are clearly concerned that these exemptions could let criminals use legitimate businesses as a cover for illegal activity.

International Transactions

The Bank Secrecy Act also requires the filing of a Currency or Monetary Instruments Report (CMIR; IRS Form 4790) with the commissioner of customs when currency or other monetary instruments of more than $10,000 are transported from or to the United States. The act does not apply, however, to a transfer of funds through normal banking procedures —like a wire transfer of funds—nor to instances where there is no physical transportation of currency or monetary instruments. When thrifts are required to file a CMIR, a copy of the form must be retained for five years.

Of greater concern to most thrifts, however, are regulations that the Treasury has not yet invoked—under which the Secretary may require one or more of the following international transactions to be reported: checks or drafts; wire or electronic fund transfers; loans to or through a foreign financial agency; commercial paper; stocks; bonds; and certificates of deposit.

Recordkeeping Disclosures

Financial institutions must maintain other records that have a "high degree of usefulness in criminal, tax, or regulatory investigations and proceedings." These include copies of each check, draft, or money order drawn on the bank in excess of $100; each item of more than $10,000, including checks, drafts, or transfers of credit, remitted or transferred to a person, account, or place outside the United States; each document granting signature authority over each deposit or shared account; records granting certain extensions of credit in excess of $5,000; and various customer identification information. With few exceptions, these data must be retained for five years and be readily accessible to law enforcement officials.

Bank Board Reviews

For federally insured thrifts, the Treasury has delegated enforcement oversight duties to the Bank Board, which is responsible for ensuring compliance and reporting violations.

The Bank Board was expected to conduct reviews of compliance as part of its annual examination of member thrifts, but because of the growth of the industry and a shortage of Bank Board examiners, this target has not been met. Instead, the Bank Board has tended to target institutions previously found to have financial or regulatory problems, putting these firms under scrutiny as often as every six months or less. Institutions that have avoided these problems are reviewed much less frequently.

The Bank Board's regular reviews of thrifts, including a look at Bank Secrecy Act compliance, are conducted by district examiners in accordance with a modified uniform examination procedure developed by the Treasury in cooperation with the federal bank regulatory agencies, including the Bank Board. The examination has two steps, or "modules":

- Module 1 requires the examiner to review and evaluate the institution's written formal operating procedures for Bank Secrecy Act compliance, obtain copies of the institution's list of exempt customers, and review all correspondence between the institution and the IRS or Treasury concerning exempt cus-

tomers. The examiner also must compare the total cash shipments reported under the Bank Secrecy Act with cash reports made to the federal reserve bank and correspondent banks, and make sure there i program to educate employees about the act's provisions.

□ If problems are detected during the initial review, Module II is employed. This expanded procedure focuses on institutions that have been targeted for special compliance review and involves on-site inspection of teller and other personnel operations involved in the reporting and recordkeeping requirements of the Bank Secrecy Act.

Penalties for Secrecy Act violations are no slap on the wrist

If, during a regular review, an examiner finds Bank Secrecy Act violations of a material or suspicious nature, or a significant number of them, he or she reports them to a supervisory agent in an interim report. That report is sent, in turn, through the Bank Board's Office of Examinations and Supervision to the Treasury for the possible imposition of penalties.

In 1985, the Bank Board reported 46 Bank Secrecy Act violations to the Treasury, 40 of which involved failure to file CTRs; the other six involved failure to maintain an exemption list. The Federal Home Loan Bank System also has stepped up its review of Bank Secrecy Act compliance as part of its overall increase in examinations and supervisory staff; about 750 new examiners have been added since July 1985. Examiners will also be using a newly revised examination objectives and operating procedures manual to implement the modular review.

Ultimately, the IRS has responsibility for processing CTRs and conducting criminal investigations of all financial institutions. According to testimony April 16, 1986, before the House Subcommittee on Financial Institutions Supervision, Regulation and Insurance by IRS Assistant Commissioner Richard Wassenaar, the tax-collecting agency's criminal investigation division had more than 300 Bank Secrecy Act investigations—some 60 of them involving financial institutions, including thrifts—in "open inventory." During 1985, he said, the IRS had recommended prosecution of 31" cases involving money laundering, some of them involving thrifts.

Penalties

Civil or criminal penalties for Bank Secrecy Act violations are no slap on the wrist. They include the following:

CIVIL PENALTIES. For each willful violation of any requirement of the act, up to $10,000 may be assessed on a thrift and any of its partners, directors, officers, or employees. (The maximum penalty for violations committed before October 1984 is $1,000 per violation.) Civil penalties may be imposed for any failure to file a currency or monetary instruments report or for filing a report containing any material omission or misstatement. Treasury interprets the term "willful" in this context to mean action taken knowingly, consciously, intentionally; or with reckless disregard. There need not be a knowing violation or specific intent to violate the law in order to sustain a civil penalty.

CRIMINAL PENALTIES. Felony convictions can result in maximum prison terms of up to five years and a fine of up to $250,000 per willful violation. That penalty is increased to $500,000 when a violation is committed as part of a violation of federal law or as part of a pattern of illegal activity involving transactions of more than $100,000 in a 12-month period.

Aggressive Enforcement

Prosecution of banks and bank officials under the Bank Secrecy Act has not been limited to cases where corruption is alleged or suspected. In 1984, the Bank of Boston was prosecuted under the act even though no individuals were indicted and no corruption alleged. But the firm pleaded guilty to willful violations of the act for failing to report $1.22 billion in foreign currency transactions, and was fined $500,000.

Since that plea, the Treasury has assessed civil penalties against 16 other banks or bank holding companies in amounts ranging from $121,000 to the $4.75 million imposed on the Bank of America, and many other penalties are expected soon. House Banking, Finance and Urban Affairs Chairman Fernand J. St Germain stated this April that "scores of banks have approached the Treasury Department . . . for similar violations . . . described by some as 'Dial a Confession.'" St Germain observed that about 65 other financial institutions are currently being considered for possible civil penalties.

Most of the recent civil actions taken by the Treasury involved simple failures of reporting. But in other cases the financial institution has been unwittingly involved in a money laundering scheme; in still others, the institution appears to have actively participated in the scheme.

Last June, for example, as a result of an investigation by a joint Federal Financial Investigative Task Force known as "Operation Greenback–Puerto Rico," more than 200 law enforcement personnel participated in a "sting" operation that led to the arrest of 17 people, including 14 current or former officials of the Caribbean Federal Savings Bank of Puerto Rico. During the undercover operation, IRS agents laundered $335,000 through Caribbean Federal by purchasing bearer certificates of deposit with currency. The deposit tickets prepared by bank officials, however, falsely indicated that the cash purchases were check purchases. As a result, CTRs were never prepared or filed. Caribbean pleaded guilty to three counts of having knowingly and willfully failed to file CTRs in violation of the Bank Secrecy Act and was fined $450,000. Charges against officers of the firm are still pending.

Congress Bears Down

Law enforcement officials are still unhappy over the government's inability to combat money laundering. Among the most outspoken is Stephen Trott, chief of the Justice Department's Criminal Division. Trott recently reported to the Sen-

...ate banking committee that present law is inadequate to sustain the prosecution of a person who intentionally structures transactions to avoid the Bank Secrecy Act reporting requirements. Trott added that "the courts are essentially providing a blueprint to 'smurfs' on how to launder money." (A smurf is somebody hired by money launderers to run from institution to institution structuring transactions in increments of $10,000—generally by purchasing cashier's checks—to avoid filing requirements.)

In response, Congress has been debating several bills that would significantly tighten reporting requirements as well as make money laundering a federal offense. For example, the Money Laundering and Related Crimes Act of 1985 would make it a crime to launder money intentionally through financial institutions and businesses with willful knowledge that the funds were illegally earned. Further, the legislation would amend the Right to Financial Privacy Act by allowing a bank or other financial institution to provide to law enforcement officials information that it believes may be relevant to criminal activity—without risking civil liability under the act or entailing any obligation to notify the customer of such cooperation, which the act now requires.

Another piece of legislation would impose civil and criminal penalties on those who cause or attempt to cause an institution to fail to file a CTR or who violate the Bank Secrecy Act, or structure or attempt to structure transactions to avoid the reporting requirements of the act. The idea is to get at not only the smurf who does the actual transaction but also those who plan the activity. The legislation also provides the government for the first time with forfeiture and seizure power for funds underlying CTR violations. Still another bill would require financial institutions to maintain an internal log of customers who engage in transactions of more than $3,000.

Strategy for Compliance

Thrifts have to develop and implement adequate written procedures and policies for compliance with the Bank Secrecy Act if they are to meet their obligations as set forth by the Bank Board. This can best be accomplished through an approach that emphasizes employee education and central control of compliance.

To begin with, thrifts should make the Bank Secrecy Act requirements a part of every training program for new employees, with periodic updates for continuing employees. These programs should stress:

- Requirements of the act and related regulations;
- Potential civil and criminal penalties; and
- The circumstances of common money laundering schemes involving financial institutions.

The program also should include distribution of bulletins relating any changes in existing laws and periodic reminders of the importance of compliance. Francis M. Passarelli, acting director of the Bank Board's Office of Examinations and Supervision, said recently that he believed internal training programs —especially for tellers and others who handle currency—were the single most important tool a thrift has to ensure compliance.

Merely disseminating the requirements of the act, however, is not enough to protect an institution from mistakes by the staff. Courts have held, in fact, that an institution may still be liable for the failure of its employees to file CTRs even when the omission is contrary to the express instructions and policies of the firm; the liability attaches, according to a court ruling, when the institution does not "diligently enforce" its policies. It is thus important that thrifts follow up their written internal operating procedures with thoroughgoing management reviews.

A risk-management officer, or other senior official, also should be responsible for making sure that all forms are filed within the prescribed time period and retained for at least five years. The same official should closely scrutinize the granting of exemptions in an effort to avoid various laundering schemes. Before granting exemptions, institutions should perform thorough background investigations. Special attention should be given to the customer's business needs and proposed upper range of exempt business transactions. If an exemption is granted, the decision should be approved by at least two officers of the institution. In addition, exemption lists and exemption dollar amount limits should be regularly reviewed and updated.

> The act's requirements should be part of every training program for new employees

A thrift should document its compliance procedures. Documentation of procedures can assist not only internal auditors, but also Bank Board examiners, who determine compliance through personal verification of reports and records as well as by statements made by an institution's management.

Thrifts also should conduct regularly scheduled internal Bank Secrecy Act audits. These audits—whether daily, weekly, or monthly—can help ensure compliance by detecting inadequate operating procedures and employee errors. In its audit, an institution should sample currency transactions to verify that all procedures and guidelines are effective, understood, and implemented. Any apparent violations of the act should be discussed with the Treasury Department and the appropriate federal home loan bank.

Pressure for Action

While compliance with Bank Secrecy Act regulations may impose yet another layer of burdensome recordkeeping and paperwork, it would be imprudent to give it short shrift. Failure to ensure that all thrift offices are complying fully can result in tremendous losses—not only in civil and criminal fines, but also the loss of public confidence in thrifts as responsible financial institutions. That, of course, is not to be risked. Here, the ounce of prevention is indeed far cheaper than the pound of cure. □

Federal Home Loan Bank Board

1700 G Street, N.W.
Washington, D.C. 20552
Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

May 26, 1987

Ronald Muntean, Esq.
Kellett & Muntean
10100 Santa Monica Blvd., Suite 2600
Los Angeles, CA 90067

Re: Criminal Referrals - Assistance to Agency Group, Federal Home Loan Bank of San Francisco

Dear Mr. Muntean:

This is to advise you that the Agency Group of the Federal Home Loan Bank of San Francisco ("Agency Group") which, as you know, has regulatory responsibility for all institutions insured by the Federal Savings and Loan Insurance Corporation ("FSLIC") in the Eleventh District ("District"), has formed a Criminal Referral Task Force to ensure that criminal referrals are made on all individuals and all transactions involved in suspected criminal activity under federal and state law.

The Department of Justice, through the United States Attorney's Office and Federal Bureau of Investigation, has agreed to provide immediate assistance to the Criminal Referral Task Force in evaluating criminal referrals for prosecution. Since you, as fee counsel for the FSLIC, have the benefit of investigations subsequent to the failure of an institution, you are in the best position to the Agency Group and their lead attorney Glenda Robinson in this task. FSLIC requests that you provide the Agency Group, and at their request, the appropriate Department of Justice personnel, with whatever information will assist a rapid analysis of possible criminal violations that have occurred at any institutions for which you have been retained by the FSLIC as counsel. It is this agency's obligation, and your obligation as its counsel, to make all appropriate criminal referrals. The FSLIC, therefore, advises you to provide all necessary information to make criminal referrals where appropriate, and, if requested to do so, to actually assist in the preparation of criminal referrals.

EXHIBIT 3

Should you have any questions regarding this matter or attorney-client work produce or other privileges that might apply to the material in question, please contact the undersigned or Paul Grace at the Office of General Counsel, Litigation Division, Federal Home Loan Bank Board.

Sincerely yours,

Dorothy L. Nichols

Dorothy L. Nichols
Senior Associate
General Counsel
Litigation Division

cc: Glenda Robinson
Federal Home Loan Bank
of San Francisco

STATEMENT OF

JAMES H. LAUER, JR. OF THE

FEDERAL HOME LOAN BANK BOARD

BEFORE THE

COMMERCE, CONSUMER AND MONETARY AFFAIRS SUBCOMMITTEE

OF THE

COMMITTEE ON GOVERNMENT OPERATIONS

UNITED STATES HOUSE OF REPRESENTATIVES

JUNE 13, 1987

TESTIMONY OF JAMES H. LAUER, JR.

Mr. Chairman, members of the Subcommittee, thank you for this opportunity to provide testimony on this important subject. As you know, I am a trial lawyer in the Office of General Counsel of the Federal Home Loan Bank Board ("Bank Board"). In that capacity, I have been assigned litigation responsibility as to various failed savings and loan associations. Your invitation asked that I address certain problems in the California thrift industry, giving particular attention to the activities at the institutions that have been assigned to me. I note that much of the substance of the questions addressed to me have also been asked of my former supervisor, William K. Black, and for the sake of continuity, my answers to most of your inquiries, have been incorporated into his testimony. There is also submitted with this statement Joint Testimony of William K. Black, James H. Lauer, Jr, James Blair, and Mark Gabrellian which included (1) my experience and interactions with federal and state criminal justice agencies and (2) the extent to which our office monitors criminal investigations arising from our assigned associations. Therefore, I would like to summarize for the Subcommittee the relevant activities at the institutions that I supervise.

The first institution I would like to discuss with you is Consolidated Savings Bank ("CSB") which is one of the associations that has been assigned to me. On May 22, 1986, the Bank Board appointed the Federal Savings and Loan Insurance

Corporation ("FSLIC") as Conservator for CSB. At that time, the Bank Board found that institution was in an unsafe and unsound condition to transact business, had dissipated its assets as a result of unsafe and unsound practices, and it made a factual finding that CSB was insolvent.

On May 23, 1986, FSLIC as Conservator for CSB filed a lawsuit in the Federal District Court for the Central District of California to attempt to recover some of the losses incurred through the reckless and speculative actions of the prior management of CSB. This suit named several officers, directors and borrowers of the institution including Robert Ferrante, the sole shareholder and one-time director of CSB, Ottavio Angotti, the Chief Executive Officer of CSB, and Scott McHenry, its President and Chief Operating Officer. Also named was a major borrower, Charles Bazarian and his company, CB Financial. Mr. Bazarian was recently convicted on multiple felony charges stemming from his association with Florida Center Bank and he has been sentenced to serve a prison term as a result of this conviction. In June of 1985, CSB loaned CB Financial $9 million without even requiring a loan application or other financial data. To date, no payment has been made to the institution by CB Financial or Mr. Bazarian.

This suit by FSLIC arose from the numerous negligent and fraudulent acts committed by Mr. Ferrante and his associates while in control of CSB. Many of these claims arise from poor underwriting and the reckless manner in which loans were made at the institution in violation of numerous federal regulations. However, the bulk of the claims stem from the self-dealing loans that were made to Mr. Ferrante, his many companies, his relatives and close associates.

In this regard, one of the most egregious acts alleged in the complaint involves a $20 million loan to World Industrial Center ("WIC"), an entity totally controlled by Mr. Ferrante. In addition to the fact that this loan was grossly out of proportion for an institution with total assets of approximately $70 million, it clearly violated the prohibitions against loans to affiliated persons as well as the loans-to-one borrower regulation. In addition, CSB loaned $1.2 million to a Ferrante partnership and in excess of $300,000 to his sister, Gloria Morris. Further, Ms. Morris was given a position at CSB and her husband, Leonard, was hired as a "consultant" to the CSB Service Corporation.

On November 4, 1985, the former directors of CSB signed a Supervisory Agreement which set certain limits on the institution's lending activities including a prohibition against the making of certain commercial loans without prior approval

from the regulators. In March 1986, CSB decided to make a commercial loan to Pyrotronics Corporation in direct violation of this agreement and without the requisite approval. Pyrotronics is a fireworks manufacturer which was owned by W. Patrick Moriarty. At some point, Mr. Moriarty, another convicted felon, transferred some control and beneficial interest in that entity to Ferrante. Pyrotronics needed a loan to purchase the necessary items for the 1986 4th of July season and, with Ferrante's influence, turned to CSB for help. However, as stated, CSB was prohibited from making this loan. Unfortunately, this did not stop the parties from their intended purpose.

To evade the regulators, the former management of CSB devised a scheme whereby "dummy" or false loans were made to relatives and friends of Ottavio Angotti, secured by residential real estate valued at inflated levels as a result of improper appraisals. The proceeds of these loans, which normally would have been paid to the borrowers, went instead to a new corporation controlled by Ferrante & Ferrante operations called Federal Finance Corporation. Federal Finance then made the desired loan to Pyrotronics. However, on the books of CSB, these loans appeared as residential home mortgage loans which were allowed under the Supervisory Agreement instead of a commercial loan which was prohibited. The total amount loaned in this manner was $1.3 million.

Pyrotronics is currently in bankruptcy and CSB does not appear to have adequate security for the loans. It is anticipated that a substantial loss will occur from these transactions.

There are additional activities that form the basis of the suit which are described more fully in the first forty pages of the complaint itself which was previously supplied to the Subcommittee staff for your use. There are seventeen claims for relief in the complaint including ones for negligent and fraudulent breach of fiduciary duty, fraud, and violations of the Racketeer Influenced and Corrupt Organizations Act ("RICO").

On August 29, 1986, FSLIC was appointed as Receiver for CSB and it is proceeding with the orderly liquidation of the institution. The Receiver for CSB estimates that losses will exceed $40 million.

The other institution assigned to me that I have been asked to discuss is Presidio Savings and Loan Association ("Presidio"). This institution was a state-chartered stock institution that was incorporated in 1974 and was one of the few Hispanic-owned thrifts in the country. On August 28, 1985, the Bank Board appointed FSLIC as receiver and transferred most of the assets and liabilities to a newly created federal mutual

("New Presidio"). At the time of its failure, Presidio had approximately $700 million in assets on its books. On August 8, 1096, the Bank Board determined that New Presidio was insolvent, not capable of rehabilitation, and appointed FSLIC as receiver for New Presidio for the purpose of liquidation. At that time, New Presidio was determined to have a negative net worth of approximately $100 million.

The demise of Presidio was the result of several factors. First, in an attempt to reverse the negative impact of its interest rate spread, this institution engaged in rapid asset growth funding large scale construction/ADC loans and joint venture arrangements. These projects were normally structured in a manner such that Presidio would put up 100% of the funding, but receive a lesser percentage of the profits (if any) without requiring the joint venture partner to put any equity into the deal. Most of these projects were unprofitable and many of the joint venture partners wound up in bankruptcy. The unsafe and unsound lending practices together with the joint venture projects are estimated to have caused losses in excess of $70 million.

The second major cause of the failure of this association was its speculative trading in Treasury Bond futures and options. This trading was for the stated purpose of hedging its interest rate exposure, however, in reality, it was pure

speculation in an area where the institution had no expertise. Primarily, these investments involved "day trades" where Presidio was essentially betting on the interest rate fluctuations during a given day. In no way could their trading be considered hedging. At one point, 90% of association's assets were comprised of these types of investments. In short, the management of Presidio gambled in the futures market in an attempt to recover some of the monies lost in their poorly conceived and underwritten loan and investment program. Further, at one point, the Board of Directors was told by the regulators to stop all futures trading, and agreed to do so. However, in spite of this prohibition and their statements to the contrary, management continued this speculative trading. Losses to the institution resulting from this futures trading activity was in excess of $10 million.

FSLIC has filed a lawsuit against certain officers, directors as well as the brokers involved in the securities trading which is currently in the discovery phase. The amount of damages sought is in excess of $80 million dollars.

As for the additional testimony you requested, please refer to the Testimony of William K. Black and the Joint Testimony of William K. Black, James H. Lauer, Jr., James Blair, and Mark Gabrellian.

I appreciate the opportunity to submit this statement to the Subcommittee.

STATEMENT OF

JAMES L. BLAIR, TRIAL ATTORNEY

FEDERAL HOME LOAN BANK BOARD

BEFORE THE

COMMERCE, CONSUMER AND MONETARY AFFAIRS SUBCOMMITTEE

OF THE

COMMITTEE ON GOVERNMENT OPERATIONS

UNITED STATES HOUSE OF REPRESENTATIVES

JUNE 13, 1987

Mr. Chairman, members of Subcommittee, thank you for this opportunity to provide testimony. Your invitation requests that I address problems in the California thrift industry, giving particular attention to the specific FSLIC cases which I have supervised as a trial attorney at the Bank Board. I note that many of the questions addressed to me have also been addressed to my former supervisor, William K. Black, who is providing both written and oral testimony to the Subcommittee. Mr. Black's having incorporated into his testimony many of my observations relating to your inquiries, I will limit my testimony to a summary of the relevant activities of two institutions for which I am the responsible trial attorney in the Bank Board's Litigation Division: the San Marino Savings and Loan Association receivership and the North America Savings and Loan Association receivership. There is also submitted with this statement supplemental Testimony of William K. Black, James H. Lauer, Jr., James L. Blair, and Mark Gabrellian which includes our experiences concerning law enforcement issues arising from thrift failures.

The first institution that I will discuss is North America Savings and Loan Association ("North America"), Santa Ana, California. On January 23, 1987, the Federal Savings and Loan Insurance Corporation ("FSLIC") was appointed the receiver of the property and assets ($219 million) of North America, the Bank Board having found that North America was insolvent, that the association was unsafe and unsound to transact business, and that it had dissipated its assets. The assets and

liabilities of North America were transferred to North America Federal Savings and Loan Association in accordance with the Bank Board's management consignment program. Seven days earlier, on January 16, Dr. Duayne D. Christensen ("Christensen"), 100% owner and Chairman of the Board of North America (and a defendant in the pending litigation described below), died in a one car accident on his way to the office. Besides Dr. Christensen, the other parties primarily responsible for North America's failure are Janet F. McKinzie, a close personal friend of Christensen, who was also a consultant to, controlling person, and de facto vice chairman of the association, and Plaza Group, an organization created by Christensen and McKinzie to funnel millions of dollars out of North America.

On February 10, 1987, the FSLIC filed suit in the Federal District Court for the Central District of California, seeking an attachment of all known assets of McKinzie, the estate of Christensen and Plaza Group, as well as an order freezing all assets of these defendants. FSLIC v. McKinzie, et al., Case No. 87-861 HLH (TX). The judge immediately issued the temporary restraining order, and the next day signed temporary protective orders preventing the defendants from transferring any interest an identified accounts, securities, mortgages, and notes receivable.

One month later, the court signed a preliminary injunction order which includes: (a) writs of attachment against all known property of McKinzie and Plaza Group; (b) appointment of a probate administrator to oversee the Christensen estate; (c) appointment of a receiver to take control of

all property subject to the FSLIC suit, to assess the value of the property, and to conserve the property pending judgment; and (d) limitation on McKinzie's monthly expenditures.

The injunctive relief and the FSLIC's pending complaint are based on flagrant insider abuse. A graphic illustration of the unlawful self dealing by Christensen and McKinzie is their creation and utilization of Plaza Group to siphon off $11 million of North America's money for their own use. This was accomplished through a complex series of transactions using sham escrow arrangements, fraudulent certificates of deposit, and forged bank confirmations.

Plaza Group was created in September, 1985, ostensibly to purchase real estate for immediate resale, i.e., a land flip scheme, using association funds. The association entered into an agreement with Plaza Group, owned and controlled by McKinzie which may be characterized as follows:

(1) Plaza Group was to seek out real estate for purchase by one David L. Morgan (a personal friend of McKinzie from Little Rock, Arkansas), and then for immediate resale at significantly higher prices to Morgan's holding company;

(2) when/if Morgan purchased a property, Plaza Group would serve as the broker, preparing the purchase and sales agreement and awarding itself a sales commission;

(3) North America would provide the down payment for the purchase by depositing money in various banks, including the Imperial Bank, Sacramento, California and the Bank of Alex Brown, Elks Grove, California, in interest bearing accounts in the name of Plaza Group;

(4) if a purchase failed to close, North American was to be refunded its deposit with interest; and

(5) if the property acquisition was completed, and Morgan "flipped" the property to his holding company, Plaza Group would receive the additional commission on the resale, which it would then assign to North America, also returning North America's down payment.

North America directly invested $11 million in the Plaza Group operation, all of which was deposited into Plaza Group accounts on or before March 31, 1986. However, in January, 1987, regulators discovered that Plaza Group had nothing in any account for the benefit of North America. The FSLIC has every reason to believe that the entire $11 million was used for the benefit of various McKinzie and Christensen interests. It appears that no North America-Plaza Group-Morgan flip sale ever occurred; certainly there is no record of any interest payment or commission assignment from Plaza Group to North America.

The scam went undetected because McKinzie and Christensen, when challenged, prepared bogus certificates of deposit and bank confirmations. In May, 1986, examiners questioned the safety and soundness of North America's arrangement with Plaza Group. Evidently

fearing detection, McKinzie prepared forged letters purportedly from officials at the Imperial Bank and Bank of Alex Brown, on bank letterhead, which seemingly confirmed the deposit of funds into trust accounts for the benefit of North America. Upon investigating North America's files, the FSLIC has discovered a draft letter telecopied by McKinzie to her secretary, instructing her to "be sure to sign good" and to put the letters in "sealed envelopes so that it looks professional."

Later in 1986, the San Francisco Bank learned that McKinzie, as a signatory to these purported Plaza Group trust accounts, could transfer North America's funds in and out of the accounts without joint authorization from any other North America principal. Recognizing this to be an unsound practice, the Bank's supervisory agent directed North America's Board of Directors to withdraw immediately all North America funds from the Plaza Group trust accounts, and to deposit such funds only in accounts in North America's name. McKinzie and Christensen instead prepared false bank confirmations, using forms from Imperial Bank and the Bank of Alex Brown, ostensibly verifying that North America had complied with the directive. By maintaining insider control of North America, Christensen and McKinzie were able to prevent the regulators from learning of the Plaza Group scam until the receivership was imposed.

Another example of insider abuse concerns the Kingsbury of Tahoe property, a 20 unit Lake Tahoe condominium timeshare. In December, 1983, Christensen "donated" an option to North America valued at $2.995 million, to acquire Kingsbury. A company with which Christensen was

affiliated had purchased the property one year earlier for $5 million. At the direction of Christensen and McKinzie, North America immediately exercised the option and paid $14.7 million in cash for Kingsbury. Christensen later claimed to have transferred his interest in Kingsbury; however, the records supporting the transfer, according to Christensen, were lost in a private plane crash.

North America still owned the asset at the time of the receivership, Kingsbury being the association's largest non earning asset. Appraisals on the property have ranged from as low as $2.8 million, by California state officials in January, 1987, to as high as $72 million, by W. W. Horsman, Plano, Texas, dated January, 1986. Certain of the appraisals appear to have been self serving, particularly the latter one. Losses on the Kingsbury property will likely exceed $10 million.

The North America litigation is ongoing. The FSLIC's other claims against the named defendants are described in some detail in its Complaint, which was previously provided to the Subcommittee.

The second receivership which I discuss in this testimony is San Marino Savings and Loan Association ("San Marino"). On February 3, 1984, the Bank Board appointed the FSLIC as conservator for San Marino, an $850 million institution in Tustin, California. Ten months later the Bank Board appointed the FSLIC as liquidating receiver for San Marino.

Beginning in 1981, San Marino adopted an operating policy of extremely rapid growth. From late in 1981 through June, 1984, San Marino's assets grew from $23.9 million to $841.5 million. To achieve this growth, San Marino's leadership, the named defendants in the litigation described below, committed the institution to large-scale financing of high risk activities, abdicated their responsibilities to conduct the institution's operations in a safe, prudent, and lawful manner, and committed San Marino to a hazardous course of numerous and repeated unsafe and unsound lending practices and regulatory violations. San Marino's ultimate failure is directly attributable to these activities.

Among the individuals responsible for San Marino's failure were certain of its officers and directors, its outside accountants, Jack Bona and Frank Domingues, developer/borrowers ("Bona/Domingues"), and John J. Brennan, San Marino's appraiser ("Brennan"). All were named defendants in FSLIC v. Forde, et al. in the Federal District Court for the Central District of California, Case No. 85 774 WDK (GX). The FSLIC's case against the former directors has been settled. The FSLIC continues to prosecute its claims against San Marino's accountants, Mr. Brennan, and Messrs. Bona and Domingues.

The Bona/Domingues loans exemplify the riskiness and unlawfulness of the defendants' practices. These loans also represent the largest single source of losses to San Marino, in excess of $70 million.

Between 1982 and 1983, San Marino loaned approximately $193 million to Bona/Domingues for 17 condominium conversion projects in California and Texas. Bona/Domingues would locate an apartment complex available for purchase in bulk by them, and at the same time solicit "investors" to purchase individual apartment units in the complex. Bona/Domingues would next arrange financing from San Marino for the purchase of the complex and the sale of the individual units to the investors. Then Bona/Domingues would purchase the apartment complex and simultaneously close the sales of the individual units using funds loaned by San Marino. San Marino's security consisted of nonrecourse first trust deeds.

These loans made little or no economic sense. First, the loans were in excess of the value of the security property. Although the loans made to Bona/Domingues or the investors were nominally 80% of appraised value, the appraised value was far in excess of the amounts Bona/Domingues paid to purchase and rehabilitate the property. While the total appraised value for the 17 projects was approximately $243 million, Bona/Domingues acquired the projects for only $103 million. Obviously these San Marino appraisals are suspect because subsequent appraisals are suspect because subsequent independent Bank Board appraisals valued the 17 condominium projects at less than $110 million. In short, San Marino loaned out more than $193 million in secured by properties with a value less than $110 million.

Second, the loans provided Bona/Domingues with excessive profits. The FSLIC estimates that even after allowances for loan fees and rehabilitation costs, $35 to $50 million remains as profit for Bona/Domingues. Further, the loans being nonrecourse and the proceeds being disbursed in toto, Bona/Domingues had the use of these vast sums of monies regardless of the success or failure of the projects.

Also, the investors who purchased the individual units from Bona/Domingues had no real incentive to repay the loans. Although some San Marino records reflected that investors were to make a 10% cash down payment with 80% of the balance of the purchase price to be financed by a loan from San Marino and the remaining 10% by a second trust deed from Bona/Domingues, most of the investors paid only 1% as a cash down payment. The remainder of the down payment was paid by Bona/Domingues in the form of a repurchase option, also with San Marino's money. As a result, the investors were at risk for at most 1% of the purchase price, and had no real incentive to meet their obligations. The consequence: foreclosure. And, when San Marino subsequently foreclosed on these properties, it received much less back in value than its original investment.

The Bona/Domingues loan scam depended fundamentally on grossly overstated property appraisals. These appraisals were provided by Bona/Domingues, through Brennan, and were not independently verified by San Marino.

A related matter, also fraught with great risk, is the La Jolla Exchange transaction. La Jolla Exchange represents an obvious attempt by San Marino's insiders to circumvent regulatory authority.

In January, 1984, a Bank Board supervisory agent directed San Marino to establish and maintain loss reserves of approximately $16 million to reflect losses on four of the Bona/Domingues projects. Recognition of these losses would have put San Marino dangerously close to insolvency. In an obvious effort to avert recognition of these losses, San Marino, in February, 1984, consummated a transaction with an entity known as La Jolla Exchange, Inc. ("LJE") designed to move these problem projects from its books.

Under the agreement, San Marino agreed to (1) convey to LJE a fee interest in six of the Bona/Domingues projects; (2) loan $37 million to LJE, secured by the six projects; and (3) pay $8 million in cash to LJE. In exchange, San Marino received a 123 acre parcel of undeveloped land located in La Jolla with an "agreed value" of $69 million.

As an economic matter, the transaction made no sense. It was evident the property had a market value far less than $69 million. It had been acquired that same day by Central Savings and Loan Association for $36 million and resold to LJE for $43 million. (A Bank Board appraiser has valued the La Jolla property at approximately $33 million.)

Besides the economic deficiencies, San Marino (1) disregarded the loan to one borrower limitation, i.e., the $37 million loan to LJE was more than double the thrift's then reported net worth; (2) ignored its obligation to get an appraisal of the La Jolla property; (2) failed to make any meaningful investigation of LJE's creditworthiness, e.g., no credit report, no audited financial statement; and (4) violated every provision of a cease and desist order previously issued by the California Department of Savings and Loan. The FSLIC's claims for damages relating to the La Jolla Exchange transaction are in excess of $40 million.

The FSLIC's other claims are described in some detail in its Complaint, which was previously provided to the Subcommittee.

I appreciate the opportunity to submit this statement to the Subcommittee.

STATEMENT OF

MARK GABRELLIAN OF THE

FEDERAL HOME LOAN BANK BOARD

BEFORE THE

COMMERCE, CONSUMER AND MONETARY AFFAIRS SUBCOMMITTEE

OF THE

COMMITTEE ON GOVERNMENT OPERATIONS

UNITED STATES HOUSE OF REPRESENTATIVES

JUNE 13, 1987

STATEMENT OF MARK GABRELLIAN, ESQ.
TO THE HOUSE COMMERCE, CONSUMER, AND
MONETARY AFFAIRS SUBCOMMITTEE
JUNE 13, 1987

Mr. Chairman, members of the subcommittee, thank you for this opportunity to testify on the subject of problems in the California thrift industry. I am a trial attorney in the Litigation and Special Projects Division of the Office of General Counsel for the Federal Home Loan Bank Board ("FHLBB"). When a thrift institution that is insured by the Federal Savings and Loan Insurance Corporation ("FSLIC") becomes insolvent and is placed into receivership or conservatorship, the FSLIC conducts an investigation into the circumstances and reasons for the thrifts' failure. It is my responsibility to supervise that investigation. It is also my responsibility to supervise the prosecution of any civil lawsuits that the FSLIC might file as a result of its investigation.

Among those failed thrift institutions that comprise my case load are three California savings and loan associations: (1) Columbus Savings and Loan Association; (2) Ramona Savings and Loan Association, and (3) SouthBay Savings and Loan Association.

My written statement addresses these three institutions. Also submitted with my individual statement is the Joint Testimony of William K. Black, James H. Lauer, Jr., James Blair and Mark Gabrellian. Finally, I note that those questions which address FSLIC policy have also been asked of William K. Black, who is providing written as well as oral testimony today. Accordingly, and for the sake of continuity, I am incorporating my responses to those specific questions into Mr. Black's testimony.

Columbus Savings and Loan Association, San Rafael, CA

Columbus is a state chartered savings and loan association which commenced operations in early 1978. During its first four years it operated primarily as a traditional deposit taker and mortgage lender; in 1983, however, Columbus' assets increased by more than 500%--from approximately $27 million to approximately $160 million. Simultaneously, Columbus redirected its operations to investment in large-scale real estate development activities, particularly through investment in real estate development joint venture projects. The shift in Columbus' operational strategy coincided with the assumption, by Ted A. Musacchio, of virtually complete management control over Columbus' affairs. In 1985, due in large part to substantial write-downs on its real estate joint venture projects, Columbus recognized operating losses in excess of $27 million and had a negative net worth in excess of $24 million. On April 14, 1986, the Federal Home Loan Bank Board ("FHLBB")

determined that Columbus was insolvent and, based on that finding and with the written approval of the California Department of Savings and Loan, appointed the Federal Savings and Loan Insurance Corp. ("FSLIC") as Columbus' conservator. As of December 31, 1986, Columbus' net worth was negative $69,084,000.

The principal components of the decline in Columbus' net worth at the time it was placed into FSLIC Conservatorship consisted of approximately $23.2 million in write downs on real estate projects and the establishment of approximately $3.1 million in new loan loss reserves. Based upon the FSLIC's investigation into the circumstances of Columbus' insolvency, the FSLIC has concluded that the primary reason for Columbus' failure was the unsafe, unsound and imprudent management practices engaged in by Ted A. Musacchio, Columbus' former Chief Executive Officer, and a number of his senior officers. The unsafe, unsound and imprudent management practices included, but were not limited to:

A. Investment of assets in high risk real estate development joint ventures without complete or proper financial data or development information and without the benefit of adequate policies or plans for supervision or management of the projects.

B. Inadequate underwriting practices with respect to Columbus' Acquisition, Development and Construction ("ADC") lending operations.

C. Concealment of facts from, and misrepresentation of facts to Columbus' Board of Directors by Musacchio and a number of his senior officers.

D. Fraudulent or improper loan and fee arrangements.

The following are two examples of Columbus' largest joint venture real estate projects:

(1). 505 Montgomery Street

The 505 Montgomery Street project involved the acquisition of approximately 25,000 square feet of land in San Francisco's financial district for the construction of a highrise office building. Columbus' participation began in March 1983 by way of its funding of a $5.1 million participation loan to the project. In August 1983, Columbus entered into a joint venture agreement by which it became a partner with the developer, Montgomery/Sacramento Partners, for development of the project. By this time, Columbus had increased its total loan commitment to the project to approximately $11.6 million, and the joint venture agreement obligated Columbus to make an additional $11.68 million equity

investment. In June 1984, Columbus agreed to increase its previous loan commitment by another $10 million, raising the total loan commitments to $21.6 million, in addition to its committed equity investment. In December 1984, Columbus signed an amendment to the joint venture agreement formally converting its total loans of $21.6 million to equity. The partnership was unable to obtain the necessary construction financing for the project, however, and Columbus attempted unsuccessfully during 1985 to sell its interest. In December 1986, after an in-depth review of the history, current status and prospects of the project, and a detailed analysis of the real estate market and the options available to it, the FSLIC sold Columbus' remaining interest in the project to the former joint venture partner for $3,550,000. The total investment by Columbus in the 505 Montgomery Street property was approximately $33 million, including accrued interest and other costs. Columbus has, accordingly, recognized a total loss of approximately $29.4 million on the project.

(2). Serramonte Highlands

Columbus' participation in this project began in August 1983, when it entered into a joint venture agreement with Frumenti Development Corporation ("FDC") for the development of a condominium project on approximately 14 acres of real property in Daly City, California. The land, on which 11 model units had been construed, was acquired for a purchase price of approximately $9.3 million. All funds provided to the joint venture were provided by Columbus. The project was to be developed in three different phases; only the first phase was completed, however. During 1985 it became apparent that the Serramonte Highlands joint venture project was in severe financial difficulty due to cost overruns and inability to sell completed condominium units. In July 1985, the losses on the project were estimated to be approximately $5.2 million as of December 31, 1984. All construction on the Serramonte Highlands project was discontinued in December 1985 because of disputes between Columbus and FDC. Columbus ultimately filed suit against FDC and Peter J. Frumenti. While FDC is responsible for 50% of the joint venture losses, FDC may not have sufficient financial resources to pay any portion of its share of those losses. Columbus has invested--by way of direct investment and losses to the joint-venture--a total of approximately $20.7 million in the project, including carrying costs. Total receipts through sales of condominium units have been approximately $8.6 million. Based on its assumption that the remaining land is worth $3.8 million and will not be sold before June 1, 1988, and in light of anticipated future rehabilitation costs, Columbus estimates the net realizable value to be $2.5 million as of December 31, 1986. Accordingly, it has recognized and booked a loss of $9.6 million with respect to the project.

Columbus' investment of substantial portions of its assets in highly speculative real estate joint venture projects was a major cause of the deterioration of its financial condition and its ulitmate insolvency. These projects were entered into for the most part without Columbus having first obtained any marketing, financial or risk/benefit analyses. Rather, Columbus relied upon interested parties for information concerning proposed and ongoing projects. Moreover, Columbus failed to adequately manage and monitor its investment in these real estate development projects. Indeed, Columbus granted virtually exclusive management control over the projects to its joint venture partners. In the 505 Montgomery Street project, for example, Columbus, through Ted Musacchio, agreed upon a joint venture agreement which relinquished virtually all effective power and control over the project to Columbus' partner.

The FSLIC's investigation into Columbus' joint venture projects and lending activities resulted in its filing of a Complaint on November 28, 1987 in United States District Court in San Francisco. Named as defendants in the action are Ted A. Musacchio, Columbus' former president, chief executive officer and a member of its Board of Directors, Eric J. Noda, former senior vice president and commercial loan officer, Robert W. Kenney, former senior vice president and chief lending officer, Herbert Worden, former assistant corporate secretary and personal secretary to Musacchio, and a number of Columbus' borrowers. The Complaint alleges, among other things that the defendant-officers breached their fiduciary duties to Columbus by failing to manage and protect Columbus' interests in its real estate investments, by failing to conduct Columbus' lending operations in the best interests of Columbus, and by causing or permitting Columbus to commit numerous and repeated violations of federal and state statutes and violations, such as those limiting the amounts of loans to one borrowers and direct investments. The Complaint also alleges that Musacchio and Kenney committed fraud by failing to apprise Columbus' Board of Directors of significant problems and risks associated with the Serramonte Highlands project. The Complaint further alleges that Noda committed fraud through his involment in the approval and/or consummation of loan transactions involving Columbus in which he had a personal interest and with borrowers with whom he had personal relationships. These borrowers are also defendants in the lawsuit. The Complaint alleges that loan proceeds provided to the defendant-borrowers were diverted to Noda for his personal use and benefit.

Immediately upon Columbus' conservatorship, the U.S. Attorney's Office served a Grand Jury Subpoena upon Columbus. In responding to the subpoena we met with the FBI agents and Assistant U.S. Attorney assigned to the investigation. On January 12, 1987, the U.S. Attorneys Office filed a criminal complaint against Eric

J. Noda alleging that he defrauded Columbus by diverting $1.3 million of loan proceeds for his own personal use (18 U.S.C. § 215). In large part, the allegations contained in the affidavit accompanying the criminal complaint were similar to the allegations in the FSLIC's civil complaint. On March 26, 1987, Noda pled guilty to wrongfully receiving $1.3 million in loan proceeds. The District Court sentenced Noda to a five year term which included six months' incarceration with the balance to be spent on probation. The sentencing order also included as a special condition that Noda liquidate his assets and pay restitution to FSLIC.

Ramona Savings and Loan Association, Orange, CA

Ramona Savings and Loan Association ("Ramona") was a state chartered stock institution incorporated on April 15, 1927. For more than fifty years, Ramona operated as a traditional thrift institution which serviced the local population in rural Ventura County. On December 31, 1980, Ramona reported total assets of $40.5 million and a regulatory net worth of $3.4 million, or 8.4 percent of assets.

On April 4, 1984, Donald P. Mangano, Sr. and John L. Molinaro acquired 100% of the outstanding voting stock of the Association from the former stockholders for a total of $3.9 million. Mangano became Chairman of the Board and Chief Executive Officer and Molinaro became a director. On May 15, 1985, Molinaro purchased all of Mangano's stock, thereby becoming the 100% stockholder of the Association. He also became Ramona's Chairman of the Board and Chief Executive Officer.

In the first month after Mangano and Molinaro's acquisition of control, Ramona's assets grew at an annualized rate of 490 percent, from $55.0 million as of March 31, 1984 to $77.5 million as of April 30, 1984 due to the addition of $24.0 million in jumbo accounts. In April 1984, Ramona purchased three real estate development projects, and in June 1984 it purchased a fourth project. As of June 30, 1985, Ramona's concentration in direct investments reached a peak of 50.2 percent of total assets, or $39.3 million.

Molinaro and Mangano after acquiring control of Ramona on April 4, 1984 transformed Ramona from a traditional thrift institution into a real estate development company. They caused Ramona to purchase, sometimes from affiliated persons, a portfolio of real estate properties based upon inaccurate valuations of their net realizable value. They further caused Ramona to develop certain of the properties without engaging in any economic analysis upon which to ascertain the projects' ultimate profitably. Moreover, in developing these projects, Ramona entered into construction

contracts with affiliated persons which provided for compensation in excess of market rates. Molinaro and Mangano subsequently caused Ramona to "sell" the real estate projects in transactions which were illusory, because, among other things, the sales were 100 percent or more financed by Ramona and the buyer's payment obligations deferred, in order to record a gain on the transactions and thereby give Ramona an appearance of profitability. This appearance of profitability enabled Molinaro and Mangano, Ramona's sole stockholders, to cause Ramona's Board of Directors to declare a total of $4.85 million in cash dividends over an approximately two year period of time. Ramona's primary appraiser and its accountant contributed to the scheme engineered by Molinaro and Mangano by providing Ramona (and consequently the CDSL and FHLBB) with inaccurate and inflated appraisals and certified financial statements.

The following are a few examples of Ramona's direct real estate investments:

1. West Hampton Cove: Molinaro and Mangano caused Ramona on June 4, 1984 to purchase West Hampton Cove ("WHC"), a 120 unit condominium project then under construction from M&M Partnership (a partnership co-owned by Molinaro and Mangano) for a price of $2.10 million and the pay-off of an existing debt secured by the property in the approximate amount of $3.5 million. In 1985, Ramona made bulk exchanges of WHC units for unimproved real properties which were assigned excessive valuations in order that it would seem that Ramona had recorded more than $1 million in profits from the exchanges. In actuality, Ramona incurred a loss and West Hampton Cove.

2. Rancho Cucamonga: On September 25, 1985, Ramona Service Corporation sold the Rancho Cucamonga Property (86.5 acres of unimproved land) to a business associate of Mangano for $2.8 million, while Ramona simultaneously granted a $6.7 million construction loan to the purchaser including a $2.8 million land draw which effectively provided 100% financing for the purchase. The purchaser eventually defaulted on the construction loan (not having made any payments) and delivered back to Ramona a deed to the property in lieu of foreclosure.

3. Cherokee Village: Ramona, in transactions occurring in October 1985 and January 1986 recorded sales of 173 units in the Cherokee Village Project (a resort condominium project in Palm Springs) for $29,426,000. Ramona, however, provided 100% sale financing in the form of promissory notes secured by first and second trust deeds on the units. Payments on the first and second trust deeds were deferred for three and five years respectively. Ramona concurrently entered into a management contract with each unit's buyer by which Ramona agreed to operate Cherokee Village as

a hotel and to pay all expenses on the property for three years. The required accounting adjustments from the Cherokee Village Project reversed Ramona's apparent profit on the transaction from $6,980,000 to 0.

In fact, Ramona incurred losses from its investment in the Cherokee Village Project. Cherokee Village was completed by September 1985 at a cost to Ramona in excess of $23 million. Ramona, however, was unable to sell either the Project or the individual units at prices sufficient to recoup Ramona's investment. Mangano and Molinaro, therefore, conceived and executed a scheme which was intended to conceal from state and federal regulators the losses Ramona had incurred in the Project. In effect, Molinaro and Mangano caused Ramona to transfer 173 Cherokee Village units to Mangano while disguising the transactions as profitable sales to unrelated third parties who in reality were strawmen. The scheme culminated with Ramona, through its service corporation, repurchasing the 173 units.

On September 12, 1986, the FHLBB ("Bank Board") determined that Ramona was insolvent, had substantially dissipated its assets and earnings due to violations of law and unsafe and unsound practices and was in an unsafe and unsound condition to transact business. The Bank Board appointed FSLIC as Receiver for Ramona, subject to approval by the Commissioner of the California Department of Savings and Loan, which approval was given on the same date.

Also on September 12, 1986, the Bank Board approved the charter for Ramona Federal Savings and Loan Association ("New Ramona"). New Ramona acquired substantially all of the assets and liabilities of Ramona. Potential claims against Ramona's former officers, directors and related third parties for the losses incurred by Ramona, however, were retained by the Receiver and then assigned to FSLIC in its corporate capacity.

On September 16, 1986, the FSLIC filed suit against Molinaro, Mangano, Ramona's outside directors and Ramona's accountant (FSLIC v. Molinaro, et al., CD Calif. No. 86-6016 AHS). The FSLIC simultaneously obtained a Temporary Restraining Order (and eventually, a Preliminary Injunction) restricting Molinaro's monthly expenditures to $2000 per month for the pendency of the litigation, and a Pre-Judgment Attachment Order against Molinaro for $2 million. In March of 1987, the FSLIC obtained, in a partial adjudication of its claims against Molinaro, a $2 million summary judgment based upon an illegal cash dividend paid by Ramona to Molinaro in May of 1986. On June 1, 1987, the Court granted FSLIC leave to file its First Amended Complaint which, among other things, added as a defendant the appraiser who performed the appraisals on many of the projects that resulted in Ramona's

greatest losses. The post-receivership audit report of Kenneth Leventhal and Co. has concluded that at year end 1985, Ramona's net worth was negative $19 million.

SouthBay Savings and Loan Association, Gardena, CA

SouthBay Savings and Loan Association ("SouthBay") was a state-chartered, stock institution that received its insurance of accounts and opened for business on May 16, 1983. By December 31, 1986, SouthBay reported assets of $62.5 million, a negative net worth of $2.8 million and year to date losses totalling $1.9 million.

On March 6, 1987, the Commissioner, Department of Savings and Loan of California ("Commissioner") found that grounds existed for the appointment of a receiver for SouthBay and, pursuant to the California Financial Code (§ 8250), applied to the California state court for confirmation on the receivership appointment. Upon the Court's granting of the Commissioner's application, the Commissioner tendered to the FSLIC the appointment as receiver for SouthBay. The FHLBB subsequently determined that, upon the appointment of the FSLIC as receiver for SouthBay for the purpose of liquidation, SouthBay was "in default", as that term is defined in 12 U.S.C. § 1724(d), and consequently designated the FSLIC as sole receiver for SouthBay pursuant to 12 U.S.C. § 1729(c)(1).

The FHLBB, also on March 6, 1987 approved a proposed agreement between the FSLIC as Receiver for SouthBay and Standard Pacific Savings, FA ("Acquisition Agreement") whereby Standard Pacific Savings purchased substantially all of the assets and assumed substantially all of the liabilities of SouthBay. In addition, the Bank Board approved on March 6, 1987, a proposed agreement between the FSLIC as Receiver for SouthBay and the FSLIC in its corporate capacity ("Corporation") ("Receiver's Agreement") pursuant to which the Corporation purchased from the Receiver certain assets of SouthBay not purchased by Standard Pacific Savings. The most significant of these assets is potential claims of SouthBay against its former officers, directors, related third parties and those professionals who performed services for SouthBay.

Finally, on March 6, 1987 the Bank Board approved a proposed assistance agreement between the Corporation and Standard Pacific Savings through which FSLIC would provide Standard Pacific Savings with financial assistance and indemnification from certain liabilities. The FSLIC assistance has an estimated present value cost of $4.6 million and is capped at $5 million.

SouthBay's failure was due to: (1) its high volume of non-earning assets; (2) the establishment of substantial loan loss and interest reserves resulting from poor appraisal and loan

documentation practices; and, (3) its inability to retain competent management staff. The vast majority of SouthBay's problem assets were acquired within the first two years of its operation.

Frank J. Dominquez and Jack Bona, in purchasing an aggregate amount in excess of 50 percent of SouthBay's authorized stock, provided the cash infusion necessary to sufficiently capitalize SouthBay. One day after its opening, however, SouthBay funded 196 loans to 13 investors for the purchase of condominium units in the Briarcliff Apartments (Dallas, Texas). The borrowers purchased the units from Real Property Ventures, Inc., ("RPV"), a joint venture owned by Dominquez and Bona. SouthBay's loans, which totalled $5.9 million financed the purchase. Approximately $3.8 million of loan proceeds were disbursed to RPV.

On July 31, 1983, SouthBay granted 59 loans to 18 investors totalling $1,538,000 for purchases of condominium units in the Biscayne Apartments (Dallas, Texas). The loan documentation indicates that the units were appraised as condominiums, but that the conversions had not yet been completed. Moreover, the appraisals did not provide a comparative "as is" valuation. The appraised values did, however, equal the condominiums' sale price. FHLBB-ordered appraisals resulted in the loans being designated substandard and the requirement that SouthBay establish a $400,000 valuation reserve. All of the Biscayne condominium loans have been foreclosed. Standard Pacific Savings is having the building converted back to apartments and will sell it as such at anticipated loss of approximately $1.0 million.

In September 1983, SouthBay purchased as a direct real estate investment, the Greenway Apartments in Corpus Christi, Texas. The purchase price was $4.8 million. Like Briarcliffe and Biscayne, the Greenway Apartments was marketed as a condominium conversion. Like Briarcliff and Biscayne, the appraised value was based upon the units' value as condominiums. Like Briarcliff and Biscayne, the "conversion" amounted to little more than a paper transaction. The units continued to be run like apartments. In October 1984, based upon FHLBB-ordered re-appraisals, SouthBay was required to establish a $2.2 million loss reserve for its investment in Greenway.

The foregoing are examples of the major projects which SouthBay entered into in its short history. Since its inception, SouthBay had always been heavily involved in ADC loans as a lead lender. In order to finance these loans and direct investments, SouthBay solicited jumbo certificates of deposits for its primary deposit base. As of June 30, 1983, jumbo accounts totalled $6.3 million or 80.8% of SouthBay's total savings balance. By December 31, 1983, jumbo accounts comprised 92.6% of SouthBay's savings base. The combination of non-performing assets and the cost of its

high yield deposits constituted the major contributing factor of SouthBay's insolvency. In 1986, as a result of its operations during the preceding three years, SouthBay had incurred approximately $2.0 million in operating losses.

