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FEDERAL RESPONSE TO CRIMINAL MISCONDUCT AND INSIDER ABUSE IN THE NATION'S FINANCIAL INSTITUTIONS

FIFTY-SEVENTH REPORT

BY THE

COMMITTEE ON GOVERNMENT OPERATIONS

together with

ADDITIONAL VIEWS

95403

1984.—Committed to the Committee of the Whole House on
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LETTER OF TRANSMITTAL

HOUSE OF REPRESENTATIVES,
Washington, DC, October 4, 1984.

Hon. THOMAS P. O'NEILL, Jr.,
Speaker of the House of Representatives,
Washington, DC.

DEAR MR. SPEAKER: By direction of the Committee on Government Operations, I submit herewith the committee's fifty-seventh report to the 98th Congress. The committee's report is based on a study made by its Commerce, Consumer, and Monetary Affairs Subcommittee.

JACK BROOKS, *Chairman.*

U.S. Department of Justice
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Union Calendar No. 637

98TH CONGRESS 2d Session } HOUSE OF REPRESENTATIVES { REPORT 98–1137

FEDERAL RESPONSE TO CRIMINAL MISCONDUCT AND INSIDER ABUSE IN THE NATION'S FINANCIAL INSTITUTIONS

OCTOBER 4, 1984.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

Mr. BROOKS, from the Committee on Government Operations, submitted the following

FIFTY-SEVENTH REPORT

together with

ADDITIONAL VIEWS

BASED ON A STUDY BY THE COMMERCE, CONSUMER, AND MONETARY AFFAIRS SUBCOMMITTEE

On September 25, 1984, the Committee on Government Operations approved and adopted a report entitled "Federal Response to Criminal Misconduct and Insider Abuse in the Nation's Financial Institutions." The chairman was directed to transmit a copy to the Speaker of the House.

I. INTRODUCTION AND BACKGROUND

Over the past several years, this country's banking industry has experienced its worst turmoil since the Great Depression. Record numbers of financial institution failures, a deep world-wide recession, and an international debt crisis have shaken public confidence in the industry and pushed our bank regulatory system to its limits.

The dramatic increase in commercial bank failures alone illustrates the problem. The number of failures jumped from 10 in 1981 to 42 in 1982, 48 in 1983, and 53 as of August 1984. Particularly disturbing is that these failures have included some of the Nation's largest and seemingly most secure institutions. The recent "near-

failures" of Continental Illinois National Bank and Financial Corporation of America—which necessitated costly and complex rescue plans—have only added to this concern and caused an increasing number of Americans to wonder if the domestic banking industry is fundamentally sound and whether our bank regulatory system is meeting its supervisory responsibilities in the emerging era of bank deregulation.

The Subcommittee on Commerce, Consumer, and Monetary Affairs has oversight responsibility for the operations of the Federal banking agencies, including the Federal Deposit Insurance Corporation (FDIC), the Federal Reserve Board, the Federal Home Loan Bank Board (FHLBB), the Office of the Comptroller of the Currency (OCC), and the National Credit Union Administration (NCUA). Over the past 10 years, the subcommittee has maintained an active interest in the causes of the major bank and thrift failures and the regulatory agencies' responses to the conditions causing those failures. The subcommittee has investigated or held hearings into the failures of the Franklin National of New York,[1] the Penn Square Bank of Oklahoma City, OK,[2] the United American Bank Knoxville, TN,[3] and, most recently, the Empire Savings and Loan Association of Mesquite, TX.[4]

The subcommittee's hearings revealed that insider abuse and criminal misconduct [5] either caused or substantially contributed to each of these failures. They also demonstrated that in each of these failures, the appropriate Federal bank regulatory agency had ample advance warning of unsafe and unsound banking practices—particularly insider misconduct—prior to insolvency, but failed to take prompt and effective remedial action. In each case, such action might have prevented the institution's failure or at least greatly reduced the eventual losses suffered by depositors, shareholders, and the FDIC/FSLIC deposit insurance funds.

This apparent pattern of criminal misconduct by insiders in some of the Nation's largest financial institution failures, the increasing number of failures, and the past supervisory neglect of the banking agencies prompted the subcommittee in the spring of 1983 to launch a major study of the nature and extent of criminal misconduct by insiders in the country's financial institutions and the ef-

[1] "Oversight Hearings into the Effectiveness of Federal Bank Regulation (Franklin National Bank)," before the Commerce, Consumer, and Monetary Affairs Subcommittee of the House Committee on Government Operations, 94th Congress, 2nd Session, February 10, May 25, 26, and June 1, 1976. House Report No. 94-1669, "Adequacy of the Office of the Comptroller of the Currency's Supervision of Franklin National Bank," September 23, 1976.

[2] Hearings "Federal Supervision Failure of the Penn Square Bank, Oklahoma City, Okla." before the Commerce, Consumer, and Monetary Affairs Subcommittee of the House Committee on Government Operations, 97th Congress, 2nd Session, July 16, 1982.

[3] Hearings "Federal Supervision Failure of United American Bank (Knoxville, Tenn.)," before the Commerce, Consumer, and Monetary Affairs Subcommittee of the House Committee on Government Operations, 98th Congress, 1st Session, March 15 and 16, 1983.

[4] Hearings "Adequacy of Federal Home Loan Bank Board Supervision of Empire Savings and Loan Association," before the Commerce, Consumer, and Monetary Affairs Subcommittee of the House Committee on Government Operations, 98th Congress, 2nd Session, April 25, 1984. House Report No. 98-953, "Federal Home Loan Bank Board Supervision and Failure of Empire Savings and Loan Association of Mesquite, Tex.," August 6, 1984.

[5] The term "insider abuse," as used in this report, refers to a wide range of misconduct by officers, directors and insiders of financial institutions committed with the intent to enrich themselves without regard for the safety or soundness of the institutions they control, in violation of civil banking laws and regulations and perhaps also in violation of criminal banking laws. The term "criminal misconduct" refers strictly to criminal acts committed by such insiders against the institutions they control.

fectiveness of the Federal Government in detecting and penalizing such misconduct. This report therefore represents, in many ways, a culmination of the subcommittee's numerous hearings over the past 10 years into the adequacy of the regulation and supervision of troubled financial institutions. It is also the first comprehensive congressional examination of the Government's record in dealing with insider misconduct in a large number of problem finacial institutions, many of which ultimately failed.

THE SUBCOMMITTEE'S HEARINGS AND STUDY

The subcommittee's inquiry focused initially on the banking agencies' policies and procedures for referring to the Justice Department criminal misconduct by officers, directors and insiders of financial institutions. As it became apparent, however, that the Justice Department was not criminally prosecuting many instances of insider abuse, the study was expanded to include the banking agencies' use of their civil enforcement powers to halt such misconduct.

The subcommittee's first hearing on June 28, 1983, inquired into the number of criminal referrals the agencies had made to the Justice Department in recent years and whether these referrals were being prosecuted by U.S. attorneys' offices throughout the country. As subcommittee Chairman Doug Barnard, Jr., remarked in his opening statement at the hearing:

> Because of the all too frequent relationship between insider abuses and failed financial institutions and because of the expanding powers of such institutions, effective supervision by the banking agencies, including vigorous referral and prosecution of criminal misconduct by officials and insiders, is vital.
>
> This subcommittee seeks to determine if the present system of criminal enforcement is working efficiently to identify and prosecute criminal violations of the banking laws so as to deter future misconduct and to protect the financial system against unsafe and unsound practices. . . .
>
> We want to know whether . . . . the responsibility of the regulators to protect and safeguard the banking system conflicts with their responsibility to identify and punish wrongdoers.[6]

The results of this hearing were disturbing. The FDIC, OCC, FHLBB, and the Federal Reserve were unable to provide the subcommittee, with information on criminal activities by insiders because they lacked systems for (1) compiling data on the numbers and types of criminal referrals they make to the Justice Department, (2) tracking the ultimate disposition of these referrals, and (3) maintaining records on civil enforcement actions taken against individuals who were the subject of these referrals. Worse, the agencies' indifferent attitude toward keeping useful records on

[6] Hearings, "Federal Response to Criminal Misconduct by Bank Officers, Directors, and Insiders (Part 1)," before the Commerce, Consumer, and Monetary Affairs Subcommittee of the House Committee on Government Operations, 98th Congress, 1st Session, June 28, 1983 (hereafter referred to as Hearings (Part 1)). Additional hearings on the same subject were held on May 2 and 3, 1984, and the record on that is hereafter referred to as Hearings (Part 2).

criminal miscondct reflected a deeper—and much more fundamental—lack of interest in dealing with insider abuse in a meaningful way.

Because the agencies failed to compile even the most basic statistics on criminal referrals, the subcommittee was unable to draw any definitive conclusions about the impact of insider criminal misconduct on financial institutions or the effectiveness of the Federal Government in dealing with the problem. To do that, it became necessary for the subcommittee to conduct its own empirical study and to compile its own statistics.

The subcommittee conducted two statistical surveys. The first involved a review of the Nation's 75 commercial bank failures, 12 savings bank failures, and 30 savings and loan failures (i.e., involuntary receiverships) that occurred between January 1980 and June 1983. It sought to determine how widespread criminal misconduct by insiders was among these failures and whether the Department of Justice was adequately prosecuting insider misconduct involving these institutions. In order to obtain information on the disposition of the agencies' criminal referrals involving these institutions, the subcommittee had to initiate an entirely new, previously non-existent system for tracking referrals from the banking agencies to the Department of Justice.

The subcommittee also required statistics on the existence of insider abuse and criminal misconduct in open institutions. This, however, proved to be impossible because the banking agencies do not have any way of providing such statistics. For example, the OCC indicated that in order to retrieve its criminal referrals involving insiders in open institutions, the agency would have to conduct a manual search of each of its 4,500 banks' files. Accordingly, the subcommittee constructed a second survey that was limited to all criminal referrals involving insiders in "problem" institutions during 1980–81.[7] This survey traced the disposition of each of the agencies' criminal referrals during this period to see if the case was prosecuted by the Justice Department, and the subcommittee also requested the appropriate banking agency to report whether it had taken any civil action against the individuals involved.

In addition to these two surveys, the subcommittee reviewed and analyzed thousands of pages of documents regarding the agencies' policies and procedures on (1) the training of examiners in detecting insider abuse and criminal violations, (2) the use of the bank examination process to detect such conduct, (3) the civil investigation of insider abuse (4) the criminal referral process, (5) the use of civil enforcement actions against individuals, and (6) the recovery of FDIC and FSLIC insurance losses due to criminal misconduct in failed institutions through fidelity bond claims.

[7] The FDIC, OCC, and Federal Reserve share the Uniform Interagency Bank Rating System, which assigns each bank a composite rating, based upon a combination of five individual components: Capital, Asset Quality, Management, Earnings, and Liquidity ("CAMEL"). Banks rated "1" or "2" are essentially sound. Composite "3" banks have weaknesses that could deteriorate under adverse economic circumstances or in the absence of remedial action. Banks rated "4" and "5" are "problem" institutions and clearly warrant special supervisory attention. The subcommittee's survey, however, defined "problem" institutions as those with a classification of "3" or worse at any time during 1980 or 1981. The FHLBB has a slightly different rating system, with composite ratings ranging from "1–A" to "4–D." The subcommittee's survey of thrifts was limited to institutions with ratings of "3–D" or worse during the same period.

Finally, the subcommittee staff interviewed scores of U.S. attorneys and their assistants, FBI agents, bankers, insurance underwriters, and former bank examiners to learn about their personal experiences with bank fraud and abuse. The subcommittee had only limited success in this effort, however, because the banking agencies prevented the subcommittee staff from talking directly to examiners who had first detected abusive conduct in certain institutions covered in the subcommittee's two surveys.

Therefore, this report provides Congress and the public with their first comprehensive look at how the Federal Government deals with insider misconduct, both civilly and criminally, in failed and problem institutions.

AN OVERVIEW

What emerges from this exhaustive study is a deeply disturbing picture of a banking industry that suffers too many failures due to insider fraud, a bank supervisory system that frequently fails to detect, investigate or penalize such fraud, and a law enforcement system that frequently fails to prosecute it. The costs of such failures, just to the Federal deposit insurance funds, are staggering. The subcommittee's study of 105 banks and savings and loan failures reveals that criminal activity by insiders was a major contributing factor in roughly one-half of the bank failures and one-quarter of the savings and loan failures. The FDIC and FSLIC have estimated that their insurance losses in just these institutions will exceed $1 billion.[8] Failures that have occurred since the conclusion of the subcommittee's survey in mid-1983 are expected to add at least another $1 billion to this total.

Despite such enormous losses, neither the banking nor the criminal justice systems impose effective sanctions or punishment to deter white-collar bank fraud. The few insiders who are singled out for civil sanctions by the banking agencies are usually either fined de minimis amounts or simply urged to resign. The few who are criminally prosecuted usually serve little, if any, time in prison for thefts that often cost millions of dollars.

The subcommittee's study reveals that the Federal Government lacks any kind of overall plan or policy to deal with the threat of insider abuse. In fact, there is an astonishing lack of communication and cooperation among the banking agencies themselves and between the banking agencies and the Justice Department to control such activity. The subcommittee has uncovered examples where this lack of coordination has allowed convicted felons, con artists, real estate swindlers—and even well-known organized crime figures—to penetrate and gain control of banks and to cause the banks to fail before the regulators even knew what was going on.

Unfortunately, weak civil enforcement and criminal prosecution of insider abuse has allowed bank fraud to become an accepted—and expensive—cost of doing business. Hundreds of thousands of

[8] Hearings (Part 2), pp. 605, 680. The agencies did not provide an estimate of the percentage of this figure that could be attributed specifically to criminal misconduct by insiders. After the date that the agencies provided these estimates, new ones have raised the expected losses to more than $1 billion.

small bank investors, the Federal deposit insurance funds, and ultimately American consumer end up paying the high price of insider abuse. Moreover, bank failures are having an increasing "ripple effect," causing consumers and investors in Chicago, Seattle, New York, and elsewhere to suffer from insider fraud committed in Oklahoma or Tennessee.

This gloomy picture, however, does have its few bright spots. The subcommittee has found many individual bank regulators, bank examiners, and law enforcement officers who are working hard to reduce the toll of insider abuse. The Comptroller of the Currency and the FHLBB appear to be placing a higher priority on making strong criminal referrals than the other banking agencies. In his testimony on May 3, 1984, FHLBB Chairman Edwin J. Gray proposed the creation of a special bank and thrift task force to coordinate the agencies' efforts. He stated:

> . . . I make this recommendation for three reasons.
>
> (1) Recent increases in incidents of insider misconduct at thrift and banking institutions are deeply troubling. Cases of outright fraud involve millions of dollars that have disappeared into pockets of individuals at the expense of savings institutions or the FSLIC. Such frauds also are becoming more sophisticated and complicated, resulting in the need for special and dedicated prosecutorial skills to obtain convictions. . . .
>
> (2) Secondly, the special purpose and attention of our thrift industry to meeting America's housing needs is harmed whenever anyone—insiders, borrowers, or others—can criminally manipulate a thrift institution. Each of the dollars involved in such manipulation is diverted from the legitimate savings and loan activities that are designed to promote home financing for the public. . . .
>
> (3) And finally, the economic pressures that have caused so many S&L's to fail in the last three years have created the need to protect our still vulnerable industry from criminal conduct within the institutions. . . . To now permit this still-struggling thrift industry to be attacked, damaged and pillaged by the quiet white-collar criminal falls short of the vigilant protection needed.[9]

Despite such scattered signs of commitment, however, the performance of the banking agencies and the Justice Department requires dramatic improvement.

As this report indicates, what is needed is nothing short of a fundamental revamping of the banking agencies' role in the fight against insider abuse and fraud. As Professor John A Spanogle, Jr., Professor of Law at the State University of New York at Buffalo stated in his testimony.

> I think you have to change the attitude of the agencies at the top as to what it is the agencies are interested in and what it is that they feel is the major threat to the banking industry. Congressional hearings say there is a link between problem banks and insider abuses. That linkage doesn't seem to be appreciated by the agencies, because they are still expending most of their resources on appraisal rather than audit. . . . Until you change the attitude at the top so that they believe that the guys who are getting the crooks are also helping the bank system function better, you still have the same old problems.[10]

[9] Ibid., pp. 376–379

Recent experience shows that the agencies can no longer afford to sit by and nonchalantly contend that the investigation of insider abuse is not one of their primary jobs or that dealing with individuals engaged in criminal misconduct must be exclusively left to Federal prosecutors.

Because of their unique opportunity to examine financial institutions and to supervise their operations, the banking agencies must lead the fight against insider abuse. Such a responsibility arises, not from the agencies' role in punishing wrongdoers and criminals, but from an awareness that abusive and criminal activities are destroying an increasing number of otherwise safe and sound institutions.

As Chairman Barnard noted at the May 2 hearing, "These issues of enforcement go to the very heart of the bank supervisory process."[11] The Nation's banking industry can neither serve as the foundation for a strong economy nor expand and compete freely in the marketplace if the Federal Government is unable or unwilling to control abuse and criminal fraud by the very people who control these powerful institutions. Increased Federal efforts to reduce insider abuse would be a major step in restoring the public's confidence in the soundness of the Nation's banking industry and the effectiveness of its bank regulatory system.

II. Findings

SUMMARY

1. a. Criminal misconduct by insiders of financial institutions has been a major contributing factor in approximately one-half of all commercial bank failures and one-quarter of all savings and loan failures between 1980 and 1983. Projected FDIC and FSLIC losses from these institutions are expected to exceed $1 billion.

b. Despite this high correlation between criminal misconduct and financial institution failures, the banking agencies have a poor record of detecting and investigating such misconduct until an institution fails or is about to fail.

2. a. Moreover, when the banking agencies do detect insider misconduct, they often fail to take direct civil enforcement action against the individuals responsible, notwithstanding their clear statutory responsibility to penalize those who threaten the safety and soundness of financial institutions. The subcommittee's survey of the banking agencies' criminal referrals involving insiders of problem institutions reveals that the agencies failed in 80 percent

[10] Hearings (Part 1), p. 80.
[11] Hearings (Part 2), p. 2.

of the referrals to pursue direct civil enforcement action against the individuals involved.

b. When the banking agencies do use their primary enforcement powers against individuals—cease and desist orders, removals, prohibitions, and civil money penalties—they do so in an inconsistent and arbitrary manner that subjects insiders to vastly different standards, depending upon which Federal agency regulates their institution. For example, the OCC uses civil money penalties against individuals at least 10 times more often than the other three agencies. Similarly, the FHLBB uses removal orders at least four times more often than the other three.

3. a. The banking agencies procedures for dealing with insider abuse are inherently flawed because the agencies perceive and essentially treat misconduct by individuals in the same manner as unsafe or unsound institutional banking practices, such as inadequate capitalization or concentration of loans. Institutional deficiencies are amenable to normal supervisory methods. However, insider misconduct defies traditional regulatory responses because it involves individuals who willfully enrich themselves at the expense of the institutions they control.

b. Because the agencies often handle cases of insider abuse through forced resignations rather than formal enforcement actions, individuals guilty of serious misconduct can, and do, move freely from one financial institution to another.

4. When the banking agencies' do make criminal referrals they are generally weak and ineffective. Their referrals to the Justice Department frequently lack adequate factual details, supporting documentation, or recommendations for the prosecution of major cases. In addition, the agencies rarely follow up on their referrals to determine their disposition or to encourage prosecution. Accordingly, the referral process is incapable of producing the intended result—the timely and successful prosecution of bank fraud cases.

5. a. The Justice Department's record of prosecuting insider misconduct is uneven, at best. The Department generally has a good record of prosecuting insiders after an institution has failed. However, it largely fails to prosecute insider misconduct in open institutions.

b. Because the Justice Department fails to prosecute insiders in open institutions and the banking agencies fail to take civil enforcement action against them, two-thirds of all insiders in open institutions whose conduct is the basis for criminal referrals face neither criminal nor civil sanctions.

c. The Criminal Section of the Justice Department in Washington has failed to provide adequate leadership in monitoring, coordinating, and supervising the prosecution of important bank fraud cases or to serve as a liaison between the Federal banking agencies and the 93 U.S. attorneys' offices throughout the country.

6. Archaic criminal statutes, which do not readily apply to, or properly penalize, many modern bank fraud schemes, and the Right to Financial Privacy Act, which unduly restricts the legitimate exchange of bank records among Government law enforcement agencies, have impeded the effective prosecution of criminal misconduct by insiders.

SPECIFIC FINDINGS

A. THE SCOPE OF CRIMINAL MISCONDUCT BY OFFICERS, DIRECTORS AND INSIDERS IN FINANCIAL INSTITUTIONS

1. a. Statistics compiled by the subcommittee demonstrate that out of 75 commercial bank failures between January 1980 and June 1983, 61 percent involved actual or probable criminal misconduct by officers, directors or insiders. Criminal misconduct was a "major contributing factor" in at least 45 percent of these 75 failures.

b. It is difficult, however, to determine the scope of insider abuse and criminal misconduct in the banking industry as a whole because neither the Federal banking agencies nor the Justice Department routinely compile meaningful statistics on such conduct.

2. a. The total projected losses of the FDIC and FSLIC in 41 recent bank and thrift failures where criminal misconduct was a "major contributing factor" will exceed $1 billion.

b. Despite such significant losses, neither the FDIC nor the FSLIC routinely compiles any statistics on its insurance losses due to insider misconduct.

3. a. Insider criminal misconduct occurs twice as frequently in failed commercial banks as in failed savings and loans, although there is evidence that the rate in the latter is increasing significantly.

b. Insider criminal misconduct does not appear to be a major contributing factor in recent credit union failures or FDIC-insured savings bank failures.

B. THE DETECTION AND INVESTIGATION OF INSIDER ABUSE AND CRIMINAL MISCONDUCT BY THE BANKING AGENCIES

4. The subcommittee's survey of recent bank and thrift failures shows that the banking agencies frequently fail to detect and report insider criminal misconduct prior to failure. In 50 out of the 75 recent bank and thrift failures giving rise to FBI investigations, the banking agencies either made no criminal referrals or made referrals only after the institutions had failed.

5. Examiners are the banking agencies' "front-line troops" in the fight against insider abuse and criminal misconduct. The agencies, however, prevent examiners from effectively performing this role by failing to provide them with adequate training, resources, and incentives to detect and investigate suspected insider misconduct. For example:

a. With the limited exception of the OCC, the agencies have failed to provide examiners with adequate training or instructional manuals that cover the various types of insider abuse schemes, the techniques of investigation, the preparation of criminal referrals, the preservation of evidence, or the various civil and criminal enforcement options available to combat insider abuse.

b. The bank examination process itself has been revised in recent years to place less, rather than more, emphasis on the detection of insider abuse and criminal misconduct. Such revisions include a reduction in the frequency of examinations, greater reliance upon statistical data and trend analysis, and less use of traditional audit techniques that are specially designed to detect internal fraud.

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c. In examining questionable loan transactions, examiners are discouraged from going outside the institution being examined to follow the loans' "paper trail" to other banks or to interview bank customers and witnesses. Such limitations are particularly troublesome, given the increases in chain banking relationships, the national character of modern banking transactions and the "ripple effect" that insider abuse often has on other financial institutions.

d. Some examiners, particularly those with the FDIC, are often discouraged from conducting comprehensive investigations of insider abuse because of the agencies' strict deadlines for competing routine examinations.

e. Several of the banking agencies suffer a high turnover of field examiners due to low pay, difficult working conditions, personnel cutbacks, and increased workloads.

6. Even when examiners detect evidence of serious insider misconduct during the course of regular examinations, the agencies generally fail to conduct full scale fraud investigations. This failure to investigate prevents the agencies from gathering sufficient evidence to legally support direct enforcement actions against individuals and, more importantly, prevents the agencies from uncovering the full extent of the misconduct until it has already destroyed an institution.

7. a. A major reason for the banking agencies' inability to establish a proper strategy for dealing with insider abuse is that they have totally lacked comprehensive computerized information systems. Without such systems, it is difficult for the agencies to mobilize their full supervisory resources against institutions and individuals involved in such misconduct.

b. The agencies lack any interagency computerized files that combine information from all of the agencies on (1) criminal referrals, (2) civil enforcement actions, (3) change of control applications, and (4) active investigations.

c. The OCC and the FDIC, however, have recently initiated efforts to assemble more complete records on insider abuse. The OCC has installed a computer system which includes records of the agency's past and pending criminal referrals and its civil enforcement actions. The FDIC compiles centralized—but not computerized—records on the agency's criminal referrals, civil enforcement actions previously taken against individuals, and change of control applications.

8. a. The banking agencies generally fail to investigate or verify information furnished by applicants under the Change in Bank Control Act or the Change in Savings and Loan Control Act. Consequently, persons lacking in integrity, experience, and financial ability—and even persons with criminal record—have acquired control of financial institutions.

b. This absence of proper scrutiny by the banking agencies is evidenced by the agencies' rejection of only 33 change of control applications out of 2,211 filed between 1980 and 1984.

c. The statute governing the approval of change of control applications (12 U.S.C. 1817(j)), grants wide latitude to the banking agencies in disapproving applicants. The agencies need only find that acquisition by an applicant "would not be in the interest of the depositors . . . or . . . of the public . . .", and such findings are

reversible only if "arbitrary or capricious." Nevertheless, the agencies rarely disapprove applications unless an applicant is a convicted felon—even if other adverse information is uncovered.

C. THE CRIMINAL REFERRAL PROCESS

9. The banking agencies have abdicated much of their responsibility in detecting, investigating, and referring cases involving insider criminal misconduct by relying routinely upon open institutions themselves to make criminal referrals. This policy seriously jeopardizes successful criminal prosecutions because:

a. It results in lower quality and incomplete referrals. Typically, top management of an institution is relucant to make complete or persuasive criminal referrals of 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.

b. The law enforcement authorities do not receive the benefit of the banking agency's prior supervisory experience with the individuals involved or their more expert opinion on the seriousness of the alleged misconduct.

c. It results in delayed and stale referrals. Occasionally, banks refuse to make a referral, even after an examiner has requested that one be made. Examiners, however, may not discover this until the next regularly scheduled examination, many months or years later. Such delays in referrals often allow the evidence to become stale or be destroyed.

10. a. The banking agencies' procedures for dealing with both civil and criminal misconduct by individuals are inherently flawed from a management perspective because they fail to recognize that individual misconduct requires a specially coordinated and expedited civil and criminal enforcement approach. Such coordination is presently impossible because the agencies do not place primary responsibility for civil investigations, and for initiating and coordinating both types of enforcement actions on a single designated official at the regional or district level.

b. This lack of special attention, as well as the agencies' slow internal review process for approving referrals, often causes months of delay in alerting law enforcement agencies to insider misconduct.

11. Federal prosecutors and FBI agents often do not understand and are unable to evaluate the banking agencies' criminal referrals and therefore decline them or give them a low priority because:

a. Many agency referrals, particularly those of the Federal Reserve and the FDIC, consist of "bare bones" letters or pre-printed forms which contain little factual information about the alleged offense and make no attempt to apply the criminal statutes to the specific facts of the case. On the other hand, referrals made by the OCC and the FHLBB tend to be more comprehensive documents that often set forth the basic factual allegations, the applicable law, and the minimum documentation necessary for law enforcement officials to understand the nature and gravity of the conduct.

b. The banking agencies generally fail to indicate in their referral documents whether a referral is a particularly serious or significant violation that requires top priority, or whether it is a technical, de minimis violation.

c. Except for isolated cases, the banking agencies lose interest in their referrals once they are made. The agencies fail to systematically monitor the progress of their referrals or to follow up with U.S. attorneys' offices or the FBI to encourage the prosecution of significant referrals.

12. When banking agency referrals are declined, the agencies rarely, if ever, contact the U.S. attorneys or the Criminal Division of the Justice Department to seek reconsideration of these declinations. The Criminal Division's principal bank fraud specialist testified that he had not received a single telephone call during the past 3½ years from any of the banking agencies protesting a U.S. attorney's decision to decline one of the agencies' referrals.

13. The Right to Financial Privacy Act of 1978 (RFPA) prohibits financial institutions and the banking agencies from disclosing to law enforcement agencies financial information derived from customers' bank records unless the customers are notified. The act has a significantly adverse effect on the criminal referral process and seriously impedes the investigation and prosecution of insider criminal misconduct because:

a. The RFPA's requirement that insiders who are the targets of criminal investigations be notified that their financial records are being turned over to a law enforcement agency gives such persons an unreasonable opportunity to alter or destroy bank records and to impede or delay criminal investigations. By including insiders in the definition of bank "customers," the act fails to distinguish between the privacy interests of "arm's length" customers and those of employees or insiders who may be defrauding their own institutions.

b. Certain provisions of the act are ambiguous and hence have been subject to widely differing interpretations by financial institutions and by the banking agencies. In particular, one of the main reasons why the Federal Reserve and the FDIC provide inadequate factual information and documentation in their referrals is their narrow and restrictive interpretation of the act.

c. The act discourages the banking agencies from providing effective assistance to the Justice Department, either before or after a referral has been made, and has practically eliminated informal contacts between bank examiners and FBI agents in the field.

d. The Justice Department's routine use of grand jury subpoenas to avoid the notice provisions of the act has proven unsatisfactory. First, in order for a U.S. attorney to seek a grand jury subpoena, he must make a preliminary judgment that a matter warrants grand jury attention—a difficult determination when the referral document lacks sufficient information. Second, the act's requirement that documents be delivered to the physical possession of sitting grand juries causes significant delays and unnecessary expense. This is an unprecedented requirement that applies to no other category of subpoenaed documents.

D. DEPARTMENT OF JUSTICE INVESTIGATION AND PROSECUTION OF INSIDER FRAUD CASES

14. a. The Justice Department's record of prosecuting insiders of financial institutions is uneven, at best. On the one hand, the Department has a good record of prosecuting insiders of failed institutions, in part because a failed institution is an obvious victim. On the other hand, it generally fails to prosecute insiders of open institutions. The subcommittee's survey shows that the Justice Department declined only 21 percent of the banking agencies' recent referrals involving failed institutions, as opposed to 64 percent of the referrals involving open "problem" institutions.

b. In addition, a significant number of the Department's bank fraud investigations have been delayed for 2–3 years. The subcommittee's survey reveals that, as of April 1984, 31 out of 78 investigations in failed and problem institutions had been pending within the Justice Department since 1980–81. By July 1984, that number had been reduced to 21, but many of these were still pending after almost 4 years.

15. a. The Justice Department's overall record of prosecuting insider fraud is mixed, at best, because it generally places a low priority on such cases. Until very recently, the Department failed to encourage U.S. attorneys' offices to prosecute insider bank fraud cases because it did not recognize the increasingly national impact of bank fraud cases on the Nation's financial markets, extending beyond limited geographical areas.

b. This low priority is reflected by the Department's failure to provide the FBI with adequate resources to investigate these cases:

(i) The FBI has recently cut the number of FBI agent workyears devoted to white-collar crime investigations by approximately 15 percent.

(ii) Many U.S. attorney's offices and FBI offices lack adequate staff resources, and expertise to undertake large-scale bank investigations.

(iii) The FBI lacks an adequate number of agents who are trained in accounting and sophisticated bank fraud techniques.

c. This low priority and inadequate staff resources have resulted in a great disparity in the prosecution rate of insider fraud cases among the 93 U.S. attorneys' offices.

16. Antiquated criminal banking statutes also discourage the vigorous prosecution of "white-collar" bank fraud cases:

a. Section 656 of Title 18 (the basic misapplication/embezzlement statute), originally enacted in 1877, fails to cover many types of schemes typically involved in modern bank fraud. Consequently, insiders who may be guilty of major fraud are often charged with narrow or technical violations of other statutes, such as making false statements to a bank examiner. Juries often find it difficult to convict on technical grounds when more substantive misconduct is involved.

b. The maximum penalties provided for many bank fraud violations are so inadequate that law enforcement officials do not consider lengthy investigations and trials to be cost-effective. Nor, in comparison to other crimes, do they discern any legislative mandate for vigorous criminal enforcement. For example, a bank offi-

cer who is prosecuted under 18 U.S.C. 656 for receiving a $1 million fraudulent insider loan can receive a maximum sentence of 5 years, whereas an individual, who, without use of force, robs a bank of a much lesser sum, faces a maximum sentence of 20 years.

17. The Justice Department's Criminal Division in Washington has failed to exercise adequate leadership in monitoring, coordinating, and supervising the prosecution of the Nation's criminal banking laws. Specifically, the Fraud Section of the Criminal Division has:

a. Failed to monitor the status of significant bank fraud cases.

b. Failed to devote adequate resources to bank fraud prosecutions, allotting only one attorney full-time and three attorneys part-time—out of 43 attorneys in the Section—to assist U.S. attorneys in their prosecution of major bank cases.

c. Failed to assess the law enforcement needs of the U.S. attorneys' offices. Instead of actively offering its assistance in major cases, it simply reacts to U.S. attorneys' requests for advice and assistance.

18. The Justice Department is unable to evaluate properly the effectiveness of its investigations and prosecutions of bank fraud because it fails to maintain adequate data reporting systems on "white-collar" crime in financial institutions:

a. The FBI's Bank Fraud and Embezzlement Statistics do not distinguish between minor bank teller defalcations and major white-collar fraud offenses and do not provide adequate details about the particular statutes violated or the types of criminal schemes involved.

b. The Fraud Sections fails to track or compile adequate statistics on banking agency referrals or major bank fraud investigations and prosecutions. For example, the Section receives copies of all banking agency referrals involving amounts greater than $50,000, but does not use this information for any purpose.

19. a. There is a shocking lack of cooperation and communication between the Justice Department and the banking agencies. For example, the FBI rarely notifies the Federal banking agencies when it independently initiates investigations of white-collar crime in open financial institutions. This policy has adversely affected the banking agencies' efforts to monitor closely the financial condition of these institutions and to take prompt and effective civil enforcement action against insider abuse.

b. Occasionally, the banking agencies' staff have refused to provide the Justice Department with copies of bank examination reports that are needed in the investigation of criminal misconduct, even when such reports have been requested under grand jury subpoena. There is nothing in 18 U.S.C. 1905 [12] or 1906 [13] which justifies such behavior.

[12] Prohibitions on "Disclosure of confidential information generally."
[13] Prohibitions on "Disclosure of information by bank examiner."

E. THE BANKING AGENCIES' CIVIL ENFORCEMENT EFFORTS AGAINST INSIDER ABUSE

20. a. The banking agencies often fail to take direct civil enforcement action against individuals engaged in insider abuse, notwithstanding a clear statutory responsibility to do so. For example, the subcommittee's survey of banking agency referrals involving insiders of problem institutions reveals that the agencies failed in 80 percent of the referrals to pursue direct civil action against the individuals involved. Taken together with the Justice Department's reluctance to prosecute insiders unless an institution fails, the result is that two-thirds of all insiders of open institutions who are referred for criminal prosecution face neither civil nor criminal sanctions.

b. The banking agencies use their four primary enforcement powers against individuals—cease and desist orders, removals, prohibitions, and civil money penalties—in an inconsistent and arbitrary manner that subjects insiders to vastly different standards, depending upon which Federal agency regulates their institution. For example, the OCC uses civil money penalties against individuals at least 10 times more often than the other three agencies. Similarly, the FHLBB uses removal orders at least four times more often than the other three. A part of this inconsistency is due, however, to different statutory grounds of the imposition of civil money penalties by the four agencies.

c. This lack of civil enforcement action by the agencies violates the intent of the Financial Institution Regulatory and Interest Rate Control Act of 1978, in which Congress indicated that the agencies should "vigorously utilize" civil enforcement actions against individuals as "midway approaches" that would be more severe than informal reprimands but less drastic than formal orders against institutions or criminal referrals against individuals.

21. a. The banking agencies frequently fail to take timely and effective enforcement action against insiders because they perceive and essentially treat insider abuse by individuals in the same manner as institutional supervisory problems, such as inadequate capitalization or concentrations of loans. While moral suasion and gradually tougher enforcement actions imposed against recalcitrant institutions may be successful in dealing with normal bank supervisory problems, such approaches are totally inadequate to deal with corrupt individuals who willfully enrich themselves at the expense of the institutions they control. Equally important, this "graduated response" approach allows sufficient time for the abusive practices to worsen until they destroy an institution.

b. In addition, the agencies fail to take timely enforcement action against individuals because (1) they impose too many layers of internal review for the consideration of most types of enforcement actions, and (2) because they disperse responsibility for taking action against insider abuse among too many individuals, rather than assigning primary responsibility to a single, designated official at the regional level.

c. When the agencies do impose money penalties for abusive practices, the amounts are usually so low—generally $2,500 or

less—that they fail to serve as an effective deterrent against serious insider abuse.

22. Resignations are often the agencies' preferred way of dealing with insider abuse. However, once insiders resign, the agencies almost never pursue further civil or criminal action against them. Reliance on this approach fails to (1) deter other insiders from engaging in similar conduct, (2) alert other banking institutions about the person's illegal conduct, or (3) sanction the individual for his misconduct. There are examples where dishonest insiders have, in fact, moved freely from one financial institution to another after having been forced by the bank supervisory agencies to resign.

23. Although the banking agencies do not adequately use the civil enforcement powers they already have, they do lack statutory authority to impose effective sanctions against certain types of insider abuse. For example, none of the agencies has the power to prohibit an individual from particpating in the affairs of a federally insured financial institutions outside its own jurisdiction. Also, except for the OCC, the other banking agencies have excessively narrow authority to issue civil money penalties for insider abuse.

24. Unlike the SEC, the FTC, and other Government law enforcement agencies, the banking agencies rarely disclose enforcement actions that have been taken against individuals or institutions for insider abuse. This policy of exccessive secrecy fails to properly consider the important benefits which accompany reasonable and timely disclosure, including deterrence against future misconduct and notice to shareholders and the public about an institution's true financial condition.

F. FDIC AND FSLIC FIDELITY BOND LOSSES DUE TO INSIDER ABUSE

25. The FDIC and FSLIC presently are able to reduce their insurance losses due to insider abuse in failed institutions by filing claims under the institutions' fidelity bonds, which insure against various types of employee dishonesty.

26. The FDIC has been negligent in its failure to require more comprehensive fidelity bond coverage for open banks and in its negotiation and litigation of fidelity bond claims in failed banks:

a. Between 1980–83, the FDIC negligently lost millions of dollars in unsatisfied fidelity bond claims based on insider abuse. The agency was unable to collect on these claims because it failed to (1) require open banks that subsequently failed to carry high enough coverage limits to cover potential losses due to insider abuse, (2) require that the banks' policies cover losses due to certain types of insider abuse, such as dishonest acts by directors, and (3) pursue its claims vigorously in failed banks through negotiations for litigation with the insurance companies.

b. The agency has failed to keep adequate statistics and records on the amounts and types of fidelity bond coverage carried by FDIC-insured banks or on claims filed by banks involving dishonest bank officials.

c. The agency's failure to establish specific minimum amounts of fidelity bond coverage for all insured banks has resulted in many banks operating without sufficient coverage to provide adequate protection, either to shareholders or to the FDIC in the event of failure.

27. The Federal Home Loan Bank Board and FSLIC have failed to adequately supervise the fidelity bond coverage requirements for open thrift institutions or to pursue potential fidelity bond claims in failed institutions. In addition, the FHLBB has abandoned its former policy of reviewing the bonds of all insured institutions, to make sure that the FSLIC is fully protected in the event of failure.

28. None of the banking agencies makes satisfactory supervisory use of fidelity bond claims filed by institutions against insiders and cancellation notices by insurers. Such information could help the agencies to identify institutions which are poor fidelity risks and to target certain institutions for closer scrutiny and supervisory action.

G. OTHER FINDINGS

29. The banking agencies' current policies and procedures on civil and criminal enforcement are inadequate under present laws governing the powers of financial institutions to invest depositors' funds. Such ineffectual policies and procedures could prove disastrous in dealing with insider abuse problems under the expanding powers of financial institutions and could impede the movement towards further expansion of such powers.

30. The banking agencies have hindered this committee in conducting its investigation of insider abuse and criminal misconduct by refusing to provide certain essential documents, to reveal the names of institutions and individuals who have been the subject of civil enforcement orders, and to reveal the names of bank examiners who had detected instances of insider abuse in certain institutions studied by the subcommittee. In the performance of its legitimate oversight responsbilities, this committee should not be forced to issue subpoenas for access to even sensitive information, particularly in light of Congress' indisputable constitutional right to such information.

III. RECOMMENDATIONS

A. SUMMARY

1. The committee strongly recommends that the four banking agencies and the Department of Justice appoint a special "Task Force on Insider Abuse in Financial Institutions" to develop a common strategy for dealing with insider abuse and criminal misconduct in the Nation's financial institutions and to implement the recommendations contained in this report.

2. The banking agencies should revise their basic policies and procedures for dealing with insider abuse and criminal misconduct:

a. Central to these new strategies and procedures should be (1) the concept that misconduct by individuals should be treated in a substantially different and separate manner from institutional supervisory problems, and (2) the designation of special regional counsels to bear prime responsibility for investigating suspected insider abuse and for initiating, tracking, and coordinating criminal referrals and civil enforcement actions against individuals.

b. The agencies should improve their field examiners' effectiveness in detecting and investigating insider abuse by providing them with special training on white-collar crime and with additional time and resources to investigate instances of suspected abuse. Such resources should include the establishment of an interagency computerized information system on insider abuse and criminal misconduct.

3. The banking agencies should make major changes in their criminal referral processes. First, they should assume primary responsibility for reporting to the Justice Department all major instances of insider criminal misconduct and not leave this responsibility to the institutions themselves. Second, they should improve their criminal referral letters by providing law enforcement officials with sufficient factual information to permit informed judgments about the merits of the cases and forcefully "sell" their important cases to these officials. Third, the agencies should track the disposition of their criminal referrals and routinely follow up on their important cases to make sure they receive top priority by the Justice Department.

4. a. The banking agencies should greatly increase their use of direct civil enforcement actions against individuals who engage in insider abuse, even in instances where the agencies have made criminal referrals or where the individual has resigned.

b. The agencies should routinely disclose civil enforcement actions against individuals unless such disclosure would clearly threaten the safety or soundness of an institution.

5. The Criminal Division of the Justice Department in Washington should assume a greater leadership role in the fight against insider criminal misconduct by (a) monitoring the prosecution of major bank fraud cases, (b) providing greater assistance to U.S. attorneys' offices in the prosecution of such cases, and (c) serving as a link between the civil banking agencies, the FBI, and U.S. attorneys' offices throughout the country to resolve problems and conflicts.

6. Congress should enact legislation to broaden and improve the civil enforcement powers of the banking agencies, to amend the Right to Financial Privacy Act, and to reform certain criminal banking statutes.

B. SPECIFIC RECOMMENDATIONS

1. The banking agencies and the Department of Justice should appoint a special "Task Force on Insider Abuse in Financial Institutions" to develop a unified strategy for reducing insider abuse, to reconcile inconsistent policies among the agencies, and to implement the recommendations contained in this report.

2. a. The banking agencies should establish an interagency computerized information system so that each will have access to the other's information on insider abuse and criminal misconduct. The data base should include information on (1) institutions and individuals who are or have been the subject of civil enforcement actions and criminal referrals, and (2) the results of FBI and other investigations of applicants for bank charters and changes in control.

b. This information system, which should be modeled after the SEC's computer system, would consist of two parts:

(i) The Name Relationship System—This system would serve as an interagency investigative tool by consolidating information from all of the agencies on institutions and individuals who have been engaged in abusive or criminal misconduct, who have been the subject of civil enforcement actions, and who have filed change of control applications.

(ii) The Case Tracking System—This system would serve as an internal management tool for each agency by tracking the progress of the agency's civil investigations and enforcement actions. The system would also serve as a more efficient means of notifying the other banking agencies of pending actions.

c. If necessary, the agencies should seek additional statutory authority to implement such a computer system.

3. The agencies should revise their basic policies and procedures for dealing with insider abuse and criminal misconduct. These new procedures should treat misconduct by individuals in a substantially different and separate manner from institutional supervisory problems and might include the following steps:

Step One.—The field examiner who first detects evidence of serious insider abuse should conduct a brief preliminary investigation of the matter including, if necessary, going outside the institution to trace loan proceeds to other institutions and interviewing customers and witnesses. He should then complete a special "Insider Abuse Report"—separate from the regular examination report—in which he would describe the nature and seriousness of the alleged abuse.

Step Two.—Each agency should designate a special counsel in each regional or district office to receive this "Insider Abuse" report and to take primary responsibility for investigating the alleged abuse and taking further action, as appropriate against the individuals involved. This special counsel, in cooperation with the examiner, would be responsible for the following: (1) Permit the examiner to deal with the problem informally, (2) determine whether further investigation or a formal examination is necessary, (3) recommend civil enforcement action, or (4) make a criminal referral. In each case where the special counsel decides to make a criminal referral, he should also initiate a civil investigation or recommend civil enforcement action against the individual who is the subject of the referral, unless he issues a written finding that there is no basis for such action.

Step Three.—The special counsel should bear responsibility for monitoring the status of his criminal referral after it goes to the Justice Department and for coordinating civil and criminal enforcement actions taken against individuals.

Step Four.—A supervisor for all the special counsels should be appointed in the Office of General Counsel in Washington. This individual would be responsible for overseeing the ultimate disposition of civil enforcement actions against individuals and for continuously monitoring the status of each special counsel's pending investigations, enforcement actions, and criminal referrals to assure that they are not sidestracked or delayed.

4. The Federal Financial Institutions Examination Council (FFIEC) should establish an interagency training course for examiners on "white-collar" crime, modeled after the OCC's course. This course should be mandatory for all Federal bank examiners.

5. The banking agencies should set up special fraud detection units in each region, composed of senior examiners with extensive training and experience in "white-collar" crime. These fraud units would assist the special counsels and regular examiners in conducting investigations of suspected abuse.

6. The Federal Reserve, the OCC, and the FDIC should revise their examination policies and procedures to focus greater attention on the detection of insider abuse. Such changes should include the increased use of audit techniques, more frequent examinations of problem banks, and expanded use of simultaneous examinations.

7. In order to reduce the turnover rate among Federal bank examiners and to encourage examiners to pursue long-term careers with the banking agencies, the agencies and the Office of Management and Budget should strongly consider (a) restoring recent cuts in the number of Federal bank examiners, (b) increasing the pay scales and career incentives for examiners, and (3) equalizing the pay scales among the various banking agencies.

8. a. The banking agencies should improve their change of control application process, to prevent the acquisition of financial institutions by unqualified or dishonest individuals:

(i) The agencies should conduct more thorough background checks and independently verify (through field visits or telephone calls) the accuracy of statements in the applications.

(ii) If the FBI reports that a particular applicant is or has been under criminal investigation but declines to give further information, the banking agency should conduct its own investigation to determine if there is a reasonable basis for denying the application.

(iii) The agencies should give immediate consideration to a change in policy that would provide for the public disclosure of change of control notices and the solicitation of public comment on such notices.

b. The FFIEC should establish uniform interagency guidelines on the denial of change of control applications that (1) reflect the wide latitude that the agencies have been given by Congress to deny the applications of dishonest or unqualified individuals, and (2) prevent "forum shopping" among the agencies. Such action is particularly appropriate, given the fading distinctions in the powers of different types of financial institutions.

9. The banking agencies should assume primary responsibility for reporting to the Justice Department all major instances of suspected criminal misconduct by officers, directors, and insiders and should not leave this responsibility to the institutions themselves.

10. The Federal Reserve and the FDIC should substantially improve the quality of their criminal referral letters to the Justice Department. Specifically, they should provide more factual information on alleged criminal transactions, a thorough legal analysis of the facts, and sufficient documentation to assist law enforcement officials in evaluating the prosecutive merits of the case.

11. The banking agencies should establish priorities among their criminal referrals and develop procedures to guarantee that particularly significant or important referrals receive special attention from the Justice Department:

a. Such procedures should require the special regional counsels to make initial determinations as to whether a proposed referral is particularly significant or important. If so, special counsels should:

(i) Make an expedited written referral to the appropriate U.S. attorney, with a copy sent to the Fraud Section of the Criminal Division, Department of Justice, in Washington.

(ii) Explicitly state in the referral letter that the agency considers the referral to be a high priority case, and that the agency recommends prosecution.

(iii) Keep in close contact with the appropriate law enforcement officials to "sell" the case, to offer whatever assistance the agency can provide, and to encourage prompt resolution of the case.

b. In addition, if the magnitude of suspected criminal misconduct may threaten the institution's continued operations, or if there is any indication that the suspected insider may destroy evidence or flee, then the special counsel should make telephone contact with the FBI or the U.S. attorney, prior to making a written referral.

c. The banking agencies should work together with the Justice Department and State law enforcement officials to develop procedures for screening out technical or de minimis offenses, so that U.S. attorneys' offices are not inundated with relatively insignificant referrals.

d. If a banking agency disagrees with a U.S. attorney's decision to decline a referral which the agency considers significant, it should formally request the U.S. attorney to reconsider his decision. If still dissatisfied, the agency should notify the Criminal Division in Washington of its concerns.

12. The banking agencies should take steps to reduce excessive delays between the time that criminal misconduct is first detected and the agencies' actual referrals, including the establishment of specific deadlines for making referrals.

13. The Justice Department should improve its allocation of resources and its management of bank fraud investigations and prosecutions by compiling more useful statistics on such cases. Specifically:

a. The FBI should revise its Bank Fraud and Embezzlement Statistics, so that they (1) distinguish between "white-collar" offenses by management officials and offenses by low level employees and (2) provide more details about the statutes violated and the types of fraud schemes involved.

b. The Fraud Section of the Criminal Division should utilize aggregate statistics generated by the banking agencies' computer systems to improve the Justice Department's management of bank fraud prosecutions.

14. The Justice Department's Criminal Division should assume a greater leadership role in the investigation and prosecution of major bank fraud cases. In particular, the Fraud Section of the Criminal Division should (1) actively monitor all criminal referrals which the banking agencies have identified as significant cases, (2)

offer greater assistance to U.S. attorneys in prosecuting such cases, (3) take the initiative in assisting in the prosecution of important cases that do not get proper attention from local U.S. attorneys offices, (4) increase the number of Fraud Section attorneys devoted to bank fraud prosecutions, and (5) serve as a liaison between the banking agencies and the U.S. attorneys' offices whenever problems or conflicts arise.

15. a. The Justice Department should place a higher priority on the prosecution of fraud cases involving open financial institutions and should convey this message to U.S. attorneys, by stressing that frauds committed against open institutions frequently result in the failure of those institutions and others with which they are affiliated.

b. The Department should reexamine its enforcement policies to consider giving the Criminal Division in Washington more prosecutorial responsibility for bank fraud cases, due to the increasingly national nature of such crimes and their effect on other institutions. The Justice Department presently assumes primary jurisdiction over criminal cases in areas of national importance such as antitrust, civil rights, the environment and tax.

16. The Justice Department and the Office of Management and Budget should increase and upgrade FBI resources devoted to bank fraud investigations. Specifically, the agencies should:

a. Restore the recent 15 percent cut in FBI workyears devoted to "white-collar" crime investigations, particulary bank fraud investigations.

b. Hire more qualified agent accountants, including former bank auditors and examiners.

c. Upgrade the Bureau's training for agents on bank fraud and extend such training to more agents.

d. Increase the resources that are available to less populated regions of the country for bank fraud investigations.

17. The Justice Department should establish procedures requiring the FBI and U.S. attorneys offices to (a) notify the appropriate Federal banking agency when they initiate an investigation of an open financial institution and (b) seek the assistance of that agency in their investigations.

18. The banking agencies should substantially increase their use of direct civil enforcement actions against individuals engaged in insider abuse:

a. Instead of relying largely on orders directed against institutions, the agencies should also take action directly against individuals who are responsible for abusive practices. This can readily be accomplished by entering into formal agreements with, and issuing cease and desist orders against, individuals at the same time that such measures are imposed against institutions.

b. The Federal Reserve, OCC, and the FDIC should substantially increase their use of removal, suspension, and prohibition orders against individuals engaged in insider abuse.

c. The Federal Reserve, the FDIC, and the FHLBB should substantially increase their use of civil money penalties against such individuals. The agencies can accomplish this under their present statutory authority by issuing cease and desist orders against individuals which, when violated, can serve as the basis for imposing money penalties.

d. Even if individuals engaged in abusive practices resign or otherwise cease their involvement with institutions, the agencies should vigorously pursue civil money penalties against them. This is essential in order to penalize those individuals and deter similar abusive conduct by others.