SUPPLEMENTAL STATEMENT OF MESSRS.

BLACK, BLAIR, GABRELLIAN AND LAUER

OF THE

FEDERAL HOME LOAN BANK BOARD

BEFORE THE

COMMERCE, CONSUMER AND MONETARY AFFAIRS SUBCOMMITTEE

OF THE

COMMITTEE ON GOVERNMENT OPERATIONS

UNITED STATES HOUSE OF REPRESENTATIVES

JUNE 13, 1987

SUPPLEMENTAL TESTIMONY OF BLACK, LAUER, BLAIR AND GABRELLIAN

This supplemental testimony is intended to discuss the issue of the use of criminal referrals and the interaction between those working for the Federal Home Loan Bank Board ("Bank Board") and the Federal Savings and Loan Insurance Corporation ("FSLIC"), and law enforcement agencies.

Employees of the Bank Board, FSLIC and Regional Banks are instructed to make criminal referrals whenever the known facts indicate that any criminal activity has occurred at a FSLIC-insured institution. Many such referrals have been made in the past and will continue to be made in the future whenever appropriate. In the California institutions that you have listed, an aggregate of 22 criminal referrals have been made by either Bank Board attorneys or outside counsel, representatives of FSLIC, and the Federal Home Loan Bank of San Francisco.

Generally speaking, the relationship between our agencies and the Justice Department has been very good and there has been much cooperation on both sides. However, it appears that the Justice Department, as with most federal agencies in this era of tight budgets, has limited manpower to devote to criminal cases involving financial institutions. As you know, Justice is responsible for the prosecution of many different types of criminal conduct and those cases involving thrifts are only a part of its overall workload.

Further, the type of crimes found at these institutions is quite different from those normally confronted by federal prosecutors and investigators. Often it takes a special background to understand the precise consequences of the conduct we see at certain savings and loans. These investigations require hours of reviewing bank documents and loan files. Without an accounting, real estate or general business background, the task of ascertaining the criminal conduct which those documents evidence can become not only difficult for law enforcement personnel, but almost impossible. Therefore, it appears the law enforcement response to these referrals may be limited by budgetary constraints which may have produced both qualitative and quantitative restrictions on the investigation and prosecution of these matters.

Often, in spite of these inherent problems, the Justice Department has responded enthusiastically and promptly to prosecute these cases, and we have seen some important convictions as a result. However, in a few instances, due to a lack of resources, the law enforcement agencies have not been able to respond as quickly as they would have liked.

An example of this resource problem occurred when a litigation attorney uncovered evidence of criminal activity at a thrift that was under FSLIC control. This evidence needed immediate attention and investigation. An FBI agent was contacted who indicated that he would like to look into this matter, but he needed his supervisor's approval to do so. The supervisor stated that he did not have the manpower to conduct the

required investigation. The litigation attorney then approached the highest levels of the FBI in Washington that were available to him to try to rectify the situation. After that contact, the attorney was told that the evidence described to the FBI would be reviewed, but the FBI would not conduct a full investigation into all the criminal activity at the association in question because the FBI simply did not have the resources to do so at that time.

Litigation attorneys in the Office of General Counsel of the Bank Board are to monitor the criminal investigations and prosecutions ongoing with respect to the associations assigned to them. Often what happens in the criminal context has a significant bearing on the civil suits filed or contemplated. Therefore, within the limits of the resources of that office, this monitoring of the criminal prosecutions is generally viewed as an important part of the job. In this regard, litigation attorneys or outside counsel retained by them have attended criminal trials and hearings, and are involved in briefing the FBI and Assistant U.S. Attorneys as to the facts of the cases.

Further, they have worked with the federal prosecutors seek to secure restitution orders as part of sentencing, which would require defendants to pay certain monies back to FSLIC.

We strongly believe that the vigorous prosecution of the wrongdoers at these institutions will serve to deter abuse and prevent at much

misconduct from reoccurring in the future. The Litigation Division stands ready to assist the Department of Justice and the FBI in the prosecution of these cases in whatever way would be most effective and appropriate.

We thank the Subcommittee for its support of these important matters, and for the opportunity to present this statement.

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Mr. BARNARD. In order that we might have some continuity on the next four witnesses, at this time, I would like to call Mr. Robert C. Bonner—if he would come to the witness panel—Robert C. Bonner.

Mr. Bonner is a U.S. attorney for the Central District of California. He will be accompanied by Terree Bowers, who is the Chief of the Fraud Unit of the U.S. attorney's office.

And just so that the other witnesses might know, following them, we are going to have Mr. David Lundin and Mr. Robert Rose, and then Mr. Peter Nunez; and then following him, Mr. Jerry J. Jamar.

Mr. Bonner, we will hear from you at this time.

STATEMENT OF ROBERT C. BONNER, U.S. ATTORNEY FOR THE CENTRAL DISTRICT OF CALIFORNIA, ACCOMPANIED BY TERREE BOWERS, ASSISTANT U.S. ATTORNEY AND CHIEF, MAJOR FRAUD SECTION OF THE CRIMINAL DIVISION, U.S. ATTORNEY'S OFFICE

Mr. BONNER. Thank you, Mr. Chairman, and members of the subcommittee. First of all, let me introduce Assistant U.S. Attorney Terree Bowers, who is sitting to my right, who is the Chief of the Major Fraud Section of the Criminal Division of my office.

As you know, Mr. Chairman, I have submitted to the subcommittee a written statement, and I don't propose to read that in its entirety because it is quite lengthy. What I would like to do here is to summarize, I think, some of the salient points that I was attempting to make in the written statement.

Mr. BARNARD. Without objection, your entire statement will be in the record, and we appreciate your summarizing it.

Mr. BONNER. Fine. Also, Mr. Chairman, I have an appendix that I am not sure was attached to the statement that I would, perhaps, ask Mr. Bowers to hand up to the subcommittee, and this is an appendix, which is simply a listing of the failed institutions in the Central District of California, both savings and loans—I think the first page are the savings and loans, and on the second page are the banks; and virtually all of those are matters which the FBI here in Los Angeles has under investigation.

With that I appreciate the opportunity to be able to address the subcommittee, regarding the Federal response to insider misconduct and fraud in and against financial institutions in southern California, and particularly the Central District of California.

I think it's important to note that the Central District of California is something of a misnomer, because it is a Federal judicial district that covers most of southern California, with the exception of San Diego and Imperial Counties. It covers a seven-county area, including Los Angeles and Orange County, and it is by far the most populous Federal district in the United States, with something over 14 million inhabitants. I might note in that regard that the district is nearly twice as large as the next largest Federal judicial district in population, that being the Southern District of New York. I should also note, I think, in terms of any comments I am going to make, that for a Federal district of 14 million people, I have a total authorized strength of 79 assistant U.S. attorneys, or Federal prosecutors—that is to say, assistant U.S. attorneys assigned to the

Criminal Division in my office to address a multitude of problems, serious Federal crime, among which are, of course, the major and significant outsider bank fraud and insider embezzlement and collusion in bank fraud cases.

To illustrate a little bit about the bank fraud problem—and when I say "bank fraud," I'm using that generically to include fraud and abuse on savings and loans institutions, credit unions, and the like. But to give you some idea, or illustrate the nature of the problem of insider and outsider fraud in this area, I am reminded of the 1946 movie classic, "It's a Wonderful Life." That was a film, you may recall, Mr. Chairman, that starred Jimmie Stewart in which he portrayed a small-town banker who gives his depositors his honeymoon money in order to stop a run on his bank. Recently, a local reporter from one of the newspapers in our area noted that if this movie took place in this area, southern California, today the lead character most probably would be stealing money from his depositors to finance his honeymoon. [Laughter.]

Unfortunately, there is an element of truth in the reporter's cynical view of the financial world here in southern California. Insider greed and fraud perpetrated on financial institutions, savings and loans and banks here, are rampant in southern California, and the number of such cases are proliferating at an alarming rate with dollar losses that are astronomical. Unless brought under control, unquestionably public confidence in our banking and savings and loan system may be destroyed.

The U.S. attorney's office for this district, the Central District of California, is facing an increasing number of investigations into criminal misconduct by officers, directors, and employees of financial institutions. The extent of bank fraud, in general, and savings and loan fraud, as well as insider affiliated and outsider fraud, in particular, has, in my opinion, reached epidemic proportions in this district.

I anticipate that the problem will in all likelihood continue, in view of the rapid growth of Los Angeles, as a world trade and financial center, and also in view of the fairly large number of smaller savings and loan and bank institutions that we have here in this area, as well as the cyclical "boom or bust" nature of southern California real estate development over the years.

The Federal prosecutors in my office are seeing an ever-widening spectrum of insider fraud. They range from simple transactions involving insiders who make direct payments and bogus loans to friends and relatives, to the more complex fraud schemes featuring shell companies, double escrows and other devices designed to obfuscate transactions in which financial institutions purchase overvalued properties or companies controlled by bank insiders.

While insider abuse continues to be a major problem, Federal prosecutors in my office are increasingly tackling complex fraud perpetrated by outsiders, such as appraisers and major borrowers.

One case involves loan losses that we have under investigation in this district, which is what we refer to in our office as the Bank of America/NMEC case. In that case alone, there is a loss of at least $95 million that has already been documented to a financial institution in this area. I've described how we have been attempting to handle and deal with that case in my written statement. The case

involves fraudulent mortgage pools, and what turned out to be bogus financial guarantee bonds, which has turned out to be a series of interrelated cases involving what might be in excess of $250 million in losses to all of the institutions involved.

We have also indicated—and I can indicate to this committee—that our office has encountered instances of affiliated outsiders using identical schemes to defraud more than one financial institution, and one of the examples that I gave in my written statement is Leo Peterson, who was an appraiser, who initially was at one savings and loan, submitted some bogus appraisals, moved on to another institution in which he was submitting false and inflated appraisals in connection with property to secure loans, and who ultimately has been prosecuted and convicted after being able to perpetrate his scheme at several savings and loan institutions in our area.

In another case, we have had an individual convicted by the name of Victor Bagha——

Mr. BARNARD. How much did Peterson get?

Mr. BONNER. Mr. Peterson appraised, for example, in one of these instances——

Mr. BARNARD. I'm sorry—how much time did he get?

Mr. BONNER. How much time did Mr. Peterson get? Let me ask Mr. Bowers if he could respond to that.

Mr. BOWERS. I believe on the first conviction he received a 6-month sentence, and we recommended a greater period of incarceration than that.

On the first conviction, we used the incident that was the basis for the second conviction, in an attempt to enhance the sentence, so in the second conviction, he only received a 3-month sentence, I believe.

Mr. BONNER. Note from the question that that case alone, not that that stands in total isolation, illustrates the fact that the kinds of sentences we get after the tremendous investigative and prosecutive effort that has to go into these cases is entirely inadequate to deter others similarly situated from engaging in these kinds of fraud.

In fact, one can make the statement that that kind of sentence is actually counterproductive and invitational to outsiders and other insiders to perpetrate large fraud schemes on the supposition that, if they happen to get caught, and prosecuted and convicted, that their sentences are not going to be very substantial. And that's the wrong kind of message to be sent out by the judges. With respect to Mr. Peterson, we did ask for several years' imprisonment.

In another case, by the way, which is one of the few examples of an individual who did get socked by a Federal district judge here in Los Angeles, Victor Bagha: This is an individual who went through several banks starting with Mitsui Manufacturers Bank in which he defrauded that bank of around, over $2 million, essentially in a scheme in which he was building limousines, and he would have straws come in and borrow money and there wasn't any security, or there weren't any limousines except in a very few instances standing behind these loans.

After fleecing one bank, he moved to another bank, in which—and that is the United Savings Bank, which is one of the banks

that has failed in this area, and then he moved on, after having fleeced that bank for about a million, to a third bank, the Crocker Bank, attempted to bribe the loan officers there, and Crocker, to its credit, that was reported—well, I am not sure that was reported, but the Crocker Bank loan officers did not take the bribes, and there were no further losses, at least, to that bank. Evidently in looking into this case, there was yet another bank, Capistrano National Bank, at which Mr. Bagha had perpetrated the same scheme, and that's another bank, a small bank in this area that has failed.

Mr. Bagha, I must say, got the type of sentence that we do need. He was sentenced to a term of imprisonment of 18 years, which, in my judgment, certainly was an appropriate sentence, given the amount of money that he had obtained from the scheme but an appropriate sentence and the kind of sentence that we need to set the examples to help deter this kind of conduct in the future.

Much of the bank fraud in this district, and savings and loan fraud, can be traced to certain national trends that have already been alluded to, among which are the fluctuation in interest rates, and the downturn in the real estate market in California, starting in the early 1980's, particularly in the area of condominium development, among others.

It appears that there have been institutions, though, that have been sufficiently desperate for income in the competitive arena for loan money, that they have become less conscious and vigilant than one would like. Indeed, in the case that we have under investigation and have prosecuted, successfully prosecuted, which I refer to in my written statement as the *Chatsworth* case, a case that involved about $21 million in losses to financial institutions—part of the property there was in the north San Fernando Valley; it was actually outside the San Fernando Valley in the mountain area, and it's a situation in which none of the financial institutions that took on that extended credit in which the so-called Chatsworth property was the security, had even bothered to look at land that was backing these loans, which was inaccessible land. They would have found, had they gone there, that there was no way to reach the property in question.

It's doubtful that the recent string of banks and savings and loan failures in southern California has run its course. The FBI continues to open major bank fraud investigations in the Los Angeles area on a weekly basis. Clearly, financial institution fraud is an enormous problem in southern California, and I have targeted that kind of fraud as the No. 1 priority of the Major Fraud Section of my office.

I want to touch very briefly on something that the FBI can no doubt expand on, but, just briefly, the number and quantity of major and significant bank fraud investigations that are being worked on by the FBI in this area. The FBI's Los Angeles division is coterminous with my Federal judicial district, the Central District of California. In this Federal district, the FBI has over 270 pending investigations involving fraudulent misconduct in, or against, financial institutions where the amount of the alleged violations involves $100,000 or more, slightly over 270 matters that are open and under investigation by the FBI here in that category.

Of those, 145 involve losses to financial institutions of over a quarter of a million dollars; and we have given the committee a breakdown as to how many of those involve commercial banks and savings and loans and so forth.

So, there are many very significant cases that are actively being investigated by the FBI here. The U.S. attorney's office is currently pursuing 59 major cases involving insider or affiliated outsider abuse, although the exact figures change in this regard as investigations progress, they involve approximately 120 principals, or potential targets of these investigations.

Many of the over 270 FBI investigations that I have just referred to involving losses of over $100,000 have not yet been presented to my office—and I say, thank God for that because when they do, when they are all there, it is going to place an extraordinarily severe burden on the prosecutive resources of my office to handle them.

I have also summarized some figures on the number of indictments and convictions—let me just say in that regard, since about 1985, my office has filed criminal charges and prosecuted approximately 159 cases involving significant bank fraud and embezzlement. We have convicted 168 defendants. Because of the—and I will allude to this a little further in a moment—because of the very high prosecutive guidelines that my office has, virtually every case that we do undertake for prosecution is significant in that it involves very substantial sums of money losses.

The committee asked about the Department of Justice's special monitoring system. I will be brief in this regard. I think that I've indicated that we first received a listing from the Department of Justice in about March of this year in connection with the main Justice Department's bank fraud tracking system. This was the first list of significant cases provided to my office by the Department, and it includes a total of 30 cases arising in this district. It is my understanding that the Criminal Division of the Department of Justice began monitoring significant bank fraud cases in about early 1986. Let me say that I believe the concept of tracking significant bank fraud cases is a valuable one, in view of a large number of bank failures in this Federal district, and in certain other districts of the Nation. The monitoring of significant bank fraud cases on a national level should be of ongoing assistance in assessing the scope and the focus, or location, of the problem in determining where additional investigative and prosecutive resources are needed.

I might also say that equally valuable in that assessment are the FBI's own data with respect to open cases that they have under investigation that involve failed savings and loan or bank institutions or involve losses in the seven figures to institutions, whether they have failed yet or not.

The committee asked me to address, and I would like to address very briefly, the question of resources, and resource requirements, both from the point of view of the FBI and the U.S. attorney's office here in Los Angeles. I think the point has already been made that investigations into financial institution fraud, particularly of the magnitude that we are talking about in this district, are extremely labor-intensive, both from the investigative, or FBI, and

the prosecutive standpoint. These investigations virtually always require a protracted length of time in the investigative and grand jury phases, and require a considerable amount of time and effort, once we have secured an indictment in terms of processing it through trial or guilty plea, if that be the case.

We have, in terms of the kinds of resources and numbers of resources, we have been given—I have been given—as an example in my written statement, again the BofA/NMEC case, in which it took agents well over 6 months just to collect the basic documentation that was needed in that case, and we are still issuing grand jury subpoenas to collect documentation that is needed to adequately and accurately complete that investigation.

Mr. BARNARD. Did Bank of America make that referral? Or how did that referral come about?

Mr. BONNER. My understanding of that, Mr. Chairman, is that, first of all, this was a case in which the Bank of America essentially took the loss for 13, 14—something in that order—smaller thrift institutions mainly located on the east coast, as a matter of, what shall we say?—accepting civil liability. The case came to our attention, in part, through complaints and concerns that were raised by the 13 or so institutions, many of which, about 8 of which, were on Long Island, NY, initially came to the attention of certain components of the Federal Government, including the FBI.

It is my understanding also though that the Bank of America here in Los Angeles had made contact with the FBI relatively early on in this situation.

Because a thorough investigation of these more complex bank frauds requires significant expenditures of time and resources, ideally, the FBI should be able to staff such investigations with more than one agent, minimally. When we are talking about a major case—and let me give a definition of that, because we have many instances of it in this district—I mean by that a case in which based upon the preliminary evidence, it looks likely that fraud, insider, outsider, or a combination of both, has contributed to the failure of the savings and loan or other financial institution, ought to be defined as a major high-priority case always; and, two, I would put into that category also cases that have not resulted in the failure of an institution, but involved incredibly large dollar losses to the institution, let's say, in the seven or eight figures.

And we have numerous instances of that in this district, but those ought to be high-priority cases. And, minimally, the FBI should be allowed, or in a position to devote at least one agent, one FBI agent's time and attention to that case on a full-time basis.

The fact is that——

Mr. BUSTAMANTE. How can we provide that continuity? You mentioned that in your testimony. One of the things that is lacking sometimes is continuity. An agent is diverted to some other area, and so you lose valuable time in reference to that case.

Mr. BONNER. There is no question that that can and has happened, but I am sort of at the threshold question here, that agent that we are losing continuity as to, that agent frequently is handling four, five, or six other major bank fraud cases in any event.

I think the initial premise that I'm trying to state here is that, if you have something to which we all agree, or any objective observ-

er would agree to, is a major significant, something that should be classified as a high-priority investigation, that ideally you would have at least one FBI agent, who is told, "That's your case; we want you to spend your time and effort as quickly as possible"—and it may take many months—"to determine whether there is criminal fraud and enough evidence to successfully prosecute the case."

That is rarely the cases, despite the fact that we do have, in my judgment, many, many cases that fall in this category. It is the rare case in which the FBI here, because of the lack of resources it has, is able to assign more than one FBI agent to one of these major and highly significant cases, but it is extremely rare that they can assign one agent and give them that as his full-time responsibility.

As Mr. Bustamante has indicated, there is also the further problem that compounds it, the occasional reassignment, transfer and lack of continuity on these cases, and that particularly impacts complex savings and loan or bank fraud cases, because these cases by their very definition are not "quick-hitters." They are going to take months and many times years to adequately and successfully investigate, and reach a prosecutive decision to determine whether we have enough of a case to prosecute, is going to frequently take 12, 18, 24 months.

The committee also asked me to address specifically some questions about what I have described in my testimony and as "institutions 1 and 2"—and both of these matters are still under investigation by both the FBI and my office. For that reason, I have referred to them by numbers. We have noted that, in particular in those cases, that, with respect to institution No. 1, early on that case was, did suffer delays from a lack of investigative resources by the Bureau in terms of the time that an FBI agent could spend and devote to the case.

Let me address very briefly, if I can, the sufficiency of FBI resources, then.

I do want to say that during my tenure as the U.S. attorney here, which has been about 3½ years, and formerly as an assistant U.S. attorney in the office's Criminal Division, back in the early 1970's, I have been greatly impressed with the dedication, diligence, and overall competence of special agents of the FBI assigned to the Los Angeles division. Some of the more experienced agents have acquired valuable expertise in analyzing bank records and investigating major bank and other kinds of fraud cases. Indeed, unquestionably, some of the finest fraud investigators to be found anywhere in the United States or the world are FBI agents assigned to this district.

But there is a serious shortage of FBI agents in the Central District of California, and particularly, the FBI has a critical shortage of agents assigned to bank fraud and other white-collar crime investigations, in my view; and I have set forth—that's true both with respect to the Los Angeles office, which is located in the part of Los Angeles, what we call Westwood, but it is also true of the major resident agency of the Los Angeles division, which is down in Orange County. Both of them suffer from, in my judgment, acute shortages of agents.

The agent shortage is acute here in Los Angeles. The bottom line is there simply are not enough FBI agents in the Los Angeles division to consistently, with the Bureau's many other priorities and responsibilities here, to investigate the numerous financial institution fraud and embezzlement cases arising in this district. The FBI's Los Angeles division, in my judgment, sorely needs reinforcements.

I have commented, too, on the adequacy, because the committee asked it, of the expertise and training of the FBI agents that work in the white-collar and bank-fraud cases in this area; and it varies. There are, as I said, some extremely competent FBI agents here that are very experienced and have a high-level expertise in this area, but then, again, there are not as many of them as are needed for the type, volume, quantity and magnitude of bank and savings and loan fraud cases that the Bureau is responsible for investigating in this district.

Let me turn, if I could, very briefly, to the prosecutorial resources of the U.S. attorney's office, and let me give you quickly my assessment of that. I did, in the fall of 1986 reorganize the white-collar sections of my Criminal Division, and the effect of that reorganization was to recognize the growing financial institution fraud problem in the Central District of California, and to address some other areas of concern in our district. But, in essence, I increased the Major Frauds Section from 7 to 13 assistant U.S. attorneys, and I also created another white-collar crime section to deal with Government fraud and public corruption, which had theretofore been handled within the Major Frauds Section, significantly increasing, at least, while it seems like a small number of assistant U.S. attorneys—and, Mr. Chairman, it is—but significantly increasing in terms of the overall size of my office and number of assistants that I have allocated to bank fraud, within the Criminal Division of the office.

The No. 1 priority of the Major Frauds Section of my office, as I have indicated, is the area of financial institution fraud, and the next highest priority in that section is the telemarketing or boiler room fraud.

And I think you should know, this committee should know that there are several hundred fraudulent telemarketing companies operating out of the Central District of California, in Los Angeles and Orange County, who are preying on investors and consumers across the Nation; and that those fraudulent operations result in millions of dollars in losses to victims nationwide.

So that's the second highest priority of the Major Frauds Section.

Mr. BARNARD. What was that classification? You said "telecommunications"?

Mr. BONNER. Telemarketing fraud, and what this is essentially are these boiler room operations that we have in Los Angeles and Orange County, which are selling investments, precious metals, gem stones, what have you——

Mr. BARNARD. Penny stocks.

Mr. BONNER [continuing]. To investors in Illinois and across the United States.

The Major Frauds Section also has responsibilities for securities fraud and insider trading prosecutions, bankruptcy fraud cases, as well as traditional wire frauds.

With respect to the resources of the U.S. attorney's office, let me tell the committee that my office has not yet recovered from the long arm of Gramm-Rudman. During Gramm-Rudman, the Gramm-Rudman mandated hiring freeze that started in February 1986, I was unable to replace assistant U.S. attorneys who resigned to go into private practice.

After the lifting of Gramm-Rudman, those restrictions last October, I have embarked on an aggressive hiring program, to fill over 20 assistant U.S. attorney vacancies, most of which, I might say, have been filled; but it is not simply a matter of filling vacancies, because most of the new assistant U.S. attorneys that are hired have to go, before they can be brought on board, have to go through the FBI background screening process, a process, in my experience, takes between 3 and 4 months before we get the final approval to bring a new attorney on board.

Even now, the Criminal Division in my office, which, as I said, has an authorized strength of 79 assistant U.S. attorneys has only 65 on board. There are 13 assistant U.S. attorneys who are hired that are awaiting completion of their FBI background checks, and I am interviewing for one remaining opening.

Consequently, I can't overemphasize that, as a result of the lingering effects of the Gramm-Rudman mandated hiring freeze, my office will not be at full strength until August or September of this year. So that's a long tale for that interesting experiment.

In addition, it has become increasingly difficult to keep experienced attorneys in the U.S. attorney's office because of the growing and drastic disparities, Mr. Chairman, between salaries paid to private practice lawyers, and those paid to Government attorneys. This is particularly significant in the Los Angeles area, because of the high cost of living here compared to other areas of the country, but there are private practice attorneys at comparable levels of experience to assistant U.S. attorneys in my office that work for major LA law firms that are earning in compensation two, three, and sometimes even four times the salary of assistant U.S. attorneys. Even the salaries of district attorneys, deputy district attorneys, in LA or California, are greater than they are for assistant U.S. attorneys.

And this is a problem that is going to have to be addressed, because if we don't address it, we are not going to have any, or the numbers of experienced Federal prosecutors and assistant U.S. attorneys that we need, particularly to address the kinds of difficult and complex criminal fraud investigations that are of concern and of interest to this committee.

Mr. BARNARD. Mr. Bonner, let me ask you two questions at this point. No. 1 is: Does the Justice Department in Washington take note of the volume of crime that is happening here in the central division here and try to respond, from the standpoint of what your needs are? For example, we have had some comparisons this morning on numbers of attorneys, U.S. attorneys, we have in New York City, considering population and the amount of white-collar crime, and so forth, as compared to what it is in California.

Do they ever make any evaluations of the need and make some changes?

Mr. BONNER. Well, they do do that through the Department's Resource Allocation Board, if it is done, but I think we have—first of all, we have a historic imbalance that has occurred perhaps over a period of a decade or more, in which more resources seem to be thrown at, for example, the east coast, or New York City, than at the, what is the second largest metropolitan area of the country, which is Los Angeles.

And we certainly have not caught up. There are, for example, something in the neighborhood between the Southern and Eastern Districts of New York, which cover the entire New York City Metropolitan area, something in the neighborhood of 220 assistant U.S. attorneys in those two districts. I have a district that is about the same size of those two districts in population with very serious Federal crime problems, but I have a total for my office, including the Civil Division, of about 117 assistant U.S. attorneys now.

Mr. BARNARD. Let me ask you, if you would, would you assess the fact that we do have such a scarcity of personnel, both within the FBI and the Justice Department—primarily the U.S. attorneys' offices—would you even attempt to assess how much crime is not being prosecuted because of that?

Mr. BONNER. Well, that would call for significant speculation. Here's what happens though. As a practical matter, Mr. Chairman, what happens is this: As the amount of serious Federal crime exceeds capacity of the FBI or the U.S. attorney's office to handle, for both—and we have to be sort of in conjunction with each other here, what happens is I simply raise, tighten up the spigots; that is I raise the prosecutive guidelines for bringing a case into the U.S. attorney's office. Very frequently, these kinds of guidelines are monetary guidelines, and I have been very reluctant and haven't stated specifically what our monetary guideline is, for example, for bank fraud and embezzlement cases. But I will tell you it is beyond question, I believe, the highest prosecutive guideline in the country, and that means that we don't take those cases unless they involve a loss that is above our guideline. U.S. attorney's office in Los Angeles and it is purely because of a resource shortage and of assistant U.S. attorneys in the Criminal Division—does not take those cases.

And, as a practical matter, I don't get a lot of dispute from the FBI on that issue because they have the same problem out here that I have, and so it is really by mutual agreement—nobody is saying that, nobody wants to be in the situation but we are simply in that situation.

On the other hand, I truly believe, as I have indicated, that in terms of the major and significant high-priority frauds on financial institution cases, that none of those go wanting for lack of resources, because what we do, we stop devoting our time to cases that involve losses of under so many thousands of dollars and we devote our resources to much more lengthy time-consuming situations, but to what are, in my judgment, the most important cases that we have to address and have to attach priority to, and those are the ones where you have had a bank failure that may have been caused or was caused by fraud or insider or outsider abuse

that is prosecutable, or cases that involve just substantial numbers in terms of losses.

Mr. MARTINEZ. Mr. Chairman.

Mr. BARNARD. Just one second—yes.

Mr. MARTINEZ. In other words, if I were a smart criminal, I would commit a crime below that cash limit because I know you wouldn't get around to prosecuting me.

Mr. BONNER. Well, we would like to think that's not true. We would like to think that in those cases that they are picked up locally by the local district attorney's office, so—you wouldn't be home scot-free. You would still have some arrests; those cases would be picked up by local, by the local investigative agency, the local police department bunko squad and presented to a district attorney's office for prosecution.

Mr. MARTINEZ. I would hope so.

Mr. BONNER. So, we hope that there aren't cases falling through the cracks.

Mr. MARTINEZ. I would hope so, but, you know, we've heard from the district attorney's office, the State attorney general's office that they have limited resources, too, so I wonder if they don't also defer cases of lower cash value. It would be interesting to find out.

Mr. BONNER. I'm not sure anybody really wants to know exactly.

Mr. MARTINEZ. I thank you, sir.

Mr. BONNER. Let me go on and indicate that the—certainly the prosecutors in my Fraud Section have a heavy preindictment load, caseload, each one of them; they are working long hours to complete important investigations.

Most of these cases, as I have indicated, require extensive grand jury investigations, presentations, prior to even getting the case indicted. Once the case is indicted, there is still a great deal of the prosecutive workup that must be done, and for those cases that do go to trial—and there are cases that do go to trial, because we have relatively restrictive plea bargaining in this district——

Mr. BARNARD. How do you feel about your record of prosecutions? Good, bad, or average, or what?

Mr. BONNER. I think the record of prosecutions is excellent in the sense that——

Mr. BARNARD. Are you getting convictions?

Mr. BONNER [continuing]. That we get convictions in well over 90 percent of the cases that we prosecute, and the inadequacy here, I think, Mr. Chairman, lies more in the area of the kind of sentences we are getting from the Federal district court on these cases where we do secure convictions.

On the other hand, one does have to understand that we do not prosecute a case, under Department guidelines, unless we have evaluated and analyzed that case, and we are satisfied that we have a reasonably good prospect for obtaining a conviction before a jury, which means proving fraud beyond a reasonable doubt.

Mr. Adler indicated, by the way, who is the deputy attorney general for the State of California, who was one of the early witnesses, indicated that California, unlike apparently some other States—California is in a position to give us very little help from the State point of view, in terms of what the State could absorb in terms of major financial institution fraud either perpetrated by outsiders or

insiders. The fact is that we can't rely on the State of California to prosecute any significant numbers of these financial institution fraud cases.

As Mr. Adler indicated, the attorney general's office—he has a total in his unit, his fraud unit, he has a total of six attorneys. That's for the entire State of California. So they can provide, at best, some marginal help to us, where we cross-designate them to be special assistant U.S. attorneys and come in and assist us in cases being handled by the U.S. attorney's office. And even there, you have to understand that I still have to assign an assistant U.S. attorney to supervise and oversee that case to make sure that precious tools that we have, such as Federal grand juries, are not subject to abuse and criticism so that some defense lawyer can turn around and make it more difficult to prosecute Federal criminal cases.

In addition, by the way, as this committee heard, the State criminal justice system is so cumbersome itself that, as Mr. Adler stated, it is virtually impossible to successfully investigate, much less prosecute a complex white-collar crime case in the State court system.

In the final analysis, whether we like it or not, it is going to have to be a Federal responsibility, at least in the State of California, for the foreseeable future, a primary Federal responsibility to handle fraud, insider and outsider, on financial institutions occurring in the State.

I talked a little bit about my guidelines. I think you have an idea that we do have very high guidelines. That means that I do not have the so-called fast track system for handling smaller embezzlement cases. I'd be happy to have a system to handle smaller bank fraud embezzlement cases, and I will do that when I have adequate numbers of assistant U.S. attorneys to handle those cases.

I've spoken in my written statement, so I won't duplicate it, about the coordination between the regulatory agencies and the U.S. attorney's office. Perhaps it will remain forever true, but the banking agency examiners, some of them are adept at discerning or discovering fraud. The bank examiners still, in my judgment, and the judgment of the assistants in my office, do not pursue the way we would like questionable transactions far enough or quickly enough.

And some of these cases are very difficult because you cannot simply review the loan documentation to determine fraud. You have to put a few things together, which could even on occasion mean checking where the security is that underlies the loan, and maybe making a commonsense judgment as to whether the appraisal is even within the ballpark that's supposedly is supporting the security for the extension of credit.

Regarding referrals, definitely it seems to us that the referrals from the FDIC, as well as the other bank and financial institution regulatory agencies, have improved. We do have a common format for these referrals, which is helpful to us. The Comptroller of the Currency actually provides our office with periodic updates of these criminal referrals, which do aid us in tracking these major financial institution fraud cases. Obviously, we'd like more from the examiners that initiate referrals. In addition, it seems to us that early detection and referral of these cases would be of great assist-

ance to the FBI in terms of getting in early into a case, and having more investigative possibilities and opportunities, which are foreclosed if the referral is not made early enough.

I've also—I think I'll skip over it, unless the committee has any questions—discussed in my written statement coordination between financial institutions and the Department of Justice, which is, I guess, in a nutshell, varied.

We have discussed the document control and retention problems——

Mr. BARNARD. Do you think there ought to be some formal procedure for that?

Mr. BONNER. Well, let me put it this way. There are so many different situations that can arise. But you do have situations in which institutions are sometimes wary of referring anything because the level of involvement in the institution is so high; and I don't know what systematically you can do other than you have to rely on your examiners to catch something in that situation.

There are situations, though, that have occurred here for as long as I can remember, in which you have employees, sometimes bank officers who are caught with having embezzled substantial sums of money, sometimes into the hundreds of thousands of dollars, who are more or less allowed to resign. Sometimes, the next institution is not informed, and they go and get employed with another financial institution and steal from it. And so we have that kind of problem, and the concern, as you know, Mr. Chairman, if you talked to bank counsel, is the concern with wrongful termination suits in California, an area of tort liability that is so ripe out here and has resulted in substantial judgments, which makes the bank counsel very nervous. It is an area for potential legislation, perhaps—Federal legislation to address that kind of problem so that, rather than be concerned about not reporting these to further financial institutions and to the FBI and U.S. attorney's office, they are given some incentive to do so.

Mr. BARNARD. Let me ask you this question: On page 38 of Mr. Deardorff's testimony, Mr. Deardorff said this to which I would just like your quick response. We asked him the question of how many criminal referrals involving senior insiders or affiliated outsiders have California thrifts made themselves in 1985 to date, and his answer was this:

"With the exception of institutions in the MCP or under supervisory control, we are not aware of any criminal referrals involving senior insiders or affiliated outsiders made by the California thrifts themselves since 1985."

Mr. BONNER. Well, I'm shocked that it is zero. [Laughter.]

I would have expected at least some.

Mr. BARNARD. Can you imagine that?

Mr. BONNER. Again, I think that the concerns there are where you do have a high level of involvement in an institution you are not going to be getting a referral from the institution itself.

Mr. BARNARD. The reason I'm pursuing this issue, whether or not we ought to have some formal procedure for referrals, is because we have encountered the following situation. The FSLIC fee counsel handling the civil cases arising out of the massive failure of Beverly Hills in early 1985 told two of our subcommittee staffers

that he did not believe it appropriate for him to make a referral. He said that he has not been asked by his client, the FSLIC, to undertake an analysis of criminal liability, and that such would require substantial efforts, even though he has had six to eight attorneys going over documents and trying civil cases.

I ask you two questions: How do you respond to this assertion, especially as two parts of the transaction involving possible criminal misconduct, which have not yet been examined? There has been only one agent working part time only, as we understand? In other words, it looks like we have an entirely inadequate resources here for the referral system.

Mr. BONNER. Well, I'll tell you, it is entirely unacceptable and inappropriate that you would have fee counsel that would take the position that their interest is solely limited to recovering what they can recover monetarily for FSLIC in civil litigation. I mean, that is totally inappropriate; that is unacceptable to me.

Mr. BARNARD. Have you had——

Mr. BONNER. I find it absolutely astonishing that fee counsel would take that position. I have a suggestion that I want to make on that.

Mr. BARNARD. Sure.

Mr. BONNER. And that is that it seems to me that fee counsel perhaps in the retainer agreement that's entered into between FSLIC and fee counsel, there ought to be a specific provision in that agreement that if they uncover anything that appears to be prosecutable criminal fraud, that that ought to be brought to the attention immediately to the U.S. attorney's office and the FBI. I think anything short of that is unacceptable.

Second, I want to point out to this committee something else that at least irks me in this regard, and that is that FSLIC goes out and it retains fee counsel at rather large hourly rates, and significant compensation is being paid to the attorneys for these private law firms and they can put several attorneys on these cases.

Now, there is something wrong with the system in which I have at best—I am lucky if I can put one experienced assistant U.S. attorney on a major criminal fraud case from the criminal side of the case, which has to be in the long run, from an institutional sense, and from a sense of the entire system, more important than recovering some money for the FSLIC in one failed institution. There is something wrong with that system. And at least there is an irony there that is not lost on the assistant U.S. attorneys in my office who are working on these cases.

Mr. BARNARD. I might say that I've had, not with FSLIC—but with FDIC—I've had the situation occur of notice that whereby these fee counsels have continued their service year after year after year after year under the retainer basis and it has been very—it hasn't been a lot—I am not saying this happens across the board, but I have seen instances whereby those representations continue 5 and 6, and 7 years after the bank has closed, on a retainer basis, which could be very lucrative to them.

Mr. BONNER. Well, I'm just saying, too, I'm losing assistant U.S. attorneys from my office to go out into private practice, some of them to these very law firms, because I can't pay them an ade-

quate sum of money, and, yet, the FSLIC is paying out, in some cases, millions of dollars in fees.

Mr. BARNARD. I'll tell you about FSLIC fee counsel compensation in California. In 1986, there were 12 law firms in California, 29 nationwide; and FSLIC in California alone dispensed $6 million in 1986, $5 million in 5 months of 1987; nationwide—this is a nice lucrative figure; you can use this—nationwide they spent $20 million in 1986, and $19 million in the 5 months of 1987, on fee counsel.

Mr. BONNER. Those are extraordinary figures, particularly when you take into consideration that I'm only one of four districts in California, that the entire payroll for every assistant U.S. attorney in my office is about $5 or $6 million.

Mr. BUSTAMANTE. Well, Mr. Chairman—Mr. Bonner, are you saying that fee counsel really hurts the criminal prosecution area?

Mr. BONNER. Well, it has, or can. First of all, I'm saying that they ought to be mindful and cognizant of information that they develop through deposition or otherwise, discovery in civil cases, that could be abused in support of a Federal criminal prosecution. They ought to have an obligation to tell us that.

Second, I'm saying that they can, on occasion, impair a Federal criminal case. I have one example in mind of that where in a case that we were handling in my office from the criminal point of view, fee counsel had entered into a settlement agreement with some of the potential targets of our investigation; and the settlement agreement was essentially that FSLIC was being paid something, but in the agreement, it agreed to what was the appropriate valuation of the underlying security, which was going to be an issue in the criminal case; and it agreed that—I'll use hypothetical examples here—rather than about $100,000, which we thought was the value of the security, the FSLIC attorneys, fee counsel, agreed that it was $200,000.

Now the problem is, if we ever end up prosecuting that case—I want you to think about it—we've had counsel for an agency of the U.S. Government, which the FSLIC is—it's a Federal Government corporation—somehow or another a clever criminal defense attorney is going to get that in front of a jury, and it has compromised our ability to argue, no matter how many experts we would have, that in fact the real valuation of that property was much lower, and that there was a false inflation of the appraisal.

Mr. BARNARD. Incidentally, we have the record now that the—and I want to put it in the record at this time—that Mrs. Dorothy L. Nichols, who is the senior associate general counsel, Litigation Division, has written a letter to a fee counsel, where she has told them that they should make referrals of suspected criminal violations and cooperate with the criminal referral task force. This was dated May 26, 1987, so that there has been at least an attempt to correct it by the FSLIC, at least in California.

[The letter follows:]

Federal Home Loan Bank Board

1700 G Street, N.W.
Washington, D.C. 20552
Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

May 26, 1987

Ronald Muntean, Esq.
Kellett & Muntean
10100 Santa Monica Blvd., Suite 2600
Los Angeles, CA 90067

Re: Criminal Referrals - Assistance to Agency Group, Federal Home Loan Bank of San Francisco

Dear Mr. Muntean:

This is to advise you that the Agency Group of the Federal Home Loan Bank of San Francisco ("Agency Group") which, as you know, has regulatory responsibility for all institutions insured by the Federal Savings and Loan Insurance Corporation ("FSLIC") in the Eleventh District ("District"), has formed a Criminal Referral Task Force to ensure that criminal referrals are made on all individuals and all transactions involved in suspected criminal activity under federal and state law.

The Department of Justice, through the United States Attorney's Office and Federal Bureau of Investigation, has agreed to provide immediate assistance to the Criminal Referral Task Force in evaluating criminal referrals for prosecution. Since you, as fee counsel for the FSLIC, have the benefit of investigations subsequent to the failure of an institution, you are in the best position to the Agency Group and their lead attorney Glenda Robinson in this task. FSLIC requests that you provide the Agency Group, and at their request, the appropriate Department of Justice personnel, with whatever information will assist a rapid analysis of possible criminal violations that have occurred at any institutions for which you have been retained by the FSLIC as counsel. It is this agency's obligation, and your obligation as its counsel, to make all appropriate criminal referrals. The FSLIC, therefore, advises you to provide all necessary information to make criminal referrals where appropriate, and, if requested to do so, to actually assist in the preparation of criminal referrals.

EXHIBIT 3

Should you have any questions regarding this matter or attorney-client work produce or other privileges that might apply to the material in question, please contact the undersigned or Paul Grace at the Office of General Counsel, Litigation Division, Federal Home Loan Bank Board.

Sincerely yours,

Dorothy L. Nichols

Dorothy L. Nichols
Senior Associate
General Counsel
Litigation Division

cc: Glenda Robinson
Federal Home Loan Bank
of San Francisco

Mr. BONNER. Yes, the problem with those things are, Mr. Chairman, is that sometimes it takes a long time to have things trickle down from Washington to the local people——

Mr. BARNARD. We realize that.

Mr. BONNER [continuing]. And then fee counsel out here, in my experience.

The only ther thing I was going to address, before asking whether there are additional questions, is the sentencing area, and I think I've already covered that, and that is that it is clear to me that the sentences in the bank fraud cases in this district are, with very few exceptions, entirely too lenient. I have spoken a little bit on the latest version on the sentencing guidelines, and while they do represent an improvement overall in the situation because at least they mandate some jail time if you manage to defraud or steal over a certain figure, still they are, it seems to me, almost invitational, particularly if you are talking about the seven-figure-type fraud situations.

Mr. BARNARD. I have one final question, and I apologize for taking you as long as it's taken, but you have very appropriately, and in an excellent manner, addressed all the questions that were in our first letter to you. I compliment you on that. For that reason, we probably don't have nearly as many questions as we would have had.

Any other questions that we do have, we will submit them in writing to you.

Mr. BONNER. Fine.

Mr. BARNARD. But I do want to ask you this final question. Congress amended the Right to Financial Privacy Act last year to make absolutely clear that financial institutions and the banking agencies can make criminal referrals providing a description of the alleged misconduct and identifying information preempting State laws such as California's own Right to Privacy Act. Has that information filtered down to the financial institutions and their legal counsel, as far as you are concerned?

Mr. BONNER. Let me ask Mr. Bowers, who's the Chief of my Fraud Section, to respond to that, if I might, Mr. Chairman.

Mr. BOWERS. It may have filtered down, Mr. Chairman, but they have refused to acknowledge it at this point, I think. We continually encounter problems in this area, and particularly with our nondisclosure letters that we send out in connection with grand jury subpoenas, where we request them not to disclose the existence of the subpoena, because it might jeopardize an ongoing criminal investigation.

With the exception of Bank of America, the financial institutions are still requiring us to get court orders before they will honor our nondisclosure requests.

Mr. BARNARD. So, you haven't seen any change in the willingness to make complete and timely referrals since that change?

Mr. BOWERS. Not significantly.

Mr. BARNARD. Good.

Well, thank you, gentlemen, both of you, for being here today, and taking of your valuable time on a Saturday. This has proved to be very interesting, and I know it is going to be very helpful. Thank you very much.

Mr. BONNER. Thank you, Mr. Chairman.
Mr. BOWERS. Thank you.
[The prepared statement of Mr. Bonner follows:]

STATEMENT

OF

ROBERT C. BONNER
United States Attorney
Central District of California

BEFORE

THE

SUBCOMMITTEE ON COMMERCE, CONSUMER AND MONETARY AFFAIRS
COMMITTEE ON GOVERNMENT OPERATIONS
HOUSE OF REPRESENTATIVES

REGARDING

FEDERAL RESPONSE TO CRIMINAL MISCONDUCT AND FRAUD IN SOUTHERN CALIFORNIA FINANCIAL INSTITUTIONS

ON

JUNE 13, 1987

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Mr. Chairman and Members of the Subcommittee:

I appreciate the opportunity to address the Subcommittee about the federal response to criminal misconduct and insider abuse in financial institutions in Southern California, and particularly in the Central District of California.1/

A. Nature and Extent of Financial Institution Fraud

1. General Overview and Examples

In the 1946 movie classic "It's A Wonderful Life" Jimmie Stewart portrays a small-town banker who gives depositors his honeymoon money to stop a run on his bank. Recently a reporter for the Orange County Register noted that if the movie took place in Orange County today, the lead character probably would be stealing money from his depositors to finance his honeymoon.

Unfortunately, there is a grim element of truth in the reporter's cynical view of the financial world here. Insider greed and fraud perpetrated on our financial institutions -- our banks and savings and loans -- are rampant in Southern California. The number of such cases is proliferating at an alarming rate, and the dollar losses are astronomical. Unless brought under control, public confidence in our banking system may be destroyed.

The United States Attorney's Office for this federal district is facing an increasing number of investigations into criminal misconduct by officers, directors and employees of financial institutions. The extent of "bank"2/ fraud in general, as well as insider and affiliated outsider fraud in particular, has reached epidemic proportions in this district. I anticipate that the problem will continue to be very significant in view of the rapid growth of Los Angeles as a world trade and financial center, the number of relatively small financial institutions, and the cyclical "boom or bust" nature of Southern California real estate development.

Federal prosecutors are seeing an ever widening spectrum of insider fraud schemes ranging from simple transactions

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1/ The Central District of California consists of seven Southern California counties, including Los Angeles and Orange counties. With more than 14 million inhabitants, the Central District is by far the most populous federal district in the nation.

2/ The term "bank" fraud is used generically throughout this statement to include, without limitation, fraud on all types of financial institutions, including commercial banks, savings and loans, thrift institutions, credit unions and the like.

involving insiders who make direct payments and bogus loans to friends and relatives, to more complex schemes featuring shell companies, double escrows and other devices designed to obfuscate transactions in which financial institutions purchase over-valued properties or companies controlled by bank insiders.

While insider abuse continues to be a major problem, federal prosecutors increasingly are tackling complex frauds perpetrated by affiliated outsiders, such as appraisers and major borrowers.

Throughout 1986 and 1987, a task force comprised of the United States Attorney's Office for this federal district, the FBI, the California Attorney General and the Orange County District Attorney's Office has been investigating and prosecuting a series of interrelated cases involving affiliated outsider fraud on an unprecedented scale. Both major financial institutions, such as Bank of America and Wells Fargo, and smaller institutions, such as the Bank of Yellville in Arkansas, were victims of complex schemes involving mortgage/loan pools, Southern California real estate and worthless financial guarantee bonds. The glamour of Southern California real estate, combined with the false security of financial guarantee bonds, enticed financial institutions into positions they normally would have avoided. The losses in these mortgage pool fraud cases may exceed a quarter of a billion dollars. Thus far, nine defendants have been convicted as a result of the current task force effort. Six of the defendants have entered guilty pleas to charges ranging from a RICO violation, to mail fraud and interstate transportation of stolen property. Additionally, after a three-month jury trial, three defendants were found guilty, including a dishonest appraiser and two loan brokers. The task force is pursuing additional indictments involving these interrelated fraud schemes.

The United States Attorney's Office has encountered numerous instances of affiliated outsiders using identical schemes to defraud more than one financial institution.

Leo Peterson is an example of an appraiser who moved from one institution to another. In 1979, Peterson, a loan officer at Gibralter Savings and Loan, was responsible for preparing draft appraisals for the Gibralter appraisal department. Because the Gibralter appraisal department became inundated with appraisals for loan applications in 1979, it did not verify Peterson's draft appraisals. After Peterson discovered that no one was verifying his appraisals, he started accepting bribes to inflate the figures on the appraisals he submitted. Prosecutors indicted Peterson in mid-1984 and ultimately he pleaded guilty to three felony counts arising from misconduct at Gibralter.

Soon after Gibralter discovered Peterson's misconduct, but before his indictment, Peterson set up his own appraisal business where he prepared inflated appraisals for potential borrowers in exchange for money payments. For example, Peterson appraised 442 acres of vacant land in Chatsworth, California at a value of over $18 million. In fact, the borrowers had purchased the property for slightly over $1 million -- a figure closer to its actual market value. The borrowers used Peterson's appraisal to justify a $14 million loan which numerous financial institutions in the east and mid-west funded collectively. The borrowers, who had paid off Peterson, ultimately defaulted on the $14 million loan. We indicted Peterson for this misconduct in 1986, and he was convicted following a lengthy jury trial.

In another case which we successfully prosecuted last year, Victor Bagha put together a scheme to defraud lending institutions through phony limousine loans. Bagha sent "straw" borrowers into the bank to get loans to buy limousines from his company. Bagha obtained the loan proceeds, but produced almost no limousines. In 1983, Bagha used the scheme to get over $2 million from Mitsui Manufacturers Bank in Los Angeles. In 1984, he used the same scheme to defraud Unified Savings Bank (one of the banks on the failure list provided by Congressman Barnard) of more than $1 million. In 1985, he unsuccessfully tried his scheme at Crocker Bank in Los Angeles, where loan officers rejected offered bribes. There was also evidence that Bagha placed some of these phony loans at other area institutions in 1983, including Capistrano National Bank, which later failed. Bagha was ultimately sentenced to eighteen years imprisonment for his fraudulent activities.

Much of the bank fraud in this federal district can be traced to both regional and national trends. The high interest rates of the late 1970s and early 1980s placed financial institutions in a precarious position because existing fixed-rate loans failed to produce the income necessary to pay depositors. Additionally, the sudden leveling of Southern California real estate put many financial institutions at risk as borrowers defaulted because of the downturn in prices.

It appears that as some institutions become more desperate for income in an increasingly competitive arena, they become less cautious and less vigilant. Some institutions failed because of poor risk management. Others have been the victims of outright fraud. Affiliated outsiders have taken advantage of institutions that fail to do their homework. In the aforementioned Chatsworth case, none of the financial institutions even bothered to view the inaccessible land backing the loan.

It is doubtful that the recent string of bank and savings and loan failures in southern California has run its course. The FBI continues to open major bank fraud investigations on

almost a weekly basis. Clearly, financial institution fraud is an enormous problem in Southern California, and I have targeted such fraud as the number one priority of the Major Frauds Section of my office.

2. Number of Bank Fraud Investigations, Including Significant Cases

In this federal district the FBI has approximately 145 pending investigations involving fraudulent misconduct in or against financial institutions where the amount of the alleged violation involves $250,000 or more. Of the 145 major investigations, 102 involve commercial banks, 41 involve savings and loan institutions and 2 involve credit unions. Thirteen of the major fraud investigations involve failed banks, while 12 involve failed savings and loan institutions. (See APPENDIX for a list of failed institutions). The FBI also has 123 additional investigations open involving losses to financial institutions in this district of between $100,000 and $250,000.

The United States Attorney's Office is currently pursuing approximately 59 major cases involving insider or affiliated outsider abuse. Although the exact figure changes as investigations progress, current investigations involve approximately 120 principals. Many of the nearly 270 FBI investigations involving losses of over $100,000 have not yet been presented to our office.

3. Number of Indictments and Convictions

During fiscal year 1985 the United States Attorney's Office for this district filed 12 informations, obtained 53 indictments and convicted 75 individuals in financial institution fraud cases.

During fiscal year 1986, we filed 14 informations, obtained 44 indictments and convicted 58 individuals in financial institution fraud cases.

To date, during fiscal year 1987, the office has filed 7 informations, obtained 29 indictments and convicted 35 people in financial institution fraud cases.

In 1986, our office convicted Victor Bagna, a principal involved in the failure of Unified Savings Bank, one of the 13 failed institutions in this federal district listed on Congressman Barnard's attachment.

4. Criminal Division's Special Monitoring System

In March 1987, the United States Attorney's Office for this district received from the Department of Justice's Criminal Division a list of major bank fraud cases compiled

under the Criminal Division's "Bank Fraud Tracking System." This was the first list of significant cases provided to my office by the Criminal Division, and it includes a total of 30 cases arising in this district. It is my understanding that the Criminal Division began monitoring significant bank fraud cases in early 1986.

Stephen P. Learned of the Department of Justice Fraud Section is coordinating the monitoring of these cases. He is the appropriate person to contact regarding the criteria for the Criminal Division's selection of major bank fraud cases and the specific uses for and objectives of the tracking system on a national level. Learned acts as a liaison between my office, the Department of Justice and the various regulatory agencies. Whenever there is a financial institution fraud of particular national importance, Learned generally contacts the Chief of the Major Frauds unit in my office.

I believe that the concept of tracking significant bank fraud cases is a valuable one in view of the large number of bank failures in this federal district and elsewhere in the nation. The monitoring of significant bank fraud cases on a national level should be of ongoing assistance in assessing the scope and loci of the problem and in determining where additional investigative and prosecutive resources are needed.

B. FBI and U.S. Attorney Resources Devoted to Bank Fraud Cases and the Priority of These Cases in the U.S. Attorney's Office

1. Resource Requirements

Investigations into financial institution fraud are extremely labor intensive, both for investigators and prosecutors, and require greater time and expertise than most other criminal investigations. Such investigations will almost always require extensive time and effort to gather, organize and review documents -- a task which by itself takes weeks, months and sometimes even years. Often investigators must untangle a complex web involving complicated transactions and sham entities specifically designed to thwart an investigation and throw investigators off the track.

In the Bank of America/NMEC cases it took agents over six months to collect the basic documentation generated by the involved transactions. Two years after opening the investigation, agents are still using grand jury subpoenas to obtain necessary documents. It also took the FBI over six months to organize the tremendous volume of documents seized pursuant to the initial searches in the case. Agents and support staff spent thousands of hours reviewing documents and entering relevant data into two special computer systems designed to aid the government in organizing and using the vast amount of materials.

Not only must an investigator be familiar with banking procedures, but often agents must master special areas of knowledge to decipher the entire fraud. For example, one current investigation involves a complicated scam involving the purchase of leases of recording equipment. Before an agent can even begin to understand the series of complicated transactions, the agent must acquaint himself with a variety of customs and practices in the recording industry.

Because a thorough investigation of the more complex bank frauds requires significant expenditures of time and resources, ideally the FBI should staff such investigations with more than one agent, including an accountant where necessary. Alternatively, the FBI should allow an agent to devote full time to a complex investigation until the matter is concluded. Because the number of FBI agents in Los Angeles is inadequate, this type of investigative staffing is rarely possible.

Generally, a single Assistant U.S. Attorney can handle the investigation, grand jury work-up, and trial of a typical financial institution fraud case. However, occasionally the fraud is so complex that two or more prosecutors are required to guide the case through investigation and ultimately to prosecute it. The Bank of America/NMEC investigation is an example of a case requiring more than one prosecutor. All of the prosecutors in the Major Frauds Section of the United States Attorney's Office are capable of and in fact simultaneously handle several investigations and prosecutions involving financial institution fraud. Only rarely can we assign an Assistant U.S. Attorney full-time to one case.

The fact that a particular financial institution fraud case may require a significant commitment of resources has had absolutely no affect on the decision whether or not to prosecute the case. If a case has prosecutive merit and meets our monetary guidelines,3/ the United States Attorney's Office prosecutes the case. Resource requirements do not and will not affect prosecutive decisions in major cases. Availability of resources, however, does make a difference with respect to how expeditiously a case is pursued. For example, when prosecutors and investigators are responsible for a large number of cases, as is typically the case in this federal district in view of the limited resources and volume of significant cases, some cases that are ripe for more extensive investigation or ready for indictment may be delayed briefly.

The Bank of America/NMEC fraud investigation has affected my Major Fraud Section's overall resources. The investigation

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3/ Resource limitations, however, account for the very high monetary guidelines for prosecution of bank fraud and embezzlement cases in this district.

continues to develop evidence of separate but related frauds. In January of 1985 I assigned two attorneys from the Major Frauds Section to supervise the investigation and prosecute the resulting cases. Two other attorneys from the Orange County District Attorney's Office and the California Attorney General's Office, respectively, have assisted in the investigation. One attorney from my fraud unit has devoted approximately 75% of her time to the investigation, while a second attorney spends approximately one third of his time on the case. When one indictment led to a lengthy trial, the Major Frauds Section lost one of its 12 Assistant U.S. Attorney's for the duration.

The four attorneys assigned to the investigations have divided them into sub-parts so attention can be focused on the various frauds which need to be investigated. Ideally, the attorneys should be devoting full-time to all major bank fraud investigations that warrant such attention. The Major Frauds Section, however, cannot afford such an allocation of attorneys due to the large number of competing and equally important investigations.

2. Institutions Nos. 1 and 2

The Subcommittee asked how limited FBI resources may have contributed to the "long delays" in the investigation of Institutions Nos. 1 and 2. While limited resources played a part in the delay of the subject investigations, the two investigations involve extremely complex transactions. It is neither unreasonable, nor unusual, for complex bank fraud investigations to take two to three years to complete.

The Assistant U.S. Attorney who supervised the initial investigation of the failure of Institution No. 1 informs me that a lack of investigative resources caused substantial delays. It took approximately two years to determine that the initial re erral by the FHLBB lacked the solid evidence necessary to pursue a criminal prosecution. Only one FBI agent worked on the case at any given time, and there was a change of agents midway through the investigation. There were over 50 important witnesses to interview and tens of thousands of documents to review. One agent could not efficiently and expeditiously accomplish this task.

Optimally, a team of two to three agents should be assigned to such cases, and there should be continuity of investigators. There is no longer a need for multiple agents in the Institution No. 1 case, because the government has been able to narrow the investigation.

Regarding Institution No. 2, the FBI initially assigned only one agent to work part-time on the case. The FBI recently added two additional agents and the IRS has joined the investigation with two more agents and accompanying support

staff. The investigation concerning the failure of Institution No. 2 is now fully staffed and progressing.

3. Sufficiency of FBI Resources

During my tenure as the United States Attorney for this district and earlier as an Assistant United States Attorney here, I have been greatly impressed with the dedication, diligence and overall competence of the Special Agents assigned to the FBI's Los Angeles Division. Some of the more experienced agents have acquired invaluable expertise in analyzing bank records and tracing loan proceeds through the typical labyrinth of shell entities and disguised transactions. Indeed, some of the finest fraud investigators to be found anywhere are FBI agents here in this district.

In general, however, there is a serious shortage of FBI agents in the Central District of California. In particular, the FBI has a critical shortage of agents assigned to bank fraud and other white collar crime investigations.

The Santa Ana Resident Agency (Santa Ana RA) of the FBI's Los Angeles Division has an acute shortage of agents. For example, one FBI agent in Santa Ana has four major bank fraud investigations, any one of which should be staffed full-time by at least two agents. In my view, the Santa Ana RA is simply performing triage as it confronts an ever increasing number of cases, not only in the bank fraud area, but in the fraudulent telemarketing and investment and securities fraud areas, as well. Some significant Orange County bank fraud investigations are in holding patterns because the assigned agent is handling too many cases.

It is unrealistic to expect the Santa Ana RA FBI office to handle its present caseload without significantly increasing its staffing. The shortage of agents has affected its ability to investigate other major fraud cases. Our most recent referral to the FBI's Santa Ana RA involves a multi-million dollar investment fraud scheme (not involving a financial institution) with numerous victims. We received the following response:

> Unfortunately, the limited manpower now available in the Santa Ana Resident Agency to work White Collar Crime matters has, as you know, already been assigned to higher priority ongoing investigations. Until such time as more manpower becomes available, this matter will have to be maintained in a control file where it will be reviewed periodically and opened for investigation as resources become available.

The agent shortage is almost as acute in the FBI's Los Angeles Headquarters office. There simply are not enough FBI agents in the Los Angeles Division to, consistent with the Bureau's many other priorities and responsibilities here, investigate the numerous financial institution fraud and embezzlement cases arising in this district. The FBI's Los Angeles Division sorely needs reinforcements.

4. Adequacy of FBI Agent Expertise and Training

The FBI agents working the bank fraud cases in this district are among the most dedicated and hardest working individuals I have encountered. Yet, the skills and expertise of the individual agents vary considerably. Some of the more experienced agents here are among the finest fraud investigators in the nation. On the other hand, the unprecedented proliferation of bank fraud cases in this district has forced the FBI to assign less experienced agents to investigate extremely complex bank frauds.

A new agent can attend training seminars, master theories of document control and learn to trace funds; but until the agent first walks into a storage room with 20 or more filing cabinets brimming with documents and begins the painstaking task of finding pieces of evidence to construct the mosaic of a criminal case, the agent cannot reach his full potential as a fraud investigator.

It takes a long time before an agent develops familiarity with the procedures, documents and patterns that make up a complex bank fraud investigation. More so than in any other area of white collar crime, an agent can only develop expertise with years of hands-on experience. Consequently, the FBI should concentrate its experienced bank fraud agents in the districts with the greatest bank fraud problems. The FBI also should assign its more experienced and skilled agents to the complex investigations. The less experienced agents can develop their skills on cases involving the less complicated false loan applications and straight embezzlement cases.

Additionally, in the more complex cases it might be useful for the FBI to assign both an experienced and a newer agent to each case. The less experienced agent receives on-the-job training, and the experienced agent receives badly needed assistance.

Continuity is also one of the most important requirements for a successful bank fraud investigation. The reassignment of agents to other cases, or the transfer of agents to other districts, can destroy the momentum of any criminal investigation. Such a break in continuity in a complex bank fraud investigation is even more devastating because it will take the replacement agent months to learn the case. The FBI should make every effort to keep effective agents on an investigation until its completion.

5. Prosecutorial Resources in the United States Attorney's Office

a. Composition of the Major Frauds Section

Between June 1985 and June 1986 there were seven attorneys and no vacancies in the Major Frauds Section of the U.S. Attorney's Office. During that time the Major Frauds Section devoted approximately one-third to one-half of its time to the prosecution of bank fraud cases. The Section prosecuted the major cases in all areas of white collar crime, including frauds against the government, public corruption, as well as all financial crimes perpetrated in the private sector.

In October 1986, I implemented a reorganization of the U.S. Attorney's Office to respond to the widespread and continually growing financial institution fraud problem in the Central District of California and to address other areas of concern in our district. More specifically, I expanded the Major Frauds Section and shifted responsibility for government fraud and public corruption to a separate unit. As a result of the reorganization, I increased to thirteen the number of attorneys assigned to the Major Frauds Section. This section currently has twelve attorneys, with one vacancy. By establishing a separate unit known as the Government Fraud and Public Corruption Section, to handle the prosecution of defense procurement fraud and public corruption cases, the Major Frauds Section now can focus exclusively on white collar crime in the private sector. Currently, the Major Frauds Section handles cases involving financial institution fraud, bankruptcy fraud, securities fraud and telemarketing (boiler room) fraud, among others.

b. Priorities of the Major Frauds Section

The number one priority of the Major Frauds Section is financial institution fraud, and every Assistant U.S. Attorney in the unit is handling major bank fraud cases. Generally, prosecutors in Major Frauds spend between 30% and 50% of their time working on bank fraud cases, with some attorneys spending as much as 75% of their time on financial institution fraud.

The Assistant U.S. Attorneys assigned to the Major Frauds Section are attorneys with extensive prosecutive experience. Collectively the attorneys in the unit have more years of prosecutive experience than the other units of the office's Criminal Division.

The Chief of the Major Frauds Section also distributes some bank fraud cases to Assistant U.S. Attorneys assigned to the other units of the office. The distribution alleviates some of the pressure on the Assistant U.S. Attorneys in Major Frauds, and also acquaints other Assistant U.S. Attorneys with the intricacies of investigating and prosecuting financial institution fraud. By occasionally assigning a bank fraud case

outside the Section, Major Frauds can assure that there will be a pool of assistants familiar with such investigations when vacancies occur in the Section. Vacancies are filled with experienced Assistant U.S. Attorneys who are both interested in and qualified to prosecute financial institution fraud cases.

The Major Frauds Section's next highest priority is the prosecution of telemarketing or "boiler room" fraud. I estimate that there are several hundred fraudulent telemarketing companies operating in the Central District of California, preying on investors and consumers across the nation. Such fraudulent operations cause hundreds of millions of dollars in losses to victims nationwide, many of whom lose substantial portions of their life savings. We currently have over 100 pending investigations involving major boiler rooms.

In addition to its priority areas, the Major Frauds Section is involved in securities fraud prosecutions. With the significant growth of Los Angeles as a major worldwide financial center, the number of cases in this area of fraud is increasing. The Major Frauds Section is working closely with the SEC, and we anticipate developing a greater number of securities fraud and insider trading cases in the near future.

The Major Frauds Section is also responsible for prosecuting significant bankruptcy fraud cases and the Section currently has approximately 15 significant investigations, some of which involve very complicated schemes to defraud the bankruptcy court.

Finally, the Major Frauds Section has numerous cases involving mail and wire fraud. It seems that virtually every scam known to mankind has either been originated or perfected by con artists operating in the Los Angeles area.

c. Resource Limitations of the U.S. Attorney's Office

My office has not yet recovered from the long arm of Gramm-Rudman. During the Gramm-Rudman mandated hiring freeze, I was unable to replace Assistant U.S. Attorneys who resigned to go into private practice. After the lifting of the Gramm-Rudman hiring restrictions last October, we embarked upon an aggressive hiring program to fill over 20 Assistant U.S. Attorney vacancies. Even now, the Criminal Division of my office, which has an authorized strength of 79 Assistant U.S. Attorneys, has only 65 on board. Another thirteen attorneys hired for the Criminal Division are awaiting completion of their FBI background checks. (I am currently interviewing for one remaining vacancy). Consequently, and as a result of the lingering effect of Gramm-Rudman, my office will not be at full strength until August or September 1987.

In addition, it has become increasingly difficult to keep experienced attorneys in the office because of dramatic

discrepancies between salaries paid to private attorneys and those paid to government attorneys. This is a particularly significant problem in Los Angeles because of the high cost of living, compared to other areas in the country. For example, private attorneys at comparable experience levels in major Los Angeles law firms are typically paid somewhere between two and three times as much as most of the attorneys in our office. The salaries in the District Attorney's Offices also are noticeably higher than salaries paid to federal prosecutors. Clearly, something must be done to improve the salaries and benefits paid to Assistant U.S. Attorneys if we are to keep our best prosecutors.

Currently our office is just keeping pace with the FBI in prosecuting the major bank fraud cases that are ready for indictment. Our resources are barely adequate, however, and would be critically insufficient if the FBI adds additional agents to its white collar investigations and/or begins referring backlogged investigations to us.

All prosecutors in my Major Frauds Section have heavy pre-indictment case loads and are working long hours to complete our important investigations. Most of these cases require extensive grand jury presentation prior to indictment, and the majority of these major fraud trials last an average of three to four weeks. The Assistant U.S. Attorneys in the Major Frauds Section are among the hardest working, most dedicated prosecutors in the office. Yet, if a major bank fraud case came into the office today, we would not have an Assistant U.S. Attorney available in the Major Frauds Section to devote any substantial period of time to the case, without postponing some other pending investigation. The entire office, too, has reached a saturation point.

The significant lack of prosecutorial resources in this federal district is not unique to the bank fraud area, nor to the United States Attorney's Office. It is part of a much larger problem, especially in the area of white collar crime, in that increases in federal prosecutors and law enforcement agents have not kept pace with the dramatic population and economic growth in this district. The United States Attorney's Office in Los Angeles could easily support twice as many federal prosecutors as we currently have.

In the area of financial institution fraud, the FBI has approximately 268 cases over $100,000. These fraud cases are extremely labor intensive, requiring a great deal of time to review documents and to interview witnesses on the part of both the investigative agent and the prosecutor. I believe that at least 15-20 additional Assistant U.S. Attorney positions are needed to prosecute all of the bank fraud cases effectively and expeditiously. Moreover, additional agent and prosecutorial resources will also be needed if this district is to have any significant impact on bank fraud cases under $100,000, many of

which must be referred to local law enforcement agencies because of inadequate federal resources.

This federal district has in the past requested and received prosecutorial assistance from the Fraud Section of the Justice Department's Criminal Division, Washington, D.C. The Department's Fraud Section, however, also has limited resources and must address a variety of white collar crimes in addition to its responsibilities concerning financial institution fraud.

Between January 1985 and the present, the Fraud Section of the Department's Criminal Division in Washington, D.C., has provided significant assistance to us in the form of six Fraud Section attorneys who have worked on government procurement fraud cases and one part-time attorney who has worked on "boiler room" fraud cases. The assistance from the Fraud Section on the government fraud and "boiler room" prosecutions has allowed my office to devote more time and resources towards prosecuting financial fraud cases.

There are, however, severe limitations upon the Department's Fraud Section, and it cannot solve our staffing problems with respect to major bank fraud cases. As a practical matter, these cases are long-term and protracted. The investigations are occurring here, and the prosecutor must be on the scene. Not only is it extremely expensive to fly a Fraud Section attorney to Los Angeles and pay per diem, but the lengths of time these cases take can be severely disruptive to the attorney's family life. A solution greatly preferable to bringing Fraud Section attorneys to Los Angeles for many months and possibly years is to increase the number of attorney positions in the U.S. Attorney's Office in Los Angeles, at least until the volume of serious and significant bank fraud cases abates.

Our lack of federal prosecutors has had an effect. For example, although the Bank of America/NMEC investigation has been highly successful from the standpoint of convictions, a lack of prosecutorial resources has delayed the overall investigation. This investigation has uncovered numerous separate but related frauds, producing numerous indictments and informations. Each new fraud has proven to be extremely complex. Once a case is indicted, the speedy trial act is triggered and prosecutorial resources must be devoted to preparing the case for trial. One recent lengthy trial monopolized two of the attorneys. The other two attorneys focused on another aspect of the Bank of America/NMEC investigation which resulted in another indictment and again required substantial prosecutorial resources to produce guilty pleas and cooperation agreements. In the meantime, the remainder, and still significant, portion of the Bank of America investigation received minimal attention. Only after indicted cases are resolved can the attorneys return to reviewing and digesting the evidence and address tactical issues such as grand jury subpoenas and immunity grants. The FBI has conducted

hundreds of witness interviews and collected tens of thousands of documents. Substantial attorney time is required to digest this information in order to provide adequate direction to the investigation. If our office had an adequate number of prosecutors, we could have two Assistant U.S. Attorneys working exclusively on the Bank of America/NMEC investigation.

Undoubtedly, the great demands on the prosecutor in the office also caused some delay in the Institution No. 1 investigation. It is nearly impossible to supervise such an investigation, let alone conduct necessary grand jury work, when the prosecutor is in trial. Because Institution No. 1 was but one of fifteen cases handled at the time by the experienced prosecutor, it received only a percentage of her working time.

To date, there has been only one prosecutor in charge of the Institution No. 2 investigation. There is no need for any additional prosecutors at this stage. If it becomes necessary at later stages of the prosecution, additional personnel can and will be made available.

6. Guidelines

Because of limited prosecutorial resources, the U.S. Attorney's Office for this district has been required to establish "guidelines" for prosecuting bank fraud and other types of cases. Such prosecutive guidelines are necessary because this office does not have adequate personnel to develop, grand jury and prosecute all federal crimes presented to us. The guideline for bank frauds and embezzlements is based upon the amount of monetary loss. As the number of cases with substantial losses has increased in this district, without any commensurate increase in investigative and prosecutive resources, the U.S. Attorney's Office has reacted by tightening up the spigot, i.e., by raising our prosecutive guidelines. We now have one of the highest monetary guidelines in the country for acceptance of bank fraud cases. Bank fraud cases that involve losses of over $250,000 are handled by the Major Fraud Section. Cases that are below $250,000, but above our office guideline are treated as routine cases and handled by our Criminal Complaints Section.

Our limited prosecutorial resources have not resulted in any declinations, except for those cases involving losses below our office's monetary guidelines. Those cases are referred to the local authorities. In my experience most declinations in the bank fraud area are based on insufficient evidence of criminal conduct or pending prosecutions, or convictions, in other districts. We have not declined a single significant bank fraud case because of a lack of prosecutorial resources.

The Major Frauds Section prioritizes the bank fraud investigations according to amount of loss, number of victims, the nature of the misconduct, the position of the involved insider and the recidivism of any potential targets, among other

things. Fraud cases which have contributed to the failure of a financial institution are of the highest priority.

Currently the Chief of the Major Frauds Section conducts an initial review of every incoming case to determine if it requires immediate attention. The Section Chief monitors most cases in the early investigative stage, when initial subpoenas and witness interviews take place and opens a file on a case as soon as an agent seeks a grand jury subpoena or sends in a Letter Head Memorandum outlining the case. The Chief assigns the case to an Assistant U.S. Attorney as soon as it appears the case is in a posture to begin grand jury presentations. Because of complexity or the need for immediate action, the Chief also assigns some investigations to assistants as soon as we learn of the case.

As noted above, bank fraud is the number one priority of my Major Frauds Section. It is also, along with major narcotics and defense industry fraud cases, among the three highest priority areas of my office.

C. Coordination Among Bank Regulatory Agencies, Financial Institutions and the United States Attorney's Office

1. Coordination Between Bank Regulatory Agencies and the U.S. Attorney's Office

a. Detection

While some banking agency examiners are adept at discovering fraud by bank insiders, bank examiners do not pursue questionable transactions far enough or quickly enough. Theodore J. MacDonald's observations concerning examiners, although presented to the Subcommittee in June 1983, remain largely valid. There are still examiners who only concern themselves with a check of assets and liabilities and do not go deep enough to detect an ongoing fraud.

Out of fairness to the examiners, their task is often a difficult one. For example, one of our attorneys recently convicted a bank president of making fraudulent loans. The defendant had served as a bank examiner before he became president of the bank, and therefore, knew how to doctor the records to avoid the scrutiny of the examiners. The examiner relied solely on the records and failed to detect the fraudulent loans. Had the examiner simply traced the loan proceeds, he would have discovered the fraud.

It would be helpful to have the FBI periodically meet with examiners to discuss the types of bank frauds prevalent in a given district. Many frauds follow certain patterns. Experienced FBI agents and examiners could exchange information which would assist examiners in identifying the "badges" of fraud.

b. Referrals

The content of the FDIC's referral reports has improved. Complete descriptions of the suspected violations now seem to be the rule, rather than the exception. Similarly, the Federal Home Loan Bank Board referrals are more detailed than in the past. The process depends on the individual completing the form, and we still receive some referrals that are too cursory, however. The Comptroller of the Currency provides our office with periodic updates of its criminal referrals, which aid us in tracking the bank cases. My office has not been receiving referrals from the FSLIC.

The Chief of the Major Frauds Section retains all agency referrals, and upon receipt, reviews the referral to see what actions, if any, should be taken. Our Major Frauds Section should receive copies of all referrals involving $100,000 or more.

Even with the increased detail on the referral form, prosecutors in my office do not view the referral form as a significant investigative tool. The agency referral on a major case usually comes, if at all, after the FBI and my office are already aware of the fraud, either through notification from private attorneys or newspaper articles.4/

Even when the agencies file timely referrals, they simply file the form without any follow-up whatsoever. At a minimum, examiners who uncover significant frauds should follow-up by providing copies of key documents and interview memoranda of key witnesses.

In the Institution No. 1 case the referral was woefully inadequate. The referral simply quoted from criminal statutes and did not contain any documents, summaries or reports. When the Assistant U.S. Attorney requested follow-up information, including a simple debriefing from the agency's attorney, the agency demanded a grand jury subpoena before the attorney would even discuss the case with us. In most cases, it is still a difficult and slow process to obtain follow-up information from the referring regulatory body.

The most serious failure of the agency in the Institution No. 1 case was the failure to notify the FBI when examiners initially discovered indicia of fraud. The prosecutor tells me that the FBI's investigation shows that the agency had notice of possible criminal fraud almost two years before the institution failed. Rather than refer the case to the FBI, or even compare quarterly audits, the regulatory agency did not make a referral

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4/ In the Institution No. 2 case, the FBI never received a referral. Congressional inquiries precipitated the FBI's investigation. A referral now would serve no purpose.

until the institution closed. The delay created severe document control problems and made a complex investigation even more difficult.

If examiners would initiate more referrals based on suspected fraud, as opposed to those based on faits accomplis, the FBI could better interdict bank fraud. Earlier detection and referral to the FBI could result in savings in time and resources, especially if targets could be caught in the act. The FBI can only use effective undercover techniques if examiners make early referrals of suspected criminal activity.

Referrals after the FBI has begun its investigation are of little help. However, the agencies should forward referrals in all cases. At the very least, the referral alerts the FBI and the U.S. Attorney's Office to the possible existence of agency examination and supervisory files.

2. Coordination Between Financial Institutions and the Department of Justice

Financial institutions vary widely in the timeliness and detail with which they report suspected criminal activity. Delay can have a significant impact on the FBI's ability to investigate, and the ability of the U.S. Attorney's Office to prosecute cases to a successful conclusion. When referrals are delayed, the FBI may not be able to locate important evidence or witnesses. Witnesses' memories often fade. Worse, the target of the investigation may have perpetrated the same scheme at another institution by the time the first victim gets around to reporting the crime.

In a recent case, the delay in reporting had an effect on the sentences imposed. An Assistant U.S. Attorney in our office recently prosecuted a savings and loan officer in Los Angeles and convicted him of altering loan documents and receiving kickbacks from a loan broker. Although the offenses occurred in late 1981 and early 1982, the savings and loan did not refer the case until 1985, after the settlement of civil lawsuits. In sentencing the two defendants to custody terms of one and two months, the judge said that he would have imposed much higher sentences if the case had been brought soon after the offenses had occurred. Unfortunately, the incident is not isolated, as prosecutors continue to see delays in reporting while financial institutions move to secure civil remedies.

I cannot overemphasize the value of a financial institution making early contact with the FBI. The FBI can only foil attempted frauds if the financial institutions report suspicious activity immediately. Too often the loan officer simply declines the loan and allows the con artist to try his luck at another institution.

3. Document Control and Retention and Related Problems

When the regulatory body closed Institution No. 1, agency authorities walked into the institution and seized all documents in sight, commingling the documents without regard to where the items had been located. The seizing authorities did not identify the documents in any way, and it was impossible for the FBI to reconstruct the location of any particular document. The careless handling of the material destroyed chain of custody and created enormous problems concerning authenticity. As a direct result of such conduct, the government lost invaluable proof as to what individual directors were doing and what they knew.

In most bank failure cases, the regulatory personnel and "fee attorneys," i.e., the law firm retained by the FSLIC or FDIC after a takeover, obtain the documents before the FBI does. If proper document control is not exercised, the investigation can be irreparably crippled. Excessive handling of documents may destroy crucial fingerprint evidence, in addition to creating the authentication and chain of custody problems mentioned above.

One solution to the document control problem is to require the agency to notify the FBI when it is closing a financial institution. If there is sufficient probable cause to obtain a search warrant, the FBI can take immediate control of original documents and assure proper control and custody. At the very least, all agency personnel who will be seizing documents should receive training concerning document control and preserving evidence for criminal investigations.

Another problem arises when agency or fee counsel has possession of the original documents and is pursuing a civil case on behalf of FSLIC or FDIC. Inevitably, the FBI's request to obtain the original documents is met with great resistance. It is critical that the FBI has access and custody over the original documents because certain investigative techniques, such as handwriting and fingerprint analyses, require original documents.

Coordination among agency and fee counsel, on the one hand, and the federal prosecutor on the other is critical. In the Institution No. 1 case, the agency attorney improperly promised immunity to certain individuals for their cooperation. The fee attorney settled critical aspects of the civil case without notifying or consulting with the prosecutor. The settlements directly contradicted part of the government's criminal theory of the case. Finally, the agency attorney improperly threatened civil defendants with criminal actions.

The agencies must stress to agency and fee counsel that they are not conducting their civil case in a vacuum. Civil

actions may undercut or even destroy ongoing criminal investigations. The timing of civil depositions can even jeopardize criminal investigations, especially if a key witness testifies at several depositions before he appears at the criminal trial. As each civil attorney attempts to extract certain testimony, a distorted record may be created which later undercuts the witness's effectiveness in the criminal trial.

The contracts between fee counsel and the agency should include language requiring the fee attorneys to keep the FBI and the U.S. Attorney's Office apprised of all significant developments in civil cases and require deference to federal prosecutors whenever proposed actions by the fee counsel will adversely affect a potential or ongoing criminal prosecution.

Additionally, it would be wise to promulgate regulations and guidelines for agency personnel and fee attorneys to follow when they seize documents pursuant to an institution's closure.

D. Statutes and Sentencing

1. The Right To Privacy Act (RFPA)

One problem in the RFPA area continues to be the refusal of some financial institutions to honor government requests that a subpoena for financial records not be disclosed to the customer. Under the current statute, our prosecutors must seek court orders to force the institutions not to disclose the subpoena requests. It would be helpful if Congress promulgated an unequivocal statutory requirement that all federally insured financial institutions comply with the government's nondisclosure requests.

2. Title 18, United States Code Provisions

Generally, prosecutors in my office are satisfied with the current statutes governing bank fraud. The newly-enacted Section 1344 (bank fraud) is proving to be an effective prosecutive tool. There still is some uncertainty as to whether each transaction committed to further a scheme to defraud a bank or obtain money from the bank constitutes a separate violation of the statute.

Although the case law is still sparse, it appears that the courts are interpreting the statute as making each transaction or act in furtherance a separate offense.[5/] Currently the issue is before the Ninth Circuit Court of Appeals in United States v. Robert J. Polin (CA No. 86-1096,

5/ United States v. Jones, 648 F. Supp. 241, 243 (S.D.N.Y. 1986).

D.C. CR 85-2087-WAI). If the courts do not adopt the government's proposed interpretation of Section 1344, it may be necessary to amend the statute to make each act or transaction a separate offense.

In the Central District of California we also have noticed an increase of real estate appraiser involvement in major bank frauds. Occasionally, we have a difficult time establishing that the appraiser knew the inflated appraisal would be used in a fraudulent loan application. We suggest that appraisers be required to sign all appraisals submitted to federally insured institutions. A federally insured institution could not rely on an appraisal without the appraiser stating in writing that he knows the appraisal is being used in support of a loan application. Not only would the signature help prove the appraiser's knowledge, but it might well make it more difficult for fraudulent borrowers to obtain inflated appraisals in the first instance.

3. Sentencing

Sentences in bank fraud cases in this district are, with very few exceptions, entirely too lenient. Thus, since January 1986, almost 60% of the defendants convicted in this district under the bank fraud and embezzlement statutes[6/] received sentences of probation, with no jail time imposed. Another approximately 10% received sentences of less than one year in custody. Less than 5% received sentences of five years or more in prison. Needless to say, these types of sentences do not reflect the seriousness of the crimes, nor do they set an example sufficient to deter others from defrauding financial institutions or embezzling their funds.

The white collar criminal, unlike the bank robber who is typically a narcotics addict attempting to obtain money to feed his drug habit, is most often an intelligent, well-educated and relatively sophisticated person who is in a position to consider the potential consequences of his or her action. Such an individual is capable of weighing the chances of being caught (which in many cases may not be very high), as well as evaluating the fact that even if caught the most likely sentence will be probation or a short period of incarceration. In view of the fact that the potential gains from financial institution fraud and other white collar crime range from the tens of thousands to millions of dollars, the most rational analysis by the white collar criminal would be and frequently is that the crime is worth committing because the benefits are so high, and the risks and costs of being caught are so low. In short, there is little possibility of deterring bank fraud in view of current attitudes toward sentencing white collar criminals.

6/ See, 18 U.S.C. §§ 656, 657, 1014 and 1344.

The lax attitudes toward bank fraud are carried over in the current guidelines of the United States Sentencing Commission. For example, in the case of an insider or affiliated outsider who has no criminal record and defrauds a financial institution out of $499,000, the recommended sentencing range under the Sentencing Commission's April 1987 guidelines is a mere 12 to 18 months' imprisonment. And if he obtained more than $5 million in a "sophisticated scheme," the sentencing range would be 30 to 37 months. In other words, in the latter case, the criminal offender would be serving only about one year for each one and three quarter million dollars obtained by fraud.

Although an improvement over the current system, the Sentencing Commission's guidelines for financial institution fraud do not adequately respond to society's need for just punishment and deterrence in cases involving the more sophisticated white collar criminals who obtain astronomical amounts of money.

In this respect, there are a number of specific defects in the guidelines. For example, the guidelines for fraud and deceit provide only insignificant sentencing enhancements for schemes involving sophisticated planning, multiple victims, false claims that the defendant was acting on behalf of charitable or other non-profit organizations, and violations of administrative or judicial orders. In my view, the guidelines also do not adequately increase the level of offense as the dollar amount of the fraud increases. Although the guidelines provide for increasing the offense level to a specified maximum if foreign bank accounts are used, that maximum offense level will already have been reached if the fraud involves $100,000 to $200,000. It is highly unusual for foreign bank accounts to be used in a case involving less than $200,000, so the effect of this purported sentencing enhancement is meaningless. In addition, the guidelines fail to provide any enhancement where the fraud contributes to a bank or savings and loan failure.

I strongly believe that there is a great potential for deterrence through the imposition of far more substantial periods of incarceration than are currently being imposed and than are recommended in the current Sentencing Commission guidelines for defendants convicted of significant financial institution fraud. This type of criminal can and in many cases will recognize that the costs and hardship resulting from conviction are unacceptable if more substantial penalties are certain to be imposed. I also believe that more substantial penalties are necessary in order to achieve "just punishment" in view of the severity of the offense and harm caused by financial institution fraud.

APPENDIX

INSTITUTION FAILURES (Congressman Barnard's Attachment)

INSTITUTION	TAKEOVER DATE	FBI INVESTIGATION
San Marino S & L	2/3/84	Yes
Beverly Hills S & L	4/23/85	Yes
Butterfield S & L	8/7/85	Yes
Manhattan Beach S & L	1/9/86	Yes (No Referral)
American Diversified	2/14/86	Yes
Westwood S & L	3/27/86	Declined (No Referral)
Consolidated	5/22/86	Yes
Ramona S & L	9/12/86	Yes
Unified Savings Bank	10/10/86	CONVICTION
North American S & L	1/16/87	Yes
Southbay S & L	3/6/87	Yes
Perpetual S & L	3/18/87	Yes
Equitable S & L	3/27/87	Yes

INSTITUTION FAILURES

(Not Contained in Congressman Barnard's Attachment)

INSTITUTION	AMOUNT OF LOSS	FBI INVESTIGATION
Heritage Bank	$36,000,000	Yes
Western National Bank	$3,300,000	CONVICTION
Westcoast Bank Encino, California	$15,168,000	Yes
Westcoast Bank Los Angeles, California	$25,500,000	Yes
Garden Grove Community Bank	$300,000	Yes
West Valley Bank	$8,500,000	Yes
First City Bank	$3,200,000	Yes
Commercial Bank of California	$1,843,000	Yes
Valencia Bank	$18,500,000	Yes
Orange Coast Thrift	$1,700,000	Yes
Independent National Bank	$950,000	Yes
Newport Harbor Bank	$7,300,000	Yes
Bank of Irvine	$4,000,000	Yes

Mr. BARNARD. The next panel, if you would, please, it will be Mr. David E. Lundin and Mr. Robert Rose. If you gentlemen would please take your places at the witness table.

[Pause.]

Mr. BARNARD. Mr. Lundin, I appreciate your helping our staff, but could you just put that name tag in front of you, I would appreciate it. Well, thank you very much for being here. I apologize for the time it has taken, but let me say this: Time is not an important ingredient when you are dealing with as serious a subject as we are dealing in this morning, and even on a Saturday.

Necessarily, though, because of time, I am going to have to ask both of you to summarize your testimony. Without objection, your formal statements will be included in the record, and if you could summarize, it would be very helpful. And we will hear from Mr. Lundin first and then Mr. Rose. Mr. Lundin.

STATEMENT OF DAVID E. LUNDIN, ATTORNEY, FINLEY, KUMBLE & WAGNER, SAN DIEGO, CA

Mr. LUNDIN. Thank you, Mr. Chairman, members of the committee.

In my written statement I introduce myself and my capacity. I am outside fee counsel to the Bank Board and FSLIC on matters in San Diego County that arise out of closure and subsequent civil litigation involving Sun Savings & Loan Association.

In that capacity, and with the benefit of what I've heard today and some of the discussions which have been precipitated by this very hearing, I'd like to focus on some issues that are of unique significance and importance to outside fee counsel in integrating with the prosecutorial forces as well as administrative agencies, FSLIC and the Bank Board. I'll just start with those.

The first issue is criminal referrals. Ms. Nichols' very recent letter of May of this year, I think, was, in fact, precipitated by this committee—and I thank the committee for it. I think to some extent it is also due to some activities on our part and other fee counsel who were inquiring, "What should we do? Should we be making these referrals? If so, how?" And I want to applaud the Board and its staff for eliciting responses to that move and moving, I think, in the appropriate direction.

The dilemma, of course, as a civil litigator, when you come across activity which may, in your opinion, be criminal in nature, what do you do with it? And I have a client, the Bank Board—what do they want done with it? And I have some people across the street that I deal with regularly, the FBI and the U.S. attorney's office. Which individuals within these offices should I be dealing? And I think we are moving in the right direction that way. It used to take several months, a while ago; it goes much more quickly now.

One specific recommendation that I allude to in my written testimony, when an institution is closed, you have a multitude of forces coming together in usually what is a period of confusion. The association is thoroughly padlocked; you have Pinkerton or other guards coming in with boxes and identification badges and so on. You have a fee counsel who comes swooping in, often to an association with which he has never had any substantive prior contact.

The FBI is often in the same position. The U.S. attorney is often in the same position.

Outside fee counsel often don't know whether some preliminary criminal investigation is already ongoing. They have no idea. There is no system in place to integrate all these forces. And my specific suggestion is that it would be almost obligatory at closure that the FBI, the U.S. attorney's office, fee counsel, and FSLIC staff get together and say, "OK, is this the type of operation that either we know there are elements of possible criminal fraud, or there probably are? If so"—if the answer to that is "yes"—then, "what steps should we take" to address Mr. Bonner's appropriate concerns, evidence, paper trail, not disturbing investigations that may have already been in place, letting outside fee counsel know in which areas he or she should be stepping more gingerly than he might otherwise, areas that he should avoid, or areas that you go through a routine loan files, doing routine litigation to recover funds for the FSLIC, foreclosures, sales for real properties, and so forth. What kinds of themes should you be looking for? How should your sensitivities be raised, and how might those most better integrate with criminal investigations that are going on, or other thrusts in the civil arena?

That isn't done currently. It could, I think, very easily be done.

The third recommendation that I spoke of in my written testimony is the indexing of the "bad guy" file.

You have people, the committee is very much aware of this, who travel around the country, or deal repeatedly with institution after institution after institution. In our own case, we have come across the loan brokers whose custom list looked like the dope board in the post office, and virtually all their clients had either been indicted or convicted for bank fraud. These are the people for whom they provided loan brokerage services time and time again.

If I was a bank loan officer, I would want to know if the person on the other side of my desk has been convicted—that's fairly easy from a civil rights and due process area, or even indicted, or ideally, if there is a pending indictment on the guy that has not yet been resolved. That's information that I'd like to know before I would advance him a $10 million loan with no downpayment.

Mr. BARNARD. I hate to interrupt you at this point, but when you, as a fee counsel, look into those matters, when you look into the credit file, do you see a credit report indicating some of those matters?

Mr. LUNDIN. There is no place on a standard credit report for criminal convictions. There is not even a box where you check yes or no. And I think there should be.

Mr. BARNARD. Or have you been sued by the FSLIC?

Mr. LUNDIN. Have I?

Mr. BARNARD. No, no—I mean asking that on the application?

Mr. LUNDIN. I don't recall that there is such an inquiry. I think particularly in the criminal prosecution area where the loan applications and financial statements are signed under penalty of perjury. Those kinds of boxes could and should——

Mr. BARNARD. We've got some in Congress who think that will violate someone's privacy. You know, we ought not to be looking

into those kind of things. That's personal, and that's private, and we just ought to stay away from that. But, anyway, go ahead. I didn't mean to interrupt.

Mr. LUNDIN. No, I appreciate it. I understand the civil rights concern, and my heart goes in that direction to a large extent; my wallet goes in the other direction. [Laughter.]

With Sun Savings & Loan Association, the losses at this point attributable to a small six-branch association in southern California, are $114 million. And that's a fairly large theft.

When it comes to checking small boxes and concerns for the civil rights of a convicted bank fraud defendant, I don't have a lot of patience. I certainly agree, I think, with the chairman.

The tracking issue, I think, is being addressed in a preliminary way now by FSLIC. The acronym is subject to some debate. The computer system—the hardware, as I understand it, is in place; the software has been designed; the computer is programmed. Again, as outside fee counsel, one of my concerns is what information, in fact, is being fed into that system? Is it adequate? Does it really take care of the problem?

I know Mr. Black's testimony goes into that to some extent; some of the obvious categories are transfer files, information that is routinely filed with the FSLIC by known parties, but, as an example, again, loan brokers aren't registered with the Federal Government. There is no routine reporting system. Then it becomes a more casual ad hoc entry of data, and that could be potentially dangerous, or potentially valuable, and I don't have certainly any perfect solution to that.

But when you have borrowers, loan brokers, appraisers, and even attorneys that are associated with fraud or have been indicted or convicted, again that is a body of knowledge in an ideal world—for a moment ignoring the Constitution, ignoring the Privacy Act, and ignoring some of the difficulties of reporting—as a lender, I would like to know about in the complete context before I approve a loan.

So, I think what this committee has to wrestle with is how do you do that? And I think one thing you can do is send a clear message to FSLIC. I think, you are doing that by being here today. The message is that is a problem, that is a way to go, that FSLIC should come up with a system, come up with the type of data that you need. You may need amendments to the Privacy Act. Tell us and we'll try to address this, as best we can.

But from that point of view, the integration with the prosecutor's office, with FSLIC, is vital so that the three heads of the hydra know what the others are doing. I think it is critical. I think identifying that borrowers have been convicted or indicted is critical; and I think several of these issues that Mr. Black addressed, and which I touched on much more briefly in my written testimony are the absolute bottom line critical issues, because everything I am addressing is taking care of the symptoms after the fact.

What Mr. Black addressed so eloquently were some institutional and structural changes, behavior modification on the part of management, changes and incentives—changes in the law—that can

address some of these problems at the source so that we don't have to get involved. I think that's the real solution to the problem.

Thank you.

Mr. BARNARD. Thank you very much.

[Mr. Lundin's prepared statement follows:]

STATEMENT OF DAVID E. LUNDIN

BEFORE COMMERCE, CONSUMER AND MONETARY AFFAIRS SUBCOMMITTEE

OF THE COMMITTEE ON GOVERNMENT OPERATIONS

U.S. HOUSE OF REPRESENTATIVES

JUNE 13, 1987.

76-791 O - 87 - 13

My name is David Lundin. I am an attorney in private practice in San Diego, California. I first became involved with Sun Savings, a small federally chartered and insured savings and loan, in 1984 when I was retained by a faction of Sun directors to conduct an internal investigation for a special committee of the Board relating to certain acts and practices of controlling management.

My appearance here today is voluntary, and is made at the request of the Committee. Let me emphasize that my testimony is simply that, and does not represent the opinion of the FSLIC, Federal Home Bank Board or that of my law firm.

As a result of that investigation, I initiated litigation on behalf of Sun against the former president and CEO of Sun, alleging that bribes and kickbacks had been received in exchange for approval of loans, loan commitments and the payment of brokerage fees.

In July of 1986, Sun was declared insolvent and seized by the FSLIC. I was then retained by the FSLIC to continue the then-pending civil litigation.

As a product of this civil litigation and related discovery, I have become familiar with certain patterns of management operations which contributed to the collapse of Sun Savings. Some of these relate to alleged direct misconduct by senior management, others may be more accurately characterized as mere inexperience or incompetence.

Our inquiry at Sun was triggered in part by the discovery of a secret account at Sun opened under the fictious name of Dan Danzer. This account was opened by Sun's president and CEO under a false name, based upon a false address and without proper tax identification. Over a period of 14 months, this officer deposited over $200,000 exclusively in $100 bills. He explained that he won all of these funds while gambling in Las Vegas.

When asked to support this story with documents, witnesses, hotel or casino records or other evidence, the hard data presented was either non-existant or inconsistant with the gambling explanation.

For obvious reasons relating to both attorney-client and attorney work product, I cannot comment on any specific non-public details of the pending civil litigation.

I can comment on several themes which we have seen at Sun and which have been either mirrored or magnified by other savings and loan associations.

First, Sun was a new, publicly-traded savings and loan association emerging in the newly-deregulated marketplace of the 1980s. Much of Sun's management can best be described as agressively incompetent. They did, however, respond to market pressures to stimulate rapid and profitable growth -- at least in the short run.

Growth in the thrift industry results from an ability to generate deposits and make profitable loans. Traditionally in the thrift industry deposits were nurtured over a period of time from a geographically local deposit base and were prudently lent within that same geographic market place, a market place known to the lender.

By contrast, Sun generated the majority of its deposits as brokered funds in short-term jumbo C.D.s, paying broker's fees for the initial deposits and premium rates for the privilege of holding these volitile, short-term funds.

Sun then had to place these funds at work. As a new and small association, it neither had a significant share of the local lending market, nor did it have the resources to single-handedly underwrite a volume of local loans to profitably occupy its brokered deposit base.

Once again the "solution" was to go to the national market and seek loans beyond the immediate geographic market.

Sun's need to make loans created a demand for two products: participation interests primarily underwritten and serviced by other lenders and loans privately brokered to Sun.

While there is nothing inherently wrong with loan participations, a participating lender is often dependent upon the lead and servicing lender for detailed underwriting, experience with the borrower, local appraisers and knowledge of the local geographic market. If this dependence is misplaced for any reason, the results are obvious.

Many of Sun's participations were good, performing loans. Many were not. Many of Sun's participations were with other ultimately troubled and now-closed associations, including Eureka Savings and Loan, State Savings and Loan Association of Utah, and Hawaii and First Savings and Loan Association of Orland Park, Illinois.

Eureka, now closed by regulators, was operated by the Kidwell brothers. Its failure has been attributed in part to losses arising from loans to Las Vegas casinos and to William Oldenberg.

State Savings and Loan was owned and controlled by Mr. Oldenberg. That failure has been attributed in part by self-dealing by Mr. Oldenberg, including the sale of a parcel of Bay Area property which he had personally acquired for $800,000 which was then sold to State for $55 million.

First of Orland Park was closed by regulators in late 1986. Several among its controlling group have been indicted by a Federal Grand Jury in the Northern District of Illinois.

Sun also relied upon loan brokers to provide borrowers of the brokered deposits. Again, the majority of loan brokers provide a legitimate service to financial markets, placing a prospective borrower with a fully-informed lender which is ready, willing and able to make the loan.

Other brokers extract large up-front fees for loans promised and never made. Some facilitate their clients' frauds by not disclosing adverse credit information or even prior criminal convictions for bank fraud. Others are more overt and may simply bribe bank officers as needed to obtain loans and related brokerage fees.

A highly disproportionate share of the loans brokered to Sun were non-performing loans and resulted in losses to the Association and ultimately to the FSLIC. Among these loans were ones to Morris Shenker and the Dunes Hotel and Casino, where Sun's president and CEO claims to have won much of his $200,000 which was deposited to the secret account.

These participations and brokered loans were a major contributing cause to Sun's failure. It is currently estimated that this failure alone will cost the FSLIC approximately $114 million dollars.

In addition to deposits and actual funded loans, Sun was active in the loan commitment market. Loan commitments are often a valuable commodity in the construction industry. Obviously a construction loan is much more easily obtained if the borrower has a fixed, written commitment for permanent take-out financing. Accordingly, there is a demand for written loan commitments.

From the side of the lender, commitments can be a valuable source of income. If a written commitment is skillfully drafted with numerous conditions it may be of doubious enforcability. Most importantly, a commitment generates immediate income from commitment fees without an immediate corresponding use of capital.

Sun generated a relatively high volume of loan commitments. Fortunately, a mere loan commitment rarely results in a loss to the committing lender. Aside from the few cases where disputes arose over unfulfilled commitments, Sun realized a profit from the making of commitments.

However, some of these commitments may have facilitated fraud having an impact on other lenders.

In 1984 and 1985, a group of promoters in California were pooling loans, obtaining mortgage guarantee insurance and re-selling these bundled loans on the secondary market to Wells Fargo Bank, Bank of America and others. Although Sun did not make loans to this group, Sun did issue substantial commitments to purchase portions of these pooled loans and contributed to the credibility of the offering. Sun was paid hundreds of thousands of dollars for such commitments.

There were a few problems. The underlying loans were based upon inflated appraisals and unsound underwriting. The "insurance" offered was through an undercapitalized Montana corporation, Glacier Insurance. Sun and the principals of the alleged scam were introduced to each other by a well-compensated loan broker who brought a number of non-performing loans to Sun.

The financial press has estimated California lenders have incurred losses in excess of five hundred million dollars from the Glacier Insurance insured mortgages.

The lesson of all this is simple. Financial markets are interrelated and interdependent. No lender operates in a vacumm. The fraud committed upon a lead lender impacts its participants. The fraud facilitated by one lender through the issuance of income-generating but largely illusory commitments impacts other lenders relying upon these apparent commitments.

These themes and problems are hardly state secrets. U.S. Attorneys and Organized Crime Strike Forces around the country are deeply involved in these matters. The "Fast Track" program of the FBI and local enforcement agencies developed in San Francisco has already scored some successes.

We are civil litigators for an agency having no criminal jurisdiction. Focusing upon the civil arena, there are certain steps which may make fraud more difficult and less profitable.

First, lenders should know if they are dealing with one who has already been convicted of bank fraud or a related offense. The Department of Justice and Federal regulatory authorities should develop a simple systematic method to circulate names and social security numbers of those convicted of these crimes.

Second, most lenders would reasonably like to know if their prospective borrower has been indicted for bank fraud or related offenses. Obviously indictments are not convictions, but is it rational for a bank loan officer not to know that his prospective customer has been indicted in four states over the last five years for bank fraud? This Committee should consider whether a system to collect and distribute such information could be created consistent with all appropriate regard for the due process and civil rights of innocent parties who may be indicted.

Third, when a savings institution is closed by federal regulators, several issues are raised simultaniously. If negligence or worse on the part of officers or directors is determined to be a contributing cause to the failure, the FSLIC may wish to pursue civil litigation to obtain restitution from individuals, insurance carriers or the surety on fidelity bonds. If criminal acts are believed to have occured, a referral to the appropriate federal authorities should be made.

The appropriate civil and criminal remedies create a dilemna of their own. The FSLIC may wish to pursue a civil action to recover money. Under certain circumstances the necessary civil discovery process may be stayed in whole or in part if a parallel criminal proceeding is actively going forward. Additionally, the FHLBB has certain administrative remedies available to it. The administrative process necessary to that effort could also be affected by criminal proceedings.

These problems are compounded by the simple fact that civil and criminal jurisdiction and the decision making process are independently exercised by the FSLIC and FHLBB on the civil side and the Department of Justice in the criminal area.

Ideally, some informal process should exist where the regulators and the Department of Justice could coordinate the decision-making process as to avoid conflicts in objectives where possible.

Although in our limited role as outside fee counsel we properly are not privy to all relations between the FSLIC, FHLBB and the Department of Justice, it is our experience that such coordination is random and ad hoc, at best, and at times leads to an assumption by both sides that the other is taking care of the problem with the end result of nothing being done.

While the criminal enforcement agencies may not properly share information with outside fee counsel, counsel in civil litigation often may discover facts which should be brought to the attention of criminal authorities.

Although this has been done in the case of Sun Savings, this process was initiated by us with the encouragement of the Office of Enforcement of the FHLBB. Prior to our initiating contacts with U.S. Attorneys around the country and Organized Crime Strike Forces where appropriate, there was no system or even informal network between fee counsel and the enforcement agencies. Such a system could and should be established such that a civil litigator could easily identify the persons having jurisdiction and an interest in criminal referrals relating to specific institutions or borrowers.

Lastly, the Committee has asked what priority is given to bank fraud cases within the Southern District of California. I am not privy to the systemm of allocating resources within that office, so cannot comment in any meaningful way. I can tell you that I am aware that shortages of experienced and qualified attorneys and staff support appear to make prosecution of complex fraud cases difficult. The assistant U.S. Attorney most familiar with Sun Savings matters is leaving the office next week to go into private practice. I doubt that this department will accelerate the government's progress in the case.

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Mr. BARNARD. Mr. Rose.

STATEMENT OF ROBERT ROSE, ATTORNEY, DUCKOR & SPRADLING

Mr. ROSE. Thank you, Mr. Chairman, members of the subcommittee, I appreciate your invitation to appear today. I am here as a citizen who was once a Federal prosecutor for nearly 12 years, and I can assure you I do not speak on behalf of the Department of Justice. I thought perhaps I could assist this committee just in offering you the views of what an average prosecutor, working with an agent would have as an incentive to prosecute bank fraud, because that is where all of this is leading to, if it is as bad as we think it is, out there in the banking industry.

To touch upon something, though, that Mr. Lundin mentioned a moment ago, and that was the question of asking about someone's prior arrest or conviction, I can recall a case that involved a con man in San Diego, who was conducting an advance fee scheme; and on the application to the prospective investor, he asked that question. And every prospective investor answered no, and sent the money very promptly because like every advance fee scheme the offer was limited. He took all of their money, about $150,000, and it came about, thereafter we learned that this man had been convicted of fraud in Florida, and was on bail pending appeal, while he was asking his new targets if they had been arrested before.

It's an easy thing to do, and it should be done, and perhaps if we look at some of the things that we can do with understaffed and underbudgeted offices, we can make more with what we have.

What incentives are there for a Government prosecutor to go after bank fraud?

One of the elements to consider, I think, gentlemen, is that these cases do not come in a package, ready-made to indict. That eliminates prosecutors who don't like to investigate. And there are many who don't. It eliminates prosecutors who are unable to investigate. These are not reactive cases, or the kinds of cases that typically come to a district attorney, where the police officer or the detective has put it together, and you simply take it to court.

They require different skills. They are labor-intensive cases. I have read through the report of this committee from 1984, September, I believe it was. I was impressed with the quality of the work and the writing and thought, if I were a prosecutor or a supervisor, as I was, of prosecutors, I would make that report required reading: to give somebody who is working in an office, perhaps detached from what is going on in other parts of the State, or of the country, an idea of what is happening and how it takes place—how it comes to that person's desk.

But the bank fraud case simply doesn't mix well with many of the cases that an average prosecutor has assigned to him or her to handle. It doesn't mix well because there are no deadlines on these cases other than the statute of limitations. They don't mix well with the Speedy Trial Act; they don't mix with cases where someone is in custody and must be tried within a set period of time.