19. The banking agencies should take steps to reduce excessive administrative delays in approving civil enforcement actions against individuals by delegating additional enforcement authority to their regional offices and setting specific deadlines for each stage of review.

20. The banking agencies should alter their present policies of systematically maintaining the secrecy of civil enforcement actions taken against individuals. On the contrary, they should routinely disclose all such actions, including the underlying facts and circumstances of the actions. Only if an agency formally determines in writing that full disclosure would seriously jeopardize the safety or soundness of an institution should factual details be omitted or disclosure be delayed.

21. The FDIC and FSLIC should take action to reduce their insurance losses due to insider abuse in failed institutions by establishing standards for fidelity bond coverage in open institutions that would assure the greater recovery of such losses:

a. The FDIC, like the FSLIC and the National Credit Union Administration, should establish mandatory minimum amounts of fidelity bond coverage for all insured banks, or at least for all banks requiring more than normal supervision. The FSLIC should seriously consider increasing its mandatory coverage amounts, in view of the agency's recent loss experiences due to insider abuse.

b. The FDIC and FSLIC should carefully monitor all institutions' fidelity bonds to ensure that they adequately protect the Federal deposit insurance funds in the event of an institution's failure. The agencies should disapprove any institution's bond which fails to meet certain minimum standards. For example, the agencies should require all institutions to carry fidelity bonds that grant the FDIC/FSLIC the right to discover and file fidelity bond claims for 1 year after the institution fails.

c. The FDIC should take a much more aggressive stance in negotiating with the bonding companies its fidelity claims in failed institutions and should increase its staff and resources devoted to the investigation, negotiation and litigation of such claims.

d. Like private insurance companies, the FDIC and FSLIC should routinely compile and evaluate statistics on their losses due to insider abuse in failed institutions. Such statistics should include (1) the amount of losses that are attributable to insider abuse, (2) the percentage of such losses that are recovered through fidelity bond claims, and (3) the amounts of basic and excess fidelity coverage carried by all institutions. The agencies should use this information to monitor trends in their fidelity losses and to determine ways to reduce such losses.

22. The banking agencies should require all institutions to notify their appropriate supervisory agencies when they file bond claims based upon insider abuse, when such claims are paid, and when

their bonds are terminated. Such information could help the agencies pinpoint institutions with insider abuse problems and take more timely civil enforcement action against such institutions or individuals.

23. a. Congress should approve pending legislation that amends the Right to Financial Privacy Act (RFPA) by: (i) Exempting insiders of financial institutions from the notice provisions of the act, so that under certain circumstances, their financial records of insiders can be transferred to law enforcement agencies without providing notice. (ii) Congress should repeal the RFPA's highly unusual requirement that financial records under grand jury subpoena be physically returned to a sitting grand jury.

b. Congress should study a number of other enforcement problems posed by the RFPA, including the serious delays in SEC investigations caused by the requirement that bank customers be notified prior to the SEC's acquisition or transfer of records.

24. a. Congress should enact legislation, which has passed the House of Representatives, that (1) expands the bank bribery statute (18 U.S.C. 215) to include persons who offer—as well as receive—kickbacks or bribes and upgrades the offense from a misdemeanor to a felony, and (2) creates a new generic crime of "financial fraud."

b. Congress should enact legislation to modify the specify intent requirement of the false statements and entries statute (18 U.S.C. 1005) governing commercial banks, to make it conform to the less stringent and more reasonable intent standard required by the false statements and entries statute (18 U.S.C. 1006) governing thrifts.

25. Although the banking agencies already have substantial statutory authority to deal effectively with insider abuse, Congress should broaden this authority by enacting legislation to:

a. Give the Federal Reserve, FDIC, and the FHLBB the same authority that the OCC now has to impose civil money penalties for insider abuse.

b. Increase the maximum amount of civil money penalities that can be imposed for insider abuse from $1,000 per day to $5,000 per day.

c. Expand the power of the banking agencies to issue prohibition orders against individuals by (1) authorizing such orders to prohibit individuals from participating in the affairs of any federally insured depository institution, and (2) permitting the agencies to issue such orders against persons within 1 year after they resign or cease their participation in the affairs of an institution (currently a person's resignation precludes such an order).

d. Amend 12 U.S.C. 1464(d), 1730(p) and 1829, to include controlling shareholders in the class of persons prohibited from participating in the affairs of federally insured institutions if they have been convicted of felonies involving dishonesty or breach of trust.

26. Congress should also seriously consider a number of other legislative proposals recommended by the banking agencies and the SEC to strengthen the agencies' civil enforcement powers. For example, Congress should consider amending the Change in Bank Control Act and the Change in Savings and Loan Control Act to allow the banking agencies to extend the application review period

in order to allow the agencies additional time to fully investigate applicants.

27. The banking agencies should make substantial efforts to improve their cooperation with this committee in the performance of its legitimate oversight responsibilities, by complying with the committee's requests for information, documents, and reasonable access to agency employees.

DISCUSSION

IV. The Threat of Insider Abuse

A. How Insiders "Rob" Banks

The story of Ernest "Pug" Vickers, Jr., is, in many ways, typical of the increasing number of bank insiders who begin as aggressive entrepreneurs but end up as convicted criminals for "robbing" the very banks they control. A former World War II pilot and local automobile dealer in Huntingdon, TN, Vickers decided in 1977 that he wanted to own a bank. Using money that he had borrowed from United Southern Bank of Nashville, a bank controlled by Jake and C.H. Butcher, he and his family purchased an 80 percent controlling interest in the Carroll County Bank of Huntingdon. He immediately installed several buddies to run the bank and, together with them, proceeded to follow a course of gross mismanagement, insider abuse, and criminal misconduct that finally ended in the bank's failure in April 1982.

Although the bank had had management and other problems for years, it did not face serious problems until 1980, when Vickers personnally began to encounter some serious financial problems. To solve these problems, he decided to steal money from his own small bank ($8.1 million in assets) using one of the simplest and most common devices of insider fraud, "nominee loans."[14] He got several of his friends, including a mechanic at his auto dealership, to sign large personal notes from the bank and simply turn over the proceeds to him, assuring them that he would take care of repayment. After he had misappropriated over $500,000 from the bank under false pretenses, far in excess of the legal lending limit, notes came due, but neither he nor his friends could repay the loans and the bank failed. Vickers and several officers from the bank were later convicted of misapplication, making false entries, and making false statements involving loan applications. Vickers was sentenced to 3 years imprisonment and is currently appealing his conviction. The FDIC estimates that its losses in the bank will be $1.7 million.

Vickers' story is typical in a number of ways. His bank, like a majority of those that fail, was a small one. While a larger bank might have been able to absorb several millions of dollars in losses from insider fraud, a small institution like the Carroll County Bank was wiped out.

[14] The bank's failure was precipitated by both Vickers' nominee loans and a series of huge continuing overdrafts. He was ultimately charged with more than a dozen felony counts. See Hearings (Part 2), pp. 2032-2033.

In personality, Vickers also appears to be typical of many insiders who "rob" their own banks from the inside. Although the subcommittee did not deliberately set out to draw a "profile" of the typical insider thief, one cannot help but be struck by the striking similarities among the individuals who have caused so many recent bank failures. The "typical" insider bank thief, like Vickers, is a male officer, director, or majority stockholder of a commercial bank, who either commits his crimes alone or in association with a few close associates or banks employees. He is often an outgoing, flamboyant businessman who runs his bank as if it were a sole proprietorship, such as a real estate office or automobile dealership. He spends, borrows, and lends money freely, often singlehandedly exercising control over the bank. The criminal schemes he uses may be simple or complex, depending upon his own ingenuity, but they usually involve a continuing series of related transactions that extend over a substantial period of time. The activities he engages in, while hidden from public view, are usually so abusive and involve such large sums of money that any reasonably alert board of directors should discern what is really going on inside the bank. Insider abuse and fraud cannot grow or flourish in a vacuum.

Third, Vickers' case is also typical in the relatively light sentence he received, 3 years. In fact, materials submitted by the Justice Department show that the average sentence of imprisonment imposed against convicted insiders in such cases is much less severe, because the sentences are often suspended with the convicted insider receiving probation. Moreover, with Federal parole standards, this means that those few convicted insiders who go to prison actually spend less than 1–2 years in prison.

Certain States, such as Tennessee, appear more frequently in the subcommittee's two surveys of failed and problem institutions. California, Texas, Florida, Tennessee, and Illinois account for nearly one-half of all the criminal misconduct studied in this report. On the other hand, certain other large States, such as New York, Michigan, and Ohio appear very infrequently.

The bank insider who, like "Pug" Vickers, steals $1 million from a bank by writing fictitious loans to himself uses methods that are practically invisible to the general public but that usually cause far more damage to an institution than the masked man who walks into a bank and passes a note to a teller, instructing her to hand over $1 million in small bills. As one U.S. attorney whose district has been hit by an unusually large number of insider bank fraud cases testified,

> In the last 18 months, we've had three bank failures and one savings and loan failure in the eastern district of Texas.
>
> As we are going through and preparing these cases for prosecution, Mr. Chairman, we are finding that it is the rule, not the exception, that in major banking transactions insider abuse is taking place.
>
> We are of the position, in the eastern district of Texas anyway, that the pen is certainly mightier than the sword.[15]

[15] Hearings (Part 2), pp. 36–37.

These insider frauds are usually prosecuted as one of the following crimes:

(1) Section 212—Prohibits bank employees from making loans or paying gratuities to Federal bank examiners.! A534A EXT .014 EDITED BY "EDSTD" ON 30-SEP-84 #56582 Man Number Name Livingston Chine 9-29-84 %132.0 F. 50-53-A534A

(2) Section 215—Prohibits bank employees from accepting bribes (misdemeanor);

(3) Section 656—Prohibits embezzlement or the "willful misapplication" of bank funds;

(4) Section 1001—Prohibits any person from making false representations or statements of a material fact with regard to any matter within the jurisdiction of any Federal agency;

(5) Section 1005—Prohibits any person from making false entries in a bank's books or records with the intent to injure or defraud the bank or to deceive anyone as to the true condition of the bank;

(6) Section 1014—Prohibits any person from making false statements on a loan or credit application to any federally insured bank; and

(7) Section 1341—Prohibits any scheme to defraud by means of false pretenses, representations, or promises, by using, or causing to use, the mails in furtherance of such scheme (the "mail fraud" statute).

In addition to these crimes, insiders of financial institutions are often in a position to be charged with other financial crimes, such as money laundering, bribery of foreign officials, conspiracy, and illegal political contributions.

These crimes pose special investigative and prosecutorial problems for Federal prosecutors. The secrecy of financial records and the various methods used to hide fraudulent bank transactions make these cases extremely difficult to detect and prove. In his May 3, 1984, testimony, Gregory C. Jones, First Assistant U.S. Attorney for the Northern District of Illinois (Chicago) described in detail some of these problems:

> Unlike a small embezzlement by a bank teller, these insider offenses can be extremely difficult to prove and require lengthy investigations. Fraudulent bank transactions can take a variety of forms. They are sophisticated crimes that by their very nature are designed to disguise and conceal the financial relationships that exist between the offenders. One of the most common forms involves the issuance of loans by officers or directors of a financial institution to companies in which they have a concealed financial interest or to individuals who are willing to pay kickbacks to obtain loans. Other forms may involve the receipt by a financial institution of phony or stolen collateral as security for loans. Finally, they may involve the issuance of loans to nominee borrowers who immediately turn the loan proceeds over to others who could not borrow directly from that financial institution.[16]

[16] Hearings (Part 2), p. 30

Not only are the transactions difficult to detect, but they are even more difficult to prosecute. According to Jones, this is due to a combination of factors, including (1) the Government's burden of proving beyond a reasonable doubt that the insider acted with the specific intent to injure or defraud the institution, (2) the lengthy investigations needed to prove an insider's personal finances, (3) the tracing of loan proceeds to determine how they were disbursed and who ultimately received them, and (4) many problems with outmoded criminal statutes. As Jones summarized,

> Unfortunately, therefore, despite a thorough investigation, the Government may be unable to come up with sufficient evidence to prove the crime. I have emphasized the difficulties in prosecuting cases of insider abuse because it is my belief that the primary solution to this problem lies in the area of prevention and in the detection of these offenses at an early stage. When we get into it 3 years later and the bank has failed, really your harm has occurred and while the prosecution is useful to deter others and maybe set an example for the other bank officers that they will get caught and they will go to jail if apprehended, the real concerns are in the area of prevention.[17]

These crimes, because of their very nature and the inherent problems of investigation and prosecution, are better handled through preventive action by institutions and the bank regulatory agencies than at a later date by the criminal justice system.

B. THE LINK BETWEEN CRIMINAL MISCONDUCT AND BANK FAILURES

It is hard to estimate the amount of money lost each year by bank depositors, investors, and the Federal deposit insurance funds, due to insider abuse and criminal misconduct in failed financial institutions. By any measure, however, such losses have mushroomed since 1981. Neither the FDIC nor the FSLIC keep any statistics on their losses that are attributable to insider misconduct. However, in response to the subcommittee's request, they estimate that the two insurance funds will lose more than $1 billion in those institutions that failed between 1980 and 1983 in which criminal misconduct was a "major contributing factor".[18] Expressed another way, the FBI estimates that eight times as much money was stolen during 1982 by employees and insiders of financial institutions as was stolen through bank robberies and burglaries. This represents a 100 percent increase from 1981.[19]

As noted earlier, criminal misconduct by officers, directors and insiders have been a major contributing factor in nearly half of all recent bank failures. Despite this high correlation, the banking agencies do not routinely compile or maintain any meaningful statistics or conduct any research on the causal relationship between criminal misconduct and bank failures. The subcommittee therefore has conducted its own survey to determine the extent of crimi-

[17] Ibid., p. 30.
[18] Hearings (Part 2), pp. 605,680. The agencies, however, caution that these represent their total estimated losses, not just those attributable solely to criminal misconduct.
[19] The FBI estimates that $401.6 million was stolen through bank fraud and embezzlement in 1982. Ibid., p. 2037 and 2042.

nal misconduct in recent bank failures. The subcommittee surveyed the 75 FDIC-insured commercial banks that failed between January 1, 1980, and June 17, 1983, and found that 61 percent of such failures involved actual or probable criminal misconduct by officers, directors or other insiders.[20] The following chart (Figure 1) shows that the subcommittee derived this estimate from actual indictments, convictions, and Justice Department estimates of likely indictments in pending cases.

These figures, of course, do not mean that 61 percent of these failures have been directly caused by criminal misconduct. In a few cases, it appears that the insider fraud was an isolated event, but usually it is part of a larger scheme of insider abuse, self-dealing and gross mismanagement. The subcommittee's estimate appears to be consistent with the FDIC's own estimate that criminal misconduct was a "major contributing factor" in 45 percent of the 75 bank failures in the subcommittee's survey.

FIGURE 1.—*Actual and probable criminal misconduct by officers, directors and insiders of failed commercial banks (1980–mid-1983)*

Total number of FDIC-insured commercial bank failures, January 1980–June 1983	75
Number of failed banks from which bank officials have been convicted[1]	15
Number of failed banks from which bank officials have been indicted and cases are still pending	4
Number of pending cases in which Justice Department considers indictments "likely"	21
One-half[2] the number of pending cases in which Justice Department considers indictments "possible or probable"	6
Total number of failed Banks in which criminal misconduct is probable	46
Percentage of failed banks in which criminal misconduct is probable: (46÷75=61 percent)	61

[1] This chart is based upon information supplied to the subcommittee by the Department of Justice, as of October 1983.
[2] The Justice Department estimates that in 12 pending cases, indictments are "possible or probable". In order, however, to be conservative in its estimate of probable criminal misconduct, the staff included only one-half of the 12 cases.

It is fairly safe to conclude from the two estimates that roughly half of all bank failures are caused, in large part, by the criminal misconduct of officers, directors and insiders and that the threat posed by such frauds has increased significantly in the past several years.

The FDIC contends that this is not a new phenomenon:

> It can be safely concluded that insider criminal misconduct was a major cause of recent bank failures. This is not a new development unique to this period. In a detailed study of 67 bank failures from 1960 to 1974, the FDIC determined that 31.3 percent were caused by defalcation, embezzlement, and manipulation. An additional 53.8 percent were caused by self-serving loans to bank management or friends of management.[21]

[20] Ibid., p. 4. For a list of the 75 failed banks surveyed, see Hearings (Part 1), pp. 287–295.
[21] Hearings (Part 2), p. 283.

The FDIC states that it cannot make any definite conclusions as to whether the rate of inside abuse in bank failures has increased. FDIC contends that, because the absolute number of criminal-related failures has risen, "insider abuse account[s] for a lesser percentage of those failures than in earlier years" [22] However, the agency's own estimate that criminal misconduct was a major contributing factor in 45 percent of the failures between 1980–1983 suggests an increase from the agency's older study that attributed only 31.3 percent of the failures to criminal activity.

This percentage is particularly alarming because it does not even include the harmful effects of insider abuse that does not reach the level of criminal misconduct. The older FDIC study attributed 31.3 percent of the failures to criminal misconduct and an additional 53.8 percent to "self-serving loans to bank management or friends of management" i.e., insider abuse. Similarly, the subcommittee's 61 percent figure is a conservative estimate because it includes only one-half of the cases in which the Justice Department considers indictments "possible or probable" but which may be impossible to prosecute due to problems of proof or lack of jury appeal or which may result in acquittal.

This high correlation between insider criminal misconduct and failures does not appear to hold true for savings and loan, savings bank, or credit union failures.[23] The subcommittee surveyed the 30 savings and loans which were placed in involuntary receivership by the FHLBB between January 1980 and July 1983 [24] and the 12 savings banks that either failed or received FDIC meager assistance during the same period. The Justice Department reported that out of the 30 failed savings and loans, there had been two convictions, one indictment, and eight cases still pending. Out of the 12 savings banks, none had resulted in any criminal investigations or prosecutions.[25] On the basis of these initial findings, the subcommittee did not seek further details on the pending S&L cases. Even if all eight of these cases resulted in indictments or convictions, the total would have involved only 11 out of 30 institutions or 36 percent, little more than half the rate for failed commercial banks.

This estimate of criminal misconduct in savings and loan failures is buttressed by the FHLBB's own estimates. According to the agency, criminal misconduct was a "major contributing factor" in approximately 23 percent of the 30 failures, exactly one-half the 45 percent estimate given by the FDIC. Based on both the subcommittee's survey and the FHLBB estimate, criminal misconduct is apparently a major cause of approximately 25 percent of all recent S&L failures.

The higher rate of criminal misconduct in commercial bank failures is probably due to several factors. First, commercial banking involves many more opportunities for high-risk, large-scale transactions than does most mortgage lending. Second, the FHLBB's own requirement that all savings and loans have annual independent

[22] Ibid.

[23] Because of their mutual ownership, their size, and the limits on the types of loans they can make, credit unions do not appear to suffer failures that are caused largely by insider abuse. See Hearings (Part 1), pp. 130–138.

[24] For a list of the 30 institutions surveyed, see Hearings (Part 1), p. 332.

[25] Ibid., pp. 370–383.

audits may have helped to keep down the level of insider abuse. (These audits are designed to assess the quality of an institution's system of internal controls, and often result in the detection of insider abuse and fraud.) Third, the FHLBB has adopted restrictions on the size of insider loans to "affiliated persons" which are more stringent than those set by the other banking agencies. According to the agency,

> . . . [I]t should be noted that the Bank Board has regulations on conflict of interest that restrict the type of lending and other transcations permitted with an institution's own affiliated persons. . . . These rules are more comprehensive than those of the banking agencies and reach a much broader class of affiliated persons and companies than do the banking agencies' current restrictions on insider transactions. . . .[26]

Despite such differences, there are signs that the level of insider abuse in thrift institutions is increasing. Not only has the FHLBB increased its number of removal actions against individual officers and directors with the last 2 years, but fidelity bond carriers, who insure savings and loans against insider fraud, have predicted that with deregulation and their recent loss experiences in thrift institutions, fidelity insurance rates for thrifts can be expected to rise in the near future.[27]

C. INSIDER ABUSE IN OPEN INSTITUTIONS

It is difficult to determine the scope of insider abuse and criminal misconduct in the banking industry as a whole because neither the Federal bank agencies nor the Justice Department routinely compile meaningful statistics on such conduct. The bank regulators tend to downplay any such threat. The FDIC, for example, states, "The importance of insider abuse in bank failure situations is well documented, yet it is not a pervasive problem within the banking industry generally." [28]

The subcommittee is not in a position to agree or disagree with this assessment, since the banking agencies do not keep sufficient statistics on records on insider abuse and criminal misconduct to support any such broad generalizations. However, since most failed banks go through a crucial "problem" period, sometimes for several years prior to failure, it is likely that the problem of insider abuse is far more prevalent among problem institutions than is reflected in the few criminal referrals that the banking agencies have made in such institutions.

Because of the lack of adequate records kept by the agencies, the subcommittee conducted an empirical study of all criminal referrals made by the bankings agencies involving insiders of "problem" institutions during 1980–91. The survey shows that the banking agencies made criminal referrals in only 2 percent of all problem institutions in 1980 and 4 percent in 1981. Although these numbers

[26] Ibid., p. 386.

[27] Interviews and letters from several of the Nation's largest fidelity carriers have been omitted from the record but are on file with the subcommittee.

[28] Hearings (Part 2), p. 288.

do not take into account the referrals made by the institutions themselves—which the agencies do not record—the following chart (Figure 2) demonstrates that the agencies make very few referrals on insiders in these institutions.

FIGURE 2.—PROBLEM BANKS AND THRIFTS IN WHICH INSIDERS WERE SUBJECTS OF CRIMINAL REFERRALS BY BANKING AGENCIES,[1] 1980–81

Agency name	1980		1981	
	Number of problem institutions	Number of institutions where insiders were referred by agencies[2]	Number of problem institutions	Number of institutions where insiders were referred by agencies[2]
Federal Reserve	98	2	107	2
FDIC	477	16	642	27
OCC	257	4	251	11
FHLBB	114	1	274	11
Total	946	23	1,274	51
Percentage		2		4

[1] Problem banks were defined as those having a composite CAMEL rating of "3," or "4," or "5" at any time during 1980–81. Problem savings and loans were defined as those having a composite rate of "3–D" or "4–D" during the same period. The total number of problem institutions was reduced by the number of institutions that eventually failed.

[2] This column does not include situations in which the institution itself, rather than the banking agency, made a criminal referral.

D. THE DIFFERENCE BETWEEN CRIMINAL MISCONDUCT AND INSIDER ABUSE

It is important in any discussion of insider abuse to keep in mind the distinction between insider abuse and criminal misconduct. The term "insider abuse," in this report, is used to refer to a wide range of illegal activities by officers, directors, major shareholders, agents, and other controlling persons in financial institutions that are intended to benefit such insiders or their related interests, without regard for the safety or soundness of the institutions they control. Under such a definition, most criminal fraud violations by insiders also constitutes "insider abuse."

The Federal Reserve has properly drawn the distinction between the two terms:

> . . . [I]nsider abuses may include unsound lending practices, such as inadequate collateral and poor loan documentation, excessive concentrations of credit to certain industries or groups of borrowers, unsound or excessive loans to insiders of their related interests or business associates, violations of civil statutes such as legal lending limits, as well as violations of criminal statutes such as fraud, misapplication of bank funds or embezzlement. The critical point is that while insider abuse may include criminal misconduct, the term also comprises a number of other actions or practices by insiders that may harm or weaken a bank but that do not necessarily constitute a violation of criminal statutes.[29]

[29] Ibid., pp. 327–382.

In other words, virtually every criminal violation by an insider constitutes insider abuse, but not all insider abuse necessarily constitutes a crime.

This distinction becomes crucial in defining the Federal banking agencies' responsibilities in combatting insider abuse. In most problem institutions where insider abuse is detected, examiners will find a mismash of unsafe and unsound banking practices, insider abuse and mismanagement which may eventually turn out to also involve criminal acts. For example, a bank president who charges $15,000 worth of personal expenses on his bank's credit card has clearly violated civil bank regulations, but he may have also violated the criminal missapplication or false entry statutes, depending upon whether a criminal intent exists.

On the other hand, even criminal acts which may not pose an immediate threat to an institution's overall safety and soundness are still generally considered to be "abusive." Money laundering is a good example. An individual who knowingly fails to report large cash transactions violates Treasury Department regulations and the criminal provisions of the Bank Secrecy Act may not necessarily threaten the soundness of an institution. At Senate hearings in 1980 on money laundering, Paul M. Homan, Deputy Comptroller of the Currency, said,

> So long as the bank invests those deposits in overnight money and is able to cover when the deposits are withdrawn, there is no financial threat to the bank other than the peripheral one of perhaps affecting the confidence that people have in it because of known associations with criminals.[30]

However, by most any definition, money laundering still must be considered an "abusive" practice when insiders participate or profit from it, due to its illegality, the volatility associated with such transactions, and the insiders' willful disregard for the integrity of the institution.

Clearly, a very thin line often separates the criminal act from the abusive act, just as in other types of "white-collar" crime such as tax fraud or insider trading. The agencies, however, have the responsibility and the authority to investigate and take action against all insider abuse, regardless of whether or not it may be criminal. It is this overlap, this subtle relationship, between insider abuse and criminal misconduct that requires close coordination between civil and criminal enforcement efforts.

V. PREVENTING ACQUISITIONS OF FINANCIAL INSTITUTIONS BY DISHONEST, UNQUALIFIED, OR INEXPERIENCED PERSONS

A. INTRODUCTION

In 1978, Congress enacted the Change in Bank Control Act of 1978, 12 U.S.C. 1817(j), and the Change in Savings and Loan Control Act, 12 U.S.C. 1730(q), to authorize the banking agencies to disapprove changes of control of financial institutions within their jurisdictions. This act presents the banking agencies with one of the

[30] Penny Lernous, "In Banks We Trust," (New York: Doubleday, 1984), p. 126.

best opportunities to prevent dishonest persons, particularly those with a prior history of inside abuse or criminal misconduct, from gaining control of financial institutions.

Both acts, containing parallel language, require persons seeking to acquire control of a bank or a thrift to file written notices with the appropriate agency within 60 days prior to the transfer. In addition to financial data, the notice must include the following information:

> The identity, personal history, business background and experience of each person by whom or on whose behalf the acquisition is to be made, including his material business activities and affiliations during the past five years, and a description of any material pending legal or administrative proceedings in which he is a party and any criminal indictment or conviction of such person by a State or Federal court. 12 U.S.C. § 1817(j)(6)(A).

The appropriate banking agency may disapprove the acquisition on various anticompetitive or financial grounds, or because:

> the competence, experience, or integrity of any acquiring person or of any of the proposed management personnel indicates that it would not be in the interest of the depositors of the bank, or in the interest of the public to permit such person to control the bank. 12 U.S.C. § 1817(j)(7)(D).

And the purchasers may not proceed with the acquisition if the agency disapproves it.

All of the agencies state the same objective in implementing the act:

> The [OCC's] objectives in its administration of the act are to enhance and maintain public confidence in the banking system by preventing identifiable serious adverse effects resulting from anticompetitive combinations of interests, inadequate financial support, and unsuitable management in these institutions.[31]

The act was passed as part of the Federal Institutions Regulatory and Interest Rate Control Act of 1978, which addressed insider abuse by establishing insider lending limits, by increasing civil enforcement authority against individuals, and by allowing the banking agencies to step in and prevent dishonest or unqualified individuals from acquiring financial institutions. The legislative history substantiated the need for this legislation:

> One of the most glaring gaps in the regulatory structure for our depository institutions is the lack of control over transfers of ownership of banks and savings and loans between individuals or groups of individuals. When an institution is chartered, when it applies for insurance, when it plans to merge with another institution, when it wants to establish a branch, or when it becomes part of a holding company, an application has to be filed with, and approval obtained from, the appropriate regulatory authority. However, when an individual or a group of individuals want to buy a bank or a savings and loan, Federal regulatory agencies have no authority over the transaction even though the institution has been granted a charter and deposit insurance.[32]

[31] Hearings (Part 2), p. 520. See also pp. 661 and 780.

Misconduct within a bank or a thrift institution often follows an ownership change, because "[i]f a person is going to use a bank for an illegal purpose the obvious first step is to get control of a bank"[33] First Assistant U.S. Attorney Gregory Jones (Chicago) testified as to what often occurs after such changes:

> And the final circumstance . . . in change of control is that sometimes you have people that acquire banks, not with the long-range benefit of the bank in mind, but their own short-range interest. It is almost similar to what we call a "bust out", which is where a company goes into business, acquires lots of properties from various creditors without paying for it, and then disposes of that property quickly before the creditors are alert that this is just a fraud. . . . [Or] they . . . engage in conduct, insider abuse, by issuing loans to people who are making kickbacks to them.[34]

Sometimes the acquiring individuals do not originally plan to engage in insider abuse but ultimately feel compelled to do so. As Mr. Jones testified:

> *The one condition that seems to be prevalent in many of the bank failures is a change of control in the bank.* There are various pressures at the time of a change in control that may cause bank officers to corruptly discharge their duties. They may need funds to acquire a bank or to acquire stock in a bank. Of course, to get that money they may make promises to various people who lend them money that they will make them loans once they get into control of a bank. We have seen a number of cases of bank failures where that is exactly what occurred.[35] (Emphasis added.)

From 1980 to early 1984, the four banking agencies reviewed 2,211 change of control applications but formally rejected only 33.[36] These numbers, standing alone, raise serious questions as to whether the banking agencies are effectively and vigorously enforcing the change of control acts, particularly in view of increasing insider abuse. The following case studies, the agencies' investigative procedures, and the agencies' tortured and restricted interpretation of their statutory authority demonstrate their extreme reluctance to deny change of control applications.

[32] Citation from House Report 95-1383, p. 19. See also Hearings (Part 2), pp. 1355-6.

[33] Hearings (Part 2), p. 1954; reported statement of Assistant U.S. Attorney Chris Harrison, Eastern District of Texas.

[34] Ibid., pp. 26-7.

[35] Ibid., p. 26.

[36] The FHLBB has informally applied pressure to withdraw applications, and consequently 30 applications made have been withdrawn. The FRS, the FDIC, and the OCC did not have that information available. In any event, the number is minimal.

B. CASE STUDIES

1. Orrin Shaid and Ranchlander National Bank

The U.S. Attorney in the Eastern District of Texas, Bob Wortham, and Assistant U.S. Attorney Chris Harrison told a story of intrigue and bank fraud, where a felon obtained control of a national bank, proceeded to defraud it and other Texas banks, eventually caused this bank's failure, and then escaped to the Cayman Islands.[37]

I

In 1974, Orrin Shaid was convicted of 45 counts involving bank fraud and embezzlement at the Chireno State Bank, Chireno, TX. Thereafter, he served 5 years of an 8-year prison sentence, and then was released. Posing as a financial consultant, he arranged for Lynn C. Maree, his "common law" wife, to acquire Ranchlander National Bank in Melvin, TX. On May 28, 1981, Maree filed with the OCC's regional office in Dallas a change of control notice which contained no references to Shaid's involvement.

Shortly thereafter, but before the OCC's written approval of the final purchase, the then-owner of the bank, Doyle Todd, relinquished the position of president and allowed Maree's-Shaid's choice, Roger Pipkin, to assume that role, in response to the OCC's April 1, 1981, cease and desist order against the bank, requiring a new chief executive officer. Immediately, Shaid and Maree locked Todd out of the bank, even though he was still the owner.

In order to raise the $186,000 purchase price, Shaid "bought" from Ranchlander two $1,000 certificates of deposit (CDs) with a postdated check, and proceeded to alter them to $100,000 certificates of deposit (CDs), all in front of Jean Moon, a former waitress and the bank's next president. He then went to another bank, pledged these certificates for a $200,000 loan, received the proceeds, and used that money both for the $186,000 purchase price and to cover the $2,000 check used to buy the original certificates of deposit.

After Shaid took complete control of the bank, he proceeded to raid it, making numerous fictitious cattle and real estate loans and issuing more phony CDs which he used as collateral for loans from other banks. With the proceeds, he acquired a pair of Rolls Royce cars, two airplanes and a yacht. He also diverted $6 million to the Cayman Islands. While this was going on, Shaid was planning to pyramid his acquisitions. In March 1982, he acquired control of the First State Bank, Wells, TX, by paying a $50,000 kickback to secure a fraudulent loan there for the purchase money price.

Shaid planned his eventual escape to the Cayman Islands. In November 1982, he told Ranchlander President Jean Moon to destroy the bank's records and to fly to his house. Believing that Shaid would kill her as a link to his crimes, Moon drove to San Antonio and approached the FBI. Within 3 days, the FBI, the OCC, and the FDIC descended on Melvin and declared the bank insolvent. Shaid was apprehended several weeks later when he returned to the U.S. to kidnap his son.

[37] Hearings (Part 2), pp. 39–45, 86, 1954–1962 (news articles).

After a trial in early 1983, Shaid was convicted of mail fraud, false statements to federally insured banks, and bank fraud. He was sentenced to 35 years in prison. Both Jean Moon and Lynn Maree each received sentences of 5 years' probation.

During the May 2, 1984, hearing, the subcommittee heard testimony concerning the OCC's failure to adequately check and verify factual statements in the change of control application, a simple procedure which could have aborted Shaid's plan and prevented these losses. U.S. Attorney Bob Wortham furnished Maree's change of control application to the subcommittee—after the OCC had repeatedly refused to do so—which, on its face, contained highly suspicious and improbable factual statements. Mr. Wortham described the application:

> Now in [Maree's] application to buy the bank, to me when I look at it, I mean it is just beeping red lights. When I look on page 14 of the application, and . . . [a]nd her prior employment job description was, she was a lease secretary. She prepared leases. Her starting salary when she started the job was $600 a month. When she finished the job, she was making $625 a month. Now, her claim to fame was that she was an heiress to a large estate out of Houston. Well, her name is pronounced the same, but it spelled differently.
>
> . . . her next job after being a lease secretary, she said was owner and manager of various investments. That is all she put for current title and job description. Here you have a half a page and she has one line that says, "owner and manager of various investments."
>
> What? What has she done? She was asked how she was going to purchase the bank. . . . She says . . . she has $182,712.674 cash on hand." She anticipates that she will get this money by liquidating Carnes Auto Loans and J & L Insurance Agency, both of which are shell corporations. *If they [the OCC] had simply checked to see what they were, they would have found out they didn't exist. . . . When I see a secretary making $600 a month who is buying a bank I would scratch my head.*[38] (Emphasis added.)

During their investigation, the FBI had little difficulty uncovering the falsity of her statements as to the source of the purchase money. Several phone calls uncovered the fact that she was not an heiress, and that the companies she was supposed to liquidate did not really exist.

II

The OCC initially refused to disclose to the subcommittee any information on the nature and extent of the inquiry it conducted to confirm Maree's statements in the change of control application. Beside refusing to provide the change of control application, OCC did not respond to other parts of the subcommittee's March 23, 1984, letter, which requested both the application and information

[38] Ibid., pp. 39–40.

about the inquiry. Moreover, although OCC's Enforcement Chief Bob Serino had been previously advised that the subcommittee would likely ask questions about this subject during its May 3 hearing, he was inexplicably unprepared to answer. He stated:

> . . . [OCC's] district office did make some inquiries. I am not aware of the extent of those inquiries.[39]

In response to Representative Coleman's request Mr. Serino did agree to submit additional information about the extent of OCC's inquiry and the OCC's reasons for approving the change of control application.

OCC's May 22, 1984, follow-up letter to the subcommittee reveals the extent of OCC's inquiry; it states:

> On June 15, 1981, the OCC requested that Ms. Maree submit additional information to clarify certain items in her change in bank control application . . . among other things: (1) Ms. Maree's plans for bringing the bank's assets and operations into conformity with the outstanding cease and desist action and (2) information supporting certain assets held by her which constituted a portion of her net worth. As a result of [this request] for this information, the OCC extended the time period for disapproval. . . .[40]
>
> By letter dated June 19, 1981, Ms. Maree provided a response . . . which included specific plans to bring new management into the bank, [and to take specific corrective action] *Ms. Maree's response also included information relating to certain of her investments.*[41] (Emphasis added.)

OCC then stated three reasons for approving the change of control appliation:

> The bank had been under special supervision by the OCC as a result of unsafe and unsound practices and violations of law . . . by previous management and ownership; Ms. Maree had already taken certain actions as a [bank] director . . . which demonstrated her commitment to turn the bank around;
>
> Ms. Maree had the financial ability to purchase the bank; and
>
> The OCC was unaware of any derogatory information to warrant the disapproval of the application.[42]

Clearly, the OCC was pleased that Maree was acquiring the bank from Doyle Todd. As Serino testified at the subcommittee's hearing:

> At the time the application was submitted . . . what we had before us was a financial institution that needed some help.[43]

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[39] Ibid., p 477.
[40] Ibid., p. 498
[41] Ibid., p. 499.
[42] Ibid.
[43] Ibid., p. 477. See also p. 2040, which sets forth the problems which the OCC encountered with the bank and which were the subject of the cease and desist order: "Deterioration as a result of unsafe and unsound practices by the president [owner]; conditions included high classi-

Continued

Interestingly, in September 1981, when Shaid had tried to indirectly acquire the Wells State Bank through Lynn C. Maree, the owner of that bank checked into the situation, discovered Shaid's involvement, and learned that "he was not the kind of person I wanted to sell to."[44] When a reporter apparently asked OCC's Bob Serino whether an additional inquiry would have uncovered Maree's involvement with Shaid, he responded:

> Even if we had known that she was living with Mr. Shaid, that would not be a basis for saying "you can't have [the bank]. We'd be overreaching as a government agency. . .[45]

The OCC confuses the issue. The fact that Maree lived with Shaid obviously would not have been grounds for disapproving the application. But a rudimentary inquiry would have revealed that Shaid was Maree's financial consultant and the primary negotiator in the purchase of the bank. This association would have raised questions, especially if OCC had eventually obtained information from the FBI on Shaid's prior conviction. There was certainly enough information readily discoverable, such as her lack of stated assets, sufficient to deny the change of control application. (Apparently, the OCC knew about her lack of experience but was not influenced by it.)

In its second follow-up letter to the subcommittee, dated June 20, 1984,[46] the OCC vigorously defended its approval of Maree's change of control application, primarily on the ground that the applicant was taking significant steps to correct the bank's problems and that, based on information before the OCC, there was "no basis" for denying the application.[47] The OCC also defended its "review" procedures, making no reference to investigational procedures or the lack of them.

OCC's continued assertions that there was nothing in writing to deny the change of control application is technically accurate. But OCC again confuses the real issue: OCC failed (1) to verify from outside sources any of the information in this application, especially given the questions raised by the application itself, or (2) to conduct a minimal background check in order to develop information concerning integrity, competence, or financial ability of the applicant. Unless there is derogatory information on the face of the application, sufficient to deny it, or by chance another agency has uncovered something derogatory and passed it on to the OCC, the OCC believes it must approve the application. Of course, that is not what the Congress intended and would effectively make it possible for unscrupulous change of control applicants to nullify these stat-

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fied assets and credit and collateral exceptions, insufficent capital, lack of internal controls, poor earnings, and fraudulent transactions involving extensions of credit to the president through his relatives, checks drawn on insufficient funds and cashiers checks issued without payment."
[44] Ibid., p. 1955.
[45] Ibid.
[46] Because the OCC's May 22d letter did not elaborate on Maree's response to the OCC on the extent and nature of her investments, the subcommittee once again found it necessary to request additional information. the OCC responded in its June 20th letter and attached the June 19, 1981, letter from Maree, (reprinted at Hearings (Part 2, pp. 502–510)). In her letter, Maree indicated that she paid a fair market value on the two corporations which she was going to liquidate for the purchase price, based on recent sales of like corporations, naming two other corporations. She set forth no appraisals. OCC once again accepted these statements at face value.
[47] Hearings (Part 2), p. 502.

utes. Subcommittee Chairman Barnard summed up the subcommittee's frustration with the OCC's response in the Ranchlander case:

> . . . there was an indication, based on what I can see, that if you had been a banker, you would not have made this crowd a loan, much less given them a bank charter. I mean they had no experience in running a bank. . . . As I said, I don't know if I was a banker whether I would have even made them a loan, much less given them a bank charter.[48]

As a consequence of the OCC's failure to perform a minimal investigation, the FDIC lost over $1 million in payouts, many other banks suffered losses in the millions of dollars, and Melvin, TX, lost its only bank.

2. Danny Faulkner and East Town National Bank

The subcommittee uncovered another situation which, while not as egregious, raises questions about the OCC's routine approval of change of control applications. This situation arose out of the subcommittee's examination of the Empire Savings and Loan Association failure in Mesquite, TX.[49]

Here, the Home Loan Bank Board had developed information on Danny Faulkner, indicating his possible complicity in insider loans and other misconduct. Mr. Faulkner, a real estate developer, had financed the purchase of, and subsequently had borrowed heavily from, Empire Savings. The Bank Board shared some of this information with the OCC during that agency's consideration of Faulkner's change in control application for East Town National Bank, Garland, TX. Thereafter, it is unclear what the OCC knew and why it approved that change of control application if it knew of Faulkner's possible complicity in connection with insider abuse in another institution.

During and subsequent to the subcommittee's May 3, 1984, hearing, the following testimony and information—some of it contradictory—were received. Robert Serino for the OCC testified:

> In the Garland case, the application was pending before our office. We made an inquiry to the Federal Home Loan Bank Board and were specifically informed that in fact although they stated it, that it was not being investigated in any manner and [Danny L.] Faulkner's name was not even mentioned in the investigation. So we did make some inquiries and were informed on December 30, 1983, that in fact he was not involved in the investigation.[50]

FHLBB's Enforcement Director Rosemary Stewart responded:

[48] Ibid., p. 531.

[49] The committee has issued a report, "Federal Home Loan Bank Board Supervision and Failure of Empire Savings and Loan Association of Mesquite, Tex.", 44th Report by the Committee on Government Operations, August 6, 1984, House Report 98-953, hereafter "the Empire Report."

[50] Hearing (Part 2), p. 522.

> Information about Faulkner was provided to the OCC. . . .
>
> * * * * *
>
> That he had been a major borrower on the transactions that were under investigation, particularly the land flip transactions.[51]
>
> * * * * *
>
> Mr. BARNARD. Back in the Comptroller's ballpark now, You got that information from the Home Loan Bank Board?
>
> Mr. SERINO. My records reflect, Mr. Chairman, that based on a lack of any adverse information, the OCC approved the change of control on January 6, 1984. It was not until after that date we received some adverse information.[52]

After the hearing the FHLBB furnished to the subcommitte an internal April 2, 1984, memorandum describing the information which the FHLBB provided to the OCC, how it was provided and when. The memo reveals that on December 15, 1984, an OCC Dallas Bank Examiner contacted Rosemary Stewart, who then referred him to Charles Brewer in the FHLBB's Office of Examination and Supervision. The memo states in part:

> Ms. Spellman [of the OCC] informed Mr. Brewer [about Faulkner's plans to acquire control of the Garland, Texas bank and] she would like to know if we had any information concerning Faulkner that would indicate whether he is a person that should not be in control of a bank.
>
> Mr. Brewer indicated that our examiners were *in the process of developing information regarding the full extent of Faulkner's complicity regarding Empire's financial problems.* We requested and received a copy of the Faulkner application to review regarding this issue. . . .
>
> Mr. Brewer was also informed that Faulkner had promised the OCC-Dallas Office that he would hold up his Change of Control Notice indefinitely not withstanding [sic] the statutory time constraints. *Mr. Brewer suggested to Ms. Spellman that OCC hold Faulkner to his promise; however, Brewer later learned that OCC had decided to go forward based upon a meeting that they had with Faulkner.*[53] (Emphasis added.)

After the May 3rd hearing, the OCC furnished to the subcommittee additional information to respond to the Bank Board's assertions. The OCC's June 20, 1984, letter states:

> On or about December 6, 1983, the OCC learned of allegations in several newspaper stories that Mr. Faulkner had a possible role in various transactions relating to Empire Savings and Loan and that Empire . . . was the

[51] Ibid.

[52] Ibid., p. 527.

[53] Ibid., p. 524.

> subject of an investigation by the Federal Home Loan Bank Board (FHLBB). For that reason, the OCC extended the disapproval period [on the change of control notice] for an additional thirty days. . . . On approximately December 15, 1983, [OCC staff] advised [FHLBB] representatives of the pending Notice and inquired whether the FHLBB had any information to justify the OCC's disapproval of that Notice. *At that time, the FHLBB staff informed the OCC that it had no derogatory information on the Faulkners. The OCC had several follow-up conversations with the FHLBB and was never informed of any derogatory information.* In fact, on December 30, 1983, the OCC was told by a [FHLBB] representative from the . . . Washington office *that Mr. Faulkner's name was not even mentioned in the FHLBB's investigation.* Therefore, on January 6, 1984, the OCC conveyed its intent not to disapprove the Notice based on the . . . lack of any relevant adverse information against the Faulkners to justify disapproval.[54] (Emphasis added.)

The subcommittee was unable to reconcile these different versions as to what specific information was shared between the OCC and the FHLBB. In any event, the exact content of the FHLBB's concerns is not the key issue. It is clear that the OCC was given a timely and substantial warning by a sister regulating agency, which should have prompted the OCC to initiate a thorough investigation. Once the OCC had uncovered any information bearing on Faulkner's integrity, competence, and other qualifications—whether or not it rose to the level of being sufficiently derogatory—the OCC should have initiated an inquiry. Once again, it did not.

While these two case studies bear on OCC's procedures and policies, the change of control procedures and policies of the other banking agencies are very similar, and, except for the FDIC, none provide for investigations of applicants. Accordingly, if the Ranchlander change of control application had been filed with the Federal Reserve, the FHLBB, or possibly the FDIC, the same situation could have occurred.

C. AGENCIES' REVIEW, INVESTIGATION, AND VERIFICATION PROCEDURES

1. General agency procedures

Change of control review and comment procedures are, with small variations, the same among the agencies. The FDIC procedures are typical: The FDIC (1) reviews the reports of examinations of banks or thrifts with which the acquiring party is associated and requests comments on those banks from the OCC or the Federal Reserve; (2) notifies all of the other Federal banking agencies and the appropriate State banking agency of the proposed acquisition and asks for their comments; (3) requests name and identification checks from the FBI; [55] and (4) resolves questions of financial ability—source of funds and ability to service the debt—through correspondence or meetings with the acquiring party.[56] While the Federal Reserve encourages its staff to conduct background checks on associated companies, it is the only agency which does not require an FBI name and identification check.[57] The Federal Home Loan Bank Board, which does the most of any agency, searches for prior SEC enforcement actions and checks the names of any suspect applicants through the computerized LEXIS and NEXIS systems.[58]

[54] Ibid., p. 529.
[55] In practice only the FDIC orders an FBI check on all applicants; the others do not.
[56] Hearings (Part 2), p. 614.

The FDIC is the only banking agency which requires a regional office or field investigation of the applicant, the preparation of a letter report of its findings, and a compilation of staff time and travel time involved.[59] The other agencies' voluminous material on change of control procedures in no way refers to or mentions "investigations", "inquiries", or "verification", or the need to conduct these activities. Rather, these agencies place an emphasis on analysis and review of the application itself, particularly the completeness of the information.

All of the agencies place tremendous emphasis on speed, given the several layers of agency review and the 90-day deadline set by the statute, particularly if disapproval is recommended, in which case the agency heads usually become involved. In fact, the FDIC requires that the processing of the application/notice and the FDIC's regional director's recommendations or actions not be delayed because "the [FBI] records check results have not been received. . . ."[60]

Accordingly, if a person of questionable integrity wants to acquire a financial institution, he or she can lie on the change of control application and probably get away with it.

2. Lack of public disclosure

Publicizing the filing of a change of control notice and soliciting input from the public would serve a useful function and could bring to light possible problems. However, none of the agencies do this; to the contrary, they consider these notices confidential.

The OCC and the FDIC follow this policy, but for different reasons.

The OCC's disclosure policy is particularly interesting because it conflicts with its general disclosure policies. For other national bank activities, such as changes in locations of head offices or domestic branches, major financial changes, etc., the OCC requires that the "applicant . . . publish a notice in a newspaper of general circulation in the community in which the applicant proposes to engage [or is engaging] in business." 12 C.F.R. § 5.8. Thereafter, under § 5.10 any person may submit to the OCC's regional administrator written comments and data on the application. Unfortunately, this procedure does not apply to change of control notices.

The OCC interprets the Freedom of Information Act (FOIA), 5 U.S.C. 552, as exempting change of control notices from public disclosure. Once the notice is approved (or not disapproved), the OCC believes that the exemption no longer applies, so OCC will make public the existence of the notice. Contrary to OCC's position, none

[57] Ibid., pp. 770–797.
[58] Ibid., p. 681.
[59] Ibid., pp. 657–8. Whether the FDIC actually conducts a thorough investigation in every case is not known.
[60] Ibid., p. 659.

of the exemptions in the FOIA prohibit the release of the information which would identify the change in control notice and the acquiring party. Although § 552(b)(4) exempts commercial or financial information obtained from a person, such information could be deleted from the public notice, so that the agency could make public basic identifying information. In fact, the FOIA mandates that this be done. OCC's reliance on the FOIA is misplaced and misleading. Even if the FOIA provided an exemption for release of information, the agency can still, as a matter of public policy, release information.

The FDIC nondisclosure policies are predicated on completely different grounds, but recognize that certain change of control notice information may be obtained under FOIA. A relevant November 4, 1981, FDIC memorandum states:

> Although our internal processing of Notices may be similar to that of various types of application, e.g. branch applications or new bank applications, the Act does not require that the "convenience and the needs of the community" be considered nor is there any provision that comments from third parties, including the management of a bank to be acquired, be considered or solicited. Because it is our policy to minimize interference with the functioning of the marketplace, during the period when a Notice is pending . . ., the information contained in a Notice is considered confidential . . . [and] our policy is to neither confirm or deny the existence of a Notice. . . .[61]

The FDIC does allow exceptions to this policy and permits disclosure: (1) where the proposed transaction involves a public tender offer for securities; (2) in a situation where an FDIC field investigation of the proposed acquisition occurs and disclosure of the notice is deemed necessary; (3) following the acquisition and change in control (but only certain summary information is made publicly available); and (4) "if deemed necessary and appropriate, a persistent inquirer may be advised that such information may be requested in writing pursuant to the Freedom of Information Act." [62]

FDIC's policy of not disclosing even the existence of the notice because it might interfere with the function of the marketplace shows a *strong bias* in favor of changes of control and against any information coming to light which could prevent it from happening. Unlike the OCC, however, the FDIC recognizes that the FOIA is not a bar to the release of some information.

There may be valid reasons for *not* disclosing the receipt of a particular change of control application, but there is no justification for not disclosing the existence of most of them.

3. Lack of agency followup upon notification of other investigations

The FDIC, the OCC, and the FHLBB complain that the FBI will often conduct a name check on a change in control applicant and inform the agency only that this person is "under investigation". FDIC Chairman Isaac elaborated:

[61] Ibid., p. 668.
[62] Ibid., pp. 668–9.

> One of the problems that we have occurs when we know in our hearts that somebody is not good for a bank, but we can't prove it. We don't have the statutory basis for keeping somebody out of a bank and frequently we encounter a situation where we will call the FBI or CIA or somebody . . . and they will say, "We have this person under investigation." "For what?" "Can't tell you." "Well, is he going to go to jail?" "I don't know. I hope so."
>
> How can you deny a change of control because the FBI has somebody under investigation? That happens to us quite often that we will have that kind of information and the statute says we have to make a finding to deny.[63]

Comptroller of the Currency Conover summed up his views:

> I am afraid we are as frustrated as the [FHLBB] and the FDIC on the subject of the Change in Bank Control Act. Our belief is that just because someone is under investigation, that is not a sufficient reason to deny his or her acquisition of a bank, in spite of the fact that, as Chairman Isaac indicated, that makes us feel awfully uncomfortable.[64]

Correctly, the mere existence of such an investigation is not grounds for disapproving the change in control application. The underlying facts concerning an ongoing FBI or other law enforcement agency investigation would have to establish a basis for disapproval consistent with the statutory requirements.

Unfortunately, the agencies do nothing to uncover the underlying facts. On an informal basis, FBI and other law enforcement agencies staff will often disclose a minimal amount of information to another agency's staff if there are valid purposes and if confidentiality and discretion are assured. They banking agencies do not even try. They simply "wash their hands" and complain that they can do nothing.

D. Agencies' Reluctance to Disapprove Notices and Narrow Interpretations of Disapproval Authority

Even when confronted with evidence of prior misconduct or questionable integrity, the agencies rarely deny change of control applications. Former OCC examiner Donny Palmer testified about the OCC's handling of change of control applications, new charter applications, and chief executive officer changes:

> In my experience, the filing of change of control reports is normally just a formality. Certainly any well-known banker with a questionable background might be identified if he should appear as the new owner of an institution; however, unless the individual is actually a convicted felon, the opinion of the OCC appears to be noncommital with respect to allegations of probable misconduct.

* * * * *

[63] Ibid., p. 530.
[64] Ibid., pp. 530–31.

Without a system to "track" an officer's employment, it is possible for detrimental information to go undetected where the officer or director might fail to provide sufficient data in the change of control notification [preventing checks of examination reports of banks where the officer has been employed].

Informal discussions are routinely held at the district level concerning information about a prospective bank owner or prospective CEO, but again this system is far from being comprehensive. This lack of initiative is also prevalent in other matters, such as the approval process [in connection with] de novo charters. . . . Once again the stigma of being a "convicted felon" appears to be the only grounds for nonapproval.[65]

Present and former agency staff at other banking agencies confirmed that usually a person must have been convicted of a crime before a change of control application will be disapproved on the basis of lack of integrity. One FDIC examiner listed the lack of proper enforcement of the act as "one of the biggest shortcomings of the entire agency." He gave as an example a bank president, recently convicted of bank fraud, who gained control of a bank despite the fact that "everybody knew he was a crook".[66]

Even the FDIC told of a change of control situation where they approved, which eventually caused a bank's failure:

> At times we have suspicions concerning the integrity and intentions of new owners but are unable to develop a case which would justify a disapproval of a change in control notice. For example, in one recent instance, after diligently searching for some basis for disapproval, none could be found and we had no alternative but to enter a nonobjection to the transactions. Examiners were dispatched to the bank less than a week after the stock was acquired and insider abuse was found to be already taking place to such an extent that the bank was insolvent.[67]

The FDIC's threshold of evidence necessary, and the burden of proof required to deny an application is very high, before it will disapprove a change of control notice on the basis of lack of integrity. The FDIC states in a 1979 memorandum that,

> . . . however, an indictment that did not result in a conviction would appear insufficient to sustain a recommendation for disapproval. Should [there be a] conviction or a plea of no contest to any criminal charge involving dishonesty or breach of trust, further information and supporting documents may be required.[68]

FDIC Chairman Isaac put it very succinctly:

> That is not the way our society works. People are innocent until proven guilty by someone.[69]

[65] Ibid., pp. 110–111.
[66] Ibid., p. 1345.
[67] Ibid., p. 291.
[68] Ibid., p. 659.
[69] Ibid., p. 530.

Like the OCC and the FDIC, the Federal Reserve also apparently believes that a criminal conviction is usually the only sufficient grounds for proving that an applicant lacks integrity:

> The Federal Reserve may have obtained information from an investigative agency that may reflect adversely on an individual's character or reputation; however, in many cases, the information may be raw intelligence data, or hearsay information that has not been legally supported by *a finding of guilt*.[70] (Emphasis added.)

The Federal Reserve believes that it cannot disapprove the application on the basis of "unsubstantiated allegations." The Federal Home Loan Bank Board takes a very righteous approach and does not even want to know what information may be contained in the FBI's computers on any particular applicant:

> But more importantly, the FBI computer banks hold volumes of information about individuals who are witnesses, acquaintances, and associates of suspected wrongdoers as well as the actual subjects of suspected criminal activities or their suspected accomplices. This agency cannot act adversely on an individual's acquisition of control on the basis of lack of "competence, experience or integrity" just because the name appeared in an FBI check. Surely the need to protect our nation's financial institutions must be balanced with the traditional rights of persons who have not been charged or convicted of criminal conduct."[71]

The overall problem of inadequate agency investigations and verifications is closely and directly tied to the agencies' policies as to when they can disapprove change of control applications. The banking agencies do not really believe that pursuing allegations of criminal or other serious misconduct is valuable, or a function of their statutory responsibilities. Their policies assume that the absence of a criminal conviction carries with it an almost inviolable right to acquire a financial institution. They are applying to acquisition cases the same standards applied in criminal cases.

Unfortunately, they completely misread the 1978 statute and confer the same rights on an acquiror as they do on a criminal defendant. They are not the same; one does not lose his civil rights and his liberty when denied the right to acquire a financial institution. The change in control statute does *not* require that questionable integrity be proven beyond a reasonable doubt and that the misconduct giving rise to "lack of integrity" have resulted in a criminal conviction.

The relevant statutory provision 12 U.S.C. § 1817(j) states:

> (7) The appropriate Federal banking agency may disapprove any proposed acquisition if—
>
> * * * * *
>
> (D) The competence, experience, or integrity of any acquiring person or of any of the proposed management per-

[70] Ibid., p. 337.
[71] Ibid., p. 682.

sonnel indicates that it would not be in the interest of the depositors of the bank, or in the interest of the public to permit such person to control the bank;

While the standard could be more specific, no reasonable interpretation would require criminal misconduct, let alone an actual criminal conviction, before an agency can disapprove. Furthermore, the standard of evidence required is the most favorable existing for appellate review of agency action. Title 12 U.S.C. 1817(j)(5) (and the companion provision in the statute applying to thrift changes in control) states that the person whose proposed acquisition is disapproved after agency hearings may appeal to the court of appeals. The statute then goes on to state:

> The findings of the appropriate Federal banking agency shall be set aside if found to be arbitrary or capricious or if found to violate procedures established by this subsection.

Assuming that the banking agencies follow correct procedures, the agencies do not have to prove "substantial evidence" or some other higher evidentiary threshold. The initial burden of proof rests with the appealing party, not the agency, and the agency need only show that its finding, that the acquisition would not be in the public interest, was not arbitrary or capricious but rested on some rational basis. Undoubtedly, an unsubstantiated allegation or rumor would not be enough. But if the agency conducted an investigation and uncovered evidence to show a rational basis for its decision, then it is unlikely the court of appeals would reverse it, although such evidence would not be sufficient in a civil case requiring "substantial evidence" or in a criminal case. As one commentator has written, "For the most part, the courts have paid great deference to agency judgments in enforcement actions." [72] The agencies have much more latitude than they are willing to use.[73]

Recently, the Federal Home Loan Bank Board has indicated a greater willingness to assert its authority in this area. As the Bank Board staff advised the subcommittee:

> . . . I would add that the change in control statute is not an easy one for us to use to deny applications. The standards are very strict. We at the Bank Board have in the last year decided that the statute notwithstanding, *we are going to get tough and we are going to make more inquiries, but for several years we felt that it was almost impossible to deny someone without a prior criminal conviction.*[74] (Emphasis added.)

The FHLBB claims it has recently used the process effectively by asking probing questions about an applicant's background, financial ability, etc., casing many "suspect applicants to withdraw their

[72] Ibid., p. 2019.
[73] While the FDIC has publicly taken the same position as the other agencies, it does state in one of its memoranda to regional directors: "The difficulties associated with evidence and documentation are recognized, however, and deficiencies in available evidential material need not deter a disapproval recommendation where a proposed transaction is likely to have serious harmful effects." Hearings (Part 2), p. 671.
[74] Ibid., p. 522.

applications." [75] In 1983, for example, applicants filed 110 change of control applications with the Board; while none were denied, 19 were withdrawn. In addition, the Bank Board stated:

> We consider many of these withdrawn applications to reflect a successful use of the act. . . . Moreover, it is expected that 1984 will produce a number of disapprovals of change of control applications as the Bank Board is increasingly adopting a "get tough" policy in this area.[76]

E. POSSIBLE STATUTORY CHANGES

The Federal Reserve recommended no statutory modifications to the change in control provisions. The FDIC was uncertain on the need for such modifications. FDIC Chairman Isaac initially seemed to indicate that statutory modifications were needed to deny acquisitions of control to unqualified or dishonest individuals, but then thereafter the FDIC seemed to change its position.

The OCC suggested two statutory changes. First, the OCC stated:

> . . . it would be helpful to have better and more specific standards regarding what are sufficient grounds for determining that a person lacks sufficient integrity that his or her acquisition would not be in the best interest of depositors or the public.[77]

While more specificity in the act might be desirable, it is extremely difficult to foresee all the types of misconduct and negative factors bearing on integrity, sufficient to disqualify an applicant. Also, a list of specific grounds might make it impossible to deny an application to someone who did not meet one of the criteria, but who now can be denied an application under the more general "public interest" standard. In any event, the OCC has general authority to draft more specific standards and to publish them in the Code of Federal Regulations.

Second, the OCC suggested the possibility of a longer time frame under the act or an ability to extend the time for agency action, a change which the committee believes has merit. At present, the agency must disapprove the application/notice within 60 days, or the acquisition may proceed unless the agency extends that period an additional 30 days maximum. OCC believes that extending the time might facilitate the gathering of information necessary to make an informed judgment. Both the FDIC and the Federal Reserve System, for example, have set deadlines for the several layers of regional and Washington headquarters review. For example, by the 40th calendar day, the Federal Reserve bank must have sent a memo to the Federal Reserve Board's clearing unit.[78] Accordingly, the committee has recommended that Congress consider amending the statute to allow for agency extensions, with a maximum allowable number of days, possibly 120 to 180 days.

The Home Loan Bank Board has proposed comprehensive legislation modifying the Change in Savings and Loan Control Act, their

[75] Ibid., p. 388.
[76] Ibid.
[77] Ibid., p. 738.
[78] Ibid., p. 774. See also p. 671 for the FDIC's deadlines and review stages.

civil enforcement authority, and a number of other statutory provisions. (In June 1984 Congressman Wiley introduced. H.R. 5739 on behalf of the Bank Board; S. 2700 is the companion bill in the Senate.)

In its recent report on the FHLBB's supervision of the Empire Savings and Loan, the committee agreed that the proposed amendments to the act would be useful and recommended that Congress approve them.[79] (The exact legislation has been reprinted in Hearings (Part 2), pp. 433-452.) The Bank Board's summary of its proposal follows:

> The Change in Control Act should be amended to require the acquiring entity's future business plans to be specified in the application, to be consistent with the safe and sound operation of the institution and not otherwise detrimental to the insurance risk of the FSLIC. The Board should be given the power to condition change in control approvals on any affirmative requirements or pledges that the Board believes necessary.
>
> The coverage of the act should be expanded to provide that potential acquirors must disclose the identity, history, background financial ability and experience of all acquirors and persons who control prospective acquirors.
>
> The conditions under which a change in control may be disapproved should be broadened. First, previous activities conducted by the acquiring person which are detrimental to the insurance risk of the FSLIC should be added to the list. Second, the adverse effect on the public's trust and confidence that may result from a lack of competence, experience or integrity on the part of the acquiring person or affiliated persons should be recognized as an adverse condition which may precipitate disapproval. Third, refusal to furnish information by a person in control of an acquiring person should be grounds for disapproval. Finally, a previous history of business plans which are inconsistent with safe and sound operation or are detrimental to the insurance risk of the Corporation should be grounds for disapproval.
>
> Civil and criminal penalty provisions for violations of the act should be added.[80]

VI. The Detection and Investigation of Insider Abuse

A. PROBLEMS IN DETECTING INSIDER ABUSE PROBLEMS

1. Overview

Insider abuse in financial institutions is discovered in many ways. It can be detected by a secretary who innocently looks through a bank officer's desk drawer when he is away on vacation and finds a stack of uncashed checks. It can be detected by a bank's independent auditor who notices that a major borrower's signature on a loan application doesn't match his signature on a

[79] Reprinted from the "Empire Report", p., 16.
[80] Hearings (Part 2), pp. 10-11.

personal check. Or it can be detected by a teller who knows that the bank's owner has daily overdrafts and anonymously tips off the local police or the FBI.

Very often, however, serious insider abuse first comes to the attention of law enforcement authorities through an alert Federal bank examiner who detects questionable banking transactions during the course of a routine bank examination. Their examinations, which consist of onsite reviews that usually last from 1 to 3 weeks, are designed to (1) verify and appraise the assets and liabilities of an institution, (2) determine compliance with a myriad of banking statutes and regulations, (3) evaluate the quality of management, and (4) consider a number of factors that affect an institution's solvency, such as capital adequacy and liquidity. Through this examination process, the examiner determines the institution's overall condition, based on both his quantitative findings and his subjective "feel" for the institution.

In recent years, the job of the bank examiner, has become increasingly complex and demanding. Whereas examiners used to spend an overwhelming percentage of their time assessing the quality of an institution's loan portfolio, they are now charged with an array of other duties that are expanding along with the powers of financial institutions. As Congressman Spratt remarked at the subcommittee's June 28, 1983, hearing, "Examiners are stretched out in their responsibilities already. They used to be auditors. Now they have to look at community reinvestment, they have to look at truth-in-lending, and they have to look at nuclear evacuation plans, of all things."[81]

Thus, insider abuse is just one of many aspects of an institution's overall condition that the examiner must consider as he conducts a routine examination. Insider misconduct, however, presents a unique challenge to the examiner. Unlike such quantifiable factors as capital or liquidity, insider abuse is not readily apparent from the bank's balance sheet. Instead, it is often deliberately concealed by top officials who are much more knowledgeable about the operations of a particular institution than the examiner and can therefore often disguise illegal transactions or readily "explain" apparent discrepancies.

In addition, the examiner faces another special challenge when he decides to confront the institution's CEO or board of directors with allegations of insider abuse. Whereas bank officials will usually admit problems of solvency or lending practices and be willing to accept an examiner's criticism, they will deeply resent questions about their personal business dealings as an affront to their integrity. This double difficulty of detecting and confronting insider abuse can quickly bring examiners into direct confict with management. It makes them, in a very real sense, the banking agencies' "front-line troops" against insider abuse. They serve as the Government's only organized means of routinely detecting insider misconduct in financial institutions, and, to be effective in that role, they must be trained and equipped to maintain a proper lookout for signs of fraud and to uncover suspicious banking practices.

[81] Hearings (Part 1), p. 147.

It is difficult to determine how well bank examiners detect insider misconduct, since we do not even know how widespread insider abuse is in the banking industry. However, the subcommittee's survey of failed banks and thrifts showed that in two-thirds of the institutions in which the FBI conducted investigations, the banking agencies made no criminal referrals prior to failure. In addition, the agencies' statistics on referrals that they made involving insiders of problem institutions during 1980-81 shows that they made referrals in only 2-4 percent of such institutions. While this clearly indicates that the agencies made very few criminal referrals involving insiders of problem institutions, it does not indicate how many referrals should have been made. Trying to estimate the amount of insider abuse that goes undetected by examiners is like trying to estimate the amount of crime that goes unreported—in each case it is impossible to compile "hard" numbers.

However, the subcommittee's investigation reveals that a substantial portion of all insider abuse and criminal misconduct that does exist does not get detected or reported by the banking agencies in a timely fashion. The committee finds that five major factors serve to hamper current efforts by examiners to detect insider abuse: (1) inadequate training for examiners in "white-collar crime," (2) revisions in the examination process, (3) the failure of examiners to pursue the "paper trail" of questionable loan transactions outside the institution being examined, (4) time pressures and manpower cutbacks on examining staff, and (5) the high turnover rate among experienced examiners in several of the agencies.

2. Inadequate training for examiners

Except for the OCC, the banking agencies do not provide any special kind of training for examiners in "white-collar" crime detection or investigation. All of the former examiners contacted by the subcommittee staff, including OCC examiners, agreed that they lacked adequate training in the intricacies of "white-collar" crime and that the agencies should provide such special training for examiners. One examiner, who recently left the FDIC after 10 years with the agency, stated categorically that "lack of qualifications and training is the single biggest obstacle" to examiners' efforts to reduce insider abuse.[82] Another former examiner estimated that half of all insider abuse is never detected at all by examiners and blamed a good part of this on lack of training. "I used to teach at the FDIC school in Washington," he said "and their 'white-collar' crime training was nil." [83] Donny Ray Palmer, the former OCC examiner testified at the subcommittee's May 2 hearings, that the only OCC training for preparing criminal referrals was simply to look over a past referral made by another examiner.[84]

Federal prosecutors agree that examiners need more training in detecting and investigating "white-collar" crime cases. One prosecutor told the subcommittee of a recent case in which an examiner was assisting him in a criminal prosecution. In looking over the examiner's workpapers, the attorney discovered that the examiner

[82] Hearings (Part 2) p. 1343
[83] Memorandum contained in subcommittee's files.
[84] Hearings (Part 2), p. 106.

had made notes of conversations which he had had with various bank officers and employees, in which they had made certain false statements. The examiner had not realized the statements were not only important evidence of criminal activity, but criminal violations since it is a Federal crime to make false statements to a Federal bank examiner.[85]

In 1978, the OCC first discerned the need for special training in bank fraud and initiated an intensive 1-week training course for its senior examiners. The agency reports that it decided to begin such a special course because:

> National bank examiners are trained and qualified to examine the condition and operation of banks, the ability of management, asset quality, capital, earnings and banking policies and practices for safety and soundness and compliance with banking laws and regulations. Examiners are not, however, trained as criminal investigators. The White-Collar Crime Seminar, itself, is not intended or designed to create skilled criminal investigators such as the FBI. However, in order for the OCC to effectively assist other law enforcement agencies in the detection of bank fraud, national bank examiners must know "what to look for" i.e., must be able to recognize suspicious situations and transactions that may form the basis of a criminal referral.[86]

The OCC has conducted this course ever since 1978. The course is a comprehensive training program that includes (1) a basic overview of the criminal justice system, (2) the differences between criminal proceedings and administrative actions, (3) the identification and preservation of evidence, (4) the role of examiners as witnesses in criminal trials, (5) the restrictions imposed on criminal investigations by the Right to Financial Privacy Act, and (6) specific types of bank fraud, such as computer and securities fraud, money laundering, and nominee loans. It also provides examiners with the rare opportunity to share their common experiences in the investigation of complex fraud cases.

The OCC course is held approximately four times a year, with 30-35 participants in each course. The agency reports that the response by examiners to the course has been "extremely good" and that it currently has a 2-year waiting list.[87] However the course has been limited to senior examiners and therefore does little to assist the junior field examiner.

In contrast to the OCC, none of the other banking agencies has any special training for examiners in "white-collar" crime. The FDIC and the FHLBB both contend that there is no need for such a course. Chairman Isaac of the FDIC stated at the hearings, "We teach white-collar crime, insider abuse and fraud detection in all of our courses. We don't have a special course and we don't feel the need for a special course." [88] In the agency's appendix to Mr. Isaac's written testimony, the reasoning behind this position is set forth:

[85] Ibid., p. 28.
[86] Ibid., p. 227.
[87] Ibid., p. 229.
[88] Ibid., p. 475.

In our view, examination techniques designed to detect fraud and embezzlement cannot and should not be segregated from those employed to assess a bank's internal controls, policies, ethics, employment practices and overall management capabilities. Accordingly, we believe in an integrated approach to assessing the condition of a bank in which detection of fraud is but one element. Our training efforts also reflect this philosophy; thus, the instruction on fraud detection techniques is spread throughout the mandatory schools that career bank examiners attend. A separate training program specifically designed to develop "fraud detection specialists" is not consistent with our programs and is not necessary to carry out our supervisory responsibilities.[89]

The FDIC training materials submitted to the subcommittee, however, fail to reveal any such "integrated approach" or any discussion of specific types of bank fraud, schemes (except check kites), techniques for interviewing witnesses, preparation of criminal referrals, or handling of potential criminal evidence.[90] The FHLBB also acknowledges that it has no special training:

The Bank Board has no written materials or courses for educational training of agency personnel on insider abuse, fraud or criminal misconduct. It must be noted that the ability to detect possible criminal conduct is an acquired talent that an examiner learns "on the job." No amount of formal training makes a "good" examiner; he/she learns the talent by "doing." As you know, the Bank Board, like the Federal banking regulatory agencies, supplements its formal training program by immediately assigning new examiners to assist with ongoing examinations of insured institutions. The examiner learns by doing and learns from the experienced senior examiners on the job.[91]

On the other hand, the Federal Reserve, is reportedly planning a training course for examiners that is similar to the OCC program.

In 1981, the Federal Financial Institutions Examination Council (FFIEC), which was established by Congress in 1979 to promote greater uniformity in bank supervision, considered the possibility of creating an interagency training course on white-collar crime. As part of that process, the OCC and the FDIC conducted an experimental course in September 1981, but it failed because of major differences in the two agencies' "perceptions of their proper role in documenting suspected cases."[92] The FFIEC instructed its Task Force on Supervision to try to resolve the policy differences and to report back to the Council. At the March 4, 1982, FFIEC meeting, the Task Force reported that the agencies still could not reach any agreement. The NCUA and the FHLBB indicated that the training offered by such a course did not apply to situations encountered by their examiners, while the FDIC representative stated that his

[89] Ibid., p. 289.

[90] Ibid., see Appendix 5.

[91] Ibid., p. 1187. Recently, however, the FHLBB has indicated to the subcommittee that it would not "object" to the formation of an interagency training program.

[92] Ibid., p. 1337.

agency simply did not see the need for a comprehensive course.[93] Since that time, no further efforts have been made and the OCC is still the only agency with a white-collar crime course. It appears that the FDIC continues to be the primary obstacle to the creation of a joint training program.[94]

In a recent report on the overall performance of the FFIEC, the General Accounting Office concluded that the Council had been unable to fulfill its goal of standardizing and consolidating examiner education programs, partly because the Council "has not developed uniform principles and standards for examinations."[95] This committee strongly believes the agencies should develop a joint training program on white-collar crime, since many of the topics covered in such a course—fraud schemes, evidence, investigative techniques—are subjects which are common to all financial fraud investigations. Such a course would serve not only to teach examiners the "nuts-and-bolts" of insider abuse cases, but also to convey forcefully to examiners the importance of their role in the detection and investigation of insider fraud.

In addition to their lack of special training opportunities, examiners do not receive adequate guidance from the agencies' examination manuals on dealing with insider abuse and criminal misconduct. From the agencies' materials provided to the subcommittee, there are no comprehensive or practical discussions of the different types of insider frauds, the subtle—yet important—differences between civil and criminal offenses, investigative procedures, or guidelines to help examiners determine when to recommend one type of civil enforcement action as opposed to another. As former OCC Examiner Donny Palmer stated, "Unless examining bulletins or circulars have been issued in the last year, there is still not a definitive guide to assist the examiner in putting together an acceptable referral."[96]

3. Shortcomings in the examination process

The banking agencies have altered their examination procedures in recent years to place less, rather than more, emphasis on the detection of insider abuse. This was done as a cost-saving measure to free examiners from many of the old "tedious, time-consuming audit procedures."[97]

To understand the proper role of bank examinations in the fraud detection process, it is important to keep in mind the difference between examinations and audits. Examinations focus primarily on assessing or appraising various factors, such as the quality of assets or capital adequacy, and not on physically verifying of individual records and assets. In classic accounting practice, the auditor will count the money in a vault or count the number of widgets in a

[93] Ibid., pp. 1338-1342. Attending this FFIEC session was Mr. Edward D. Dunn, Commissioner of Banking and Finance for the State of Georgia, who was serving as the State Liaison Committee's representative to the FFIEC. Dunn expressed his support for the establishment of the joint training course since white-collar crime was becoming a more prevalent problem.

[94] The FHLBB now takes the position that it would "not object" to such an interagency course.

[95] General Accounting Office, "Federal Institutions Examination Council Has Made Limited Progress Toward Accomplishing Its Mission," February 3, 1984. See Hearings (Part 2), p. 1323.

[96] Hearings (Part 2), p. 106.

[97] Ibid., p. 119.

warehouse. This means that independent auditors are more likely than examiners to uncover certain types of fraud, such as forgeries, because they physically verify that documents do, in fact, exist and that they are in their proper place.

Although examiners do perform a limited audit by taking physical possession of the cash, securities, and the general ledger accounts and verifying them, the examiner does not usually go behind the entries to make sure they are correct or to perform other typical audit procedures, such as deposit review, officer check review, or verification of correspondent bank accounts. In the words of one former examiner, these procedures have become "ancient regulatory history."[98] Internal controls—the systems that banks employ to detect internal mistakes and fraud—now receive less attention in exams, in the sense that examiners look to see if there is a "paper trail" for items that pass through the bank, but they do not generally follow that trail to see where it leads or if the assets shown along the trail really exist.[99] That responsibility has been delegated to the institution's board of directors. As Ralph W. Christy, Deputy General Counsel of the FHLBB testified:

> The regulatory examination process itself is not an audit process. It is neither designed or intended to uncover all possible violations of criminal statutes or fraud. The examination is for the purpose of general oversight of institutions regarding compliance with the applicable laws, rules and regulations affecting the business of the savings and loans and the conduct of safe and sound operations.
>
> The Board's role is not to function as a super auditor in the detection of all criminal activity undertaken by individuals within the institution. The Board relies upon the thrift industry itself to detect whether criminal activity has occurred, and Board representatives undertake the responsibility then for investigating and referring suspected criminal violations only where institutions are unwilling or unable to do so.[100]

Despite Christy's statement, the FHLBB does not delegate nearly as much of its audit responsibilities to the institutions as the other banking agencies do. It is the only agency that requires all institutions to undergo an annual independent audit and reviews the quality of those audits. This delegation of most audit functions to

[98] Ibid., p. 128.
[99] Hearings (Part 1), p. 57.
[100] Hearings (Part 1), p. 112. Mr. Christy's testimony raises the interesting question of how effective independent audits are in detecting insider abuse and whether such audits should be required by the banking agencies as one means of improving detection. Several agencies, particularly the Federal Reserve, will occasionally require a bank with suspected insider abuse to appoint a special counsel or hire an outside accounting firm to conduct an audit, in lieu of its own special investigation. Such an approach, however, is a poor substitute for two reasons. First, the accounting firm is hired and paid by the very management suspected of abusive practices. Second, it is hard to imagine that the accounting firm's approach and interests will necessarily coincide with those of the regulatory agency.

There is a genuine difference of opinion among bankers and regulators over the usefulness of independent audits in the detection of insider abuse. Several recent large bank failures—Penn Square Bank and the United American Bank—have been immediately preceded by glowing independent audit reports that clearly failed to detect serious insider abuse problems that existed in those banks. On the other hand, the FHLBB considers mandatory independent audits to have been effective in detecting and preventing insider abuse in thrift institutions.

banks has been strongly criticized by some experts. Professor Spangle testified:

> Such delegation of duties to the bank's board of directors is a hopeless evasion of any possible solution to the problem. If the main reason for problem banks and bank failures is abuse by insiders, to make insiders responsible for discovering such abuses by performing audit functions is like setting a thief to catch himself, and it doesn't work very often, for obvious reasons. Thus, examiners are not emphasizing the discovery of fraud, embezzlement, insider abuses and other crimes. Sometimes they stumble upon them. But to this outsider of the system, it somehow reeks of a "see no evil" mentality.[101]

This approach might be more accurately termed a "follow no evil" mentality. Even when examiners detect suspicious practices, they are discouraged from pursuing leads that might prove abusive or criminal conduct. Federal prosecutors repeatedly stress that abusive practices in banks could be confirmed sooner if examiners would take the time to contact borrowers or trace loan proceeds through other banks. For example, first assistant U.S. Attorney (Chicago), Gregory C. Jones, testified that examiners with whom he had worked were not encouraged to go outside the examined bank to interview witnesses or to check land records. He emphasized that rudimentary checks would be particularly helpful in situations where the examiner suspected wrongdoing but did not have enough evidence to make a criminal referral.[102]

The failure of the Ranchlander National Bank of Melvin, TX.[103] clearly demonstrated how simple inquiries could have uncovered massive insider fraud. Jean Moon, former president of the bank, was eventually convicted of bank fraud after the bank failed in November 1982. At that time, she told Federal prosecutors that she had been "closely questioned" by OCC examiners during bank examinations in 1981 and 1982 about out-of-territory loans and loans which exceeded the legal lending limit. At that time, the bank was actually carrying many fictitious cattle loans with no collateral, but the examiners did not follow up their questions by independently verifying whether the cattle actually existed.[104] The FBI informed the subcommittee staff informally in this case that the examiners could have uncovered these fraudulent loans with "one or two phone calls" to the purported borrowers.

Former Assistant U.S. Attorney Theodore J. MacDonald, Jr., described another situation in which examiners should attempt to pursue "the paper trail" of suspicious loans. In a scheme he termed "airing loans," a bank undergoing an examination may temporarily move or "air out" its bad loans at another bank while the examination is underway and then take them back at a later date.[105]

[101] Hearings (Part 1), pp. 60-61.
[102] Hearings (Part 2), p. 27.
[103] For a more complete discussion of the Ranchlander case, see Section VII.B. of this report.
[104] Hearings (Part 2), p. 45.
[105] This can be done several ways. One technique involves the making of a new loan by the examined bank to a new borrower, who then transfers the proceeds back to the original borrower. Or, a new loan can be made through insiders who also control an affiliated or wholly independent bank that will hold the bad loan for a year or two and then send it back to the original bank. Hearings (Part 1), p. 7.

According to MacDonald, the examiner who notices the transfers or has certain suspicions will often fail to pursue the transaction because the loan was taken out of "his" bank and therefore no longer poses an immediate danger to the bank's capital account.

Such schemes are particularly likely to succeed if the banks involved are regulated by different Federal agencies. MacDonald said that in his part of southern Illinois this technique of transferring illegal loans was so refined that it became known as "running the money through the Wabash River," meaning that the bad loans were moved across stateline from a national bank on one side of the Wabash River to a State bank on the other side of the river.[106] In this way, the crooks could doubly protect themselves by involving two different Federal and two different State regulatory agencies, confident that the various agencies would not pool their information.

Bank examiners themselves confirm that they are discouraged from pursuing leads that involve tracing loans to banks that are regulated by different Federal banking agencies. As former FDIC examiner John Ray testified,

> Concerning the matter of detecting insider abuse and the difficulties faced, I think the major problem that I discern from all of the previous conversation is one of a lack of communication between agencies and *the inability because of policy to cross agency lines. It has been very frustrating over the years for field examiners to come on a situation and pursue it within the confines of that bank's records and then reach a deadend as far as pursuing this further.*
>
> For example, I think if you will look at most of the recent sizable default cases and these failed banks, they involved sizable loans and nominee borrowers and involved a number of other institutions. These crooks are very discerning. They soon recognize how to launder these loan funds from one institution to another and from one institution which is supervised by a different agency. So, I think it is very important that agency personnel be able to cross agency lines. I think this could be effected—you know, it is no big deal if you cross agency lines and if that other agency says, "Fine, but we want to send one of our men with you." I don't see anything wrong with that. In fact, it would probably serve to better inform that agency.
>
> So, I think a change in attitude among the several agencies regarding this sharing of information and regarding this crossing of agency lines is needed.[107] [Emphasis added.]

The FDIC, OCC, and the Federal Reserve have recently attempted to address this issue by adopting procedures to notify the other agencies whenever a bank under their regulatory authority transfers questionable or poor quality assets to another institution.[108]

[106] Hearings (Part 1), p. 6.
[107] Hearings (Part 2), p. 119.
[108] Ibid., p. 329.

While such procedures are helpful, they still do not address the more important issues of encouraging examiners to pursue questionable banking practices or conducting simultaneous examinations.

Longer intervals between exams for most institutions is another recent development which some examiners think has hurt the detection of insider fraud. The FDIC, for example, used to examine all banks at least once a year. Now, banks with CAMEL ratings of "1" or "2" may not be examined but once every 3 years, "3"-rated banks but once every 18 months, and "4" and "5"-rated banks once every 12 months. The purpose of such a protracted examination schedule is to better focus the time and resources of the agencies on problem institutions, but a 2- or 3-year cycle for the majority of banks may be too long if insider abuse does exist and is allowed to worsen for that long. As former examiner Donny Palmer stated,

> The move toward streamlining the examination process during a period of increasing bank failure does not seem to be prudent. While the incidence of insider abuse is on the rise, the manpower and time required to perform a detailed review of all insider relationships which might expose abuse is not feasible; however, it is also unfeasible to alter the scope and frequency of the examination process to coincide with existing manpower during times of crisis.[109]

The agencies should consider ways to increase the efficiency of the examination process without extending the intervals between exams to the point where they cease to be effective in halting abusive practices.

4. Manpower cutbacks, time pressures, and high turnover

The subcommittee discovered a number of internal agency administrative and budgetary problems which seriously affect the ability of examiners to detect and investigate insider abuse. First, examiners complained about facing extreme time pressures in completing exams as quickly as possible. Former FDIC Examiner Anthony D. Doyle stated in his written testimony,

> To further complicate the issue, deregulation has spread the regulatory agencies too thinly to respond adequately to the burdens of identifying insider abuse. The field staffs of the FDIC are much more disadvantaged in dealing with insider abuse than one might realize. Such staffs are usually given the task of examining institutions with just enough personnel to get the job done in the minimum amount of time given the size of the bank.[110]

These time pressures have been caused both by the "streamlining" of the exam procedure itself and by manpower cutbacks.

The FDIC, in particular, has suffered significant cutbacks in its field examining staff in the past few years. The FDIC has been cut from 1,680 positions in 1981 to 1,507 in 1983, a cut of roughly 10

[109] Ibid., p. 95.
[110] Ibid., p. 129.

percent in 2 years.[111] Such manpower reductions, at a time of record number of problem and failed banks, are unjustified and have had an adverse impact on the ability of field examiners to spend the necessary time and resources to deal with insider abuse. The FHLBB, OCC, and the Federal Reserve report no cutbacks during the last year, but their workloads have increased significantly. For example, Federal Reserve officials indicated that the number of bank holding companies under their supervision has increased from roughly 1,500 in 1980 to 4,000 today.

In addition, several of the agencies acknowledge that they have problems with high turnover among examiners. The FHLBB, in particular, has indicated to the subcommittee that its turnover rate for field examiners was 18 percent in 1983, significantly higher than the other agencies.[112]

Many field examiners are hired as young college graduates with accounting degrees who find that working for several years as an examiner is good experience to learn about the banking industry. They often then leave to work for a financial institution, perhaps one that they have previously examined. A number of examiners interviewed by the subcommittee staff expressed the view that the inexperience of young examiners is one major reason insider abuse goes undetected or unreported. These young examiners, they say, can often be intimidated by the imposing and powerful bank officials with whom they come in contact.

One reason for high turnover is that the salaries paid to junior-level examiners are lower than similar career opportunities in the private sector. According to the FHLBB, "Unfortunately, the primary reason that examiners leave the Bank Board is pursuit of a higher salary, and our ability to respond to this particular subject is restricted by the federal government personnel rules and payroll schedules."[113]

The FHLBB attributes a part of its unusually high attrition rate to the lower salaries that their examiners receive, as compared to those paid by the other banking agencies. Statistics provided to the subcommittee by the agencies tend to confirm the FHLBB's claim that its examiners are paid less. The four agencies report that their mid-level or average field examining staff salaries are as follows: (1) FHLBB–$24,755 (GS–10.22), (2) OCC–$30,764, (3) FDIC–$32,585 (GS–12, Step 3), and (4) Fed–$37,900 (includes regional allowances).[114] Although these figures provide only a rough comparison, it seems clear that FHLBB examiners are paid considerably less than those of the other agencies.

5. Recommendations: The proper role for examiners

With the partial exception of the OCC, the banking agencies have not trained or taught their field examiners that insider abuse and criminal misconduct require their extra attention or that it should be pursued during the routine examination process. The

[111] Figures based on subcommittee staff telephone conversations with agency officials and documents contained in the subcommittee files.

[112] The FDIC and Federal Reserve reported turnover rates of approximately 10 percent. The OCC could not provide figures for field examiners.

[113] Hearings, (Part 2), p.694.

[114] See footnote 111.

committee finds such a lack of emphasis on individual misconduct shortsighted and recommends (1) that all examiners receive thorough training in "white-collar" crime, (2) that examination manuals set forth fully the responsibilities of examiners in detecting, investigating, and reporting insider abuse, (3) that examiners be charged with responsibility, under the new procedures set forth in the committee's recommendations, to complete an "Insider Abuse Report" that is separate from their examination report whenever they uncover abusive practices, and (4) that they be given the resources and encouragement to go outside the examined institution to pursue leads of suspected insider abuse.

B. THE FAILURE TO INVESTIGATE INSIDER ABUSE

The banking agencies have broad statutory authority to conduct civil investigations, issue subpoenas, take sworn testimony, and conduct administrative hearings.[115] While recognizing this authority, the agencies have adopted widely differing policies in their use of such authority. On the one hand, the OCC and the FHLBB have developed specific strategies to conduct extensive investigations of insider abuse through the use of special fraud examiners or through formal examinations. On the other hand, the FDIC and the Federal Reserve fail to use either approach except in rare circumstances.

1. Fraud examiners and formal examinations

The OCC has used its special training course in white-collar crime to develop a cadre of special "fraud examiners" who are stationed throughout the country to assist field examiners and to conduct special fraud examinations. Robert B. Serino, the agency's Director of Enforcement, explained their function during an exchange with Congressman Spratt at the subcommittee's June 28 hearing:

> Mr. SPRATT. It would seem to me to be worthwhile creating within your units special auditors, who aren't identified as such, who could be called upon if the team suspected something and didn't have the expertise to follow it up. There would be certain indicia that they would be wary of. Once these indicia provoked suspicion, they would call in this additional assistance.
>
> Mr. SERINO. Mr. Spratt, that is exactly what our fraud examiners are slated to do. What we have done is we have trained several in each regional office of the Comptroller's Office. They go back and examine banks nominally. Then if we have a major problem in a major institution that we need special investigators, we will bring them in separately to conduct this special investigation while the examination goes on.
>
> So, we do use them both ways: One, so that they will have a knowledge of the criminal law generally as they examine banks; and two, for special examinations.[116]

[115] 12 U.S.C. § 1820(c) and 12 U.S.C. § 1730(a)-(j).

[116] Hearings (Part 1), pp. 147–48.

The OCC is the only banking agency to have developed a system for training special fraud examiners or using them to conduct fraud examinations. The committee recommends that the other agencies establish similar units of fraud examiners to conduct full-scale civil investigations of insider abuse.

Another investigative tool available to all the agencies is the formal examination.[117] This process, used to some degree by all the agencies, consists of issuing subpoenas, compelling the production of documents, and taking sworn testimony from witnesses in depositions or administrative hearings. The subcommittee's two surveys show that the Bank Board uses formal examinations more often than any of the other agencies. (Figure 3.) The Federal Reserve, however, uses them so rarely that is has not even developed formal procedure for their use.[118]

FIGURE 3.—FORMAL EXAMINATIONS CONDUCTED BY THE BANKING AGENCIES IN CONNECTION WITH CRIMINAL REFERRALS MADE IN FAILED AND PROBLEM INSTITUTIONS

Name of agency	Failed institution survey		Problem institution survey	
	Number of institutions where agency made criminal referral prior to failure	Number of formal examinations	Number of institutions where agency made criminal referrals	Number of formal examinations
1. FDIC	12	2	16	0
2. OCC	14	1	15	1
3. Federal Reserve	1	0	4	0
4. FHLBB	9	2	15	5
Total	36	5	50	6

FHLBB policy requires that formal examinations be used in most instances where enforcement actions are contemplated:

> Because of the possibility that an association will contest a cease and desist action in a hearing or later in court, it is imperative that we possess evidence to support the charges in the notice of charges that must be given to the affected association. This is the reason why the Office of General Counsel requests an investigation of the facts in most instances, upon a recommendation for the initiation of a cease and desist action. The investigation generally involves the issuance of subpoenas, taking testimony under oath, a search of public records, and obtaining independent appraisals, among other things. *The investigation is the most crucial part of a cease and desist proceeding and requires teamwork and cooperation among examiners, supervisory personnel and OGC attorneys.*[119] [Emphasis added.]

The benefits of formal examinations are apparent. Even if an agency thinks that it already has sufficient information to take civil enforcement action against an individual, a formal examination produces sworn evidence to support the action and may uncover new abusive practices that were never suspected initially. In addition, the examination may produce evidence that would be very helpful to a subsequent criminal investigation.

[117] Such formal examinations are authorized under Section 10(c) of the Federal Deposit Insurance Act and Section 407 of the National Housing Act.
[118] Hearings (Part 2), p. 342.
[119] Ibid., p. 1512.

Formal examinations are the most elaborate types of investigations the agencies can conduct, but they are not the only way to conduct fraud investigations. As mentioned earlier, the OCC uses its fraud examiners to conduct what it refers to as "special" or "extended" exams, where the investigative techniques employed are more extensive than those of the routine exam but are less far-reaching than those of a formal one. The crucial difference between the two types of investigations is that the "special" or "extended" examinations are oriented toward uncovering evidence within the examined institution, while the formal exam is oriented toward producing testimony from witnesses and documents outside the institution.

In the subcommittee's failed bank survey, each agency reported the number of formal exams it had conducted in institutions where the agency had made criminal referrals prior to failure. In the problem bank survey, each agency reported the number of formal exams it had conducted in conjunction with its criminal referrals. The preceding chart shows that none of the agencies relied heavily on formal investigations in either group of institutions, but that the FHLBB used them three times more often than the other agencies.

The other agencies explain their failure to use formal exams in connection with criminal referrals by contending that (1) formal examinations are unrelated to criminal referrals, (2) such exams are time-consuming and expensive, and (3) "special" or "extended" exams provide sufficient information to support either a civil enforcement action or a criminal referral. The OCC, for example, states that

> The determination to conduct such an investigation is made on a case-by-case basis and is not contingent on the existence or potential of a criminal referral. Rather the decision is based on whether an investigation is necessary to develop and document a potential administrative action.[120]

The FHLBB, however, considers such examinations crucial to the development of many of its administrative actions. As one FHLBB enforcement attorney commented, "The 407 [formal] examinations are usually directed at questions of conflicts of interest and insider abuse, questions that cannot be substantiated strictly on the basis of the association's records." [121] It is the very nature of insider abuse that requires the use of depositions and production of customers' documents because the motives of the parties and their verbal agreements are often the only way to document or prove a willful violation of civil banking laws and a disregard for the safety and soundness of the institution. Thus, the agencies' use of formal examinations would indicate their willingness to devote the neces-

[120] Ibid., p. 240.
[121] Memo contained in subcommittee's files.

sary time and resources to go outside the confines of the examined institution to prove individual misconduct that would support a removal or other strong remedial action.

2. Differences among the agencies

As noted above, the OCC and the FHLBB have tried to provide some extra manpower and additional investigative tools to deal with suspected abuse. Several former OCC examiners praised the agency's willingness to devote the extra time and resources needed to conduct "special" investigations. On the other hand, the Federal Reserve and the FDIC have shown a marked reluctance, if not hostility, toward conducting full civil investigations. This seems particularly odd in the case of the FDIC, since it would seem that a deposit insurance agency—which stands to lose money due to insider abuse—would not hesitate to use some of the investigative techniques routinely used by private insurance companies to reduce their losses.

Former FDIC examiners, in particular, have criticized the agency for this. One advised the subcommittee, "Formal investigations are not conducted nearly enough. It is simply a matter of time. . . . You were leery of investigating cases because the FDIC would not back you up."[122] In other words, if the examiners conducted an investigation and uncovered abusive practices, the agency often failed to take civil enforcement action against the individuals engaged in the abusive practices. Another examiner commented that the agency discouraged investigations, particularly if they involved potentially criminal misconduct. "Finding criminal misconduct," he said, "disrupts the whole process in regional offices and delayed things."[123]

The FDIC's failure to investigate insider abuse was evidenced by its inadequate supervision of the United American Bank of Knoxville, TN, which failed on February 14, 1983. During the subcommittee's hearings on UAB, subcommittee Chairman Barnard asked FDIC Chairman Isaac about the agency's reaction to a pattern of questionable and suspicious practices continuing for years prior to the FDIC's simultaneous examination in 1982:

> Mr. BARNARD. It just looks like to me that there never was any pattern of improvement in the bank from the period of time that the FDIC took over up until the time that it was closed. Between one examination and another, there was some small change in the percentage of classified loans but, significantly, it did not appear that there was any real change in management policy from the testimony.
>
> How do you react to that?
>
> Mr. ISAAC. I do not think that the bank ever changed or improved its procedures to the point where you could have considered it anything other than a marginal bank, but I think the bank did improve certain aspects of its operations from time to time in response to the pressures that were brought to bear on it by the Regional Director.
>
> For example, there were several issues of new capital during this period. The 1980 exam showed significant improvement in asset classifications and liquidity.
>
> Mr. BARNARD. At that point could you determine then from that examination—there have been several statements made that they were a lot of transfers of loans and assets in between the Butcher banks. Could this possibly, this improvement that you are talking about, could it have come about because of the sale of some classified loans?
>
> Mr. ISAAC. That is possible.
>
> We are still investigating to find out just what happened and when, but our examiners are aware of some asset shifting that was occurring.
>
> Mr. BARNARD. Did the examination reports indicate possibly that loans were not in existence on one examination in one period that were there in a later examination?
>
> Mr. ISAAC. That, too. We have seen some evidence of that and we are continuing our investigation into that.
>
> Mr. BARNARD. Well, in the event that that was true and that there was a general practice of it, would not that be sufficient indication in itself of question as far as the bank management was concerned?
>
> Mr. ISAAC. If you find it. We did not see any definitive proof of it until the 1982 examination, which was an important reason why we went into 12 banks simultaneously.[124]

[122] Hearings (Part 2), p. 1344.
[123] Ibid.

This committee's report on United American Bank found that the FDIC's examiners had "meticulously recorded" many of the abusive practices that resulted in UAB Knoxville's insolvency, but that the agency failed to exercise its disciplinary powers to halt those practices. In his testimony at the subcommittee's hearings on UAB, Chairman Isaac suggested that the agency did not use its disciplinary powers because it lacked "definitive proof." This committee concluded, however, that lack of proof did not justify doing nothing:

> In reviewing the FDIC's perfomance, the essential point to understand is that even if the Corporation did not have definitive proof of the bank's most abusive practices (i.e., allegations regarding the shifting of bad loans throughout the chain to confuse bank examiners; the use of inflated collateral values for loans; the use of nominees for loans to the bank's principals, et cetera), the results of its regular examination process were sufficiently alarming to cause a prudent supervisory agency to take far more aggressive remedical action than was ever taken by the FDIC. The Corporation's supervisory documents (examination reports, supervisory letters and memorandums of supervisory meet-

[124] Hearings, "Federal Supervision and Failure of United American Bank (Knoxville, Tenn.)," before the Commerce, Consumer, and Monetary Affairs Subcommittee of the House Committee on Government Operations, 98th Congress, 1st Session, March 15 and 16, 1983 pp. 64-65.

ings) establish an overwhelming case of a bank out of control and flirting with disaster.[125]

At the very least, this remedial action should have included a thorough investigation to determine if "definitive proof" existed. Several former FDIC examiners interviewed by the subcommittee staff during the course of the present investigation agreed that for a number of years prior to the 1982 simultaneous examination of the Butcher banks, FDIC field examiners had strong suspicions about UAB Knoxville but were frustrated by the agency's unwillingness to investigate the problem. Former FDIC Examiner Tony Doyle expressed the view that the FDIC's failure to investigate UAB was not an isolated case:

> Insider activities, where they are identified as abusive or not, tend to be monitored for long periods by the regulatory agencies. In the case of the Butcher system in Tennessee, as far back as 1975 and 1976, it was known the United American System was fast-tracked and dangerous. The question was always whether there was abuse or not. At that point in time Butcher-owned banks were examined one at a time with never the feeling that what was seen was all there was. The UAB system was fragmented and examined by different agencies, different field officers and different state agencies. The FDIC could not get along with the Comptroller's office; there were political issues involved at the state level, etc. Memo after memo went into the FDIC offices pointing out the frustration of field examiners in evaluating stock and participation loans. It was always felt if a major coordinated effort was ever made to examine the entire system there would be major revelations that constituted abuse. It took almost six years to orchestrate such a move.[126]

This extended "monitoring" of abusive practices can be seen in many of the failed and problem FDIC banks in the subcommittee's survey.[127]

The FDIC is even more reluctant to investigate insider abuse if the agency makes a criminal referral. In other words, a referral is made in lieu of any civil investigation. In its Examination Manual, the agency gives its examiners the distinct impression that their responsibilities are over at the point a case is referred to the Justice Department:

> It is expected examiners will offer their full cooperation to the investigatory agency. However, examiners are not law enforcement officers and the definitive investigation of criminal matters after notification to an investigatory agency is the jurisdictional responsibility of that agency and not the Corporation.[128]

[125] "Federal Supervision and Failure of United American Bank in Knoxville, Tenn., and Affiliated Banks", 23rd Report by the Committee on Government Operations, House Report No. 98-573, November 18, 1983, pp. 23–24.
[126] Hearings (Part 2), p. 130.
[127] Ibid., see Appendix 5, Part D.
[128] Hearings (Part 2), p. 1617.

According to the agency's General Counsel,

> As a matter of policy, FDIC examiners in potential criminal matters do not conduct interviews or attempt to determine the motives or intentions of the individuals involved.[129]

The clear implication is that examiners are encouraged to curtail their own civil investigation. This policy prevents the agency from collecting enough evidence to take strong remedial administrative action against specific insiders.

The FDIC and the other agencies assert that they should not involve themselves in potentially criminal areas since this would constitute an abuse of their civil subpoena power. For example, FHLBB Deputy Counsel Ralph W. Christy testified, "It is important to note . . . that the Board's investigative and subpoena powers may not be used to investigate suspected criminal conduct." [130] This, however, is not entirely accurate. The case law is well settled that the banking agencies, like other Government agencies with civil subpoena power, have full authority to conduct—and to continue—their civil investigations so long as those investigations are not conducted solely to obtain evidence for criminal prosecutions.[131] Whether or not the agency makes a criminal referral is irrelevant to its own civil investigative responsibilities. The banking agencies are free to conduct extensive civil investigation both prior to, and after, making criminal referrals and to share the results of their investigations with law enforcement agencies.

The agencies' frequent admonition to examiners that they are not supposed to act as criminal investigators has been effective in deterring examiners from performing their legitimate investigatory role. Former Assistant U.S. Attorney MacDonald stated,

> The conclusion I have reached is that the current regulations offer no incentive, nor compulsion, for an examiner to continue to investigate, refer and follow up questionable loans which have been uncovered, but, thereafter, seemingly removed from the bank's books. In fact, I have heard comments by bank examiners to the effect that their purpose in a bank examination is merely to check assets and liabilities and that they are not criminal investigators.[132]

This lack of incentive runs through the entire process, from detecting and investigating abuse to making criminal referrals, and taking civil enforcement action. The examiner is told that any potentially criminal conduct is the exclusive domain of the law enforcement agencies and not a matter of civil concern.

3. Two case studies

Of all the failed and problem institutions studied by the subcommittee, two cases reflect the two extremes of the agencies' interest and initiative in investigating insider abuse. The first involves a

[129] Hearings (Part 1), p. 142.
[130] Ibid., p. 111.
[131] *U.S. v. Lasalle National Bank*, 437 U.S. 298 (1978).
[132] Hearings (Part 1), p. 8.

certain savings and loan association in Texas in which the FHLBB conducted a formal examination in 1980.[133] The second involves the Metropolitan Bank & Trust Company of Tampa, Florida, which failed on February 12, 1982. There, the Federal Reserve negligently failed to conduct a timely or effective investigation of insider abuse, despite extensive evidence and repeated warnings that insider abuse existed in the bank. The two cases offer an interesting contrast in how two banking agencies have responded, in specific instances, to allegations of abuse.

a. The Texas Savings and Loan case

According to the testimony of Gerald F. Chapman, staff counsel with the FHLBB Office of General Counsel, the Texas Savings and Loan involved (hereafter "the association") had been a chronic supervisory problem for at least 6 or 7 years prior to the formal exam. An earlier formal examination had been conducted in 1974–75, in anticipation of cease and desist proceedings which were brought against the association in 1975. Between 1975 and 1979, there was limited improvement in the association's compliance with the terms of the 1975 order. Then, in 1979, a routine examination revealed suspected violations of the 1975 order and, in addition, an unusual number of large loans that appeared to be going to corporations controlled by, or benefiting, the chairman of the board. In addition, the examiner suspected that some of the association's problem assets were "disappearing" from its books and being recirculated in different forms. He recommended that a formal examination be conducted. This recommendation was forwarded to Washington, and the full Bank Board approved it in December 1979.[134]

An investigative team, headed by an attorney from the Enforcement Division in Washington, issued subpoenas to several of the association's major borrowers who were closely associated with the chairman. The borrowers resisted the subpoenas and the Board was forced to seek enforcement of the subpoenas in Federal court. After a delay of several months, the investigation continued, new subpoenas were issued, and depositions were taken. The 11–12 month investigation resulted in both the chairman and the president being forced to resign and to sign consent decrees barring them from participating in the affairs of any federally savings and loan without the agency's prior permission.