So, if you have a prosecutor, whether it is in Los Angeles, or San Diego—wherever, whatever the mix of cases are for that geogra-

phy, and you have a marijuana case, and a theft of a Social Security check, or a bank robbery case, and maybe alien smuggling cases—those cases will get priority, and they will continue to get priority because they will always be there, and so will the bank fraud investigation. You don't need to get to it today, tomorrow, next week, or a year from now. We know it is going to be complicated; we know it's going to take time. It doesn't have a deadline; let's work with something that does.

The way in which to get to those cases, though, is to make it a priority. People are motivated by any number of things; love and fear are among them.

I can recall when I started in the Justice Department. One of the things that required the utmost, immediate attention was a congressional inquiry. That got attention. I think this committee has turned on the heat on this project, and I think it got the Attorney General's attention, so that he has now declared bank fraud to be a high priority.

But there are lots of high priorities. As U.S. attorneys will tell you, every group, every committee, every group of public interest groups, and lobbyists have their priorities. What this committee has served, and serves, I think, is an exceptionally fine purpose: To turn on the heat and make bank fraud a priority, not on paper, but a true priority.

In order to accomplish the prosecutive job of attacking bank fraud and insider abuse in our financial institutions, you need to make the most with what you have but you need to use those people who are most experienced on the cases that require the most experience. An approach to the problem that takes a 10-year veteran in the prosecutor's office and has that person working on parrot smuggling, and thefts of checks from the mail, and the smuggling of Latin Americans into the United States, along with a bank fraud that didn't come in a package and will require a good bit of cooperative effort with fee counsel, FDIC examiners, FBI agents, that's not going to get the attention.

Taking this off paper and making it a real priority serves a fine purpose, and there are numerous examples within the recent history of the Justice Department where investigative needs have been prioritized. Selective Service cases were the top priority at one point in time, except that the prosecutive effort thereafter turned into a joke, and there were hardly any such cases. But a person was told by Washington in every one of the 94 districts to assign a prosecutor to that problem and become adept at it, and be ready and prepared to prosecute those cases when they were sent. At other times, election fraud has been called a priority. Child pornography has been called a priority. Boiler-room activities has been called a top priority.

What this committee can do with bank fraud is to heed the messages that have been delivered this morning about more investigators and more prosecutors, and to pay each of those groups more than they are presently being paid. That is how these cases will get done, and to put them in a place within a structure that they can focus their attention on that, and to—and whatever way you can influence or even command the people who know the ins and outs of that particular institution, to make them work together, I would

suggest to this committee, among other things that a better publicity effort would help this problem, better publicity about convictions and better dissemination of that news, not just to the community that listens to the news on television and reads the newspapers, but to disseminate what has been learned in the course of a 2- or 3-year investigation to other people who haven't learned it yet.

Now, part of that is training, but you can only do so much with training. Part of it is perhaps it takes a report to be sent to a central place, perhaps the Fraud Section in Washington, DC, of the Justice Department about what was learned in the course of 2 or 3 years of investigating a failed bank. What was learned in the course of a 6-week trial of the insiders who were convicted, or perhaps acquitted in that failed bank.

Mr. BUSTAMANTE. Mr. Rose, how serious is the patient? How serious is this problem? We've heard about out of 31 failed institutions in California the shareholders, and the American people have lost—what is it, five-point——

Mr. BARNARD. Billion.

Mr. BARASH. $5.7 billion.

Mr. BUSTAMANTE. $5.7 billion, in the last 3 or 4 years——

Mr. BARASH. Three years.

Mr. BUSTAMANTE. The last 3 years.

All around the country, we have lost over $15 billion. How serious is this problem?

Mr. ROSE. Congressman, you really—you answer your own question. It is serious. It is as serious as everyone before me has perceived it, but I am not in the position to tell another committee who is exploring the impact of organized crime in America, or narcotics trafficking that their concerns are any less serious than your own.

Mr. BUSTAMANTE. The U.S. attorney's office has some concerns; the Justice Department obviously has no real concerns. OMB has no real concerns in this area.

My concern is: Should we really tell the people that it is really, really serious? And what percent of the S&L's are in trouble in this country? A high percentage of them are in real trouble.

What happens if we have a bank run or an S&L run? What happens then?

Mr. ROSE. The more you tell the people, in whatever way you get the message to them that this is a serious problem, the more likely something will be done about it. This committee, I believe, has been responsible for this matter being elevated considerably from where it used to be.

I've not been a prosecutor for about 18 months now. I have some clients fortunately that are not banks that are in trouble. They are very satisfied in San Diego with the fast track program, whereby small embezzlements can be prosecuted fairly promptly.

But the ability to do anything beyond small embezzlements is not there. There are not enough people, and they aren't, I don't think, properly utilized to make the most out of the experienced prosecutors. San Diego has a very serious fraud problem, and it is not simply banking fraud. Orange County has a very serious fraud problem, but it is totally ridiculous that there should be a dozen

FBI agents for one of the largest metropolitan areas of the United States.

There are some very fine FBI agents that have worked on these cases in San Diego, but they have suffered in several ways. One was a policy that was devised within the FBI, referred to as the "10-1-69 policy" which meant that it simply put, that an agent who had not served enough time in a major FBI office, was going to have to go to one of those offices during his career, if he had been in the FBI for a certain period of time. That caused a number of experienced people to be transferred out of San Diego. It also caused a number of people to resign.

As a result the San Diego office, I have always been told, went from one of the most experienced levels to the second youngest in experience level in the United States, and they are still recovering from that.

The other thing that affected the FBI in San Diego was the creation of the drug task forces, and it was an incentive for agents from white-collar crime assignments, and some of them accountants, to go work on this new project; and it ended up decimating the white-collar squad.

You have already heard about transfers, and I won't talk about that. That happens in any large institution, but if you have accomplished anything at all, you have moved this up the ladder toward the top where it belongs.

Mr. MARTINEZ. Would the gentleman yield?

Mr. BARNARD. Let me ask a question at this point. I should have asked this to Mr. Bonner, and I didn't, but I will submit it in writing.

Let's say the Attorney General's Office in Washington had a corps of experts, experienced attorneys who really knew how to go in and investigate these matters and develop cases, and they were available to go into areas like southern California and Texas, where we seem to have such a proliferation of these cases. If they have such a task force, where they could put out fires, send attorneys—I mean, prosecutors, U.S. attorneys—into those areas, who had knowledge and experience and know-how to work with other U.S. attorneys, do you think that would be helpful?

Mr. ROSE. We thought they had such a group available several years ago, when in San Diego, there were a half dozen referrals, or at least in one instance we opened the case ourselves, based upon newspaper stories, of insider abuse. They were only suspected; there was no one charged or arrested, and we simply didn't have the manpower. We went to Washington, DC, where they did have the expertise; we received, I believe, one visit, or perhaps two by an experienced prosecutor who we had arranged this as a package, as a group that he could work on and make the most use of his travel dollars. He didn't come back; he was detailed to work on matters, I believe, in Oklahoma, and there was no one in Washington to replace him.

In 11½ years with the Justice Department, I was always led to believe that there were a corps of people in Washington who had the most experience, and that's why they were there, and they were the firemen that would go out to the countryside and put out

the fires. After 11½ years, I realized that there were no trucks in the station.

Mr. BARNARD. Mr. Martinez.

Mr. MARTINEZ. The chairman earlier, in response to a comment I made, raised a very valid point, and it goes back to what you and Mr. Bustamante were talking about just a minute ago, and that is: Doesn't it concern you that there might be a run on all the savings and loans should there be a total disclosure to the public of the kinds of problems that seem to be inherent and a potential for abuse by executive officers in the thrift savings and loan industry?

Mr. ROSE. If knowledge is power, then the more knowledge that your constituents and the people in this room have about the problem, the more likely that they agree with the recommendations that you propose.

Mr. MARTINEZ. Well, I agree with that, but I am wondering, because, when the chairman made that statement, you know, it riled a certain fear in me. I remember in Maryland when the people were trying to get their money out, and it took a State order by the Governor to close the savings and loan.

But you saw how consumers rushed to their thrifts. I'm wondering if total disclosure to the public—I agree with such disclosure since it will give us the necessary pressure on Congress to do something about this problem—but still will cause a run, dash on the savings and loans. Aren't you a little concerned about this?

Mr. ROSE. Am I personally, Mr. Martinez?

No, I don't think so.

Mr. MARTINEZ. No.

Mr. ROSE. People put a lot of faith in the guarantees of FSLIC and FDIC.

Mr. MARTINEZ. Mr. Lundin. Oh, I thought you were going to respond, too.

Mr. LUNDIN. I'd like to.

I'm not a former prosecutor, but I am certainly involved with the industry, and I know it is a concern on the part of management of major S&L's, as this committee well knows that the flight from the FSLIC fund to the FDIC as a migration is a major issue.

I think this committee publicly and privately probably needs to tread carefully because of this insurance. As a depositor, albeit not major, in savings and loans, I can identify, for instance, with the public that says to itself, "all things being equal, why should I go to the basket-case thrift industry when I can go to the conventional banking industry? Banks, at least, based on what I read in the financial press, seem to be more healthy." And that's a judgment call people make on a day-to-day basis. I just mentioned depositors with a few thousand dollars. The major institutional depositors have funds well in excess of the insured amounts. Flight of funds is a serious concern, a serious potential problem to the industry.

I think one thing that this committee can say, and I think very honestly, notwithstanding all the troubles—and they are legion—the strong ones within this business are strong and fundamentally sound, and the system works if it is properly regulated, properly supervised, and properly managed. And in terms of the total dollar volume of the industry, that's the overwelming majority of what's going on. In terms of numbers of hazards—when you talk about

numbers of thrifts—you have got a lot of small shops out there that weren't around 10 years ago, and aren't going to be around 10 years from now—and some of them aren't around now.

And those are the problems, again, that Mr. Black addressed. There are the types of institutional, management, and legal issues that can and are being very specifically addressed. But I think the thrift industry is alive, is well, and will be alive and well a decade from now. But it is going to require continued attention from this committee, and also sensitivity to, quite frankly, the bad publicity given the industry. And I think that it is well that you recognize it.

Mr. MARTINEZ. In view of what you have just said, and as a result of what we have heard, or what we have read in committee reports, there is a reluctance on the part of fee counselors to pursue criminal actions when they would primarily prefer civil action to recoup loss. I wondered if it wouldn't also be because of the notoriety of a criminal action and calling immediate attention to or, creating a bad image of an industry, or even a particular savings and loan.

And is that the reason why most fee counselors are reluctant to press for or ask for, or report, or have reported a criminal, or made a criminal referral—and I say that because I've read your testimony and I know that you hold the opposite: You think that there should be criminal and civil action concurrently, but you advise that, in some instances, one detracts from the other, or hinders the other. And so, would you respond to that?

Mr. LUNDIN. The FSLIC actively discourages having its own fee counsel also represent the industry, and I am one of those, and I fall into that role. My client is the FSLIC, not the industry.

I don't think any of the fee counsel are reluctant to refer criminal cases, because they feel protective of the industry. I don't think that is a concern. If it ever is a concern, it is not proper.

The more difficult issue, to me, is the one that that I touched on briefly in the written testimony. When a pattern of criminal activity becomes apparent to a civil litigator, what should he do? I'm outside of my own arena of expertise; and when I first started working for the FSLIC on these cases, I always felt somewhat in limbo: What do I do with this? There was no clear direction as to what outside fee counsel should do.

In our particular case it was like the layers of an onion, a great number of players that were involved with one particular initial association, as we got into it, were involved with others. There was an array of facts that I found interesting, and I thought others should find interesting. So I went to work. The trouble with this it was a delight to me, but no one was telling me what to do. We began talking to people in the Enforcement Division of the Bank Board, the Litigation Division, ultimately integrating with the U.S. attorneys' offices in other parts of the country, other fee counsel in other parts of the country were relating overlapping cases, and we ended up establishing something of a working network that hadn't existed thus far as to this nexus and cast of characters.

This is the kind of thing that should be happening routinely. Although I got nothing but the active support from the Bank Board staff, "yes, that is what should be going on," and "how could we

help you?" and, "if this works, how can we instruct other fee counsel in other parts of the country to do this?"

But I guess my concern was, nobody had done it before, and I don't know why.

Mr. MARTINEZ. I don't either.

Mr. BARNARD. Well, gentlemen, I want to thank you for taking of your personal time to be with us today. I know that you both traveled from San Diego, to be here; and, as far as I'm concerned, that's a long way, especially when you travel by train, which we did yesterday; and I now say that all the scenic part of that train ride is about two blocks after you leave San Diego. But, anyway, that is neither here nor there, but I know that you have made a lot of effort in the testimony you brought to us. It's excellent testimony, and we appreciate it, and very possibly we will be communicating with you about additional questions that might develop after this is over.

Thank you very much.

Mr. LUNDIN. Thank you.

Mr. ROSE. Thank you.

Mr. BARNARD. Our next witness is Mr. Peter Nunez, who is the U.S. attorney for the Southern District of California. Mr. Nunez will be accompanied by Mr. Bill Braniff, assistant U.S. attorney.

Mr. Nunez, and Mr. Braniff, I'll just say that, as I am going to say to the next panelists, we appreciate your patience and your indulgence. There is no way to properly select the priority of witnesses, because there is no priority; everybody has a priority as far as his testimony is concerned, so our selection has not been for any priority purpose, and that's just the way it sort of falls.

But, as I have told the rest of the witnesses, your complete testimony will be included in the record, and we would appreciate it if you could summarize it, and then we will have the questions. Mr. Nunez, we'll hear from you at this time.

STATEMENT OF PETER NUNEZ, U.S. ATTORNEY FOR THE SOUTHERN DISTRICT OF CALIFORNIA, SAN DIEGO, CA, ACCOMPANIED BY BILL BRANIFF, CHIEF OF THE SPECIAL PROSECUTIONS UNIT, CRIMINAL DIVISION, AND ASSISTANT U.S. ATTORNEY FOR THE SOUTHERN DISTRICT OF CALIFORNIA

Mr. NUNEZ. Thank you, Mr. Chairman, and members of the committee—thank you for inviting me.

Mr. Braniff on my right is the Chief of the Special Prosecutions Unit in my office in San Diego, within the Criminal Division.

I imagine that being placed at the end of the agenda is attributable to Mr. McSpadden, whom you probably know, formerly was a law clerk in our district, before he became a distinguished staff counsel. He probably had something to do with our position on the agenda.

Mr. BARNARD. You know, I wouldn't be at all surprised if he didn't. He felt like he could treat you like anybody. He's maybe getting back at you, Mr. Nunez.

Mr. NUNEZ. I think that is probably right. [Laughter.] Well, first of all, let me summarize briefly what the Southern District of California consists of. We have two counties in the southernmost part

of the State, San Diego and Imperial Counties. Those two counties consist of the entire 180-mile border between California and Mexico. We go from the ocean to the Arizona border at the Colorado River. Because of the border, that is the dominant feature of our district, and also of the law enforcement effort within the Southern District of California.

In addition to the border, we have a large military presence in the district. San Diego is next to Norfolk, or maybe contends with Norfolk as being the largest Navy port in the world. The Navy and Marine Corps have numerous bases in the district. There are many defense contractors involved in aerospace and high technology on Government contracts. Defense contracts in excess of $3 billion are awarded annually to San Diego-based firms.

Because of the border and the presence of the Federal Government in the district, our caseload is amongst the highest in the country. Last year, we filed 1,031 felony indictments and informations involving 1,576 defendants. In addition to that, over 7,000 cases were filed in the magistrate courts, and disposed of, in front of Federal magistrates. We had 77 criminal jury trials, plus a number of civil cases.

In addition to our criminal caseload, we had an ever-increasing civil caseload, also primarily resulting from the Federal presence in the district. The presence of so much Federal activity, and in particular the presence of two Government operated medical facilities, produces more civil litigation than we can cope with.

In this context, I have attempted to maintain some Federal deterrent presence in the various areas of fraud, including defense contract fraud, Federal program fraud, investor fraud, and bank fraud. We have recently reorganized our Criminal Division to increase from 8 to 20 the number of attorneys that are available to handle special prosecutions in the fraud area, consistent with other assignments.

I should note that in the 5 years that I have been the U.S. attorney, all the increases in attorney resources that we have received have been specifically designated for the narcotics area. In 1982 and 1983, we received a complement of attorneys for the drug task force, and just within the past year, we received an increase of 13 assistants because of the Southwest Border Initiative, called the Operation Alliance. The only other assistants we received were two other assistant positions in 1986 that were never filled.

With regard to bank fraud, one point I would like to make after hearing the other speakers this morning is to point out that, at least from our perspective, it is a relatively small problem in our district compared to others. Up until 1983 to 1984, we did not have a deluge of financial institution cases. We would get one or two a year. From 1984 to the present, we have gotten an increasing number of cases, and there was one period of time in 1985, I believe, where we received nine cases, almost all at one time.

Since then the number of referrals of these cases has slacked off a little bit in volume. I have the numbers in my prepared testimony as to the number of existing investigations. We have 18 bank fraud investigations, where the value was in excess of $100,000, 9 of which involved amounts in excess of $250,000. Eight of those investigations involve insider and affiliated outsider fraud, which our

office regards as significant. And currently we are conducting investigations involving three failed institutions.

Mr. BARNARD. Have there been any referrals made as to those in open institutions?

Mr. NUNEZ. Pardon me?

Mr. BARNARD. Have there been any referrals made as far as to individuals in open institutions?

Mr. NUNEZ. We have cases involving open institutions, yes. When you say "referrals," many of the kinds of cases that we open are not referrals from the regulatory agencies themselves, but are cases that are brought to us by fee counsel, bank counsel, the bank itself, or things we read in the newspapers. And, in addition to that, the FBI, in their testimony, describes the source of the cases that they have opened in their office.

I think it is clear from the information that you have heard before today, and today, that the financial problem within financial institutions is clearly overwhelming the criminal justice system. There are not enough prosecutors and investigators anywhere apparently to handle the problem, and that's particularly true here in California.

You asked the question earlier of one of the prior witnesses as to what the process—I believe you asked Mr. Lauer—the process, of whether the Department of Justice was sensitive to problems of this nature, and I think the answer is yes. But they are also sensitive to the fact that there are 94 judicial districts, all of which, to one degree or another, have the same problems, and they all seem to have unique problems.

Mr. BARNARD. Do you really think that is true? Except for New York, Texas, and California, I don't believe the other States have the problems as severely as they do in this particular area.

Mr. NUNEZ. In the area of bank fraud?

Mr. BARNARD. Yes.

Mr. NUNEZ. Oh, that's correct. I didn't mean to imply that. What I'm saying is that they have all had priorities of one sort or another.

Mr. BARNARD. Oh, yes. Well, this is why, I guess, I am so conscious of that because of these hearings: it really worries me, you know, that there is not more of a priority given to it in the Attorney General's Office, as far as U.S. attorneys are concerned. But, go ahead. I didn't mean to interrupt you.

Mr. NUNEZ. My point was simply that there are a lot of competing interests, and to a very great extent the 94 U.S. attorneys compete for whatever new resources the Department can get from Congress, or ask for from Congress. And, for instance, if you talk to the U.S. attorney from the district of Arizona, he will tell you that one of his most significant problems is Indian crimes; and that's something that most U.S. attorneys are not encumbered with. But everybody has problems to solve.

Mr. BARNARD. And we may pass more laws having to do with Indians than we do with strengthening the law enforcement in our country.

Mr. NUNEZ. You are probably right.

To augment one of my statistics in my prepared testimony, I indicated that we had 26 fast-track cases prosecuted or convicted in

1986. So far, this year, in 5 months this year, we have had 45 fast-track cases. And that program does seem to be working fairly well.

Mr. BARNARD. Well, how do you identify or define a "fast-track" case?

Mr. NUNEZ. A "fast-track" case, in my definition, is a case that does not require the expenditure of either FBI or assistant U.S. attorney resources in the investigation or the filing of the case. In other words, in many of these cases, the bank refers the case to the FBI, which refers it to us. The bank internal auditors, security staff have already solved the crime, if you will. They have identified the defendant. In many cases, the employee has already confessed to the bank security folks, and in that instance there is very little left to do.

In those instances, we file a complaint. Depending on the amount of money involved, the defendant usually pleads guilty either on the first day they appear in court or within 10 days thereafter, so that the prosecution does not consume resources either at our level or at the FBI level. Admittedly, these are small, small-amount cases, not the kind the committee is really interested in.

I will not bother to summarize the three cases that we have included in our testimony—various trials that we have had over the last 3 years.

However, it does include a case that was just concluded in a 6-week trial in early May, and they are still awaiting sentencing.

Mr. BARNARD. Was there a conviction in that case?

Mr. NUNEZ. Yes. Two defendants were convicted in that case. And this involved a vice president loan officer who was making loans with the aid of an outsider who was steering loans.

Mr. BARNARD. Did you do that complete case within your staff?

Mr. NUNEZ. Yes.

Mr. BARNARD. You didn't get any outside help?

Mr. NUNEZ. Well, the FBI, other than the investigative agency, the FBI; but there were no bank lawyers, if you will, or FSLIC lawyers.

Mr. BARNARD. How many FBI agents worked on the case?

Mr. NUNEZ. When the case was presented, when it was tried, there were three that were assisting the assistant U.S. attorney in the prosecution.

Mr. BARNARD. Did they spend considerable time on the case?

Mr. NUNEZ. Yes.

Mr. BARNARD. Do you have a—you heard Mr. Bonner testify, Mr. Nunez—do you have sort of a cutoff figure, a threshold for prosecution?

Mr. NUNEZ. No, and in our district we will prosecute any case that any agency will bring us that has all the elements necessary for successful prosecution. What we try to do is to dispose of them in a different fashion, depending on the amount of the loss, the amount of money involved. If this is a narcotics case, the amount of narcotics involved. We try to dispose of the cases early in the game, perhaps with plea bargaining and sentence bargaining.

Just to add a note to the comments that Mr. Adler made initially, and then Mr. Bonner followed up on, it is my feeling that because the California criminal justice system does not allow for the general prosecution of white-collar offenses in the State courts,

that basically leaves us in the Federal camp all by ourselves. We do get assistance from the State attorney general's office, but, as you know, they only have six lawyers. We do get assistance from the local district attorney's office if they have a case they want to present in Federal court.

But I do believe that if the California system worked better, that there would be more of a law enforcement presence. You would have district attorneys, especially in the larger cities and counties and police and sheriff's offices would be handling some of these cases; and the problem of moving the caseload would be alleviated to some extent. As it is now, we're stuck with the whole ball of wax.

I would defer any further comments to the committee, and whatever questions you have.

Mr. BARNARD. Any questions?

Mr. MARTINEZ. Yes, going back to what you just said about being left with the "whole ball of wax," he indicated and I believe it's true that where they have State-chartered, federally insured savings and loans, that they have jurisdiction, but usually recommended to FSLIC, through the FBI, to the Attorney General, and only if they are brought into it by the commissioner that they would be able to act as cocounsel, cojurisdiction in the Federal court.

Mr. NUNEZ. That's the way it works now, because the State system basically doesn't work. I guess what I'm suggesting is that if the California criminal justice system was more realistic, and it worked like the Federal system did, that all of the prosecutorial and law enforcement agencies in the State would have the option on their own to do these cases, some of these cases, they would not have to come to the Federal court system, to the U.S. attorney's office, or to the FBI.

Mr. MARTINEZ. Oh, I see, what you are saying is that—well, because Mr. Adler was saying that he would "prefer to go to" not that he "can't go to State court," but that he would prefer to go to Federal court because of what you just said—a different system.

Mr. NUNEZ. It's very bad.

Mr. MARTINEZ. Yes. And so that—but it can be done in a State court, just that it——

Mr. NUNEZ. It doesn't work.

Mr. MARTINEZ. It doesn't work as well. It doesn't work as well; it doesn't work to the degree that you want it to.

Mr. NUNEZ. Well, I really don't think it works at all. I think every major white-collar crime case that the district attorney in San Diego has prosecuted in the last few years, has come through the Federal court system.

Mr. BUSTAMANTE. Let me ask you, one of the cases in the survey that we had, the *Sun Savings*, with estimated losses of about $114 million, what is the status of that case?

Mr. NUNEZ. The case is pending in both my office and the FBI.

Mr. BUSTAMANTE. Why is it being delayed? Is it being delayed?

Mr. NUNEZ. Well, it was assigned, it has been assigned to an assistant who just tried this other case that I mentioned, who is now going to leave the office, I should point out, and today you talked about FBI agents who can transfer. That same thing happens in U.S. attorneys' offices, and it would not be fair to leave the com-

mittee with the impression that rollover, turnover only affects the investigative agencies. I'm sure they are as frustrated with us on occasion as we are with their transfer or turnover problem. We have one, too; this is an instance where the case is assigned to an assistant; it is now going to have to be reassigned to another assistant.

I should also point out there were two defendants that have been convicted in that case, one of whom failed to appear, I think, for sentencing. The complexion of the case could change dramatically if that defendant were ever located.

Mr. MARTINEZ. Thank you, sir.

Mr. BARNARD. Mr. Nunez, thank you very much, and you, too, Mr. Braniff. We appreciate your being here today and bringing us this testimony. Thank you, sir.

[Mr. Nunez' prepared statement follows:]

STATEMENT

OF

PETER K. NUNEZ
UNITED STATES ATTORNEY

BEFORE

THE

ONE HUNDREDTH CONGRESS
CONGRESS OF THE UNITED STATES

HOUSE OF REPRESENTATIVES
COMMERCE, CONSUMER, AND MONETARY AFFAIRS
SUBCOMMITTEE
OF THE
COMMITTEE ON GOVERNMENT OPERATIONS

CONCERNING

BANK FRAUD

ON

June 13, 1987

Thank you for letting me appear to testify about the efforts of the United States Attorney's Office for the Southern District of California in the area of bank fraud. First, however, I believe it would be helpful to say something about the overall law enforcement efforts in the district to give you the context of our bank fraud prosecutions.

The Southern District includes the entire 180-mile border between California and Mexico. The border crossing at San Ysidro is the most heavily crossed border in the world. With the border comes an enormous federal law enforcement responsibility to curtail the illegal influx of aliens and the smuggling of narcotics.

We also have a large military presence in the district. The port at San Diego rivals Norfolk as being the largest Navy port in the world. The Navy and Marine Corps have numerous bases in the area. There are many major defense contractors involved in aerospace and high technology on government contracts. Defense contracts in excess of $3 billion are awarded annually to San Diego-based firms.

There were 1,031 felony indictments and informations involving 1,576 defendants returned in the district in calendar year 1986. In addition, 7,364 cases were filed before the magistrates. Our office tried 77 criminal jury trials last year.

Of course, in addition to our criminal case load, we have an ever-increasing civil case load, increasing both in size and complexity. The presence of so much federal activity--and in particular the presence of two government-operated medical facilities--produces more than enough civil litigation for us to cope with.

In this context, I have attempted to maintain some federal deterrent presence in various areas of fraud, including defense contract fraud, federal program fraud, investor fraud, and bank fraud. We have recently reorganized our Criminal Division to increase from eight to twenty the number of attorneys available for fraud investigations, consistent with their other obligations.

I should note that since I became United States Attorney in 1982, my office has grown from 39 Assistants to 63. Of that increase, 9 positions were added specifically due to the creation in late 1982 of the President's Organized Crime Drug Enforcement Task Force; 13 Assistants positions were added in late 1986 as part of the Southwest Border Initiative, also known as Operation Alliance. The remaining two positions, added in early 1986, were the only new positions not dedicated to drug enforcement.

Like everyone else, I could always use more resources; but those resources could be used across the board in our law enforcement and civil efforts. By its nature, a federal prosecutor's office is an office of limited response. We will never have all the resources necessary to prosecute every one of the hundreds of thousands of illegal aliens who cross our border every year. Nor could we investigate every scam pulled off in San Diego. Recognizing this limitation, I have attempted to allocate my resources to achieve a deterrent presence in all the areas of concern to San Diego. In effect, I have tried to establish the principle that there is no "free crime" in San Diego by not abdicating any particular area of enforcement. This has resulted in measured responses in the prosecution of drug, alien, and merchandise smuggling, student loan fraud, advance fee schemes, investor frauds, and a whole host of other offenses. In each case, I have tried to use the substantial possibility--rather than the certainty--of prosecution as a deterrent.

I have also taken the same top-to-bottom approach in the area of bank fraud. At the bottom, we have long had in place an effective "fast track" system to prosecute tellers who embezzle relatively small amounts from banks. We have worked out specific guidelines with the FBI that give clear guidance on how to proceed in a wide range of teller frauds. As a result, I am confident that there is no bank employee within the district who feels that he or she could embezzle bank funds--no matter how small--with impunity. The latest statistics for the "fast track" program show that

during 1986 we prosecuted 26 tellers for embezzling approximately $82,000 in bank funds.

In the area of major bank frauds, I have tried to allocate sufficient resources to establish the principle that bank officials cannot abuse their trust without concern for possible criminal repercussions. Again, I cannot guarantee the certainty of prosecution, but only the substantial possibility. Our efforts were hampered during the prior fiscal year by the effects of Gramm-Rudman: First, the hiring freeze prevented us from replacing attorneys as they left. We specifically identified five bank fraud investigations that we could not address because of the hiring freeze, and the Fraud Section of the Department of Justice agreed to send an attorney to handle the investigations. After one trip, however, the Fraud Section's travel funds were limited by Gramm-Rudman; the attorney could no longer make the trips to San Diego. We had to wait until October 1, 1986, when the hiring freeze ended, to assign those investigations to attorneys.

One of the inevitable consequences of unplanned-for reductions in manpower is that it throws our priorities out of balance. We have less discretion, in the short run, in reducing our prosecutorial efforts in dealing with reactive crimes arising along the border than we do in delaying pending investigations. As a consequence, when the unplanned-for reductions come, investigations are among the first casualties. We are now trying to redress the balance with the increased resources we have been authorized. Since last October we have been engaged in a full-time effort not only to fill the additional positions authorized, but to keep pace with the higher-than-normal departures from the office, many of which have come from the ranks of our senior fraud prosecutors.

The following statements are in response to the specific inquiries of the Subcommittee:

1. General Overview And Examples

Over the years, our office has investigated and prosecuted a wide range of bank fraud cases. In United States v. Forde, which was tried in May of 1984, we prosecuted the chairman of the board and other high bank officials who took over a bank and then used the bank's funds for their own personal business ventures. Numerous loans were made to uncreditworthy accommodation borrowers, who then returned large portions to the defendants under the assurance that they would not have to repay the loans. In one group of loans, the proceeds were used to help finance the acquisition of a bank in Hawaii. When the bank officials could no longer cover up the deficient loans, the bank was closed by the FDIC with a loss of in excess of $6 million. After a two-month trial requiring two prosecutors, we succeeded in convicting the prime mover behind the scenes as well as several bank officials, including three attorneys. Two others had pleaded guilty before trial. All received substantial prison sentences, ranging from 15 years to 6 months.

In United States v. Castro and Cotter, a vice president/loan officer was repeatedly making loans of $75,000 and then $100,000 (as his lending limit increased) to unworthy borrowers brought in by a confederate of the loan officer. The borrowers, in turn, were kicking back 10 percent of the loan proceeds to the confederate, who then shared the kickbacks with the loan officer. Loans totalling in excess of $1.5 million were made in this fashion, and the bank wound up losing $1.4 million. We convicted the loan officer and his confederate after a six-week trial in early May, and they are awaiting sentencing.

In United States v. Alford, we convicted a note teller of a bank of embezzling almost $157,000 in bank funds. He had found a way to manipulate the bank's computerized accounting system in such a way that checks were issued to other banks as a normal interest expense of the victim bank and thereafter were deposited by the

defendant in his own accounts at the payee banks. The fraud would have gone undetected had not a replacement note teller stumbled upon the same weakness in the accounting system. The defendant was sentenced to four years' imprisonment.

2. Numbers Of Financial Institution Fraud Investigations

a. We currently are conducting 18 bank fraud investigations where the alleged violation involves in excess of $100,000. Nine of these investigations involve amounts in excess of $250,000.

b. Eight of the above investigations involve insider and affiliated outsider fraud which our office regards as significant. We are activity investigating or prosecuting each of them. Eight principals are involved in these cases.

c. We are currently conducting investigations involving three failed institutions.

3. Numbers Of Indictments And Convictions

We are in the process of gathering these statistics.

4. Criminal Division's Special Monitoring System

As a member of the Attorney General's Economic Crime Council, I am aware of the recent efforts of the Fraud Section to monitor significant bank fraud cases. It is still too early to tell how that system will benefit the U. S. Attorneys. Its listing of three significant cases for my district obviously does not coincide with the number of criminal investigations which we consider to be significant.

B. RESOURCES

1. Resource Requirements

Financial institution fraud cases differ from other criminal matters in a number of significant ways. First of all, the mere fact of loss is no necessary indication of criminal wrongdoing. Banks are in the business of taking risks, and losses are a natural consequence of those risks. What separates a loss due to criminality from an ordinary

business loss are often a whole series of hidden factors that are not apparent to an investigator. For example, a bank official may make a high risk loan to a borrower because of a kickback from the borrower. Neither party will advertise the kickback, so it will be an unknown ingredient unless some pattern can be established, such as the immediate cashing of the loan checks. Where many such loans are made, it might be necessary to grant some of the borrowers immunity in order to prosecute the inside official. Nevertheless, we still wind up with witnesses who are "deadbeats," who are claiming they gave cash to bank officials who have otherwise spotless records. It is necessary for us to corroborate this testimony with experts who can analyze the loan files and establish the pattern of reckless loan granting based on inadequate documentation. One most recent trial involving this type of fraud took six weeks, and we had to contend with a large number of borrowers who denied paying kickbacks even though they too received loans based on inadequate documentation.

Bank fraud arises in the context of what appears to be normal commercial transactions. We cannot begin to prove the criminality involved until we first understand the commercial context. This could involve thousands of documents and hundreds of witnesses, many of whom are reluctant to cooperate. Such investigations are highly labor-intensive and cannot be launched without some solid leads to justify them.

2-3. FBI Resources

I shall leave it for the FBI to comment on the adequacy of its resources.

4. Prosecutorial Resources In The U. S. Attorney's Office

a. As of April 1, 1987, at least eight prosecutors are handling bank fraud cases in my office. One prosecutor spent about 80 percent of her time on such prosecutions, another spent about 40 percent of his time, and the rest spent between 10 and 30 percent of their time. These prosecutors are also handling organized crime

cases, narcotics cases, bankruptcy fraud cases, investor fraud cases, health care provider fraud cases, as well as the reactive cases resulting from the border. There are presently seven vacancies in the Criminal Division, five of which are earmarked for fraud-type prosecutions.

b. I believe that, when we are up to full strength, our office will be able to timely investigate all bank frauds in excess of $100,000, at least at the rate that these cases have been referred to us in the past.

Often, the decision on whether or not to prosecute a bank fraud case turns on the issue of intent. Can we prove that the bank official involved acted with an intent to injure or defraud the bank? As is often the case, we must prove intent by circumstantial evidence. For example, the bank official who approves a loan but fails to disclose that he has an interest in the business venture of the borrower. If the loan was imprudent, the hidden interest will be strong evidence of intent. If, on the other hand, there is no strong direct or circumstantial evidence of intent, we may be unable to proceed with the prosecution. The element of intent--like the other elements of the offense--must be proved by the government beyond a reasonable doubt.

I have previously detailed our experience with the assistance provided by the Fraud Section.

c. As previously stated, past inadequacies in resources have caused us to delay investigations. I do not believe that these delays have been fatal to any of these investigations.

d. The only guideline I have adopted for the prosecution of bank fraud cases is whether or not we can prove the case. I am committed to bring all prosecutable cases.

5. Priorities Within The U. S. Attorney's Office

a. Within the category of fraud and white collar crime, (1) defense contract and procurement fraud and other (2) federal program fraud have been established as our highest priorities. (3) Federal official corruption is next in order, followed by all other investment frauds. As a result of recent directives from the Attorney General, we are now elevating bank fraud and embezzlement above all other investment frauds. I intend to bring our commitment up to the equivalent of four attorneys full time to reduce the backlog in investigations and then further assess the office's needs.

b. Narcotics trafficking is the highest priority of both the Department of Justice and my office. Even if this were not a national priority, the border with Mexico would necessarily dictate that it be a district priority.

It is inaccurate to say that alien smuggling is a higher priority within the district. I have continually looked for ways to reduce our resource expenditure on such cases while still maintaining a deterrence. In 1986 we changed our guidelines to reduce the number of immigration indictments. The border will not go away, however. As previously stated, unexpected reductions in manpower could not be absorbed in this area; therefore all proactive investigations suffered. I look forward to predictable increased resources, with a much larger portion being used for bank fraud cases than for immigration offenses. I should note, however, that it is difficult at this point to predict the impact on our office of the Immigration Reform and Control Act passed in 1986 by Congress. No new resources were provided to us to handle employer sanction cases and/or amnesty fraud prosecutions..

C. ADEQUACY OF COORDINATION

1. Detection Of Insider Abuse

a. Bank regulatory examiners rarely report criminal misconduct in an adequate or timely manner. This is probably due to the limited investigations they conduct (for the most part limited to the bank records themselves) and their caution in alleging criminality without all the facts. Furthermore, the referrals are likewise cautious in stating what is suspected and contain very few facts. I believe the referrals should give us the benefit of the informed judgments of the examiners as to the motivations of the participants as well as detailing the setting of the transactions.

b. Financial institutions rarely report insider abuse above the level of a teller. They are also reluctant to report major borrower criminal misconduct for fear of being sued for violations of either California or federal laws.

2. Receipt Of Referrals

I believe we receive copies of the same regulatory agency and institution referrals received by the FBI.

3. Monitoring

The Department of Justice recently set up a procedure for notifying bank regulatory agencies of the status of referrals. We are in the process of implementing this procedure.

4. Coordination

I am aware of no coordination between the bank regulatory agencies and criminal investigators at the time of bank closings. There might be cases where such coordination could further a criminal prosecution, but this is based on the general assessment that the earlier one gets into an investigation, the better.

Our most thorough post-closing experience has been with the FDIC in the Forde prosecution. There, it provided an examiner full time for three months to aid in the

preparation and conduct of the trial and another examiner to trace numerous loans and testify at trial.

D. RIGHT TO FINANCIAL PRIVACY ACT

1. The RFPA generally sets up a barrier to communication between the banks and investigators even where the bank itself is a victim of the fraud. The statute should specifically authorize communications between a bank and investigators so long as a customer is not identified.

2. The primary problem with 18 U.S.C. § 656 is the requirement that the government prove an intent to injure or defraud the bank. I believe it would be helpful to cast the intent element in terms of knowingly subjecting the bank to some unauthorized risk.

3. It has been our experience that the courts have given adequate sentences to defendants convicted of bank fraud violations. By way of example, in the prosecution of United States v. Forde, and others, the sentences ranged from 15 years' to 6 months' imprisonment. I believe that bank robbery sentences are appropriately more severe because of the added dimensions of physical danger and intimidation.

Mr. BARNARD. Our next panel will consist of the Federal Bureau of Investigation, Mr. Jeffrey J. Jamar, who is the Chief of the White-Collar Crime Section of the FBI, who will be accompanied by Mr. Tony Adamski, Jr., William Stollhans, and Mr. Thomas Hughes.

Mr. Jamar, did you ever know a fellow named Tom Kelleher?

Mr. JAMAR. I sure did.

Mr. BARNARD. Did you? He's my constituent back in Augusta, GA. The only thing he does now is play golf. I think he does a little investigation on cars.

Mr. JAMAR. And he looks awfully good, too. Georgia is agreeing with him, then.

Mr. BARNARD. Well, I could tell who this panel consisted of because you are the last ones in the audience. [Laughter.]

Gentlemen, we appreciate your patience, and again I wasn't—I hope you don't hold it against me that you all are the last panel of the day, but such is how life will dispense justice.

We are delighted to have you gentlemen here this morning. We appreciate—Mr. Jamar, I understand that you came all the way from Washington, DC, to appear before this panel today, and we will now hear your testimony at this particular time.

STATEMENT OF JEFFREY J. JAMAR, CHIEF, WHITE-COLLAR CRIMES SECTION, CRIMINAL INVESTIGATIVE DIVISION, FEDERAL BUREAU OF INVESTIGATION, WASHINGTON, DC, ACCOMPANIED BY TONY ADAMSKI, CHIEF, FINANCIAL CRIMES UNIT; WILLIAM STOLHANS, ASSISTANT SPECIAL AGENT IN CHARGE OF WHITE-COLLAR CRIMES, LOS ANGELES DIVISION; AND THOMAS HUGHES, SPECIAL AGENT IN CHARGE, SAN DIEGO DIVISION

Mr. JAMAR. Thank you, Mr. Chairman.

I appreciate the opportunity to come out to your subcommittee. Before we get started, I would like to introduce the other members of the panel. Tom Hughes is the special agent in charge of our San Diego office. Mr. Tony Adamski is the Chief of the Financial Crimes Unit, which is part of the White-Collar Crimes Section in Washington. Bill Stolhans is the assistant agent in charge of our Los Angeles office, responsible for white-collar crimes.

If you are agreeable, I'll make some brief opening remarks and submit the rest of——

Mr. BARNARD. Your full testimony will be included in the record, and summarize as you would like.

Mr. JAMAR. At the time this subcommittee held hearings on this issue in Washington in 1983, there were 5,371 pending FBI investigations of bank fraud and embezzlement. By the end of 1986, the number of those investigations had risen by 35 percent to 7,286.

Reported losses from 7,811 bank fraud and embezzlement investigations which were closed during 1983, totaling $282 million rose 390 percent by the end of 1986 to $1.1 billion in 10,416 cases that were closed.

In 1983, 1,825, or 33 percent of our pending investigations involved losses in excess of $100,000—33 percent. That number rose

by 61 percent by 1986 to 2,948, or 40 percent of our total bank fraud investigations, involving cases in excess of $100,000.

In 1983, the 134, or 51 percent of our agents investigating bank matters, were assigned to matters where the loss exceeded $100,000. That number increased by 69 percent by 1986, to 226, or two-thirds of the agents.

As of February 1987, the FBI had 282 failed financial institutions under investigation.

In 1984, due in part to hearings held by your subcommittee, it was recognized that there was a need to concentrate the efforts of prosecutors, bank regulatory agencies, and law enforcement agencies to provide an effective response to this criminal problem. As a result, in December 1984, the Attorney General Interagency Bank Fraud Enforcement Working Group was formed. The purpose of the group was to attempt to more effectively address the problems of prosecutors, supervisory agents and law enforcement, and to promote cooperation, thereby improving the Federal Government's response to white-collar crime in the Nation's federally regulated financial institutions.

This group is comprised of representatives of the Department of Justice, the FBI, Comptroller of the Currency, Federal Deposit Insurance Corporation, Federal Home Loan Bank Board, the Federal Reserve, National Credit Union Administration, and the Farm Credit Administration.

This working group was tasked to identify, address, and resolve issues of major significance relating to the detection, reporting, and prosecution of bank-related crimes, focusing especially on crimes by insiders of financial institutions. As a result of their combined efforts, this group has been able to achieve the following:

Development of a new criminal referral mechanism with a comprehensive standardized form to be utilized by all bank supervisory agencies which will refer all apparent criminal violations to law enforcement authorities.

Increased contact and coordination of examination, investigative, and prosecutive efforts at the local level.

Establishment and direction of a comprehensive bank fraud investigation training program.

Establishment of computerized tracking mechanism to monitor the prosecutive response to bank fraud referrals.

The Attorney General and his Economic Crime Council elevating bank failure matters involving losses in excess of $100,000 to the highest priority in white-collar crimes program equal to defense procurement fraud, which has been for the last 2 or 3 years our No. 1 priority.

Increased emphasis on investigations and prosecution in bank fraud and embezzlement matters involving $100,000 or more.

It was the belief of the working group that improvement in the ability to better detect and refer instances of criminality was needed. These needs are being addressed by a cooperative specialized bank fraud training program for FBI agents and supervisory agency examiners. During fiscal years 1984 to 1986, 146 agency examiners received this training, and during fiscal year 1987, it is anticipated an additional 122 will be trained.

In addition, the FBI has made presentations at bank fraud training seminars for examiners sponsored by the bank supervisory agencies and the Federal Financial Institutions Examination Council.

The training of FBI agents has been reviewed to enhance their ability to address these matters. The training which is afforded to special agents investigating bank frauds, as well as that afforded to all new special agents is continually being updated and modified, in an effort to make it more useful and relevant to the investigative needs. During the 13 weeks of training of new special agents, a total of 26 hours are devoted to white-collar crime matters. Between 1984 and 1986, 1,682 new special agents received this training. It is anticipated that 750 more will receive it during fiscal year 1987.

The special agents who are assigned to investigate financial crimes and financial institution fraud include those with backgrounds or experience in business, banking, or public accounting.

In addition, specialized FBI training is afforded special agents who are assigned to investigate financial crimes matters. Since January 1985, eight basic financial crimes investigative techniques courses afforded this training to 289 agents. Two advanced financial crimes investigative techniques courses provided this training to 90 special agents. Fifty-seven special agents received training in money laundering investigations. In the fiscal years 1984 to 1986, specialized training in bank fraud investigations with an emphasis on bank failure investigations was afforded to 167 agents, and an additional 84 agents are expected to receive this training this year.

As a result of their training and experience, it is believed that FBI agents who are assigned to investigate these bank fraud and bank failure matters possess the necessary expertise to effectively investigate them.

I have furnished prepared responses to the questions raised by the committee concerning our efforts and investigations of bank fraud and embezzlement and bank failure. At this time, we would be happy to respond to any questions.

Mr. BARNARD. Thank you, Mr. Jamar.

[Mr. Jamar's prepared statement follows:]

Testimony of

Jeffrey J. Jamar

Chief, White-Collar Crimes Section

Criminal Investigative Division

Federal Bureau of Investigation

Before The

United States

House of Representatives

Subcommittee On

Commerce, Consumer and Monetary Affairs

Los Angeles, California

June 13, 1987

Thank you, Mr. Chairman. We are pleased to be able to appear before this Subcommittee on Commerce, Consumer, and Monetary Affairs to describe what the FBI has done to date nationally and in California to address the growing problems of bank fraud and embezzlement, and bank failures.

Before I make any opening remarks, I would like to introduce to you my associates who are here with me today.

Tom Hughes, Special Agent in charge of our office in San Diego; Bill Stollhans, Assistant Special Agent in charge of our Los Angeles Office, who is responsible for bank fraud matters in the Los Angeles Office; and Tony Adamski, Chief of the Financial Crimes Unit at FBI Headquarters.

At the time this subcommittee held hearings on this issue in Washington, D.C. in 1983, there were 5,371 pending FBI investigations of bank fraud and embezzlement. By the end of 1986, the number of those investigations had risen by 35% to 7,286. Reported losses from 7,811 bank fraud and embezzlement investigations which were closed during 1983 totalling $282 million rose 390% to a level of $1.1 billion in the 10,416 investigations which were closed in 1986. In 1983, 1,825, or 33% of the pending investigations involved losses in excess of $100,000. That number rose by 61% by 1986 to 2,948 or 40% of the total number of pending investigations. The 258 FBI Special Agents investigating bank fraud and embezzlement matters in 1983 rose by 30% in 1986 to 337 Special Agents. In 1983 the 134, or 51% of the Special Agents investigating those matters, were assigned to matters where the loss exceeded $100,000. That number increased by 69% in 1986 to 226, or 67% of those agents assigned to investigate bank fraud investigations.

As of February, 1987, there were 282 failed financial institutions which were under investigation by the FBI.

In 1984, due in part to hearings held by this subcommittee, it was recognized there was a need to concentrate the efforts of prosecutors, bank regulatory agencies, and law enforcement agencies to provide an effective response to this criminal problem. As a result, in December, 1984, the Attorney General's Interagency Bank Fraud Enforcement Working Group was formed. The purpose of this group was to attempt to more effectively address the problems of prosecutors, supervisory agencies and law enforcement, and to promote cooperation, thereby improving the Federal Government's response to white collar crime in the nation's federally regulated financial institutions. This group is comprised of representatives of the Department of Justice, Federal Bureau of Investigation, Comptroller of the Currency, Federal Deposit Insurance Corporation, Federal Home Loan Bank Board, Federal Reserve, National Credit Union Administration, and the Farm Credit Administration. This Working Group was tasked to identify, address, and resolve issues of major significance relating to the detection, reporting, and prosecution of bank related crimes, focusing especially on crimes by "insiders" of financial institutions. As a result of their combined efforts, this Working Group has been able to achieve the following accomplishments:

o Development of a new criminal referral mechanism with a comprehensive standardized form to be utilized by all bank supervisory agencies which will refer all apparent criminal violations to law enforcement authorities.

o Increased contact and coordination of examination, investigative, and prosecutive efforts at the local level.

o Establishment and direction of a comprehensive bank fraud investigation training program.

o Establishment of computerized tracking mechanism to monitor the prosecutive response to bank fraud referrals.

o The Attorney General and the Attorney General's Economic Crime Council's elevating bank failure matters involving losses in excess of $100,000 to the highest priority in white-collar crimes equal to defense procurement fraud.

o Increased emphasis on investigations and prosecution in bank fraud and embezzlement matters involving $100,000 loss or more.

It was the belief of the Working Group that improvement in the ability to better detect and refer instances of criminality was needed. These needs are being addressed by a cooperative specialized bank fraud training program for FBI Special Agents and supervisory agency examiners. During Fiscal years 1984 through 1986, 146 agency examiners received this training, and during Fiscal year 1987, it is anticipated an additional 122 will be trained. In addition the FBI has made presentations at bank fraud training seminars for examiners sponsored by the bank supervisory agencies and the Federal Financial Institutions Examination Council.

The training of FBI Special Agents has been reviewed to enhance their ability to address these matters. The training which is afforded to Special Agents investigating bank frauds as

well as that afforded to all new Special Agents is continually being updated and modified in an effort to make it more useful and relevant to the investigative needs. During the thirteen weeks of training of new FBI Special Agents, a total of 26 hours are devoted to White-Collar Crime matters. Between 1984 and 1986, 1,682 new Special Agents received this training. It is anticipated that 750 more will receive it during Fiscal year 1987. The Special Agents who are assigned to investigate financial crimes and financial institution fraud include those with backgrounds or experience in business, banking, or public accounting. In addition, specialized FBI training is afforded Special Agents who are assigned to investigate financial crime matters. Since January, 1985, eight basic financial crimes investigative techniques courses afforded this training to 289 Special Agents. Two advanced financial crimes investigative techniques courses provided this training to 90 Special Agents. Fifty-Seven Special Agents received training in money laundering investigations. In the Fiscal years 1984 through 1986, specialized training in bank fraud investigations with an emphasis on bank failure investigations was afforded to 267 Special Agents. An additional 84 Special Agents are expected to receive this training in Fiscal year 1987. As a result of their training, and experience it is believed the FBI Special Agents assigned to investigate these bank fraud and bank failure matters possess the necessary expertise to effectively investigate them.

THE FBI'S INVESTIGATIVE PROCESS

The FBI becomes involved in investigatons of misconduct in banks and savings and loan associations upon receipt of

allegations of criminal activity, or suspected criminal activity, which are obtained from various sources, including referrals from the victim financial institutions, the supervisory agencies, informant information, public source information, other independent law enforcement agencies, and independent FBI investigation. If the case falls within the existing prosecutive guidelines in the venue of the alleged crime and the priorities of the FBI field office involved, an investigation is initiated.

The FBI does not have a field-wide policy requiring offices to open a file when it learns an institution has failed, prior to receiving a criminal referral. However, when a financial institution does fail, contact is normally made with the supervisory agency.

SAN DIEGO DIVISION

The San Diego Division, for example, does not automatically open a file upon learning of a failed institution unless it learned of the failure in the form of a criminal referral, or information regarding criminality from other sources.

LOS ANGELES DIVISION

When information is received regarding a failed financial institution by Los Angeles, a dead file is opened which becomes a repository for information, and FBI Headquarters is advised of the failure. The FBI learns of a failure through public sources such as the news media, through liaison with the supervisory agencies, from the institution itself, or other creditable sources. Upon learning of a failure, contact and

liaison are established with the supervisory agency governing the failed institution, but active investigation regarding the failure is held in abeyance pending the receipt of any criminal referrals or information regarding criminality from the regulatory agency. The FBI does not have the resources available to initiate any other type of response to the failure until fraud is detected and reported, or a criminal referral is received.

FBI REPORTS

Upon the FBI's initiating a bank fraud and embezzlement investigation where the loss or exposure is over $100,000, and at the conclusion of those investigations an FBI Letterhead Memorandum (LHM) is prepared. The LHM is a report of investigation which is suitable for dissemination to agencies outside the FBI.

The initial LHM contains the then known details regarding the initiation of the investigation, the descriptions of all known subjects of the investigation, and a brief description of any initial investigation conducted. The final LHM contains a summary of investigation conducted and the end result of the investigation whether it be a successful prosecution, declination of prosecution by the appropriate USA, or administrative closing by the field office.

The LHMs are submitted to FBIHQ for dissemination to appropriate outside agencies. They do not include information obtained by grand jury subpoena or protected by the Right to Financial Privacy Act.

When these LHMs are received at FBI Headquarters, they are reviewed for completeness then disseminated to the Criminal Division of the Department of Justice as well as the financial institution's supervisory agency. In the case of National Banks,

the LHM is disseminated to both the Federal Deposit Insurance Corporation and the Comptroller of the Currency. If the institution is a thrift institution, a copy is furnished to the Federal Home Loan Bank Board. When the institution is a credit union, a copy is furnished to the National Credit Union Administration. When appropriate, we also disseminate to the Federal Reserve Board. This dissemination is made by us at the headquarters level of the supervisory agency involved.

An FBI Prosecutive Report is prepared in those bank fraud cases where prosecution is anticipated or the U.S. Attorney's Office has already authorized prosecution and has requested the report be prepared.