At this point, the agency wrote a lengthy and detailed criminal referral, setting forth the illegal transactions in which the insiders had been involved, and encouraged the U.S. attorny to prosecute the case. Over the next 6 months, the agency worked with the FBI agent and the assistant U.S. attorney who were handling the case and one of the FHLBB attorneys testified before the Federal grand jury. In the end, however, the U.S. attorney's office decided to drop the case without seeking any indictments. (For a discussion of this declination, see Section VIII., Part E.4., of the report.)

[133] The subcommittee agreed with the agency that it would be unfair to individuals involved in this case to reveal their identities, although they were the subject of criminal referrals and investigations, because they have never been formally charged with any crimes.
[134] Hearings (Part 2), p. 186.

In this case, the formal examination was the only adequate means of solidly documenting suspected violations of the 1975 cease and desist order and of proving that the individual misconduct of the president and chairman of the association was substantial enough to warrant removal actions. The examiners suspected large-scale fraud, but needed to examine customers, records outside the institution and to take sworn testimony in order to get definite proof of fraud. In the opinion of the Bank Board, the case was improperly declined by the Justice Department, but the formal investigation achieved the originally intended result, i.e., to remove the principals from this particular institution and from the thrift industry in general. It is fortunate that the Bank Board conducted a formal exam and took strong civil action because, as it turned out, theirs was the only enforcement action that was ever taken against these individuals.

b. The Metropolitan Bank & Trust Company case

The story of the meteoric rise and fall of the Metropolitan Bank & Trust Company of Tampa, Florida, is a lengthy, but fascinating, tale of real estate speculation, mismanagement, insider fraud, and regulatory neglect. The bank, which was a member of the Federal Reserve System from its founding in 1974 until its failure only 8 years later in 1982, grew so fast that by the time it failed, it was the fourth largest bank in Tampa and the fifth largest bank in the country to fail between 1980 and 1983.[135] Although the story of its fall has been overshadowed by the larger failures of Penn Square and UAB-Knoxville, the impact of the failure has been felt, not only in Florida but in many other parts of the country. It resembles these other failures in that the Federal supervisory agency failed to take timely and effective remedial action to deal with insider abuse, just as the OCC failed to take effective action against Penn Square and the FDIC failed to take action against UAB. Estimated FDIC losses in the bank exceed $10 million.[136]

The group of Tampa businessmen that joined together in 1974 to form Metropolitan included Don Regar, the president of another Tampa bank, the Marine Bank & Trust. He left Marine to join the new bank as president, a job which he alone occupied until the bank's final months. From the beginning, Regar was known as an aggressive, dynamic individual who promoted the idea of a king-sized bank for himself and the community. On opening day, the founders managed to sell enough subscriptions to bring the new bank's initial capitalization to a phenomenal $11 million, and had 600 customers line up to deposit $6 million before the day was over.[137]

Although Regar ran the bank the whole time, the bank's original ownership changed hands over the next 2 years. Originally financed by a group of local businessmen, including several prominent Tampa attorneys, the bank was sold—through Regar's help—to an Ohio real estate magnate named Edward J. DeBartelo, Sr. DeBartelo's vice president for Florida operations, former Tampa

[135] The FDIC lists the bank's assets at the time of failure as $260,797,000.
[136] Hearings (Part 1), p. 289.
[137] Hearings (Part 1), p. 468.

mayor Dick Greco, was installed as chairman of the board in 1978, even though he reportedly admitted to knowing nothing about banking.[138] From that time on, the fortunes of Metropolitan began a steady decline until it failed in 1982.

Over the past year, the subcommittee has compiled hundreds of pages of confidential bank records and agency documents and interviewed various Florida bankers, law enforcement agents, State and Federal bank regulators, and even Allen Z. Wolfson, the mastermind behind the fraud that ultimately destroyed the bank. The Federal Reserve refused to provide the subcommittee with crucial documents it needed to learn what really transpired in the bank during 1979–80. The agency also refused to provide the names of examiners who conducted examinations of the bank and refused to let the subcommittee staff talk directly with certain key agency staff in Atlanta who had direct personal knowledge of the case.

Despite this lack of agency cooperation, the subcommittee concludes that the Federal Reserve was negligent in its supervision of Metropolitan, because it failed to (1) conduct a full investigation in 1979–80 of the questionable banking practices which it knew, or should have known, existed in the bank, and (2) take timely action to remove or discipline the president and other insiders whom the agency knew were engaged in misconduct.

A combination of factors eventually destroyed Metropolitan, but unlimited access by insiders and certain customers to the bank's assets was the primary cause. One of the main sources of trouble was Allen Z. Wolfson, a fast-talking "wheeler-dealer" who had been convicted in 1978 for bribing James Porter, the president of the Key Bank of Tampa. After his 1978 conviction, Wolfson simply moved his base of operations to Metropolitan. According to a 1982 Tampa Magazine article, Wolfson was soon playing a major role in running the bank's affairs:

> That Wolfson should find the Metropolitan Bank was no quirk of fate. He had been specializing in real estate developments since the early seventies. It was his business to know what banks were lenient with loans, and Don Regar was well-known in financial circles for exactly that kind of leniency. . . .
>
> * * * * *
>
> It was almost a daily occurrence in 1980 and 1981 for Wolfson to pull up at the bank in his $40,000 pearl-gray Lincoln stretch limousine—driven by his black chauffeur, Fred, and financed by the Metropolitan—and stroll from office to office, greeting people and chatting amiably about business. Wolfson was Don Regar's de facto bad-loan work-out specialist. Wolfson would often assume the notes on bad business loans with the aim of turning the business around. It apparently did not bother Don Regar that his work-out specialist had already been adjudicated guilty of defrauding one bank.[139]

[138] Ibid., p. 472.
[139] Hearings (Part 1), p. 471–472.

Beginning in 1978, Wolfson became increasingly involved in the bank's affairs until, at one point, he and his friends were reported to have accounted for nearly one-half of the bank's $160 million loan portfolio, most of it backed by grossly inflated real estate appraisals.[140] Wolfson pled guilty in June 1984 to numerous charges, including conspiring with Regar to defraud the bank and borrowing bank funds to purchase illegally the bank's own stock. At the time this report goes to press, Regar is still awaiting trial on similar charges.

Throughout the period from 1979–80, the Federal Reserve failed to take timely and effective action to investigate highly suspicious and questionable banking practices and allegations of insider criminal misconduct. The agency finally speeded up its routine exam schedule "late in the game," but only after the Organized Crime Strike Force came to the Federal Reserve in early 1981 and presented the results of its investigation involving the bank. However, by the time that the February 1981 examination was completed and a cease and desist order put into effect in June, it was too late to save the bank. Seven months later, it failed.

Beginning as early as 1975, and continuing up to its June 30, 1980, examination, the Federal Reserve received a steady stream of information about suspicious activities inside Metropolitan that should have served as "red flags" to warn the agency about seriously abusive practices in the bank. According to confidential documents obtained by the subcommittee, the Federal Reserve was aware of the following:[141]

(1) In February 1975, the Federal Reserve received information that Metropolitan was involved in purchasing low quality loans from Don Regar's former employer, Marine Bank and that $2.9 million in loans had been made by Metropolitan to persons who had been large borrowers at the other bank. In addition, these loans at Metropolitan were listed as substandard and doubtful in the 1975–77 examination reports.

(2) In 1975, the Federal Reserve learned that the bank had made a number of questionable loans to American Agronomics Corporation and to persons associated with the company, after the company had been suspended from trading by the SEC.

(3) In April 1977, the Federal Reserve considered making a criminal referral against Regar because Marine Bank had filed a $6 million claim against Regar for fraudulently handling seven loans totaling approximately $14 million, while he was at Marine Bank. The agency finally decided to do nothing because "the FBI was already aware of the matter," and the agency's own review "did not produce sufficient indication of criminal misconduct."

(4) In the summer of 1976, the agency became aware of irregularities concerning the bank's attempts to acquire American Guaranty Bank. Having been turned down in its own offer to purchase the bank, Metropolitan financed a private individual to purchase a controlling interest in the bank and then purchased that person's stock. (American Guaranty merged with Metropolitan in 1978.)

[140] Ibid., p. 482.
[141] Hearings (Part 2), Appendix 14.

(5) In 1976, the Federal Reserve learned that Metropolitan's owner, Edward DeBartelo, Sr., had violated Florida banking laws in his acquisition of another bank that was closely associated with Metropolitan. This other bank (hereafter "Bank B") was already suffering difficulties, due in part to its acquisition of over $800,000 in bad loan participations from Metropolitan.[142]

(6) Bank B, which was also a Fed member bank, shared several top insiders with Metropolitan. In September 1977, the agency discovered a numbr of serious unsafe and unsound banking practices and insider abuses in Bank B. One of the transactions involved Bank B's purchase of real estate contracts which (1) were already delinquent at the time of purchase, (2) were supported by inadequate documentation, and (3) constituted a serious conflict of interest existed among the participants, one of whom was currently an officer at Metropolitan.

(7) In January 1978, the Federal Reserve's exam of Metropolitan revealed that while the bank's overall condition was satisfactory, its 44 percent concentration of real estate loans was considered "excessive" and its management was rated "fair," due to Regar's history at Marine Bank of "concentrating heavily in real estate-oriented loans and that this practice, coupled with an economic downturn, had caused severe loan losses in that bank." The examiner also noted that an excessive number of loans were not supported by current and/or adequate credit information.[143]

(8) In July 1978, the agency became aware of hazardous liquidity problems at the bank, and that the ratio of loans to loanable funds exceeded 100 percent. As a result, the bank had been placed on a monthly reporting schedule by the Florida comptroller.

(9) In March 1979, the agency received a personal visit from the commissioner of the Florida Department of Law Enforcement, and his counsel, Mr. Richard Hackmeyer, who were very concerned about certain information which they had received about unsafe banking practices at Metropolitan and about major shareholders and borrowers of the bank who were already the target of an FDLE investigation and whom they considered to be closely associated to organized crime figures.[144] The FDLE officials informed the agency that the American Agronomics loan still appeared to be lacking adequate collateral, that a particular company with known ties to organized crime had become one of the bank's largest shareholders, and that they suspected money laundering and other illegal activities were going on in the bank. They indicated that they were restricted in providing any more specific information about the allegations, but that what they had provided to the agency was "only the tip of the iceberg."[145]

(10) The same month, March 1979, the Federal Reserve itself examined Metropolitan and discovered that the overall condition of the bank had deteriorated. Violations of Regulation O were noted

[142] Supporting evidence for points numbered 4, 5, 6, and 8 are derived from confidential documents in the subcommittee's files.

[143] The subcommittee requested the Federal Reserve to provide the "Comments and Conclusions" sections of this exam report and the two subsequent exams. The agency refused to provide this information, but allowed a subcommittee staff member to view "summaries" of these sections and to take notes from them.

[144] Hearings (Part 2), p. 171.

[145] Information derived from documents in the subcommittee's files.

and the same problems of inadequate loan documentation, excessive concentration in real estate, lending policies, management, and liquidity that had been problems in the previous exam were still present. The bank's liquidity had become such a severe problem that this factor was rated "marginal."

(11) In March 1980, the agency was informed that one of the insiders identified by FDLE officials had exceeded the bank's legal lending limit by $500,000.

Thus, by the June 30, 1980, examination, the Federal Reserve was aware of a number of suspicious banking practices and serious allegations from law enforcement agents about the reputation and criminal connections of major insiders. The June 30 exam should have prompted a prudent supervisory agency to conduct a full and immediate investigation. According to the agency's own reports, the bank's condition had deteriorated to the point where it was clearly a "problem" institution. Its worsening condition was due to a number of factors, including (1) the continued high concentration of bad real estate loans, (2) a decline in its capital account, due partly to excessive dividends paid to the holding company and various insiders, (3) poor management, specifically the lending practices of Don Regar, (4) poor earnings, and (5) a serious liquidity problem. According to the exam report, the bank's liquidity position placed it in the lowest 5 percent of banks in its peer group with respect to liquid assets and interest-sensitive funds. In addition, the examiner was concerned about the bank's unhealthy relationship with Bank B. He noted that the same people controlled both banks, that both the holding company and Bank B had large sums of deposits with Metropolitan and there appeared to be a number of bad loans being passed between the banks through participations. In particular, he noted the excessive dividends that had been paid to the small group of interlocking directors, and the excessive management fees they were paid.

Even if the Federal Reserve lacked "definitive proof" of criminal misconduct, the agency should have launched its own civil investigation at this point. Comparing the Federal Reserve's response with the Bank Board's response to the questionable loans in the Texas case, the conditions that prompted an investigation in the FHLBB case were no more questionable or alarming than those that existed in Metropolitan.

What makes the Federal Reserve's response to insider abuse in this case so disturbing is that at this very time—June 1980—Metropolitan submitted an application to the Federal Reserve to purchase the First Bank & Trust Company of Belleair Bluff, Florida. Instead of conducting an investigation or denying the application, the agency approved the application, on condition that the bank pay no more dividends to the parent company and that the bank attain a 7 percent gross capital to total assets ratio by the end of 1980. Six months later, when the FBI informed the agency about its investigation of Regar and Wolfson, the agency withdrew its approval for the acquisition.

It is clear that if the Federal Reserve had conducted a full investigation of Metropolitan in June 1980, it would have walked right into the very activity for which Allen Wolfson has pled guilty to

and for which Regar is now awaiting trial. The agency would have discovered, among other things:

(1) That the bank was in the process of making unsound loans to Wolfson and other persons to invest in a Miami options trader's "get-rich-quick" scheme that eventually cost Metropolitan millions in losses;

(2) That the bank was lending half of the money in the bank [146] to Wolfson and his related interests, much of it in real estate loans that lacked adequate appraisals or documentation;

(3) That Wolfson and Regar were arranging loans that were supposedly for real estate development, but which were really intended to help them and their friends buy up control of Metropolitan; and [147]

(4) That Wolfson was violating State election laws by soliciting illegal campaign contributions, which were collected—according to Wolfson—on behalf of the bank.

Records indicate that this illegal activity was at its height during 1980, at the very time that Federal Reserve examiners were examining the bank.

In addition to its failure to investigate insider abuse at the bank, the agency was also slow in taking action against Regar and other corrupt officers after the FBI had confronted the agency with hard evidence of Regar and Wolfson's criminal activity. When it did finally take action, it proceeded against the institution itself and not against Regar. Although the FBI approached the Federal Reserve at the end of 1980, a cease and desist order was not issued against the bank until 6 months later in June 1981. Finally, on September 29, Regar resigned, on the day that the Federal Reserve staff prepared a removal order against him. The bank failed 4 months later. To this date, the agency has imposed no civil money penalties or taken any other action against Regar.

The agency's apparent lack of interest in removing Regar surprised at least one of the FBI agents working the case. He stated that he asked the Federal Reserve examiner working on the case in early 1981 why the agency didn't remove Regar. "I never got an answer," the agent said.[148] By the time that Regar was forced to resign, the action was almost irrelevant. Since the bank was on its "deathbed," there was little effect that Regar's ouster could have had to improve the condition of the bank. The time for effective action had passed.

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[146] If the banking agencies routinely shared information on insider abuse with each other, the Federal Reserve examiner would have immediately suspected something as soon as he saw the name of Allen Wolfson. The OCC regional office in Atlanta and the FDIC regional office were both well aware of Wolfson by 1980. Wolfson had borrowed funds from Metropolitan in 1979 to purchase two banks in Tennessee, the First National Bank of Rhea County (Spring City, TN), and the Southern United Bank of Polk County (Benton, TN). Wolfson managed to buy both banks immediately prior to the effective date of the Change in Control Act of March 1979. He did this in order to escape the provisions of the new law, having been convicted of bribing a bank official in Florida in 1978.

The agencies knew about his conviction but decided that there was nothing they could do to prevent his acquisitions. At a later date, Wolfson attempted to become chairman of the board of the national bank. The OCC and FDIC disagreed about whether they could prevent this, since his conviction had never become "final." The OCC, in the end, insisted that he could not become an officer and Wolfson finally withdrew his application.

Wolfson sold his Tennessee banks when he began to experience serious financial troubles in 1982.

[147] Hearings (Part 2), p. 1904 and documents in subcommittee's files.

[148] Subcommittee staff interviews with FBI agents. Memo contained in subcommittee's files.

4. Proposed solutions

Some critics have looked at the agencies' poor record of investigating insider abuse and suggested that this responsibility should be taken away altogether and given to some other agency. As Professor Spanogle stated,

> I recommend to this committee that the responsibility for discovering criminal violations be given to someone other than the bank regulatory agencies, because the bank regulators don't want it . . . and if you continue to place this responsibility on them, they are not going to do it well.[149]

Former prosecutor MacDonald suggested in this testimony that a separate investigative branch of the agencies be created to ferret out abuse. Others have recommended that a single examining agency be created in order to reduce the lack of interagency communication and coordination.

Although such suggestions have merit, the immediate concern should be to focus the agencies' attention on the need for more adequate and timely investigations and on the need for examiners to realize their special responsibility in this area. Regulatory changes may ultimately be appropriate and beneficial, and Congress should consider such changes in due course.

C. THE FAILURE TO KEEP ADEQUATE RECORDS ON INSIDER ABUSE

1. The impact of inadequate records

The banking agencies are seriously handicapped in their efforts to detect and investigate insider abuse or to prevent its occurrence through change of control applications, by their failure to keep adequate records on individuals who engage in such abuse. None of the four agencies has a comprehensive, up-to-date computer information system. The agencies' regional offices do not have immediate access to their own agency's data recordkeeping system or those of the other banking agencies, concerning (1) insiders, institutions, or customers who have been previously identified with insider abuse or criminal misconduct, (2) the status of pending civil investigations or enforcement actions, and (3) past and pending change of control applicants.

Without such information, the agencies' efforts to locate and halt insider abuse are bound to fail because they do not have the basic, readily retrievable records needed to keep track of corrupt and dishonest individuals. Try to imagine how effective the FBI or the SEC would be as law enforcement and regulatory agencies if they maintained no centralized files on individuals who have been convicted of crimes or who have some connection with a prior investigation by these agencies. To take a simple example: Assume that an OCC examiner suspects Mr. Jones, the president of First National Bank, of embezzling bank funds. If the examiner wants to conduct a preliminary investigation, he has no effective way of fining out whether Mr. Jones has been the target of a civil enforcement action by the OCC or a criminal referral by another Federal

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[149] Hearings (Part 1), p. 61.

banking agency. The examiner may know that Mr. Jones was part of a group of individuals that sought to purchase a bank in another State, but doesn't know where the bank was or which agency regulated the bank. The examiner has no quick or reliable way of determining if another agency disapproved Mr. Jones' change of control application or why it was disapproved. Instead, the examiner must rely on the memories of his associates in the agencies' regional offices or must try to track down the right FBI agent or assistant U.S. attorney in the right judicial district and hope that that person remembers the case.

In addition, examiners rarely know what happens to their own referrals, whether the regional counsels ever send them to the Justice Department or what happens to a case after it gets to the Justice Department. One examiner commented that making criminal referrals was "like dropping something into a Black Hole—it never comes out again."[150]

At the June 28, 1983, hearing, the subcommittee requested the banking agencies to report the number of criminal referrals they had made since 1981 and the number of those referrals that had resulted in indictments or convictions. None of the agencies could provide this information. The following is a brief description of the information that they were and were not able to provide:[151]

The Federal Reserve.—kept no central records at all and had to compile information from each of its 12 Reserve Banks. There was little uniformity in what each bank provided as to the types and amount of information; usually the reports did not include the statutory section that was violated in each case, the dispostion of the referrals, or any information on referrals under $10,000.

The FHLBB.—kept no centralized records at all, but sent two reports. The first listed all referrals made by the Washington office, regardless of amount, with the date of each referral, the position of the individual, and a brief description of the offense; it did not include the amount of the defalcations or the dispositions of the referrals. The second report actually consisted of 10 separate reports from each of the regional offices. Each was different, but they generally failed to provide the position of the individual, the amount of the defalcation, or the State where the institution was located. None provided the dispositions of the referrals.

The OCC.—was unable to provide any records at all. Neither the Washington office nor the regional offices kept any composite records. The agency stated that all referral information was contained in each national bank's file and that to compile such information for the subcommittee "would require a search of the files of each region, subregion, or district office for each of the approximately 4,600 banks, for each year."[152] Instead, the agency simply provided an estimate of the total number of referrals made by national banks themselves and by the OCC.

Since the date of that hearing, the FDIC and the OCC have begun efforts to improve their recordkeeping systems for tracking insider abuse. While neither system constitutes an adequate data

[150] Confidential memo in subcommittee's files.
[151] Hearings (Part 1), see Appendix 1.
[152] Hearings (Part 1), p. 250.

base, the agencies' efforts indicate that at least they recognize this serious informational gap.

2. The FDIC's 50,000 index cards

The FDIC's recordkeeping system on insider abuse consists of 50,000 index cards and matching files. The Special Activities Section of the agency maintains the system, which actually consists of two distinct groups of records. The first is called the Bank and Proposed Bank Irregularity Records System and consists of files on officers, directors and employees of FDIC banks or proposed banks who have been the subject of criminal referrals or who have been the subject of FBI checks.[153] (The FBI regularly performs such checks for all FDIC proposed bank and change of control applicants.)

The second group is called the Change in Bank Control Ownership Records System and contains files on individuals who file change of control applications or who have obtained loans from FDIC banks where such loans are secured by 25 percent or more of the bank's outstanding stock. The information contained in these files includes the number of shares of stock involved in the transfer, the personal background of the applicant, any proceedings pending against the person, his business plans, and any changes of the institution's management within 1 year of change of control.

The FDIC Special Activities Section receives copies of all criminal referrals and all change of control applications and files both types of records together in one large alphabetical file. Although the system combines both types of information on specific individuals in one location, it has obvious shortcomings that accompany any manual filing system. For example, there is no cross-reference with bank's files. Thus, it is impossible for the office to take a particular bank and locate all of the criminal referrals or change of control applicants that have been connected with that bank.

Within the past 6 months, the Section has also begun recording and filing information on persons who have been subject to (1) FDIC civil money penalty, removal, or other enforcement actions and (2) FDIC fidelity bond or officers' and directors' liability claims.

The agency claims to have "installed" a computer system this year that improves the capability of the agency to track its criminal referrals.[154] However, as this report goes to press, the computer equipment has arrived, but no one has been hired to operate or even design the software program. It is also unclear what information will be included in the system, whether it will be compatible with, or accessible to, the other banking agencies' computer systems, and whether sufficient staff will ever be hired to fully operate the new system.[155]

3. The OCC's computer system

In May 1978, the OCC proudly announced that as part of its increased efforts to fight insider abuse, it was launching a new com-

[153] The record system also contains other miscellaneous data, such as actions taken against money brokers and municipal securities dealers.
[154] Hearings (Part 2), p. 284.
[155] Memo contained in subcommittee's files, based upon conversations with FDIC officials.

puter system to track criminal referrals. According to a story which then appeared in the American Banker,

> The Office of the Comptroller of the Currency has developed a computer system to track criminal activity against national banks. The system, scheduled to go into effect next fall, would permit the agency to retrieve reports on specific violators and violations, the status of individual criminal cases and historical records on specific banks. The national bank regulator is considering providing the information on a routine quarterly basis to the Justice Department.
>
> The monitoring plan would also provide a primary base for statistical information requested by Congress, as well as provide the agency's regional offices with updated information on the status of criminal referrals, according to the national bank regulator.[156]

More than 5 years elapsed, however, before this system became operational in March 1984 (9 months after the subcommittee's first hearing on insider abuse). Despite this delay, the OCC's new system is probably the single most important step taken recently by any of the banking agencies to improve their investigative efforts against insider abuse. The system, called the Enforcement and Compliance Information System, is designed to track the status of three groups of criminal referrals: (1) all referrals made by the OCC, (2) referrals made by national banks that involve bank management officials, and (3) all other major criminal referrals that involve lower-level employees and customers. The file on each referral includes the following information: (1) the date of the referral, (2) the name and address of the institution, (3) the name and position of the person referred, (4) the statutory violation, (5) the expected losses, (6) the name of the OCC attorney making the referral, (7) the name of the OCC examiner who detected the misconduct, (8) the name and position of the Justice Department official to whom the referral is made, (9) the post-referral disposition, and (10) the OCC administrative action taken against the person and the current status of that action.[157] The responsibility for completing this form and updating it lies with the attorney who has responsibility for handling the referral.[158]

Although this new system is a vast improvement in the agency's recordkeeping, it still does not include information on any OCC referrals prior to 1984, criminal referral information from the other banking agencies, or other important data, such as change of control applications.

4. Compiling and sharing other information

Although the FDIC and the OCC have begun to make significant improvements in their recordkeeping systems, they and the other banking agencies are still a long way from having comprehensive files on insider abuse. The FHLBB, the OCC, and the Federal Reserve do not maintain any centralized, alphabetical records of new bank charter applications, change of control applications, or the FBI checks that usually accompany these applications. Only the FDIC has made the important link between referral records and change of control records by combining these records in its 50,000 index card system.

[156] Hearings (Part 1), p. 454.

[157] An important feature of the program is that the information can be formatted by bank, by statutory violation, or by State, thus making it a useful investigative tool.

[158] Hearings (Part 2), pp. 722–723.

The other agencies' failure to compile new bank and change of control applications ignores an important source of information on insider abuse. For example, suppose that an examiner is considering making a criminal referral on Mr. Smith, a bank official. If the examiner could consult a master file, that file might show that Mr. Smith was the subject of a criminal referral 2 years ago and that he also filed a change of control application 6 months ago. With access to such data, the examiner would be able to gather a significant amount of information from one source and allow him to conduct an adequate investigation.

At present, the agencies' review of change of contol applications inevitably leaves much room for errors and oversights. Although the agencies do clear all change of control applications through their national offices, the applications are reviewed largely by the regional offices.[159] Therefore, it is unlikely that a regional office is in a position to learn derogatory information about an applicant from the other agencies' regional offices or from national headquarters.

It would be very useful for an examiner to have immediate access to the agency's records of (1) past enforcement actions against individuals, and (2) pending civil investigations and enforement actions. None of the agencies, except possibly the OCC, can presently interface such information with its criminal referral files. The OCC's new computerized referral system appears to come close to having this capacity. The agency's larger computer system includes a program for tracking all pending enforcement actions. Using that system, it is possible to find out the current status of an enforcement action that is being considered or that is in litigation, the name of the attorney handling the case, and the names of the parties. A computer user can therefore simply switch "libraries" and gain access to either the criminal referral files or the case tracking files. Such a capability also enables a manager to coordinate civil and criminal enforcement actions and to share such information quickly with regional offices and other agencies. Such a system is essential to hold agency staff accountable for timely and effective civil and criminal enforcement action.

One of the greatest obstacles to the effective civil investigation of insider abuse is the agencies' difficulty in sharing such information with each other. This objective, which would be a simple administative problem in a single agency, has become a major enforcement obstacle to the four separate banking agencies.

The banking agencies have gradually increased the amount of insider abuse information that they share with each other, but such efforts are not effective because the agencies keep so few computerized records. For example, the FDIC, the OCC, and the Federal Re-

[159] According to the Federal Reserve, both the Reserve banks and the Washington office review all applications.

serve[160] now share change of control applications and advance notice of formal civil enforcement proceedings. However, these exchanges accomplish little since none of the agencies has access to the kind of centralized computer systems that can generate, utilize, or store information on these thousands of documents. What good does it do, for example, if the Federal Reserve sends a copy of Mary Smith's pending change of control application to the OCC for comment if the OCC keeps no centralized alphabetical list of its enforcement orders? In a case such as this, an OCC regional office may recognize Mary Smith's name, remember that she was the subject of a criminal referral 3 years ago, and alert the Federal Reserve, but this is not likely to happen.

5. The need for an interagency system

The FDIC and the OCC have recognized the need for improving their recordkeeping systems to compile centralized records on insider abuse. On the other hand, the Federal Reserve and the FHLBB have shown a noticeable reluctance to institute centralized recordkeeping, largely on the ground that such records would violate privacy and constitute illegal "blacklists" under the Privacy Act of 1974. As Governor Partee of the Federal Reserve stated:

> It should be pointed out that the banking agencies routinely exchange examination and related supervisory reports in accordance with applicable statutes. These reports contain information on the background and performance of bank management and directors and are used in connection with our supervision of banks and our review of notices of changes in bank control. This less formalized exchange of reports with our sister supervisory agencies assists us in identifying potential situations in which an individual of questionable background could have an adverse effect on a banking organization. While not perfect, we believe this approach is preferable to the maintenance of formal lists which may be subject to error, misuse, or inadvertent disclosure, and which could, in turn, deny an individual due process or unfairly damage his reputation.[161]

For this reason, the Federal Reserve apparently keeps no centralized records on any individuals.

The OCC, on the other hand, supports the concept of a centralized records system. Mr. Robert B. Serino, Director, Enforcement and Compliance Division, testified that the effectiveness of the OCC's new computer system will be limited if it does not include information on the enforcement and referral activities of the other banking agencies:

> The best solution would be a central system in the Department of Justice or someplace else, where all of these referrals go so we could cross-reference them. Then when Bob Serino has been referred from the credit union, if he is also referred when he leaves the credit union and goes to

[160] The Bank Board is formulating procedures to join in these exchanges of information. See draft proposal, Hearings (Part 2), pp. 453–459.
[161] Hearings (Part 2), p. 314.

> an FDIC bank, his name can be held in a central location. That is the kind of computer system I think is essential.[162]

The committee is well aware of the privacy implications of such a centralized computer system and recommends that the agencies work together to establish a system that fulfills the legitimate civil enforcement needs but does not infringe upon the important privacy rights of the American public.

The computerized information system used by the Securities and Exchange Commission should serve as a model for the type of interagency system the banking agencies need to establish. Most Federal securities enforcement is concentrated within the SEC's Enforcement Division, which maintains two computer systems. The first, called the Case Tracking System, tracks all pending investigations and enforcement proceedings, so that top supervisory personnel within the Division can instantaneously know the current status of each case, who is responsible for the case, and how long the case has remained at a particular stage. Such a system provides an excellent management tool that encourages efficiency and allocates agency resources where they are most needed.

The second, called the Name Relationship System, contains data on the thousands of individuals and corporations that do business each year with the SEC. These files include the names of persons who have been the subject of civil investigations, disciplinary proceedings, or injunctive actions. It also serves as an important investigative tool. As John Fedders, Director, SEC's Enforcement Division, stated in his testimony:

> A young man comes in from law school. He is beginning his work at the Commission. He gets a name, Mr. X. We're going to take Mr. X's testimony. Does the young attorney have to begin de novo with his inquiry about Mr. X?
>
> If we've taken this chap's testimony before, the young attorney can go to the computer, find out every time we have taken Mr. X's testimony before, and where those previous testimony transcripts are.[163]

Fedders feels strongly that these two complimentary computer systems are essential to the agency's effectiveness in securities enforcement:

> We are operating in the computer age. Law enforcement has to have computer capabilities to be effective and we designed our program so that I can function as a manager. On at least an every 2-week basis, I am in a position to know the status of every one of the 739 investigations [in our office]. Without these capabilities, I would not be effective; the Commission could not continue its growing enforcement volume.
>
> Two years ago in fiscal year 1982, Congress saw fit to cut the Commission's enforcement budget 6 percent, but with the computerized capabilities that I have described to you,

[162] Hearings (Part 2), p. 146.
[163] Hearings (Part 2), pp. 132–133.

we increased the number of cases that we brought by 30 percent over fiscal year 1981.[164]

The banking agencies cannot expect to increase their civil enforcement efforts unless they increase their productivity and improve their ability to conduct sophisticated investigations of insider abuse. For these reasons, the committee recommends that the banking agencies establish an interagency Task Force on Insider Abuse in Financial Institutions, which should develop, as one of its highest priorities, an interagency computer system for the exchange of information on insider abuse and criminal misconduct among all the banking agencies.

VII. The Criminal Referral Process

A. INTRODUCTION AND OVERVIEW

1. Description of process and objectives

The banking agencies' criminal referral process begins at the time a bank examiner first detects insider abuse that may involve criminal violations, extends through the agency's processing of referral of that misconduct, and ends with the final disposition of that referral by the Justice Department. Usually, at the beginning, an examiner will note the suspected criminal misconduct in the comments section of the examination report and bring it to the attention of the institution's management and request that the institution itself make a criminal referral to the Justice Department. Sometimes, the examiner will initiate an agency referral, and not wait for the institution to act if the misconduct is serious or if the financial institution fails to make a referral.

At the FDIC, a referral usually consists of a ½-page form, "Report of Apparent Criminal Irregularity", which the examiner fills out and which contains (1) the name of the suspect, (2) the names of associated persons, (3) the nature of the irregularity and description of transactions, (4) a description of evidentiary materials (and their location), (5) additional remarks, and (6) the name of the examiner, sometimes with additional pages attached. The examiner also prepares a cover letter to the U.S. attorney. The examiner then sends this package to a regional office or district office, which may or may not forward it to the appropriate U.S. attorney. The Home Loan Bank Board (FHLBB) usually follows a similar procedure, with examiners filling out a Form 366, although the Bank Board enforcement attorneys actually prepare most major referral letters. At the OCC, the examiner prepares a memorandum, often 2 to 3 pages, attaching summaries of his findings, which is then sent to the OCC district counsel, who prepares the letter to the U.S. attorney. The Federal Reserve banks follow a similar procedure.[165] The examiner's role in the process is limited, particularly at the FDIC, the FHLBB, and the Federal Reserve banks.

At the agencies' district or regional bank levels, legal staff will review the information and issue the referral letter to the appropriate U.S. attorney, with copies to the local FBI offices and occa-

[164] Ibid., p. 134.
[165] Hearings (Part 2), pp. 1627–49, for sample referrals from each agency.

sionally to the Justice Department's Fraud Section in Washington, D.C. (if more than $50,000 is involved).[166] The legal staff primarily determines that sufficient evidence exists to proceed, that the referral is in the proper format, and that the information is not so detailed as to require notice under the Right to Financial Privacy Act, or if it is, that notices are sent to the customers whose records are affected. (See Part C., below.)

In the referral letter the agencies offer to provide assistance. At this point, unless the U.S. attorney or the FBI requests assistance, the agencies' involvement often ends.

The subcommittee's investigation reveals serious deficiencies in the criminal referral process, the primary objective of which is the timely sharing of sufficient information between the banking agencies and the Justice Department to initiate Justice's investigation of allegations of criminal misconduct, and if warranted, eventual prosecution. As First Assistant U.S. Attorney Gregory Jones (Chicago) testified, the real problem with inadequate referrals and ineffective agency assistance is that the agencies are not, through whatever channels exist, sharing information back and forth between their staffs and the Justice Department.[167] As U.S. Attorney Bob Wortham (of the Eastern District of Texas) testified, "even though [the agencies] have that expertise, if it is not being given to us and shared with us, it is not helping us in criminal prosecutions."[168] Wortham elaborated on the lack of agency referrals in his district:

> First, Mr. Jones has brought up that we have a lack of communication between the investigative agencies. Mr. Chairman, I tell you that is a total lack of communication. We have not received any information from any of the investigative agencies on any major case. Once we start an investigation and get some people convicted, we then may get some referrals on lesser cases.[169]

Mr. Wortham testified that his district received approximately 80 referrals a year involving banks (small thefts, embezzlement, misapplication, etc.) but that only 10 to 15 percent of these referrals "come from the . . . referring agencies. Most of them, the majority of them come from the victim banks themselves."[170]

The referral process encompasses more than just providing timely and adequate information to Federal prosecutors and the FBI. It extends to agencies' promoting and monitoring referrals they have already made. Former Assistant U.S. Attorney Ted MacDonald contrasted the banking agencies' failure to "sell" their referrals with the active promotion by other agencies:

> This contrasts with typical referrals received by U.S. attorneys from U.S. Postal authorities, the FBI or DEA,

[166] In 1982 the Bank Board "streamlined" its procedures by transfering the criminal referral function for all but detailed referral letters resulting from the findings of formal investigations, which function remains with the Office of General Counsel, to the District Office of Examinations and Supervision. Hearings (Part 1), p. 121.
[167] Hearings (Part 2), p. 89.
[168] Ibid., p. 90.
[169] Ibid., p. 37.
[170] Ibid., p. 36.

> which even after the referrals have been made continue to sell their cases with numerous followup calls and letters. Too often the Comptroller [of the Currency] and FDIC merely make the referral required under the statute and then do nothing further.[171]

Securities and Exchange Commission's Director of Enforcement, John Fedders, told the subcommittee of his efforts for SEC referrals:

> When you work with the Department of Justice, you can't expect these criminal prosecutors to have the same experience that you have on a day-to-day basis, so we solicit. I am in the selling business when I deal with a prosecutor. I go out and I sell him my cases; I sell him an interest in what we are doing and how it helps him. Anytime you tell a man how you are going to help his career, you have his ear and you have his interest. I take the attitude that all U.S. attorneys are running for Governor, and I try to give them cases that will help them become Governor.[172]

2. Referral statistics

The subcommittee asked the banking agencies for the numbers of agency referrals made in the period January 1, 1981, through May 1983. The data furnished by the agencies, while not uniform, revealed the following:[173]

Agency:	Number of referrals
Federal Reserve	2,048
FDIC	*208 **312
FHLBB	1,167
OCC	172
NCUA	26

*Includes only referrals over $10,000.
**Penn Square and UAB.

The Federal Reserve System's and the Bank Board's numbers are high for two reasons. First, the Federal Reserve Bank of San Francisco referred over 1,043 possible criminal violations involving amounts under $10,000, primarily teller and other lower level employee embezzlements. Like the Federal Reserve banks, the Home Loan Bank Board refers many cases of alleged teller embezzlements involving relatively small dollar amounts. Therefore, these numbers do not reveal the extent of referrals for criminal misconduct by officers, directors, or shareholders.

More revealing are the number of problem institutions out of which the banking agencies made referrals, since insider loans and insider abuse are a relatively common feature in problem bank situations.[174] The subcommittee's survey of the banking agencies revealed:

[171] Hearings (Part 1) p. 8.
[172] Hearings (Part 2), p. 134.
[173] Hearings (Part 1), p. 285. These numbers were compiled from data reprinted on preceding pages in the hearing record and from data in the subcommittee's files.
[174] Hearings (Part 2), p. 1628 (OCC referral letter).
[175] Ibid., pp. 5-6. The subcommittee's survey revealed 99 actual criminal referrals in the years 1980 and 1981, ibid., p. 21. However, these referrals implicated individuals in only 74 financial

Continued

> [I]t is clear from the statistics provided that [the banking agencies] make criminal referrals involving insiders in very few problem institutions. Out of 946 problem institutions in 1980, the agencies made referrals involving individuals in only 23, or 2 percent.
>
> In 1981, out of 1,275 problem institutions, referrals were made in only 51 institutions or 4 percent.[175]

FDIC Chairman Isaac reacted to these relatively low numbers in the same way the subcommittee initially reacted and stated:

> I don't understand your number. I can't believe that there are only 51. The number is inconceivable. . . . [Even excluding verified bank referrals] I suspect the numbers are understated. I don't know how you arrived at that number.[176]

B. INSUFFICIENCY OF INFORMATION IN REFERRAL DOCUMENTS AND ITS IMPACT

1. Inadequate information

U.S. attorneys and the Justice Department Criminal Division officials repeatedly complained to the subcommittee about the inadequacy of bank agency referrals. The subcommittee staff informally interviewed 24 Federal prosecutors and most believed in one way or another that agency referral documents were "perfunctory or brief and concise, but in any event, not that helpful", particularly those of the FDIC.[177] The panel of U.S. attorneys testifying at the subcommittee's May 2, 1984, hearing confirmed these observations.

The subcommittee's review of sample referrals from all the agencies confirms the paucity of information in referral documents, particularly those issued by the FDIC, the Federal Reserve System, and, to a lesser extent, the FHLBB.

The FDIC instructs its examiners to make brief, "bare bones" referrals. The FDIC told the subcommittee, "By law most referrals must be brief. . . ."[178] Throughout its Examination Manual (Section S), the FDIC repeatedly emphasizes that the examiner should state only essential facts (on the ½-page irregularity report form) and express no views, analysis or conclusions as to the guilt or innocence of the suspected party.[179] All of these cautionary warnings and limitations, here and elsewhere in FDIC materials, can only

institutions. At times additional evidence will come to light during subsequent examinations or an agency will make a separate referral on each insider implicated in one institution, resulting in several referrals for one institution.
[176] Ibid., p. 469. For the statistics provided by the agencies, see Hearings (Part 2), Appendixes 2 and 5. After the hearing the subcommittee verified the accuracy of these compilations.
[177] Ibid., p. 859.
[178] Hearings (Part 1), P. 193. The FDIC was unable to cite any law other than the Right to Financial Privacy Act, discussed shortly.
[179] Ibid., p. 1616.
[180] Buried deep in the FDIC's examination manual is the following statement, which does recognize the need for more detailed referrals:
"Particularly in cases involving large amounts . . . or where implicated bank officials remain in the employ of the bank, the cover letter might contain a concise, persuasive statement of the nature of the offense and significance of the irregularity to the condition of the bank. Such a statement may gain the immediate attention of the U.S. Attorney and cause an investigation to be promptly initated." (Hearings (Part 2), p. 1617.)
We found no evidence that the FDIC issues such referrals, although it may do so occasionally.

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serve to make the examiner overly cautious and results in little information in the actual referral document.[180]

On the other hand, most OCC referrals are detailed and explain the factual circumstances giving rise to potential violations, including the names of individuals, detailed summaries of the transctions giving rise to the misconduct, and lists of supporting documentation. OCC's representatives at the subcommittee's June 1983 hearing testified:

> We [OCC] believe that a successful prosecution requires a comprehensive and detailed referral that explains the violation in a form easily understood by a prosecutor with no banking expertise. That takes an extraordinary amount of time; however, it enhances the chances for a successful prosecution.[181]

All of the agencies blamed the restrictions of the Right to Financial Privacy Act, 12 U.S.C. §§ 3401–3422, for the limited information in referral documents. That act, discussed fully in Part C., below, prevents banking agencies and financial institutions from generally transferring to the Justice Department information derived from customer bank records or the actual records themselves, unless the customer (including an insider) is notified of the transfer.

The Committee agrees that there are serious problems with the act and that the act should be amended. Nevertheless, the FDIC's, the Bank Board's, and the Federal Reserve's unreasonable perceptions of the act's restrictions explain their failures to make adequate referrals. The OCC makes detailed and thorough referrals because the OCC interprets and applies the act less restrictively and more reasonably in light of specific exemptions in the act.[182] Basically, the OCC recognizes and utilizes frequently the exception in 12 U.S.C. 3413(a), effectively allowing the transfer of customer record information if such information "is not identified with or identifiable as being derived from the financial records of a particular customer." The other agencies narrowly interpret this exception or disregard it and they invoke the act generally as a pretext for their inadequate referrals.

The Home Loan Bank Board explained to the subcommittee how it tries to provide adequate information under the act.

> Mrs. STEWART [FHLBB's Chief of Enforcement]. I don't want to leave the impression that because the Financial Privacy Act is burdensome that it in any way restricts or keeps us from making criminal referrals. It does not. We feel we make very detailed referrals and if necessary, we

[178] Hearings (Part 1), P. 193. The FDIC was unable to cite any law other than the Right to Financial Privacy Act, discussed shortly.

[179] Ibid., p. 1616.

[180] Buried deep in the FDIC's examination manual is the following statement, which does recognize the need for more detailed referrals:

"Particularly in cases involving large amounts . . . or where implicated bank officials remain in the employ of the bank, the cover letter might contain a concise, persuasive statement of the nature of the offense and significance of the irregularity to the condition of the bank. Such a statement may gain the immediate attention of the U.S. Attorney and cause an investigation to be promptly initated." (Hearings (Part 2), p. 1617.)

We found no evidence that the FDIC issues such referrals, although it may do so occasionally.

> send the notices to the people that are required to get them. . . .
>
> * * * * *
>
> Mr. SPRATT. There seems to be a disagreement among the regulatory agencies as to exactly what you can provide in the way of referral information.
>
> Mr. Keeney says in his testimony that the OCC tends to take a less conservative view of the act and accordingly provides somewhat greater detail in its referral. You indicate that you don't feel constrained and you provide more. On the other hand, FDIC in previous testimony said by law most referrals must be brief and cannot include copies of bank records. The type and amount of information that can be referred to the Justice Department is restricted by the Right to Financial Privacy Act of 1978.
>
> Mrs. STEWART. *It is a matter of policy.* That information could be provided if customer notices were sent to the people who were named in those exhibits. That is the choice.[183] (Emphasis added.)

Clearly, the banking agencies have flexibility and can provide more information in their referral documents, often without providing notice to customers.

2. Impact on Justice Department's investigation and prosecution

An assistant U.S. attorney in Los Angeles, who has reviewed a large number of banking agencies' referrals, told the subcommittee staff that these referrals are not sufficiently detailed and lay out the barest factual situations, and that consequently "this [lack of information] usually leads you to believe that it is not a serious problem when it very well may be." [184] Given the press of handling more Federal agency referrals than can ever be fully investigated, let alone prosecuted, Federal prosecutors will give more urgency to other cases. At the subcommittee's May 2, 1984, hearing, Assistant U.S. Attorney Joseph Hartzler described how inadequate referrals resulted in lower priority:

> . . . it is not so much a problem of resources, but resources are always necessarily limited, and so the individual line assistant that has a substantial case load, at least in the Chicago office, has to decide his own particular priorities. And the priorities, of course, are based many times on the nature of the crime. . . . But when there is not any particular top priority crime that that particular line assistant is devoting his attention to, then he devotes [it] to cases which are frankly packaged best, and so frequently the bank referral cases come to us without any attractive packaging, very, very much unlike tax cases, for example.
>
> * * * * *
>
> When the IRS refers a case, it sets out the exhibits, the tax returns, interviews with various witnesses, the various

[183] Ibid., p. 860.

[184] Ibid., p. 860.

income items. It is a very thorough report, and for a young assistant whose time is somewhat limited and somewhat pressed, frankly, it is very easy for me to take that package home over the weekend and work on it. It is unlike a bank referral case where I have a large number of documents that are maintained in a file in my office, and I can't really get access to them except when I am sitting at my desk. So, . . . you might consider how the referrals . . . could be beefed up and packaged with frankly more sex appeal for the Department of Justice.

* * * * *

. . . I think if they are packaged more substantially, there was more meat in the package, it would be more comprehensible.[185]

Deputy Assistant Attorney General John Keeney (Criminal Division) testified that U.S. attorneys have complained to him about the "cumbersome nature of the process" and compared banking agency referrals unfavorably with those of other agencies such as the Postal Service and Secret Service. Kenney testified:

> . . . U.S. attorneys who receive these referrals are simply unable to make a fully informed evaluation of a case without resorting to grand jury process. The requirement of intervention by a grand jury before even initial assessment of the case can be made is unparalleled in the Federal law enforcement system. In most cases these communications difficulties are overcome on a case-by-case basis, but we have a genuine concern that occasional prosecutions which might otherwise be brought remain neglected because of the initial difficulties encountered in obtaining pertinent information in the first instance.[186]

Inadequate and untimely referrals have contributed to the consequent neglect and the low priority which the Justice Department has accorded many of these cases, fully discussed in Section VIII. of the report.

C. IMPACT OF THE RIGHT TO FINANCIAL PRIVACY ACT ON THE REFERRAL AND INVESTIGATIVE PROCESS

1. Overview

The investigation and prosecution of "white-collar" crimes generally and banking violations specifically require a thorough analysis and review of documentary evidence.[187] Often, in bank fraud cases, falsified documentary evidence is the crime itself or documentation revealing financial transactions is the only readily available evidence of the larger crime. During the course of an examination, a banking agency will uncover evidence revealing possible criminal violations by bank officers or directors, such as (1) kickbacks for making loans, or (2) misapplication or misappropriation of bank funds by making loans directly to themselves (often using false doc-

[185] Ibid., pp. 87–88.
[186] Ibid., p. 557.
[187] Ibid., pp. 1741–2.

umentation) or through fictitious or nominee borrowers. Often the crucial financial records pertaining to such fraudulent loans or other financial transactions are "customer records", since both borrowers and depositors are customers within the meaning of the Right to Financial Privacy Act ("RFPA"), even though the "customer" may be an insider who has committed a criminal act.

The need to make that customer's financial records and information derived from them available to law enforcement authorities gives rise to the problems with the RFPA. In the course of their supervisory, regulatory, or monetary functions, banking agencies have access to such information and documentation. However, under 12 U.S.C. § 3412 the banking agencies can transfer this financial information to the Justice Department (and State law enforcement authorities), as long as (1) such information is relevant to a legitimate law enforcement inquiry and (2) the agency provides notice to the affected customers within 14 days. Alternatively, under § 3413(a), the agency can provide customer record information in a referral without giving notice, as long as such information is not specifically identified to the particular customer, if that is feasible.

2. Problems with giving notice under the RFPA

Although a financial institution's officer or director (or an outside co-conspirator who may technically be a "customer") will receive the agency's notice after the transfer of his or her financial records information to the law enforcement agency, such persons are in a position to destroy, alter or generate bank records, particularly those which were not copied by the examiner, or otherwise obstruct an investigation. The OCC advised the subcommittee:

> Subsequent to the passage of the RFPA, the Department of Justice has consistently maintained that the prosecution of bank-related crime is uniquely vulnerable to frustration as a result of premature disclosure of criminal investigations. Not only can evidence disappear and witnesses fail to come forward, but defenses can be manufactured through the generation of new, fraudulent evidence. Consequently, the Department of Justice prefers that OCC-referrals be accomplished through techniques that do not trigger the post-transfer notice provisions of the Act.[188]

Thus, the notice serves as a warning to the target of an investigation and effectively can close off a number of traditional investigative techniques which might otherwise be employed by law enforcement officials. We question whether advance warning can ever be an appropriate privacy requirement in the context of ongoing criminal investigations.

Also, this ex post facto notice can also alarm and confuse innocent customers "who become upset at the receipt of the formally worded letter about a matter of which they are completely unaware," [189] and in which they are not implicated.

[188] Hearings (part 2), p. 248.
[189] Ibid., p. 395.

Either the banking agency or the Justice Department can seek to delay such notice if it knows and can prove that certain emergency situations jeopardizing the investigation exist and are imminent. However, an agency rarely discovers such a situation until it is too late.[190]

The subcommittee's analysis of information on the total number of agency notices under the RFPA reveals the following: the Bank Board sends notices to between 50 and 100 customers per year.[191] The number of actual customer notices given by OCC is unknown; however, OCC did state that in 1983 notices were given in connection with only 4 referral/investigations.[192] The FDIC instructs its examiners to furnish notice if the referral is detailed,[193] and in 1983 FDIC furnished notice to 18 customers in 10 cases which confirms the lack of detail in most FDIC referrals.[194] The Federal Reserve provides so little information in its referral documents that it has never had to provide notice to customers.[195]

The committee believes that the RFPA can reasonably be interpreted and applied so that much more information can be provided by the banking agencies, in a fashion similar to the OCC's detailed referrals, without the need to furnish notice. Nevertheless, there will be times when an agency believes it must give notice and should. This decision to give notice is too important to be made by the agency alone, because of the potential to seriously jeopardize an investigation. Before an agency gives notice in a serious insider criminal misconduct case, it should consult informally with the appropriate U.S. attorneys office, to discuss the degree to which evidence is preserved and complete, without divulging identifying information. For example, if an agency believes that it has uncovered "only the tip of the iceberg" of criminal misconduct, then the U.S. attorney may want to proceed and obtain information by grand jury subpoena or search warrant and may want a less detailed referral in order not to alert the suspected insiders. Decisions to send notice should not be made lightly.[196]

Unfortunately, and incredibly, the FDIC Examination Manual effectively requires examiners to give another form of notice in connection with almost all possible criminal referrals. The Manual instructs examiners, upon discovery of a criminal violation, (1) to notify immediately the senior executive officer—provided he or she is not involved, and also (2) to notify directors of the involved bank of criminal misconduct, near the completion of the examination—immediately if serious or involving key management. Even if the persons notified are not directly implicated, in all probability they

[190] Under 12 U.S.C. § 3412(c) and § 3409, the Justice Department or the banking agency may seek a court order to delay such notice indefinitely, if there is reason to believe and supporting evidence that such notice would result in the destruction of or tampering with evidence, intimidation of potential witnesses, flight from prosecution, obstruction of justice, or other serious activities jeopardizing an investigation. Unfortunately, this is not a viable solution. Not only is it burdensome, but, more importantly, the agency will have to know, before the fact, that a genuine emergency exists; often this cannot be determined until after the fact, when evidence has been altered or destroyed. Hearings (Part 2), p. 145; see also p. 248.

[191] Hearings (Part 2), p. 396.

[192] Ibid., p. 253–4.

[193] Ibid., p. 1617.

[194] Ibid., p. 300.

[195] Ibid., p. 354.

[196] The OCC's policy and procedures manual does indicate that OCC or the law enforcement agency may wish to delay the notice 14 days, as allowed under the act. Ibid., p. 1698.

will communicate these events to the insiders implicated, allowing them sufficient time to alter or destroy records or otherwise impede a future investigation.[197] Such notification directly contravenes good investigative technique and may jeopardize a subsequent criminal investigation. FDIC should revise its instructions, so that examiners at least consult with their supervisors or agency attorneys prior to alerting top management about suspected criminal activities involving officers, directors, or other insiders.

3. Different agency interpretations and applications of RFPA: Historical context

The RFPA took effect in March 1979 and immediately created much confusion. The Federal Reserve and the FDIC both questioned their implied authority to make any referrals of criminal misconduct whatsoever, and few, if any, referrals were made. (This is when the agencies began to rely increasingly on financial institutions to make referrals and to require that proposed agency referrals be reviewed by legal counsel.) The agencies were particularly concerned about provisions in the RFPA that authorized civil penalty violations and OPM disciplinary action against agency employees who wilfully violated the act.[198]

Clearly, the agencies overreacted. Section 3412(a), Title 12, provides such authority; it states:

> (a) Financial records originally obtained pursuant to this [act] shall not be transferred to another agency or department unless the transferring agency or department certifies in writing that there is reason to believe that the records are relevant to a legitimate law enforcement inquiry within the jurisdiction of the receiving agency or department. [Subsection (b) requires the furnishing or notice.]

What troubled the banking agencies was the absence of a provision similar to § 3403(c), which conferred on financial institutions the specific authority to make referrals without notifying bank customers:

> (c) Nothing in this [act] shall preclude any financial institution, or any officer, employee, or agent of a financial institution, from notifying a Government authority that such institution, or officer, employee, or agent has information which may be relevant to a possible violation of any statute or regulation.

One commentator has written about the conflicting agency interpretations of the RFPA:

> In many respects, the RFPA is ambiguous. For example, although Congress did not intend to prohibit the reporting of crimes when the reporting financial institution is the victim, the RFPA is vague as to precisely what a bank official may tell the FBI about a bank robbery, a case of loan fraud or an embezzlement. Moreover, though the RFPA

[197] Ibid., p. 1616 and 1300.

[198] See, for example, OCC's directive on this. Hearings (Part 2), p. 1684.

> was part of a twenty-two title omnibus measure strengthening federal regulation of financial institutions, the act has created uncertainty as to how federal financial supervisory agencies can report criminal banking offenses to the Department of Justice for investigation and prosecution. Even the . . . federal financial supervisory agencies disagree as to how a criminal case can be reported to the Department of Justice; reporting varies, therefore from agency to agency.[199]

The agencies went in different directions, primarily because of confrontation between the Justice Department and the Congress. On July 17, 1979, the Justice Department issued a 6-page Advisory on the act, which was sent to most of the Nation's financial institutions, in reaction to the reluctance of both financial institutions and banking agencies to make referrals.[200]

While addressed to financial institutions, the 1979 Advisory's criteria and guidelines also apply to the banking agencies, since both agencies and institutions operate under the same restrictions of what can be provided. The Advisory states that the following information can be disclosed to a Federal law enforcement agency:

> (a) the name(s) and adddress(es) of the person(s) suspected and his (their) relationship with the financial institution, if any;
>
> (b) the identity of the financial institutions(s) or offices(s) thereof involved;
>
> (c) the specific offense(s) suspected;
>
> (d) the name(s) and address(es) of the account holder(s) and the account number(s) and type(s) of account(s) in which evidence of the suspected offense(s) is located; and
>
> (e) a general description (dates and any suspicious circumstances) of the transaction(s) involved in the suspected offense(s).[201]

Also, on July 17, 1979, Deputy Attorney General Civiletti sent to the OCC a memorandum from the Criminal Division and a memorandum from Justice's Office of Legal Counsel, which contended that the banking agencies had "implied authority" to provide the information set forth above in their criminal referrals, without sending notice to customers. Accordingly, OCC changed its policy to include more information.

However, in February 1980 and May 1980, in two separate letters, a total of 20 members of the House of Representatives communicated their disagreement with Justice's interpretations of the act, and subsequently GAO issued a draft report disagreeing with Justice's position. These representatives contended that very little information could be provided in a bank agency criminal referral document without providing notice to the customer involved.[202]

Subsequently, in response, Deputy Attorney General Renfrew issued a letter on July 3, 1980, refuting the May 9, 1980, letter

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[199] Ibid., p. 1757.
[200] It is reprinted at Hearings (Part 2), pp. 1687-93, and also Hearings (Part 1), pp. 156-61.
[201] Hearings (Part 2), p. 1696.
[202] See Ibid., pp. 246-48.

from 15 Members of Congress. However, Renfrew's letter had minimal impact. OCC advised the subcommittee:

> While some financial supervisory agencies chose to follow the Congressional view, OCC did not and, instead, adhered to the Department of Justice's position. . . .
>
> * * * * *
>
> Efforts during the summer of 1980 by the Federal Financial Institutions Examination Council to develop a unified position among the financial supervsiory agencies were unsuccessful, and to our knowledge the division of opinion continues to this day.[203]

OCC's Chief of Enforcement, Bob Serino, summarized this "tug-of-war" at the May 3rd hearing:

> When we went along with the Department of Justice's recommendation, we got a letter from the Congress saying we should not go along with the Department of Justice's recommendation. We decided that since they were our lawyers, we would go along with the Department of Justice's recommendation.
>
> Significant disagreement continues, and if you can resolve it, it would do wonders for our law enforcement community.[204]

Pursuant to OCC's interpretation of the act and in reliance on Justice's 1979 Advisory, the OCC had advised its staff that they could include the following in referrals:

> This notification may also include an *analysis* of the information described, together with an analysis of the significance of the suspected offense. While the description and analysis may not be so detailed as to eliminate any need for law enforcement access to actual records, it should be sufficient to enable Federal authorities: (1) to reasonably describe records needed in the investigation; and (2) to determine that there is reason to believe such records are relevant to a legitimate law enforcement inquiry.[205]

OCC then specified how the OCC regional offices could provide detailed and fully explanatory referral documents, without triggering the notice requirements:

> Before the matter is referred to another Federal agency, *all* identifying details as to the customer involved must be eliminated. This may include the customer's name, the account number, the bank involved or any other details which permit the customer to be identified from the summary prepared by the examiner on the records attached. Consistent with these requirements, the facts of the suspected violation should be fully detailed. . . . The privacy of the individual is protected because the information

[203] Ibid., p. 248.
[204] Ibid., p. 539.
[205] Ibid., p. 1696.

> cannot be traced to him. The memorandum, without the identifying details, can then be transmitted to another Federal agency.[206]

The OCC's directions are correctly based on 12 U.S.C. § 3413(a), which allows the disclosure of financial records and information derived from such as long as it

> . . . is not identified with or identifiable as being derived from the financial records of a particular customer.

Of all the banking agencies, the OCC has the clearest and most reasonable interpretation of the act, and interestingly, the OCC has the clearest directives to examiners on referrals and the applicability of the RFPA.[207]

In its completely different approach, the FDIC emphasizes the limited "amount" of referral information that can be transferred to the Federal authorities without having to notify the customer, and the FDIC therefore instructs its examiners to make the referrals "brief". While it is true that specific indentifying information may not be included in a criminal referral in order to avoid customer notification, the RFPA does not limit the *amount* of information in the referral.[208]

In sum, except for the OCC, the banking agencies are not following a reasonable interpretation of the RFPA. Nothwithstanding these agencies' ability to provide better and more comprehensive referrals if they interpreted the RFPA more reasonably, the heart of the problem is the RFPA, particularly as applied to insider criminal misconduct. As the OCC stated:

> The net result is that the initial Department of Justice decision whether to commit investigative resources to a referred case is still made in many instances based on less information and expertise than would be the case in the absence of the RFPA. . . . [T]he RFPA has imposed that cost without perceivable benefit to customers.
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> * * * * *
>
> . . . The chief reason is that the RFPA imposes its primary restriction on a criminal referral by limiting the information communicated in the initial referral and raising the likelihood that the Department of Justice will decide not to pursue the case.
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> * * * * *
>
> Consequently, the only cases that are likely to be fatally "hindered" are those that the Justice Department fails to initiate a full investigation, [because if one is initiated, the RFPA will become irrelevant through use of a grand jury subpoena, not requiring notice under the act.] [209]

In effect, Congress has accorded customer financial records a special status which no other type of documentary evidence possesses,

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[206] Ibid., p. 1697.
[207] See, for example, OCC's "policies and procedures manual" excerpts, Hearings (Part 2), pp. 1694–1701.
[208] See Hearings (Part 2), p. 1729, for further discussion on this point.
[209] Ibid., p. 251–2.

including tax returns, medical records, etc. We question whether Congress foresaw that the main consequence of the act would be less vigorous and effective investigation and prosecution of insider criminal misconduct. Constraints upon law enforcement agencies' access to information should be no greater than absolutely necessary. The RFPA's constraints are greater than necessary or desirable.

The act's legislative history reveals that its primary purpose was to protect the confidential relationship between banks and their "arms length" customers, not insiders who also happen to be customers.[210] In some instances, in fact, a person's status as a customer may be due primarily or entirely to his illegal financial relationships with bank officials. Such a relationship to the bank should not give rise to the same level protection accorded "arms length" customers.

4. RFPA's impact on referrals by financial institutions

The RFPA and its overly restrictive interpretations by financial institutions has resulted in inadequate institution referrals.[211] The RFPA has had a chilling effect on the willingness of financial institutions to make criminal referrals, or to provide sufficient information in the ones which they do make, because of their fear of possible civil suits under RFPA [212] and the possible loss of customer goodwill.

The lack of adequate referrals from financial institutions has hindered law enforcement efforts, particularly the investigation and prosecution of insider bank crime. Although the Justice Department issued the Advisory on July 17, 1979, to alleviate this situation, problems still persist.[213]

Federal prosecutors confirmed this problem. New Mexico's U.S. Attorney, William Lutz, testified:

> In producing records, our experience has been in New Mexico that banks tend to be quite conservative under the Financial Privacy Act. Generally to secure any records from the bank involving insider abuse, we must do so through grand jury subpoena. In many cases, technically the information we are requesting does not come within the terms of the bank privacy act even on a broad reading.[214]

Several assistant U.S. attorneys told subcommittee staff that banks will often invoke the RFPA and fail to cooperate in furnishing requested information, even after a referral is made. As one Federal prosecutor stated, "It is an easy excuse for them to rely upon." [215]

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[210] *Congressional Record,* May 7, 1977, pp. 13721–13722.
[211] Part D of this section, below, discusses the inadequacy of bank and thrift referrals to law enforcement agencies, and criticizes their use as a substitute for bank agency referrals.
[212] 12 U.S.C. § 3417, reprinted at Hearing (Part 2), pp. 1674–5.
[213] See Hearings (Part 2), pp. 1724–5, for a discussion of this problem.
[214] Hearings (Part 2), p. 73.
[215] Ibid., p. 860.

5. Agency restrictions on assigning examiners to assist Justice Department

Federal prosecutors have complained about the agencies' reluctance to permit the examiners who detected the misconduct and prepared the referral documents to discuss the matter with the FBI or with them. One assistant U.S. attorney stated that the OCC refused to send an examiner or an investigator involved in that particular referral to assist the FBI agent or to develop a case, without a grand jury subpoena. She believed that this was not an apropriate way to obtain Federal agency assistance in prosecuting referrals.[216] Six former banking agency examiners confirmed that the banking agencies discourage or actually prohibit contacts between examiners and law enforcement officials.[217]

The OCC confirmed that it will not send the bank examiner who knows the particular facts of the proposed criminal case. OCC stated:

> Obviously, an experienced bank examiner can guide a prosecutor through the intricacies and implications of a complicated set of financial transactions only if it is possible to discuss that particular set of facts. Yet, given the scope of the RFPA, even information that is merely derived from customer records is protected. OCC is compelled, in the face of possible personal penalties imposed by the act, to limit such assistance to bank examiners who know nothing about the facts of the actual criminal case at issue until an appropriate grand jury subpoena is issued. This sort of preliminary assistance is so limited, and susceptible of so many misinterpretations, that it may well impair the quality of the information on which the Department of Justice must make its threshold resource commitment decisions.[218]
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> * * * * *
>
> We believe that . . . OCC generally feels compelled by the act to select examiners who lack knowledge of the particular customer information associated with individual criminal referrals [and that this] frustrates prosecutors. While OCC agrees that making decisions without such information is a deficient procedure, we adhere to our view that under the RFPA the grand jury subpoena is now the only device available that permits the transfers of information . . . without giving potential damaging notice to the target of the referral.[219]

According to the OCC, this is an example of where the act "degrades" the ability of the Department of Justice to make informed decisions about whether to initiate a criminal investigation.[220]

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[216] Ibid., p. 860.
[217] Ibid., p. 1345.
[218] Ibid., p. 250.
[219] Ibid., p. 251
[220] Ibid.

The FDIC has a mixed record in lending examiners to U.S. attorneys offices to assist in developing and investigating a case.[221] Chairman Isaac testified:

> Well, as far as lending our examiners to the Justice Department, our examiners are not primarily criminal investigators. You get into all sorts of problems with the Privacy Act and the like if they become such.
>
> We do lend a fair amount of assistance in open banks to the criminal process within the constraints of our own workload.[222]

Either subpoenaing an examiner or deputizing an examiner as an agent of the grand jury are usually the preconditions to obtaining information from an examiner.[223] Often a Federal prosecutor only wants a very basic explanation from the person most knowledgeable about the case, an explanation missing in the referral document. On several occasions U.S. attorneys and their assistants have suggested to the subcommittee that examiners should sit down with them and an FBI agent to "lead them through the case," particularly where a complicated set of financial transactions needs explanation.[224]

The committee agrees that a potential problem exists whenever the knowledgeable examiner discusses a matter with the FBI and Federal prosecutors. Unless he or she can delineate customer record information without specifically identifying customers, and is prepared to refuse to answer quesions in a congenial and cooperative atmosphere, then the agencies have some reason to be concerned. On the other hand, the banking agencies should attempt to deal with the problem in ways other than by requiring grand jury subpoenas. For example, they could direct the district or regional counsel who actually issued the referral to attend all meetings to be sure that customer record information is not identified with particular customers, if at all possible, and to generally set the limits. However, this will only work if the banking agencies, excepting OCC, follow a more reasonable interpretation of the RFPA than they do now.

6. Problems with use of grand jury subpoenas under RFPA

Federal prosecutors must often resort to grand jury subpoenas to obtain a bank's or thrift's financial records. This creates several problems. First, because of the RFPA's restrictions, banking agencies and institutions usually do not detail the allegations of criminality and outline bank records necessary to develop a case. Accordingly, grand jury subpoenas are very broad and usually require the production of more information than would otherwise be necessary. Second, the grand jury subpoena alerts insiders in a financial institution to the investigation at a very early stage in the investigation, which creates problems if they are in control. And, third,

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[221] Ibid., p. 860.
[222] Ibid., p. 469.
[223] The Bank Board was the only agency able to quantify the amount of examiner assistance it provided to the Justice Department. For calendar years 1982 and 83, 3,340 "man-hours" were spent by 120 Bank Board examiners in criminal cases involving 56 thrifts. Ibid., p. 475. See also p. 538.
[224] See Ibid., pp. 849–62.

the RFPA requires that subpoenaed financial records be physically returned to the grand jury, a highly unusual requirement which delays investigations.

As Deputy Assistant Attorney General John Keeney testified:

> To get sufficient information to enable us to make an informed judgment as to whether a criminal investigation should be conducted, we have to in most instances issue a grand jury subpoena.
>
> Mr. Chairman, this is an unheard of procedure in law enforcement outside of the banking area. It has the following disadvantages from the standpoint of both efficiency and economy.
>
> It frequently requires a broad demand for records even beyond records needed for the initial investigative determination for us to determine whether a criminal investigation should be conducted, or even for any subsequent investigation that is conducted.
>
> As a corollary, it requires the Government to reimburse the banks for keeping what may prove to be irrelevant documents of little use in the prosecution and whose review is both time consuming and wasteful.[225]

First Assistant U.S. Attorney Jones described the impact on cases; he testified:

> Now, in many cases it may not be that difficult for our office to issue a subpoena. However, it may be hard to delineate documents early in an investigation and give a real specific subpoena. We have had cases where if you have the insider who still has control of the bank, of course, the lawyers then can be resisting some of these subpoenas or forcing you to particularize them or give you difficulties in turning over records. That can be one of the biggest problems when you have the control group, which is corrupt, still in power. . . .[226]

The Justice Department prosecutors and FBI agents are precluded from making informal inquiries to financial institutions or even conducting preliminary reviews of documents (if the holder consents), restrictions affecting no other source of evidence in the United States, not even tax returns. Unquestionably, the need to subpoena all records relating to individual accounts is clumsy, time consuming, and expensive.[227]

Title 12, § 3420 requires that financial records obtained from a financial institution under a grand jury subpoena be physically turned over in front of the grand jury. This is a very unusual requirement because other types of subpoenaed records are normally furnished to the U.S. Attorney's Office or to an FBI agent when the grand jury is not in session. Such records are often not physically returned to the grand jury, but only presented to it at time of indictment. This "return" requirement is burdensome and costly, causes long delays, and serves no valid privacy interest be-

[225] Ibid., p. 547; see also p. 1775.
[226] Ibid., p. 85.
[227] Ibid., pp. 551 and 582.

cause grand jury subpoenas were expressly exempted from the notice requirements of the act[228] More Federal prosecutors complained about this provision and its impact than about any other problem.[229]

Usually, under a grand jury subpoena an FBI agent deputized by the grand jury or a Federal prosecutor can review all other types of subpoenaed records on a business' premises (assuming the business consents), deciding which records are necessary and should be photocopied. In effect this narrows the scope of the subpoena. For example, the U.S. Attorney may only want to select checks of certain amounts which look suspicious, but under a "blanket" subpoena, the bank will have to assemble and photocopy all checks written by a customer for several years for the Justice Department just to find the ones which are relevant.

U.S. Attorney William Lutz (New Mexico) described the problem in detail

> . . . A much more serious problem is the fact that by having to subpoena the documents, we end up with a large number of documents that have nothing to do with the investigation and cause delays. The FBI has to sort through many documents and analyze them to determine whether they have anything to do with the bank fraud.
>
> We are required to subpoena whole accounts of customers where only two or three items may be in issue in the fraud, yet we wind up with 400 or 400 checks to the 7-Eleven Store, and whatever. Not only is that expensive, but it is a much more serious problem in the time that it is taking. . . . [T]his problem could be alleviated by amending the act to allow the FBI agents to assist in the search of the bank records and review the microfilm.[230]

In effect, this RFPA requirement means that many more financial records will be made available than would otherwise be the case, increasing the chances of a real privacy violation. Excessive reimbursement to the financial institution for all of these documents and the consequent delays caused by scheduling the grand jury and by assembling and photocopying many unnecessary records are further negative consequences of the act.

7. RFPA's negative impact on SEC investigations and law enforcement

John Fedders, Director of the SEC's Division of Enforcement, strongly criticized another RFPA's provision, which requires that notice be given prior to the transfer of financial records to the SEC. He described how the targets of SEC investigations have unsuccessfully invoked the RFPA to delay for months, if not years, the SEC's ultimate investigation of these cases.

> If you are professional at law enforcement, you know that law enforcement must be swift to be effective. What is happening today is that the [RFPA] . . . is now serving as

[228] Ibid., p. 1734.
[229] Ibid., p. 860.
[230] Ibid., p. 74.

an impediment to law enforcement agencies working together, cooperating and exchanging information.

* * * * * *

I think that these recommendations [to amend RFPA] would expedite law enforcement. They would not interfere with the liberty or privacy of our citizens.

But one thing that we have got to start paying attention to is saving time, saving Government resources, and right now the Right to Financial Privacy Act provides targets of our investigations and potential defendants an avenue to delay us, to string us out, and to cause 1 or 2 years extra effort.[231]

Mr. Fedders testified that these challenges are never upheld in court but only serve to delay. The Federal courts have rejected all 27 customer challenges filed against the SEC.[232]

During his testimony, Mr. Fedders also described how the RFPA requires a ridiculous amount of paperwork and delay. For example, where the records of 5 to 10 customers are sought from a bank, the RFPA effectively requires that the Commission produce 50 to 200 pages of customer notice material. Also, sometimes when a bank official's testimony is involved, questioning may have to cease in the middle of the testimony in order to send out more notices. In fact, a bank customer may receive an RFPA notice on three separate times in a single case.[233]

SEC's Enforcement Chief Fedders recommended serious reappraisal of the RFPA and a better reconciliation of two contrary goals:

The goals that Congress sought to achieve when it enacted the statute are laudable. I support them. But experience has shown that the burdens upon enforcement may be greater than the Congress intended or anticipated. There is a need to reassess the balance that the RFPA draws between two fundamental goals—the protection of individual privacy and the public interest in swift and effective law enforcement.[234]

He then recommended three modifications to the RFPA which would remove the serious impediments to SEC investigations, including those involving bank holding companies. Congress should seriously consider the SEC's proposals.[235]

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[231] Ibid., p. 132.
[232] Iblid., p. 143; see also pp. 159–63.
[233] Ibid., pp. 141–2.
[234] Ibid., p. 148.
[235] He specifically recommended: (1) Enacting a new provision requiring notice to the customer, whose financial records are subpoenaed, *only* after the SEC has obtained the customer's records or information based on such records, similar to the procedure followed in transferring records to Justice. This would assure that customers would continue to know that the SEC has obtained their records or information.

(2) Amending § 3413(h) to make clear that customer notice is not required when an investigation is directed at a financial institution;

(3) Amending § 3401(6) of the RFPA to make clear that any one of the supervisory agencies may obtain information from another supervisory agency, and that such sharing is not limited to only those supervisory agencies having authority to conduct examinations in a particular financial institution. Ibid., pp. 148–50.

8. Legislative solutions

The overall public perception that the law is more concerned about privacy than about enforcing the criminal banking laws ultimately and seriously jeopardizes bringing bank defrauders and embezzlers to trial.[236] In order to deal exclusively with the problems of insider abuse raised in this investigation, the committee recommends that Congress amend the RFPA (1) to exempt from the notice requirement all transfers of financial record information to the Justice Department when insider criminal misconduct is alleged, and (2) to abolish the grand jury evidence return requirement.

On August 6, 1984, Subcommittee Chairman Barnard and Subcommittee Members Coleman of Texas, Conyers, and Spratt introduced H.R. 6079 to carry out these goals. Section 2 of the bill reads as follows:

(l) Nothing in this title shall prohibit any financial institution or supervisory agency (or any officer, employee, or agent of a financial institution or a supervisory agency) from providing to the Department of Justice financial records which such financial institution or supervisory agency has reason to believe are relevant to a possible violation of any law relating to crimes against financial institutions or supervisory agencies by—

(1) any employee, officer, director, agent or shareholder of such financial institution; or

(2) any other person who aids or abets or conspires with any employee, officer, director, agent or shareholder of such financial institution in the commission of any such crime.

During the subcommittee's May 1984 hearings, the FDIC, the Home Loan Bank Board, the OCC, several U.S. attorneys, and the Justice Department all urged Congress to create, at the very least, an exemption for insider criminal misconduct.[237]

The physical-return-of-evidence requirement serves no valid function. Other provisions in the Financial Privacy Act, 12 U.S.C. 3420, pertaining to grand jury records, protect against their unwarranted and unauthorized use. And they, together with Rule 6 of the Federal Rules of Criminal Procedure relating to grand jury secrecy, would continue in force and serve to prevent grand jury abuse.

D. INADEQUACY OF BANK/THRIFT REFERRALS AS SUBSTITUTE FOR AGENCY REFERRALS

Fueled by their initial concerns about their ability to make referrals under the RFPA, the banking agencies developed a policy of requiring the financial institutions to refer and report all possible violations of criminal statutes. Under normal circumstances, even if the examiner is the first person to detect the insider abuse or criminal misconduct, an examiner will ask a bank to make a crimi-

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[236] Ibid., p. 298.
[237] Governor Partee of the Federal Reserve indicated that the Federal Reserve would probably support such an amendment. Ibid., p. 536.

nal referral.[238] Only if the bank or thrift does not eventually make the referral will the agency make one. Consequently, the banking agencies make very few referrals, as reflected by the statistics cited in Part A of this section. And banking agency referrals constitute a very small percentage of all referrals involving banking violations, sent to U.S. attorneys offices.[239]

The committee has found serious problems with this policy, which jeopardize the timely and successful investigations and prosecutions of insider criminal misconduct, and recommends that it be terminated immediately. First, there is no guarantee that the institution will even make a referral, and this failure may only be discovered later. Second, bank and thrift referrals tend to be extremely inadequate and perfunctory documents, provide little information and often recommend against a criminal prosecution because the insider involved has either resigned or made restitution.

Everyone recognizes that banks and thrifts do not always make referrals. All of the agencies instruct their examiners to make the criminal referrals if the institution does not; but the examiners may not discover this failure for 1 or 2 years or until the next examination. The Federal Reserve advised the subcommittee that it does not keep records of unwritten criminal referrals by banks.[240] The FDIC does not require banks it examines to report such violations to it; it instead relies on their good faith compliance. FDIC stated that, should a "bank fail to notify us within a reasonable amount of time after making [the] referral, FDIC may not become aware of the referral until the next onsite bank examination." [241]

The Federal Reserve and the Home Loan Bank Board consider it probable that senior management will not refer misconduct implicating itself. The Bank Board advised the subcommittee:

> We never wait for [senior] management to make a referral in order to avoid our responsibility to do so.[242]

The Federal Reserve System similarly stated:

> In instances where there is doubt as to whether or not a referral was made by the bank, or in those situations where it appears that senior management itself may be involved in a possible criminal violation, Reserve banks will refer the circumstances to the law enforcement.[243]

Even when financial institutions do make referrals, the referral letter is often completely inadequate and not useful. U.S. Attorney Bob Wortham was very blunt about the problems with financial institution referrals:

> If the bank make[s] the referral, the agency doesn't. And I can be honest when I say that when the banks make the referral, they don't want them prosecuted because they don't want the bad publicity. So, more times than not, the letters are going to be put out by the bank in such a manner where they are saying, "we're getting the money back. The man is going to leave the bank." There is really no reason to prosecute. [And] the agency doesn't [send a referral letter under those circumstances]. [244]

One of the bank referral letters reviewed by the subcommittee confirms Wortham's testimony. In an April 14, 1981, letter to the FBI, the president of the financial institution (Federal Reserve Problem Bank No. 4) reported that a vice president and senior loan officer had forged their names to two notes—one for $5,000 and $8,000, to charge off a $13,000 loan as a loss. The letter stated:

> We have satisfied ourselves that [name deleted] did not intend to defraud, harm or cause a monetary loss to anyone, and none of the parties involved intend to prosecute. [name deleted] has made full restitution.
>
> . . . and his resignation . . . was accepted. . . .[245]

Not surprisingly, prosecution as declined in that case. There are other problems with bank and thrift referrals.

> OCC has found that letters it receives form the bank management [reporting suspected misconduct] often reflect ignorance and confusion about the rules governing criminal referrals. This confusion sometimes reflects fears that disclosure may have adverse consequences for the bank. Second, the RFPA raised the potential cost to banks of reporting wrongdoing.[246]

to overcome this problem, the OCC has instructed its regional offices:

> to consider making an additional referral, if the bank's referral is inaccurate or incomplete, or if the complexities of a particular case or the position or the person involved make it appropriate.[247]

OCC and the other agencies stress that they do not want to make duplicate referrals, to complicate the process.

However, these agencies lose sight of a much more important goal: successful and timely investigation and prosecution of cases, which only timely and adequate referrals will produce. Except possibly for those de minimis referrals which agencies should screen out, see Part F below, the banking agencies should make referrals in all cases of insider criminal misconduct. Alternatively, the agencies should change their policies and directives to instruct their staffs to make referrals in all cases of serious criminal misconduct involving officers, directors, or shareholders.

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[238] FDIC examiners will still fill out a "report of apparent criminal irregularity" and other agency examiners will usually note the alleged misconduct in the examination report or working papers.

[239] Hearings (part 2), p. 23. And most of the financial institution referrals involve embezzlements by employees usually under $25,000.

[240] Ibid., p. 1443. FRS' "Enforcement Policies and Procedures."

[241] Ibid., p. 611. The OCC also said that if the bank does not send a copy to the OCC, "the examiners will review the . . . referral as part of the next regularly scheduled examination." Ibid., p. 738.

[242] Ibid., p. 394.

[243] Ibid., p. 346.

[244] Ibid., p. 90.

[245] Ibid., p. 1648.

[246] Ibid., pp. 252-3.

[247] Ibid., p. 1699.

E. AGENCY FAILURES TO MAKE TIMELY REFERRALS AND LACK OF ACCOUNTABILITY

1. Delays in the referral process

Often there are substantial delays between the time an examiner uncovers criminal misconduct and the time that the legal staff in an agency's regional or district office sends the referral document to the U.S. attorneys office and the FBI. These delays can jeopardize criminal investigations and prosecutions.

U.S. attorneys have complained to the Criminal Division about the staleness of evidence, resulting from the time lag between detection and the submission of a case to them.[248] U.S. Attorney Bob Wortham (Eastern District of Texas) testified about the slowness of the process and how untimely referrals can cripple criminal investigations. He advised the subcommittee in June 1984 about a Home Loan Bank referral involving a known loss in excess of $51 million, which he received in May 1984, but which the Bank Board had under discussion in September 1983, nine months prior to the actual referral document.[249]

In addition, the subcommittee's review of OCC referrals included in the subcommittee's survey of problem bank referrals reveal substantial delays between the approximate dates of examination and actual referral.[250]

Delays often occur at two levels. First, it occurs at the examination level. For example, although an FDIC examiner prepares a report of criminal irregularity upon detecting misconduct, the FDIC's regional office may not review the report and the proposed referral letter until the examination report is finalized and returned to the bank, often 60 to 90 days after the close of the examination.[251] Six to nine months may pass, therefore, before the proposed referral is reviewed. The same is generally true of the other agencies.

Delay also occurs at the regional or district level, where the agency's enforcement division's or general counsel's legal staff (depending on the agency) review it. Often, there are several levels of review. Ironically, if the criminal referral described a particularly complex or serious situation, then the agencies will often wait to obtain more information and will require a higher level of review,[252] further delaying the referral.

At the May 3rd hearing, Representative Spratt asked the OCC about ways a U.S. attorneys office could be brought into a matter at an earlier stage, as soon as potential violations are detected, rather than at the completion of the OCC's legal review. The OCC's Enforcement Chief, Bob Serino, rejected this idea and emphasized the need for a thorough legal review at the district office and the undesirability of letting examiners contact U.S. attorneys on their own. The OCC refused to indicate the ways the process could be speeded up. In fact, Mr. Serino admitted that the lag between detection and the actual referral can be substantial, but stated that "the right of individuals must be protected, and we must make sure we have a good case before we make a referral."[253] OCC has not addressed the real issue: Creating a system to speed up the process, while assuring that the referral is good.

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[248] Ibid., p. 591.
[249] Ibid., p. 69.
[250] See OCC Problem Bank Ref. No. 1, 8 months; OCC Problem Bank Ref. No's. 2 & 4, 10–12 months; OCC Problem Bank Ref. No. 14, 9 months. Ibid., pp. 1068–82; 1011–24.
[251] Ibid., p. 612.
[252] Ibid., p. 392.

2. Lack of expedited procedures when time is essential

U.S. Attorney Bob Wortham described several instances where he obtained referrals long after his office and the FBI had already initiated an investigation. He recommended another procedure:

> As soon as a member or a bank regulatory agency staff finds significant irregularity in his examination, he should immediately contact the FBI and not wait for a final report to be completed. The sooner the violation is reported, the better the chance of a successful prosecution, as witnesses' memories are fresher, there is less chance of documents being destroyed or altered, and there exists the possibility that lesser but significant irregularity, if promptly investigated, may lead to a larger scheme.[254]

With the exception of the FDIC, none of the agencies have such a procedure. And, as noted above, the OCC dismissed this suggestion. FDIC's procedure emphasizes expedited notification to the FDIC headquarters but allows for such notification to the law enforcement agencies. FDIC's Examination Manual, Section S states:

> Upon disclosure of certain apparent irregularities, the examiner must notify the Regional Office by telephone. Such cases include those where (1) there is a likelihood the suspect(s) will flee and the bank will not make necessary notification, (2) magnitude of the irregularity may imperil continued operation, or (3) key personnel are involved, necessitating removal. In either of the last two situations, the Regional Office will in turn notify the Office of the Associate Director of the Division of Bank Supervision as soon as practicable. *The Regional Director may elect to telephonically inform the field office of the appropriate investigatory authority, thereby enabling immediate entry by that agency prior to formal written notification. Such action is of special importance where the suspect holds a position such that further actions could expose the bank to additional peril or where continuation and expansion of an irregularity might present a significant threat to the bank's operation.* These preliminary notifications are required in addition to the following procedures.[255] (Emphasis added.)

How frequently FDIC utilizes this procedure is unknown, but we do know that the FDIC did not use it for any of the FDIC referrals in the subcommittee's survey. Unfortunately, none of the other banking agencies includes any such procedure in their referral directives.

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[253] Ibid., p. 537.
[254] Ibid., p. 46.
[255] Ibid., pp. 1615–6.

The SEC has a special arrangement with the Department of Justice, called "access grants", which addresses the occasional need to move quickly.[256] The banking agencies should closely examine this arrangement, and they should create and utilize an expedited referral system, under the same circumstances and conditions listed in the FDIC's manual.

3. Lack of communication and accountability

Former OCC examiner Donny Palmer testified that, in the experience of many examiners, proposed criminal referrals seem to enter a great "void" once they are sent to the district office. The same is true in other agencies, as well. All of the agencies place tremendous emphasis on procedures, focusing on the examiner's responsibility, but place very little on (1) the extent and timeliness of district or regional level review and (2) good channels of communication between examiners and legal staff. Mr. Palmer recommended a new system:

> A viable solution to the problem could begin with a system devised by the OCC—with input from the Justice Department—to train examiners and provide detailed guidelines . . . for developing criminal referrals that would "stand up" in court. Such a system would necessarily include better communication between the examiner and the district counsel. Measures to trace the referral through the system would be vital in monitoring accountability. This would be very important when interagency contact is required and also when official recommendations are necessary.[257]

Former FDIC examiner John Ray suggested that evidence of criminal misconduct be set forth in a separate report, which would not be made part of the formal examination report.[258] Examiners could send such a report to the next level of review before the examination is even completed, to begin the process much sooner.

Such a system must include better standards and guidelines for mid-level legal review, actual deadlines, and a separate report; but it must include accountability, above all else.

Designating at the district or regional level a special counsel or enforcement attorney to be responsible for all criminal enforcement (and also civil enforcement action against individuals) would enable agency senior staff to hold accountable one person.[259]

The agencies' failures to systematically monitor referrals and to informally appeal declined referrals stem from this absence of accountability. The agencies have failed to elevate the referral process—both at the examiner level and at the regional or district

[256] Under this procedure, the SEC will notify the Justice Department that a matter has unusual significance, prior to the transfer of information and evidence to the Department of Justice. Justice then initiates an immediate investigation and obtains quick access to information and documentation. Furthermore, the SEC does not expend staff resources to produce an extensive written factual and legal analysis of the referral. Ibid., p. 156.

[257] Ibid., p. 116.

[258] Ibid., p. 124.

[259] If one person at the regional or district level could not handle all of the responsibilities for reviewing, processing, issuing, and monitoring criminal referrals, then he or she should be assigned assistants. But the agency could still hold accountable one person at the district or regional level for these tasks.

level—to an importance accorded other supervisory and regulatory actions.

The lack of communication between examiners and mid-level counsel and the complete exclusion of the examiners from the referral process, once they make the referral, are symptomatic of the present insignificance of the whole criminal referral process. The subcommittee's staff report on its discussions with 18 present and former examiners revealed the depth of examiner dissatisfaction with this system:

> Although all the examiners interviewed had made criminal referrals involving officers, directors and insiders, few of them seemed to have any idea what had happened to their referral recommendations or whether the individuals who were the subject of the referrals had been prosecuted or convicted. They all agreed that the field examiner is basically excluded from the actual criminal referral process and that his only function is to report suspected abuse to his superiors. . . . In almost every case where these examiners had filed reports of apparent criminal misconduct, they were unable to say whether the individual was ever prosecuted, or even whether the referral was made by the regional offices to the Justice Department.[260]
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> * * * * *
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> Several examiners expressed frustration at being left out of this process. As one FDIC examiner said, "I have written hundreds of referral letters but I only know of one case where the person actually served any time. We would write a referral and 6 months later get a letter back [from the U.S. attorney's office] saying the case had been declined. You get discouraged. You're just beating your head against a wall." Another acknowledged that he had deliberately made few referrals "because it was common knowledge that the regional office considered them a pain in the butt." This examiner recommended that the regional counsel staff acquaint themselves with the facts of significant cases, make onsite inspections themselves, and work closely with the field examiners to prepare the best possible referral letters.[261]

Examiners are a crucial part of the process. They should be advised of the ultimate disposition for the referrals and should, within the constraints of the RFPA, be included in agency discussions with the FBI and U.S. attorneys office. Essential to their understanding and detection of criminal misconduct is feedback on the referrals which they did propose. Before the RFPA, examiners at the FDIC had more responsibility preparing the referral document, and frequently contacted FBI agents.[262]

The legal counsel reviewing these cases are also excluded from the reverse part of the process. Their failure to make onsite inspections and to work closely with the examiners means that they (1)

[260] Ibid., p. 1344.

[261] Ibid., p. 1345.

[262] Ibid., p. 1344.

are often denied an essential understanding of the alleged criminal misconduct, (2) cannot necessarily prepare good and comprehensive referral letters, and (3) possess insufficient knowledge to fully assist the U.S. attorney and the FBI.

F. AGENCY FAILURES TO SCREEN OUT LESS SIGNIFICANT REFERRALS AND TO IDENTIFY AND PROMOTE MORE IMPORTANT REFERRALS

1. Agency policies

All of the banking agencies refer (or require financial institutions to refer) all instances of possible criminal misconduct to the Justice Department and, in varying degrees, question their authority or their ability to screen out minimal conduct unlikely to be prosecuted. The FDIC and the Federal Reserve further fail to highlight significant or important matters which deserve special attention by Justice.

To support their policy of not screening out de minimis matters, the banking agencies rely on an outdated brief November 8, 1935, memorandum from the Assistant Attorney General, Criminal Division, to the FDIC requesting that examiners send to the Department of Justice all reports of irregularities at any insured bank.[263]

The OCC has repeatedly emphasized that under 12 C.F.R. 7.5225, both the OCC and national banks must refer all cases of suspected criminal misconduct and that accordingly, there is no discretion to screen out minor misconduct. Disingenuously, the OCC omits to tell the listener/reader that this regulation was promulgated by the OCC and can be changed at any time.

The OCC also states that the statute concerning misprision of felony could be construed to apply to OCC staff, whenever they have knowledge of the commission of a felony and do not report it to law enforcement authorities.[264] As confirmed by a recent legal memorandum to the subcommittee, this statement is completely falacious, for there must be active concealment of the offense for misprision to occur.[265]

The Federal Reserve Board very much opposes either screening out any referrals of minor offenses or highlighting others. It told

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[263] Hearings (part 1), pp. 153–4.

[264] Hearings (part 2), p. 736.

[265] The pertinent statute reads, in part:

"Whoever, having actual knowledge of the commission of a felony cognizable by a court of the United States, conceals and does not as soon as possible make known the same to some judge or other person in civil or military authority under the United States, shall be...." 18 U.S.C. § 4.

The subcommittee asked the American Law Division, Library of Congress, for a legal opinion on the OCC's assertion. In an August 14, 1984, memo from M. Maureen Murphy, Legislative Attorney (and criminal law specialist), the ALD specifically rejected OCC's rather tortured interpretation of this statute. The ALD memo states:

"The situation you have described does not meet all of these elements. First, an actual felony must have been completed. Presumably, the evidence uncovered by the bank supervisory agencies does not in all instances point to actual felonies; it may raise suspicions; it may indicate further investigation is in order; or it may relate to misdemeanors. Secondly, the defendant [in a misprision case] must have actual knowledge of the commission of the felony. Mere suspicion is not sufficient.... Third, it must be proved that the defendant failed to notify 'some judge or other person in civil or military authority under the United States.' The bank supervisory agencies are comprised of persons in civil authority under the United States....[Citations omitted.] Once a bank regulatory agency possesses information with regard to the commission of a felony, the United States may be presumed to be aware of it. *Fourth, the defendant must be shown to have committed an affirmative act of concealment. Mere failure to disclose is insufficient to meet the requirement of an affirmative act. Courts that have faced this issue are unanimous.* ALD Memorandum. p.6." (Emphasis added.) (The memo is in the subcommittee's files.)

the subcommittee that (1) such activities are not within its responsibilities; (2) it does "not have the expertise nor the authority" to make prosecutorial judgments (even after the U.S. attorney has declined a case); and (3) it is not a criminal prosecutorial agency.[266]

2. Impact of these failures on Justice Department prosecution

OCC's Enforcement Chief Bob Serino, a former Justice Department attorney, succinctly stated the problem about the lack of prioritizing bank agency referrals. He stated, "That is one of the problems. One of the problems is we send everything over there."[267] Mr. Serino elaborated:

> Banks and the bank regulatory agencies have historically made referrals of all violations of law to the Department of Justice and the FBI regardless of the amount involved, seriousness of the violation, or the likelihood of successful prosecution.
>
> In light of the overwhelming number of these referrals, many, because of the de minimis nature, are not prosecuted. We believe all agencies should consider appropriate steps to eliminate the burden of making and receiving referrals that stand a remote change of prosecution.[268]

Deputy Assistant Attorney General Keeney testified:

> We seek early referrals of major criminal activity before it has catastrophic consequences. At the same time we discourage investment of time by the agencies in referring matters which have little or no criminal potential, whether because of small amounts of money involved or because the violation is technical in nature and sufficiently addressed by civil sanctions available to the supervisory agencies.[269]

Clearly the Justice Department does not require referral of all evidence of potential criminal misconduct. Agency assertions to the contrary are directly contradicted.

Most bank agency referrals, particularly FDIC and Federal Reserve referrals, contain insufficient information for U.S. attorneys to understand and evaluate a case. The lack of screening de minimis cases and the failure to identify major cases only "adds insult to injury" and makes the referral documents even more inadequate.

Present agency practices have another undesirable consequence. Throughout his testimony, John Keeney, the Criminal Division's senior official who testified at the subcommittee's May 3rd hearing, reiterated how screening minor referrals and highlighting serious ones would help improve the Criminal Division's involvement in the Justice Department's prosecution of these cases. He pledged that if the banking agencies would identify those significant bank fraud or insider criminal misconduct cases warranting special prosecutive attention, then the Criminal Division's Fraud Section

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[266] Ibid., pp. 352 and 1639.

[267] Hearings (Part 1), p. 162.

[268] Hearings (Part 1), pp. 84–5.

[269] Hearings (Part 2), pp. 558.

would increase its monitoring of, coordinating, and, as resources are available, allocating of more manpower resources to these cases.[270] He testified:

> We believe the supervisory agencies themselves are best situated to identify cases and bring to our attention the more significant cases. A special notice obligation of the victim agency currently is used in our enhanced enforcement efforts involving DOD and SEC frauds. Early notice of the more serious fraud situations enable the Criminal Division to give such cases special prosecutive attention, insure adequate investigative resources are assigned, provide whatever special advice and guidance which might be suggested by the referral and coordinate available . . . remedies.[271]

Keeney also disagreed that Justice, particularly the Criminal Division, should be the agency to create prosecutorial guidelines, particularly to screen out cases. He testified that the regulatory agencies should consult with the individual U.S. attorneys and the FBI on the subject of investigative and prosecutive priorities in their respective districts, to develop evaluative criteria for screening.[272]

3. OCC's willingness to develop a new system: A possible model

In June 1983, the OCC advised the subcommittee that it was evaluating the following measures: (1) a minimum threshold level for reporting violations; (2) a mechanism to handle de minimis offenders; and (3) coordination with the States to handle cases not prosecuted by the Federal Government.[273] The OCC and the other agencies should revise their regulations now requiring examiners and financial institutions to refer all violations to Justice, regardless of the amount involved, the seriousness of the violation, or the likelihood of criminal prosecution. OCC's proposed system does not address highlighting significant referrals, probably because OCC does that occasionally.[274]

The committee agrees with the OCC that it, and the other banking agencies, should work to eliminate the burden of making referrals that stand only a slight chance of prosecution. OCC's reasons for believing that it, not the Justice Department, is in a better position to weigh the factors, evaluate a case, and screen it out or assign it a priority are compelling:

> Inevitably, OCC has expertise in bank regulation that the Department of Justice lacks. In addition, at the crucial time when judgments must be made about whether to commit criminal investigatory resources to a case, OCC has substantially better access to the relevant facts.
>
> For example, it is difficult for the Department of Justice to assess the strengths and weaknesses of a potential bank fraud case relative to the significant commitment of time

[270] Hearings (Part 2), pp. 570.
[271] Ibid., p. 553–4.
[272] Ibid., p. 206.
[273] Hearings (Part 1), pp. 97. One year later, the OCC is still developing such a system.
[274] Hearings (Part 2), pp. 270–271.

> and resources required to bring such a case to trial unless it is able to evalute the nuances related to jury appeal and culpability. Such factors can only be appreciated if specific amounts of money are known, if the precise time intervals between various actions can be analyzed, and if details about relationships between persons, organizations, and accounts maintained by or for them can be weighed in context.
>
> Armed with both practical expertise and factual information that the Department of Justice initially lacks, it is natural that we would have more confidence in our own judgments about referrals.[275]

Unfortunately, neither the OCC nor the other banking agencies are developing systems or procedures for highlighting important cases and for screening out minor ones.

New policies and new systems, as suggested, are a precondition to improved Justice Department investigation and prosecution of banking agency referrals. Yet, ironically the Justice Department is the only agency actively considering procedures for the banking agencies to alert the Criminal Division to particularly sensitive or important cases. The banking agencies must cooperate or such Criminal Division efforts will be futile.[276]

G. AGENCY FAILURES TO MONITOR REFERRALS

As discussed in Section VI., Part C., except for the OCC, the banking agencies do not maintain any comprehensive computer systems to track the status and ultimate disposition of their criminal referrals or to follow up their referrals.

Former Assistant U.S. Attorney Ted MacDonald recommended such a system:

> Any referrals should be monitored and supplemented with additional updated information from subsequent examinations or investigations and, at a minimum, some followup inquiries to at least keep the investigatory branch of the single auditing body or the FBI and U.S. attorneys' offices at least apprised of cases, even if they are not willing to engage in selling.[277]

Agency failures to systematically monitor their referrals (1) deprives the banking agencies of even knowing whether the Justice Department is vigorously investigating and prosecuting their cases and (2) are symptomatic of a greater problem, varying degrees of banking agency apathy and neglect.

Except for the Office of Comptroller of the Currency, there is a laissez-faire attitude which pervades the banking agencies concerning their responsibility to monitor their referrals to Justice. They all agree that it would be a good idea, but they seem to "shrug their shoulders" and say that the Justice Department must do it. As the Federal Reserve stated:

[275] Ibid. pp. 249–250.
[276] Ibid., 559.
[277] Hearings (Part 1), p. 10.

Any improvement in the Federal Reserve's ability to monitor criminal referrals would have to result from the active cooperation of the law enforcement authorities.[278]

The Bank Board, which probably contacts more U.S. attorneys' offices than any other agency, does not believe that a formal system to track or monitor criminal referrals is necessary.

> The majority of referrals made relate to low-level employees, whose positions already have been terminated by the financial institutions. The more serious referrals *are* tracked informally by the attorney or examiner making the referral where prosecution is desired by Bank Board representatives. In fact, the Bank Board staff often have lobbied vigorously for the initiation of criminal investigations or the return of indictments against wrongdoing S&L officials.[279]

If the Bank Board itself and other agencies screened out de minimis referrals, as the committee recommends, then a formal tracking system would involve only the more serious referrals. Also, while lower-level staff may track and advocate prosecution of referrals, the Bank Board and the other agencies' governing bodies or heads should know the status of their referrals, to assure that all serious ones are being pursued and for general supervisory purposes.

Justice recognizes the need to expand communications between the Justice Department and the banking agencies to advise them of the disposition of matters referred for prosecution, and apparently discussions are ongoing in the context of the Economic Crimes Council, at least to monitor the more important referrals. (See Section VIII.A. of this report.)[280] Yet, the impetus for establishing new monitoring systems rests with the banking agencies, not Justice, given the competing demands on Justice and the bank agencies' ultimate responsibility for deterring criminal misconduct in the Nation's financial institutions.

VIII. Justice Department Investigation and Prosecution of Insider Criminal Misconduct Cases

A. Introduction

The referral process is the middle part of a larger, overall system which begins with the detection and investigation of insider abuse and which ends with the Justice Department's investigation and prosecution (or declination) of the bank and banking agency referrals. This section examines the last part of the entire process and will focus on Justice Department's resource and internal management problems, difficulties with proving these cases, and serious statutory problems.

[278] Hearings (Part 2), p. 353.
[279] Notwithstanding its practice, the Bank Board is considering the preparation of an internal directive to all of the Examining and Enforcement staff, to reiterate its policy and practice of periodically following up on all significant criminal referrals. Hearings (Part 2), pp. 383–384.
[280] Ibid., p. 594.

However, the reader must keep in mind the overlap and the nexus between the problems with the referral process and the lack of timely and vigorous prosecution of these cases and the low priority they receive. As First Assistant, U.S. Attorney Gregory Jones testified about the impact of delay resulting from the referrals process:

> The additional problem that we have in many of these investigations is that we don't see them for 2 or 3 years after the offense. At that time the records may be missing. They have been destroyed by insiders. You have a problem in locating witnesses, and when you do locate witnesses, their memories may have faded about events or transactions, or their recollection of loans, and the kinds of collateral pledges. Where you don't have bank files it makes it very difficult to prosecute these kinds of cases.[281]

B. Nature and Extent of Justice Department Prosecutions, Declinations, and Delays

1. Survey findings

As previously discussed, with the Justice Department's cooperation, the subcommittee conducted its own empirical study of (1) 66 criminal referrals from the banking agencies involving "problem institutions" during 1980 and 1981 and (2) 75 FBI investigations (two-thirds of which were initiated by referrals) arising out of 105 financial institutions which failed between January 1980 and June 1983.[282]

The subcommittee's surveys disclosed a significant difference in the rates of prosecution of criminal cases involving failed institutions and those involving "problem" institutions. Of the 66 referrals made by the banking agencies in "problem" institutions during 1980–81, U.S. attorneys declined prosecution in 44 cases (67 percent). On the other hand, out of the 75 FBI investigations in failed institutions, U.S. attorneys declined prosecution in only 20 cases (27 percent). When asked to explain this difference, the Justice Department stated:

> Generally speaking, in cases involving failed institutions the violations are repeated, the amount of money is larger, restitution is not available, the damage to the institution's economic viability is more severe, witnesses are more inclined to cooperate, and administrative remedies are not available.
>
> * * * * *
>
> [Justice Department guidelines published in 1980] envision consideration of the damage to the victims and alternative noncriminal remedies in the decision to initiate prosecution.[283]

[281] Ibid., p. 25.
[282] Ibid., pp. 3–18.
[283] Ibid., p. 568. The reference to the nonavailability of administrative remedies is puzzling because civil money penalties are still available after bank failures.