Prosecutive reports are prepared at the conclusion of the investigation, and contain a succinct summary of the case and all details of the investigation, including reports of interviews (FD-302s), investigative inserts, technical reports from the FBI Laboratory and Identification Division, arrest records, results of investigation conducted by other FBI divisions, and detailed listings of evidence obtained and witnesses. The prosecutive report is primarily prepared to aid the U.S. Attorney in preparing for prosecution. Prosecutive reports prepared in those bank fraud cases with loss or exposure over $100,000 are forwarded to FBIHQ, but are not in a form suitable for dissemination to outside agencies because of Privacy Act, Right to Financial Privacy Act provisions, as well as Rule 6E of the Federal Rules of Criminal Prodedure. Prosecutive reports are not prepared in cases where prosecution is declined.

Declinations in cases with loss or exposure over $100,000 are reported to FBIHQ via the closing LHM which is then disseminated to the Criminal Division of the Department of Justice, as well as the bank supervisory agencies involved.

The FBI prosecutive report makes no recommendations for either prosecution or declination, but merely presents the facts obtained in the investigation to the United States Attorney who renders the prosecutive decision.

The committee has requested the FBI provide responses to specific questions with regard to bank fraud and bank failure investigations in both the San Diego and Los Angeles FBI offices. The remainder of this statement will address those areas.

SIGNIFICANT INVESTIGATIONS

LOS ANGELES DIVISION

At this time, the Los Angeles FBI Division has pending investigations which involve fraudulent misconduct in financial institutions at a level of loss as follows:

Loss Between $100,000 and $250,000 - 133 investigations

Loss $250,000 and above - 143 investigations

It should be noted that these totals are only for Bank Fraud and Embezzlement cases (including bank failures), and do not include those Interstate Transportation of Stolen Property, Fraud by Wire, or other investigations within the FBI's jurisdiction where a financial institution was victimized.

Criminal referrals in the 133 cases where the loss was $100,000 to $250,000 were made in 78 of those matters by the victim institution. The FDIC referred 25 of those investigations. None were referred by FSLIC. The Comptroller of

the Currency referred one case, and the FHLBB referred three investigations. Referrals were made by third parties in 12 investigations. Other FBI sources referred 7 investigations, and another 7 investigations were initiated by the FBI itself as a result of investigations in other matters.

In the 143 Los Angeles investigations involving losses over $250,000, 95 were referred by the victim institution. The FDIC referred 12 investigations and the FSLIC, two investigations. The Comptroller of the Currency referred 6 investigations and the FHLBB, 5 investigations. Third parties referred 8 investigations. Other FBI sources referred 4 investigations, and the FBI itself initiated 11 investigations as a result of investigations in other matters.

SAN DIEGO DIVISION

In the San Diego FBI Division, there are 9 open investigations of fraudulent misconduct in or against financial institutions wherein the loss is between $100,000 and $250,000. Two of those investigations were referred by the financial institution itself. Three were referred to the FBI by the bank supervisory agency (1-FDIC, 1-FHLBB, 1-COC). No investigations were referred by the FSLIC or FDIC Fee Counsel. Two were initiated by FBI confidential sources. One was referred by the San Diego District Attorney's Office. The last investigation was initiated based on a newspaper article regarding alleged criminality at the financial institution.

In the San Diego FBI Division, there are 9 pending investigations of fraudulent misconduct in or against financial institutions wherein the loss exceeds $250,000. Six of these

matters were referred by the victim bank, and one was referred by the supervisory agency. No referrals were received from the FDIC or FSLIC Fee Counsel. Two other referrals were received from the United States Attorney. One investigations was initiated by the FBI itself as a result of information developed in other investigations.

The San Diego FBI Division has defined major or significant bank fraud investigations within its territory as those bank frauds or bank failures which (A) involve a loss over $100,000 or (B) involve a loss between $25,000 and $99,000. The first group involves 12 Commercial Banks, 6 Savings and Loans, and 2 Federal Credit Unions.

In the San Diego Division, financial institution fraud cases amounting to losses equal to or in excess of $100,000 are considered a #1 priority within the Financial Crimes subprogram, which is the 3rd priority within the WCC program. Government Fraud and Public Corruption have recently been delineated as the #1 and #2 priorities of the WCC Squad.

LOS ANGELES DIVISION

The Los Angeles Division has defined major or significant bank fraud investigations within its territory as involving financial institutions as those where the amount involved is $250,000 and above, or the investigation involves a high ranking official of the financial institution. Los Angeles has 143 such investigations currently under investigation, with 102 involving commercial banks, 41 involving savings and loans, and two involving credit unions.

Bank Fraud and Embezzlement cases in the Los Angeles Division have been elevated to the top priority within the White Collar Crime Division. These cases, involving $250,000 or more are given the highest priority.

FBI investigations in both Los Angeles and San Diego include many arising out of financial institutions which have failed.

The following is a list of financial institutions within the Los Angeles Division which have failed, and for which there is a pending investigation:

Western National Bank
San Marino Savings and Loan
Hacienda Federal Savings
Heritage Bank
West Coast Bank
Beverly Hills Savings
First City Bank
Commercial Bank of California
Butterfield Savings
American Diversified Savings
Valencia Bank
West Valley Bank
Consolidated Savings
Independent National Bank
North American Savings
Perpetual Savings Bank
South Bay Savings

The following is a listing of failed financial institutions within the Los Angeles Division for which there is no active investigation due, either to the lack of a criminal referrals in 9 instances, in two instances where attention is being given to higher priority matters, and the statute of limitations having expired in the last instance:

Newport Harbor Bank
Bank of Irvine
Garden Grove Community Bank
Southern California Savings
Capistrano National Bank
Manhattan Beach Savings
Center National Bank
Saddleback Valley Bank
Orange Coast Thrift and Loan
Ramona Savings and Loan
Unified Savings Bank
New City Bank

The following is a list of the failed financial institutions within the San Diego FBI Division:

Central Savings and Loan
Sun Savings and Loan
Seapoint Savings and Loan
California Heritage Bank
Frontier National Bank

No criminal referrals were received by the San Diego FBI from either the FSLIC or the FDIC regarding any of these failed institutions.

An FBI investigation was initiated by the San Diego FBI based on confidential information received regarding criminality at Sun S&L which failed. As a result of that investigation, one borrower has pled guilty and another was convicted. This investigation is still underway.

PROSECUTIVE GUIDELINES

Currently, the Los Angeles Division has an agreement with the U.S. Attorney's Office regarding matters which are automatically declined with no presentation of the facts to an Assistant United States Attorney (AUSA). This policy was established because of manpower limitations in the U.S. Attorney's Office and in the Los Angeles FBI Division. Currently, any matter where the loss is less than $25,000, and

the suspected person involved does not hold a position of responsibility in the financial institution or has not been identified in a previous fraud or embezzlement at another financial institution, is automatically declined.

Those criminal referrals in Los Angeles, wherein the loss or exposure is between $25,000 and $99,999, are evaluated and only those matters having potential prosecutive merit are opened and investigated. Those having no apparent prosecutive merit are not investigated and are placed into an unaddressed control file to be opened for investigation only if and when manpower resources become available.

All matters in Los Angeles with a loss or exposure of $100,000 and above are opened and assigned for investigation. These matters with a loss or exposure of $250,000 and above, have been given the highest priority in matters involving financial institutions.

SAN DIEGO DIVISION

In the San Diego Division, all matters involving losses equal to, or in excess of $25,000 are considered priority matters and will be pursued. Size of the loss and impact on community would certainly heighten the priority with which a case is investigated, so also potential destruction of records and availability of witnesses.

Absent unusual circumstances, the U.S. Attorney's Office, Southern District of California, will decline prosecution of matters where the subject(s) are unknown and the loss does not exceed $25,000. Accordingly, the FBI does not investigate these matters.

No known subject matters are declined based solely on the amount of loss.

All known subject matters are immediately referred by the FBI to U.S. Attorney's Office for prosecutive opinion.

San Diego currently operates a Fast Track Program (FTP) in conjunction with the U.S. Attorney's Office to quickly prosecute BF&E matters, particularly as they relate to bank or savings and loan employees.

If the amount embezzled does not exceed $25,000, the Assistant U.S. Attorney (AUSA) will work directly with the victim institution and the Grand Jury to obtain the necessary evidence, with FBI investigative support as necessary.

When an AUSA authorizes prosecution, a complaint is filed. If the loss is less than $100.00, a misdemeanor is charged. If the loss is between $100.00 and $2,500.00, the AUSA will charge a misdemeanor and a felony with expectation that subject will plead to the misdemeanor.

Losses exceeding $25,000 are prosecuted as straight felonies with the appropriate full investigative support of the FBI.

In addition to size of the loss, certainly prior similar acts as well as position of the subject, influence the approach to prosecution and investigation on a case by case basis.

PROSECUTIVE EFFECTIVENESS

LOS ANGELES

In the Los Angeles U.S. Attorney's Office, all major bank fraud matters are assigned to the Major Fraud Section and

are assigned to experienced AUSAs with expertise in working fraud matters. This unit is also handicapped by a lack of personnel resources. Bank Frauds with losses under $250,000 are assigned to the Criminal Complaints Section of the Los Angeles U.S. Attorney's Office, which is designed to handle immediate situations such as complaints, arrests, search warrants, filing of affidavits, and initial appearances before U.S. Magistrates.

The Fast Track Program in San Diego is highly successful and a vastly improved method of handling the large volume of relatively small bank fraud and embezzlement matters which might otherwise remain unaddressed. Its success is largely due to coordination with the U.S. Attorney's Office whereby the prosecution process was streamlined to efficiently use the limited investigative resources.

Recognizing the volume of criminal fraud matters and the availability of resources, the FBI has no recommendation for improvement in the U.S. Attorney's Office in either Los Angeles or San Diego.

COMPLEXITY OF INVESTIGATIONS

Bank fraud matters usually require a substantial review of documents and lengthy technical interviews, relating to bank policies and procedures. Within the past few years, the amount of losses in bank fraud matters has increased drastically with a commensurate increase in the complexity of the investigation required. The number of major cases has also increased substantially, with the highest percentage of increases falling in the area of million dollar losses and bank failures. There

has also been a significant increase in those cases involving bank officers and executives. The time required to investigate and prosecute those cases involving large losses, complex schemes, substantial document review, and bank executives, who typically hire top level legal representation for their defense, is dramatically longer than the typical teller defalcation case.

In addition, because of the complexities involved, the investigators in these cases need a definite expertise that can only be acquired through education, training, or experience.

The investigators and prosecutors of these complex financial crimes matters must seek a balance between presenting a case in enough detail to substantiate the charges, yet still make it understandable to a jury.

FBI RESOURCES AVAILABLE FOR BANK FRAUD
AND BANK FAILURE INVESTIGATIONS
LOS ANGELES DIVISION

The FBI measures its investigative resources in terms of Direct Agent Work Years (DAWYs). A DAWY is the full year's efforts of one Special Agent which can be devoted to an investigation, absent any administrative time. For the Fiscal Year (FY) ending September 30, 1985, the Los Angeles FBI Division expended 74.7 DAWYs on White-Collar Crime matters. Of that amount, 18.15 DAWYs were expended on Bank Fraud and Embezzlement (BF&E) matters and 33.82 DAWYs on other financial fraud matters.

During the FY ending September 30, 1986, the Los Angeles Division expended 77.5 DAWYs on WCC efforts. BF&E efforts amounted to 18.95 DAWYs and other financial fraud matters addressed by 33.17 DAWYs.

For the first half of the present FY ending March 31, 1987, the WCC efforts (when annualized) amount to 77.08 DAWYs. The BF&E DAWYs (annualized) are at the 21.28 DAWY level, with other financial fraud investigation amounting to 33.16 DAWYs.

Currently, there are ten vacancies in the White Collar Division of the Los Angeles Division. Due to the growing white-collar crime and other criminal problems, the investigative priorities of the Los Angeles Division are constantly reassessed. Based on these priorities the Special Agents are assigned to the highest priority matters.

The limited FBI agent resources and the myriad of criminal problems in Los Angeles has impacted on the investigation of persons involved with certain failed financial institutions. The cases involving losses over $100,000 and the bank failures receive high investigative priority in the Los Angeles Division, but have to be addressed in addition to the high volume of other major criminal matters.

SAN DIEGO DIVISION

In the San Diego Division, in June, 1985, there were 15 Special Agents assigned to WCC efforts. In June, 1986, and also at the present time, there are 14 Special Agents assigned to WCC efforts.

The ranking of the National priorities of the FBI in the WCC Program are (1) Governmental Fraud, (2) Public Corruption, and (3) Financial Crimes, with Defense Procurement Fraud and Bank Failure Fraud where losses exceed $100,000 as equal number one priorities. These are also the priorities of the San Diego Division. At the present time, the San Diego FBI Division has adequate resources and will continue

to address bank fraud and bank failure problems as priority matters. If increases in bank fraud criminal referrals are experienced, it will become necessary to reassess the adequacy of those available resources.

For the Fiscal year (FY) ending September 30, 1985, the San Diego FBI Division expended 12.6 Direct Agent Work Years (DAWYs) on White-Collar Crime (WCC) matters. Of that amount, 2.4 DAWYs were expended on Bank Fraud and Embezzlement (BF&E) matters, and 6.1 DAWYs on other fraud matters.

During the FY ending September 30, 1986, the San Diego Division expended 11.8 DAWYs on WCC matters. BF&E efforts amounted to 3.6 DAWYs, and other fraud matters were addressed by 5.2 DAWYs.

For the first half of the present FY ending March 31, 1987, the San Diego WCC efforts (when annualized) amount to 7.5 DAWYs. The BF&E DAWYs (annualized) are at the 2.3 DAWY level, with other fraud being addressed with 3.0 DAWYs (annualized).

There are currently two vacancies in the San Diego Division; one supervisory position, and one Special Agent position. An experienced supervisory agent in San Diego, who handled bank fraud cases was promoted and transferred to FBI Headquarters in September, 1986. His successor was promoted from within the ranks of the WCC Squad, retired from the FBI in May, 1987. A replacement Supervisor has been selected for San Diego. The Special Agent position is scheduled to be filled in late July, 1987, with an SA accountant who is presently under transfer. Transfer funds are available for those transfers.

In the San Diego Division, agent manpower allocations have neither delayed nor negatively impacted the investigations in matters pertaining to either Sun Savings or Seapoint Savings and Loan.

The personnel resources of the FBI are constantly being reassessed to address investigative needs as priorities dictate. The FBI has made major personnel commitments to bank fraud and bank failure investigations throughout the country.

FINANCIAL INSTITUTION'S EXAMINATION AND REFERRALS

Banking agency examiners detect and report few cases involving insider abuse and criminal misconduct when compared with those detected and reported by the victim financial institutions themselves. When the examiners do make a referral, the referral usually contains sufficient and objective information.

Referrals are usually delayed due to the length of time necessary to conduct the examination and prepare a report of the findings. The problems of better detection and referral have been addressed by the development of the cooperative specialized bank fraud training program for both FBI Special Agents and supervisory agency examiners.

LOS ANGELES DIVISION

In 1985, the Mitsubishi Bank of California did not make a criminal referral in a $5 million fraud case to either the FBI or the United States Attorney in Los Angeles. The case was later addressed by the Los Angeles District Attorney's Office at a time long after the individuals suspected of the fraud had fled, making prosecution difficult if not impossible. A prompt

referral of suspected criminality to the FBI could have allowed timely investigation and reduced the time available for the subjects to flee to avoid prosecution.

SAN DIEGO DIVISION

The experience of the San Diego Office is that banking agencies (FDIC/FSLIC) generally detect and report criminal misconduct in financial institutions within San Diego's jurisdiction in a timely fashion. The reports have provided sufficient, albeit minimal, information to initiate investigations. The limited information furnished is viewed as a direct result of the Right to Financial Privacy Act (RFPA).

Problems encountered by FBI agents are usually related to the timeliness of records provided, again the result of RFPA. A solution would be complete and immediate disclosure when the institution is the potential victim.

Other problem areas have included those situations where unusual or suspicious activity on the part of bank personnel (or loan problems) are detected by examiners, but not reported until, or unless, the examiner is convinced criminal activity has occurred. Since examinations occur only about once a year, these problem areas may go unreported until years after the fact.

Easier access to both examination reports and the examiner most knowledgeable in the area of the reports would be of great assistance, particularly in an office such as San Diego where neither the FDIC or FSLIC maintain offices.

Detection and reporting of insider and major borrower criminal misconduct varies from institution to institution. The major financial institutions for the most part appear to adequately detect and report criminal activity. Smaller and/or independent banks and savings and loans occasionally have to be reminded of reporting requirements.

The referrals sometimes appear to depend on the relative position of the bank insider or the financial status of the customer. Bank employees may be more reluctant to report suspicious activities of a bank president, for example, as opposed to a teller.

There have also been instances where financial institutions have been reluctant to report criminal misconduct, or even to assist in the investigation. In these instances, the institutions may have acted under the belief (often mistaken) that they would recover their loss.

Institutions may also be reluctant to report information which may institute an FBI investigation and adversely affect the reputation of the bank, its officers, or its employees.

Based on past experience, it would appear that financial institutions should continue to submit referrals of criminal misconduct to both the FBI and the appropriate banking agency (FSLIC/FDIC) simultaneously, advising each of their actions. This allows the banking agencies to monitor the referral process and permits the FBI to address the referral in a prompt and timely manner.

When fee counsel is assigned to a financial institution failure, they conduct their examination, which in some instances has taken as long as one year. During the course of that examination, or at the completion of the examination, referrals of criminal activity or suspected criminal activity are made to the United States Attorney and/or the FBI. These referrals represent the legal predication for the initiation of an FBI investigation. It is viewed by the FBI as imperative that all criminal activity discovered by examiners be referred to enable the FBI to carry out its investigative responsibilities. In ongoing complex investigations such as Beverly Hills S&L, referrals enable the FBI to efficiently focus its limited resources on specific activity or transactions in the incompleted portions of the investigation.

The FBI's experience is that in some failures, fee counsel have made timely and adequate referrals while in other instances they have not.

Coordination and assistance between the FSLIC, FDIC and the FBI has improved through the efforts of the Bank Fraud Working Group. Previously, problems were encountered when the regulators would not provide information regarding any criminal activity because of perceived Right to Financial Privacy Act restrictions. In addition, at times problems were encountered in obtaining information and documentation regarding a criminal referral even pursuant to a Federal Grand Jury subpoena.

It is preferable for appropriate banking agencies to refer any criminal misconduct uncovered while examinations are still underway rather than waiting until the institution is actually closed (or afterwards). This facilitates the investigative process by allowing FBI agents to interview examiners and/or institution employees while they are still available and while the records are still both accessible and available for review by both the examiner and the FBI agents. This is especially important in San Diego where no FSLIC/FDIC office exists.

RIGHT TO FINANCIAL PRIVACY ACT

The Right to Financial Privacy Act has created substantial problems and delays in investigating bank fraud cases. Most bankers are not aware of the specific details of the provisions of the Act and rely on instructions from their legal departments. Problems arise when there is confusion between the provisions of the Federal Right to Financial Privacy Act and the provisions of the California Financial Privacy Act.

Problems occur when circumstances make it necessary to expeditiously obtain financial records or information covered by the Act in order to support an affidavit for an arrest warrant or a search warrant. At times, delays are experienced in obtaining Grand Jury subpoenas and the time required for the documentation to be returned to the Grand Jury and used for investigative purposes. At times, these delays can be critical when trying to obtain an arrest warrant, recover assets or obtain evidence.

Normally, when the financial institution is the victim of the crime, obtaining the financial information pursuant to a Grand Jury subpoena presents no problems. Some financial institutions have instituted requirements that the customer, whose account is being subpoenaed, be notified of the subpoena. They they require a two week wait in order for the customer to be notified and given time to protest the subpoena. This has occurred even in situations where the financial institution has been the victim and the customer is the subject of the investigation and for whom an arrest warrant had been issued. Other financial institutions have requested a grand jury subpoena be issued for documents or records not covered by the Right to Financial Privacy Act. Some institutions have made this demand even after they have been the victim of the fraud.

The investigations of complex bank fraud cases involving large sums of money and many different financial institutions, obtaining and tracing the necessary documentary evidence through these accounts is very time consuming. These factors, and the need to obtain Grand Jury subpoenas prior to the financial institutions providing documents as well as insuring these documents are returned to the Grand Jury, add significantly to the investigative burden of the agent, and to the time required to complete the investigation. These would not be significant problems if each FBI Special Agent was only responsible for a few investigations. However, when the agent is responsible for investigations of several major bank fraud cases,

as well as many other cases, which all require Grand Jury subpoenas due to the Financial Privacy Act, the workload of that Special Agent is increased by tracking of all these subpoenas which have been served.

Another problem occurs when it becomes necessary to have investigation conducted by another agency or in a foreign country. In order for the other agency or the foreign investigator to conduct the investigation, it is necessary to provide background information regarding the case. When this background information is account information obtained by Grand Jury subpoena, the secrecy provisions of the Grand Jury governs, and the information cannot be disseminated. There are ways to resolve this situation, but it results in more time being required for the case agent to complete the investigation.

Although these investigative problems are not insurmountable, when taken together, they create obstacles which add to a burdensome caseload for the agents.

CONCLUSION

The massive investigative problems created by bank fraud and bank failure are fully recognized by the FBI. Those problems have been addressed by revised training programs, greater coordination with financial institution supervisory agencies, increased manpower commitments nationwide, and higher prioritization of large bank losses and failures. Many of these approaches are still evolving, and will continue commensurate with the crime problem. The task at hand is not an easy one nor are there quick solutions. It is the continued coordination efforts of all which are needed if these problems are to be effectively addressed, and the FBI is committed to that goal.

Mr. BARNARD. Mr. Jamar, I think that's a very impressive report as to what has been done since this matter has become somewhat of an important subject, not only to this committee, but to the Congress.

It appears from the testimony today and from the FBI's statistics that, because of the activities in the criminal fraud area in the years of 1984, 1985, and 1986, we have a preponderance of cases at this particular time, which we probably will not have in the future, hopefully, because of the beefing up of savings and loan and bank examination forces.

Would it be appropriate to say that we have such a situation that it needs, at least by the—well, for the next several years, in order to complete this prosecution effort—would it be appropriate to set up a task force within the FBI to better handle the emergency that seems to be existing right today?

Mr. JAMAR. Well, we allocate our resources and concentrate agents that have the experience in these cases in the special areas, the States you've talked about: California, Louisiana, Oklahoma, Texas; and what we do, we take the agents we have and concentrate them in those areas, from within if we can. Transfer of agents is tremendously expensive, as you know.

So what has happened in those offices, they sit down and they are forced to review their priorities, not only the priorities of the whole field office but the priorities in white-collar crime. Some offices are fully occupied with white-collar crime assignments, and will concentrate on these types of cases. Others have other criminal priorities that they cannot pull all the agents away from.

So, when you call it "task force," I think we do that, Mr. Chairman. It's just that we concentrate our agents in a matter; we try to get from the beginning of the case, the U.S. attorney's side. We work hand-in-hand from the beginning.

Mr. BARNARD. Mr. Stolhans, what is your appraisal of the Los Angeles office, especially in considering the tremendous number of cases that have developed in the central district? Do you feel like your staff is adequate?

Mr. STOLLHANS. Mr. Chairman, I would address the answer to that question in two parts.

The first part is what is the experience factor of the agents in the individual abilities to work this specific type of financial fraud? I think without question, as Mr. Bonner said previously, Los Angeles FBI has the very best bank fraud investigators in the entire United States. I know one agent particularly that has 17 years of experience investigating bank fraud here in Los Angeles, and there are many others that are just a little bit short of that kind of experience. These are usually accountants. Some of them are former CPA's or CPA's; and I think from an experience level, we have got the best that the FBI has to offer.

From a numbers question, that would probably be something that I would have to say that, based upon the workload, that certainly I could use some more agents in this area. I have been talking to Jeff Jamar's section; Jeff has supported us in this area, and we expect an enhancement the next time we get agents, which will be at the beginning of the fiscal year.

Mr. BARNARD. You know, I wouldn't dispute the standpoint of the quality of the agents in the Los Angeles area. Let's take that Bank of America case itself.

Mr. STOLLHANS. Yes, sir.

Mr. BARNARD. Which involves activities in the secondary mortgage market. It looks like to me that you would need additional experienced people to come in and help you with a case like that.

Mr. STOLLHANS. Well, I think you have got to look at a case like that, which, first of all, is not a routine case. That is certainly an exceptional case, and the way we work that, was, first of all, that is one of the few cases that has multiple FBI agents on it—we have six agents on that case, and have had six agents for at least 1½ years that I can recall. In addition to FBI agents, that is more or less a task-force-type case, because we have used other agency investigators and auditors, and so the real strength of that investigation is you're talking 12 to 14 people.

I don't think, even though this is a very, very complex and large-dollar, and multitransaction type case, I don't think you can hit on any case much more than 12, 14 investigators and auditors. In other words, I don't think that we can get our prosecutions any quicker or any additional prosecutions if we hit that with 30 or 40 people. There's a point that managing those big ones, I think, is counterproductive.

Mr. BARNARD. Well, now, are you saying, then, that the agent to fill the vacancies that you have in the—the 10 vacancies in the White-Collar Division of the Los Angeles FBI, you really don't need them?

Mr. STOLLHANS. No, I wouldn't say that.

And, of course, talk about vacancies in any program here in the FBI, or any other office, when I talked to Mr. McSpadden a couple of months ago, I did, in fact, have—I believe there were 9 or 10 vacancies at that point, and right now I've got 10 vacancies, which, although that sounds static, it's not a static picture.

I've had people transferred in, since I talked to Mr. McSpadden. I've had one agent resign; I've had one agent going on maternity leave. This is a constantly changing thing. Most recently, and this is why I'm getting more and more optimistic, last week, I was telephonically advised that our headquarters had cut orders for six additional agents, in addition to these six transfers in. My boss, Rich Bretsing, who runs the entire office, has recently instructed that we take a look at the agents that have accounting backgrounds and white-collar crime experience in the LA office who are no longer assigned to white-collar matters, and we have, in fact, identified 12 of those, and we are now evaluating which of those 12, if not all of them, to bring back to and assign white-collar crime.

So, I am optimistic that my vacancies, although I think literally as of tonight, I think it's nine, I believe that I am very optimistic that I'll have most of these filled in the very near future.

Mr. BARNARD. Mr. Jamar, U.S. Attorney Bonner's testimony of this morning stated that it would be helpful to have the FBI periodically meet with examiners to discuss the types of bank fraud prevalent in a given district, any frauds below certain patterns and experienced agents and examiners could exchange information

which would assist examiners in identifying the badges of fraud. What are your views on this in a local level?

Mr. JAMAR. It's done.

Mr. BARNARD. Is it successful?

Mr. JAMAR. It's fundamental procedure. That's one of the pluses that has come out of the working group, is better communication with the supervising agencies. We encourage our offices to establish very close liaison with the local office. I think, in California, the Bank Board is up in San Francisco. They are very important. We work very close together, and we take the time to try to educate them, for them to look for what we need, and the type of cases that we can address. That's being done now, across the country.

Mr. BARNARD. Do you also work with the U.S. attorneys in that regard, as well?

Mr. JAMAR. Yes, Mr. Chairman. We encourage, as I said earlier, that we lock in with the assistant U.S. attorney, at the very beginning of the case. We investigate cases to obtain prosecution, and we don't want to waste our time on cases that don't have prosecutive possibilities,-and so we prefer the ideal situation: Agents and assistant U.S. attorneys working hand in hand from the outset.

Mr. BARNARD. Mr. Stollhans, how would you evaluate the quality of referrals that you are getting in your office these days? Are they better than they have been, the referrals from the five Federal banking agencies?

Mr. STOLLHANS. Yes. I think the answer is, first of all, the consistency of what we're getting is very, very helpful, and therefore I think not only is it consistent, but because they are all trying—there's an understanding as to what's the minimum threshold for information we need to predicate a criminal investigation, and that is being, consistently being put in the referral forums. I think it is definitely an improvement.

Mr. BARNARD. Mr. Stollhans, you listed 12 failed institutions as to which there is no active investigation, often because there is no referral. I would like you first, if you would, to identify the two institutions as to which there is no active investigation because a priority is given to higher matters, and explain what that means.

Mr. STOLLHANS. As far as the individual banks and investigations, I would be glad to follow up, and pull those files and get that information to you.

I think there are a couple of areas, though, that do come to mind. First of all, on a failed institution, where then there is a criminal referral of an activity that has passed the statute of limitations, if that on the surface is what the information we get at the beginning and because of the priorities that we are faced with right now, there is probably going to be nothing done on that investigation. That is not to say that if somebody had the time to go through a lot of records, that there couldn't be something brought out where there would be other criminal referrals within the statute of limitations, but if, on the surface, there isn't anything in the statute of limitations, then we are not going to predicate an investigation.

Mr. BARNARD. Do you use a threshold standard, when there is a referral, do you use any standard, such as that enumerated by Mr. Bonner, as far as a dollar amount is concerned?

Mr. STOLLHANS. On the practical level, I could give you a rough estimate. In Los Angeles—and you've got to realize, if you are talking about the full universe of referrals going down to the $500 mysterious disappearance. We get over 100 of these every month, sometimes over 200, but there's a lot of those that fall in that category in this district; they'll never be prosecuted, and there will be no entertainment of prosecution.

But, of the ones that we do get, and we have to make a decision. If it falls over $100,000, then that case is going to be open and assigned. Now, with 270-some-odd cases falling in that general category, and with approximately 30 FBI agents working those cases, they may not get immediate attention, and I'm not trying to deceive you on it.

However, there is full expectation, as time becomes available, we can look into those cases, and if they are prosecutable, they will be pursued.

If you are talking about below $100,000, a decision has to be made, first of all, and this falls into that range that we really don't have too many to address any of those cases under $100,000. If it is a case where there is a known subject and a very good expectation that I can put minimal investigative hours in that case and it will result in prosecution, that case will be opened and assigned. If there is very little doubt that I can do that—in other words, it might take a lot of investigation; there simply is nobody left to go around, those cases, though, are under the $100,000.

Mr. BARNARD. Isn't there a requirement in the law—at least I know that there is a place on the bank examination form that asks the bank whether or not it has made a criminal referral to the FBI, having to do with any violation of Federal law? Also, do you get many referrals from banks themselves?

Mr. STOLLHANS. I believe the statistical data we gave in the statement—and we did a whole followthrough to determine this—was that over 65 percent of the cases that we open were predicated by direct referral from the victim institution.

Mr. BARNARD. By banking institutions?

Mr. STOLLHANS. By the bank itself.

Mr. BARNARD. By the bank itself.

Mr. Hughes, let me ask you this question: This has to do with the testimony of Mr. Rose—I don't know whether you were here when he testified; but he indicated that there was an FBI transfer policy, a policy within the FBI which removes experienced bank fraud agents, in effect, and replaces them with inexperienced agents and white-collar crime supervisors. In your area, San Diego, do you find that—has this taken place? Do you know?

Mr. HUGHES. I think what Mr. Rose was referring to was a transfer program that was established maybe 3 or 4 years ago, called the 10/1/69 program. The program was initiated because they looked at the 59 field offices, showed that in our larger offices where the more complex work was being sustained, that the agent's staffing level, the experience of the agent's staffing level was very low. In the smaller offices where there is less complex work, the experience level was very high. The purpose of the transfer policy across the board in the Bureau that was instituted was to move the experienced agents where the most difficult work was.

Mr. BARNARD. Did that transfer policy impact on you in San Diego as to timely and effective investigations?

Mr. HUGHES. It impacted on San Diego in that, yes, a number of the not particularly inclined to the white-collar crime program itself, across the board, experienced agents were transferred from San Diego to larger offices. The San Diego office is a building office—in other words, our agent complement has been increasing significantly in the last 4 to 5 years, and the agents who are then replacing those that were transferred, the experienced agents, were new agents, and the increased staffing is with new agents. Our staffing level is about 50 percent agents coming right out of training school.

Now, we have addressed this problem with the Administrative Services Division, and have somewhat of an understanding that, yes, we are getting a high proportion of new agents, but we are going to be able to keep them longer.

Our target staffing level—we are right up close to our target staffing level, as far as agents on board.

Mr. BARNARD. Mr. Jamar, I probably covered this in a previous question, but possibly I didn't, so let me put it to you in this way. As far as the FBI's policy of transferring agents is concerned, the question is, couldn't there be an exception made in areas like central California and Texas at this particular time, as we seem to particularly need experienced agents here and there?

Mr. JAMAR. In the Dallas office, all transfers were frozen from Dallas.

Mr. BARNARD. I beg your pardon?

Mr. JAMAR. All transfers in Dallas were frozen. There are no transfers from Dallas.

The transfers are—sometimes it's the timing of them. I think the 10/1/69 program's, and, in fact, it's over. If an agent is involved in a very complex case, one thing he'd understand, we send the younger agents out of training school to a medium-small office for seasoning, and then they are transferred to a major office. That is the point that Mr. Hughes just made, that that is being slowed, because of money, more than anything else. And if an agent is involved in a very complex case, the office asks for an extension, and, say, he is due for rotation, say, he's been there 3 years—they ask for an extension and normally they are extended.

Somehow there has to be a balance. Let's say that the agent's going to be used in an undercover operation, has unique capabilities, say he has a family problem. You balance those interests and in 98 percent of the time it's balanced in favor of the investigation; that's our business.

Mr. BARNARD. So, you would say that you are mindful that they have a high workload in California and Texas?

Mr. JAMAR. Absolutely.

Mr. BARNARD. Mr. Bustamante.

Mr. BUSTAMANTE. I have no questions.

Mr. BARNARD. Mr. Martinez.

Mr. MARTINEZ. No questions.

Mr. BARNARD. Are you sure you haven't got a question?

Mr. MARTINEZ. No.

Mr. BARNARD. I think the hour has taken its toll, gentlemen. I don't mean to prolong this hearing any longer than we need to but, of course, there could not be a doubt in anybody's mind, who has been here today, that we still have a very serious problem in prosecuting bank insider and affiliated outsider crime.

What do you think that the FBI would suggest that we need to do to help the situation? I mean, do we need to enforce the laws in any respect? I hope that you will agree that, in spite of Gramm-Rudman, that FBI could use some additional experienced agents, at least——

Mr. JAMAR. The FBI can always use more agents. We have a lot more than we can do in almost every field.

Mr. BARNARD. Well, I know what you've got to do, in the area of the drug traffic and from what I can see. I know that's so in the area of the national security of our country, and I guess sometimes, when you see all of the things that the FBI does, to improve the security of our country, that bank and thrift fraud may not take as high a priority, but on the other hand, of course, there is a great temptation for people to take advantage of the situation.

Mr. JAMAR. It is a very high priority, Mr. Chairman.

I think that one thing that's happened, in 1986, in particular, we finally got to the point where we are using all our available white-collar resources. When we got narcotics jurisdiction in 1982, there was a diversion of a lot of resources from other programs. White-collar crime is the biggest criminal program. About 20 percent of the FBI resources. A lot of these agents were diverted toward narcotics.

In 1986 we have turned them back; we've got them working on white-collar crime. The white-collar crime priorities are very strict, and we can enforce them as best we can. But our SAC's have the option to put the agents where they think they are needed at the time, but they probably will stress enough, in bank fraud cases involving losses in excess of $100,000 are equal to the highest priority within the white-collar crime program.

Mr. BARNARD. I would like to address this in a separate letter, not here today, but I would like for you all to give us some good suggestions, we want suggestions from the U.S. attorneys, but we would like to have some suggestions from the FBI, as to how we need to strengthen the laws. You take, for example, the money laundering bill last year, we were able to put in amendments which strengthened the Right to Financial Privacy Act and the Change in Bank/Thrift Control Acts. You know, here we were sitting with an act [the REPA] whereby there was insider abuse and insider crime, and we could not get the records to prosecute the man who is holding the records, you know.

But those are the kind of things that I think that we need to determine, in light of what's going on today.

Mr. JAMAR. Well, your previous hearings, I don't think there is any question, helped amend bank fraud statutes and other fraud statutes, which has greatly enhanced the ability to prosecute insiders. I think the proof, double proof has changed, and I don't think there is any question about it, and we'll be happy to furnish you any suggestion that we are able to.

Mr. BUSTAMANTE. Mr. Stollhans, what is the budget more or less for the LA office of the FBI?

Mr. STOLLHANS. The budget in terms of dollars?

Mr. BUSTAMANTE. In terms of dollars.

Mr. STOLLHANS. I don't know that figure in dollars. You mean of the whole operation. I can only give it to you separately, I don't know.

Mr. BARNARD. We keep that secret.

Mr. JAMAR. But our agents—the white-collar crime in Los Angeles is 90—90 agents.

Mr. BARNARD. I would say this, though, we would be able to—we could pretty well pay for all the expenses of the FBI in Los Angeles if we could collect some of these losses.

Mr. JAMAR. Yes, sir.

Mr. BARNARD. Mr. Martinez.

Mr. MARTINEZ. Let me ask a question because, you know, as we sit and listen to all this testimony, we conjure up images in our head, and ideas. One that has been running through my head constantly is how important is this to those agencies that are charged with the responsibility of correcting the problem that exists here?

And the thing that I kept thinking about from previous testimony is the one guy got 18 years, and the gentlemen said his name was Bagha—I thought he said Bagha. I said, "There it goes again. Poor Hispanic, he gets 18 years, the other guy gets 2 months, you know." But it turned out it was Indian or something.

But what I also thought about at that same time is the guy that comes in and holds up a bank. They've got these pictures in the camera department—they've got a good picture of it—and maybe he's hit four or five banks, and maybe got a couple of thousand dollars at each bank. So he's got maybe $8,000, $12,000. You know, this is not the amount of money these white-collar criminals are ripping off. This is in a much more devious way, because they were entrusted. It seems like with those pictures of bank robbers, law enforcement really goes to work, and maybe it's a simpler case, I don't know—he goes to work and all of a sudden finds out where this guy is and who he is and they got him in custody, and they prosecute him, and the guy is off to jail for a good number of years.

Mr. JAMAR. There is no question; that's a simpler case, much simpler.

Mr. HUGHES. The point there is that that fellow has a gun in his hand, and he poses a personal threat to the people in the bank. He poses a personal threat to any other bank that he goes to. He poses a threat to the general community, a physical threat, and when something like that goes down, particularly if you have increased violence about the bank, yes, an SAC is going to put the push on to get that fellow off the streets.

Mr. MARTINEZ. Now, that sounds big. But the thing you have to understand is that a person who takes his life savings to a thrift is stuck if that thrift goes under because of fraud. You know, that could be a personal hazard to him too, because that guy all of a sudden he is in a situation where he's really desperate and needs that money, and he's got nobody else to turn to, he may take, pick up himself, and inflict on himself harm.

Mr. HUGHES. It doesn't decrease the priority of the crime itself. What it does affect is how you approach the solution to the crime. That's where, as Mr. Stollhans has mentioned, it is a constant juggling process, day in and day out with the personnel, the agents that you have assigned to you, in an office. If you have major rush of kidnapings, or if you have a major terrorist situation, or a hijacking, SAC's have to address those immediately personally threatening situations.

Mr. MARTINEZ. Life-threatening situations?

Mr. HUGHES. Immediately, and what takes a life; certainly it is the white-collar crimes.

Mr. MARTINEZ. In that regard, do you transfer personnel? You mentioned major terrorist action, you know that is going to require extra personnel almost immediately—and your agents, I imagine, from the indication in your report, are trained, multifaceted agents, really; and in that regard, you have 12 agents in the agency that probably have the expertise and background to work in LA.

Do you move personnel back and forth as a crisis situation develops? In this situation, some of us imagine that there had been a very deep crisis situation, and it really hasn't mitigated itself to the point that we may need to focus our attention in lieu of the fact you are restricted in funds. And, your budget is as much restricted by us as anybody else. Do you have the ability to move into crisis situations?

Mr. JAMAR. When a major case that requires, like a terrorist group, or surveillance on a terrorist, we'll send in enough people to that. I mean, we'll address that immediate problem, no matter what the costs are. We have to address certain things.

Mr. MARTINEZ. And take them off other things?

Mr. JAMAR. We'll just pull them off and put them on there, but that has to be done. The call is the SAC's. If it's a case that is involving several divisions—we have had cases where we would bring in surveillance teams from all over the country, and run it for weeks. You have to do that. It is a matter of priorities at the time. If one time in a case we may pull a surveillance group off this crew, and put them over here because it is a more pressing matter.

Normally, though, you would want to avoid transferring people to an isolated place. Like we've done that—for example, in Dallas; we transferred four agents into where a bank failed in Lubbock, TX. Now, those cases are over, so we've got four agents in Lubbock, TX, that there is not enough work for four agents in Lubbock, TX.

In the future, maybe in these Dallas cases, we are going to concentrate on covering Dallas. We have a bunch of agents in Midland, working bank failures.

In the future, we are going to concentrate in the major cities so we won't waste those transfers. A transfer costs us about $50–$60,000 to transfer an agent. So, on a temporary basis, we will put them in on per diem special. That's hard on the agents, on their family, but that's what we have to address in a crisis situation.

Mr. MARTINEZ. So it's really a very complex situation. It's not simply just determining the priority.

Mr. JAMAR. Priorities change every day in most major offices. They have a crisis decision almost every day.

Mr. BARNARD. You've got families involved and all that to consider.

Mr. MARTINEZ. Very good.

Mr. BARNARD. Well, gentlemen, I appreciate very much your being here. I apologize for the length of time that it has taken to reach you, but your testimony was very fine, and we appreciate it very much.

Mr. JAMAR. Thank you.

Mr. BARNARD. Before we adjourn the committee, I would just like to say that we came here today searching for information, for explanations and solutions, and I think that we have done that.

We strongly feel that this is an issue that should be of great interest to many, not just to the Congress. It is not an issue just of interest to bank regulators, or to the criminal justice agencies. But this is an issue that sincerely needs to be addressed by the financial community, the banks and savings and loans, themselves. And I'm hoping that our hearings in Washington later this summer will provide the thrift and the banking industries with an opportunity to tell us what they are doing themselves, to avert some of this bank problem.

With that, the subcommittee is adjourned.

[Whereupon, at 3:17 p.m., the subcommittee adjourned, to reconvene subject to the call of the Chair.]

APPENDIXES

APPENDIX 1.—SUBCOMMITTEE STAFF'S JUNE 9, 1987, BRIEFING MEMORANDUM, TOGETHER WITH SUPPORTING MATERIAL

NOTE: Sensitive material referred to in memo has been deleted.

CONFIDENTIAL*

CALIFORNIA THRIFT INDUSTRY/INSIDER MISCONDUCT HEARING

BRIEFING MEMO
AND
FAILED INSTITUTION CASE STUDIES (WITH ATTACHMENTS*)

*Summaries of Federal Home Loan Bank supervisory actions against S&L's; Summaries of criminal enforcement actions against S&L insiders.

ONE HUNDREDTH CONGRESS
Congress of the United States
House of Representatives
COMMERCE, CONSUMER, AND MONETARY AFFAIRS
SUBCOMMITTEE
OF THE
COMMITTEE ON GOVERNMENT OPERATIONS
RAYBURN HOUSE OFFICE BUILDING, ROOM B-377
WASHINGTON, DC 20515

June 9, 1987

MEMORANDUM

TO Chairman Doug Barnard and Members, Commerce, Consumer and Monetary Affairs Subcommittee

FROM: Peter S. Barash, Staff Director
Steve McSpadden, Counsel

SUBJECT: BRIEFING MEMORANDUM, CALIFORNIA THRIFT INDUSTRY/INSIDER MISCONDUCT HEARING

I. INTRODUCTION AND BACKGROUND

Several months ago, the California Savings & Loan Commissioner, William J. Crawford, paid a call on the Chairman and the staff of the Commerce, Consumer, and Monetary Affairs Subcommittee to alert them to and seek their assistance regarding severe problems of insider misconduct in the California thrift industry. Commissioner Crawford stated that over the past 2½ years he had been forced to close 30 state-chartered, federally insured S&L's and that in almost every closure, insider misconduct played a significant or even a determining role. He also advised that in many instances, negligent or fraudulent appraisals that grossly overvalued real estate collateralizing thrift loans, facilitated the misconduct.

Commissioner Crawford's visit to the Barnard subcommittee was due, in part, to his knowledge of the subcommittee's extensive oversight work in the areas of financial institution misconduct and the contribution of appraisal fraud to such misconduct. Indeed, in October 1984, the subcommittee issued a report, "Federal Response to Criminal Misconduct and Insider Abuse in the Nation's Financial Institutions." In September 1986, another report was approved entitled, "Impact of Appraisal Problems on Real Estate Lending, Mortgage Insurance, and Investment in the Secondary Market."

The subcommittee's "Criminal Misconduct" report was based on a comprehensive review (with the assistance of the FBI, the Justice Department and the federal bank regulatory agencies) of the role of fraud in 150 recent financial institution failures. The report concluded that (1) misconduct was a principal factor in 50 percent of the commercial bank insolvencies studied and 25 to 35 percent of thrift insolvencies; (2) the bank regulatory agencies were lax in searching for criminal misconduct and slow to make referrals to law enforcement agencies when such misconduct was detected; and (3) the FBI, the U.S. Attorneys' offices and the Fraud Division of the Justice Department in Washington were insufficiently sensitive to financial institution fraud cases; and that the FBI lacked

the expertise and the Justice Department the resources to prosecute such fraud. The "Appraisal Report" concluded that "faulty and fraudulent real estate appraisals have become an increasingly serious national problem; that their harmful effects are widespread, pervasive, and costly; that they have contributed directly to the insolvency or problem status of hundreds of the Nation's financial institutions and are at least partially responsible for billions of dollars in losses to federally insured lenders, private mortgage insurers, investors in mortgage-backed securities and mortgage guarantee funds."

The subcommittee's investigation of problems in the California thrift industry, conducted subsequent to Commissioner Crawford's visit, confirmed his basic findings. Serious insider abuse has been a significant factor in most of California's thrift failures over the past three years and appraisal fraud and negligence have been implicated in many of these failures. Clearly, insider misconduct and appraisal abuse are responsible for much of the $3.75 billion in estimated FSLIC losses resulting from the 30 thrift failures studied by the subcommittee staff.

II. KEY SUBCOMMITTEE ISSUES AT LOS ANGELES HEARING

At the hearing in Los Angeles, the subcommittee will be seeking detailed information and data on (1) the nature and extent of misconduct by California thrift industry insiders (officers, directors, and principal stockholders) and by certain affiliated outsiders (major borrowers, and appraisers); (2) the role of abusive appraisal practices in such misconduct; (3) the relationship between misconduct and the insolvencies or problem status of California savings institutions, including losses to the Federal Savings & Loan Insurance Fund (FSLIC); (4) the effectiveness of the Federal Home Loan Bank Board's and FSLIC's detection of criminal misconduct and the referral of such misconduct to the appropriate criminal justice agencies; (5) the adequacy of the Justice Department's responses to insider, borrower and appraiser criminal misconduct; and (6) specific recommendations for solving the misconduct problem and for improving the reactions of federal and state thrift supervisory and criminal enforcement entities when misconduct does exist.

The subcommittee's investigation has identified two interrelated and important phenomena that may well be central to consideration of the financial institution misconduct issue:

The first, is that dishonest or incompetent persons who are insiders or affiliated outsiders of thrifts, often engage in misconduct at more than one financial institution. The subcommittee's investigation has identified many such multiple relationships by dishonest or incompetent individuals that have damaged numerous financial institutions. Because there is a lack of systematic information collection and sharing by the financial regulatory agencies and the criminal law enforcement agencies, these individuals have been able to move from institution to institution with virtual impunity. In many instances, individuals suspected or convicted of misconduct and fraud at one financial institution show up as insiders or affiliated outsiders at other financial institutions. This is the financial industry counterpart to the "Typhoid Mary" syndrome.

The second is that even without the movement of corrupt or incompetent individuals, misconduct that causes an insolvency or net worth problems at one financial institution, often leads to financial difficulties at many other financial institutions. This is because of the common practice of one financial institution selling loan participations to other financial institutions. Because participating thrifts often do little or no independent underwriting of the loans they buy from other institutions, a default by the borrower on the original loan can create havoc at these other institutions.

Examples of both these phenomena can be found in the case summaries attached to this memorandum. In questioning witnesses and fashioning solutions to the misconduct problem, subcommittee members may want to focus on the need to keep dishonest and incompetent persons from moving from institution to institution; and on the importance of proper loan participation policies and procedures.

III. SUMMARY OF SUBCOMMITTEE STAFF FINDINGS

A. Federal Home Loan Bank and FSLIC Issues:

1. The Federal Home Loan Bank of San Francisco (the supervisory agency for federally insured S&Ls in California) has a more heightened awareness of fraud issues than when the subcommittee conducted its initial investigation of this issue in 1983-84; and its criminal referrals are more comprehensive than previously. Nevertheless, the San Francisco Bank's supervisory procedures are still not adequate to assure that criminal referrals are always made in a timely fashion; and that referrals are effectively monitored when they are made.

2. There are five central reasons for the Home Loan Bank's inadequate criminal referral system:

First, the Bank of SF fails to alert the FBI and Federal prosecutors of the possible existence of criminal misconduct in an institution at the time it is closed, so that the FBI can be present to stamp and safeguard documents (which are often misplaced during the insolvency process) and to interview witnesses (when they are easy to locate and when their memories are fresh). As a consequence, investigations and prosecutions arising out of failed institutions require more resources than would otherwise be necessary, suffer delays and criminal acts become more difficult to prove.

Second, no specific person or persons are designated and charged with responsibility for monitoring the prosecutive progress of referrals. Rather, responsibility for referrals appears to be dispersed among many individuals (e.g., senior supervisory staff; persons who oversee the Management Consignment Program, etc.).

Third, the provisions of the Right To Financial Privacy Act continue to inhibit the timely disclosure of information about criminal misconduct to criminal law enforcement agencies.

Fourth, the Federal Home Loan Banks lack information exchange systems with each other and with bank regulatory agencies to (i) monitor the activities of persons associated with the financial institution industry who have been charged with and/or convicted of financial frauds; and (ii) properly track loan participations among large numbers of associations.

Fifth, the Home Loan Bank Board has abdicated to thrift institution management much of its responsibility to identify and refer instances of criminal misconduct to the FBI and Federal prosecutors. As a consequence, some investigations have been negatively impacted. For example, in Hancock S&L (Hancock is an open institution) criminal misconduct was discovered by management in 1981, but it refused to make a referral until 1984, after it had recovered civil money damages. As a result (because of the statute of limitations), prosecution was prevented on several transactions; but was successful on others.

3. a. The Federal Savings & Loan Insurance Corporation (FSLIC), which examines the conduct and potential liability of directors, officers and other affiliated persons in insolvent thrifts, is somewhat alert to criminal misconduct issues and makes a number of criminal referrals to law enforcement agencies. Nevertheless, FSLIC's effectiveness as an initiator of criminal misconduct referrals is diminished by the belief among some FSLIC attorneys and their fee counsel (private practitioners hired to represent FSLIC), that criminal referrals inhibit efforts to negotiate restitution settlements with defendants in FSLIC law suits.

b. Although there may be occasional merit in the contention that criminal investigations and prosecutions chill civil restitution efforts, the fact remains that damages are increasingly difficult to collect because defendants are increasingly sophisticated in secreting or shielding assets; directors and officer liability insurance is becoming increasingly difficult to obtain; and cases are often excessively lengthy and expensive to pursue. Moreover, civil suits do not appear to be nearly as effective as criminal prosecution in deterring white collar criminal behavior.

B. Problems with the Criminal Justice System: Inadequate Investigation and Prosecution of Financial Institution Criminal Misconduct

An unacceptably large backlog of open FBI financial institution fraud and embezzlement cases currently exists in the Central District of California (Los Angeles and Orange Counties). At year end 1986, there were 290 open criminal investigations where the amount involved in the alleged misconduct totals $100,000 or more. Some of these cases are close to indictment and prosecution, while others involve just an open FBI file (with no active investigation). The subcommittee staff found significant problems with the present criminal justice system, as applied to financial institution fraud. In many ways they are the same problems highlighted in our 1984 report on this subject. Although swift prosecution and imprisonment are the most effective deterrence to criminal misconduct in thrifts and banks, there has not been one indictment or prosecution arising out of the failure the 13 major state-chartered thrift failures in Southern California studied by the subcommittee. We have asked the hearing witnesses to respond to the issues raised by the staff's following preliminary findings:

1. The Justice Department's commitment to financial institution fraud cases is severely lacking in Southern California:

a. First, FBI manpower resources are wholly inadequate, agents are often inexperienced or poorly trained, and are ineffectively utilized. For example, the Los Angeles Division, FBI, will not assign more than 2 agents to major cases and often assigns only one agent part-time to such cases, even though many agents may be needed. The FBI's San Diego Division apparently transfers out experienced financial fraud agents because of an inefficient application of the Bureau's transfer policy.

b. The U.S. Attorneys' offices often fail to conduct effective and timely grand jury investigations and prosecution of principals in these cases, either because of inadequate manpower (the situation in both Los Angeles and, to a lesser extent, San Diego) or because of a much lower priority given to financial fraud cases (the situation in San Diego).

c. Recent efforts by the Justice Department's Criminal Division to give these matters a greater priority at the national level have either been ineffective or are "window dressing". For example, the Criminal Division's new computerized significant criminal referral monitoring system, which tracks major cases where there has been a formal referral, lists 36 major financial institution fraud cases in the Central District of California. However, not one involves a thrift institution, although some of the U.S. Attorneys' biggest cases there are thrift fraud cases. Also, a February 1987 Attorney General memorandum directing U.S. Attorneys to inventory bank and thrift fraud cases and accelerate their prosecutions, has not been implemented, and in fact, assistant U.S. Attorneys interviewed by the subcommittee staff seemed to be unaware of it.

2. Federal investigators and prosecutors habitually encounter serious problems with the Right to Financial Privacy Act (RFPA), either with the refusal of financial institutions to make criminal referrals or with the Home Loan Bank Board's extremely narrow interpretation of the Act. RFPA delays these matters and requires precious resources to overcome obstacles raised.

3. Many federal prosecutors believe that sentences imposed by Federal judges, rarely including imprisonment, are insufficient to deter criminal misconduct by financial institution insiders and affiliated outsiders.