FDIC basically concurred in this assessment:

> Intuitively, we would expect failed banks to spawn more criminal prosecutions and convictions . . . A defense based on high moral character, integrity and community service is not as readily believable when facts such as [unsound and unsafe banking practices, large loan losses, violations of law, and inept management, present in most bank failures] have already been presented. Failed banks also enhance the jury appeal of bank fraud cases. It is less difficult for prosecutors to convince a jury of the harm done to people or society by pointing to the actual and substantial losses—usually widely publicized—resulting from the failure of the bank.[284]

In sum, referrals involving problem banks may be just as meritorious, but often have less prosecutorial appeal.

There have been very lengthy delays in many of the criminal investigations covered in the subcommittee's surveys. According to the information possessed by the subcommittee in April 1984, out of 141 criminal investigations in the subcommittee's surveys, 31 criminal investigations had been pending within the Justice Department since 1980 or 1981,[285] many of which had been pending for 3½ years.[286]

Interestingly, where indictments are returned, the conviction rate is very high. In fact, the subcommittee was not able to locate a single case in its surveys where all the bank officials charged had been acquitted.[287]

2. Reasons why cases are declined and banking agency reactions

The U.S. attorney's declination letter, if one is sent, or the FBI document closing the case, usually provide only a short pithy reason when a case is declined. In the subcommittee's survey, U.S. attorneys gave a total of 81 declination reasons, as follows:

Reasons given for declination:	Number of times
No loss to bank	19
Lack of prosecutable violation (including lack of offense, lack of provable offense, lack of prosecutive merit, and no clear-cut violation)	18
Lack of criminal intent	11
Lack of evidence	5
Allegations without merit	4
Civil remedies available	4
Mismanagement	4
Case is stale/statute of limitations	3
Not serious offense/minimal Federal interest	3
Not meeting minimum threshold amount (FHLBB referrals only)	3
Other reasons	[288] 7

[284] Ibid., p. 301.
[285] Ibid., pp. 838–858. See also pp. 1638–1641 for a Federal Reserve Report of several other insider abuse cases pending for 3 years or more.
[286] At the May 1984 hearings, Justice provided additional information showing that of those 31 referral investigations, 2 had resulted in indictment, 6 had been declined, and another 2 had been partly declined with indictments having been returned against lesser officials. Ibid., pp. 600–602. Accordingly, 21 investigations still remain pending, some of which have now been pending for 4 years.
[287] Ibid., p. 5.

Discerning the underlying cause for a decline is often difficult, particularly for those declinations based on "lack of prosecutable violation" or "not serious offense."

The banking agencies have criticized Justice for the lack of prosecution of their referrals. The criticism in certain quarters was particularly severe. The Home Loan Bank Board complained that too few of its referrals are prosecuted. The subcommittee's survey of referrals from problem thrifts bear this out: Out of 20 problem thrift referrals during 1980–81, 16 were declined and 4 were still pending: none had been prosecuted; FHLBB Chairman Gray testified:

> It has long been the opinion of many veteran Bank Board staff members that too few of our criminal referrals receive serious attention by the U.S. attorneys to whom they are sent, and even fewer result in criminal prosecutions. . . . I have heard stories of cases where our own investigations documented clear violations of law, resulting in detailed criminal referrals being made, but which, after long periods of "consideration" by the Justice Department, resulted in declinations of prosecution. But a more objective observation is that our experience in this area has been mixed, depending upon the particular U.S. attorneys offices involved.[289]

Federal prosecutors usually state "lack of gain by the insider" and "no loss to the bank" as the two main reasons for their declining to prosecute these cases, and that without evidence of "loss" or "personal gain" it is difficult to prove fraudulent intent. However, former OCC examiner Donny Palmer, a witness at the subcommittee's May 2nd hearing, disagreed and placed the blame for the dearth of criminal enforcement on U.S. attorney's offices:

> In several instances, the data prepared during investigations has been detailed and thorough, even according to the FBI standards; yet the U.S. attorney sees no need to prosecute as the individual "has no personal gain" from the misconduct. In my experience, the lack of personal gain on the part of the insider cannot conceivably mitigate the actual loss to the institution and its shareholders.[290]
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> * * * * *
>
> As previously mentioned, on numerous occasions, the reason given for lack of prosecution by the U.S. attorney is that the individual cited for abuse did not materially benefit from the misconduct. All too often the bank suffered because of the misconduct but the circumstances of the loss, whether it be hundreds of millions of dollars, can sometimes be irrelevant.[291]
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> * * * * *

[288] Ibid., pp. 838–858. Sometimes two or three reasons were given for one referral.
[289] Ibid., p. 373.
[290] Ibid., p. 97.
[291] Ibid., p. 99.

The real weakness in the process lies with the U.S. attorney's office for declining to prosecute any criminal act and/or for being irresponsible in accepting plea bargain agreements which leave the institution without financial recourse, the criminal virtually unpunished, and the taxpayer footing the bill for exorbitant investigations and legal proceedings.[292]

3. Disparity among districts

The Justice Department's record of expeditious investigation and vigorous prosecution of bank fraud cases is uneven, depending on the particular district involved. As OCC's Deputy Chief Counsel Robert Serino testified:

> There are some U.S. attorney's offices that do magnificent jobs. There are others where we encounter problems. The U.S. attorney who testified yesterday concerning the prosecution of some individuals from the Clovis National Bank in New Mexico did a magnificant job in prosecuting the case. . . . There are others who do not work so hard and are not that interested in bank fraud cases. You have 94 U.S. attorneys offices. You have got a lot of different personalties and a lot depends on the particular U.S. attorney's office.[293]

The subcommittee's analysis of its survey results confirms this disparity. Two of the U.S. attorneys who testified at the subcommittee's May 3rd hearing have prosecuted a substantial number of cases. During the last year, New Mexico's U.S. Attorney William Lutz had opened seven cases of alleged criminal misconduct or fraud by bank officers or directors in that sparsely populated State.[294] The U.S. attorney for the Eastern District of Texas, Robert Wortham, has successfully prosecuted approximately 40 major bank fraud and insider abuse cases during the last 4 years, and has investigated many more.

However, other districts have not been as vigorous, particularly those in large urban centers. The subcommittee's survey of 66 problem bank referrals and 75 FBI investigations in failed banks revealed the following. The U.S. attorney for the Northern District of Illinois (Chicago), whose First Assistant testified and who has several very able fraud specialists, has a mixed record: 14 of these cases have been pending in that office for at least a year, and 10 of them have been pending for over 3 years. (Unlike other offices, however, the U.S. attorney in Chicago does not decline many cases.)[295] The U.S. attorney's office in the Northern District of Texas (Dallas) has an even poorer record for prosecuting cases in this subcommittee's surveys. There, five cases have been pending for 2 to 3½ years; and five cases have been declined, often because the bank or thrift suffered no loss. In the Central District of California (Los Angeles) five matters have been pending for 1 to 3 years; one of which the OCC considers particularly significant has been pending there since April 1982 (OCC Failed Bank C).

[292] Ibid., p. 102.
[293] Ibid., p. 466.
[294] Ibid., p. 72.
[295] The reasons for the large number of pending cases, 10 percent of all matters in the subcommittee's survey, is puzzling. Unfortunately, it was not discovered until very recently, after First U.S. Attorney Gregory Jones' had testified. It may be caused by the understaffing problems affecting most U.S. attorney offices in very large metropolitan area.

Many districts appear to apply vastly different standards in deciding whether to prosecute bank fraud cases. For example, the FDIC Problem Bank Referral No. 33 involved 13 separate referrals against a former president of an open problem bank in Orange County, CA. These referrals alleged a number of serious offenses.[296] There was no apparent restitution, and the reason for decline was simply that the bank suffered no loss.[297]

In contrast FDIC Criminal Referral No. 50 involved a single criminal referral against the president of an open Tennessee bank. The FDIC alleged that he had misapplied bank funds through the use of drafts, in order to benefit from a bank float, and that he had falsified entries on the bank's books, presumably to conceal the use of drafts.[298] Although the bank had suffered no loss because the president made restitution, the U.S. attorney prosecuted the individual. He pled guilty, was sentenced to 6 months' probation, and paid a $250 fine.[299]

Home Loan Bank Board enforcement attorney Jerry Chapman discussed the declination of another case involving the unnamed Texas savings and loan case described above in Section VI.B, which the Board believed was particularly meritorious. The FHLBB's referral involved a significant volume of illegal transactions pointing to particularly egregious behavior by the chairman and president of a failed thrift.[300] Chapman testified that the 17-page referral letter:

> Emphasized our agency's interest in seeking prosecutions because of the substantial damage caused to the Association due to the insider dealings, and we offered to assist in any way.[301]

Chapman testified as to the Federal prosecutor's reaction after the extremely lengthy FBI investigation and grand jury testimony:

> From my own contacts with the assistant U.S. attorney in charge of the case, it was clear that the attorney was overwhelmed by the complexity of the transactions and had difficulty comprehending the interrelationship between the transactions and the individuals. Indeed, at one point, the assistant U.S. attorney exclaimed that he did not believe that any judge in Texas would be willing to sit still for 3 weeks to allow him to present his entire case,

[296] The allegations included falsification of documents to conceal transactions and personal interests; arranging loans for personal benefit through overdrafts to his corporation; arranging for loans to benefit business entities, to overcome lending limits; false statements to examiners; extension of excessive and self-serving credit to corporation in which he had an interest; and other misconduct in violation of 18 U.S.C. §§ 215, 656, 1001, and 1014. Hearings (Part 2), pp. 1273–75.
[297] Ibid., p. 839.
[298] Ibid., pp. 842 and 1291.
[299] The individual in Tennessee cannot be reemployed in another FDIC-insured bank without the approval of the FDIC, because of his conviction. No such requirement applied to the former president of the Orange County, CA bank.
[300] Ibid., p. 197.
[301] Ibid., p. 205. The Federal Savings and Loan Insurance Corporation lost over $46 million in connection with this failure, which was primarily caused by this officer's misconduct.

and it was therefore necessary to consider narrowing an indictment to one or two simple criminal violations.[302]

Subsequently, the Bank Board tried to narrow the case for the prosecutor to a few simple and easily provable violations, when it became apparent that that was the only way the case would go forward. However, in December 1982, the assistant U.S. attorney sent a letter to the Bank Bord declining prosecution, on the ground that a "clear-cut violation of banking statutes could not be proven" despite an "exhaustive inquiry." [303]

Chapman testified as to the Bank Board's reaction:

> [Bank Board staff] was greatly disappointed by the decision . . . not to prosecute, as we felt that the case had significant merit. We believe that vigorously prosecuting cases of significant insider abuses would have a substantial deterrent effect on others in the thrift industry.[304]

Because of the letter's finality, the Bank Board decided not to pursue reconsideration of this case with Justice's Criminal Division.

C. PROBLEMS WITH FEDERAL CRIMINAL STATUTES

1. Introduction

The criminal statutes relating to insider loans, bank bribery, and bank fraud are archaic and do not satisfactorily address the types of 20th Century schemes uncovered in modern bank fraud investigations. Consequently, the difficulty of proving these complicated cases is made even more burdensome by unwieldly and unworkable criminal statutes. Professor John A. Spanogle, Jr. explained the problem:

> The problem is that these criminal statutes are not specifically adapted to the particular kinds of crimes that we are observing today. Until you have criminal statutes that are precisely adapted to insider abuses in use now, you are going to have enormous difficulties in having a successful prosecution.
>
> First, there is the problem of developing the evidence of the misdeed which caused the bank failure. Second, there is the problem of trying to shade that evidence to come within the statutory language. Third is the problem of explaining all of this to a jury, some of whom don't have checking accounts. At that point you have a problem of such magnitude that most prosecutors would much rather prosecute the guy who came in with the note saying "please give me $1,000." In human terms that makes some sense.[305]

The Justice Department and the banking agencies have been extremely vocal in their complaints about the difficulties posed by these antiquated laws.

[302] Ibid., p. 206.
[303] Ibid., p. 207.
[304] Ibid.
[305] Hearings (part 1), p. 34.

2. Problems with the misapplication statute: Impact on prosecutions

Enacted in its basic form in 1877, the wilfull-misapplication-of-bank-funds provision, Title 18, U.S.C.§ 656, is the only statute directly applicable to bank fraud, although violations of the false statement provisions are usually also found in these cases. It reads as follows:

> Whoever, being an officer, director, agent or employee of [a nationally-regulated or insured financial institution] . . . embezzles, abstracts, purloins or misapplies any of the moneys, funds, or credits of such bank or any moneys, funds, assets or securities intrusted to the custody or care . . . shall be fined not more than $5,000 or imprisoned not more than five years, or both; . . .

There are four basic elements to the offense: (1) the accused is or was an officer, director, employee, or other insider (2) of a particular type of federally-connected bank, (3) who wilfully misapplies money or other assets (converting them to his or her own use or to the use of a third person), (4) with intent to injure or defraud the bank.[306]

Interestingly, several Federal courts of appeal cases make clear that actual loss to a bank is not an element of the crime and that subsequent restitution has no bearing on the offense. Still, many cases are declined because of "no loss to the bank", as we have noted. Of course, such loss is helpful showing the defendant's intent to effect a wilful misapplication.[307]

The term "misapplication" is confusing to juries and judges alike. (For example, it is interpreted differently in different Federal circuits.) The following exchange between subcommittee member, Representative John Spratt, and former Assistant U.S. Attorney Ted MacDonald, during the subcommittee's June 1983 hearing, explains the problem:

> Mr. SPRATT. . . . Do you have specifically anything to recommend in the way of an improvement [of existing bank laws], a further specification of criminal activity by bank officers or bank employees?
>
> Mr. MACDONALD. I think that there is language which has effectively evolved into terms of art. The present statute says thou shall not misapply. When you are presenting instructions to juries, 98 percent of the argument is in chambers as to what we should tell them "misapply" means. . . .
>
> Why not just tell them what it means, that a bank director or executive officer who makes a loan for his own use and benefit with an attempt to conceal that from bank examiners shall be guilty of—
>
> * * * * *

[306] See *U.S.* v. *Vanatta,* 189, F.Supp. 939 (D. Hawaii 1980) and *U.S.* v. *Wilson* 500 F.2d 715 (5th Cir. 1974), cert. denied 420 U.S. 977.
[307] See, for example, *Golden* v. *U.S.,* 318 F.2d 357 (1st Cir. 1963) and *U.S.* v. *Matsinger,* 191 F.2d 1014 (3rd Cir. 1951).

Mr. MacDonald. . . . But the problem is, . . . when you start getting into these exotic things in front of a jury by saying the real crime here when this man put $1 million into his own pocket is that he didn't tell the bank examiner what he was doing. It is ridiculous to argue what the bank examiner knew or didn't know.

When you start focusing on the regulations, you tune out the jury because invariably any defense attorney worth his salt will get up and say, "I have a country banker here who didn't know the regulations. They didn't sit down and teach him the regulations. He doesn't know what he is doing. But if you direct and cast the statute in terms of if you steal $1 million from your own bank, you are going to jail, that is pretty easy for a jury to understand.

Mr. Spratt. That is what I am saying. What you are looking for instead of more specific statutes is a broad catchall category of violations, something like conspiracy to defraud the United States, some catchall into which you can throw criminal violation of your fiduciary duty to the bank as an institution and to its depositors, a breach of faith to the public.

Mr. MacDonald. I think that is true. . . .[308]

Having to charge false statement violations, false record entries, or false statements to examiners violations, to prosecute for the significant crime of bank fraud, is extremely confusing and unsatisfactory. Unfortunately, it is a common occurrence.[309]

Recently, a Federal grand jury convicted the former owner and the former president of the Carroll County Bank of fraud, including false statements, discussed in Section IV, above. A newspaper article discussed how the wording of the criminal statutes made the jury's task more difficult:

> Jury members said there was no argument among them about the guilt of Vickers [owner] and Ligon [president], but said they had difficulty interpreting complicated federal banking laws and applying them to each of the counts in the 20-page indictment.
>
> Jurors experienced the most trouble on counts charging Ligon and Vickers with making false entries into bank records. Twice they sought clarifications on the law from U.S. District Judge Robert M. McRae Thursday before returning their verdict at 6 p.m. Under the false entry provisions, Vickers could not be found guilty unless Ligon, who caused the entries to be made, was convicted.[310]

Section 1005 applies only to officers, directors and employees. Therefore, Vickers, the owner, could not be convicted as a principal, since he did not occupy any of those positions. The jury was

[308] Hearings (part 1), p. 81.

[309] Seven assistant U.S. attorneys contacted by the subcommittee staff complained that this was a cumbersome and ineffective way to proceed. Hearings (Part 2), p. 861. And frequently allegations of false statements do not receive priority by U.S. attorneys, according to the Home Loan Bank Board in an October 2, 1980, letter to the subcommittee.

[310] Hearings (Part 2), p. 2032.

confused by the judge's instruction that Vickers could only be convicted of aiding and abetting Ligon, the bank's president, although Vickers was actually the main culprit.

3. Problems with the bank bribery statute

Under 18 U.S.C. 215, only the receipt of a "fee, commission, gift, or thing" of value by a bank officer, director, or insider, for "procuring or endeavoring to procure" a loan or other beneficial renumeration is a crime and therefore punishable. The payment of a bribe or kickback is not punishable. Therefore, only the recipient of the bribe, not the payor, can be held accountable, even though both are equally culpable. Several assistant U.S. attorneys complained to the subcommittee's staff about this problem, and one indicated that juries are confused as to why the person making the bribe has not been charged.[311]

4. Light penalties in Sections 215 and 656

Bribery under Section 215 is a misdemeanor with a maximum penalty of $5,000, or 1 year imprisonment or both. Unfortunately, misdemeanor cases receive low priority in many U.S. attorneys' offices.[312] As U.S. Attorney Bob Wortham testified:

> I'm not even going to accept the case [of an officer kickback scheme]. How can I accept misdemeanors when I've got everything else going? The laws are inadequate. Under [title 18] section 215, it is only a misdemeanor offense. We don't have the manpower to handle misdemeanor offenses.[313]

Wortham believes that upgrading bank bribery to a felony would deter officers of institutions from making poor risk loans or engaging in outright fraud although monetary rewards for such conduct might be high.[314]

The maximum penalties for violations of the misapplication statute, section 656, are also low—$5,000 or 5 years' imprisonment, or both. Clearly, the $5,000 fine is very low for the size of thefts that are often involved. Former Federal prosecutor Ted MacDonald believes that the maximum time of imprisonment may also be unfairly low. He testified:

> The disparity in penalties under this section for criminal activity involved in stealing bank funds in comparison with basic bank robbery statutes is extraordinarily great for seemingly, morally indistinguishable conduct.
>
> For example, a bank officer who is prosecuted under section 656 for loaning himself $1 million in a single transaction . . . might only receive a maximum sentence of 5 years' imprisonment.
>
> On the other hand, an individual who is not a bank officer who walks over to a teller's cage in the same bank and, without a gun, hands a note to the teller requesting

[311] Hearings (Part 2), p. 861.

[312] Ibid., (Subcommittee discussions with assistant U.S. attorneys).

[313] Ibid., p. 38.

[314] Ibid., p. 49.

$1 million could possibly receive 20 years' imprisonment.[315]

5. Problems in the false record entry provisions

Title 18 U.S.C. 1005, providing felony penalties for false statements and entries in bank records, requires a higher burden of proof than does 18 U.S.C. 1006, which prescribes the same conduct in thrift institutions. Under 1006, the Government must prove an "intent to deceive", whereas under 1005, the Government must prove an "intent to injure or to defraud." The latter results in a much higher burden, since it requires proof that the dependent not only hid, or lied about, the fraudulent transactions, but that he also had a willful intent to harm the institution. There is no justification for treating false record entries in banks less severely than those in thrifts.

6. Legislative solutions

The Justice Department and the banking agencies have strongly supported remedial provisions in the omnibus crimes bills now before Congress. Most recently, on July 30, 1984, the House of Representatives passed by voice vote H.R. 5872, the "Financial Bribery and Fraud Amendments Act of 1984", which effectively responds to the major problems encountered in prosecuting bank officials:

1. The bill makes criminal the offering or giving of a bribe to an officer, director, or insider of a financial institution;
2. It creates a new crime, "graft in financial operations", to cover companion bribery situations where an insider is rewarded after the desired action has been taken;
3. It increases the penalty for bank bribery, upgrading it from a misdemeanor to a felony if the bribe is more than $250, with a maximum penalty of $250,000, 5 years' imprisonment, and a fine for individuals, and a $1,000,000 fine for business entities; and
4. It creates a new crime of "financial fraud", applying to anyone (a) who devises a scheme to defraud a financial institution or (b) who obtains funds from a financial institution by false or fraudulent pretenses.

The committee fully supports the bill's enactment. With these changes, prosecutors would no longer be forced to rely on section 656 and to reconcile all the different interpretations of "misapplication". Instead, prosecutors, courts, and juries will be able to focus on the actual fraud perpetrated on the victim banks and thrifts.

D. INADEQUATE JUSTICE DEPARTMENT RESOURCES AND SPECIALIZED TRAINING

1. Substantial resource requirements on bank fraud cases

The FDIC recommended that the Justice Department expand the number of personnel trained in investigating and prosecuting bank

[315] Hearings (Part 1), p. 5.

fraud cases, and the OCC urged Justice to consider allocating additional resources to this task.[316]

A tremendous resource problem exists because these cases require much time to investigate. Often, there are many avenues to explore, many of which do not lead to incriminating evidence. Two Justice Department witnesses attempted to shed some light on the difficulties and delays in proving these cases. First Assistant U.S. Attorney Gregory Jones cited a litany of difficulties:

> Of all the offenses that we, in Chicago, and most U.S. attorneys prosecute in the bank fraud area, the insider abuse cases are the most difficult to detect and to prove when they are committed by senior officers and top management.
>
> * * * * *
>
> These offenses are difficult to detect and to prove because . . . they are designed to be concealed from regulatory agencies, and from law enforcement agencies, even from internal bank personnel.
>
> As a result they may require lengthy investigations. . . .
>
> * * * * *
>
> These offenses are difficult to prove, because of the intent element that the Government must establish for the bank officer. It must prove that the bank officer intended to injure and defraud the bank in these actions. It is not enough for the Government to show that the loans or the conduct of the officer was stupid, showed bad judgment, or was completely incompetent. . . . Unfortunately, this can be complicated by laxity in bank procedures.
>
> It is not uncommon to find . . . that the loan officers even in legitimate cases where the bank officers were not getting any money, and were not corrupt, did not follow even rudimentary procedures for credit checks, for obtaining a financial statement from the borrower. There was no attempt to secure collateral; no attempt by the bank personnel to verify the representations made by the borrowers; no attempt to check that the collateral exists that is being pledged, and to obtain the collateral or get a security interest.
>
> Now when you have that kind of laxity [in bank procedures]: it is hard to distinguish those kinds of cases from the criminal cases where the individual is not doing these things, because he is receiving money, or is receiving some form of benefit for not checking on the collateral, and not obtaining financial statements.
>
> * * * * *
>
> The one way that we can, and usually do, attempt to prove the fraudulent intent on the part of the insider is to show that he received some personal benefit as the basis

[316] Hearings (Part 2), pp. 308 and 215. The U.S. Attorneys Manual offers the assistance of 6 to 10 national bank examiners in 15 regions, who have been trained as "fraud examiners", and also lists the OCC regional counsel to contact if help is needed. Ibid., p. 1995-96.

> for his issuing these loans. . . . To show that . . . we've tried to go back and look at the bank records of that particular officer [which is] a laborious process. . . .[317]

Deputy Assistant Attorney General Keeney testified that the transactions underlying the alleged violations are sophisticated and that the process of unraveling the transactions is lengthy and often requires the tracing of money from account to account, proving overvaluation or nonexistence of collateral, disproving statements made in financial statements, and determining the persons responsible at each stage. He added:

> [I]t is not uncommon for a major banking investigation to last for months, or even years, before the information assembled is sufficient to support a responsible prosecutive decision.[318]

Former Federal prosecutor Ted MacDonald explained how a U.S. attorney reconciles those conflicting pressures and applies a cost-benefit approach:

> [T]he problem with a thorough bank fraud investigation is that it requires a large concentration of accounting and technical manpower for a long period of time, the outcome of which, because of the inherent difficulty and lower success rate of white collar prosecutions, particularly bank fraud, may be uncertain.
>
> Accordingly, an FBI field office or U.S. attorneys' office may not have, or not want, to commit the resources necessary to properly investigate bank fraud. However, because of the desire for publicity and prestige which necessarily flow from convicting bankers in their jurisdictions, neither office is inclined to defer to the Department of Justice. Consequently, because of this lack of resources, yet unwillingness to defer, the result may be the development of a quick in, quick out attitude toward bank fraud.
>
> * * * * *
>
> On the prospect of expending funds and manpower for a long period of time to catch two or three sophisticated bank manipulators is not as appealing and does not seem to be as cost efficient as other less expensive, less uncertain investigations.
>
> It is much easier, much better public relations and more appealing to stand next to 500 bales of marihuana, a briefcase full of money and a speed boat on the beaches of Florida than to take a box of No. 2 pencils, a pile of spread sheets and disappear for 2 years.
>
> Consequently, the result is that local U.S. attorneys' offices and FBI field offices, which by their very nature are extremely reluctant to relinquish bank fraud investigations in their jurisdictions, are at the same time reluctant to expend resources on a bank fraud investigation.[319]

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317 Ibid., pp. 24–25.
318 Hearings (part 1), p. 172.
319 Hearings (part 1), p. 9.

And as First Assistant U.S. Attorney Jones testified at the May 3, 1984, hearing:

> You have to have a really large devotion of resources or interest on the part of a particular agent or a particular assistant [U.S. attorney] or these kinds of cases can sit.[320]

These cases often require, not only a large allocation of investigative resources, but also a large commitment of prosecutorial resources. New Mexico's U.S. Attorney William Lutz testified about having to assign three attorneys, out of a total of eight attorneys in his office, to a large bank fraud case, in which the bank owners were making loans for kickbacks of money.[321]

2. Reductions in FBI resources devoted to "white-collar" crime

In fiscal year 1983, the FBI reduced by approximately 15 percent the number of agents assigned to investigating "white-collar" crime, particularly frauds and embezzlement. The White-Collar Crime Program utilized 191 fewer FBI agent workyears than were budgeted for fiscal year 1983.[322] Moreover, the Administration has requested further cuts in spending authority for such investigations in fiscal year 1985.

In addition, the thresholds of money which must be involved before the FBI will investigate a crime have been moving upward. The Wall Street Journal, in a February 1, 1984 article, quoted one State prosecutor on the FBI's reluctance to handle smaller fraud cases:

> "If it doesn't involve a great deal of money, they aren't interested," says James C. Anders, solicitor for Richard and Kershaw Counties, S.C. He says that federal agencies are increasingly ignoring embezzlements in his area. "They seem to be more interested currently in drug cases and cases that have a lot of publicity."
>
> Law enforcement officials worry that crooks will tailor their frauds and embezzlements to fall just short of the amount that will attract federal agencies.[323]

In New York City, the cutoff is about $50,000. Elsewhere, it is often in the $10,000 to $5,000 range.

The subcommittee found additional evidence of these cutbacks in specific bank fraud cases. In one Florida case, an FDIC referral had been placed on hold for over 2 years because the FBI agent assigned that case had been "tied up" on an extensive narcotics and corruption investigation.[324] In the Eastern District of Texas, the subcommittee uncovered two investigations arising out of bank agency referrals which had been delayed for years because there were not enough FBI agents to investigate them. (They involved OCC Problem Bank Referrals 11–14 and OCC Failed Bank L.) Several other assistant U.S. attorneys confirmed this problem in their

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320 Hearings (part 2), p. 87.
321 Ibid., p. 73.
322 Statement of Oliver B. Revell, Assistant Director, Federal Bureau of Investigation, before the House Subcommittee on Civil and Constitutional Rights, Committee on the Judiciary, Apr. 11, 1983.
323 Hearings (Part 2), p. 2006.
324 Ibid., pp. 861 and 554–5

districts. In the Central District of California (Los Angeles), the cutback has been particularly acute. The FBI's "white-collar" crime staff in Los Angeles has been reduced from 21 persons to 11 persons because of large number of bank robberies in Southern California, drug cases, and the 1984 Olympics.[325] First Assistant U.S. Attorney Jones confirmed that drug, organized crime, and official corruption investigations now have a higher priority under this Administration than "white-collar" crime.[326]

The Administration and the Justice Department respond that the Department can do more criminal investigations with less resources—a position contradicted by U.S. attorneys and FBI agents, including several witnesses on the panel of U.S. attorneys testifying at the May 1984 hearing. The Administration position follows:

> . . . with the use of specialized investigative techniques and efficient prosecutive decision-making, effective use can be made of resources currently available. . . . The FBI has stated that they are prepared to commit whatever resources are necessary to support an investigation authorized by the Department of Justice.[327]

This position flies in the face of reality and demonstrates OMB's misplaced priorities in this area. Subcommittee Chairman Barnard summer up his frustration at the cutback in "white-collar" crime resources:

> Mr. BARNARD. Now we see that the FBI is being cut back 15 percent. It looks like . . . we are at a time when—if we have any priority at all—we need to be prosecuting criminals, and . . . that we are giving an undue low recognition to these types of crimes. It is very depressing for banks . . . and it is sad when banks are being blasted, and the people inside banks committing these crimes are not getting prosecuted.[328]

Representative Ronald D. Coleman of Texas elaborated on the public's concern about inadequate allocation of funds to the FBI, before the Criminal Division's witness.

> Somebody writes a $25 hot check they get prosecuted in my county. Yet, we are dealing with criminal misconduct or insider abuse under $10,000 [in most Federal Districts] and that may not be your fault, it may be the administration's perception. . . .
>
> *　　*　　*　　*　　*
>
> I want to say to you I think *you will find in virtually every district in this country they are willing [to devote more resources to criminal enforcement], the people are willing to do that, the taxpayers are willing to do that.* I would like you to submit to us what it is that you need to do a better job. . . . It is going to be hard to explain to the woman who wrote the $25 check why she is getting prosecuted and somebody who embezzled the $10,000 isn't. . . .[329] (Emphasis added.)

[325] Ibid., p. 861.
[326] Ibid., p. 88.
[327] Ibid., p. 574.
[328] Ibid., p. 586.

3. Insufficient number of specially trained FBI agents

Apart from the problem of cutbacks in FBI resources, there are insufficient numbers of adequately trained FBI agents or agents with accounting backgrounds (called "Special Agent Accountants"). One Federal prosecutor in the Eastern District of Texas stated that he could not pursue the alleged misconduct of senior officers in OCC failed Bank L because he does not have enough FBI accountant agents. His superior, U.S. Attorney Bob Wortham, discussed the problem during the May 3rd hearing:

> . . . you are limited by your manpower, your resources and the type of manpower you have. If you have some good lawyers that can handle the complicated accounting case, if you have good FBI agents that can handle [the same type of] investigations, then your district can prosecute. If you don't have good FBI accounting agents in your district your hands are tied.[330]
>
> The Eastern District of Texas would like more accounting agents and financial experts. This is not criticism of the FBI; however, there are too many accounting cases pending and not enough agents to devote to these cases.[331]

New Mexico's U.S. Attorney Lutz explained to the subcommittee part of the reason one FHLBB referral and one OCC referral had each been pending in his district for several years:

> In the past several years in New Mexico, we have faced a shortage of agents in the Federal Bureau of Investigation with accounting backgrounds. Recently, the FBI has corrected this. The number of agents with accounting backgrounds has been approximately doubled in New Mexico since the first of the year.
>
> *　　*　　*　　*　　*
>
> In my opinion, on a national basis, the Federal Bureau of Investigation must increase the recruitment of accountants. At the same time, . . . it is recognized that the competition for accountants that the FBI desires is extremely intense with the large accounting firms and other persons requiring services of accountants.
>
> Monetary awards outside Government for accountants are certainly greater than what the FBI can pay a special agent.[332]

Ironically, at the subcommittee's June 1983 hearing, the FBI pledged to send in additional manpower, such as more special agent accountants and more support personnel, to begin tracking fraudulent paperwork, as necessary, diverting these resources from

[329] Ibid., pp. 587–588.
[330] Ibid., p. 83.
[331] Ibid., p. 49.
[332] Ibid., p. 74.

other FBI field offices.[333] Obviously, the FBI has not implemented this commitment.

In response, the Justice Department contends that (1) FBI agents currently receive 27 hours of instruction in the "white-collar" crime investigations during their initial training; (2) new agents involved in complicated bank-related criminal investigations will frequently be assigned to an experienced agent; (3) in the larger districts, if an FBI agent shows particular aptitude, he or she will be assigned to the squad which handles bank fraud and embezzlement matters; (4) agents in such squads will be eligible for additional specialized training in bank fraud investigations at the FBI academy; (5) FBI agents generally may attend regional conferences and seminars organized by FBI headquarters; and (6) there are 1,150 special agent accountants who can be assigned to assist a non-accountant agent. In fiscal year 1984, the Economic and Financial Crimes Training unit will have trained over 1,163 agents in specialized courses.[334]

Whether this additional training will substitute for more agent accountants is questionable. The FDIC expressed some degree of frustration in its experience with FBI agents assigned to bank fraud cases. It concluded that (1) many agents have difficulty fully understanding how bank frauds are perpetrated, (2) the depth of FBI talent to conduct these types of investigations is limited, and (3) the "issue may be more a question of professional background rather than something that a few training sessions would resolve."[335]

4. *Inadequate U.S. attorney resources and training*

At both the June 1983 and the May 1984 hearings, the Home Loan Bank Board strongly contended that U.S. attorneys offices throughout the United States are "overworked and understaffed" and that priority is not given to "white-collar" criminal cases.[336] Although the Bank Board was reluctant to identify particular districts where its cases are not investigated and prosecuted in a timely fashion, it did state that U.S. attorneys' offices in the less populous areas are more likely to initiate investigations of thrift fraud, but that, even as to those offices, manpower problems are just as acute.[337] In its surveys the subcommittee found that a referral arising out of OCC Problem Bank No. 8 had been pending since December 8, 1981, manpower problems in the U.S. attorney's office in the Southern District of New York are particularly acute and the Justice Department is not adequately responding to them. The assistant U.S. attorney assigned this particular investigation had until recently been devoting full time to prosecuting a kidnapping case.[338]

Providing better training to Federal prosecutors in bank fraud is essential. The Home Loan Bank Board testified that as such frauds

[333] Hearings (Part 1), p. 180
[334] Hearings (Part 2), pp. 578–9. Subcommittee staff attended the first FBI in-service training on fraud in failed banks, held in Quantico, VA, during the week of Aug. 27, 1984.
[335] Ibid., pp. 619–20.
[336] Hearings (Part 1), p. 126.
[337] Hearings (Part 2), p. 375.
[338] This information was uncovered by subcommittee staff during several telephone conversations with officials within the Justice Department.

become more sophisticated and complicated, the need for special prosecutorial skills to obtain convictions is especially evident.[339] Until recently, this type of specialized training has been rare.

Recognizing the problem, Justice is broadening its training efforts for assistant U.S. attorneys and devoting an additional week of instruction to supplement the existing 2-to-3-week basic training course.[340] While valuable, these efforts are still too limited. For example, only about 30 Federal prosecutors attended the program devoted to the problems encountered in bank fraud investigations held during the early 1984 semi-annual Economic Crime Conference. Clearly, the number participating in such courses must be increased, to have any significant nationwide impact.

E. JUSTICE DEPARTMENT'S FAILURE TO MONITOR, COORDINATE AND DEVOTE ADEQUATE RESOURCES TO BANK FRAUD CASES

1. *Inadequacy of Justice Department and FBI data and recordkeeping systems*

a. *The problem*

The subcommittee tried to determine the total number of insider bank fraud cases investigated and prosecuted by the Justice Department, in order to measure the Department's effectiveness. We found that much of that information was not readily available, and much of it simply did not exist.

First, there are no aggregate statistics separately showing the number of insider bank fraud cases prosecuted and the number of convictions. During the subcommittee's May 3rd hearing, Justice pointed to 2,143 convictions during fiscal year 1983 for banking violations, 422 of which were obtained in cases where the dollar amounts exceeded $100,000 and 346 of which involved bank officers.[341] However, these figures are misleading. First, they include embezzlements as well as insider fraud cases. Second, the Justice Department data, including specific FBI statistical reports, do not segregate the number of cases of bank fraud committed by officers, directors, or other senior insiders, from those committed by lower level employees.

Second, the Justice Department does not keep any central records on specific bank fraud cases which have been declined or prosecuted or are still pending and the banking agencies obtain little information from Justice on specific cases. U.S. attorneys rarely send letters to the appropriate banking agency advising it of the disposition of the case, irrespective of whether it has been declined or successfully prosecuted. Often, the only record kept in declined cases is an FBI "closing memorandum", sent to a regional FBI office, which is retrievable only by the names of the targets of the investigations.

In fact, the subcommittee survey became necessary because neither the banking agencies or the Justice Department could provide any comprehensive information showing the disposition of banking

[339] Hearings (Part 2), p. 377.
[340] Ibid., pp. 580 and 2006.
[341] Ibid., p. 555; this latter statistic was taken from the FBI's "Federal Bureau of Investigation Bank Crime Statistics, . . ." located in the subcommittee's files.

agency referrals. After the banking agencies had amassed lists of their referrals (with some difficulty), then and only then could the Justice Department retrieve information on the disposition of those cases. The FBI had to survey each FBI office involved to determine the referral's status, a long and laborious process.

During the subcommittee's June 28, 1983, hearing, John Keeney, Deputy Assistant Attorney General (Criminal Division), readily conceded that Justice was operating "antiquated recordkeeping procedures." [342]

b. Solutions

The FBI could provide aggregate data showing the number of investigations and prosecutions of bank fraud by senior officers, directors, and insiders, which could be published in its semi-annual Bank Crime Statistics Report without much additional burden.

Keeping records on specific banking agency referrals and FBI-initiated investigations are more difficult.

All of the banking agencies have had informal discussions with the FBI on improving communications regarding the Justice Department's investigation and disposition of their criminal referrals. While agencies must take an active interest, the responsibility for providing the information lies with the Justice Department. During the May 3rd hearing, OCC suggested the following system:

> . . . the Justice Department should consider maintaining a comprehensive computerized system containing referrals made by all the banking agencies and should periodically cross-check names to determine if individuals show up on more than one occasion. With cross-sorting, repeat de minimis offenders could be identified and prosecuted.[343]

The OCC's proposal would be particularly useful for situations like the Penn Square failure, which has had national implications and affected banks across the Nation.

At the subcommittee's June 1983 hearing, the Justice Department told the subcommittee of a new computerized system, the Fraud and Corruption Tracking System (FACT), which had just become fully operational to provide case-by-case retrievable capacity for referrals from the 17 Federal Inspectors General.[344] Although the Justice Department then testified that the system would be expanded to virtually all white-collar offenses, including bank fraud, Justice has taken little action to bring it about. Justice now states that the Economic Crime Council

> is devoting substantial attention to revamping the referral relationships with the goal of identifying and monitoring the more important referrals.[345]

[342] Hearings (Part 1), p. 183.
[343] Ibid, p. 216.
[344] Ibid., p. 175.
[345] Hearings (Part 2), p. 598.

2. Criminal Division's present policy: No primary jurisdiction over bank fraud cases

The Justice Department's Criminal Division asserts no primary jurisdiction over bank fraud cases and conducts very little monitoring or oversight of the investigation and prosecution of these cases, letting the U.S. attorneys exercise sole investigative and prosecutorial control. In other words, prosecution of bank fraud has not been elevated to the same level of importance as other types of criminal misconduct which have more of a national impact. As Deputy Assistant Attorney General Keeney testified:

> It is only in areas affecting such interests as national security, foreign relations, antitrust tax, or similar concerns of a peculiarly national impact that the Department asserts original jurisdiction or approval procedures in criminal prosecution. The Fraud Section of the Criminal Division [with 43 attorneys] provides policy and operational guidance in a wide variety of white-collar crime areas as well as prosecutive staff to those cases of national import where U.S. attorney resources are not sufficient. In the vast majority of cases involving fraud against financial institutions, the transactions primarily affect a single judicial district, and the impact is limited in geographic scope.[346]

Keeney did admit that the Department's view on this is beginning to change, due to structural changes in the financial services sector and expansion of the banking industry. He stated:

> Deregulation, as well as branch banking, multi-state banking, expanded banking services, and other reforms are all occurring at the same time. These changes will intensify the exposure of the nation's financial markets to broader and less localized schemes. This makes it appropriate that we re-examine our enforcement and regulatory procedures to insure their maximum effectiveness.[347]

The U.S. attorneys sense the low priority that the Criminal Division places on these crimes and often decline to pursue them, particularly in view of the resource, statutory, and other problems surrounding these cases. During the May 3rd hearing, the Criminal Division's witness admitted this lower priority but indicated a willingness to change. He testified:

> We do not devote a great deal of resources to the banking area now, that is, the fraud section and the Criminal Divison, but that doesn't mean that if the regulatory agencies were in a position to come to us with significant substantial cases that we would not do so. We would naturally shift our priorities and make resources available to the extent that it was possible if we were in a position where we thought that we could use those resources effectively in making significant cases. . . . We have put our resources

[346] Ibid. p. 553.
[347] Ibid.

> in [other fraud areas] because we think we can get the most for the resources.[348]

However, the strength of Justice's commitment to shift priorities and allocate more resources to bank fraud cases remains unclear.

3. The fraud section

The Fraud Section is one of several units of trial attorneys within the Criminal Division, based in Washington, D.C. It has a total staff of 43 attorneys, many of whom are experienced in complex financial cases. The Section assumes primary investigative and prosecutorial responsibilities in those instances (1) where U.S. attorneys have specifically asked for assistance (for manpower reasons, because of the technical nature of the crime alleged, or for disqualifying conflicts) or (2) where the case was developed through the Section's own investigative activities. In addition to bank fraud, the Section is involved in prosecuting (1) fraud in the sale of commodities, commodity futures, and securities, (2) other investment frauds, (3) money laundering, (4) fraud against the Government (especially defense procurement), (5) Medicare fraud, and (6) victim-oriented investment swindles. According to the Justice Department, Fraud Section attorneys are very competent to prosecute bank fraud cases, because there is little difference in trying a "bank misapplication case, a mail fraud case, an SEC investigation or a commodity fraud case." [349]

The Justice Department could not furnish workyear data on Fraud Section staff resources for bank fraud violations. However, the subcommittee learned that three Section attorneys are assigned part-time to the investigations in Tennessee and Oklahoma of the Penn Square National Bank and United American Bank failures, and that, to a lesser extent, Section attorneys have recently been involved in five other bank fraud cases. One Fraud Section attorney, Robert Clark, works full time on bank fraud matters and provides advice to U.S. attorneys concerning investigative strategy and prosecutive theories.[350] Clearly, in view of the large numbers of bank fraud cases involving insiders, the extent of the Fraud Section's involvement and assistance is extremely limited.

The Fraud Section is unable to offer assistance or encourage U.S. attorneys to prosecute major cases because the section fails to monitor bank agency referrals. The Fraud Section receives copies of many bank agency referrals involving amounts over $50,000 but it does not record or use this information for any purpose but, instead, turns around and sends these copies to the Archives. As Deputy Assistant Attorney General Keeney testified:

> In practice, the paper [on matters of $50,000 or more] that arrives in the fraud section encompasses a great deal more and the significant matters get drowned in it.[351]

The Criminal Division maintains that it would be of limited value to monitor all criminal referrals but that significant cases

[348] Ibid., p. 585.
[349] Ibid., p. 589.
[350] Ibid., pp. 571–2.
[351] Ibid., p. 595.

could be monitored *if* the banking agencies would advise the Justice Department of those significant cases which merit particular attention.[352] The committee agrees with this position, but still believes that the Criminal Division should take responsibility for establishing its own formal recordkeeping system, which would inform the banking agencies on the status and disposition of all banking agency referrals.[353]

During the May 3, 1984, hearing, Deputy Assistant Attorney General Keeney testified about the Criminal Division's intervention in the Penn Square case, a good example of what the Criminal Division could do more often, if it monitored important and significant cases or if the banking agencies asked for its assistance:

> You raised Penn Square the last time I appeared before this committee [in June 1983] and as a result of that, I talked with the Assistant Attorney General for the Criminal Division, who brought in the U.S. attorney from Oklahoma who has the case, and we had an extended discussion with him—what are the problems with moving this more rapidly, what can we do, and what can you do that we can help you accomplish?
>
> As a result of that, the investigation is moving much more rapidly. We have one person out there from the fraud section. . . .[354]

The Justice Department has rejected the idea of either reorganizing the Fraud Section or increasing its manpower resources to give serious banking violations a higher priority. It does not follow the practice, followed in other Justice Department divisions, such as Antitrust and Civil, of sending a letter to the U.S. attorney offering prosecutorial assistance, upon receiving a copy of a regulatory agency referral.

Justice did state that "the incidences of bank failures particularly warrant giving greater priority to bank fraud cases." [355] It did indicate that the Fraud Section could assign an experienced prosecutor in a very limited number of appropriate cases or "arrange for the U.S. attorney to give a particular investigation a higher priority." Such intervention would be particularly beneficial, if the banking agencies monitored their cases. The banking agencies should affirmatively respond to the Justice Department's offer (1) to assist on particularly important cases, (2) to obtain a follow-up status report on an informal case-by-case basis, if the agency requested such from a U.S. attorney and was not able to obtain it, and (3) to intervene if an agency has a problem with a particular district's handling of its cases.[356] Justice's commitment to provide more resources should be tested.[357]

[352] Ibid., p. 561.
[353] Ibid., p. 593.
[354] Ibid., p. 584.
[355] Ibid., p. 573.
[356] Ibid., pp. 591 and 593.
[357] Ibid.

4. Banking agencies, failure to promote prosecution of significant cases

During the subcommittee's May 4, 1984, hearing, the OCC and the FHLBB identified altogether 14 particularly significant or important criminal referrals which had been pending for long periods of time or which a U.S. attorney had declined.[358] During the hearing, the Comptroller of the Currency, the Chairman of the FHLBB, and, to a lesser extent, the Chairman of the FDIC, all complained about lack of vigorous Justice Department prosecution of their referrals. On May 3rd, as already discussed, Bank Board attorney Jerry Chapman testified about the unwarranted declination of a very serious matter by an assistant U.S. attorney in Texas. While it is true that more of these cases should probably have been prosecuted more vigorously and not delayed or declined, most of the blame for this situation lies with the banking agencies.

When the OCC was asked if it had made any efforts to encourage Justice Department prosecution of these significant cases, OCC replied that it encourages prosecution "by submitting as detailed and thorough criminal referrals as practicable . . .",[359] in other words, "no". The same was true for the other banking agencies. The following exchange between Subcommittee Chairman Barnard and the two Justice Department Criminal Division representatives is extremely revealing:

> Mr. BARNARD. I think you are helping us considerably here because, and I will speak for myself, while we didn't expect the banking agencies to be prosecutors, on the other hand, we would like to see them be sufficiently interested in these cases so that they would pursue the interest of the Department of Justice in them, even though at the lowest level they may not be getting the attention that they deserve.
>
> Mr. KEENEY. We solicit that. Don't make any mistake, if one of the bank regulatory agencies is of the view that a significant case that should have been prosecuted was not prosecuted, that it was a mistake, they can come to us and we will look into it. That is our responsibility, Mr. Chairman.
>
> Mr. BARNARD. *But your records don't reflect that you have gotten a lot of appeals from the agencies in that regard?*
>
> Mr. CLARK. *Mr. Chairman, I am the one that would receive the initial phone call and have been for perhaps the last 3½ years. I have not received such a phone call.*
>
> Mr. BARNARD. Not one?
>
> Mr. CLARK. Not one.
>
> Mr. BARNARD. I have no further questions. Thank you very much for being with us.[360] (Emphasis added.)

[358] Ibid., p. 398 and 405. Both the FDIC and the Federal Reserve Board believed that Justice was pursuing the most significant and prosecutable cases and declining the rest. Ibid., p. 302. Accordingly, they could not identify any significant cases which has been declined.

[359] Ibid., p. 260.

[360] Ibid., p. 595.

After the May 3rd hearing, we asked the Justice Department for the status of the 14 pending siginificant OCC and FHLBB cases and to respond generally to the OCC and FHLBB assertions. Justice stated in its follow-up letter:

> With respect to the declined matters [highlighted by the OCC and the FHLBB during the hearing], no action has been taken to date by the Criminal Division, in part due to the fact that the Subcommittee's letter is the first notice to us of the priority concerns expressed by the regulatory agencies. . . . In light of the age of these matters, we do not anticipate reopening them. . . . [W]e will further review the declination of FHLBB 21-22.[361]

As to those cases which were still pending, Justice further responded:

> . . . we are writing the affected U.S. Attorneys to advise them of the interest expressed by the referring regulatory agency and the subcommittee. We are asking the United States Attorneys to advise us of prosecutive determinations, the reasons for any declination, and the investigative obstacles or resource deficiencies which jeopardize otherwise appropriate prosecutions.[362]

The Criminal Division has shown a willingness to intervene in U.S. attorney declination decisions and to seek reconsideration, on behalf of the banking agencies. U.S. attorneys recognize the Criminal Division's authority to do so. As New Mexico's U.S. attorney testified:

> While I think it is very rarely invoked, if an agency is dissatisfied, or a victim for that matter, they can go to the Criminal Division and request that they review our declination.[363]

Evidence suggests that U.S. attorneys are giving many of these bank agency referrals low priority, for all of the reasons discussed. In one typical case, the subcommittee staff reviewed the declination of OCC Problem Bank Referral No. 1, involving a bank in the Northern District of West Virginia, a particularly important case, according to the OCC. The May 1981 referral alleged:

> . . . that senior officials were involved in kickbacks, falsifying loan applications and bank records, double mortgaging of property, granting loans in excess of the legal lending limit, embezzlement, and false statements to the Government. Prosecution was declined by the U.S. Attorney as he did not feel that extensive investigation revealed any prosecutable violations.[364]

The OCC advised the subcommittee that the conduct involved was so egregious that it had assessed civil money penalties against senior officers and directors, in view of the number and recurring nature of the violations and the losses sustained by the bank. (A

[361] Ibid., p. 602.

[362] Ibid.

[363] Ibid., p. 84.

[364] Ibid., p. 848.

$1.3 million fidelity bond claim was filed, although losses may have been greater.) OCC described some of the conduct involved:

> Seventeen violations of 12 U.S.C. § 84, in some instances four times the lending limit, without adequate security. The violations resulted in losses that seriously depleted the bank's capital. In addition to these violations of 12 U.S.C. § 84, there [were] violations of consumer law and other regulations. Criticized assets were extremely high and 19 percent of the gross loans outstanding lacked satisfactory credit information. Senior executive officer salaries and the length of their employment contracts were considered excessive. In addition the bank's Allowance for Possible Loan Losses was inadequate.[365]

After the May 1981 referral, the FBI conducted a very thorough investigation, which included interviews with numerous persons and which resulted in 23 volumes of FBI files. On June 2, 1982, the FBI agent and the U.S. attorney met and discussed the case carefully, apparently reviewing every allegation. Thereafter, the FBI agent prepared a 14-page closing memorandum. No decline letter was sent to the OCC.[366]

The U.S. attorney had a different opinion of the case. He indicated to subcommittee staff that his decision not to prosecute was based on the fact that the bank "suffered no ultimate losses", the fidelity bond claim was paid and some losses were recouped from customers. The staff memo states:

> Most of the allegations involved false statements on documents, relating to possible self-dealing or other violations. The U.S. attorney believed that the violations were technical and showed either stupidity or negligence on the part of the officers, but not actual criminal intent, such as intent to defraud or to enter a false statement [,based] . . . on the dearth of evidence showing both that the officers or directors had benefited personally and that the bank has suffered no eventual losses. Without this evidence, fraudulent intent could not be proven.
>
> * * * * *
>
> According to [the U.S. attorney] many of these allegations involved "business judgments," and it would be too hard to second guess them. He indicated that while all the allegations showed certain patterns, he would have gone forward only if he believed that he could prove criminal intent for at least one or two allegations . . . . And even where there may have technically been false statements, it was hard to show that this was knowingly done the insiders benefited to the detriment of the bank.[367]

While the subcommittee staff was somewhat skeptical that all of the 20-plus allegations were without merit, particularly in view of

[365] Ibid., p. 866.
[366] The subcommittee staff counsel's report of his conversation with the U.S. attorney is found in Hearings (Part 2), pp. 859-62.
[367] Hearings (Part 2), p. 864.

the $1.3 million fidelity bond claim and the OCC civil enforcement action, the subcommittee is not in a position to state categorically that the U.S. attorney was or was not justified in declining prosecution of each alleged violation, particularly without reviewing the 23 volumes of FBI files. Rather, the significant issue is that the U.S. attorney's response could have been far different if the OCC had asked him to reconsider his decision The U.S. attorney told subcommittee staff,

> that he would have had no trouble reconsidering his decision and would have been willing to meet with OCC staff. He said that there were minimal contacts with the OCC in this matter; either he [or the FBI's agent] had briefly talked with OCC regional counsel during the investigation, probably about documentation. He said that if OCC had presented additional evidence or offered evidence in a different perspective, one which would have resulted in showing criminal intent, he might have changed his mind and prosecuted. OCC and other banking agencies have never contacted him for that purpose, although other agencies have done so.[368]

The U.S. attorney may have unjustifiably declined this case—we will never know. However, the OCC was certainly at fault. The agency's failure to meet with the U.S. attorney and to seek Criminal Division intervention indicated an apathy and lack of interest in its own referral. These are the missing links. Until the OCC and the other banking agencies begin to highlight important cases in their referrals and to direct their staff to closely monitor and actively promote their referrals, and to seek reconsideration of declined cases, these agencies are in no position to complain about the lack of Justice Department prosecution. Other regulatory agencies, such as the FDA and the SEC, have better track records because they usually take an active interest in their cases at all stages.

5. Economic Crime Council

The Justice Department's Criminal Division is reassessing existing bank agency referral procedures and the Department's prosecution of banking violations, in part because of the subcommittee inquiry. In late 1983 it created the Attorney General's Economic Crime Council, consisting of an Associate Attorney General, 21 U.S. attorneys, and attorneys from the Fraud Sections. The Council established a separate subcommittee to focus on bank fraud.[369] The OCC has actively participated in the Crime Council's work, and the remaining regulatory agencies have been contacted.

On May 24, 1984, this subcommittee presented a draft report to the full Council. Unfortunately, without justification and in violation of Congress' right to Executive branch information, the Justice Department refused to provide this draft report to us because the report has not been finalized.[370] The Justice Department had earli-

[368] Ibid.
[369] Ibid., pp. 558-9.
[370] Ibid., p. 603.

er provided the following summary of several of the report's tentative recommendations:

> The recommendations include encouraging supervisory agencies to more actively refer suspicious situations for criminal investigation and expanded training for regulatory agency personnel in fundamental criminal and law procedure. The subcommittee is also recommending that the supervisory agencies expand the use of simultaneous examinations to increase the potential for early detection of fraudulent transactions. Procedures by which the supervisory agencies can alert the Criminal Division to particularly sensitive or important cases are also being proposed to allow for closer monitoring and direct assistance by the Criminal Division's Fraud Section.[371]

Several of these recommendations mirror the committee's recommendations and provide support for them. The Criminal Division is to be commended for taking concrete action. Of all of the agencies, it has shown the greatest willingness to respond to the problems uncovered by the subcommittee.

F. LACK OF COOPERATION AND COMMUNICATION BETWEEN JUSTICE AND THE BANKING AGENCIES

1. Bank agency failures to furnish Justice Department with examination reports

Bank agency examination reports often provide the first of suspected transactions giving rise to allegations of criminal misconduct in a referral. However, two U.S. attorneys presented evidence of difficulties in obtaining bank examination reports from the agencies. First Assistant U.S. Attorney Jones of Chicago testified:

> Even when you have a subpoena, . . . we frequently have problems in getting the report of examination. I don't mean the referral, I mean the examination report [done by the examiner]. They are very conservative in even providing that to us and that might be obviously to protect other sorts of information that are in there. . . . But it is really vital in many cases to see at an early stage the examination report and talk to examiners, and even see their work papers to get some idea of what is going on.[372]

U.S. Attorney Robert Wortham reported on the problems he faced in obtaining the Home Loan Bank Board examination reports on the Collin County Savings and Loan failure and examination reports generally:

> Examination reports and examiners of regulatory agencies are not readily accessible to Federal investigators. A substantial amount of administrative delays is always experienced even when the reports and testimony of examiners are obviously evidentiary.[373]

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[371] Ibid., p. 559.
[372] Ibid., p. 89.
[373] Ibid., p. 71.

The Justice Department's Criminal Division has also received a number of such complaints. Justice was unable to summarize all such incidents, because records are not kept, but it told the subcommittee of an incredible incident:

> As an example, in a major case in which we have active involvement, a regional office of a supervisory agency in the summer of 1983 flatly refused to provide a subpoenaed examination report. The report was finally provided only after the assistant U.S. attorney involved took the unusual step of suggesting the necessity of directing a personal subpoena to the agency chairman to require him to explain directly to the grand jury his agency's refusal to produce the subpoenaed examination report.[374]

There is no legal justification for the banking agencies to withhold examination reports which are under a grand jury subpoena.[375] Title 18 U.S.C. 1906 provides criminal penalties for the disclosure by a bank agency examiner of certain information obtained during a bank examination, unless express permission has been obtained from the agency head or unless the examiner has been ordered to do so by a court of competent jurisdiction. A grand jury jubpoena is just such an order. Also, 18 U.S.C. 1905, providing criminal penalties for the disclosure of confidential information obtained by Federal agencies, applies only to disclosures "not authorized by law" and is therefore inapplicable.

Undoubtedly these attempts to place obstacles in the Justice Department's prosecution and investigation of these matters is not surprising but is consistent with these agencies' attempts to keep secret all information concerning the supervision of financial institutions. What is troublesome, however, is that the agencies do not trust U.S. attorneys and the FBI agents who are deputized by the grand jury to strictly comply with the secrecy provision of Rule 6(e) of the Federal Rules of Criminal Procedure.[376] While it is true that the examination reports subpoenaed by a grand jury may ultimately be used during a criminal trial, there are ways to minimize the disclosure of irrelevant but sensitive information in the examination report. For example, bank agency staff can discuss with the U.S. attorney the desirability of omitting from the subpoena's coverage irrelevant material, prior to issuance of the subpoena. *Or,* alternatively, the U.S. attorney could use only those essential pages or a portion of a report at time of trial, introducing them into evidence if properly authenticated and certified.

A spirit of cooperation between the banking agencies and Justice Department would help overcome any valid concerns which the agencies hold.

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[374] Ibid., p. 600.
[375] It is not clear that the banking agencies are prohibited from releasing examination reports to Justice absent a grand jury subpoena. However, we are not addressing that issue at this time.
[376] That provision provides: "Secrecy of Proceedings and Disclosure: Disclosure of matters occurring before the grand jury other than its deliberations and the vote of any juror may be made to the attorneys for the government for use in the performance of their duties. Otherwise a juror, attorney, interpreter, stenographer, operator of a recording device, or any [transcriber] may disclose matters occurring before the grand jury only when so directed by the court preliminary to or in connection with a judicial proceeding. . . ."

2. Justice Department's failure to advise the banking agencies of investigations concerning banks or thrifts within their jurisdiction

The Justice Department fails to notify the banking agencies of investigations which the FBI and U.S. attorneys offices have initiated on their own. The OCC is particularly troubled by this and the problems this lack of communication causes:

> We believe it would be helpful to our examiners if the law enforcement community brought to our attention, early on, potential red flags that they uncover during their investigations. This would enable us to concentrate our resources on potential problems perhaps in their embryonic stage.[377]
>
> * * * * *
>
> In some cases, the OCC has not been informed of ongoing FBI investigations into the criminal activities of [insiders] of national banks. This lack of communication adversely affects the OCC's ability to effectively monitor and supervise the national banking system . . .
> . . . [S]everal reasons [for] the OCC . . . to remain informed of these investigations [follows:] First, . . . such activities may affect the overall financial condition of the bank. If the OCC is informed of suspected criminal activities in a timely manner, the OCC can provide closer supervision in order to prevent any further abuse or deterioration. In addition, the criminal activity may form the basis of necessary administrative action against the bank [insiders] or the bank itself, [including the consideration of the necessity of suspending individuals]. . . . Finally, if the OCC is informed of a pending investigation, the OCC would be in a position to provide expert assistance to the FBI and the U.S. Attorneys' Offices within the constraints of the grand jury secrecy laws and the Right to Financial Privacy Act.[378]

The subcommittee asked the OCC after the May 3rd hearing for instances where the Justice Department has not so notified the OCC. OCC advised the subcommittee:

> There are several instances that come to mind where information from ongoing investigations would have helped us in our supervisory process. Specific instances include the cases previously testified to by [former] Assistant U.S. Attorney Theodore MacDonald. . . . [I]f we had known of these investigations, we might have been able to prevent the deterioration in these institutions. The only time we became aware of those investigations was when we discovered a grand jury subpoena at one of the institutions.[379]

The Justice Department states that it cannot give such notice because of Rule 6(e), which prohibits disclosure of matters occurring

[377] Hearings (Part 2), p. 227.
[378] Ibid., p. 236.
[379] Ibid., p. 735.

before the grand jury. Moreover, Justice cited recent Supreme Court decisions which preclude Justice from providing civil regulatory authorities with information gained through grand jury investigations.

This barrier to interagency cooperation and disclosure is not a total one, contrary to the Justice Department's misleading assertions about the "veil" of grand jury secrecy. Court cases make clear that the disclosure of an investigation, even if a grand jury is involved, is not barred by Rule 6(e). The Court of Appeals in In Re Grand Jury Investigation, 610 F.2d 202 (5th Cir. 1980) stated:

> However, the disclosure of information obtained from a source independent of the grand jury proceedings, such as a prior government investigation, does not violate Rule 6(e). [Citation omitted.] A discussion of actions taken by government attorneys or officials—e.g., a recommendation by the Justice Department attorneys to department officials than an indictment be sought against an individual—does not reveal any information about matters occurring before the grand jury. Nor does a statement of opinion as to an individual's potential criminal liability violate the dictates of Rule 6(e). This is so even though the opinion might be based on knowledge of the grand jury proceedings, provided, of course, the statement does not reveal the grand jury information on which it is based. supra, at 217.

In United States v. Stanford, 589 F.2d 285 (7th Cir. 1978), cert. denied 440 U.S. 983, the Court of Appeals applied the same reasoning to documentation:

> The restrictions of Rule 6(e) apply only to "disclosure of matters occurring before the grand jury." Unless information reveals something about the grand jury proceedings, secrecy is unnecessary. supra, at 291.

The very existence of the investigation, the allegations which prompted the investigation, and the identification of relevant documents are not protected from disclosure by Rule 6(e).

This refusal to notify the pertinent bank regulatory agencies is purely a policy question, not a legal issue. In its submission to the subcommittee at the time of its May 3rd testimony, the Criminal Division conceded that, as a "matter of policy" Justice does not disseminate the names of persons who are the subjects or targets of an investigation.[380]

While appropriate in terms of public disclosure, this policy is absolutely deplorable whenever it keeps bank regulatory agencies in the dark about insider abuse and criminal misconduct. This policy may ultimately lead to bank failures and to huge losses to the deposit insurance funds. It is incongruous that the banking agencies should receive copies of FBI reports arising out of bank fraud investigations, which they have referred to the Justice Department, but not even find out minimal identifying information about cases which the FBI has initiated on its own. In view of the bank regulatory agencies' penchant for secrecy, the Justice Department could

[380] Ibid., p. 575.

place an unfaltering trust in their willingness to maintain confidentiality. Justice has recently recognized that its policy is tenuous. In its follow-up response to the subcommittee, the Criminal Division stated:

> We are evaluating the possiblity of formalizing the procedures to provide the regulatory agencies with information received through means other than grand jury investigation.[381]

G. CONCLUSION

The committee agrees with the observation of the OCC Denver Regional Counsel, who wrote on February 11, 1981, in a referral letter to U.S. attorney:

> [I]nsider loans are a relatively common feature in problem bank situations. A successful prosecution for activities of this nature would be highly useful in deterring others from this conduct and could contribute substantially to the safety and soundness of the banks in this part of the country.[382]

While the committee agrees with the position taken by the bank regulatory agencies generally that the swift and sure prosecution of potential violations of criminal law need to be improved, it also believes that improved Justice Department cooperation, investigation, and prosecution is not the entire answer. Improved prevention, and, as discussed in the next section, increased civil enforcement actions against individuals are also important components of Federal response to insider criminal misconduct.

IX. Civil Enforcement Actions Against Individuals Engaged in Insider Abuse

Despite the banking agencies' clear statutory responsibility to halt and sanction insider abuse, they generally fail to take effective civil enforcement action directly against officers, directors, and insiders of financial institutions who engage in such conduct. This section sets forth the agencies' statutory authority and responsibility to take enforcement action against individual misconduct, their overall enforcement record since 1980, their effectiveness in dealing with insider abuse in specific institutions examined by the subcommittee, and their failure to disclose such actions.

A. THE ENFORCEMENT POWERS OF THE AGENCIES

1. Historical overview

The banking agencies have a well stocked arsenal of legal weapons to use against individuals engaged in insider abuse. Over the past 20 years, this arsenal has grown considerably. In the early 1960's the banking industry and the bank regulators enjoyed a far more informal, even symbiotic, relationship that grew out of the banking collapse of the Depression. The bank regulatory agencies

[381] Ibid.
[382] Ibid., p. 1628.

wielded such awesome power over the day-to-day decisionmaking of banking that the regulators rarely had to resort to formal sanctions to correct abusive practices. Moral suasion, "jawboning," and, if necessary, pressure were used to solve problems without having to resort to formal enforcement actions.

In 1966, this relationship began to change. The bank regulatory agencies that year informed Congress that they found themselves increasingly ill-equipped to deal with recalcitrant individuals and institutions, particularly in situations where the agencies' "death penalty" powers—such as termination of deposit insurance or revocation of a national bank charter—were too drastic or cumbersome to achieve necessary changes. The agencies asked Congress for new disciplinary powers, which were granted in the Financial Institutions Supervisory Act of 1966 (FISA). The act gave the agencies the authority to issue cease and desist orders against institutions, to halt unsafe or unsound banking practices and to order the implementation of specific actions. In addition, the act empowered the agencies to remove officers and directors who engaged in insider abuse.[383]

Despite these broad new powers, the agencies made relatively little use of them over the next 10 years.[384] According to a General Accounting Office study in 1977, the three bank regulatory agencies took the follow enforcement actions during the 5-year period from 1971–76:

Type of Action	Name of Agency			Total
	FDIC	Fed Reserve	OCC	
1. Written agreements	3	21	71	95
2. Cease and desist actions	67	21	20	108
3. Removals	19	4	26	49

Focusing on the general enforcement policies of the agencies and not just on insider abuse, the GAO report concluded that they used their formal enforcement actions only as "a last resort."[385]

After several large bank failures in the mid-1970's and the Bert Lance affair, the agencies were accused of not being tough enough on mismanagement and insider abuse in financial institutions. The agencies responded by seeking still more enforcement authority that could be used against individuals. Congress again responded by enacting the Financial Institutions Regulatory and Interest Rate Control Act of 1978 (FIRIRCA), which was intended to (1) provide the agencies with broader powers against insider abuse and criminal misconduct, and (2) enhance the agencies' flexibility in sit-

[383] In order to remove a bank office or director under FISA, an agency had to prove that a person's conduct had: (1) violated a law or regulation, engaged in unsafe or unsound practices, or breached his fiduciary duty, (2) threatened substantial financial loss to the institution or seriously prejudiced the interests of depositors, and (3) involved personal dishonesty. For emergency situations, the act also empowered the agencies to issue temporary cease and desist orders and to suspend temporarily individuals whose conduct posed an immediate threat to the institution.
[384] Hearings (Part 2), p. 2018.
[385] General Accounting Office, "Highlights of a Study of Federal Supervision of State and National Banks," Report No. OCG–77–1, Jan. 31, 1977, pp. 9, 42.

uations where actions against individuals would be more appropriate than against entire institutions. In its report, the House stated:

> Regulatory agencies have often contended that their ability to control abuses by insiders and to see that financial institutions are operated in a safe and sound manner are too limited. The hearing records are filled with statements that the agency has the choice of either jawboning—sending letters to officals asking for their cooperation in correcting problems—or using a blunderbuss on the institution. Agency officials have asked for powers which lie somewhere between these two approaches so that they can tailor solutions and responses to specific problems and thus more effectively do their job. The bill provides the agencies with those tools, and it *expects the regulatory agencies to vigorously utilize those powers to make the nation's financial institutions function properly.* [386] [Emphasis added.]

The Congress clearly intended that these additional powers were not to be held in reserve or used as mere threats but should be "vigorously" utilized.

The act gave the agencies two new enforcement weapons against individual misconduct and expanded their removal authority. The agencies now had:

(1) The power to issue cease and desist orders against officers, directors, and insiders, as well as against institutions;

(2) The power to impose civil money penalties against institutions and individuals for violations of certain laws, regulations, and all cease and desist orders; and

(3) The expanded power to remove or suspend officers and directors. Such orders were authorized if a person had demonstrated either personal dishonesty (the previous standard) *or* a "willful or continuing disregard" for the safety and soundness of an institution.

Thus, the addition of these new powers gave the agencies a total of five different types of civil enforcement actions they can take directly against individuals engaged in insider abuse: formal agreements, civil money penalties, removals, suspensions and cease and desist orders.

A brief description of these and other informal powers follows:

2. Informal and indirect actions

Traditionally, the agencies have relied heavily upon informal methods of dealing with insider abuse. For example, an examiner may simply bring certain unsafe lending practices to the attention of the institution's president or the board of directors and receive assurances that the practices will cease. In other cases, higher level meetings between agency officials and the board of directors may succeed in focusing the board's attention on a problem and to force them to take official action to correct it. In more serious situations, the agency may quietly insist that the board "encourage" an individual to resign or may actually restrict his involvement in the affairs of the institution through provisions in an enforcement order against the entire institution.

[386] House Report 95-1383, reprinted in Hearings (Part 2), p. 1349.

Memoranda of understanding are increasingly used, particularly by the FDIC, as another informal enforcement tool. These written agreements are not considered legally enforceable but are a sort of "gentlemen's agreement" by which the parties put in writing the remedial actions that need to be taken.

If informal methods are unsuccessful or considered inadequate, an agency may present the board of directors with a formal agreement or cease and desist order. For example, if an agency determines that an officer has been using bank funds for his own personal benefit, a clause may be inserted into a written agreement, calling for the bank "to avoid future violations of law" or "not to make any future loans to officers or directors without the agency's prior approval."

3. Agreements

If the agency is going to take official action directly against an individual for insider abuse, the mildest course of action is to enter into a voluntary agreement with the person. Considered to be legally binding because it can serve as the basis for imposing a cease and desist order,[387] the formal agreement is still considered less onerous or drastic than a cease and desist. Because they require less red tape (i.e., less internal agency review) than cease and desist orders and bankers consider them less severe, agreements are often used a compromise:

> The agencies have not published detailed standards to guide the choice between written agreements and cease-and-desist orders, and a review of the published abstracts of decisions strongly suggests that there is no bright line dividing the two. Both forms of remedy frequently are used to deal with the same range of problems, and it appears that the choice of remedy may be affected by the enforcement staff's subjective assessment of the gravity of the situation, the attitude of management, and the need to be on record with definitive action. Many banks and bank holding companies believe that the opprobrium attaching to a written agreement is less than that of a cease-and-desist order, and the form of the action is a frequent issue in consent negotiations.[388]

Agreements with individuals, therefore, are relatively quick and painless ways for the agencies to address problems of insider abuse without stigmatizing the entire institution or going through the agencies' cumbersome procedures to issue a cease and desist order or impose civil money penalties.

4. Cease and desist orders

The agencies' authority to issue cease and desist orders constitutes one of their more powerful weapons against insider abuse,

[387] 12 U.S.C. § 1730(e)(1) and 1818(b)(1).
[388] Hearings (Part 2), p. 2019.

since they are legally enforceable and may serve as the basis for imposing civil money penalties.

The banking agencies have broad authority to issue such orders. They must only show that the institution or individual (1) is engaging, or is about to engage, in an "unsafe or unsound" practice in the conduct of the affairs of the institution or (2) has violated, or is about to violate, any law, rule, regulation, or written agreement entered into with the agency.[389] Upon receiving a notice of charges, the institution or individual has the right to an evidentiary hearing and direct appellate review.

In emergency situations, the agencies can also seek temporary cease and desist orders if the practices or violations stated in the notice of charges are likely to cause any one of four conditions: (1) Insolvency, (2) substantial dissipation of assets or earnings, (3) a serious weakening of the condition of the institution, or (4) a situation that otherwise seriously prejudices the interests of the depositors prior to the completion of the cease and desist proceedings.[390]

Although there have been some recent questions raised about how far the concept of "unsafe or unsound practices" should extend,[391] most insider abuse clearly falls within the ambit of such practices. For example, courts have upheld agency orders prohibiting excessive salaries for officers,[392] excessive rental payments made under a lease agreement with an insider,[393] and the diversion of insurance commissions paid by loan customers to insiders.[394] Even though the orders involved in these decisions were directed against institutions rather than individuals, the definition of "unsafe or unsound" practices for individual misconduct is presumably the same as that for institutions as a whole.

5. Civil money penalties

The most recent addition to the agencies' arsenal of weapons against abuse is the civil money penalty. This power, granted to all four banking agencies for the first time in 1978, was intended to increase the agencies' flexibility in dealing with abuse by serving as a "midway approach" that would be more severe than informal actions but less drastic than a cease and desist action against an entire institution or a criminal referral. The legislative history reveals:

> In many cases, the agencies have argued [a cease and desist order against an institution], may be inappropriate. For example, a bank which is controlled by one major stockholder who is firmly in control of the day-to-day management of the bank could be unjustly tainted if a cease and desist order is entered against the institution when the practices which are to be stopped by the order may have been the sole responsibility of the stockholder. . . .[395]

[389] 12 U.S.C. § 1730(e), 1818(b).
[390] 12 U.S.C. § 1730(f)(1), 1818(c)(1).
[391] *Gulf Federal & Loan Assoc.* v. *FHLBB,* 651 F. 2d 259 (5th Cir. 1981).
[392] *First National Bank of Eden* v. *Dept. of Treasury,* 568 F. 2d 610 (8th Cir. 1978).
[393] *First National Bank of Scotia* v. *Department of Treasury,* 659 F. 2d 1059 (2nd Cir. 1981).
[394] *First National Bank of LaMarque* v. *Smith,* 610 F. 2d 1258 (5th Cir. 1980).
[395] House Report No. 95-1383, reprinted in Hearings (Part 2), p. 1350.

Such penalties were seen by Congress as a means of ensuring compliance with agency directives, as a form of punishment or sanction against individuals and institutions, and as a form of deterrence against future violations. The Comptroller of the Currency's guidelines for examiners quotes from the act's legislative history:

> A monetary penalty tied to a violation can give an agency the flexibility it needs to secure compliance by individuals or institutions. Presently, an agency is often faced with the option of having to ignore a violation or imposing a penalty it often considers to be overkill. A cease and desist action against an institution or referral of a possible criminal action may be too severe for the criticized action. Daily money penalties should serve as deterrents to violations of laws, rules, regulations, and orders of agencies.
>
> Civil money penalties which accrue for violating particular laws can play a crucial role in deterring violation of such laws. Within the past several years, there have been a number of instances in which violations of law have gone unpunished. The violations referred to were of a variety that could have had a detrimental effect upon the safety and solvency of financial institutions. The remedies available to the regulatory agencies to prevent and cure these violations of law were not as broad as they might have been. . . . The civil money penalties provided in the bill are designed to be strong provisions of law. The provisions provide for the penalties to be assessed from the first day of the occurrence of any violation. Thus, the provisions should, to a significant extent, have a self-enforcing effect. . . .[396]

Penalties can be imposed against both institutions and individuals in amounts as high as $1,000 for each day that the violation continues, and $10,000 per day for violations of the change of control laws.[397]

The four agencies have the power to issue CMPs for violations of cease and desist orders, temporary cease and desist orders, and the change of control statutes. In addition, each of the agencies may impose penalties for violations of specific statutory provisions:

(1) The OCC may impose penalties for any violations under the National Banking Act or any regulation issued pursuant to it. In effect, this gives the OCC the broadest authority of any of the agencies to assess penalties, covering virtually any instance of insider abuse.

(2) The Federal Reserve may impose penalties for violations for the Bank Holding Company Act, sections 22 and 23A of the Federal Reserve Act (placing limitations on loans to affiliates and insiders), and section 19 of the Federal Reserve Act (plac-

[396] Hearings (Part 2), page 1421, see also p. 1350.
[397] Except for violations of section 19 of the Federal Reserve Act. See 12 U.S.C. § 505(1), in which case penalties are $100 per day.

ing limits on the rates of interest paid on deposits and setting reserve requirements).

(3) The FDIC may impose penalties for violations of section 22(h) and section 23A of the Federal Reserve Act.

(4) The FHLBB may impose penalties for violations of the Savings and Loan Holding Company Act.

These differences among the agencies are offset, however, by the ability of all the agencies to impose penalties for violations of cease and desist orders. Since the agencies have broad authority to issue such orders, they could routinely impose cease and desist orders against individuals, which, when violated, could then as the basis for civil money penalties.

There are no logical policy reasons why the agencies should continue to possess such widely differing authority. The fact that an institution operates under a national, rather than a state, bank charter or the fact that it is a savings and loan, rather than a commercial bank, should not affect the agencies' ability to use reasonable civil money penalties to ensure compliance with their own regulations or to deter abusive conduct by insiders. In addition, it is irrational and unfair to hold certain officers, directors, and insiders to significantly higher standards than others or to cause them to suffer greater risk of personal financial loss, simply on the basis of which Federal agency supervises and examines their institution. The committee recommends that Congress should expand the powers of the FDIC, FHLBB, and the Federal Reserve to conform to the Comptroller's broad authority to issue civil money penalties for insider abuse.

Congress set forth five specific factors that the agencies should consider in determining the amounts of these money penalties: (1) The appropriateness of the penalty with respect to the financial resources of the person charged; (2) the good faith of the person; (3) the gravity of the violation; (4) the history of previous violations; (5) and such other matters as justice may require.[398] The Federal Financial Institutions Examination Council (FFIEC) has developed uniform policies for agencies to follow in setting civil money penalties.[399]

6. Removals and suspensions

The banking agencies have identical authority to suspend or remove officers, directors, and insiders who have engaged in insider abuse. Prior to the passage of FIRIRCA in 1978, the agencies complained that their removal and suspension powers were too limited, since they needed to prove "personal dishonesty" on the part of the individual.

In response to these concerns, Congress loosened the removal standard to enable the agencies to remove or suspend individuals based upon a "willful or continuing disregard" for the safety and soundness of the institution. The House report states:

[398] 12 U.S.C. § 93(b)(1), 504(a), 505(1), 1730(k)(3)(A), 1818(i)(2), 1828(j)(3)(A), and 1847(b)(1).

[399] For a copy of these guidelines, see Hearings (Part 2), p. 1478–1483. However, it is rather ironic that the agencies have gone to such lengths to adopt uniform guidelines on the various factors to weigh in *assessing* penalties when they have such widely different—and disparate—authority to *impose* such penalties in the first place.

The agencies have also forcefully stated that present law authorizing removal of an insider from his position is unduly restrictive upon the agencies in their performance of their duties to insure that the nation has a safe and sound banking system. Presently, an individual may be removed only on a showing that the individual is engaging in unsafe and unsound practices which have an adverse effect on the institution and that the individual's activities involve personal dishonesty.

Your committee has provided statutory language which will give the regulatory agencies a less burdensome test under which they may institute removal proceedings. The provisions would authorize removal when an individual has evidenced personal dishonesty (current standard) *or* has demonstrated willful or continuing disregard for the safety and soundness of the financial institutions.

The new standard will allow the agencies to move against individuals who may not be acting in a fraudulent manner but who are nonetheless acting in a manner which threatens the soundness of their institution. As with the other powers given the agencies, requirements for due process are built into the removal statute.[400]

Despite this change in 1978, the requirements imposed by the removal and suspension statutes[401] are still extremely restrictive and reach only the most egregious cases of abusive conduct.

There are three different removal situations covered by the statutes:

a. Removal of an officer or director from an institution where misconduct has occurred

The agencies may remove an individual based upon misconduct within a particular institution if three conditions are met: (a) the person must have violated a law, rule, regulation or cease and desist order, engaged in unsafe or unsound practices or breached his fiduciary duty; (b) the agency must have determined that the institution has suffered or may suffer financial loss or other damage, the interests of the depositors could be seriously prejudiced or the individual has received financial gain by such conduct; and (c) the conduct involves personal dishonesty or demonstrates a "willful or continuing disregard" for the safety and soundness of the institution.[402]

[400] House Report No. 95-1383, 95th Congress, 2d session, reprinted in 1978 U.S. Code, Congressional & Admin. News, p. 9290.

[401] 12 U.S.C. § 1818(e), 1818(g), 1730(g), and 1464(d).

[402] In an internal FDIC memo dated March 1983, the agency quotes the 1977 Senate report on FIRIRCA as expressing Congress' expectation that the agencies would issue interpretations on the meaning of the phrase "willful or continuing disregard":

The 1977 Senate Report did state, however, that "[i]n the absence of congressionally-mandated standards for what is to be considered 'willful disregard,' the committee expects the agencies to issue interpretations from time to time, so that officers or directors will be sure of the limitations placed on their actions." S. Rep. No. 323, 95th Cong., 2d Sess. 7 (1977). FDIC has utilized the "willful or continuing disregard" criteria in several recent section 8(e) actions. FDIC has only begun to fully define its parameters. We have, however, been cognizant of the Senate's concern that individuals should be put on notice as to what conduct may subject them to removal.

None of the agencies, however, has produced adequate guidelines to interpret this clause or other sections of the removal statutes. Nor has the FFIEC issued any uniform removal standards, similar to these governing civil money penalties.

b. Removal of an officer or director based upon misconduct in another institution and removal of insiders

This section also requires that three conditions be met, two of which are different from the preceding section. In order to be removed, the individual must have: (a) engaged in conduct with respect to another bank or business that resulted in substantial financial loss or other damage to that business; (b) have shown personal dishonesty or a willful or continuing disregard for the safety and soundness of the other business; and (c) have shown an "unfitness to continue in office" or to participate in the affairs of the institution.[403] Although poorly drafted, this section is apparently intended to require a lower standard of proof to remove an insider or to remove an officer or director for misconduct that occurred in another institution or business.

One common example of this situation would be where the banking agency knows that an officer is hired by Bank B after having been involved in abusive practices in Bank A. Under this section, the agency need only prove that the person engaged in conduct resulting in "damage" to that other bank or business, that he had a continuing disregard for the business' safety and soundness, and that he is "unfit" to continue in office, without having to prove that the person engaged in specific abusive conduct.

c. Removal based upon a criminal conviction

Any officer, director or insider who has been convicted of a felony can be removed if two conditions are met: (a) The criminal offense involved dishonesty or breach of trust and the conviction is final (i.e., not subject to further appellate review), and (b) the agency determines that continued service or participation in the institution may either pose a threat to the interests of depositors or threatens to impair public confidence in the institution.

Persons who are subject to any of these removal proceedings are entitled to full evidentiary hearings, often requiring 6 months to complete. As former FHLBB Chairman Richard T. Pratt wrote to the subcommittee last year, "As you can see, the present statutory authority presents a formidable obstacle to easy or swift removal of wrongdoing savings and loan officials." [404]

Temporary suspensions are also available, provided the agency is able to justify removing someone without affording the person a due process hearing.[405] Suspensions are available in two situations:

(1) If the agency determines that a suspension is necessary "to protect the institution or the interests of the depositors," pending completion of the removal proceedings.

(2) If a person has been charged with a felony involving dishonesty or breach of trust and the agency determines that continued service may pose a threat to the interests of depositors or threatens to impair public confidence in the institution (i.e., the same standard as for removal based upon a criminal conviction).

[403] U.S.C. § 1818(e)(2), 1730(g)(2).
[404] Hearings (Part 2), p. 1497.
[405] The agency may temporarily suspend an individual without benefit of a hearing, but the person has 10 days to petition a U.S. district court for review.

Such an order remains in effect until the charge is finally disposed of, or the agency terminates it.

Judging by how rarely the agencies have used suspensions, it is clear that they consider suspensions an extraordinary remedy to be invoked only in the rarest circumstance.[406]

7. Prohibitions

Any person removed or suspended from a financial institution is automatically prohibited from participating in the affairs of that institution in the future unless the agency grants a waiver.[407] Anyone who violates this prohibition is guilty of a misdemeanor. It is possible, however, for convicted felons and persons subject to such orders to apply for special permission to become re-involved with an institution.

A separate statute provides that any person who has been convicted of a felony involving dishonesty or breach of trust cannot "serve" as an officer, director or employee of a financial institution without the appropriate agency's permission. A violation of this section can result in a fine of $100 per day for the institution.[408] If this section is read in conjunction with the removal statutes, it can be argued that the agency should never need to institute removal proceedings against any such person who has been convicted of a felony, since it could simply fine the institution that allows the person to continue in office.

Major loopholes in the prohibition provisions permit corrupt insiders who have been removed—either formally or informally through resignations—to get right back into the banking business. First, under the current provisions, the agencies can prohibit an individual's participation only in the affairs of the institution with which he is currently associated. (All of the removal and suspension sections refer to the individual's involvement with "the" bank or "the" thrift institution, not with "an" institution or "any" institution.) Consequently, the agencies do not have the authority either to prohibit someone from participating in the affairs of other institutions regulated by that agency or ones regulated by any other banking agency. Sometimes, the agencies have been successful in getting insiders to sign consent decrees promising not to participate in the affairs of other institutions, but this has been rare.[409]

Second, the agencies apparently lack the authority to issue a removal (and prohibition) order against someone who has already resigned his position as a director or officer or who is no longer participating in the affairs of an institution. Consequently, if an agency has been successful in getting an insider to resign or in getting the institution to fire the person but fails to serve a timely notice of charges against the person before he leaves, the agency is powerless to prevent the person from going to work for another institution. If the agency happens to find out by chance that the

[406] Hearings (Part 2), p. 1375..
[407] 12 U.S.C. § 1464(d)(12)(A), 1730(p)(1), 1818(j).
[408] 12 U.S.C. § 1464(d)(12)(B), 1730(p)(2), 1829.
[409] Hearings (Part 2), pp. 1354–1355.

person has joined another institution, it can begin removal proceedings, but the agency may not find this out until it's too late.

Third, the statute[410] that prohibits any person from serving as an "officer, director or employee" of a financial institution if he has been convicted of a felony contains a loophole allowing a convicted felon to serve as a majority shareholder or to act as an agent or consultant or other insider.

In order to close these loopholes, the committee recommends that the removal/prohibition provisions be expanded to authorize the agencies (1) to prohibit an individual from participating in the affairs of any federally insured financial institution, (2) to issue such orders within one year of a person's separation or resignation from an institution, and (3) to bar convicted felons from serving as majority shareholders of financial institutions without the prior approval of the appropriate banking agency.

B. THE BANKING AGENCIES' CIVIL ENFORCEMENT RECORD AGAINST INDIVIDUALS

The banking agencies often fail to take direct civil enforcement action against individuals engaged in insider abuse, notwithstanding a clear statutory responsibility to do so. This conclusion is based upon the subcommittee's review of the agencies' statistics on their enforcement actions taken against individuals from 1980 to 1983, the subcommittee's two surveys of approximately 150 failed and problem institutions, a review of the agencies' written policies and procedures on enforcement, and numerous interviews with bank examiners and law enforcement officials.[411]

1. The overall enforcement record

The banking agencies have significantly increased their use of formal enforcement actions against institutions over the past 3 years, largely because of the recession and the large number of problem institutions. As the following chart demonstrates, the OCC has increased its use of formal agreements against institutions threefold, from 54 in 1980, to 165 in 1983. Likewise, the FDIC has

[410] 12 U.S.C. § 1464(d)(12)(B), 1730(p)(2), 1829.

[411] The subcommittee staff sought to interview present and former bank examiners, to review certain bank examination reports, and to obtain other sensitive agency documents in order to learn why the agencies often failed to take strong civil action in the face of apparent insider abuse or criminal misconduct. Despite the subcommittee's repeated requests, the agencies prevented the staff from learning the full details of many of the specific cases mentioned in this report. They refused to share crucial information and examination reports with the subcommittee, notwithstanding the subcommittee's offers to keep certain information confidential, and refused to permit the subcommittee staff to talk directly with examiners who were personally familiar with these cases. Their refusal to grant direct access to examiners was particularly detrimental to the subcommittee's work, because many of the agency documents raised serious questions about the conditions examiners had discovered during specific exams. Direct contact with the examiners personally involved in these exams was the only way the subcommittee could actually verify the information provided by the agencies and to learn the examiners' "firsthand" experiences with insider abuse.

The OCC even went so far as to twist the subcommittee's goals into a justification for the agency's refusal to cooperate. As the OCC stated in a letter,

"The identify of bank examiners has been withhead to preclude the potentially disruptive effect on OCC's bank examination schedule as well as potentially undermining the Committee's goal of improving the enforcement process by causing examiners to think twice before recommending specific enforcement actions." [Hearings (Part 2), p. 931.]

Also, the OCC refused to provide the subcommittee with copies of draft studies it is currently considering on its civil money penalty and overall enforcement processes, both of which are highly relevant to this report.

increased its use of cease and desist orders sixfold, from 36 in 1980 to 212 in 1983. The number of enforcement actions directed against individuals, on the other hand, remains small. Figure 4 shows that the agencies entered into only six agreements with individuals over the past 4 years. Likewise only 22 cease and desist orders and 62 removal orders have been issued against individuals. Of the 62 removals, 30 have been issued by the FHLBB alone.

The one major exception to this overall lack of direct actions against individuals over the past 24 months has been the large increase in the number of civil money penalties imposed by the OCC and the FDIC against individuals. The OCC has increased its number of individual CMPs from 10 to 1980, to 127 in 1983; the FDIC has increased its penalties from 4 to 1980, to 61 in 1983. On the other hand, the FHLBB has not imposed any at all during the same 4-year period, and the Federal Reserve has imposed only two. (See figure 4.)

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FIGURE 4.—CIVIL ENFORCEMENT ACTIONS TAKEN BY THE BANKING AGENCIES, 1980–83

Type of action taken	Actions taken against institutions					Actions taken against individuals				
	FED [1]	OCC	FDIC [2]	FHLBB [3]	Total	FED	OCC	FDIC	FHLBB	Total
1. MOUs										
1980	14	48	502		564	NA	NA	NA	NA	NA
1981	12	43	538		593	NA	NA	NA	NA	NA
1982	27	43	514		584	NA	NA	NA	NA	NA
1983	28	44	549		621	NA	NA	NA	NA	NA
Total					2,362					NA
2. Agreements:										
1980	4	54		4	62	0	0		0	0
1981	6	62		2	70	0	0		0	0
1982	11	92		11	114	4	1		0	5
1983	11	165		37	213	0	1		0	1
Total					459					6
3. C&Ds										
1980	3	39	36	1	79	0	3	0	0	3
1981	9	22	37	8	76	1	1	0	3	5
1982	6	28	74	13	121	3	0	0	7	10
1983	7	76	212	17	312	0	0	0	4	4
Total					588					22

4. CMPs										
1980	0	5	0	1	6	0	10	4	0	14
1981	4	3	0	0	7	2	19	3	0	24
1982	1	3	0	0	4	0	95	28	0	123
1983	0	2	0	0	2	0	127	61	0	188
Total										
5. Removals, suspensions, prohibitions					19					349
1980	NA	NA	NA	NA	NA	0	1	4	1	6
1981	NA	NA	NA	NA	NA	1	2	0	2	5
1982	NA	NA	NA	NA	NA	0	6	8	6	20
1983	NA	NA	NA	NA	NA	0	4	6	21	31
Total										62

[1] Does not include bank holding companies.

[2] The FDIC notes that in a small number of cease-and-desist orders against institutions, individual insiders were specifically mentioned. In addition, the agency noted that "a majority" of its memoranda of understanding against institutions contain management clauses that relate to specific individuals' transactions with the institutions. However, no numbers were provided. In addition, the FDIC is the only agency that chooses not to utilize formal agreements.

[3] It is unclear whether the one civil money penalty listed below was issued against an institution or and individual. In addition, the FHLBB is the only agency which does not utilize memoranda of understanding.

NA=Not applicable.

The chart offers a useful comparison of the agencies' enforcement policies. The agencies' total numbers of enforcement actions taken against individuals over the 4-year period reveal that the OCC is the most active of the agencies in its enforcement efforts against individuals:

Agency:	*Number of actions taken against individuals*
Federal Reserve	11
OCC	270
FDIC	114
FHLBB	44

Even when the number of institutions under each agency's supervision is taken into consideration, the OCC is still the most active and the Federal Reserve, the least. In fact, it is rather hard to believe that the Federal Reserve, which during this period had supervisory responsibility for approximately 1,000 member banks and 2,000–4,000 bank holding companies only took 11 enforcement actions directly against individuals.

2. The subcommittee's survey of failed institutions

The results of the subcommittee's survey of failed institutions is consistent with the agency's overall enforcement statistics. The survey showed that for failed institutions where the likelihood of criminal misconduct by insiders was high or where the agencies themselves had made criminal referrals involving insiders,[412] the agencies took direct enforcement action against individuals in only 30 percent of the cases. Figure 5 shows that out of 105 institutions surveyed, FBI investigations were conducted in 75. Out of these, there were only 21 cases where civil enforcement action was taken against individuals and only 12 cases where the agency both made a criminal referral and also took civil action directly against individuals.

Figure 5 offers another useful comparison among the agencies. The FHLBB clearly took the highest number of enforcement actions (8 enforcement actions out of 15 institutions) as opposed to the Federal Reserve (1 out of 5) and FDIC (7 out of 41).[413] In addition, the FHLBB showed the highest number of instances where the agency was able to take both civil enforcement action and make a criminal referral. As opposed to the overall statistics, this

[412] For every agency except the Federal Reserve, the subcommittee's surveys covered a large number of institutions within each agency's jurisdiction. For each of these agencies, the subcommittee was able to locate instances where the agencies vigorously pursued insider abuse and instances where they essentially ignored it. The Federal Reserve, however, had so few failed banks and made so few criminal referrals involving problem banks that the subcommittee was unable to get as clear a picture of its enforcement record, compared to those of the other agencies. Since the Federal Reserve refused to provide the subcommittee with the names of any present or former examiners, thus denying this committee the benefit of the views and personal experiences of these knowledgeable sources, the subcommittee got a more limited view of the agency's overall performance.

[413] The subcommittee used as its sample group all failed institutions in which the FBI conducted investigations. The mere existence of an FBI investigation, of course, does not prove that criminal activity or insider abuse were present in the institution or that the banking agency should have taken civil enforcement action against individuals in the institution. On the other hand, FBI investigations have, in fact, almost always proven to be a good indicator of criminal misconduct. Out of the 75 investigations in the survey, the subcommittee is aware of only 6 that have resulted in declinations or closed cases.

survey shows the FHLBB is more vigorous than the other agencies in its enforcement actions.

FIGURE 5.—CRIMINAL REFERRALS AND CIVIL ENFORCEMENT ACTIONS TAKEN AGAINST OFFICERS, DIRECTORS AND INSIDERS IN FAILED INSTITUTIONS, 1980 TO MID-1983

	Primary Supervisory Agency				
	FED	OCC	FDIC	FHLBB	Total
A. Sample size:					
Total number of failed institutions under agency's primary supervision	6	15	54	30	105
Failed institutions in which FBI conducted investigations	5	14	41	15	75
B. Criminal referrals:					
Total number of failed institutions in which agency made criminal referral [1]	1	5	18	11	35
Referrals made prior to failure	1	3	12	9	25
Referrals made after failure [2]	0	2	[3] 6	2	10
C. Correlation between criminal referrals and civil enforcement actions:					
1. Failed institutions in which agency made no referral but took civil enforcement action [4] against individual officers, directors and insiders	1	3	3	2	9
2. Failed institutions in which agency both made criminal referral and took civil enforcement action [3] [4] against individuals	0	2	4	6	12

[1] Referrals made by the banking agencies more than 4 years prior to the institution's failure were not included. In an additional 13 institutions, the referral was made by the institution itself. If the agency did not directly made a referral, it was not included.
[2] All referrals listed in this column were made by the institution's primary supervisory agency. Although the FDIC, for example, may have made a referral in a national bank subsequent to the bank's failure, such referrals were not included.
[3] One of these is a State nonmember bank for which the FDIC failed to indicate when the referral was made.
[4] Includes both actions taken before and after an institution's failure.

There are a number of reasons why the banking agencies are reluctant to take civil enforcement actions against individuals in these situations, either before the institution fails or afterwards. Some of the reasons are obvious, such as the failure to detect insider abuse until the institution has failed or is about to fail. At that point, the agency's enforcement options become much more limited. Another reason the FDIC and FHLBB are reluctant to pursue civil money penalties against individual after an institution has failed is that they prefer to initiate civil damage suits against individual officers and directors. Whenever the FDIC or FSLIC is appointed receiver for a filed institution, the agency's first responsibility is to try to preserve the corpus of the failed institution and to recover as much of the assets of the institution as possible including possible claims for negligence and breach of trust against former officers and directors. Whereas the agencies must turn over all civil money penalties to the U.S. Treasury, damages recovered through civil suits directly reduce the amount of money ultimately paid out in deposit insurance claims by the FDIC and FSLIC.

This dual role of the FDIC and FSLIC raises both an internal conflict of interest for these two agencies and an external conflict between them and the other bank agencies seeking civil money penalties. The OCC and the FDIC, in particular, have been at odds over the OCC's desire to recover civil money penalties against officers and directors of failed banks. FDIC Chairman Isaac testified:

We will levy a fine to teach [individuals] and the board of directors a little lesson to deter similar activity in the future. I would say, though, probably our strongest enforcement action against individuals who cause serious problems in banks would be in the area of the failed bank activity. Whenever a bank fails, you can bet your house that we are going to be suing the officers and directors, the accounting firm, and others, that were involved in that bank.

The subcommittee staff questions why, when a bank fails and the officers caused it to fail, don't we levy civil money penalties against the officers? I think it would be a serious mistake to levy fines against officers or directors in failed banks.

What we should do at that point is precisely what we do at present. We sue the officers and directors of the bank and we try to recover all the damages we can on behalf of the people who were hurt by the bank failure—the shareholders and the creditors, including FDIC. We want to recover as much as we can. There have been some cases where fines have been levied against officers and directors by banking agencies after a bank has failed. We find that to be counterproductive and against the best interests of what we are trying to accomplish, which is to try to recover money, not on behalf of the U.S. Treasury, but on behalf of the people who were hurt by the bank failure—the creditors and shareholders . . . .

Mr. BARNARD. Do I understand what you are saying, that you don't pursue this method after the bank fails?

Mr. ISAAC. Not fines against officers and directors. We refer criminal matters and we bring civil suits against them. We do not believe it is appropriate to try to levy a fine against an officer or director after the bank has failed . . . . I do not want the Comptroller, the FDIC or the Fed collecting on behalf of the U.S. Treasury. I want the FDIC in there with a civil suit trying to collect on behalf of the creditors and shareholders of the failed bank.[414]

The OCC, on the other hand, frequently wants to pursue civil money penalties against individuals after failure.

As the Comptroller testifed:

Mr. CONOVER. Chairman Isaac said earlier that once a bank fails, the FDIC does not want to assess a civil money penalty. We have assessed civil money penalties after a bank has failed. That puts us in an awkward position vis-a-vis the FDIC, I might add, where we, as primary bank supervisors, believe we ought to proceed with a civil money penalty even though the bank has failed. I am sympathetic to Chairman Isaac's view on the subject, but I do not know how we can reconcile our differences at this stage. Obviously, we should discuss this issue, and if there is a need for congressional action, we will let you know.[415]

[414] Hearings (Part 2), pp. 532–533.

Since both agencies have legitimate interests at stake here, the committee recommends that the proposed Task Force on Insider Abuse in Financial Institutions should consider this issue and take appropriate action to resolve the agencies' differences.

3. The subcommittee's survey of problem institutions

The findings of this survey, which consisted of all banking agency criminal referrals involving insiders of problem institutions, are consistent with the finding of the other survey. The survey found that during 1980-81 the agencies were reluctant to take civil enforcement action against individuals whom the agencies suspected of criminal misconduct and had referred to the Justice Department for prosecution. The subcommittee analyzed 66 referrals made by the agencies during this 2-year period. The agencies were asked to describe the conduct which gave rise to the referrals, the nature of any civil enforcement actions taken against the institutions and the individuals, and to indicate whether fidelity bond claims were filed and paid in connection with the abusive conduct.[416] Although some of the agencies' responses were incomplete, particularly those of the FHLBB, the subcommittee compiled a chart showing the correlation between the number of criminal referrals made and the number of civil actions taken directly against such individuals.

Figure 6 shows that in 80 percent of the referrals (57 out of 66),[417] the banking agencies took no concomitant civil enforcement action against the individual who was the subject of each referral. *When this is combined with the low prosecution rate for problem institution referrals, we find that two-thirds (66 percent) of all criminal referrals resulted in neither civil nor criminal actions against individuals whom the agencies suspected of criminal activity.*

FIGURE 6.—CORRELATION BETWEEN CRIMINAL REFERRALS, CIVIL ENFORCEMENT ACTIONS, AND PROSECUTIONS IN "PROBLEM" BANKS AND THRIFTS, 1980–1981

	FED	OCC	FDIC	FHLBB	Total
Total Number of Criminal Referrals Made by Agency [1] during 1980–81 involving "problem" institutions	4	20	[3] 22	20	66
I. Total number of agency referrals which were not accompanied by civil enforcement action against the individual referred [2]	4	15	20	18	57
a. and in which prosecution was declined by Justice	3	[4] 8	13	14	38

[415] Ibid., p. 545.

[416] If fidelity bond claims were filed and paid in regard to such insider conduct, this would be a good indication that sufficient evidence of dishonest activity existed to warrant some kind of civil enforcement action.

[417] There were actually 99 referrals made by the four agencies in problem institutions. However, the staff was only able to review 22 of the 55 referrals made by the FDIC during this period because the agency insisted that it would be extremely burdensome for it to reconstruct its enforcement decisions for all 55 referrals. The subcommittee therefore limited its review to the 20 referrals made by the FDIC during 1980.