C. Status Report on Criminal Investigations and Prosecutions

Set forth below is a summary of the status of FBI/Justice Department action on 13 major thrift failures in Southern California since 1984, out of a total of 30 such thrifts throughout the entire State. What follows is a status report—by name of institution—on any FBI or U.S. Attorney/grand jury investigations arising out of those matters, based on discussions with FBI, FSLIC fee counsel, FSLIC attorneys, and the U.S. Attorney's office.

OPEN FBI FILE, INACTIVE OR MINIMALLY ACTIVE INVESTIGATION:[1]

American Diversified Savings Bank (Orange County)
Butterfield S & L (Orange County)
Manhattan Beach S & L (Los Angeles County)
Ramona S & L (Orange County)
Seapointe S & L (San Diego County)

ACTIVE FBI & U.S. ATTORNEY/GRAND JURY INVESTIGATIONS:
(Even though active, most of the following have involved lengthy delays and inadequate resources.)

Beverly Hills S & L (Los Angeles County)—(1 part completed, 3 parts remaining)
Consolidated Savings Bank (Orange County)

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1 For some cases, there is minimal information as to the status of the investigation. Where there has been little or no contact and information sharing between the FBI and the the bank regulatory agencies (including the FSLIC or its fee counsel), and no grand jury subpoena, but where there is an open FBI file, we are presuming an inactive or minimally active investigation, until the FBI advises us otherwise. (The FBI opens a file whenever an institution closes, and then awaits a referral or information from the FSLIC or FDIC, often initiating an inquiry on its own.)

North America S & L (Orange County)—(very active investigation)
Perpetual S & L (Los Angeles County)
San Marino S & L (Los Angeles County)
South Bay S & L (Orange County)

ACTIVE INVESTIGATION ALMOST COMPLETED:

Sun Savings and Loan (San Diego County)—prosecutor overloaded with other matters;

INVESTIGATION COMPLETED, PROSECUTION DECLINED

Westwood S & L (declined June 1986)

IV. DISCUSSION OF PRELIMINARY FINDINGS AND SUPPORTING EVIDENCE

A. Problems in the Criminal Investigation and Prosecution of Misconduct by Financial Institution Insiders and Affiliated Outsiders

1. Difficulties in the way criminal investigations are initiated:

The Home Loan Bank Board (including the Bank of SF and the FSLIC), has failed to place clear and definite responsibility on its staff or its fee counsel to search out and initiate criminal investigations at an early stage (whether through alerting the FBI so that it can be present when an institution is declared insolvent to interview witnesses and preserve documents; or through making written criminal referrals). On the other hand, when the California Thrift Commissioner and Bank Board have been diligent and have sought early and active FBI involvement, they have often been rebuffed.

The consequences of failing to make timely referrals or to seek early FBI involvement were well demonstrated in the Ramona S & L failure. There, the accountant for the association had issued an allegedly fraudulent financial statement, which stated that the thrift's net worth was $8.3 million, when it was a negative $19.6 million (this allowed the thrift to pay a $2 million dividend to the owner). Allegedly, the accountant was secretly paid over $100,000, often in $50 and $100 bills. In a October 28, 1986, memo, the FHLB of SF District Accountant detailed the allegations and the possible violations, including Bank Secrecy Act violations, and stated:

> It is recommended that a formal investigation be implemented to ascertain any criminal acts by Mr. Sage or Mike Sage and Company, Inc.

This was not done, and Mr. Sage fled the area. Even then, neither the Home Loan Bank of SF nor the FSLIC alerted the FBI, in order to find Mr. Sage. Instead they hired a private firm to try to locate him, which was unsuccessful. Notwithstanding strong evidence of a crime, agency staff have still not referred this matter to the FBI.

Federal prosecutors complain about stale referrals and the failure of the FSLIC, the FDIC, and other banking agencies to alert them early on to possible criminal misconduct in failed institutions and to request their intervention as soon as an institution closes. During the hearing, the U.S. Attorneys will discuss the consequences of this failure: (a) often crucial documents will be amassed and boxed with other records, making it impossible to show that culpable individuals had control of or saw the documents, whether, e.g., the document was located in the desk of a particular individual — a serious problem in the

San Marino S&L investigation — and (b) employees of the failed institution may leave shortly after its failure and are then difficult to locate, or if located much later, do not remember crucial facts. The U.S. Attorney in San Diego told us that the FBI and his office could be trusted with information of an institution's imminent closing or receivership.

On the other hand, there are at least two cases showing that, while the U.S. Attorneys may want early involvement, the FBI is not always prepared to take such steps, either because of lower commitment to these cases or inadequate manpower. Commissioner Crawford told us about an incident involving North America S & L, where he was forced to make 17 phone calls over 8 days, (calling the Orange County and L.A. County FBI offices, as well as the Home Loan Bank of SF and a U.S. Senator) trying to initiate an FBI investigation. He believes that the FBI wants an "open and shut case" before they will pursue the matter. The FBI in Los Angeles told us informally, "it has to be a surer thing, before we will place it on a fast track, before we will pursue it", due to lack of resources. FSLIC attorney Jim Lauer, who is overseeing the Consolidated S & L receivership and will be present at the hearing, told us that that case was rife with criminal activity but that he could not get the FBI to investigate it. Lauer advised us that in August 1986, "We had witnesses come forward, whose lives had been threatened with violence, who wanted to talk, who had information on false loans to [one of the principals]." The Orange County FBI agent told him, "We don't have the time to interview them", according to Lauer. Finally, in frustration, Lauer went to FBI headquarters and talked with the chief of the financial fraud unit, who said that he would look into it but cautioned, "We are not agreeing to conduct an investigation."[2] (Lauer was very concerned about this lack of timely action, and he indicated that "just one prosecution, with a conviction" would make the FSLIC's life easier by deterring some persons.)

2. FHLBB failures to make criminal referrals or otherwise provide adequate and complete information to Federal law enforcement authorities:

Some of the FSLIC fee counsel and attorneys have been diligent and have made referrals or otherwise provided complete information to the FBI and the U.S. Attorneys' offices; others have not. Unfortunately, at least several major investigations have been negatively impacted—one is simply not moving—because of the lack of written referrals.

There are four sets of allegations of criminal misconduct arising out of the failure of Beverly Hills S & L (with estimated losses of $800 million to the FSLIC). Due to insufficient resources, the FBI has not assigned enough manpower, so they have been able to investigate only one aspect of this matter, the $400 million Stout-Newberry apartment loans. The FBI has told FSLIC personnel that they desire a criminal referral on the three other parts of the transactions evidencing criminal misconduct, and the assistant U.S. Attorney confirmed this, stating that a criminal referral would still be extremely useful. Unfortunately, the FSLIC fee counsel (from Tuttle and Taylor, Los Angeles) is not prepared even to consider a referral, nor does he believe it appropriate. The head counsel told subcommittee staff over the telephone, that although he has had 6 to 8 attorneys sift through boxes of documents and file several civil cases, he does not believe it appropriate to look for criminal misconduct. He stated, "I have not been asked by our client [the FSLIC] to undertake an analysis of criminal liability". Subsequently, he expressed concern

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2 We have asked FSLIC witness Bill Black to recount this and other similar incidents; if he fails to do so, the subcommittee members may want to bring this out in questioning.

about civil cases being delayed pending the outcome of criminal investigations, although he had no solid evidence of that.[3] In the American Diversified matter, we were advised that FSLIC's Bill Black had to direct the fee counsel to make a referral, because he was very reluctant to do so.[4]

Clearly, something is wrong. Some FSLIC fee attorneys have uncovered useful evidence of criminality, but are not ready to share it with the assistant U.S. Attorney or the FBI agent. They have indicated to us their concern that criminal investigations should not get in the way of the FSLIC's attempt to obtain money restitution for the deposit insurance fund. Some in the FSLIC are giving the criminal side of these failures a much lower priority than the civil actions. While some of the fee counsel are very active in working with the U.S. Attorney's Office—the North American S & L case is an excellent example of this—others cannot be bothered with, or do not see their role as making, criminal referrals.

Another problem is that in open institutions, the Bank Board places principal reliance on the financial institutions themselves to make criminal referrals. We found one case involving Hancock Savings and Loan, an open institution, where the financial institution found criminal misconduct in 1981, refused to make the referral until after it had completed a civil case, and then finally made a referral in 1984. The Assistant U.S. Attorney involved advised us that the statute of limitations barred prosecution as to certain transactions and almost barred the ultimately successful prosecution of other transactions; and that agency policies of relying on financial institutions to refer misconduct do not work. Other Federal prosecutors told us that financial institutions will not make criminal referrals for the same reasons highlighted by findings in our 1984 report, as follows:

> Typically, top management of an institution is reluctant to make complete or persuasive criminal referrals on insiders because (1) they fear adverse publicity, (2) senior management may actually be involved in the criminal activity, and (3) the institutions often interpret the Right to Financial Privacy Act in an unnecessarily narrow way that prevents them from providing adequate details and documentation.

Although that Act was modified by the Anti-Drug Abuse Act of 1986 to specifically strengthen an exception allowing information sharing in a criminal referral, financial institution legal counsel are often providing incorrect advice, requiring grand jury subpoenas and notifying the principals involved when a subpoena is received. (Of course, without some preliminary information, the U.S. Attorney will not issue a subpoena.) This excessive reliance on thrifts to report crimes aggravates a bad situation.

The Federal Home Loan Bank Board's overly narrow interpretation of the Right to Financial Privacy Act, particularly as compared with other banking agencies, contributes to delays in the dissemination of information. In the San Marino S & L case (a 1984 failure with $260 million in estimated losses), the FSLIC attorney refused to provide even

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3 We were told that often principals will take the Fifth Amendment, irrespective of whether there is an active criminal investigation, if they have something to fear.

4 Subcommittee members may want to ask Mr. Black to confirm and to elaborate on these two instances.

minimal details to the assistant U.S. Attorney in Los Angeles. She had to subpoena him and then spend 3 days in front of the grand jury, completely in the dark. (Often, there will be some preliminary information provided, so that the prosecutor will know which documents to subpoena and which inquiries to pursue.) She was extremely frustrated by this lack of cooperation. The Fraud Section of the Criminal Division also has problems with the Bank Board's interpretation. Ultimately the information will be produced, but it requires extra resources and results in delay.

It is incumbent upon the FSLIC, the Home Loan Bank Board and the regional banks to amass the information, make timely and complete referrals, and market their cases with Federal prosecutors and investigators, which pay attention to agencies which actively do so, like the SEC.

4. Insufficient FBI and U.S. Attorney Resources and Lack of FBI Agent Expertise:

As of year end 1986, there are 318 pending U.S. Justice Department investigations of financial institution fraud or embezzlement involving $100,000 or more in Southern California and 150 such investigations in Northern California. The largest number of investigations can be found in the Central District of California (mainly Los Angeles and Orange counties), where there are 290 or more investigations, 150 of which involve more than $250,000.

I

FBI resources are clearly inadequate and the limited resources which the FBI has at its disposal are poorly utilized. Of 80 agents in the Los Angeles Division in white collar crime, approximately 25 (or about 1/3) are working on pending bank fraud investigations at any one time. Bill Stollhans, the FBI Special Agent in Charge of White Collar Crimes (who will be on the FBI panel), advised us that 2 agents is the maximum he will assign to any one investigation. In reality, until recently, not more than one agent would be assigned to these cases, particularly if the Orange County FBI branch office was assigned the matter. The Federal prosecutors assigned to two of the earliest and largest failures in our survey, Beverly Hills S & L and San Marino S & L (with estimated losses to the FSLIC of $800 million and $260 million respectively) told us the following: In each those investigations there was only one FBI agent working part-time and that, for example, in the Beverly Hills investigation, only one part of a four part case has been completed. (Recall that the FSLIC fee counsel, Tuttle and Taylor, has 6 to 8 attorneys working on it full-time, but does not want to make any criminal referrals.) The FBI headquarters has authorized the transfer of 10 agents to Los Angeles to the white collar crime unit, but indicates that it has no funds to do so this fiscal year. We do not know why.

The situation in San Diego is similar, in some ways worse, although in that FBI office there are only 28 pending investigations of bank fraud involving $100,000 or more. There, a lack of supervisory and other agents experienced in bank fraud, and a heavy emphasis on drug and alien smuggling cases, explains the lack of active and effective FBI investigations. Bob Rose, a former senior official in the U.S. Attorney's Office and a witness, told us that the San Diego FBI office "went from one of the more experienced offices in terms of bank and other fraud cases to one of the least experienced." The FBI's transfer policy is causing particular problems there. For example, an able chief of the white collar crime squad was transferred out of San Diego, and his replacement, Doug Clark, retired on June 1, 1987, when he refused a transfer out of San Diego. The FBI needs experienced bank and thrift fraud agents in California; however, once they become experienced, it wants to transfer them to areas where the problems are much less severe.

The U.S. Attorney in San Diego (a witness) believes that FBI fraud resources are devastated. For two years his office has asked for more FBI resources, and the agents who are investigating criminal fraud are often pulled off these cases for other matters, particularly for the drug cases when that situation heats up.

An assistant U.S. Attorney in Los Angeles made clear that inadequate training of FBI agents is a real problem, notwithstanding the FBI's much-touted one week white collar training program. She told us, "FBI agents become confused very easily in these cases, and are often bewildered and overwhelmed at the beginning." This happens even to experienced agents because they may not know how to approach these cases, because of the lack of specialized training. She suggested, that FBI agents need a checklist or an outline, a "plan of attack", because as it stands now, FBI agents often require a "learning period", to find out just simply how the bank or thrift operates.

II

Lack of resources and priorities to other matters exist in the U.S. Attorneys' offices also. Resources are stretched very thin, with only 40% of the time of 12 prosecutors in the fraud unit of the Los Angeles U.S. Attorney's Office available to work on these hundreds of investigations. In the Beverly Hills investigation, the former assistant U.S. Attorney previously assigned the case had been tied up in a major trial involving exports of arms to mercenaries that had lasted 4 weeks, a case which incidentally had to be retried. As a result, no action was taken against a bank which refused to comply with subpoenas in that matter, and this part of the case laid dormant for months. Also, Federal prosecutors have had to devote tremendous resources to a major fraud involving fraudulent mortgage-backed securities and the Bank of America, National Mortgage Equity Corp., and West Pac (costing the Bank of America around $90 million). Nevertheless, the U.S. Attorney's office refuses to ask the Fraud Section of the Criminal Division for assistance, because it traditionally wants to control almost all criminal prosecutions.

In San Diego, there is no fraud unit, as narcotics and drug smuggling cases get much greater priority, because the U.S. Attorney there allegedly wants to show large numbers of prosecutions to the Justice Department, to justify budget requests. Experienced bank/thrift fraud investigators get pulled off to do other matters, including teller embezzlements involving less than $25,000, taking away from the larger cases. The investigation arising out of the failure of Sun Savings in San Diego is allegedly in the final stages, but the prosecutor is simply overwhelmed with other prosecutions, according to FSLIC fee counsel. This U.S. Attorney's office did ask the Fraud Section in Washington, DC, to send an attorney to handle 6 bank/thrift fraud cases. The section rejected the request because it did not have adequate travel funds due to Gramm-Rudman's recent implementation.

Clearly bank and thrift fraud investigations are not getting nearly the priority they deserve from the Justice Department. This contributes to continued misconduct by many of the same persons who move from institution to institution, such as Jack Bona and Frank Domingues, real estate developers and major borrowers who are definitely implicated in the failures of San Marino S & L and the South Bay S & L (total estimated losses to the FSLIC of $265 million plus) and possibly implicated in allegedly similar misconduct with a San Diego FDIC-supervised bank, who are under criminal investigation in connection with these first two institutions, and who are not deterred from continuing to obtain allegedly fraudulent loans on inflated real estate appraisals, often nurturing special relationships with institution insiders to do so.

The Criminal Division points with pride to its interagency bank fraud working group and its significant referral monitoring system, as well as to a February 1986 memo from Attorney General Meese to U.S. Attorneys.[5] In our judgment, much of this is "window dressing". This new system of monitoring major and significant cases has large gaps in collecting necessary data. First, neither of the two U.S. Attorneys' Offices knew about this system, and the U.S. Attorney's Office in Los Angeles' own list of significant cases is not the same as the Fraud Section's. While the Justice headquarters' system shows 36 significant financial institution fraud investigations in the Central District of California, not one of them involves a savings and loan; most involve FDIC supervised state-chartered banks. When we pointed the lack of any significant thrift fraud cases in the Criminal Division's system, the Federal prosecutors in Los Angeles were incredulous. This shows that that system does not work, often because the banking agency headquarters decides which referrals to designate as significant, usually when it has very little idea of how significant a case is based on limited information at an early stage. It also does not work because referrals per se do not initiate many of these cases; many of the major investigations start with nothing more than a newspaper story and subsequent informal examiner—FBI agency contacts. The Criminal Division system does not take this into account. Accordingly, this system will not be effective unless it is modified.

5. Agency failures in monitoring FBI investigations:

Initially, the FHLB of SF provided incorrect information to the subcommittee as to which failed institutions in our survey there were ongoing FBI investigations. For example, it knew of no FBI or grand jury investigations arising out of the failures of Manhattan Beach S & L and also South Bay S & L, yet there are active investigations arising out of both. It stated that criminal referrals were expected in the future arising out of Westwood S & L, although, in reality, the FBI had previously declined prosecution in June 1986. No one person within either the FHLB of SF or the FSLIC was aware of the existence or status of criminal investigations arising from all of these failures. Individual FSLIC fee counsel or the particular FSLIC attorney assigned the case would often know of Justice Department activity, but not always.

Interestingly, there is an initial FBI report which would be useful to staff in the agencies but which is not well utilized. Irrespective of how an FBI investigation is initiated, within 90 days of initiation, the FBI local office usually prepares a Letterhead Memorandum which names the principals, sets forth the allegations, and discusses its preliminary findings. This memorandum is sent to FBI headquarters, which then transmits it to the appropriate banking agency. The FSLIC and particularly the FSLIC attorneys assigned the matter do not receive copies, and the FHLB of SF officials were unaware of the existence of these FBI reports, until senior officials there found that copies sent from the Bank Board were filed away in a back office, with only one person knowing of their existence. Clearly, ensuring the initiating of new investigations and the monitoring of ongoing ones has had a low priority.

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5 In that 2/24/87 memo, the Attorney General asked all U.S. Attorneys to prepare an inventory of pending bank fraud cases, to meet with FBI senior agents at local offices to obtain status reports and to accelerate prosecutions, to make prompt prosecutive determinations, and to assign needed staff to these cases and to otherwise give the cases priorities. These steps were not taken in the San Diego or L.A. U.S. Attorneys' Offices; they were not even aware of the memo, from what we could tell. (The memo was written about the time we initiated our investigation.)

FHLBofSF senior officials, particularly Chuck Deardorff (who will testify), readily admitted to us that there were shortcomings and attributed some of the problem to a reorganization within the San Francisco Bank and also to involvement of two agencies (the Bank and the FSLIC) and numerous staff. When asked, he also admitted that a draft of a criminal referral arising out of a major failure, Southern California S & L (not one of the thrifts in our survey), fell "through the cracks" when the examiner left the agency. New procedures are being implemented to prevent this. However, this general state of disorganization and lack of firm agency commitment still exists within the FSLIC and probably within other regional Home Loan Banks and the other banking agencies, which lends support for the recommendation in our 1984 report that the banking agencies designate "special regional counsels to bear prime responsibility for investigating suspected insider abuse and for initiating, tracking and coordinating criminal referrals...against individuals."

PSB/SRM:v

Attachments

April 13, 1987

Association Name	Takeover Date	Takeover Type
San Marino S&LA	02/03/84	FSLIC-Receivership
Western Community S&LA	03/08/85	FSLIC-Receivership
Beverly Hills S&LA	04/23/85	FSLIC-Receivership
Bell S&LA	07/25/85	FSLIC-Receivership
Butterfield S&LA	08/07/85	FSLIC-Receivership
Centennial S&LA	08/20/85	FSLIC-Receivership
Presidio S&LA	08/28/85	FSLIC-Receivership
Golden Pacific S&LA	09/30/85	FSLIC-Receivership
Farmers SB	10/11/85	FSLIC-Receivership
Manhattan Beach S&LA	01/09/86	FSLIC-Conservatorship
Mt. Whitney S&LA	02/12/86	FSLIC-Conservatorship
American Diversified SB	02/14/86	FSLIC-Conservatorship
Westwood S&LA	03/27/86	FSLIC-Conservatorship
United Bank, SB	03/28/86	FSLIC-Receivership
Gateway SB	04/14/86	FSLIC-Conservatorship
Columbus (Marin) S&LA	04/14/86	FSLIC-Conservatorship
Consolidated SB	05/22/86	FSLIC-Conservatorship
Seapointe S&LA	05/30/86	FSLIC-Receivership
Atlas S&LA	07/14/86	FSLIC-Receivership
Sun S&LA	07/18/86	FSLIC-Receivership
Consolidated SB	08/29/86	FSLIC-Receivership
Ramona S&LA	09/12/86	FSLIC-Receivership
Cal America S&LA	09/19/86	FSLIC-Receivership
Unified SB	10/10/86	FSLIC-Receivership
North America S&LA	01/16/87	W.D. Davis, Conservator
North America S&LA	01/23/87	FSLIC-Receivership
South Bay S&LA	03/06/87	FSLIC-Receivership
Perpetual S&LA	03/18/87	FSLIC-Receivership
Equitable S&LA	03/27/87	FSLIC-Receivership
Tahoe S&LA	04/03/87	FSLIC-Receivership
Central S&LA	04/10/87	FSLIC-Receivership

Estimated Losses to the FSLIC for Selected Institutions in California (as of April 30, 1987)

	Estimated Loss to the FSLIC (in $millions)	Net Worth as of 1/31/87 (excluding ICCs) (in $millions)
American Diversified	600	(522.1)
Atlas	6.5	*
Bell	400	(377.1)
Beverly Hills	800	(709.1)
Butterfield	250	(220.8)
Cal America	50	(47.7)
Centennial	160	(151.5)
Columbus	70	(69.1)
Consolidated	48.6	*
Farmers	140	(127.9)
Gateway	40	(36.8)
Golden Pacific	4.7	*
Huntington	5	(0.3)
Manhattan Beach	10	(8.5)
Mt. Whitney	30	(24.5)
North America	25	(2.5)
Perpetual	2	(1.4)
Presidio	35.2	*
Ramona	30	(23.7)
San Marino	260	*
Seapointe	24.9	*
South Bay	5	(2.8)
Sun	90.1	*
Tahoe	15	(8.8)
Unified	7	(5.5)
United	43.9	*
Western Community	1.2	*
Westwood	145	(139.6)

*Association is no longer in existence and hence has no net worth.

SOURCES: The Federal Home Loan Bank of San Francisco and the Federal Home Loan Bank Board.

SUBCOMMITTEE NOTE: See Exhibit A to Mr. Black's November 2, 1987, letter in Appendix 2 for updated (and usually higher) dollar figures.

APPENDIX 2.—FOLLOWUP AND SUPPLEMENTAL AGENCY LETTERS (TOGETHER WITH SUBCOMMITTEE LETTERS REQUESTING INFORMATION, AS NECESSARY)

ONE HUNDREDTH CONGRESS

Congress of the United States

House of Representatives

COMMERCE, CONSUMER, AND MONETARY AFFAIRS
SUBCOMMITTEE
OF THE
COMMITTEE ON GOVERNMENT OPERATIONS
RAYBURN HOUSE OFFICE BUILDING, ROOM B-377
WASHINGTON, DC 20515

September 4, 1987

Mr. William K. Black
General Counsel
Federal Home Loan Bank
of San Francisco
580 California Street
P.O. Box 7948
San Francisco, CA 94120

Dear Mr. Black:

During your appearance at the Commerce, Consumer, and Monetary Affairs Subcommittee's June 13, 1987, hearing in Los Angeles, I was unable to ask you a number of questions, because of a shortage of time due to the number of witnesses testifying. Also, your written statement (and that of Charles Deardorff, Deputy Director of the San Francisco Bank) raised additional followup questions and did not provide all of the data we had requested. Accordingly, to complete the record, at this time please respond (together with Mr. Deardorff, as appropriate) to the following questions, providing specific data where requested, by September 23, 1987, if at all possible:

1. FSLIC's estimate of likely losses for each failed institution: At this time please provide FSLIC's current best estimate of its likely losses for each of the 29 state-chartered institutions and the 2 federally chartered institutions in the subcommittee's survey.

2. Identification of Institutions A, B, and C: Mr. Deardorff's testimony discussed criminal investigations, particularly relating problems that his office had encountered, as to three institutions. (Problems were minimal with respect to Institution A, and there were convictions in that case.) Please identify each of these three institutions.

3. Correlation of appraisal abuses and other misconduct to particular failed institutions in the subcommittee's survey:

a. On p. 8 of your written statement, you indicate that three-quarters of the failed or failing institutions in the survey (as well as the two Federally chartered institutions failing in the same time period) had problems with insider misconduct. Please identify the institutions where you found such misconduct.

b. On p. 9 of the statement, you testified that at least ten of the institutions had appraisal problems. Please identify the institutions, so that we may correlate these problems with them and also the eight appraisers against whom the FSLIC has filed a lawsuit, arising from these failures.

c. On p. 11, you testified that the misconduct of certain borrowers has been a problem in at least nine of the institutions listed. Once again, please identify the institutions, and name the borrowers, their relationships to this and other institutions (naming institutions), and specify the dollar amounts involved. (You may provide this information on a separate confidential page for those borrowers who are not yet named in a FSLIC civil complaint.)

5. Additional information on transactions with another financial institution, arising out of San Marino S&L: On page 10 of his statement, FSLIC Attorney James Blair discussed a transaction involving six Bona/Domingues projects, a $37 million loan, an undeveloped parcel of land, and the involvement of La Jolla Exchange, Inc. and Central Savings and Loan Association. (a) How were Messrs. Bona and Domingues involved with Central Savings? Did they have any ownership interests in Central Savings or business relationships with insiders? (b) Did any insiders in San Marino S&L have such interests in, or business relationships with insiders of, Central Savings? (c) Is this the Central Savings which was placed in receivership by FSLIC in April 1987? If so, describe any insider abuse or misconduct, and how that may have related to other institutions, including San Marino S&L, and to defendants in FSLIC civil suits (such as Messrs. Bona and Domingues, as well as others).

6. Sales of fraudulent or inadequately collateralized loan participations among thrifts: Based on information furnished by the FSLIC and others for the June 13th hearing, we find numerous instances where participations in unsafe or fraudulent loans, often based on faulty appraisals, are sold by the originating thrift institution to other thrifts, affecting their net worth and often ultimately contributing to their insolvencies. (a) Discuss the consequences to the FSLIC when it later attempts to seek damages from responsible parties and financial institutions. During your tenure, did the FSLIC confront having to file lawsuits against itself, as the receiver of other insolvent thrifts which originated or purchased such loans, and does it go after the same assets or individuals? If so, provide examples. (b) Does any system exist among the District Home Loan Banks for tracking loan participation activities in problem institutions?

7. Reluctance of FSLIC fee counsel to make criminal referrals or to otherwise provide information and documentation to Federal law enforcement authorities:

a. According to pre-hearing discussions with the staff of the Home Loan Bank of San Francisco, the FSLIC fee counsel for American Diversified Savings was reluctant to make a criminal referral but did so after the matter was brought to your personal attention. Please describe what occurred and provide a chronology. What were the fee counsel's concerns (e.g., did they relate to the impact on the civil lawsuit), and how did the FSLIC respond to them.

b. The FBI has completed its investigation of only one part of a four-part set of transactions evidencing possible criminal misconduct arising out of Beverly Hills Savings and Loan. The FBI assigned only one agent to work part-time on this case, although it recently assigned 2 agents to this case. The FBI agent advised the FSLIC trial attorney assigned this matter that the FBI desired a criminal referral (according to a April 20, 1987, FHLBB, 11th District Memorandum), and the Assistant U.S. Attorney told subcommittee staff that a referral on the unexplored portions of

the case would be very useful in focussing the FBI's attention and limited resources.[1] Nevertheless, FSLIC fee counsel told 2 subcommittee staffers over the telephone that he did not believe it appropriate for him to make a referral. He said that he "had not been asked by our client [the FSLIC] to undertake an analysis of criminal liability and that such would require substantial efforts," although he has had 6 to 8 attorneys reviewing documents and preparing civil cases, some of which may also indicate potential criminal liability. (a) Is the fee counsel's belief about "substantial" additional efforts (and the implication that reimbursement might be required) valid and reasonable under the circumstances? (b) Is this a proper position for the fee counsel to take in this situation? (c) What steps, if any, is the FHLB of San Francisco (or the FSLIC) prepared to take to require the fee counsel to discuss this matter with Federal law enforcement authorities to better understand what criminal statutes may have been violated, towards a view of providing information to the U.S. Attorney/FBI to expedite this lengthy investigation?

c. To address the general concern about fee counsels' reluctance to make criminal referrals, at the hearing you furnished a copy of the May 26, 1987, letter which FSLIC Senior Associate Counsel Dorothy Nichols sent to California FSLIC fee counsel, emphasizing the importance of criminal referrals. Were similar letters sent to FSLIC fee counsel throughout the nation?

d. What additional steps is the FHLB of San Francisco prepared to take, to assure consistent and uniform application of its policies with regard to timely and complete referrals and submissions of information and documentation?

8. Special U.S. Attorney Office Task Forces: You testified that the FSLIC "had particularly good results" with the offices of the U.S. Attorneys which have established "special task forces" to deal with thrift and bank failures and which consequently have developed an expertise. Please identify those offices, describe more specifically what they have done (if possible), and identify any particularly active Federal prosecutors in those offices with whom the FSLIC staff had been in contact during your tenure.

---

1 U.S. Attorney Bonner testified (p.16) that a referral as to this institution would now serve no purpose, seeming to contradict what the FBI and the Assistant U.S. Attorney have stated. Inquiry to the head of the Major Fraud Section, Terree Bowers, who testified and who provided much of the factual information in the U.S. Attorneys Statement, clarified this discrepancy and told us that, while a brief referral would serve no purpose, an exchange of information and documentation between the fee counsel and Federal law enforcement authorities could be extremely useful and would be welcome

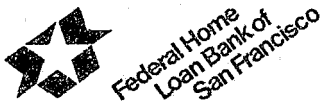
Please contact subcommittee counsel Stephen McSpadden if there are any questions. Thank you for your and Mr. Deardorff's past and anticipated future cooperation.

Sincerely,

Doug Barnard, Jr.
Chairman

DB:sm:v

cc: Mr. Charles Deardorff
Deputy Director, Agency Group
Federal Home Loan Bank
of San Francisco
580 California Street
P.O. Box 7948
San Francisco, CA 94120



William K. Black
Senior Vice President
and General Counsel

November 2, 1987

Honorable Douglas Barnard, Jr.
House of Representatives
Rayburn House Office Building, Room B-377
Washington, D.C. 20515

Dear Representative Barnard:

This letter is in response to your request for additional information following my testimony at the June 13, 1987 hearing of the Commerce, Consumer, and Monetary Affairs Subcommittee ("Subcommittee") of the Committee on Government Operations in Los Angeles. I have prepared these responses in the order of the questions presented in your September 4, 1987 letter.

1. Federal Savings and Loan Insurance Corporation's ("FSLIC") estimate of likely losses for each failed institution:

   The list of institutions and likely losses associated with them is attached to this letter as Exhibit A.

2. Identification of Institutions A, B, and C:

   The Federal Home Loan Bank Board ("Bank Board") has determined that to identify these institutions would create the risk that the individuals who are the subjects of the ongoing criminal investigations would learn of the investigations, which could lead to the destruction of evidence or the unavailability of witnesses. I therefore respectfully decline to identify Institutions A, B, and C at this time.

600 California Street
Post Office Box 7948
San Francisco, CA 94120
Telephone 415-393-0702

3. Correlation of appraisal abuses and other misconduct to particular failed institutions in the Subcommittee's survey:

   a. Institutions where evidence of insider misconduct was found:

      American Diversified Savings Bank
      Bell Savings & Loan Association
      Beverly Hills Savings
      Cal America Savings & Loan Association
      Centennial Savings & Loan Association
      Columbus Savings & Loan Association
      Consolidated Savings & Loan Association
      Equitable Savings & Loan Association
      Gateway Savings Bank
      Golden Pacific Savings & Loan Association
      Huntington Savings & Loan Association
      Manhattan Beach Savings & Loan Association
      Mt. Whitney Savings & Loan Association
      North America Savings & Loan Association
      Perpetual Savings Bank
      Presidio Savings & Loan Association
      Ramona Federal Savings & Loan Association
      San Marino Savings & Loan Association
      South Bay Savings & Loan Association
      Sun Savings & Loan Association
      United Savings Bank
      Westwood Savings & Loan Association

   b. Institutions with appraisal problems:

      American Diversified Savings Bank
      Butterfield Savings & Loan Association
      Consolidated Savings Bank
      Huntington Savings & Loan Association
      San Marino Savings & Loan Association
      Sun Savings & Loan Association
      Bell Savings & Loan Association
      United Savings Bank
      Equitable Savings & Loan Association

      The list of appraisers against whom FSLIC has filed lawsuits is included as Exhibit B. The amounts listed as claims include FSLIC's total claims against all defendants.

   c. The list of borrowers against whom FSLIC has filed lawsuits is included as Exhibit C. The amounts listed as claims include FSLIC's total claims against all defendants.

5. Additional information on transactions with another financial institution, arising out of San Marino Savings & Loan Association:

As indicated by James Blair, FSLIC Trial Attorney, in his statement to the Subcommittee, the relationships between Jack Bona and Frank Domingues and Central Savings and Loan Association ("Central") were then and are now the subject of investigation by FSLIC fee counsel. Moreover, the scope of that ongoing investigation includes the question whether any insiders of San Marino Savings & Loan Association have ownership interests or business relationships with insiders of Central. To date, fee counsel's conclusions concerning the extent of any relationships are preliminary and have not been incorporated into any public filing. Therefore, I am unable to answer your questions. Central was placed into receivership in April, 1987.

6. Sales of fraudulent or inadequately collateralized loan participations among thrifts:

a. The consequences of FSLIC filing suit against other thrifts involved in participation loans can include, in the most severe cases, rendering other FSLIC-insured thrifts insolvent. Such suits also may generate bad publicity and significant legal expenses. FSLIC, in one capacity, did face the possibility of filing suit against FSLIC in another capacity during my tenure as Director of Litigation at FSLIC. An example of this that I remember involved a dispute between Alliance Federal Savings and Loan Association, Kenner, Louisiana ("Alliance"), and Northlake Federal Savings and Loan Association, Covington, Louisiana ("Northlake"). FSLIC also was in the position, again in different capacities, of having multiple suits against the same defendants during my tenure. An example of this nature that I recall involved claims of Alliance, Northlake, and Empire Savings and Loan Association, Mesquite, Texas, against Charles Griffith.

We developed three policies to deal with these issues. First, each FSLIC litigator would do the utmost for his or her client to maximize the net recovery for that client. For example, FSLIC as receiver for Thrift A would maximize the net recovery for the creditors of Thrift A regardless of the impact on other FSLIC-insured thrifts. If FSLIC, in its corporate capacity, believed that such a suit by

Thrift A would harm the system, FSLIC in its corporate capacity could purchase Thrift A's claim and decide not to pursue it or settle it at a lower amount. I would stress that obtaining the greatest net recovery for Thrift A often led us to recommend a workout, not a lawsuit, with the other participants.

The second policy was that FSLIC, in any capacity, should not waste litigation expenses suing FSLIC in any other capacity. With the assistance of the Director of FSLIC and the American Arbitration Association, we developed an innovative arbitration program for resolving conflicts among receiverships, conservatorships, FSLIC in its corporate capacity and thrifts in the Management Consignment Program.

The third policy was to have FSLIC, in its various capacities, cooperate when bringing multiple suits against the same defendant, particularly when that defendant lacked the resources to pay any of the claims in full. This involved an agreement to divide the costs and revenues of suit to avoid duplicative litigation expenses and a wasteful "race to the courthouse."

b. The Bank Board has proposed a new Major Asset Tracking System ("MATS"), which will track all classified loans (including participations) over $5 million. A preliminary statement of the proposed objectives of the MATS is attached as Exhibit D.

7. Reluctance of FSLIC fee counsel to make criminal referrals or to otherwise provide information and documentation to federal law enforcement authorities:

a. My memory is that my personal intervention was neither requested nor necessary to insure that FSLIC fee counsel helped prepare criminal referrals arising from American Diversified Savings Bank's ("ADSB") failure. Fee counsel for ADSB faced the greatest demands for their time of any FSLIC fee counsel. The litigation and commercial law issues were immense, complex, critical and intricate. I do not remember fee counsel suggesting to me that criminal referrals should not be made or should be delayed. Fee counsel have helped us to prepare and file seven comprehensive criminal referrals relating to ADSB since April 1987. My understanding is that ADSB's advisory board of

directors believes that fee counsel have done fine work in preparing those referrals. My suggestion for future cases is that earlier brief referrals be made while such comprehensive referrals are being prepared.

b. We understand that the Federal Bureau of Investigation ("FBI") has been investigating possible criminal misconduct at Beverly Hills Savings since shortly after the receivership in April 1985, and that a federal grand jury has been issuing subpoenas and hearing evidence since 1986. It is our position that FSLIC fee counsel have cooperated with the investigation and we understand that access to accounting workpapers has been made available to the FBI.

While neither the Federal Home Loan Banks ("District Banks") nor the Litigation Division of the Bank Board's Office of General Counsel can monitor every preliminary judgment by FSLIC fee counsel in every case, we have, as I indicated in my testimony, undertaken significant initiatives to better inform, educate, direct and coordinate fee counsel in the matter of criminal referrals, providing significant policy guidance for these understandably sensitive judgments.

Fee counsel do not necessarily have to make major efforts to make a criminal referral. The U. S. Department of Justice has made it clear that a referral should be made even if the evidence available does not conclusively demonstrate that a crime has been committed. The work required to prepare a complaint for FSLIC will often establish the need and basis for a criminal referral. FSLIC fee counsel are not necessarily expected to make referrals themselves; they are expected to do the work necessary to assist FSLIC in making such referrals.

At the hearings you were furnished with a copy of the May 26, 1987 letter from FSLIC Senior Associate General Counsel Dorothy Nichols that was sent to FSLIC fee counsel in California. Attached to this letter as Exhibit E is a copy of Ms. Nichols' June 17, 1987 letter, which is also now required to be sent to all FSLIC fee counsel. The letter continued the FSLIC's longstanding policy of emphasizing the critical importance of making criminal referrals, regardless of the impact on civil suits.

As I indicated at the hearings, your timely inquiries into the area of criminal referrals come as the District Banks and the Litigation Division of the Bank Board's Office of General Counsel are enhancing their own efforts in this area. Certainly the Subcommittee's efforts and the ensuing publicity have raised the sensitivity of all prosecutors, financial regulatory agencies and fee counsel to the need for better cooperation in sorting out the potential criminal liability of financial insiders and affiliates. I also direct your attention to the answers to Questions #7d and #8.

c. Attached as Exhibit F is Ms. Nichols' May 19, 1987 letter to FSLIC fee counsel in the Eleventh District of the Federal Home Loan Bank System, which includes California, Arizona and Nevada. Ms. Nichols' June 17, 1987 letter, referred to above and attached as Exhibit E, was sent to FSLIC fee counsel nationwide. In addition, Ms. Nichols directed a letter dated September 10, 1987, attached as Exhibit G, to FSLIC fee counsel in the Ninth District.

d. To facilitate the consistent and uniform application of our policies regarding the criminal referral process, the Federal Home Loan Bank of San Francisco ("Bank") has established the Criminal Referral Unit ("CRU"). The CRU serves as a criminal referral clearinghouse within the Eleventh District and helps Bank staff evaluate and resolve referrals. The CRU is headed by an Assistant Director, who performs this function in addition to his regular line responsibilities. The CRU is staffed by an Analytical Manager and three Agency Group analysts. Four major areas of emphasis for the CRU are as follows:

1. Training: The CRU is currently developing a comprehensive program for training Agency Group staff, including Supervisory Agents, managers, examiners, and analysts to detect and recognize criminal activity and to prepare criminal referrals. Several seminars have been held to date with the cooperation and assistance of federal and state law enforcement authorities, and similar training sessions are planned for the near future. This training will provide an increased awareness among Agency Group staff of their responsibility to take an active and continuing interest in the actual detection and referral of criminal activity for prosecution.

2. Computerized tracking system: The CRU is in the process of enhancing and modifying the existing data base, the Criminal Referral System ("CRS"), so that at any time the staff will be able to determine the status of a case and to document the extent of monitoring efforts. The CRS will also be used as a tool to detect possible patterns of criminal activity that may indicate that a larger, coordinated fraudulent effort may be underway. Ideally, this computerized information system, when fully enhanced, will allow the Agency Group to monitor a referral from detection of the criminal activity to conviction.

3. Communication and coordination: The CRU has begun to establish and maintain a liaison with various criminal law enforcement and other regulatory agencies, including, but not limited to, the U. S. Department of Justice and the FBI, the California Department of Savings and Loans ("CDSL"), the California Department of Real Estate, the California State Attorney General, the Nevada Gaming Commission, the Internal Revenue Service, the Secret Service, the Securities and Exchange Commission, and the U. S. Customs Service.

Specific activities undertaken to date involving several of these state and federal agencies include training seminars on criminal referrals. Instructors have included local employees of the U. S. Department of Justice and the FBI. Students have included employees from the CDSL and the Agency Group, including Supervisory Agents, managers, examiners, analysts, and attorneys of the Bank. In addition, regular meetings are held between the CRU and representatives of the San Francisco FBI office. These meetings serve as a forum for discussion of general issues as well as specific concerns on individual cases and referrals.

4. Detection, referral and followup: It is an important goal of the CRU to promote the timely preparation of referrals in all instances in which criminal activity is suspected, to ensure the adequacy of the referrals, and to follow up with the appropriate investigative and prosecutorial agencies once the referral has been made.

Procedures which the CRU has begun drafting include: (1) the reporting of suspected criminal activity, (2) the processing and review of referrals made by Agency Group personnel, and (3) the processing and

review of referrals made by member institutions and others. These procedures are still in the process of being developed and should be finalized soon.

In addition, the Agency Group has established a Criminal Referral Backlog Committee to review cases where a referral may be appropriate but where none has yet been made. The Backlog Committee conducts weekly meetings and is moving to make all necessary referrals as soon as possible.

8. Special U.S. Attorney Office Task forces:

The San Francisco, Chicago, Dallas and Seattle District Banks have established special task forces to facilitate criminal referrals, investigations, and prosecutions in their respective districts. These task forces work closely with the U. S. Department of Justice investigators and prosecutors, providing possible evidence of criminal fraud where discovered in preparation for civil litigation. The FBI has been actively involved in all these regions, and FSLIC fee counsel have cooperated in active investigations in these districts as well. Some particularly active prosecutors in these areas are U.S. Attorney Gene Anderson and Assistant U.S. Attorney Robert Westinghouse in Seattle, Assistant U.S. Attorneys Ben Burch for the Northern District of California and Terrence Bowers for the Central District of California, and Richard Fishbein of the U. S. Department of Justice Special Task Force in Dallas.

Very truly yours,

William K. Black

William K. Black
Senior Vice President
and General Counsel

WKB/dlr/0413M

EXHIBIT A

ESTIMATED LOSSES TO THE
FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION
FOR SELECTED INSTITUTIONS

	Estimated Loss to the FSLIC (in $millions)	Net Worth as of 7/31/87 (excluding Income Capital Certificates) (in $millions)
American Diversified	650	(590.7)
Atlas	*	**
Bell	550	(419.5)
Beverly Hills	950	(840.6)
Butterfield	300	(245.4)
Cal America	100	(90.2)
Centennial	*	**
Central	*	**
Columbus	80	(76.2)
Consolidated	*	**
Equitable	*	**
Farmers	200	(174.7)
Gateway	50	(45.1)
Golden Pacific	*	**
Manhattan Beach	15	(11.3)
Mt. Whitney	35	(28.7)
North America	100	(81.4)
Perpetual	10	(6.1)
Presidio	*	**
Ramona	70	(59.8)
San Marino	*	**
Seapointe	*	**
South Bay	*	**
Sun	*	**
Tahoe	20	(17.1)
Unified	12	(9.3)
United	*	**
Western Community	*	**
Westwood	200	(181.8)

* Association either has been sold or liquidated or has gone through an asset-backed transfer. FSLIC should be able to assess the actual loss more accurately.

**Association no longer in existence.

EXHIBIT B

Institution	Appraiser	Total Claim*
Beverly Hills Savings (FSLIC v. Fitzpatrick et al.)	1. Touche Ross & Co.	$300 million
Ramona FS&LA (FSLIC v. Molinaro et al.)	1. Mike Sage & Co., Inc. 2. Difilippo	$19 million
San Marino S&LA (FSLIC v. Forde et al.)	1. John Brennan ("The Appraisers")	$82.7 million
Butterfield S&LA (FSLIC v. Safley et al.)	1. Alan A. Paget 2. Charles P. Thompson 3. Mark D. Barry 4. Stephen T. Smith 5. Harold R. Walker	$62.5 million

* These figures represent the FSLIC's estimate of the total claim against all defendants, and have not been broken down into claims against individual defendants.

EXHIBIT C

Institution	Borrowers	Total Claims*
Bell S&LA (FSLIC v. Butler et al.)	1. Richard Benvenuti 2. Don Hancock 3. James Kassis 4. Murphy Maier 5. Con Star, Inc. 6. Gateway Professional Center 7. H Street Professional Center 8. Park Plaza Associates 9. Peri Executive Center Associates 10. Christo Bardis 11. Bell Advisory Corporation 12. John Reynen 13. Romder-Karnon Properties 14. Sacramento Executive Suites--Park Plaza Center, Inc. 15. Santa Fe Development & Mortgage Co.	$150 million
Centennial S&LA (FSLIC v. Shah et al.)	1. Lakewood Enterprises, Inc. 2. Nicolas Sandmann 3. Damstraat, Inc.	$100 million
Columbus S&LA (FSLIC v. Musacchio et al.)	1. Trade Wind Traders, Inc. 2. TW Trading International 3. TWT Financial Group 4. C. E. Noda 5. C. E. Capital 6. P. Henry and H. Worden	$76.9 million
Consolidated S&LA (FSLIC v. Ferrante et al.)	1. Jorge Yavar 2. Pyrotonics Corp. 3. W. L. Seay 4. C. B. Financial Corp. 5. Balboa Fun Zone, Ltd. 6. Crowder Development	$50 million

* These figures represent the FSLIC's estimate of the total claim against all defendants, and have not been broken down into claims against individual defendants.

EXHIBIT C
(continued)

Institution	Borrowers	Total Claims*
Gateway SB (FSLIC v. Gon et al.)	1. Magna Financial Corporation 2. DVM-Westpark South Ltd. 3. Two Connecticut 4. Northill-Tucson	$40.5 million
North America S&LA (FSLIC v. McKinzie et al.)	1. Rebecca Thrall 2. Kenneth Thrall	$20 million
Perpetual SB (FSLIC v. Morady et al.)		$5 million
Ramona FS&LA (FSLIC v. Molinaro et al.)	1. Donald W. Stump 2. William Welch 3. Donald C. Calvello 4. John L. Dariano 5. Frank DeCarlo	$19 million
San Marino S&LA (FSLIC v. Forde et al.)	1. Jack Bona 2. Frank L. Domingues	$82.7 million

* These figures represent the FSLIC's estimate of the total claim against all defendants, and have not been broken down into claims against individual defendants.

FSLIC COMPLAINTS

Institution	Insiders Named	Appraisers Named	Borrowers Named	Amount Sought (in millions)
American Diversified Savings Bank	2	0	0	$60.0
Bell S&LA	14	0	15	150.0
Beverly Hills S&LA	17	1	0	300.0
Butterfield S&LA	7	5	0	62.5
Centennial S&LA	16	0	3	100.0
Columbus S&LA	4	0	6	76.9
Consolidated Savings Bank	17	0	6	50.0
Farmers S&LA	16	0	0	100.0
Gateway Savings Bank	5	0	3	40.5
Manhattan Beach S&LA	7	0	0	8.0
Mt. Whitney S&LA	15	0	0	17.0
North America S&LA	2	0	1	20.0
Perpetual Savings Bank	8	0	1	5.0
Presidio S&LA	9	0	0	80.0
Ramona S&LA	6	1	5	19.0
San Marino S&LA	14	1	2	82.7
Unified Savings Bank	3	0	0	2.0
Western Community S&LA	13	0	0	10.0
TOTAL	175	8	42	$1,183.6

EXHIBIT D

The objectives of MATS (Major Asset Tracking System) are to:

1. Improve the supervision of problem loans by

   * Facilitating uniform classification of assets through timely communication of asset classification decisions between PSAs, and

   * Alerting supervisors in an FHLBank when a loan held in whole or in part by an institution in that district has been classified.

2. Help supervisors and examiners to anticipate problem loans by

   * Allowing examiners and supervisors to research borrowers and other actors in major extensions of credit particularly where problems have occurred previously.

MATS should achieve these objectives in a way such that:

a. The burden of information collection is minimized to the degree possible; information should only be collected as it will be currently useful;

b. The information collected in MATS is fully useful to FSLIC and FADA; while FSLIC and FADA will require the collection of additional data beyond the needs of the FHLBank System, FSLIC and FADA will use MATS as the "front end" for those loans stored in MATS;

c. The "user visible" features of the system resemble the EDS/SACS/ROE system to the maximum degree possible so that MATS does not appear as a separate system but rather as a new component of existing systems;

d. The processing (i.e., inputting, correcting, etc.) of data is consistent with the processing of data in other FHLBank System information systems;

EXHIBIT E

Federal Home Loan Bank Board

1700 G Street, N.W.
Washington, D.C. 20552
Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

June 17, 1987

FORM LETTER TO FEE COUNSEL

Re: Criminal Referrals -- Cooperation with Law Enforcement Agencies

Dear _____:

As you know, it is this agency's legal obligation, and therefore your obligation as counsel, to make criminal referrals when appropriate in all matters for which you are retained. This obligation includes notifying law enforcement agencies of known or suspected criminal conduct discovered in the course of your work, and responding to requests by law enforcement agencies for information concerning particular institutions and individuals. Please consult with an attorney from this office to ensure that the requirements of the Right to Financial Privacy Act, Bank Board regulations, and other applicable laws are followed in disclosing such information.

In the course of our investigations, civil lawsuits, and administrative proceedings, including settlement negotiations, no one may, without the prior approval from the appropriate law enforcement authorities, agree with any party either not to disclose or not to refer to such law enforcement authorities any information which may be pertinent to a possible criminal violation or investigation.

When a criminal proceeding exists which parallels a civil proceeding involving FSLIC, you should consider whether any contemplated actions might adversely impact any criminal proceedings. If so, this office should be consulted before taking any such action.

When an investigation, civil action, or administrative proceeding is commenced, you may, with authorization from this office, discuss the voluntary disposition of these matters. It is the policy of FSLIC, however, that no such disposition, expressly or impliedly, shall affect in any way the disposition of any criminal charges or proceedings of any nature. Please make this policy clear if the issue should arise in connection with any settlement negotiations. This policy reflects the fact that FSLIC lacks authority to institute, conduct, settle, or otherwise dispose of criminal proceedings. Such authority is vested solely in the appropriate law enforcement agencies.

Please contact the undersigned or Paul Grace at the Litigation Division, Office of General Counsel, should you have any questions concerning this subject.

Sincerely yours,

Dorothy L. Nichols
Senior Associate General Counsel

EXHIBIT F

May 19, 1987

[FSLIC Fee Counsel
for all Eleventh District Institutions
for which fee counsel have been retained,
including liquidating receiverships,
regardless of whether litigation has yet
been filed]

Re: Criminal Referrals - Assistance to Agency Group,
Federal Home Loan Bank of San Francisco

Dear _____:

This is to advise you that the Agency Group of the Federal Home Loan Bank of San Francisco ("Agency Group") which, as you know, has regulatory responsibility for all institutions insured by the Federal Savings and Loan Insurance Corporation ("FSLIC") in the Eleventh District ("District"), has formed a Criminal Referral Task Force to review all files of operating and/or failed institutions in the District to ensure that criminal referrals are made on all individuals and all transactions involved in suspected criminal activity under federal and state law.

The Department of Justice, through the United States Attorney's Office and Federal Bureau of Investigation, has agreed to provide immediate assistance to the Criminal Referral Task Force in evaluating criminal referrals for prosecution. Since you, as fee counsel for the FSLIC, have the benefit of investigations subsequent to the failure of an institution, you are in the best position to assist the Agency Group and their

lead attorney Glenda Robinson in this task. FSLIC requests that you provide the Agency Group, and at their request, the appropriate Department of Justice personnel, with whatever information will assist a rapid analysis of possible criminal violations that have occurred at any institutions for which you have been retained by the FSLIC as counsel. It is this agency's obligation, and your obligation as its counsel, to make all appropriate criminal referrals. The FSLIC, therefore, advises you to provide all necessary information to make criminal referrals where appropriate, and, if requested to do so, to actually assist in the preparation of criminal referrals.

Should you have any questions regarding this matter or attorney-client, work product or other privileges that might apply to the material in question, please contact the undersigned or Paul Graco at the Office of General Counsel, Litigation Division, Federal Home Loan Bank Board.

Sincerely yours,

Dorothy L. Nichols
Senior Associate
General Counsel
Litigation Division

9/10/

EXHIBIT G

1700 G Street, N W
Washington, D C 20552
Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

Federal Home Loan Bank Board

[Form letter to FSLIC fee counsel for Ninth District Institutions--Texas, Arkansas, Louisiana, Mississippi, New Mexico]

Dear _____:

On June 17, I wrote to remind you of your responsibilities as counsel for the Federal Savings and Loan Insurance Corporation to cooperate fully with criminal investigations concerning savings and loan institutions insured by FSLIC. Since that letter, a special federal task force has been established to investigate possible criminal violations in connection with FSLIC-insured institutions in the Ninth Federal Home Loan Bank District. That task force enjoys the complete cooperation of the Federal Home Loan Bank of Dallas and this office.

Accordingly, it is particularly appropriate that, as FSLIC's counsel, you fulfill this agency's legal obligation by assisting to the fullest extent possible with this major initiative. Your access to institutions' files subsequent to their failure has proven particulary valuable to criminal investigations. Accordingly, your utmost cooperation with request for materials by the special task force and the Dallas Federal Home Loan Bank is requested. Should you have any questions concerning subpoenas, attorney-client privilege, criminal referrals, or other issues, please contact Paul Grace (202-377-6424) or Howard Feinstein (202-377-7466) of this office, or Robert Bonchak (214-659-8540) of the Special Investigations office of the Dallas Federal Home Loan Bank.

Sincerely yours,

Dorothy L. Nichols
Sr. Associate
General Counsel
Litigation Division

From: Washington, D.C., Legal Times

SPECIAL COUNSEL
SAN FRANCISCO

We are the Federal Home Loan Bank of San Francisco, the resource bank and federal regulatory authority for more than 230 member savings institutions located in Arizona, California and Nevada. We are looking for attorneys to provide counsel to the examiners and supervisory agents on the regulatory staff of the Federal Home Loan Bank in the identification and reporting of criminal conduct at financial institutions for which they have regulatory responsibility and in making referrals to prosecutorial agencies. In this position, you would develop evidentiary and legal memoranda in support of recommendations for prosecution and, upon request of prosecutorial agencies, would assist in grand jury investigations and criminal trials.

To qualify, you should have at least five years' successful criminal prosecution experience, preferably including prosecution of white collar crimes within a federal prosecutorial agency; and two years' lead or supervisory experience. Acquisition of California license will be required, and ability to travel within the district is necessary.

We offer an excellent salary and benefits package, including medical, dental, and vision care. Please send your resume and salary requirements to: Human Resources Manager, Federal Home Loan Bank of San Francisco, 600 California Street, Post Office Box 7948, San Francisco, CA 94120. *An Equal Opportunity Employer.*

FEDERAL HOME
LOAN BANK OF
SAN FRANCISCO

ONE HUNDREDTH CONGRESS

Congress of the United States

House of Representatives

COMMERCE, CONSUMER, AND MONETARY AFFAIRS
SUBCOMMITTEE
OF THE
COMMITTEE ON GOVERNMENT OPERATIONS
RAYBURN HOUSE OFFICE BUILDING, ROOM B-377
WASHINGTON, DC 20515

September 2, 1987

Steven Adler, Esq.
Chief, Major Fraud Unit
California State Attorney General's Office
110 West A Street, Suite 700
San Diego, CA 92101

Dear Mr. Adler:

First, I want to express the Commerce, Consumer, and Monetary Affairs Subcommittee's belated appreciation for your testimony at the subcommittee's June 13, 1987, hearing in Los Angeles, which was thoughtful and informative. During your appearance at the hearing, I was unable to ask you several questions, because of a shortage of time due to the number of witnesses testifying. Accordingly, to complete the record, would you please respond to the following questions by September 21, 1987, if at all possible:

1. Information on the Major Fraud Index:

a. Describe exactly the information contained in the Major Fraud Index, established by the California's Attorney General's Office to interchange intelligence information on fraud subjects and schemes. When is information added to the Index? During an investigation or only after an indictment? How many subjects implicated with bank/thrift fraud or embezzlement are presently entered into the system?

b. Can the (i) FBI, (ii) U.S. Attorneys' Offices, and (iii) the Federal bank regulatory agencies each access the Major Fraud Index? If not, why not?

c. Would you recommend such a system for the U.S. Justice Department (including the FBI) and the Federal bank regulatory agencies? What are your views, if any, on how such a system could be structured?

2. Could you elaborate on your statement in your written testimony, recommending that the FBI and other investigative agencies provide mechanisms "which allow for investigative continuity when investigators assigned to particular major cases are reassigned", which apparently occurs frequently, given the duration and complexity of these matters. What mechanisms do you specifically envision?

This information will be helpful in the subcommittee's deliberations. Please have your staff contact subcommittee counsel Stephen McSpadden if there are any questions. Thank you for your cooperation, past and present.

Sincerely,

Doug Barnard, Jr.
Chairman

DB:sm:v

JOHN K. VAN DE KAMP
Attorney General

State of California
DEPARTMENT OF JUSTICE

110 WEST A STREET, SUITE 700
SAN DIEGO 92101
(619) 237-7351

September 22, 1987

Honorable Doug Barnard, Jr.
Member of Congress
Chairman, Commerce, Consumer and
Monetary Affairs Subcommittee
Rayburn House Office Building, Rm. B-377
Washington, D.C. 20515

Dear Chairman Barnard:

Thank you for the opportunity to address your committee during its hearings in Los Angeles, as well as for the opportunity to provide your committee with further information.

In your letter dated September 2, 1987, you posed a number of questions which I now have data to answer.

You asked for a description of the information contained in the Major Fraud Index in the Bureau of Organized Crime and Criminal Intelligence of the California Attorney General's Office. The Major Fraud Index is an intelligence file which contains information on suspect individuals and possible scams provided to the index by law enforcement agencies in California. It follows, then, that information is added to the index both at the outset of, and during any investigation into a major fraudulent scheme. The index is still in its formative stages and, at present, contains information on 39 schemes. Most of these schemes involve multiple defendants, but not all involve fraud against financial institutions.

Next, you ask about access to this index. As a law enforcement agency, the Federal Bureau of Investigation can obtain access to Major Fraud index information by making a telephone call to the coordinator. After procedures to establish the bona fides of the caller, information from the index will be provided. The same holds true for any U.S. Attorney's Office requesting information.

Federal bank regulatory agencies pose a somewhat different problem. Access for these agencies is given by California Civil Code sections 1798 et seq., the Information Practices Act of 1977.

Disclosure is governed by section 1798.24. Subdivision (e) provides, in pertinent part, that information may be transferred ". . . where the transfer is necessary for the transferee agency to perform its constitutional or statutory duties, and the use is compatible with a purpose for which the information was collected . . ."

In addition, subdivision (f) provides information transfer is permissible, "to a governmental entity when required by state or federal law." Information will also be made available pursuant to subpoena (subd. (k)) or search warrant (subd. (l)).

The foregoing, of course, is not intended as an opinion that release is or is not appropriate. Moreover, other subdivisions of section 1798.24 may apply.

You next ask if I would recommend such a system for the U.S. Justice Department and Federal Bank regulatory agencies. I would. The system is a very good one in theory. Our Major Fraud Index, however, is not accumulating data at anywhere near the rate we would have hoped. The Index coordinator tells me this is because we do not require agencies to furnish data to the system as a condition of obtaining information from it. In my opinion, such a component is a key to the success of such a system, and I would recommend any federal system include such a requirement. Our department would, of course, participate under those conditions.

Finally, you ask for more information on how investigative agencies may provide continuity in major investigations, notwithstanding periodic reassignment of investigators to other tasks. Here are some thoughts:

1. Management and Supervision

   Management and supervisors with responsibility for specialized fraud units (or any other truly specialized function) need not necessarily be fraud experts to do their jobs. However, if they are not, intensive training in the substance of fraudulent schemes and investigation, and also the methodology of conducting the investigations and prosecutions, is required as early as possible. Without expertise or training in the area, managers and supervisors will be unable to direct subordinates in focusing investigations appropriately, targeting only those individuals against whom a real criminal prosecution is possible, and making other crucial decisions which arise during the course of an investigation.

2. Cadre

At the supervisory and senior investigative levels, an investigative agency must maintain at least a few true experts in the specialized investigative field. In our Unit, we address this problem by both recruiting and seeking to keep experienced investigators and retaining a consultant with these credentials. Individuals in the cadre have a number of crucial responsibilities. They must constantly review training levels, the conduct of individual investigations, and practices within the investigative unit; critique what is happening, and make recommendations to supervisors and managers. Members of the cadre conduct both formal and on the job training for other members of the unit. They provide direction and security for newly assigned investigative staff who will necessarily be thrown into major, complex and frightening investigations. Cadre members also help supervisors and managers judge the outfit's success and pace.

3. Indoctrination and Training

Indoctrination into the investigative unit culture must be provided to any new investigator immediately upon assignment. In addition, formal and on-the-job training must be provided, especially in specialized areas such as fraud investigation. This is difficult to do because good training is often time-consuming and will take the investigator away from casework. However, the training is essential for its substantive effects and also for the morale of the individual investigator.

4. Make Continuity a Goal

This final point may be somewhat obvious. Agent groups working on cases should be comprised of cadre members as well as new investigators. In addition, if rotation is accomplished on any kind of a fixed schedule, it is obviously inappropriate to assign a lengthy case solely to investigators who are due for rotation. Although Major Fraud investigations are often so complex and time-consuming that they must be handled by a group of investigators, the careful formation of such a group will allow for continuity despite reassignment of team members during the course of the investigation, as well as on-the-job training for inexperienced team members.

Thank you again for the opportunity to assist your committee in its important work. If you or your staff have any questions, please do not hesitate to call me directly at (619) 237-7753.

Very truly yours,

JOHN K. VAN DE KAMP
Attorney General

STEVEN V. ADLER
Assistant Attorney General
Chief, Major Fraud Unit

SVA:ejl

ONE HUNDREDTH CONGRESS
Congress of the United States
House of Representatives
COMMERCE, CONSUMER, AND MONETARY AFFAIRS
SUBCOMMITTEE
OF THE
COMMITTEE ON GOVERNMENT OPERATIONS
RAYBURN HOUSE OFFICE BUILDING, ROOM B-377
WASHINGTON, DC 20515

September 9, 1987

Hon. William J. Crawford
Savings and Loan Commissioner
California State Department of Savings
600 South Commonwealth Avenue
Los Angeles, CA 90005-4085

Dear Commissioner Crawford:

First, I want to express the Commerce, Consumer, and Monetary Affairs Subcommittee's belated appreciation for your excellent, thoughtful, and informative testimony at the subcommittee's June 13, 1987, hearing in Los Angeles. During your appearance, I was unable to ask you several questions to obtain elaboration on some points raised in your testimony, because of obvious time constraints. Accordingly, to complete the record would you please respond to the following questions by September 30, 1987, if at all possible:

1. (a) What controls has the California State Legislature adopted to address some of the abuses which were the subject of the June 13th hearing, as referenced on page 8 of your written testimony? (b) Are any similar measures under consideration by the Legislature? (c) What additional statutory powers, procedures or remedies, if any, do you need, to keep unscrupulous people out of the industry or to remove them quickly if they somehow enter it? (For example, you testified that "removal and prohibition of individuals is an expensive, time-consuming process." How could the process be improved?)

2. What actions, if any, has the State's White Collar Crime Task Force taken to respond to the this problem of pervasive fraudulent misconduct in California's financial institutions?

3. Please describe the special enforcement team within your office, how it will be constituted, what its objectives will be, and what efforts it has undertaken so far.

This information will be helpful in the subcommittee's deliberations. Please have your staff contact subcommittee counsel Steve McSpadden if there are any questions. Thank you for your cooperation, past and present, and for the time you have devoted to our efforts.

Sincerely,

Doug Barnard, Jr.
Chairman

DB:sm:b

STATE OF CALIFORNIA GEORGE DEUKMEJIAN, Governor

DEPARTMENT OF SAVINGS AND LOAN
600 S. Commonwealth Avenue, Los Angeles, Calif. 90005 - (213) 736-2798
350 Sansome Street, San Francisco, Calif. 94104 - (415) 557-3666

Los Angeles
September 29, 1987

Doug Barnard, Jr., Chairman
Commerce, Consumer and Monetary
Affairs Subcommittee
Rayburn House Office Building, Room B-377
Washington, DC 20515

Dear Congressman Barnard:

Thank you for your letter of September 9, 1987, requesting additional information. The effects of your Congressional hearing on enforcement have been excellent. Your Congressional hearings on white collar crime, which brought together the United States Attorney, the FBI, the Federal Home Loan Bank and this Department, have resulted in close communications between those four departments, with monthly updates and several seminars where subordinates were brought up-to-date and educated how to hone their skills.

The following is in response to your specific questions:

1. (a) Various bills have been signed into law by Governor Deukmejian during the last two years which address the white collar crime issue. These bills either amend the existing law to increase penalties or create new law to deal with white collar crime. Attached is a summary of recent legislation.

(b) The California State Legislature has now adjourned so there are no similar measures under consideration at this time.

(c) It would be desirable to have federal legislation to support whistle-blowing on the part of officers, directors and employees who have daily or monthly access to information that indicates that the affairs of the institution are being improperly managed by insiders. It is my understanding that you have federal legislation to protect whistle-blowers in the defense industry and other industries. I believe that you could pattern the legislation after those laws. These potential whistle-blowers should be protected as their own reputations and careers are in jeopardy. It should be made clear that the intention is not to foster personality conflicts but to clearly maintain the integrity of the institution as a whole. Attached is a copy of our whistle-blowing directive, which you might use in drafting your legislation. It has been effective for us. However, it does not protect the whistle-blower.

Removal and prohibition with due process is a very difficult area. It is slow, cumbersome and expensive. I do not have any proposed solution to that problem.

2. White Collar Crime. Our Department is participating in a White Collar Crime Task Force under the auspices of the Business, Transportation and Housing Agency for the State of California. The Task Force consists of representatives from the Departments of Insurance, Real Estate, Corporations, Banking and Savings and Loan. The objective is to improve information-sharing and a method to work together to investigate and prosecute fraud involving financial institutions. Additionally, it will provide joint training sessions to upgrade the investigation skills of the staff.

The Task Force is working together on 23 cases, has referred eight cases for criminal prosecution, has one conviction to date and has one case ready for criminal referral. Attached is a summary of the actions pending as of September 28, 1987. The White Collar Crime Task Force has met with the District Attorneys from Sacramento, San Francisco, Los Angeles and Orange County and the message appears consistent that white collar crime is on the increase. They concur there is the difficulty of a "system" in which judges have a bias and do not wish to tie up their Court calendars with economic crime cases. They give priority to violent crime cases, such as homicide, rape, child molestation and other violent crimes. To illustrate the lack of emphasis on economic crime, the Los Angeles District Attorney's Office employees 800 lawyers, of which only 15 are dedicated to the Major Fraud Division, which is the unit that deals with white collar crime.

3. Enforcement. We have entered a budget request for three investigators. We have three of our key people, the Chief Deputy Commissioner, an attorney and one of our most proficient supervisory examiners dedicated to this enforcement task. They are attending seminars and schools on white collar crime. They all have very good skills to contribute toward this effort when we get the three investigators aboard, which will not be until after the legislature has acted on our new budget. We have also included two EDP experts who will work with the Federal Home Loan Bank on their data bank.

I refer you also to the fact that speedier results are being obtained from attorneys representing the Federal Home Loan Bank. Cases are being filed much more promptly than we believe they would have been had it not been for investigation. I specifically refer you to the North America Savings and Loan Association case, which was recently filed with 55 defendants named. As these cases get cycled through the Courts, the public will be much more aware of the pervasiveness of this type of crime. We call your attention

to the fact that the primary defendant in civil and criminal cases takes the Fifth Amendment on both cases and the result is extensive delays, which may result in much greater expense and the loss of witnesses or lapses of memory on the part of witnesses, which will augur to the benefit of the perpetrator of the crime.

The only way the appraisal problem will ever be solved is to raise the profession to the level of the CPA's. Also enclosed is an article from last Sunday's Los Angeles Times indicating that an opposition group to your federal standards for appraisals is being organized. Keep the heat on.

Sincerely,

WILLIAM J. CRANFORD
Savings and Loan Commissioner

WJC:lfm
Enclosures

LEGISLATION WHICH ADDRESSES WHITE COLLAR CRIME

AB 3017 (Ch. 673 Statutes, 1986) was one such bill, which specifically related to credit unions. Various sections of law were added to the Financial Code to define certain willful acts of directors, officers, or employees detrimental to a credit union to be crimes, providing a basis for prosecution.

AB 3103 (Ch. 173, Statutes 1986) expanded existing law adopted in 1985 to give lenders and subsidiaries a cause of action against fraudulent borrowers.

SB 2452 (Ch. 1158, Statutes 1986) enhances the ability of the Savings and Loan Commissioner to restrain or control transactions that involve affiliated persons and have created financial problems for associations. Specific penalties and provisions for standards of conduct and for removal of directors, officers or employees were put into effect.

SB 1012 (Ch. 1437, Statutes 1986) expands the scope of computer-related offenses to include the publishing of a personal identification number, computer password, access code, debit card number or bank account number.

SB 1856 (Ch. 838, Statutes 1986) prohibits anyone from engaging in "rent skimming" and enhances penalties for the crime.

SB 2150 (Ch. 383, Statutes 1986) replaces the Uniform Fraudulent Conveyance Act with the Uniform Fraudulent Transfer Act, clarifying and streamlining language and procedures for judicial action.

SB 2392 (Ch. 1436, Statutes 1986) adds debit cards to current law governing crimes involving theft or forgery of a credit card and elevated specified crimes from petty theft to grand theft. This bill created a new crime involving counterfeit access cards.

SB 1462 (Ch. 534, Statutes 1986) provides that real property is subject to forfeiture if the owner is convicted of committing certain drug related crimes.

AB 295 (Ch. 1162, Statutes 1987; effective September 25, 1987) specifically added a new crime for willful acts committed by employees, officers, or directors involving commission or omission of material facts of an association's books and records. Other penalty provisions were amended to increase monetary penalties.

SB 1024 should be signed by the Governor soon and will permit various state agencies to provide information on individuals to named regulatory or supervising agencies for investigation of unlawful activities under certain circumstances.

TO: Department of Savings and Loan
600 So. Commonwealth Avenue, Suite 1502
Los Angeles, CA 90005-4085

SUBJECT: _____
(Name of Institution)
Report of Personnel Policies

As directed by your Issuance No. 86-10, dated October 17, 1986, attached are two true and correct copies of our published personnel policy as set forth and approved by our board of directors (or board of trustees) at its meeting held on _____.
(date)

As of this date, a copy of the attached publication has been distributed to each of our employees.

We certify (or declare) under penalty of perjury under the laws of the State of California that the foregoing is true and correct.

Dated _____ _____
Signature

_____
Typed Name

_____
Corporate Title

Dated _____ _____
Signature

_____
Typed Name

_____
Corporate Title

Note: This declaration must be signed by the institution's president or vice president and its secretary or treasurer or assistant secretary or assistant treasurer.

SL 104

STATE OF CALIFORNIA GEORGE DEUKMEJIAN, Governor

DEPARTMENT OF SAVINGS AND LOAN
600 S. Commonwealth Avenue, Los Angeles, Calif. 90005 - (213) 736-2798
350 Sansome Street, San Francisco, Calif. 94104 - (415) 557-3666

Los Angeles
October 17, 1986
No. 86-10

TO: All State Savings and Loan Associations, Savings Banks and All Interested Persons

RE: Reports to the Department - Personnel Policies

We believe the fiduciary responsibilities of financial institutions dictate the need for personnel policies that promote a free exchange of critical or sensitive information between an institution's staff and its statutory auditors, and regulatory agencies. This need is especially apparent in some instances of unreported violations of law and regulations and other misconduct which have contributed to significant financial losses.

We have determined, pursuant to Section 8050 of the California Financial Code (CFC), that to enhance its safety and soundness, the board of directors or board of trustees of **each savings and loan association and savings bank shall:**

1. On or before December 31, 1986, adopt a resolution directing publication and distribution to staff of the board's policy and information on how staff can **confidentially** report incidents of violations of law and regulations and other misconduct directly to its statutory auditors and regulatory agencies. The published information shall include at least the name, local address and telephone number of the statutory auditor, and the name of the official with whom **confidential** contact may be made. The following information shall also be provided for contact of regulatory agencies:

Mailing Address	Telephone No.
Department of Savings and Loan 600 So. Commonwealth Avenue, Suite 1502 Los Angeles, CA 90005-4085	(213) 736-2596 -or- (415) 557-3666
Attention: Savings and Loan Commissioner	
- a n d -	
Federal Home Loan Bank of San Francisco P. O. Box 7948 San Francisco, CA 94120-7948	1-800-652-1646
Attention: President	

(OVER)

2. On or before December 31, 1986, and thereafter, upon hiring of new staff or any revision of the personnel policy as required hereby, distribute a copy of the published policy to each of its employees.

3. Annually the association shall review its policy and recommend either retention as written or changes as necessary for action by its board of directors or board of trustees. The board's deliberations on the recommendation shall be recorded in its official minutes.

To monitor compliance with the foregoing directive, pursuant to CFC Section 8151, we have developed the attached report form (SL 104), which each savings and loan association and savings bank shall file with the Department on or before December 31, 1986, and thereafter as part of its annual report to the Department.

WILLIAM J. CRAWFORD
Savings and Loan Commissioner

Attachment

STATE OF CALIFORNIA

DEPARTMENT OF CORPORATIONS

WHITE COLLAR CRIME TASK FORCE
SUMMARY OF PUBLIC ACTIONS AS OF SEPTEMBER 28, 1987

23 CASES

Criminal:

Criminal complaints filed	10
Criminal convictions	4

Civil:

TRO's obtained	1
Permanent injunctions obtained	1

Administrative:

Denial/Revocation of licenses/registration	7
Desist & Refrain/Cease & Desist Orders	6
Accusations filed	5
Took possession of licensee	1
Barred from industry	1
Cease Business Order	1

Total:

37 public enforcement actions

* * * * *

LOS ANGELES TIMES - Sunday, September 27, 1987

Appraisers Form New Group

The Appraisers Common Cause, a nonprofit association, has been formed in response to a movement within and outside the appraisal industry to regulate appraisers.

The group consists of appraisers who either belong to one of the various appraisal groups or who are independent and not members of any association. Only about 25% of all appraisers belong to one of more than 15 major appraisal associations in the United States.

The need to establish the Appraisers Common Cause arose when Congress held hearings on the regulation and licensing of appraisers, according to John E. Steensland, approved FHA (Federal Housing Administration) appraiser and board member.

Robert G. Johnson, executive director of the National Assn. of Review Appraisers and Mortgage Underwriters and also a member of the ACC board said that "the ACC does not support any federal legislation regarding the regulation of appraisers as there are too many differences among the 50 states."

Information on the ACC may be obtained from the organization at P. O. Box 5798, Scottsdale, Ariz. 85261.

U.S. Department of Justice

Federal Bureau of Investigation

Office of the Director

Washington, D.C. 20535

September 30, 1987

Honorable Doug Barnard, Jr.
Chairman
Subcommittee on Commerce, Consumer,
and Monetary Affairs
Committee on Government Operations
House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

This is in response to your letter of September 4, 1987, wherein you requested additional information from the Federal Bureau of Investigation (FBI) concerning the Subcommittee's follow-up examination of Federal agency responses to its October 5, 1984, report, "Federal Response to Criminal Misconduct and Insider Abuse in the Nation's Financial Institutions" (House Report 98-1137).

The attached information is being submitted in response to your specific requests for information, which for the sake of clarity, are restated herein.

I understand you may be holding additional hearings on this matter in the near future. Please coordinate this matter with Supervisory Special Agent (SSA) Daniel R. Dzwilewski of the Congressional Affairs Office. In keeping with the longstanding Department of Justice policy, any contact with field personnel should be coordinated through SSA Dzwilewski.

You can be assured of our full cooperation in responding to any additional informational needs of the Subcommittee.

Sincerely yours,

John E. Otto

John E. Otto
Acting Director

Enclosure

SUBCOMMITTEE NOTE:

ONLY THAT PORTION OF THE FBI'S LETTER WHICH CONCERNS THE FBI'S LOS ANGELES AND SAN DIEGO DIVISIONS AND THEIR INVESTIGATIVE ACTIVITIES HAS BEEN REPRINTED. THE REMAINDER OF THIS LETTER (PAGES 1--18) WILL BE PRINTED IN A FUTURE SUBCOMMITTEE HEARING TRANSCRIPT.

Honorable Doug Barnard, Jr.

B. Problems with FBI Resources in two FBI Divisions

During the June 13th hearing, we heard convincing evidence that the White-Collar Crimes Unit of the FBI's Los Angeles Division was severely understaffed, that there were 10 vacancies which had not been filled because the FBI had allotted no transfer funds for the last half of Fiscal year (FY) 1987, and that the FBI's Orange County (Santa Ana) Office was severely incapacitated in investigating bank and thrift fraud cases. Although the Los Angeles Division had over 260 pending financial institution fraud and embezzlement investigations where the amount involved was over $100,000, only 21.3 direct Agent work years had been allotted in the first half of FY 1987 to such matters, and one agent in particular had been working part-time on several major investigations arising out on large thrift failures. U.S. Attorney Bonner testified:

> "The Santa Ana Resident Agency of the [L.A. Div.] has an acute shortage of agents. For example, one FBI agent in Santa Ana has four major bank fraud investigations, any one of which should be staffed full-time by at least two agents. In my view, the Santa Ana RA is simply performing triage as it confronts an ever increasing number of cases [involving all types of frauds]. Some significant Orange County bank fraud investigations are in holding patterns because the assigned agent is handling too many cases."

This situation in the Los Angeles Division is extremely troubling, especially as some of the suspects move on to other financial institutions (either as borrowers or as insiders), often repeating their misconduct. I believe this situation requires your special attention.

The Los Angeles FBI Division, WCC component was within 10 Special Agents of its target staffing level of 90 at the time of previous FBI testimony on June 13, 1987. That component as of September 21, 1987, is at its full target staffing level. In an FBI office the size of Los Angeles, it is not unusual, at times, to be slightly below or above the authorized complement level because of the frequent and overlapping transfers of personnel into and out of the division to meet the needs of the FBI.

Honorable Doug Barnard, Jr.

The Special Agent in Charge of the Los Angeles Division must assign manpower on a continuous and almost daily basis to address the often competing needs for resources to meet exigent problems.

Honorable Doug Barnard, Jr.

6. Supplemental Information Required for the Subcommittee's Record of the June 13, 1987, Hearing in Los Angeles:

a. Mr. Jamar's testimony listed 22 failed institutions in Southern California as to which there is an FBI investigation. We need the following additional information: (i) Please furnish to the subcommittee a very brief status report on the investigative/prosecutive status of the investigations pertaining to the 17 financial institutions listed on p. 11 of his testimony and the 5 financial institutions in the San Diego division. (ii) Please explain and describe the statute of limitations problem and also the priority to other matters, referenced on p. 11 of his testimony, and identify the failed financial institutions to which these respective investigative problems apply. (iii) Please identify the remaining 9 failed financial institutions which are inactive because of the lack of a criminal referral or other information.

In FBI testimony on June 13, 1987, 17 financial institutions within the Los Angeles FBI Division had failed and were under investigation. As of this time, the following is a status update on those 17 institutions:

Institution	Status of Investigation	Accomplishments	Reasons
Western National Bank	Ongoing	One Conviction, One Indictment (pending trial)	
San Marino S & L	Ongoing		
Hacienda Fed. Savings	Ongoing	One Conviction	
Heritage Bank	Ongoing		
West Coast Bank	Ongoing	One Conviction	
Beverly Hills S & L	Ongoing		
First City Bank	Ongoing		
Commercial Bank of California	Closed		Prosecution Declined
Butterfield Savings	Closed		No Criminal Referral
American Diversified Savings	Ongoing		
Valencia Bank	Ongoing		
West Valley Bank	Closed	One Conviction	
Consolidated Savings	Ongoing		
Independent Nat'l Bank	Ongoing		
North American Savings	Ongoing		
Perpetual Savings Bank	Ongoing		
South Bay Savings	Ongoing		

Honorable Doug Barnard, Jr.

In that same testimony, there was a listing of 12 failed Los Angeles financial institutions wherein an FBI investigation was not being conducted. The following is an updated status on those investigations:

Institution	Status of Investigation	Accomplishments	Reasons
Newport Harbor Bank	Closed		Statute of Limitations Expired
Bank of Irvine	Closed		Prosecution Declined
Garden Grove Community Bank	Closed		No Criminal Referral
Southern California Savings	Closed		No Criminal Referral
Capistrano National Bank	Ongoing		
Manhattan Beach Savings	Closed		No Criminal Referral
Center National Bank	Closed		No Criminal Referral
Saddleback Valley Bank	Closed		No Criminal Referral
Orange Coast Thrift and Loan	Closed		No Criminal Referral
Ramona S & L	Ongoing		
Unified Savings Bank	Closed	One Conviction	
New City Bank	Ongoing		

In the instances cited above where no criminal referral was received, the Special Agent in Charge elected to open a file in furtherance of liaison with the bank supervisory agency to insure the orderly flow of relevant information concerning the failed institution.

Honorable Doug Barnard, Jr.

When the bank supervisory agency conducting the initial review of the activities of the failed institution finds indication of criminal activity, there is normally a criminal referral made to the FBI, and an investigation is initiated. If there is no indication of criminal activity located, and there is no referral received, the FBI field division will then close its investigative file.

The investigation into alleged criminal activity at the Newport Harbor National Bank was initiated by the FBI when criminal referrals were made in 1984. Those, and referrals received in 1985, related to alleged misdemeanor bank fraud violations of a bank officer in making loans in 1982. An FBI investigation into previous, almost identical, alleged misdemeanor criminal activities by the same officer resulted in declined federal prosecution. As a matter of practice, the Los Angeles United States Attorney's Office rarely prosecutes misdemeanor bank fraud violations. The bank records regarding these loans were subpoenaed by the FBI in 1985, and received in 1986. These records were reviewed in an effort to substantiate allegations of criminality. The review was discussed with a Los Angeles Assistant United States Attorney in early 1987, who was unable to render a prosecutive opinion based on limited evidence. When the statute of limitation expired in April 1987, the investigation was closed.

Honorable Doug Barnard, Jr.

In the June 13, 1987, FBI testimony, five financial institutions which had failed in the San Diego area were listed. The following is a status update of those matters:

Institution	Status of Investigation	Accomplishments	Reasons
Central S & L	Closed		No Criminal Referral
Sun S & L	Ongoing	Two Convictions	
Seapoint S & L	Closed		No Criminal Referral
California Heritage	Ongoing		
Frontier Nat'l Bank	Ongoing		

b. Are all of the 133 bank/thrift fraud investigations involving losses between $100,000 and $250,000 and the 143 such investigations involving losses of $250,000 and above in the Los Angeles and San Diego Divisions active ongoing investigations? If not, provide a breakdown for each dollar loss category showing active and inactive investigations in both the Los Angeles and San Diego Divisions.

As of September 21, 1987, the Los Angeles FBI Division has active ongoing investigations which involve fraudulent misconduct in financial institutions at levels of loss as follows:

Loss Between $100,00 and $250,000	-	117 investigations
Loss $250,000 and above	-	160 investigations
Total		277

In addition, the Los Angeles FBI Division has received other referrals citing criminal misconduct in financial institutions, but has not yet begun active investigations due to resource limitations. Additional manpower resources have recently been made available by the Special Agent in Charge and these matters are currently being reviewed These matters involve levels of loss as follows:

Loss Between $100,000 and $250,000	-	26 matters
Loss $250,000 and above	-	0
Total		26 matters

The Special Agent in Charge of the Los Angeles FBI Office constantly reviews the other manpower resources of that Field Division and reallocates them in order to address the highest priority problems. He found the other investigative programs have taxing problems and it is not feasible to divert manpower from these other understaffed programs to bank fraud investigations.

Honorable Doug Barnard, Jr.

As of September 21, 1987, the San Diego FBI Division has active ongoing investigations which involve fraudulent misconduct in financial institutions at a level of loss as follows:

Loss Between $100,000 and $250,000	- 7 investigations
Loss $250,000 and above	-13 investigations
Total	20 investigations

All matters of financial institution fraudulent misconduct wherein the losses are over $100,000 within the San Diego FBI Division are under active investigation.

ONE HUNDREDTH CONGRESS
Congress of the United States
House of Representatives
COMMERCE, CONSUMER, AND MONETARY AFFAIRS
SUBCOMMITTEE
OF THE
COMMITTEE ON GOVERNMENT OPERATIONS
RAYBURN HOUSE OFFICE BUILDING, ROOM B-377
WASHINGTON, DC 20515

September 2, 1987

Hon. Robert C. Bonner
The United States Attorney for
the Central District of California
312 North Spring Street, 12th Floor
Los Angeles, California 90012

Dear Mr. Bonner:

First, I want to express the Commerce, Consumer, and Monetary Affairs Subcommittee's belated appreciation for your excellent, thoughtful, and detailed testimony at the subcommittee's June 13, 1987, hearing in Los Angeles and for Mr. Bowers' assistance in that endeavor. During your appearance, I was unable to ask you a number of the questions (some of which arose from other witnesses' testimony), because of obvious time constraints. Accordingly, to complete the record would you please respond to the following questions by September 22, 1987, if at all possible:

1. Information on numbers of active and major investigations involving failed institutions: Pages 11—12 of the FBI's June 13th testimony listed 12 failed institutions for which there was no active investigation due to the lack of a criminal referral in 9 instances, to attention being given to other priority matters in 2 other instances, and to the expiration of the statute of limitations in the remaining one case. (a) Please reconcile this data with the appendix to your testimony, which shows an ongoing FBI investigation as to these 12 institutions. For example, are inactive FBI investigations included in the list of pending cases, and is that why a FBI investigation is indicated as to all but 3 failed institutions on your list? If that is the case, how many of the then pending 268 Federal criminal investigations (where the amount involves $100,000 or more) in your district fall into the inactive status. (b) Following up the FBI's testimony, indicate why attention is not being given to two matters (involving failed institutions) because of greater priority to other matters, and describe what transpired in the way of delays to cause the statute of limitation to expire in that third matter (referenced to the particular institution).

2. Identification of failed institutions as to which a major investigation exists: Of your office's 59 major cases involving insider or affiliated outsider abuse in financial institutions, please specify the failed institutions as to which there is a major investigation.

3. Degree of overlap between your office's 59 major cases and the Criminal Division's "Bank Fraud Tracking System's List": (a) How many of these 59 major cases are also listed on the Criminal Division's Fraud Section's March 1987 list showing 30 cases and how many are not? (b) How many major cases does your office have involving savings and loan associations (both failed and open), and how many of these were on that Fraud Section

list? (c) Please furnish a confidential list of those major bank/thrift cases which are not on the Fraud Section's March 1987 list, naming only the institution — whether failed or open — and, also, if known, the Federal banking agency which has supervisory jurisdiction (if the institution is not a national bank). (We plan to ask the appropriate banking agencies why such matters have not been designated as "significant" bank fraud cases, to determine if modifications to that system are needed.)

4. FSLIC's response to your testimony: After the hearing, the subcommittee received a June 30, 1987, letter from FSLIC Deputy Director Black (copy attached), which responds to several important points in your testimony. Feel free to respond to any of Mr. Black's assertions, elaborating on your testimony, should you so wish.

5. Clarification on useful information in the investigation of Institution No. 2: In footnote 4 of your testimony, you state that a "referral would serve no useful purpose," which seems to contradict the FBI's position as to two unexplored parts of this case and the belief of an assistant U.S. Attorney in your office. Please reconcile this discrepancy.

6. Role of Restitution: (a) What role should restitution have in sentences imposed by Federal judges for criminal misconduct and fraud against financial institutions, particularly by insiders and affiliated outsiders, where an institution has suffered large losses? (b) Have prosecutors in your office tried to obtain restitution in past cases, and, if so, how successful have they been? (If so, please furnish us some examples.)

7. Office's response to the February DOJ Directive: On February 24, 1987, the Attorney General sent a directive to all U.S. Attorneys (attached) urging that bank fraud enforcement be intensified and specifically requesting that each office inventory pending financial institution fraud cases, meet specially with FBI senior agents at local offices (to set priorities and accelerate prosecution), assign needed personnel and, where necessary, ask the Fraud Section for assistance. Who in your office received their directive, and what, if any, specific actions were taken in response thereto and when?

8. Reaction of financial community to RFPA changes: As you know, Congress amended the Right to Financial Privacy Act as part of the Anti-Drug Abuse Act, to clarify that financial institutions can make criminal referrals to law enforcement agencies, in which they describe the suspected misconduct and identify supporting information, and to preempt State laws, such as California's own privacy act. Has that information filtered down to financial institutions and their legal counsel? Are they more willing to make timely and complete criminal referrals to the FBI and the U.S. Attorneys offices, than they were in the past?

The information requested will be helpful in the subcommittee's deliberations. Please have your staff contact subcommittee counsel Stephen McSpadden if there are any questions. Thank you for your anticipated cooperation.

Sincerely,

Doug Barnard, Jr.
Chairman

Attachments

DB:sm:b

Federal Home Loan Bank Board

1700 G Street N.W.
Washington, D.C. 20552
Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

June 30, 1987

Mr. Peter S. Barash
Staff Director,
Commerce, Consumer and
Monetary Affairs Subcommittee
Committee on Government Operations
U.S. House of Representatives
B377 Rayburn House Office Building
Washington, D.C. 20515

Dear Mr. Barash:

I am writing to respond to some of the specific statements that were made at the hearing of your Subcommittee on June 13, 1987 with respect to the coordination between regulators, financial institutions and United States Attorneys Offices with respect to criminal prosecutions.

As indicated in my testimony at that hearing, the Federal Home Loan Bank Board ("Bank Board") is committed to assisting United States Attorneys across the country in their prosecutions of those who have acted criminally with respect to savings and loan associations' activities. In this regard, we have strengthened the criminal referral process within the system. For example, a task force has been set up through the Federal Home Loan Bank of San Francisco to ensure that these referrals are made promptly and in a fashion that will be useful to the prosecutors.

Further, the attorneys in the Litigation Division of the Bank Board are available to assist in this effort whenever necessary and appropriate. Also, the outside counsel retained by the Federal Savings and Loan Insurance Corporation ("FSLIC") and the Bank Board have long been specifically instructed to support this effort and cooperate with the FBI agents and prosecutors as much as possible. Recently, letters have been sent to all such outside counsel from Dorothy Nichols, the current Director of Litigation, instructing these attorneys to cooperate fully with these investigations and prosecutions. Attached are samples of the letters that were sent nationwide.

Even though we are supportive of all of these related criminal prosecutions, it is important to state that we feel that our effort to seek civil money damages through litigation is also highly important. These suits have been extraordinarily

successful and have secured millions of badly needed dollars tc the FSLIC fund. These suits also provide a deterrence mechanism to the Bank Board. The Bank Board will continue these essential efforts, but I do not feel that they impede the parallel work of law enforcement. In fact, often our civil complaints are of great help to the Department of Justice and are often used as blueprints for the subsequent criminal investigations. Further, the Government should not be put to an election as to whether an individual should be prosecuted criminally or civilly. These processes are not mutually exclusive and must be carried out with the minimum of conflicts. The Bank Board is dedicated to ensuring that this takes place.

At the hearing, a concern was raised that our outside counsel are and were interfering with criminal prosecutions and have even promised immunity to someone who was the subject of investigation. As you know, the Bank Board does not have the power to immunize or to prosecute anyone. To my knowledge, no Litigation Attorney or outside counsel has promised immunity or threatened criminal action in order to secure a civil settlement. Further, no Department of Justice representative has ever claimed that to me or my successor, Dorothy Nichols. As indicated, our outside counsel have been instructed to cooperate with law enforcement and, to my knowledge, this has and is being accomplished.

Also, at the hearing one of the criminal justice witnesses suggested that the handling of documents by FSLIC at failed institutions was somehow improper and was making it difficult later on when the investigators are trying to trace the documents. This complaint seems to lack an understanding of what transpires when FSLIC takes over a failed institution. Usually, the takeover is done late in the afternoon on a Friday, and the institution is open for business in a new form on the following Monday. This takes extraordinary coordination, and the use of the documents is critical to this process. Further, it is essential that FSLIC have complete control over the situation to prevent any run on the institution in question which could cost the fund millions of dollars. There would be no objection if an FBI agent would like to be present to assist with the documents at every such closing, which seems to be the suggestion that was made at the hearing; however, that appears to be a waste of valuable agent time since there is no criminality involved at every failed thrift.

We encourage United States Attorneys and the FBI to make suggestions to us as we are always looking for ways to improve our take-over procedures, including document control, and we recognize that they have a significant area of expertise. Unfortunately, despite apparent frustrations tracing from early 1984, none of the suggestions that were made at the hearing were ever made to me during my entire tenure in the Litigation Division. Obviously, FSLIC also has very significant expertise in civil directors and officers litigation and in putting a

ever made to me during my entire tenure in the Litigation Division. Obviously, FSLIC also has very significant expertise in civil directors and officers litigation and in putting a failed thrift back in business over a weekend. The Department of Justice needs to confer with the relevant personnel at the Bank Board so that their suggestions can take advantage of our expertise. Further, in this regard, you should be aware that for several years FSLIC has had an extensive document control system in place where the documents of a failed thrift are "frozen" at the time of the take-over. This system has been highly successful, has greatly aided our civil litigation, and it should be of similar benefit to criminal prosecutions.

I hope this has clarified our position on this important subject.

Very truly yours,

William K. Black

William K. Black
Deputy Director, FSLIC

U. S. Department of Justice

United States Attorney
Central District of California

RCB:RLB:TAB:rrd
(213) 894-2437

United States Courthouse
312 North Spring Street
Los Angeles, California 90012

November 17, 1987

The Honorable Doug Barnard, Jr.
Chairman
Commerce, Consumer, and Monetary Affairs
Subcommittee
Committee on Government Operations
Rayburn House Office Building, Room B-377
Washington, D.C. 20515

Dear Chairman Barnard:

In response to your September 2, 1987, letter, I offer the following responses:

1. Information on number of active and major investigations involving failed institutions:

When I testified at the subcommittee's June 13, 1987, hearing in Los Angeles, it was my understanding, based on FBI computer runs, that the investigations listed in the appendix to my written testimony were active FBI investigations, with the exceptions of one declined case and two cases in which we convicted the primary defendants.

Since the subcommittee's hearing, the United States Attorney's Office (USAO) for the Central District of California (CDC), together with the FBI, has conducted an additional review of investigations involving failed institutions. We have prepared an updated summary of the investigations, including convictions obtained since the hearing. I have enclosed a copy of the new summary. Again, I request that the list not be made public in light of the pending investigations.

The two institutions that the FBI listed as inactive investigations in their original testimony (Garden Grove Community Bank and Orange Coast Thrift) are inactive because the FBI has not received criminal referrals on the cases. An institutional failure does not necessarily result in a criminal investigation and prosecution. The FBI will continue to monitor the two cases to see if an investigation needs to be activated

As to the investigation of Newport Harbor Bank, closed due to the expiration of the statute of limitations, the FBI informs me that it closed the case due to insufficient resources and because of the late receipt of criminal referrals. Please consult with the FBI if you need additional details concerning the Newport Harbor Bank investigation.

2. Identification of major investigations:

The 59 major cases identified in my written testimony are all active investigations. The Major Frauds Section of my office does not list an investigation in our PROMIS computer system unless the FBI has submitted a letterhead memorandum opening the investigation, or the FBI has obtained grand jury subpoenas as part of an ongoing investigation.

Incidentally, the number of major cases fluctuates on almost a weekly basis because new cases are opened and old cases are resolved.

3. Degree of overlap between Criminal Division's "Bank Fraud Tracking System" and my office's cases:

The Criminal Division's list of significant cases from March 1987 includes some cases that, although involving large dollar losses, are not considered by the Major Frauds Unit in the USAO to be high priority cases. This is not surprising in view of the complexity of bank cases in general, and the need to make a detailed evaluation of each case in order to determine priorities and prosecutive merit. The USAO determines its priorities in the bank fraud area on a case by case evaluation. A critical component of this evaluation is, of course, the strength of the evidence establishing fraudulent conduct by bank officials, as opposed to mismanagement and negligence.

Of the 30 cases on the Criminal Division's March monitoring list received by this office, it appears that there are in fact only 22 separate cases. Four of the cases appear to be listed twice, and two appear to be listed three times. Three of the 22 cases are considered by the USAO for this district to be of high priority because of the loss amount, the suspects involved, or both. Eleven are cases recorded on the FBI computer as open investigations involving amounts between $250,000 and a little less than two million dollars. These are considered important cases, but not high priority. One of the 22 cases has been successfully prosecuted and is a closed case. Seven of the cases do not appear on the FBI list of open bank cases over $250,000, nor are they cases being handled by the USAO Major Frauds Unit. They would therefore not be considered of high priority in the CDC.

There is no reason to expect an exact correlation between the Criminal Division's inventory and my office's list of priority cases. The Criminal Division tracking system is designed only to identify those cases which the regulatory agencies perceive as being significant. It is helpful for my office to know agency priorities, but agency priorities do not always coincide with priorities in this district.

For example, a particular suspect may be engaging in extensive litigation against a regulatory agency, thereby causing the agency to designate the criminal referral as a particularly significant one. The case may not be as significant when compared with other cases in the district.

My office does not rely on the Criminal Division tracking system to identify the significant cases in our district. The local representatives of the regulatory agencies often contact my office as soon as they generate a criminal referral that is particularly important. The FBI and my office also have extensive contacts in the banking community and receive criminal referrals outside the regulatory network.

In my opinion, the tracking system serves three purposes: 1) It allows the Criminal Division to monitor bank fraud cases across the nation in order to allocate resources in accordance with need; 2) It serves as a back-up inventory that permits my office to ensure that we are addressing the most important bank fraud cases; and 3) It gives a quick summary of the regulatory agencies' prioritization of pending criminal referrals.

While we are always interested in the agencies' views concerning priority cases, and while we generally try to give deference to the agencies' prioritization, we cannot be bound by agency priority lists. Prioritization and charging decisions must take into account a myriad of factors. The situation is dynamic in that new information comes weekly. We need the flexibility to analyze objectively the entire bank fraud picture in this district, without having to be confined strictly to the subjective determinations of the agencies, which are usually at the outset of an investigation and do not take into account potential prosecutability.

The tracking system is still in its infancy, and it remains to be seen how useful it will be. The system should not be viewed as a panacea for addressing bank fraud, but should be viewed only as an additional tool for prioritizing the enormous, pending caseload.

4. Response to FSLIC Deputy Director Black:

Deputy Director Black did not send me a copy of his June 30, 1987 letter to Mr. Barash. Thank you for bringing the letter to my attention and giving me the opportunity to respond.

When I appeared before the subcommittee in June, I decided it would be most beneficial if I candidly discussed some of the difficulties my office encounters in investigating and prosecuting bank fraud cases.

I offered my testimony as constructive criticism designed to improve our effectiveness in combatting the recent proliferation of bank fraud in the CDC.

The incidents I outlined in my testimony occurred. While most agency and fee attorneys do an excellent job of pursuing their civil tasks without jeopardizing criminal investigations, some attorneys have entered into civil agreements that have adversely affected criminal investigations. Additionally, we have encountered situations where the document control has been less than adequate.

It is not constructive to dwell on past mistakes, but to deny that they ever occurred is to forego the opportunity to learn and improve. Granted, the regulatory agencies have a difficult task. Overall, the agencies appear to be doing a good job, given their available resources. There is always room for improvement, however.

Since the June hearing the Federal Home Loan Bank Board (FHLBB) has taken numerous steps to improve communication and coordination among the regulatory agencies, fee counsel, the FBI and my office. Shortly after the subcommittee hearing, FHLBB representatives met with me and the Chief of my Major Frauds Section. The meeting proved to be very beneficial in that we candidly discussed ways to ensure that the civil and regulatory actions would not jeopardize criminal investigations.

Additionally, the FHLBB held a criminal referral seminar in Los Angeles on August 13, 1987. Federal prosecutors and FBI agents met with bank auditors and examiners to explain how criminal investigations are developed. The seminar was a resounding success. We hope to have additional sessions between law enforcement officials and regulatory officials.

Since the subcommittee hearing the criminal referrals have improved dramatically. We are now receiving more detailed referrals which will make our initial analysis of a case much easier.

The subcommittee hearing acted as a catalyst. Already we have experienced significant improvements. I believe our candid assessment of the situation has resulted in new and improved dialogues among my office, the regulatory agencies and fee counsel.

5. Clarification of referral information in the Institution No. 2 investigation:

With regard to Institution No. 2, I stated that an additional criminal referral would serve no useful purpose. In using the term "referral," I specifically meant the initial documentation an agency or fee attorney generates to notify law enforcement officials that there may be criminal conduct affecting a financial institution.

The Institution No. 2 prosecutor and FBI agents are too far along in their investigation to benefit from such an initial "referral." However, the actual "referral" of a possible criminal violation is only the first step in how regulatory agencies can assist criminal investigators. As investigations progress, examiners and auditors can provide valuable expertise and insight into how a particular fraud developed.

When the FBI agents and Assistant United States Attorney on the Institution No. 2 case stated that they could use additional information concerning unexplored parts of the pending investigation, they were referring to a continuing exchange of information through interviews with examiners and the analysis of additional documents, not an initial "referral."

6. Role of restitution:

My office views restitution as an important component of any sentence imposed upon a convicted insider or affiliated outsider. Prosecutors handling bank fraud cases generally request that the court order restitution. Additionally, most plea agreements entered into in bank fraud cases require the defendant to make restitution.

In one of our recent cases, involving a defendant in the NMEC mortgage pool fraud investigation, the prosecutors succeeded in obtaining an order of $10,000,000 in restitution against a single defendant.

7. Office's response to the February DOJ directive:

I received the Attorney's General's February directive and also gave a copy of the directive to the Chief of the Major Frauds Section. My office and the local FBI already had intensified our efforts concerning bank fraud investigations before we received the directive.

Upon receipt of the directive, my office and the FBI immediately conducted an additional inventory of our bank fraud cases. (We conduct such inventories on a monthly basis). The Chief of my Major Frauds Section and the Supervising Special Agent of the FBI's Bank Fraud Section are in constant communication, continually monitoring the bank fraud investigations to set priorities and accelerate important investigations.

We have not requested assistance from the Department of Justice's Fraud Section because we do not think such a request is a viable solution to our personnel shortage. Experience has taught us that it is expensive and inefficient to send attorneys across the continent to oversee the preindictment phases of fraud investigations and to try fraud cases in Los Angeles. It is extremely difficult to attempt to conduct cross-country investigations when the prosecutor is often four time zones removed from the investigating agents.

In my opinion the most effective solution to the personnel shortage is to increase the attorney allocations for my office so we can assign more of our experienced attorneys to the bank fraud cases.

8. Reaction of financial community to RFPA changes:

A. Criminal Referrals:

Financial institutions appear to be more willing to make referrals to criminal law enforcement agencies since the enactment of the Right to Financial Privacy Act. However, most direct referrals from financial institutions involve the relatively smaller misapplications and embezzlements by lower level employees.

Financial institutions rarely forward criminal referrals concerning the larger frauds because often the frauds are concealed until examiners or auditors uncover the improper conduct. Also, some bank officials are involved in fraud and successfully keep lower level employees from revealing the ongoing criminal conduct.

B. California's state privacy act:

Most California financial institutions still refuse to accept the fact that California's privacy act is preempted by the federal act. My office is attempting to educate the local financial institutions and persuade them to revise their positions.

For example, Bank of America now honors our written requests to not disclose grand jury subpoenas to bank customers whose records have been subpoenaed. Many institutions, however, refuse to accept the preeminence of the federal act and insist that we obtain court orders for nondisclosure, a cumbersome process at best.

We will continue our efforts to explain to the financial community the preeminence of the federal privacy act.

Very truly yours,

ROBERT C. BONNER

cc: Cary Copeland
Office of Legislative Affairs

DO NOT DISCLOSE
(Pending Investigations)

INVESTIGATIONS OF FAILED INSTITUTIONS
CENTRAL DISTRICT OF CALIFORNIA
(11/20/87)

A. Failures in which FBI investigation is active and has resulted in at least one conviction:

	FINANCIAL INSTITUTION	SQUAD/RA
1.	WESTERN NATIONAL BANK	SANTA ANA
2.	HACIENDA FEDERAL SAVINGS	VENTURA
3.	WEST COAST BANK (LOS ANGELES & ENCINO BRANCHES)	WCC-3
4.	UNITED SAVINGS BANK	WCC-3

B. Failures in which the FBI investigation is active:

	FINANCIAL INSTITUTION	SQUAD/RA
1.	WESTERN NATIONAL BANK	SANTA ANA
2.	SAN MARINO	WEST COVINA
3.	HACIENDA FEDERAL SAVINGS	VENTURA
4.	HERITAGE BANK	SANTA ANA
5.	WEST COAST BANK	WCC-3
6.	BEVERLY HILLS SAVINGS	SANTA ANA
7.	FIRST CITY BANK	WCC-3
8.	VALENCIA BANK	WCC-3
9.	AMERICAN DIVERSIFIED SAVINGS	WCC-3
10.	EMPIRE NATIONAL BANK	WCC-3
11.	CONSOLIDATED SAVINGS	SANTA ANA
12.	RAMONA SAVINGS AND LOAN	SANTA ANA
13.	INDEPENDENT NATIONAL BANK	WEST COVINA
14.	NORTH AMERICAN SAVINGS AND LOAN	LONG BEACH

FINANCIAL INSTITUTION	SQUAD/RA
15. SOUTH BAY SAVINGS AND LOAN	REDONDO BEACH
16. PERPETUAL SAVINGS BANK	WCC-3
17. UNIVERSAL SAVINGS AND LOAN	WEST COVINA
18. FIRST CALIFORNIA SAVINGS BANK	WCC-3
19. BUTTERFIELD SAVINGS AND LOAN	SANTA ANA

C. Failure in which a pre-existing FBI investigation has been closed:

	FINANCIAL INSTITUTION	SQUAD/RA	REASON
1.	WEST VALLEY BANK	WCC-3	CONVICTION
2.	NEWPORT HARBOR NATIONAL BANK	SANTA ANA	Statute of Limitations
3.	BANK OF IRVINE	SANTA ANA	Declination
4.	AMERICAN CITY BANK	WCC-3	No criminal referrals
5.	COMMERCIAL BANK OF CALIFORNIA	WCC-3	Declination
6.	SOUTHERN CALIFORNIA SAVINGS	WCC-3	Declination
7.	SOUTH COAST BANK	WCC-3	Statute of Limitations
8.	MANHATTAN BEACH SAVINGS	WCC-3	No criminal referrals
9.	CENTER NATIONAL BANK	WCC-3	No criminal referrals

D. Failures in which the FBI has received criminal referrals, but the FBI investigation is inactive due to resource limitations:

	FINANCIAL INSTITUTION	SQUAD/RA
1.	CAPISTRANO NATIONAL BANK	SANTA ANA

E. Failures in which the FBI has not received any criminal referrals, but the FBI is continuing to monitor the situation:

	FINANCIAL INSTITUTION	SQUAD/RA
1.	GARDEN GROVE COMMUNITY BANK	SANTA ANA

	FINANCIAL INSTITUTION	SQUAD/RA
2.	SADDLEBACK VALLEY BANK	SANTA ANA
3.	WESTWOOD SAVINGS AND LOAN	WCC-3
4.	ORANGE COAST THRIFT AND LOAN	SANTA ANA[1]
5.	WHITTIER THRIFT AND LOAN	WEST COVINA
6.	FOUNDERS SAVINGS AND LOAN	WCC-3
7.	NEW CITY BANK	SANTA ANA
	F. EQUITABLE SAVINGS AND LOAN	Investigation being handled by San Francisco FBI

1/ Criminal referrals predate effective date of FSLIC insurance -- no recent referrals.

STATE OF LOUISIANA
OFFICE OF FINANCIAL INSTITUTIONS
BATON ROUGE, LOUISIANA

FRED C. DENT
COMMISSIONER OF
FINANCIAL INSTITUTIONS

June 29, 1987

Honorable Doug Bernard
Member of Congress from Georgia
Chairman, Commerce, Consumer
and Monetary Affairs
Subcommittee of the House
Commerce Committee
Room B 377 Rayburn Building
Washington, D. C. 20515

Dear Mr. Bernard:

Peter Barash of your committee suggested that I write you this letter pertaining to comments made by William Black, Deputy Director of the FSLIC at a recent meeting in Los Angeles.

I am the primary regulator of the state chartered savings and loan associations in Louisiana, which number 54 at present. While our office is not privy to the condition of the federally chartered institutions, I can tell you that our State groups have fared well in a tough economy.

The following statistical data, as of December 31, 1986, on our Louisiana savings and loan associations is furnished to you:

		Total Assets	Net Worth	NW/TA
54	Associations	$9,866,751,369	$1,094,896,422	11.10%
49	Solvent	$9,048,664,717	$1,129,128,547	12.48%
Exclusions:				
a)	5 Insolvent	$818,086,652	($34,232,125)	(4.18%)
b)	1 conversion with real estate & equity debt exchanged for debt. Effective: 7-16-86	$868,817,000	$711,657,000	81.91%
48	Solvent, seasoned viable associations	$8,179,847,717	$417,471,547	5.10%

I would appreciate it if you would insert the factors as they pertain to Louisiana as a footnote to the comments which were quoted in the attached AP article quoting Mr. Black.

Incidentally, I tried to reach Mr. Black by phone but he has yet to return my call. As a matter of courtesy, I am sending him an informational copy of this letter.

If there is anyway that we can serve you or the other members of your committees, please do not hesitate to contact us.

Sincerely

Fred C. Dent
Commissioner of Financial Institutions

FCD:ch

cc: Mr. William Black

Mr. Dan Digby, President
Louisiana League of Savings
Post Office Box 14089
Baton Rouge, LA 70898

APPENDIX 3.—MATERIAL/DOCUMENTATION CONCERNING FSLIC LAWSUITS (AND OTHER ACTIONS) AND ALSO SEVERAL OF THE FAILED INSTITUTIONS

Federal Home Loan Bank Board

1700 G Street, N.W.
Washington, D.C. 20552
Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

APR 8 1987

Honorable Doug Barnard, Jr.
Chairman, Commerce, Consumer, and
Monetary Affairs Subcommittee
of the Committee on Government
Operations
House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

My letter of March 20, 1987 to you indicated that the Bank Board staff was still compiling certain information pertaining to a prospective subcommittee hearing on insider abuse in financial institutions. The staff has completed its work. Enclosed for the subcommittee's use is information regarding freeze orders and directors and officers litigation and investigations pertaining to twenty eight (28) California institutions.

The Bank Board's practice for all FSLIC conservatorships and receiverships is to routinely conduct an investigation to determine if appropriate grounds exist for bringing a suit for losses incurred by the association against its insiders, professionals, and others. Moreover, if information is discovered that would make a freeze order appropriate, the Board considers seeking one.

Please note that Huntington Savings and Loan Association is operating without government assistance; any adverse publicity concerning it may jeopardize its chances of financial recovery. If I may be of further help, please do not hesitate to contact me.

Sincerely yours,

L. Arlen Withers
Director
Congressional Relations

INFORMATION REGARDING FREEZE ORDERS AND DIRECTORS AND OFFICERS ("D&O") LITIGATION AND INVESTIGATIONS FOR 28 CALIFORNIA INSTITUTIONS. PREPARED FOR THE HOUSE COMMERCE, CONSUMER, AND MONETARY AFFAIRS SUBCOMMITTEE.

Institution	Active D&O Case1/	D&O Investigation Open2/	Freeze Order In Effect3/
Farmers Savings, a FS&LA Davis, CA	Yes	No	No
Golden Pacific S&LA, a FS&LA Windsor, CA	No	Yes	No
Mt. Whitney S&L Exeter, CA	Yes	No	Yes
San Marino S&LA San Marino, CA	Yes	No	No
Seapointe S&LA Carlsbad, CA	No	Yes	No
South Bay S&LA Gardena, CA	No	Yes	No
Sun S&LA San Diego, CA	No	Yes	No
Tahoe S&LA South Lake Tahoe, CA	No	Yes	No
Consolidated SB Irvine, CA	Yes	No	N
Huntington S&LA Huntington Beach, CA	Open and operating without government assistance.		
Manhattan Beach S&LA Manhattan Beach, CA	Yes	No	Yes
North America S&LA Santa Ana, CA	Yes	No	Yes
Perpetual SB Los Angeles, CA	Yes	Yes	No
Ramona S&LA Orange, CA	Yes	No	Yes

1/ A Directors and Officers liability lawsuit ("D&O") seeks to recover for an association's losses that are proximately caused by the fraud, negligence, or breaches of fiduciary duty of its Directors, Officers, or other insiders.

2/ An investigation is routinely conducted by the Bank Board in connection with all FSLIC conservatorships and receiverships to determine if claims exist and whether a D&O suit is appropriate.

3/ A freeze order is entered during the pendency of a D&O or other lawsuit and puts a hold on the assets of an individual who appears to have personally and wrongfully benefitted from insider dealings or abusive practices with an association.

Institution	Active D&O Case	D&O Investigation Open	Freeze Order In Effect
Bell S&LA, a FS&LA San Mateo, CA	Yes	No	No
Centennial S&LA, a FS&LA Guerneville, CA	Yes	No	No
Columbus S&LA San Rafael, CA	Yes	No	No
Gateway SB San Francisco, CA	No	Yes	No
Presidio S&LA, a FS&LA Porterville, CA	Yes	No	No
American Diversified SB Lodi, CA	Yes	No	Yes
Atlas S&LA San Francisco, CA	No	No	No
Beverly Hills Savings, a FS&LA Beverly Hills, CA	Yes	No	No
Butterfield S&LA, a FS&LA Santa Ana, CA	Yes	No	No
Cal America S&LA Walnut Creek, CA	No	Yes	No
Unified SB Northridge, CA	Yes	Yes	No
United Bank, SSB San Francisco, CA	No	Yes	No
Western Community S&LA El Cerrito, CA	Yes	No	No
Westwood S&LA Los Angeles, CA	No	Yes	No

SUBCOMMITTEE NOTE: These are the FSLIC civil lawsuits arising out of the following institution failures. Copies of the civil complaints are in the subcommittee's files.

INDEX

	Complaint Name	Institution
1.	FSLIC v. Sahni	American Diversified Savings Bank
2.	FSLIC v. Butler	Bell S&LA
3.	FSLIC v. Fitzpatrick	Beverly Hills S&LA
4.	FSLIC v. Butterfield Equities	Butterfield S&LA
5.	FSLIC v. Safley	Butterfield S&LA
6.	FSLIC v. Shah	Centennial S&LA
7.	FSLIC v. Musacchio	Columbus S&LA
8.	FSLIC v. Ferrante	Consolidated Savings Bank
9.	FSLIC v. Anders	Farmers Savings Bank
10.	FSLIC v. Gon	Gateway Savings Bank
11.	FSLIC v. Sajovich	Manhattan Beach S&LA
12.	FSLIC v. Kong	Mt. Whitney S&LA
13.	FSLIC v. McKinzie	North American S&LA
14.	FSLIC v. Morady	Perpetual Savings Bank
15.	FSLIC v. Wagner	Presidio S&LA
16.	FSLIC v. Molinaro	Ramona S&LA
17.	FSLIC v. Forde	San Marinc S&LA
18.	FSLIC v. Faria	San Marino S&LA
19.	FSLIC v. Evans	Unified Savings Bank
20.	FSLIC v. Partridge	Western Community S&LA

October 10, 1985

BUTTERFIELD SAVINGS
SUMMARY by
DOWNEY SAVINGS

When Downey Savings came into Butterfield Savings on August 7, 1985, they discovered an Association with basically a sound savings operation and consumer loan department. The loan service area was disorganized. with improper procedures and high delinquencie caused primarily by the lack of adequate training and supervision. There were no audit controls, or written procedures for any departments. Money had been spent for luxury furnishings, art work, cars, a plane and a general misspending was obvious.

The savings and loan function of the association has now stabilized. We lost $30 million in deposits in August, and broke even in September. The loan service department is now operating properly, an experienced loan service manager has been hired, an internal audit department created, and generally this area is now operating and has a value.

With regard to the subsidiaries, it was virtually impossible to get a straight answer on the properties we owned, and the syndications. We subsequently discovered that the Association is advancing funds each month to the tune of above $1 million to pay the underlying debt on the syndication properties. MOST OF THOSE FUNDS WILL BE LOST. We are currently having special counsel review these specific syndications with a view to terminating them so the Association no longer has to advance these funds.

We discovered the Association owned several pieces of property in Oregon, on which large losses will be incurred. We are investigat the possibility of rescinding some of these transactions, and a law

suit is pending against certain individuals involved in that transaction. On several other properties the decision has been made to stop making payments, and let the lender foreclose. There is no value in these properties to Butterfield. This will minimize FSLIC losses.

Other properties are being reviewed on an individual basis. A schedule listing all properties, and the details of each transaction has been prepared as a working model for the Association' personnel. A copy of this is attached.

The Wendy's operation is pending sale, with an agreement having been made which will give the Association a $3 million profit. The Loves' restaurants present a little more difficult problem. A previo Loves' executive has been hired and we believe the franchisee lawsuit can be settled and that given a little time, we will be able to find a buyer for this chain.

We believe the cause of these problems were:

a. Inexperienced management and lack of supervision

b. Lack of proper controls

c. Ego

d. Disregard for regulations

e. Subsidiaries "running" the savings and loan

If the regulations required an extensive background investig of all senior management, required written policies and procedures the time of their first examination, and gave closer supervision to new associations in the earlier years, some of this could be avoide In addition, a system to discover problems earlier needs to be devised. Also, a peer group of experienced industry executives could be of advisory assistance.

AGENDA

MEETING WITH CHAIRMAN GRAY

OCTOBER 15, 1985

Preamble

As a part of the presentation on behalf of Butterfield Savings and Loan Association, we have enclosed a copy of the Interim Business Plan dated September 26, 1985. This Interim Business Plan has been followed since the new Federal Association was created, approximately 9 weeks ago, and continues to be the outline by which the Association operates under the direction of the newly formed Board of Directors:

Allen P. Miller, Chairman
Erich C. Bendfeldt
Norman A. Peterson
Walter A. Obers

Gerald H. McQuarrie, President and Chief Executive Officer, and Anne Bacon, Executive Vice President and Chief Operating Officer, head a management team from Downey Savings and Loan Association who are following the dictates of the Interim Business Plan previously approved by the Federal Home Loan Bank of San Francisco.

The first objective was to establish rapport with the Association's employees and return the operation to normal as soon as possible. This was accomplished by several meetings held jointly with the new management team and employees, assuring them that their presence would be essential to the future success of the Association. All their questions were answered on a one-to-one basis.

In addition, an immediate written communication was given to each individual employee informing them of the action taken by the Federal Insurance Corporation (FSLIC) and the reasons why the old Association had been taken over and the new Federal Association created. We assured them that with the new infusion of capital they were now working for an institution which had a positive net worth and we asked them to communicate this information to all of their customers.

The second major objective was to create a matrix showing all of the real and personal property owned by the Association, including joint joint ventures, direct investments in properties and all real estate owned by the subsidiaries. This matrix is now complete and is included as an exhibit to this presentation. In addition to the information on the real estate owned, it also shows the major delinquent loans as well as loans anticipated to become delinquent in the near future. These spreadsheets have been created both as a management tool for information and as a system by which direct action can be taken. Where there has been any doubt as to the value of the property, appraisals have been ordered through competent MAI appraisers. This spreadsheet enables us to see at a glance the

pertinent information showing negative cash flow per month as well as the depreciation of the properties owned by the Association.

The third major objective was to take immediate action to secure all the property of the Association and prepare an effective plan for the disposal of non-earning assets for the purpose of shrinking the overall assets of the Association. In order to reach our goal under this objective, we have started several new programs.

In addition to the matrix, which we use as a guideline and control sheet, each non-earning asset in which the Association has deemed through its real estate committees should be sold is placed in a project summary which shows all the pertinent information including a picture of the subject property. A realistic sales price is determined by the Real Estate Committee which includes the President, Chief Executive Officer and Senior Vice President of Downey Savings and Loan Association along with a senior group of real estate and loan officials from Butterfield Savings and Loan Association. A follow-up log is maintained showing any action taken.

In establishing a sales price, many diverse factors are considered: the appraisal, the condition of the property, the economics of the area in which it is located, all are combined to ascertain a realistic sales price for the property which can be sold on the best economic terms that benefit the Association and minimize any losses to the FSLIC.

The fourth major objective was to prepare for submission to FSLIC and FHLB a recommendation and proposal for the future course of action for Butterfield Savings and Loan Association. This submission is currently being prepared and will contain all the information as outlined in the second and third major objectives. It is anticipated that this complete report will be ready for submittal on or before the end of the 90-day contract period by Downey Savings and Loan Association.

In addition to the major objectives, various stabilizing actions have been taken to achieve our overall purpose. Job descriptions have been realigned and individualized as necessary. Extensive reorganization has taken place in every facet of the Association through consolidation and elimination of positions not considered vital to the success of the new operation. We have been able to eliminate duplication of effort and improve the efficiency of the organization. It is our estimate that these actions will save the Association $1.3 million per year immediately.

The sale of two of the four existing branches has resulted in a decrease of operating expenses and a net profit to the Association. During August, after the takeover, we lost $30 million in savings deposits. In September, however, this outflow was halted and we ended the month at a breakeven point. At the middle of September, we were even able to reduce rates slightly.

One of the major areas in complete disarray at the time of the takeover was the Loan Service Department. There were missing files, incomplete records and almost a complete breakdown in accounting for loans serviced for others and loans purchased from others. With express help of the top loan service administrators from Downey Savings and Loan, this department has been completely reorganized with great success and is now functioning in a well-ordered manner.

During the past year approximately $1.5 million was spent on attorneys fees on behalf of the Association. Under the direction of the counsel used by the Board of Directors, two new in-house attorneys were hired and an in-house legal department has been created which is now carrying a great deal of the legal burden. We estimate the cogent manner in which legal matters are now being handled will result in a $1 million savings to the Association in the coming 12 months.

A great deal of attention has been directed to the large operating expenses for the Association. Reductions are being realized by a strict control on all out-going larger checks by either the President or Executive Vice President. This scrutiny immediately allowed management to monitor and take drastic steps to eliminate unnecessary expenses. The scrutiny of all expense accounts has resulted in a "new attitude" on the spending of money! Dues and subscriptions have been cancelled. All seminars and trips must be essential and must be approved by the President or Executive Vice President. Many other small cost-cutting programs have been put in place.

In addition to the above, the Association's airplane has been put up for sale, the services of the pilot dismissed and two of the three hot-air balloons have been sold.

Within days after the new Association was formed, efforts were begun to evaluate and liquidate the Association's restaurant operations. As of this date, a definitive agreement is in its completion stages for the sale of Wendy's franchise along with the real property involved which will result in approximately a $3 million profit to the Association. This transaction is scheduled to close by the 30th of November.

In addition, within two days after the new Association was formed, Mr. McQuarrie dismissed the President of Love's Barbecue and hired a Chief Executive Officer who has had extensive experience in the successful management of the Love's chain in previous years. This action has resulted in the revitalization of the operation and plans are being made for its sale or liquidation.

In summary, the Association has returned to a stabilized operating procedure, loss of operation personnel has been minimal and employees have an optimistic outlook for the future.

We are very concerned with a continued operation of the real estate oriented service corporations of Butterfield; principally, those in the syndication group consist mainly of a selling organization, a property management company and a company acting as a general

partner for the limited partnerships. At the present time these service corporations are the general partner in 64 partnerships. The Property Management Corporation is managing approximately 8,000 apartments owned by these partnerships as well as some REO belonging to the Association. A great deal of time has been spent in analyzing the operations of the syndication department with emphasis directed to future liabilities connected with this activity. At an early stage it became apparent that this operation should be maintained as a group and sold as a unit in the marketplace. Steps were taken to discontinue all present syndication attempts and to liquidate those which were already in progress. All prospective syndications have been terminated and the money collected is being returned to all limited investors in cases where the limited partnerships have not been completed.

Legal counsel has now been employed to evaluate the partnership agreements as well as to ascertain the liability for present and future to the Association and subsidiaries. Several buyers have been contacted and it is anticipated that, in the near future, firm offers will be received for the sale of the syndication group as a unit. Our major problem continues with the advances which have been made by the general partner, a subsidiary of Butterfield Savings. Our assessment to date would indicate that many of these advances made to the limited partners by the general partner will not be repaid when the limited partnerships are liquidated. Appraisals have been ordered of the partnerships' assets and an audit has been ordered of

the entire operation. We are most concerned that when this audit and evaluation has been completed the Association may face severe writedowns.

Observations and Comments by the Management Team as to the Reasons Leading to the Demise of the Former Butterfield Savings and Loan Association

The comments stated herein are a result of opinions formed from reading past examination reports, reviewing in detail the loans, investments, joint ventures and partnerships made by the Association, Minute Books, conversations with the former officers of the old association who are still employed and reliance of observations made by management during the past 30 years of both successful and unsuccessful associations. It has been our observation that the success of any association is in direct proportion to the ability of its management, tempered by experience, having integrity and a stated purpose. Former management had no experience in the savings and loan business, but had a background in forming syndications and borrowing money. It is apparent from the operations since the Association was chartered that the primary purpose of the savings association was to create a vehicle to help the syndication business, a business in which they were well informed and experienced. Rapid growth, fast fed with the fuel of excessive ego, prompted the leaders of the Association to take drastic measures for this accelerated growth.

Among these activities were brokered money, paying excessive rates, purchase of a larger association, purchase of a large REIT and, in line with the apparent operational attitudes of other failed associations, lived in the climate of easy money. Their modus operandi appeared to be that the insured savings deposits must be invested or spent at the earliest possible moment. This resulted in luxurious buildings, luxurious offices and accentuated growth for the purpose of reaching a goal of $2 billion within the 5 year period.

At a point in time when the management became aware of the fact that their net worth was declining to unmanageable proportions, their object seemed to be (principally due to the urging of regulatory authorities) to again rebuild and maintain capital. Conservation of capital was sought by many means, primarily by refusing to sell any asset which would cause a writedown on their books, therefore decreasing the net worth which in turn caused them to make many very poor decisions but did allow them to have a slower rate of capital depletion than would have been possible under proper writedown procedures.

In addition, they maintained an attitude that the only way to overcome the deficiency of capital was to grow at an accelerated rate, using increased savings to enter into more deals, to generate more loans at higher rates and higher points to again in turn increase capital. The latest method was to create net worth for the Association by issuing preferred stock from the holding company. The stock was then traded along with cash from the Association for

various properties with the supposed value of approximately $50 million. These properties were then contributed to capital of the Association, resulting in a temporary increase in net worth, until such time as the assets were written down to their lesser evaluation by the auditors.

In looking at other failed associations, many of the same characteristics emerge: inexperience of management, ego for quick growth, ease of brokered funds, inexperience in taking advantage "of a so-called deregulation." The inexperience, improper or directed appraisals, acquiring assets without proper evaluation and immature judgment of management, a force-feeding of management's ego through the acquisition of opulent offices, planes, cars and expense accounts to the detriment of the Association....All of this, paired with the inability to face the situation as it existed, was the major cause of failure. There were no controls on loans, no policies and procedures, and no internal audit staff. Literally, there were no good management controls at any level. Instead of attempting to remedy the problems which were so apparent, they spent all of their efforts in proposing intricate schemes which, if successful, would appear to aid in maintaining the equity at a proper level.

Suggestions for Solutions

1. A great deal more scrutiny and investigation of controlling persons before granting charters.

2. Hire additional examiners trained to spot at an early date the trends now so apparent in failed associations.

3. Continue to seek legislation to grant governing authorities the powers to step in and regulate associations before excessive losses are realized.

In our opinion, had the laws been clarified to where Butterfield could have been taken over two years before the takeover date, many millions of dollars would have been saved. It was very apparent by reading the examination reports in what direction the Association was heading at that time. We also feel it very important that when an association is in its formative years, even more supervision and attention should be given to their business plan and their adherence thereto.

There should continue to be a preponderance of outside directors in the various associations and their education, as is the policy of the present Board, should be continued. The thrift business is one in which each part is important to the whole. We would therefore like to suggest that wherever practical, a new association be assigned a

mentor of a well-run institution to act as an advisor under certain circumstances. This could also be patterned somewhat after the banking institutions for smaller local banks have correspondent banks on which they can rely as a means of credit as well as advice.

We also feel, if feasible, that it could become the obligation of an association's peers to report to a peer committee violations they have observed in the various associations.

It is our belief that a majority of associations in the Southern California area were well aware of the problems being created by those associations which are now in default. We also would observe that associations should be rewarded for outstanding performance and those which disregard prudent operating policies should be closely watched. We feel that the possibility of future management contracts should be considered for a longer term basis, at least until the association's problem loans have been liquidated and the association is stabilized and in a profitable position.

We would like to comment that we are in accord with the published and well-known objectives of the present administration to return the savings and loan business to be America's primary lender of single-family residences and to its former reputation of integrity and service to its commun ty.

PAUL A. RICHLER
JUDITH K. OTAMURA-KESTER
MORGAN, LEWIS & BOCKIUS
Forty-Second Floor
555 South Flower Street
Los Angeles, California 90071
Telephone: (213) 485-9001

Attorneys for Plaintiff
FREMONT INDEMNITY COMPANY

[Excerpt Only]

UNITED STATES DISTRICT COURT

CENTRAL DISTRICT OF CALIFORNIA

FREMONT INDEMNITY COMPANY, Plaintiff, v. FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION, AS RECEIVER FOR SAN MARINO SAVINGS AND LOAN ASSOCIATION; FIRST HOME SAVINGS ASSOCIATION; SANTA BARBARA SAVINGS & LOAN ASSOCIATION; JOHN J. BRENNAN; BRUCE STANTON; and DOES 1 through 200, Defendants.	Case No. FREMONT INDEMNITY COMPANY'S COMPLAINT FOR DECLARATORY RELIEF

Plaintiff Fremont Indemnity Company ("Fremont") alleges against defendants, and each of them:

JURISDICTION AND VENUE

1. This Court has jurisdiction of this action pursuant to 12 U.S.C. § 1730(k)(1)(B) and 28 U.S.C. § 2201.

2. Venue is proper in the Central District of California pursuant to 28 U.S.C. § 1391.

States. These participations constituted a total of $151.4 million dollars as follows:

PARTICIPANT	STATE	NET INTEREST SOLD (in millions)
American Savings	CA	$111.1
Santa Barbara Savings	CA	12.8
Colony First Fed. Savings	PA	10.0
First City Fed. Savings	FL	4.8
Midwest Federal Savins	ND	4.5
Umpqua Savings	OR	4.4
Milford Fed. Savings	MA	2.0
First Home Savings	PA	1.8
Total		$151.4

70. Upon information and belief, plaintiff alleges that the pattern of racketeering activity involving defendants, and each of them, is shown by five (5) projects known as "The Bowen Projects" involving similar condominium conversions, where the same tactics were used by another developer and the projects were finanaced by San Marino and Domingues, Bona, Bona-Domingues or an entity owned or controlled by them to purchase said condominiums.

71. In addition, plaintiff avers on information and belief

 EXHIBIT 2 6.

Mitsubishi Unit's Ex-Aide Charged With Embezzling

By a WALL STREET JOURNAL *Staff Reporter*

LOS ANGELES – The Los Angeles County district attorney's office charged a former executive of Mitsubishi Bank of California with embezzling more than $44 million from the bank and its parent, Tokyo-based Mitsubishi Bank Ltd.

In seven felony charges filed in Los Angeles Municipal Court, Hiroisugo Mizuno, 44 years old, a former Mitsubishi of California senior vice president, was accused of creating more than 135 fraudulent loans and loan renewals totaling $946 million to conceal embezzlements of $44.9 million. The complaint alleges that Mr. Mizuno used these funds to invest in the stock market and pay off his personal gambling debts.

District Attorney Ira Reiner said Mitsubishi's direct loss was about $8 million at the time the alleged embezzlement scheme was discovered in October 1984. He said the bank later recovered about $3 million from Mizuno.

Mitsubishi Bank Ltd., however, said in a statement that its losses were only $130,000. It said the amount was determined after a review by a panel of outside experts, which was audited by the accounting firm of Ernst & Whinney.

Mr. Reiner said that Mr. Mizuno began embezzling funds from the bank in September 1980, and that after his actions were discovered the bank ordered the executive to return to Japan, where he was fired. The district attorney said extradition proceedings against Mr. Mizuno, who is still in Japan, have been initiated.

If convicted, Mr. Mizuno faces a maximum of six years in prison and fines totaling $70,000.

According to the district attorney, Mr. Mizuno embezzled the $44.9 million by making loans to fictitious people or, in some cases, actual companies that didn't know of the transactions. He then would put together other new bogus loans or loan renewals to help him repay the previous loans, Mr. Reiner charged. The district attorney's office said Mr. Mizuno apparently intended to keep profits from his investments, and return the stolen money before the loans were due.

The loan irregularities were discovered by Mr. Mizuno's successor in Los Angeles after Mr. Mizuno was promoted and transferred to the parent company's New York branch as deputy general manager, the district attorney said. He said Mr. Mizuno confessed to a company executive in a statement.

Mr. Reiner added that both Mr. Mizuno and the Mitsubishi executive who had taken Mr. Mizuno's statement currently are "out of our reach" in Japan.

Mr. Reiner was critical of companies that fail to pursue legal action against embezzlers for fear of corporate embarrassment. He said Mitsubishi bank officials had urged him "in the strongest possible terms" not to prosecute Mr. Mizuno because they wanted to treat it "as an internal matter."

THE WASHINGTON POST

Former Bank Executive Charged With Embezzlement

By Daniel Shaw
Special to The Washington Post

LOS ANGELES, Feb. 19—A former senior vice president of Mitsubishi Bank of California today was charged with embezzling $44 million and misapplying $1 billion of the bank's money.

Hirotsugo Mizuno, 44, allegedly set up 135 fraudulent loans and loan renewals involving $946 million in bank assets between September 1980 and October 1984.

The criminal complaint filed in municipal court charges that Mizuno concocted these loans to cover up embezzlement of $44.9 million. District Attorney Ira Reiner said Mizuno, who is charged with seven felonies, used the money to invest in the stock market and to pay off gambling debts.

Mizuno, who had worked for 14 years with Mitsubishi Bank Ltd. in Japan before his transfer to Los Angeles in 1979, allegedly used Nomura Securities Ltd., the world's largest brokerage house, and Daiwa Securities America to invest in stocks.

Reiner said bank officials discovered Mizuno's activities after Mitsubishi promoted and transferred him to New York in October 1984.

According to Reiner, Mizuno had an $8 million fictitious loan to a Montana power company outstanding at the time of his transfer. When Mizuno's replacement in Los Angeles contacted the power company to let them know he would be handling the loan, they told him there was no such loan.

The banker alerted Mitsubishi officials to the situation.

According to Reiner, Mitsubishi flew a top executive from Japan to New York to question Mizuno in October 1984. Bank officals said Mizuno confessed and was flown back to Los Angeles, where he reconstructed the embezzlement scheme.

Mitsubishi ordered Mizuno back to Japan in November 1984. He remains there, and Reiner has begun proceedings to extradite him. He said Mitsubishi claims they do not know Mizuno's whereabouts.

Reiner said that Mitsubishi Bank of California and its parent, Mitsubishi Bank Ltd., asked him repeatedly not to prosecute Mizuno, and that they transferred employes who may be important as witnesses back to Japan.

"While this case is serious enough merely in terms of the amount of money involved, it typifies another serious problem facing business today," Reiner said. "When an embezzler is caught, the victim company frequently does not want him prosecuted because to do so raises public and stockholder questions about the corporation's financial controls."

Reiner said that after they realized they could not stop the probe, Mitsubishi urged him to limit it to Mizuno's last loan.

Office Memorandum

Federal Home Loan Bank Board

Eleventh District
Office of the Director of Examinations

Date: October 28, 1986

To: B. J. Davis, Senior Vice President and Director of Examinations

From: Ken Tokiyama, District Accountant for Examinations

Subject: Mike Sage and Company, Inc. Accountancy Corporation Certified Public Accountants

In accordance with your request, the purpose of this memorandum is to discuss a possible criminal referral action against Mike Sage and Company, Inc. and Mike Sage. The company is located at 14351 Redhill Avenue, Suite A, Tustin, California 92680. Telephone No. (714) 838-9460.

The company was engaged by Ramona Savings and Loan Association (Ramona) to perform the examination (audit) of the 1985 financial statements. That audit was performed and a report, dated March 31, 1986, was issued by the company. The company rendered an unqualified opinion on the financial statements.

Upon review by Financial Accountant John Ashton, it was determined that the report did not comply with certain standards of the FHLBB and generally accepted accounting principles. These were, namely:

1. Comparative financial statements were not shown;

2. Footnote disclosure on income taxes was incomplete;

3. The probable estimated operating loss in 1986 on a real estate project discussed in a footnote should have been fully reserved in 1985.

On July 3, 1986, a letter was sent to the institution's Board of Directors stating that the audit report was unacceptable because of the foregoing described omissions and requested that a corrected report be filed with us. Financial Accountant Ashton also met with Mr. Sage to personally discuss these omissions. A corrected report was never filed.

An examination of the institution commenced on June 23, 1986. During this examination, it was determined that several transactions during 1985 involving the sales of real estate were not properly accounted for in accordance with generally accepted accounting principles. Specifically, during 1985, profits totaling approximately $4.0 million from the sales of real estate were recognized by the institution. The terms of these transactions were such that profits could not be recognized immediately pursuant to generally accepted accounting principles. The audited net earnings for 1985 was approximately $4.2 million. A substantial amount of this amount was due to the improper recognition of the profits from the sales of real estate. Although additional discussions were held with Mike Sage on these issues, he was unable to provide information to support the institution's recognition of these profits in accordance with generally accepted accounting principles. The effect of this was that the 1985 audited financial statements filed with us by the institution were misstated and misleading. On August 8, 1986, the director of examinations rejected the

1985 audit and the related report, and arrangements were made to have the 1985 financial statements re-examined by Kenneth Leventhal & Co., Certified Public Accountants. Within approximately two weeks of the commencement of this re-examination, the FSLIC seized the institution and established a receivership.

On August 27, 1986, Mike Sage issued a letter to us requesting that we withdraw and cease from disseminating the audited and certified financial statements of Ramona. His request was based on his determination that several audit adjustments were not booked and as a consequence they were not reflected in the financial statements; and that the unbooked adjustments could lead to material differences in the statements and allow the user of the report to come to incorrect conclusions on the financial condition of the institution.

Our examiners developed information pertaining to payments made to Mike Sage or Mike Sage and Company, Inc. during 1986 and 1985 by Ramona and its subsidiaries. A summary of these payments is presented below.

Description	1986	1985	Totals
Accounting service	$ 25,000	$ 10,000	$ 35,000
Audit fees	96,050		96,050
Tax return preparation	20,000	5,000	25,000
Expenses (reimbursements)	2,881	298	3,179
TOTALS	$143,931*	$ 15,298	$159,229*

* Excludes $120,000 (2 checks of $45,000 and $75,000 received from former Chairman of the Board John Molinaro) which is the subject of a separate memorandum by Examiner-In-Charge J. Jones.

According to our examiners, a contract between the institution and Mike Sage and Company, Inc. for accounting, audit and tax services does not exist.

In all cases, the checks for these services received by Mike Sage and Company, Inc. or Mike Sage were cashed at the institution. The institution's records indicated that $50 and $100 bills were usually paid to Mr. Sage.

Attached to FHLBB Form 366 "Criminal Referral Form" is a summary of criminal statutes. Those which I believe Mr. Sage could have participated in either alone or together with Ramona's management are listed below with a discussion on the possible applicability of the statutes.

18 U.S.C. #1006 "False entries and reports or statements including material omissions, with intent to injure or defraud an insured institution or deceive a Federal Home Loan Bank examiner; receipt of any benefits by an officer, agent or employee of the institution from a transaction of the institution with intent to defraud by the individual."

It is clear that the 1985 audit report, submitted to us in accordance with the requirements of Insurance Regulation 563.17-1(a)(2), was totally erroneous as it was determined not to

be in accordance with generally accepted accounting principles although the auditor attested that the financial statements were. Whether or not the erroneous aspects of the audited financial statements can be construed to represent a material omission with intent to injure or defraud an insured institution or deceive a Federal Home Loan Bank examiner is a matter of conjecture. It is also a matter of conjecture on whether or not the auditor knowingly and with intent prepared the 1985 financial statements enabling an officer (and owner) of the institution (Chairman of the Board and Chief Executive officer John L. Molinaro) to justify and receive a $2.0 million cash dividend in 1986.

18 U.S.C. #1344 "Bank fraud - scheme or artifice to defraud a federally insured institution or take money, funds, credit, assets, security or other property by misrepresentation."

Given the fact that a written agreement for accounting services, audit services and tax services between the accounting firm and Ramona cannot be located, questions can be raised as to the propriety and reasonableness of the amounts paid for such services. A formal investigation is necessary to ascertain whether or not the auditor alone or with the cooperation of the institution was engaged in a fraud to take what appears to be excessive funds for purported services from Ramona. No factual basis, however, has yet been established to determine that the cost of these services was excessive.

31 U.S.C. #5311 "Currency Transactions/Bank Secrecy Act."

As described earlier, checks payable to Mike Sage or Mike Sage and Company, Inc. were cashed at the institution. The institution's records indicated that usually large bills ($50 and $100 bills) were paid to Mr. Sage. Although the checks cashed at any one time were less than $10,000, the frequency and timing of these cash withdrawal transactions during the period, January 22 through May 7, 1986, suggested a possible attempt to avoid the completion of Form 4789 "Currency Transaction Report." A formal investigation would be helpful in this regard.

As discussed above, it is extremely difficult to state that a crime was clearly committed by Mr. Sage alone or even possibly with the assistance of the institution. It is recommended that a formal investigation be implemented to ascertain any criminal acts by Mr. Sage or Mike Sage and Company, Inc.

Notwithstanding any concrete evidence of crime committed by Mr. Sage, the performance of the 1985 audit clearly demonstrated his incompetence and he should be prohibited from ever practicing before the FHLBB. Mr. Sage should be disbarred pursuant to the provisions of Part 513 of the general regulations of the FHLBB. Also, his incompetence should be referred to the California State Board of Accountancy with the recommendation that his license be withdrawn. It is my understanding that the attorney general's office for the State of California has expressed a similar recommendation to the Department of Savings and Loan.

In addition, Mr. Sage's check cashing and cash withdrawal activities involving large bills are highly suspect, especially with respect to the possibility of improper reporting of income. If it is appropriate, the Internal Revenue Service and the California Franchise Tax Department should be alerted of our suspicions.

KT/le

cc: D. B. Fassett, Vice President
H. Lee, Acting Field Manager
J. Jones, Examiner-In-Charge

Record Copy: Examinations (K. Tokiyama)

Office Memorandum

Federal Home Loan Bank Board

Eleventh District
Office of the Director of Examinations

Date: April 20, 1987

To: T. J. Lane, Assistant Director
Agency Functions

From: G. M. Sanders, Chief Appraiser
Technical Services

Subject: FBI Investigation of Beverly Hills Savings

Marc Brown of Tuttle & Taylor referred me to Special Agent, Dan Ray of the FBI, (714) 550-9229.

The major comments of Ray's are these:

(1) Routinely Open Cases

Whenever a savings and loan or bank fails, the FBI opens a preliminary file. A formal investigation may be instituted after the preliminary investigation is completed.

(2) Beverly Hills Case Open

A file was opened for Beverly Hills Savings based on newspaper articles.

(3) Contact with OGC

Anne Sobol, Trial Attorney, with OGC was contacted. Information was provided by the FHLBB, Washington, D.C. staff. Ms. Sobol asked if the FBI desired a criminal referral. Ray responded in the affirmative, but the FBI to date has not received a criminal referral.

(4) Focus of Investigation

Ray's primary focus is the Stout-Newberry apartment loans. These loans exceed $400,000,000 and in the typical transaction, no association personnel ever physically inspected the property.

(5) Future Investigation

Ray has reviewed Sanders' testimony before the Dingell Committee. He would like to inspect my workpapers and the workpapers of the examiners.

(6) Other FBI Personnel

Mr. Ray's supervisor is James Annes and their bank failure specialist is James Mahoney. Their office is in Santa Ana.

GMS:lre

cc: T. E. O'Brien
C. A. Deardorff

IV

SUBCOMMITTEE NOTE: Example of faulty or fraudulent appraisal for major loan from Southern California savings and loan association.

SUMMARY OF RIVERSIDE/ORANGE COUNTY LAND

On December 7, 1984, an MAI appraiser valued a 850-acre hillside site in Riverside and Orange County at $25,500,000. This property originally sold for $1,500,000 on June 21, 1983. In late 1985, the property sold for $750,000 at a foreclosure sale, and the only bidder was the lender.

The appraiser did not meet generally accepted appraisal standards and does not meet FHLBB Memorandum R 41b requirements. A summary of deficiencies includes the following:

1) Improper and Inadequate Analysis of the Sales Comparables.

All of the sales comparables were smaller in size and have superior utility, terrain and road access characteristics that are suitable for development. Judgmental adjustments were employed.

The appraiser states that the subject's hilly topography complicates the development. Only 57 percent of the land is developable. The appraiser assumed development costs of $4,000,000 for a 182-acre portion. There was no detailed construction cost estimate. There was no basis for the evaluation of the remaining 300 acres that could be developed. There was no discounting in his final analysis.

2) Incorrect Statements and Assumptions.

The appraiser states that the existing road network can be upgraded to allow development of 180 acres. An inspection of the property by the Department of Savings & Loan appraisers disclosed that road access is limited to a very narrow tunnel under the Riverside Freeway. A locked gate bars vehicle access to the property. Utilities other than electricity are not readily available to the property.

3) Incorrect State of Ownership and Legal Description

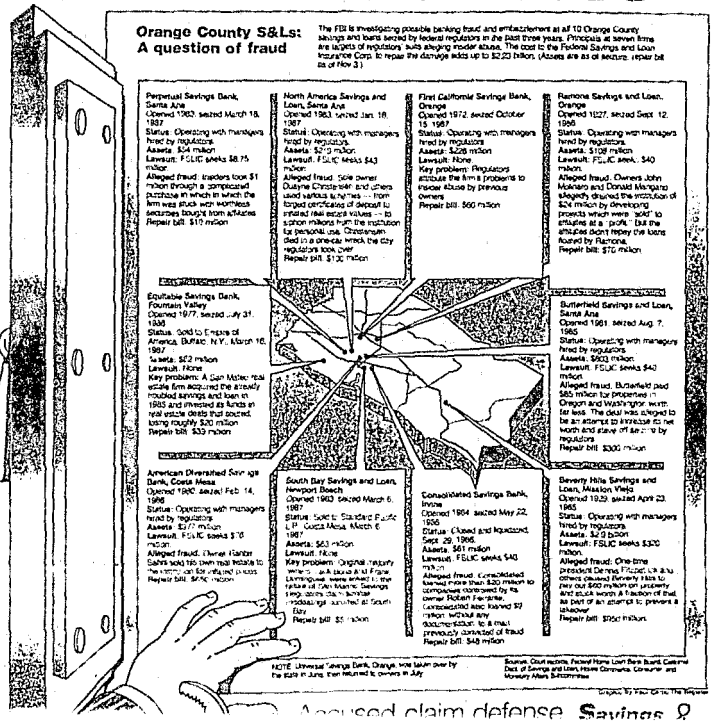
The appraisal reports 850 acres while the title reports indicate about 600 acres. The appraisal reports a value in fee while a life estate affects title.

Nov. 8, 1987,
Orange County Register

'THIS IS AN EPIDEMIC'

Criminal probes creep forward

By Jonathan Lansner and Ann Ernst
The Register



FRAUD: Orange County S&Ls are long hers at

Accused claim defense Savings &

APPENDIX 4.—LETTER AND MATERIAL SUBMITTED BY JAMES R. BUTLER, ESQ.

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REF./FILE NO.

June 19, 1987

VIA FEDERAL EXPRESS

RECEIVED
JUN 22 1987
COMMERCE, CONSUMER AND
MONETARY AFFAIRS SUBCOMMITTEE

The Honorable Doug Barnard, Jr.
Chairman, Commerce, Consumer and
Monetary Affairs Subcommittee
Committee on Government Operations
U.S. House of Representatives
Room B377 Rayburn HOB
Washington, D.C. 20515

Dear Congressman Barnard:

Thank you for the opportunity to correct the egregious misinterpretation by William K. Black (in testimony on June 13, 1987 before your subcommittee) of certain statements I made in 1984. Fortunately, Mr. Black's misinterpretation is made with respect to my written comments attached to his testimony. I stand upon those comments as written. If anyone reads my document, he or she will see that Mr. Black has taken my comments out of context and distorted the natural meaning of the words to create an impression which is exactly opposite from that conveyed by the written statement.

Unfortunately, many readers may see or read Mr. Black's erroneous interpretation and never bother to look at the document he has mischaracterized. That would be a sad and unfortunate event, and extremely damaging to my reputation.

Mr. Black refers to the use of the word "flip" in my materials to imply that my law firm and I publicly advocated fraudulent transactions by federally-insured savings institutions. Nothing could be further from the truth.

My written materials, which were distributed to an audience of approximately 500 people in New York City in early 1984, refer to a completely different kind of "flip" which is well known in the real estate development and real estate syndication industries. The "flip" I was referring to involves a bona fide transaction, negotiated at arm's length between unre-

lated parties. It is simply a quick resale which experienced people are able to accomplish on rare occasions if they have cash readily available to acquire properties under distressed circumstances, hold them for a brief period of time and resell the property to an unrelated party in an arm's length transaction.

My oral presentation in New York City, which these written materials accompanied, specifically illustrated a "flip" transaction in an actual situation in which a public real estate limited partnership fund sponsored by Balcor, one of the largest syndicators in the United States, had just purchased an apartment property from a savings and loan association. The savings and loan association had held the property for less than 90 days and derived a profit of several million dollars because of its ability to purchase the property from a distressed seller and hold it while the Balcor public fund was raising money through the sale of securities. Such transactions were and are completely legal, appropriate and highly profitable.

At the time I wrote my Narrative Outline, I had never heard the word "flip" used to refer to fraudulent transactions of the sort referred to by Mr. Black. I first heard the word "flip" used to refer to fraudulent land transactions of the type mentioned by Mr. Black when I read the House Government Operations Committee's report on the failure of Empire Savings and Loan Association of Mesquite, Texas, and discovered to my chagrin that Edwin J. Gray, Chairman of the Federal Home Loan Bank Board at that time, had similarly misconstrued my comments and attached them as an exhibit to his testimony in the Committee's Report. I immediately wrote Chairman Gray on May 3, 1984. A copy of the letter I sent to Chairman Gray is attached as Exhibit A. It is completely self-explanatory.

Shortly thereafter, one of my partners met with Norman Raiden, then General Counsel to the Federal Home Loan Bank Board. At their meeting in Washington, D.C., Mr. Raiden confirmed that our use of the word "flip" was clearly distinguishable from the land flip problem referred to in Texas. The interpretation of my comments was an unfortunate misunderstanding.

This understanding was confirmed by letter dated May 20, 1986 from Harry W. Quillian, Acting General Counsel of the Federal Home Loan Bank Board. In this letter, Mr. Quillian stated:

> "I am advised that former General Counsel Raiden spoke to a member of your Firm some time shortly after receipt of Mr. Butler's letter to Chairman Gray dated May 3, 1984. Having listened to the explanation given that the firm's use of the word "flip" was clearly distinguishable from the land flip problems we had encountered in Texas, Mr. Raiden felt the matter was closed and no further action was necessary."

If anyone reads my Narrative Outline cited by Mr. Black, that person will find an abundance of cautionary statements and warnings. Each of the following admonitions is taken from the Narrative Outline following the academic discussion of statutory or regulatory powers and authorities.

> "However technically correct something seems by the strict letter of the law, test the concept to see if it seems prudent and sound for a financial institution using public funds and FSLIC insurance." (Page 14)

> "How will this activity look when scrutinized by the press? If it wouldn't look good on the front page of the newspapers, don't do it! How will it look when scrutinized by the regulators? Are there any related-party problems? Is there even the appearance of impropriety?" [Emphasis in original text.] (Page 14)

> "Remember that in the S&L context, investments in conventional mortgages, equity participating mortgages, real estate development or syndication projects, mortgage pools or other lawful investments are made with Federally insured money raised from the public . . . . while investments described above are clearly lawful and appropriate, a 'captive' S&L cannot be used as an 'alter ego' for making 'sweetheart loans' to

> friends and relatives, nor purchasing 'white elephant' projects from related parties. The savings and loan association and its affiliated businesses must be run in accordance with prudent business standards." [Emphasis added.] (Page 14)
>
> "Given the many opportunities offered by an S&L, should everyone form a savings and loan association? Emphatically, the answer is "NO!" (Page 13)
>
> S&Ls are subject to extensive regulation by Federal and state agencies. Many successful business people simply lack the patience needed to tolerate a highly regulated environment. Moreover, regulators can react sharply if they believe their regulations have been intentionally violated. Although financial institutions are generally going through a rapid deregulation, the threat of re-regulation is constantly present, especially if the regulators perceive abuses." (Page 13)

My oral presentation was laced with even more warnings to the audience emphasizing the need of anyone entering the S&L industry to meet the highest standards of professional and ethical conduct.

It is regrettable that a person of Mr. Black's position, knowledge and experience would perpetuate a misunderstanding that should have been cleared up long ago.

I understood how Chairman Gray, under the pressure of Congressional inquiry focused on the failure of Empire of Mesquite, Texas, and lacking legal training or the time to read my remarks carefully, could take a phrase out of context and misunderstand its intention. That misunderstanding should have been put to rest at least three years ago, and again, in 1986, by Mr. Quillian's letter.

It is difficult for me to understand how, three years later, Mr. Black could perpetuate and repeat the misunderstand-

ing. A person of his position must be accurate and cautious in making damaging statements about lawyers and law firms who are committed to the highest standards of conduct in serving the industry. Indeed, no client of our firm has ever incurred regulatory disfavor in connection with transactions or activities about which we had been consulted.

Thank you again for the opportunity of correcting this injustice.

Very truly yours,

JAMES R. BUTLER, JR., P.C.
of Jeffer, Mangels & Butler

JRB/wpc
JRB256
Enclosure

cc: Mr. Peter S. Barash, w/att.
William K. Black, Esq., w/att.

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May 3, 1984

VIA MESSENGER

Mr. Edwin J. Gray
Chairman
Federal Home Loan Bank Board
1700 "G" Street Northwest
Washington, D.C. 20552

Dear Chairman Gray:

We have read your statement presented on April 25, 1984 before the Commerce, Consumer and Monetary Affairs Sub-Committee of the Committee on Government Operations of the House, in which, at page 23, you make reference to a "law firm's promotional material to potential S&L charter applications" and to the Narrative Outline which is attached to your testimony. That Narrative Outline was prepared by me on behalf of this law firm specifically for presentation to real estate syndicators at the Annual Laventhol & Horwath Real Estate Syndication Seminar.

We believe it is very important that representatives of this firm meet with you as promptly as possible.

We have concluded that there was a misinterpretation of the word "flips" used on page 4 of my Narrative Outline. On May 1, 1984, we first learned that the Federal Home Loan Bank Board (FHLBB) considers "land flips" to be something similar to the following:

> "A 'land flip' is a type of transaction where a tract of land is sold several times in a short period to create an artificially high market value for the particular tract. Typically, the last purchaser obtains a loan by submitting inflated or fictitious financial statements and loan appraisals based upon the last 'land flip' sale price. The loan amount generally includes the final inflated sale

price, development costs, loan fees, closing costs and interest."

The word "flips" as used on page 4 of the Narrative Outline refers to a wholly different type of transaction which is common in the real estate development and syndication areas.

> In the real estate industry, a "flip" is a purchase of real estate below fair market value due to the seller's distressed circumstances or other unusual economic factors which enable a purchaser to purchase and resell the property within a short period of time at a substantial profit (representing the difference between a distressed purchase price and true fair market value). The typical buyer in this transaction is a large public syndicator, which is sophisticated and qualified to evaluate the property and negotiate a price which will provide competitive economic returns to investors.
>
> In the definition of "flips" used in the real estate industry, the purchaser obtains a responsible appraisal, based upon fair market value. The term as used in our experience is limited to transactions involving existing buildings, shopping centers, and other improved properties, because of SEC and state securities laws applicable to such public syndicators.
>
> As distinguished from the Federal Home Loan Bank Board's definition of a "land flip", there are no artificial markups of price through multiple purchases and sales. Responsible appraisal are regularly obtained in compliance with applicable securities laws.

As you will note, the FHLBB's concept of a "land flip" is quite different from the real estate industry's concept of a "flip".

In the context of our representation of numerous clients, including applicants for savings and loan charters and FSLIC insurance of accounts, as well as existing associations, we believe it is very important to clarify this matter as promptly as possible. We do not believe that you or the FHLBB would want any misunderstandings as a consequence of the quite different meanings of the above-described concepts, misunderstandings which could operate to our professional detriment.

I believe that we both share the same concern for the continued integrity and profitability of the thrift industry; and, I would hope that this could be amply demonstrated at our meeting.

We would appreciate it if a representative of your office or the Office of the General Counsel would call us about an appropriate time for such a meeting.

Sincerely,

JAMES R. BUTLER, JR.

JRB:wpc

cc: Norman Raiden, Esq.
Rosemary Steidle

APPENDIX 5.—FEBRUARY 24, 1987, MEMORANDUM FROM ATTORNEY GENERAL MEESE TO ALL U.S. ATTORNEYS; SUBJECT: BANK FRAUD PROSECUTIONS

Office of the Attorney General
Washington, D. C. 20530

February 24, 1987

MEMORANDUM

TO: All United States Attorneys

FROM: EDWIN MEESE III
Attorney General

SUBJECT: Bank Fraud Prosecutions

In October I met with senior officials from the bank supervisory agencies to review the government's bank fraud prevention and enforcement efforts. I also attended the Chicago meeting of the Economic Crime Council, where we examined the extent and impact of bank fraud cases nationwide.

It was clear from both meetings that we have made considerable progress in the past several years in addressing the bank fraud problem. At the same time it was evident that financial institutions remain vulnerable to enormous losses brought about by insider fraud and misconduct. The FBI's loss figure for completed bank fraud investigations for the first half of 1986 is $894 million--a figure already exceeding the total for all of 1985. Moreover, the sheer number of bank fraud cases receiving the FBI's highest priority classification (losses exceeding $100,000) shows the problem is widespread and growing. In September 1985, the FBI had approximately 2,500 pending bank fraud cases involving losses of $100,000 or more. As of June 1986, this number has jumped to approximately 3,000 such cases.

I am convinced that our bank fraud enforcement effort must be intensified. To address the problem, the Department and the FBI are initiating a plan of action. In the next 60 days, the FBI will determine, on a district by district basis, how many of its 3,000 open cases involving losses exceeding $100,000 are awaiting prosecutive decision or action. I am asking each of you to do the following:

(1) During the next 60 days, prepare your own inventory of $100,000 plus bank fraud cases pending prosecutive decision or action.

Exhibit C

(2) After completing this inventory, contact the FBI's Special Agent in Charge (SAC) and assess the progress of the major bank fraud cases in the district. As part of this assessment, determine with the SAC which open cases can be accelerated for prosecution or prosecutive determination.

(3) Commit your office to make prompt prosecutive determinations in those cases ready for prosecutive decision.

(4) Assign the needed personnel to complete the investigation of open cases with the goal of indictment or declination within nine months. The SAC is also being requested to make personnel assignments to prioritize these cases.

I realize that, with the ever increasing work load imposed on many understaffed United States Attorneys' Offices, some of you, as well as certain FBI field offices, may lack resources to move each of your major bank fraud cases to indictment or declination in the next nine months. If this situation exists in your district, please contact James J. Graham, Acting Chief of the Criminal Division's Fraud Section (FTS 786-4381). The SAC is being asked to advise FBI Headquarters. The FBI and the Criminal Division are committed to support this enhanced effort with additional investigative and prosecutive resources where needed.

The bank fraud problem continues to be a major concern to the Department. The plan of action I have outlined is designed to clear any logjams that may have developed and to enable the Department to evaluate and compare those cases in need of special attention and resources.