FIGURE 6.—CORRELATION BETWEEN CRIMINAL REFERRALS, CIVIL ENFORCEMENT ACTIONS, AND PROSECUTIONS IN "PROBLEM" BANKS AND THRIFTS, 1980–1981—Continued

	FED	OCC	FDIC	FHLBB	Total
b. and in which the case is still pending without indictments	0	[5] 6	6	4	16
c. and in which prosecution has resulted in convictions	1	1	1	0	3
II. Total number of agency referrals which were accompanied by direct civil enforcement action against the individual referred	0	5	2	2	9
a. and in which prosecution was declined	0	2	0	2	4
b. and in which the case is still pending without indictments	0	1	2	0	3
c. and in which prosecution has resulted in convictions	0	2	0	0	2

[1] The totals do not include referrals made in problem institutions which subsequently failed prior to June 17, 1983.
[2] Although cease-and-desist orders, agreements, and memoranda of understanding against institutions often have a direct effect on individuals, such actions were not counted as enforcements actions against individuals unless the action was entered directly against a specific individual.
[3] The FDIC made a total of 55 referrals during 1980–81. As noted earlier, the subcommittee only requested information on referrals made during 1980. Of the 55 referrals made during the 2-year period, 31 were declined, 16 are pending, and 8 resulted in convictions.
[4] One of the referrals, No. 5, does not show up in FBI records, so it is assumed that prosecution was declined.
[5] Four referrals included in this total, FDIC Problem Bank Nos. 11–14, involve a single institution in which a civil money penalty was assessed against "the bank". It is assumed that individuals were not included in this assessment.

This lack of direct action against individuals appears to be common to all four agencies. For example, the Federal Reserve made four referrals during this 2-year period, but did not take civil action against the individuals in a single case. The OCC only took civil action in 5 out of 20, the FHLBB in 2 out of 20. [See Figure 6.]

4. *The agencies' failure to carry out Congress' intent*

As noted above, the legislative history of FIRIRCA clearly articulates Congress' intent to strengthen the banking agencies' civil enforcement powers, and to encourage the agencies to "vigorously utilize" these powers preferably against individuals rather than institutions. The statistics compiled by the subcommittee dramatically demonstrate that the agencies' performance since 1978 does not comport with Congress' intent. With certain exceptions, the agencies still do not perform the vigorous enforcement role against individuals that Congress intended for them to perform.

5. *Why the agencies fail to take action against individuals*

a. General reasons

The data just discussed show that the agencies generally fail to utilize their civil enforcement powers against individuals, even when there is a strong likelihood that they have engaged in criminal misconduct. There are many interrelated reasons for this. As discussed in earlier chapters of this report, the agencies may be unable to take enforcement action because their examiners have not detected insider abuse, because they have not adequately investigated suspected abuse, or because their lack of computerized information systems prevents them from learning about the backgrounds of dishonest individuals and from conducting even the most rudimentary name checks.

Important as these reasons are, they still are not the primary ones for the agencies' lack of civil enforcement action. In many, if not most, of the cases involving failed and problem institutions in the subcommittee's study, the agencies were *well aware* of abusive practices and had sufficient evidence to take some form of enforcement action but failed to do so. This failure to take action was due to at least four separate factors:

(1) The agencies treat known insider misconduct in the same manner as institutional supervisory problems, such as inadequate capitalization or low liquidity through the use of enforcement actions directed against institutions and not against specific individuals.

(2) The agencies prefer to deal with most serious cases of insider abuse by encouraging or forcing an individual to resign, so that no enforcement actions necessary.

(3) The agencies have inconsistent enforcement policies that may preclude one agency from using certain enforcement powers that are available to the others.

(4) Some of the agencies have such cumbersome and bureaucratic enforcement review procedures that such actions are delayed for months or years.

The combination of these various factors, with the reluctance of the Justice Department to prosecute many cases, results in few insiders facing either civil or criminal penalties.

b. The "Graduated Response" Syndrome

The banking agencies fail to take enforcement action directly against individuals who have engaged in abusive practices primarily because the agencies perceive and treat insider abuse in the same manner as institutional supervisory problems, such as inadequate capitalization or low liquidity. Informal reprimands, memoranda of understanding, cease and desist orders against institutions, and similar actions which place the responsibility for correcting problems squarely on the board of directors may be successful in normal supervisory situations, but such approaches are totally inadequate to deal with corrupt individuals who willfully enrich themselves at the expense of the institutions they control.

A number of former examiners interviewed by the subcommittee staff expressed frustration that the agencies are unwilling to pursue civil enforcement action against insiders whom examiners had caught engaging in abusive practices. Former OCC Examiner Donny Palmer testified that a number of factors seem to be at work:

> One of the most demoralizing aspects of my examining career involved the inaction of the OCC, especially at the District level, to follow through on well-documented willful and knowing violations of law cited for civil money penalties (CMP). My opinion was, and still is, shared by numerous field personnel. Cases where insiders boasted in board meetings, with OCC personnel in attendance, of their full knowledge of their illegal actions involving insiders has gone unenforced. Invariably, the recommendation concerning the referral at the District level appears to hinge on

matters other than the facts included in the referral. By this, I mean that the "good ole boy" or political system comes into play. I have witnessed instances where the outcome of CMP referrals hinged, not upon the proof in the referral, but on *whether the board of directors was receptive to other action such as a Memorandum of Understanding or an Official Agreement.* . . .

* * * * *

The suggestion that insider abuse is often evident long before a bank fails or long before a criminal and/or civil referral is made can be documented. . . . In several instances, several attempts at enforcement were made over a period of several examinations with no results. In one specific instance, the failure of a bank resulted from the inaction of the OCC to follow the findings of the examiner relating to poor management and incompetent directors. The agency, in my opinion, is sometimes slow to react to what the onsite examiner recommends or represents. All too often, the agencies' leniency over a period of three to five examinations is just enough time for the institution to become insolvent or require capitalization.[418] [Emphasis added.]

Palmer's sentiments were shared by other examiners.[419] One attributed the lack of enforcement actions against individuals to the haphazard and disorganized way in which the agencies keep records on individuals and that the regional offices have no way to readily determine a person's background or criminal record. Another examiner pointed to a lack of communication among the various banking agencies. She described a case where the FHLBB had made a criminal referral on a savings and loan official in 1982. As of April 1984, the criminal investigation was still pending, but the FHLBB had not taken any civil action against the individual. The examiner was particularly disturbed that the person continues to serve as a director and principal shareholder of a national bank in the same area, despite the FHLBB's serious concerns about his conduct. "We really couldn't talk to the OCC people," she said, "even though we knew of problems about this man." [420]

As Palmer noted in his testimony and as the two subcommittee surveys suggest, the agencies frequently prefer to deal with abusive practices through actions directed at the institution itself than at specific individuals. The subcommittee's surveys reveal many instances in which the examiners noted abusive practices, violations of law, insider overdrafts, legal lending limits violations, and similar abuses in their reports, but which the agencies simply treated by issuing memoranda of understanding against the institutions.[421] Although this approach seems to be particularly popular

[418] Hearings (Part 2), pp. 108, 113–114.
[419] Ibid., pp. 1343–1345.
[420] Ibid.
[421] The enforcement summaries provided to the subcommittee by the Federal Reserve, the FDIC, and the OCC, contain information on the financial conditions existing in the institutions at the time the abusive conduct was first detected, the nature of the abusive conduct, the agency's response, etc. The FHLBB never provided this type of detailed information. See Hearings (Part 2), Appendix 5.

with the FDIC, all of the agencies stress their belief that it is an institution's responsibility to correct abusive practices and that the supervisory agencies cannot spend much time tracking down every violation of law and lending limit infraction. The subcommittee found repeated examples where this approach failed to have any effect on individuals who willfully engaged in abusive practices.

For example, the FDIC's supervision of the Carroll County Bank, of Huntingdon, TN, is an excellent example of how the agency's repeated leniency allowed an insider to gradually steal everything out of his own bank. As noted earlier, Ernest "Pug" Vickers, Jr., a wealthy politician and automobile dealer, decided in 1977 to purchase a bank for himself, despite the fact that, as one FDIC examiner expressed it, he "knew nothing about banking." [422]

The bank was already considered a problem bank in 1979, when the agency discovered that Vickers was involved in serious insider abuse, including floating large personal checks as continuing overdrafts in excess of the bank's legal lending limits. As a result of this and other serious problems at the bank, the examiners recommended that a cease and desist order be issued against the bank. The regional office rejected this recommendation as "too harsh" and issued a memorandum of understanding instead. In addition, the FDIC regional director informed the bank that if the bank failed to comply with the April 25, 1979, memorandum of understanding, tougher action would be considered.[423] The FDIC now contends that a MOU was justified because the problems were a "first time offense" and the board of directors appeared willing to correct the problems.

According to subcommittee sources, however, "everyone at the FDIC knew that Vickers was a crook even before he got hold of the bank." According to one former examiner, the agency should have made a criminal referral on Vickers as early as the 1979 exam.

One year later, the agency sent another examiner into the bank, who discovered that the bank's condition had deteriorated and that new problems had developed. The bank had failed to meet the conditions set forth in the original MOU regarding the injection of new capital, the reduction in overdue and classified assets, the maintenance of adequate reserves, and the correction of various violations of law. Despite these findings, the agency simply issued another memorandum of understanding instead of taking the cease and desist action that FDIC officials had threatened to use.

In August 1981, the FDIC went back into the bank and discovered schemes to defraud the bank out of $280,000. At this point, the agency made a criminal referral. Vickers, the president of the bank, and another officer were subsequently convicted for a series of fraudulent activities dating all the way back to 1978. Within 8 months of the referral, the bank failed.

[422] See Section IV, Part A, of this report. This statement and others that follow came from subcommittee staff interviews with a number of persons with personal knowledge of the abusive practices in this bank, including former examiners. None of the sources, however, would consent to the disclosure of his or her identity. Memoranda of staff interviews are in the subcommittee's files.
[423] Apparently, the bank's management made repeated assurances that the insider abuse problem would be corrected. Such assurances are reminiscent of the ones given by the Butchers in the United American Bank and proved equally hollow. Hearings (Part 2), pp. 629, 1227–1228.

At the May 3, 1983, hearing, Chairman Isaac and Chairman Barnard had the following exchange concerning the FDIC's handling of the Carroll County Bank, in particular, and the agencies' "graduated response" strategy, in general:

> Mr. BARNARD. The point of my question is, how soon did you act? Did you act quickly enough?
> Mr. ISAAC. There was a memorandum of understanding put in place in 1979. It appears they reacted immediately, but rather than get to quibbling over a few months here and there on this bank I would point out that—I looked at one the other day. We had some bank that appeared in the newspapers and I wanted to find out what we were doing and there can be slippage of a few months here and there on banks, and I would like to tighten up these procedures and come down more firmly and forcefully, more promptly. Generally speaking, I think that our people have done a very good job. From what I can see of this case in just 30 seconds of review, we did a pretty good job. We took every enforcement action we had available.
> Mr. BARNARD. Three years from the time it was detected to the time it was closed was not an unusual time?
> Mr. ISAAC. Two years from detection to closing? We don't close banks.
> Mr. BARNARD. It failed 2 years later.
> Mr. ISAAC. It normally takes a period of time for a bank to fail after the problems are uncovered. . . . I presume what was going on here was an effort to try to get it turned around.
> Mr. BARNARD. I realize it is a problem. Of course, in Penn Square we had an unusual amount of time that elapsed between the first indications of problems and the date when it failed, as well as in the United American Bank situation, and even with the Empire Savings and Loan. So I guess that the question I am trying to get at, with the permission of Mr. Spratt and his time, is that how much time is enough time? In other words, what is the reasonable expectation of time. Do you follow me? Is it 2 years, 3 years, 4 years, 5 years?
> Mr. ISAAC. It really depends on what is happening. . . . If they are going in the wrong direction, and they are ignoring us, a month is too long. We ought to come down on them. I think that we at times tend to be a little too forgiving. People don't believe this as I get letters everyday from Congressmen and Senators and Governors and even banking commissioners saying we are ganging up on the poor banker, why don't we let him alone, and I get letters from irate bankers saying we are picking on people.
> . . . So people don't believe it, but my experience, having been in the banking industry for a number of years and having been a regulator for a number of years, is that we probably don't come down on people quite fast enough and quite hard enough . . . .[424]

[424] Hearings (Part 2), p. 543.

Another example of the agency's leniency in dealing with abusive practices can be found in FDIC Problem Bank Referrals Nos. 14, 27, 28, and 34.[425] This case involved four referrals of a director and the president of a State nonmember bank in Illinois. The referrals alleged that the director had made extensive use of the bank's expense account for personal expenses, had made "nominee" loans for his own hidden benefit, had made false entries in the bank's records concerning an unauthorized extension of credit to a personal friend, and had misapplied bank funds in order to participate a bad loan out to another bank. Instead of taking any action against the individuals, the FDIC treated the matter indirectly by issuing a cease and desist order against the bank, ordering it to "provide and retain acceptable management" (i.e., to fire certain people) and to correct various other abusive practices. The agency also made a criminal referral on the director and president.

While the agency was admittedly monitoring the situation and trying to take corrective actions, it failed to take direct action against the specific individuals responsible for the misconduct. No civil action has ever been taken by the FDIC against any person, and those involved may still be involved in the banking industry or working in the same institution. The referrals, as of late 1983, were still pending with the U.S. attorney's office after more than 3½ years.

The imposition of money penalties would probably have been appropriate. Not only did the agency suspect the individuals of criminal activity and issue a cease and desist order against the institution, but the misconduct was not so obviously criminal that the U.S. attorney rushed to secure indictments.

c. Resignations

The banking agencies often prefer to deal with insider abuse through resignations, rather than enforcement actions against individuals. This is due to the agencies' myopic perception that their responsibilities do not extend beyond the particular institution being examined. Once a dishonest banker has been "disgraced" by resigning his position and the imminent threat to that institution has been reduced, the agency considers its work completed. While this approach may be expedient in eliminating abuse in one institution, it does nothing to prevent an individual from gaining employment as an officer at another institution, becoming a director at another institution, or even purchasing another institution. Donny Palmer, the former OCC Examiner, testified about one incident he had experienced:

> Another common event in the regulatory process is the detection of criminal activity or probable activity on the part of an insider whose dismissal or early retirement again appears to mitigate any need for enforcement. I personally participated in an examination where an actual verification of vault cash, which is highly unusual under new exam procedures, resulted in a cash shortage and the dismissal of the head teller. I cannot truthfully say if she

[425] Ibid, pp. 825, 828, 830, 1262.

or I were more surprised when we saw each other at the very next examination at a different institution as she counted out currency to a customer. After consultation with the district office, the decision was made not to mention to her new employer the circumstances of her last employment due to regulations pertaining to confidentiality. I have often wondered how much her "take" was at that institution.[426]

The agencies contend that they currently lack the legal authority to impose prohibition orders against officers or employees who have already resigned from their jobs in financial institutions or against directors or shareholders who have ceased their participation in an institution's affairs. As noted earlier, the statutes do not provide authority to prohibit reemployment or participation in other institutions; therefore, Congress should amend the law to explicitly authorize such orders.

On the other hand, this argument by the agencies begs the question. There are a number of other ways that the agencies could effectively prohibit such individuals from going to other institutions. For example, the agencies could seek consent agreements from the individuals, prohibiting their involvement in other financial institutions in lieu of civil money penalties.

The agencies cannot issue a prohibition order if they do not discover the fraud until the person has already resigned from one institution and gone to work at another. An example of this is illustrated by FHLBB Failed Institution Referral No. 28.[427] In that case, the senior vice president of a State chartered savings and loan in Texas was suspected by a FHLBB examiner of diverting $38,000 in loan proceeds to his personal benefit. The examiner discovered the fraud on January 22, 1981, but the man had resigned (i.e., been terminated) on December 17. The FHLBB made a criminal referral on the individual, but took no further action against him.[428] The agency heard nothing more about the man until a year later, when the FHLBB regional office learned that another savings and loan had agreed to hire or had already hired the man. The hiring institution had written a letter to the man's previous employer, seeking information about the man's "resignation." The first association, however, refused to disclose the fraud for fear of possible litigation. The first association came to the FHLBB and wanted the agency to tell the hiring institution about the man's abusive practices. The FHLBB, however, decided that it could not disclose its findings without special approval from the full Board. Therefore, the FHLBB Enforcement Division devised a scheme whereby the FHLBB district office "directed" the first association to disclose the reasons for the termination to the second one, in hopes that this would satisfy their legal concerns.

In this case, the FHLBB was able to informally prevent the person's reemployment through the disclosure of this information. The

[426] Ibid., p. 98.

[427] Hearings (Part 1), p. 343. The correspondence and referral described herein are contained in the subcommittee's files.

[428] Under the FHLBB's limited civil money penalty authority, the agency could only impose a CMP if he had violated a cease and desist order; none existed here.

case, however, demonstrates the ease with which a dishonest official can move from one institution to another. In this case, fortunately, the hiring institution was diligent enough to write the inquiry, the previous employer was honest enough to approach the agency about the problem instead of simply writing back that the man was "a fine fellow," and the regional FHLBB offices was able to "bend the rules" enough to warn the hiring institution.

The subcommittee's surveys of problem and failed institutions are replete with instances where the agencies failed to take action against individuals whom the agency suspected of criminal fraud because the agency handled the matter through a resignation. For example:

a. FHLBB Problem Institution Referral No. 16.—This referral involved the president of a savings and loan in Louisiana, who was suspected of disregarding known falsifications on loan applications.[429] No civil action was taken against the official, but the agency informed the subcommittee that "informal legal and supervisory efforts caused officer's resignation at a later date."[430] At the time of the referral, the individual was still an officer in the institution, so the agency could have sought to remove him or he could have been the subject of a cease and desist order or agreement. The case was never prosecuted by the Justice Department because it was deemed to lack jury appeal and because it was not "a prosecutable violation." It is unclear from the agency's documents how serious a violation this was, but it is rather ironic that the agency should choose not to take civil enforcement action against the officer, but would take "informal" action to cause him to lose his job. The agency's lack of flexible civil enforcement authority, in a situation like this, forces the agency to choose between informal action that may be extremely punitive and unfair and a formal removal action. The agency should either take appropriate civil enforcement action—in this situation, a cease and desist order might have been appropriate—or should leave the person alone.

b. FHLBB Problem Institution Referral No. 11.—This referral involved a savings and loan president whom the examiner had caught posting fraudulent loan payment entries to 49 subsidiary home improvement ledger accounts in the amount of $15,050.10. The president admitted making the false entries. The agency took no formal action against the man, but "the FHLBB District office informally prevented his employment by another FSLIC-insured institution."[431] Again, the Justice Department declined prosecution because the officer made restitution. The subcommittee does not possess sufficient information about the case to determine whether either a removal action or a criminal prosecution was warranted in the case, but it is clear that the action the agency did take—an informal "blackballing"—was not the sort of remedial action that the agency should be taking without due process.

c. FDIC Problem Bank No. 40.—This referral involved the president of a Mississippi State nonmember bank who had resigned during the bank's examination. The examiner suspected the presi-

[429] Hearings (Part 2), p. 1636.

[430] Ibid., p. 805.

[431] Ibid., p. 804.

dent of complicity in a customer's check kiting scheme and of "double pledging" of the bank's securities to secure public deposits.[432] The agency took no civil action against the president and the U.S. attorney declined prosecution for "lack of evidence and problems under *U.S. v. Williams.*"[433] Although it is difficult to determine the seriousness of these allegations, the agency should have at least conducted a further investigation or should have imposed a CMP. In this case, an official who may have been guilty of serious misconduct escaped with neither a civil or criminal sanction and probably went to work for another institution.

6. Inconsistent enforcement policies among the agencies

The agencies often fail to take direct enforcement action against individuals because certain agencies are unwilling to use all of their enforcement powers against individuals. This causes officers, directors and insiders of financial institutions to be subjected to vastly different standards and potential punishment, depending upon which Federal agency regulates their institution.[434] For example, the FHLBB uses its removal authority three times more frequently than any other agency. (See Figure 4.)

Figure 4 also shows that the FHLBB and the Federal Reserve do not use civil money penalties against individuals as often as the FDIC and OCC. As noted earlier, this failure to use CMPs is only partly due to these agencies' more limited statutory authority. It is primarily due to these agencies' antipathy toward their use. The FHLBB openly acknowledges this in one of its responses to the subcommittee:

> The Bank Board does favor increased authority for civil money penalties, but must point out that in general, except for securities violations, we view the assessment of fines as a punitive measure for the knowing and willful violators, which make up a very small percentage of the problems in the financial institutions we regulate. Any civil or administrative action that can halt a violation or unsound practice, prevent its recurrence and eliminate its harm to the institution is our favored approach to enforcement. We are not a criminal, but a civil agency and believe it as [sic] our primary responsibility to assure the safety and soundness of the thrift industry by preventative actions. *The penalizing of dishonest individuals in our view properly lies with the criminal law enforcement authorities,* to whom we pledge on [sic] continuing cooperation and assistance in carrying out their responsibilities in this area.[435] [Emphasis added.]

[432] Ibid., p. 1286.

[433] Ibid., p. 843.

[434] The FFIEC has established uniform interagency guidelines on the imposition of civil money penalties but none for removals, agreements, or cease and desist orders against individuals. The removal and civil money penalty statutes use similarly broad language and are thus both well suited to the establishment of uniform guidelines and standards for examiners to follow. The civil money penalty statute sets standards for determining the amounts of the penalties the agencies impose. The factors that the agencies must consider include broad standards like "the good faith of the insured bank or person charged" and "the gravity of the violation." Likewise, the removal statute sets standards for issuing a removal order, requiring the agency to prove that the individual "may pose a threat to the interests of the bank's depositors" or that he "may threaten to impair public confidence in the bank." The agencies adoption of guidelines for CMPs but not removals suggests that the agencies view removals as such rare occurrences that guidelines are unnecessary.

Not only does such a policy violate the legislative intent of FIRIRCA,[436] but it also clearly contradicts the stated policies of the OCC and the FDIC. The FDIC's Examination Manual states that civil money penalties are intended to punish wrongdoers and to deter future misconduct:

> Civil money penalties are assessed not only to punish the violator according to the degree of culpability and severity of the violation, but also to deter future violations. Although relevant to the Corporation's interests, the primary purpose for utilizing civil money penalties is *not* to effect remedial action. Such action, in the form of restitution or other corrective measures, should be separately pursued.[437]

The FHLBB's hostility toward "punitive" measures is odd, considering that it uses removals—clearly the most punitive enforcement action available to the banking agencies—far more than any other agency.

Although the agencies may differ on whether to impose civil money penalties, the penalties they do impose are generally low. Figure 7 below shows that the great majority of the civil money penalties imposed by the agencies over the past 2 years—the first time that such penalties have been imposed in any quantity—have been $2,500 or less. (See Figure 7.)

FIGURE 7.—AMOUNTS OF CIVIL MONEY PENALTIES IMPOSED AGAINST INDIVIDUALS BY THE OCC, FDIC AND FED [1]

Amount of Penalty	Number of Penalties Imposed			
	FED [2]	OCC	FDIC	Total
$500 or less	0	8	32	40
$501 to $1,000	8	50	33	91
$1,001 to $2,500	0	110	8	118
$2,501 to $5,000	1	34	11	46
$5,001 to $10,000	0	1	2	3
$10,001 to $15,000	1	1	0	2
$15,001 to $20,000	0	2	0	2
Over $20,000	0	[3] 13	0	13

[1] The FHLBB is not included because it did not impose any civil money penalties against individuals in 1982 or 1983.

[2] The Federal Reserve submitted two different sets of data which give slightly different numbers. See Hearings, (Part 2), pp. 357, 358, 1102, and 1103.

[3] The number of large penalties shown here may be somewhat distorted because the agency imposed 7 penalties in 1982 in the amount of $22,850. This appears to be related to a single institution.

7. Delays and difficulties in imposing civil enforcement actions

For various reasons, the agencies are often slow to impose civil enforcement actions in known instances of abuse. This is undoubtedly due to a combination of factors, including the excessive layers of review that are often needed to approve enforcement actions, the

[435] Hearing (Part 2), p. 404.

[436] See Congressional Research Service memo to subcommitteee, April 26, 1984. Ibid., p. 1346 et seq.

[437] Ibid., p. 1379.

failure of the agencies to detect abuse until an institution is about to fail, and the lack of specially designated officials at the regional level who bear prime responsibility for initiating enforcement actions against individuals.

The agencies often suffer lengthy procedural delays and impose restrictive tests in considering civil money penalties. For example, according to a February 11, 1981, policy memo, the OCC considers initiating civil money penalty actions to be as effective a deterrent as assessing such penalties; the agency will often start the process, send a supervisory letter "chastising" the person or the institution, but never assess any penalty.[438]

The OCC, in particular, has experienced protracted delays in its procedures for approving all types of civil enforcement actions. Many of its nondelegated enforcement actions (e.g., cease and desist actions, removals) require an average of 138 days from the close of the exam until they are actually imposed.[439] Since the exam itself takes several months, the total time required for many enforcement actions is 6–8 months. Obviously, an institution can deteriorate significantly and insider misconduct multiply greatly over such a period of time.

The subcommittee's failed bank survey shows that the OCC suffers particularly long delays in imposing civil money penalties against individuals in failed institutions. This is partly due to the conflict, mentioned earlier, between the FDIC and the other bank regulatory agencies over the pursuit of penalties in failed banks. At the May 3, 1984, hearings, Congressman Coleman asked Mr. Conover why the OCC had not pursued any civil money penalties against officers or directors of Penn Square. The Comptroller responded:

> Mr. CONOVER. We are still in the process of evaluating those. Your obvious followup question is, Why does it take so long? I have been concerned for some time about the lag between the time when we uncover something that warrants a civil money penalty and the time when that penalty is assessed and ultimately collected. We have been looking for ways within our agency to speed up and streamline that whole process. It is a high-priority item for us, and we hope that we will be seeing significant shortening of that time in the future.[440]

The subcommittee's surveys provided a number of instances where both civil money penalties and removal actions have been delayed for months or years. In addition to the Penn Square case, two other OCC cases serve as typical examples:

a. OCC Problem Bank Referrals Nos. 11–14.—The seven referrals in this case involved the suspected misapplication of bank funds and the falsification of bank records by top officials of a Texas bank.[441] As early as 1978, examiners had discovered imprudent

[438] Ibid., pp. 1420–1429. The other agencies basically follow the same policy and procedures, developed from FFIEC statements.
[439] Ibid., p. 1398.
[440] Ibid., p. 545.
[441] Ibid., pp. 997–998.

lending practices, violations of law, and a number of abusive practices by the bank's principal shareholder. The agency first issued a memorandum of understanding and later a formal agreement in 1979, then civil money penalties against the bank (but not against any individuals) in 1980, and finally a cease and desist order against the bank in 1981. The seven referrals were made during 1981–82. The agency is *still* considering civil money penalties against individuals, after more than 2 years. The Justice Department has declined one referral and is still investigating the others, after more than 2 years.[442] More timely and forceful civil action by the OCC against these individuals should have been taken; one law enforcement official working on the case told the subcommittee staff that the agency should have even taken action to remove certain officials from the bank.

b. OCC Problem Bank Referral No. 15.—This involved an October 1981 referral and a March 1982 referral involving suspected kickbacks and the conversion of credit life insurance premiums to the personal use of the president of another Texas bank. The examiner had detected lending limit violations, preferential treatment of insiders, and other questionable practices in February 1981. However, no civil money penalty was assessed until May 1982, 15 months after the practices were initially detected and 7 months after the first criminal referral was made. The agency acknowledged that the process was delayed because the OCC district office was "understaffed for various reasons, including overall personnel limitations imposed by budgetary considerations, employee turnover, and the need for increased onsite supervision of banks."[443]

Such delay are not uncommon at the other agencies, since most formal enforcement actions require approval of Washington headquarters. Only consent orders and informal memoranda of understanding are generally delegated to the agencies' district or regional offices. The committee recommends that the agencies reduce these delays by delegating more responsibility for taking action against insider abuse to the regional offices and setting specific deadlines for each stage of review.

8. The relationship between criminal referrals and civil enforcement actions

The banking agencies have defended their failure to take civil enforcement actions against individuals who have been the subject of criminal referrals on the ground that criminal conduct may not necessarily serve as the basis for a civil enforcement action.

The Comptroller, for instance, took concomitant civil enforcement action against individuals in only 4 out of its 20 criminal referrals in the subcommittee's problem bank survey. When asked why the agency failed to impose more civil money penalties against these individuals, the agency responded:

> This question appears to be based on the premise that transactions involving potential violations of criminal law may uniformly serve as a basis for a civil money penalty

[442] Ibid., p. 856.
[443] Ibid., p. 1023.

> issued by the OCC. This is not correct. Specifically, the OCC can only assess civil money penalties for violations of final cease and desist orders under 12 U.S.C. § 1818 and for violations of various civil banking statutes such as 12 U.S.C. § 84, 371c, 375a and 375b. Consequently, the subcommittee should understand and keep in mind the very clear distinction between criminal law and criminal insider transactions, on the one hand, and civil violations and non-criminal insider transactions (such as those involving violations of legal lending limits) on the other.
>
> It must is [sic] clear that the OCC cannot enforce or prosecute violations of criminal law. In addition, the OCC cannot use a violation of criminal law as a basis for the issuance of a civil money penalty.[444]

The agency's answer appears to be based on the false assertion that civil and criminal offenses are entirely separate and distinct matters that must be treated as strictly one or the other. This is not correct. Most, if not all, criminal violations of statutes like 18 U.S.C. 215, 656, 1005, and 1014 constitute violations of various civil banking laws and regulations or come within the general category of "unsafe or unsound" banking practices. The Comptroller skirts the issue by claiming that the OCC "cannot use a violation of criminal law as a basis for the issuance of a civil money penalty." If conduct which is the basis for a criminal offense also constitutes a violation of *any* provisions of the National Banking Act or other specific statutes, the OCC has the power to impose such penalties. The OCC's narrow interpretation of its powers is actually a rationalization for not taking civil action against persons whose misconduct the agency considers to be criminal.

In one case, the OCC made a criminal referral involving a bank president who misapplied bank funds to purchase certificates of deposit which were never recorded on the bank's records. The subcommittee asked the OCC why it failed to pursue civil penalties against the man and the agency responded that the man "was convicted for violations of a statute, 18 U.S.C. 1005, for which the OCC does not have the authority to assess civil money penalties." [445] It is hard to imagine that a banking practice as abusive and unsafe as this would not constitute a civil violation under the National Banking Act or the other statutes under which the agency can impose penalties. If the agency does indeed lack any such power, it should request additional authority from Congress to deal with such conduct. In the case cited above, the bank president was convicted of a criminal offense, but if he had not been, the agency apparently would not have imposed civil money penalties against him.

The FDIC has also claimed that it lacks the power to impose civil money penalties for conduct that constitutes criminal violations. For example, in FDIC Problem Bank Referral No. 33, the agency alleged that the bank's president had violated numerous criminal statutes, including 18 U.S.C. 215, 656, 1001, and 1014.[446] The president arranged a large nominee loan, the source of which was a "huge continuing overdraft" on that nominee's demand deposit balance at the bank, which the president approved on a daily basis. He made interest payments on the debt, using checks that were drawn on insufficient funds. In addition, "bank records were manipulated and falsified to mislead" FDIC examiners. When asked by the subcommittee why it had failed to impose civil money penalties against the president at the time that the criminal referral was made, the FDIC gave two reasons. First, it stated that the president had resigned from the bank. Second, "the apparent criminal violations did not involve a violation of a cease and desist order, nor a violation of any of the four laws for which we have the power to assess civil money penalties." [447]

This is not accurate, since the FDIC does have the authority to impose civil penalties under Section 22(h) of the Federal Reserve Act, which restricts loans to directors, officers and principal shareholders. Since such overdrafts could be construed as improper "loans," CMPs could have been imposed. Unlike the previous OCC case, the Justice Department did decline prosecution of these referrals, due to the fact that the bank "suffered no loss," thus presenting another example of where an officer was permitted to resign without either civil or criminal sanctions being imposed against him.

9. Recommendations

The committee recommends that the banking agencies substantially increase their use of civil enforcement actions against individuals. Specifically, the Federal Reserve, the FDIC, and the OCC should increase their use of removal orders and the Federal Reserve, the FHLBB, and the FDIC should increase their use of civil money penalties. Congress should (1) give the Federal Reserve, FDIC, and the FHLBB the same authority that the OCC now has to issue civil money penalties for insider abuse, (2) upgrade the maximum amounts of CMPs from $1,000 per day to $5,000 per day, and (3) expand the authority of the agencies to issue prohibition orders against individuals.

The banking agencies have recently proposed a number of other suggested legislative changes which would upgrade their civil enforcement powers. Some of these would have an impact on insider abuse, others would not. The committee urges Congress to consider these various proposals carefully, particularly in terms of their effects on civil enforcement actions against individual misconduct.

C. THE DISCLOSURE OF CIVIL ENFORCEMENT ACTIONS AGAINST INDIVIDUALS

1. The agencies' failure to disclose enforcement actions

Unlike the SEC, the FTC, and other Government law enforcement agencies, the banking agencies rarely disclose civil enforcement actions that they take against individuals or institutions. The agencies follow an FFIEC policy, which provides that each agency shall publish "semi-annual "summaries" of enforcement actions

[444] Ibid., p. 265.
[445] Ibid., p. 1011.
[446] Ibid., pp. 830 and 1273–1275. There were six separate referrals involved.
[447] Ibid., p. 631.

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containing the basic facts that prompted the agency's action and setting forth in detail the nature of the actions. However, the summaries do not include "the names of financial institutions," or "any other persons involved in the matter," nor "any information that might lead to identification of any such persons or companies." [448]

The agencies have based such secrecy on the usual claims that disclosure would undermine public confidence in institutions or harm innocent individuals. As a 1983 internal FDIC memo states:

> Public disclosure of disciplinary actions by the FDIC may not necessarily deter the class of affected persons (officers and directors). Such persons are charged with certain corporate and fiduciary duties in the operation of the bank, and with knowledge of the applicable laws, as well as the respective sanctions for violation thereof. Possible deterrent effects may result from publication: (1) The public may be deterred from dealing with a bank, an officer or director of which had been sanctioned by the FDIC. This may be unwarranted where the bank is otherwise well-managed and financially sound. The same result may be produced through local press coverage. (2) Other banks (and institutions in the financial sector, or other sectors) with access to information pertaining to sanctioned individuals may be deterred from hiring such individuals. Such a result may be unwarranted, depending on the nature of the matter for which the individual was sanctioned, and depending on other mitigating factors which might not be known to the public, or might be disregarded. (3) Where, in connection with an order sanctioning an individual, the FDIC has reason to refer the matter to the U.S. Attorney for possible criminal investigation, public disclosure of an order sanctioning an individual may hamper the investigation. [449]

The general policy of the agencies is to refuse to disclose any enforcement actions against individuals, with rare exceptions. They base this upon the provisions of 12 U.S.C. 1818(h)(1), which provides that removal, civil money penalty, and cease and desist hearings "shall be private, unless the appropriate Federal banking agency, in its discretion, after fully considering the views of the party afforded the hearing, determines that a public hearing is necessary to protect the public interest." None of the agencies, however, has formulated any written policies or procedures for determining under what circumstances it would be in the public interest to have public hearings. Consequently, all proceedings have been kept secret.

The provisions of 1818(h)(1), however, do not preclude the agencies from routinely disclosing the existence of final orders issued as a result of these private hearings. While public disciplinary hearings may sometimes endanger the safety or soundness of an institution by having its innermost workings aired in public, this statutory provison should not serve as an excuse for maintaining total secrecy over the entire disciplinary and enforcement process.

[448] Ibid., p. 1547.
[449] Ibid., pp. 1517–1518.

Several of the agencies are currently reconsidering their disclosure polices. The FHLBB has recently begun to move toward greater public discolsure, by revealing two or three recent enforcement actions taken against individuals. On July 11, 1984, the Board issued Resolution 84-266, stating that the removal and prohibition proceedings involving insiders of the San Marino Savings and Loan Association (California) would be made public. In another matter, the agency declined to hold public proceedings involving the First Federal Savings and Loan Association of Philadelphia, but did disclose certain information from that hearing. [450]

In addition, the FDIC has indicated that it is currently considering a staff proposal for the agency to "notify" depositors and creditors of all insured institutions of all "publicly available" information, including all formal administrative actions against institutions and individuals. The agency did not define what "publicly available" means. Since very little information is now publicly available about privately owned banks (except by request under the Freedom of Information Act), the FDIC's proposal may not actually increase public disclosure.

2. Other regulatory agency disclosure policies

The failure to routinely disclose final enforcement actions against individuals contrasts sharply with the policies of other Federal agencies. The subcommittee requested the following 10 Federal regulatory agencies to provide their disclosure policies regarding enforcement actions which they take against individuals:

1. The Securities and Exchange Commission
2. The Federal Trade Commission
3. The Commodities Futures Trading Commission
4. The Consumer Product Safety Commission
5. The Environmental Protection Agency
6. The Federal Communications Commission
7. The Interstate Commerce Commission
8. The National Labor Relations Board
9. The National Highway Traffic Safety Administration
10. The Occupational, Safety, and Health Administration [451]

Each of these agencies reported that it publicly discloses all final enforcement actions and orders. In addition, most of the agencies also disclose notices, complaints, and other preliminary proceedings.

The SEC, in its submission, emphasized the importance of broad disclosure in the protection of consumers:

> Widespread dissemination of information regarding Commission administrative proceedings serves an important prophylactic function and thus significantly enhances the Commission's efforts to protect investors. In order to achieve such dissemination, it is essential that information be made publicly available that is sufficient for reporters

[450] Documents contained in subcommittee files.
[451] The agencies' responses are on file in the subcommittee's offices.

> to write reasonably complete articles about administrative proceedings. . . . including, at a minimum the alleged course of conduct and when it took place. . . .[452]

3. Applicable FOIA disclosure requirements

Several of the agencies cited the Freedom of Information Act as supporting their nondisclosure policies. But the FOIA, 5 U.S.C. § 522(a)(2), requires all agencies—including the banking agencies—to systematically release all "final opinions . . . and orders, made in the adjudication of cases," except where such disclosure would constitute "a clearly unwarranted invasion of personal privacy." In these cases, the agencies may delete identifying details in disclosing the order, but must justify each deletion in writing.

None of the banking agencies are complying with subsection (a)(2). They do not make routinely available for public inspection and copying the actual enforcement orders. Instead, they usually provide brief summaries of final orders, with no identifying information correlating the summary of the orders to a particular individual or institution, and they provide no special written justification in each case, as required. In addition, the FDIC is the only banking agency that currently discloses final administrative orders in response to FOIA requests for information on a particular individual or institution.

The agencies invoke the exemption in 5 U.S.C. § 522(b)(8) which permits the agencies to withhold information "contained in or related to examination, operating, or condition reports" prepared by bank regulatory agencies. However, the argument that this exemption entitles them to withhold the existence of enforcement orders against particular individuals or institutions is without merit for two reasons.

First, even if the exemption should apply—and it probably does not—it does not prohibit releasing at least parts of the enforcement order. The exemption (subsection (b)) provision in the FOIA provides:

> Any reasonably segregable portion of a record shall be provided to any person requesting such record after deletion of the portions which are exempt under this subsection. [5 U.S.C. 552(b)]

If the enforcement order was predicated entirely on misconduct reported in the examination report and no other documents, agency proceedings, or inquiry, then the agencies could arguably maintain that they are not required by FOIA to disclose a detailed description of the misconduct, but such reliance is usually not the situation. Moreover, the intent of the exemption was not to protect individuals, but institutions:

> Clearly, the central purpose of the exemption is to protect the financial integrity of banks. The Court [of Appeals] in Consumers Union [citation omitted] found legislative history to show that "there was concern that disclo-

[452] Report of the Office of the General Counsel of the SEC Regarding the Commission's Enforcement Powers and Policies as to Disclosure of Commission's Enforcement Actions, August 17, 1984, p. 16. Report is contained in subcommittee's files.

> sure of examination, operation, and condition reports containing frank evaluations of the investigated banks might undermine public confidence and cause unwarranted runs on banks." [Citation omitted.] [453]

Secondly, a more reasonable interpretation would be that none of the exemptions in subsection (b) applies and is available to remove identifying information from a final civil enforcement or other administrative order. Under subsection (a)(2) identifying details may only be deleted from the final order to prevent a "clearly unwarranted invasion of personal privacy," not for any other reason. The banking agencies could contend that in most, if not all, cases, disclosing identifying information could constitute an "unwarranted invasion of personal privacy" under subsection (2). However, this argument is completely without merit, given the open disclosure policies to 10 other Federal regulatory agencies, their enforcement goals of deterrence, and generally the public's right to know.[454] Cases have held that revealing loan documentation and financial records could constitute an invasion of an insider's or other person's privacy. However, the disclosure of an agency's order, based on a violation of a statute and issued after an adjudication, against a particular individual is not an unwarranted invasion of privacy. If it were, an indictment or any other agency disciplinary or civil enforcement action would also constitute an unwarranted invasion.

While the FDIC is to be commended for being the only banking agency to diclose final orders in response to FOIA requests, its policy is still unsatisfactory, because a requestor under FOIA usually has to know about or suspect the civil enforcement action or the underlying problem in order to request the information. The agencies' conflicting policies under FOIA offer another example of how individuals and institutions are subject to different civil enforcement standards, depending upon which agency regulates an institution.

Finally, the FOIA authorizes nondisclosure of certain information, it does not mandate it. Contrary to their assertions, financial agencies can disclose more information than the FOIA authorizes them not to disclose.

4. Conflicts with disclosure requirements under the securities laws

The agencies' disclosure policies are also incompatible with the disclosure requirements imposed on publicly held financial institutions and holding companies by the Federal securities laws. At present, all such institutions are required to disclose to shareholders any enforcement actions which constitute "material events." The FDIC's interpretation of the Securities Exchange Act of 1934 requires that such institutions disclose:

1. Termination of deposit insurance proceedings.
2. Civil money penalties imposed against the institution.

[453] *Gregory* v. *FDIC* 470 F.Supp. 1329, 1333 (D.D.C. 1979), rev'd on other grounds 631 F.2d 896 (1980).

[454] "In order to determine whether the release of particular information would constitute a clearly unwarranted invasion of privacy, it is necessary to balance the public interest in disclosure against the degree of privacy invasion." See *Dept. of Air Force* v. *Rose,* 425 U.S. 352 (1976). Ibid., p. 1335.

3. Agreements and cease and desist orders imposed against individuals, to the extent that they "materially reflect on the conditions or operations of the institution."

4. Removal proceedings and civil money penalties against individuals, under the same conditions as set forth in (3) above.[455]

The banking agencies are charged with the enforcement of the disclosure provisions of the securities laws, which clearly mandate that all "material" corporate events be disclosed. The FDIC cites *TSC Industries Inc.* v. *Northway, Inc.*, 426 U.S. 438, 439 (1976), as requiring that "an omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important . . . ."[456] Thus, it is clear that most removals, civil money penalties, and other enforcement actions taken by the banking agencies based upon serious insider abuse would be "material" events under the TSC Industries standard.

It appears that the banking agencies are following a double standard on disclosure, one for publicly held institutions that is dictated by the securities laws and one for privately held institutions that is dictated by their own preference for secrecy. There seems to be little, if any, evidence that the larger, publicly held institutions are seriously harmed by the disclosure requirements of the 1934 act or that privately held banks would be any more imperiled by similar disclosure requirements.

5. The need for more disclosure

The summaries of enforcement actions which the agencies currently publish serve little useful purpose, either for financial institutions or for the public. Professor John Spanogle testified at the June 28, 1983, hearing about his own experience in trying to decipher these summaries:

> If you read two paragraphs in the FDIC Annual Report, or ever read 40 pages worth of 1-column reports in the Comptroller's Annual Reports, and still have no idea of what the violations were when you get through reading it, then it seems to me that there is a lack of quality in the facts that are being disclosed. In part, the agencies try to disguise the situation so that people can't guess which bank it is.
>
> No, but it seems to me that this has been carried to an extreme, to the extent where they say "four violations of 12 U.S.C. 84 were discovered, as were other violations of law." Well, that doesn't tell you a whole lot. You might want to know whether those four violations of USC 84 were to insiders or not. And how serious were the other "violations of law?"
>
> There is a great deal more information that could go into the disclosures by the agencies even without naming names, if that is an absolute necessity to keep things from interfering with the continued existence of the bank.[457]

[455] Ibid., pp. 1532–1536.
[456] Ibid., p. 1532.
[457] Hearings (Part 1), pp. 78–79.

According to Spanogle, greater disclosure would inform the public about the effectiveness of the bank regulatory system, as well as the true financial condition of particular institutions:

> I think that more disclosure would probably allow folks outside the bank regulatory system to evaluate how well the bank regulatory system was doing and also the nature and dimension of the problem. The information that is now officially disclosed concerning enforcement actions tells you the size of the bank but does not name the bank, or reveal facts about its location, clientele, ownership, or whether it is related to other banks.
>
> That is perhaps defensible while the bank is undergoing problems, *but at some point in time, either after the bank has been forcibly merged, after it has failed, or after it has succeeded and stopped being a problem, the problem should be revealed,* with names and with far more data than appear in the enforcement action disclosures annually put out by the bank regulatory agencies.[458] (Emphasis added.)

As Professor Spanogle indicates, there must be a proper balancing of interests. On the one hand, the salutary effects of increased disclosure would alert financial institutions and the public about individuals who have engaged in insider abuse and would provide the marketplace with a more informed appraisal of the true financial condition of financial institutions. In addition, it would also provide the public with a better understanding of the effectiveness of the bank regulatory system. While disclosure would have an unpleasant effect on the fortunes of certain individuals and institutions, this is true of all government actions imposed against wrongdoers. When the NHTSA discloses an action it has taken against Ford Motor Company for a defect in automobiles, or when the NLRB discloses that it has cited a company for unfair labor practices, such announcements can have a definite harmful effect on those companies. Such harmful effects, however, are outweighed by the long term public interest in knowing how the Government operates and by the deterrent that disclosure provides against future misconduct.

On the other hand, there are situations in which the banking agencies should have discretion to withhold certain details of their enforcement actions, at least for a period of time until an institution is out of danger. The committee recommends that the agencies routinely disclose all enforcement actions against individuals, unless the agencies make a written finding that full disclosure would seriously jeopardize the safety or soundness of a particular institution, in which case certain factual details may be omitted or disclosure temporarily delayed.

[458] Ibid., p. 78.

X. Reducing the Impact of Insider Abuse Through Fidelity Bonds

A. INTRODUCTION

Most financial institutions carry insurance policies known as fidelity "blanket" bonds that protect them from a variety of losses due to dishonest acts, including employee dishonesty, robbery, mysterious disappearances, and forgery. When a federally insured bank or savings and loan fails and the FDIC or the FSLIC is appointed receiver, any of the failed institution's claims for fidelity losses become assets of the receiver and can be pursued as a means of reducing the losses of the FDIC/FSLIC deposit insurance funds. For example, the FDIC may have to pay out $4 million when a particular bank fails. Of those losses, $3 million may be directly attributable to insider fraud and could be recovered by the FDIC under the bank's fidelity bond. Therefore, since most instances of insider abuse and criminal misconduct fall within the definition of "employee dishonesty" under the terms of fidelity bonds, the agencies have a vital stake in making sure that open institutions carry adequate amounts of fidelity bond coverage to protect both the institution's creditors and the deposit insurance funds in the event of failure.

The subcommittee's study of failed institutions reveals that the FDIC and FSLIC have been unable to recover little more than a fraction of the losses that were attributable to insider misconduct in those institutions. The FDIC, in particular, is losing millions of dollars annually because of its failure to require institutions to carry adequate dollar amounts of fidelity coverage or to carry policies that are broad enough in their coverage to adequately protect the FDIC. In addition, the study shows that the other banking agencies could improve their supervision of problem institutions by more closely monitoring the fidelity bond coverage of open institutions and the claims that those institutions file for insider abuse.

The typical fidelity coverage carried by most banks and savings and loans is set forth in two standardized bonds prepared by the Surety Association of America. Standard Form 24 (for commercial banks) and Standard Form 22 (for savings and loans) are virtually identical in terms of coverage, exclusions, and discovery provisions. The standard bond for credit unions, on the other hand, differs considerably from the other two, largely because the National Credit Union Administration directly negotiated its terms with the insurance company and also insists upon approving any credit union's deviation from the standard form.

The SF-22 and SF-24 bonds provide the following basic coverage:

Clause A—Fidelity Losses.—Covers all losses due to employee and officer "dishonesty", i.e., acts committed with the "manifest intent" to cause loss to the institution and to obtain financial benefit for the employee or another party.

Clause B—On Premises Losses.—Covers all losses due to robbery, burglary, mysterious "unexplainable" disappearances, false pretenses, and larceny committed on the premises of the institution.

Clause C—In Transit Losses.—Covers the same acts listed in Clause B, only incurred by a messenger in transit.

Clause D—Forgery Losses.—Covers normal check and other instrument forgery committed by bank customers.

Clause E—Securities Losses.—Covers losses incurred as a result of the institution's good faith handling of various securities transactions, including loss, theft, and destruction.

Clause F—Counterfeiting Losses.—Covers losses incurred due to the receipt, in good faith, of any U.S. or Canadian counterfeit currency.[459]

An institution can purchase a whole array of additional coverages, but Clauses A, B and C constitute what is commonly referred to as "basic bond" coverage.

By far, the greatest fidelity risk for any commercial bank is from insider abuse or "employee dishonesty".[460] For this reason, many banks also choose to purchase what is called an "excess fidelity" bond, which provides additional coverage for employee dishonesty (Clause A) only. Such excess bonds are available in multiples of $1 million.[461]

According to industry sources, the bonding industry suffered a period of unusually heavy losses in financial institutions during the mid-1970's. Part of these losses were due to the FDIC's aggressive tactics in collecting on bond claims in failed banks.[462] In reaction to the industry's overall loss record and to the FDIC's success in collecting sizeable settlements, the Surety Association of America and the American Bankers Association in 1980 negotiated a new Standard Form 24 which substantially reduced the coverage of the basic bond and which limited the rights of the FDIC to recover. (See Section C below.)

B. FDIC AND FSLIC LOSSES DUE TO INADEQUATE FIDELITY BOND COVERAGE

The subcommittee sought to determine whether the FDIC and FSLIC were adequately protected against insider abuse and criminal misconduct in failed institutions through fidelity bond claims. When this proved to be difficult—due to the agencies' lack of records—the subcommittee compiled its own statistics. They reveal that the FDIC and FSLIC unnecessarily lose millions of dollars each year because the failed institutions' bonds do not adequately cover the agencies' actual losses due to insider misconduct.

The FDIC has filed fidelity bond claims in 43 out of 75 failed commercial banks (57 percent) in the subcommittee's survey. (This closely corresponds to the subcommittee's estimate that 61 percent of these failures involved actual or criminal misconduct by insiders.) Because the agency often files bond claims for the maximum amount of coverage under a bond, not for its actual fidelity losses, it is impossible for the subcommittee to determine how much the agency is actually losing each year in claims that have never been filed.

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[459] Ibid., pp. 418–21.
[460] Ibid., pp. 413–17.
[461] Excess fidelity coverage is not offered to the savings and loan industry, ostensibly because of lack of demand.
[462] Memos of subcommittee staff interviews with insurance underwriters are on file in the subcommittee's offices.

From studying the FDIC's claims[463] that do exceed the coverage amounts, it is clear that most of the banks did not carry nearly enough coverage at the time of failure to pay for FDIC losses due to insider misconduct. The following chart lists just seven claims that the FDIC has filed during this period where the losses from insider abuse far exceeded the amount of coverage:

FIGURE 8.—FDIC'S UNINSURED FIDELITY LOSSES IN SEVEN FAILED BANKS

Name of failed bank	Amount of FDIC's bond claim	Amount of coverage	FDIC's uninsured losses
1. Mission State Bank & Trust, Mission, KS	$7,000,000	$2,025,000	$4,975,000
2. Citizens Bank Tillar, AR	1,000,000	250,000	750,000
3. Farmers State Bank, Lewiston, IL	2,100,000	1,350,000	750,000
4. Penn Square Bank, Oklahoma City, OK	10,000,000	4,500,000	5,500,000
5. Hohenwald Bank & Trust Co., Hohenwald, TN	3,000,000	1,525,000	1,475,000
6. United American Bank, Knoxville, TN	6,000,000	6,000,000	unknown
7. Pan American National Bank, Union City, NJ	8,000,000	1,500,000	6,500,000
Total "automatic" loss to FDIC			19,950,000

Thus, the FDIC's "automatic" loss—the difference between the amount of the FDIC's losses and the maximum potential recovery for claims—was $20 million in just six banks.

The chart above only shows a small fraction of the losses suffered by the FDIC due to inadequate coverage in open banks. In United American Bank, for example, the FDIC filed a $6 million claim because this was the maximum amount of bond coverage, but their fidelity losses will be far higher. This practice of filing for just the amount of total coverage was true for 13 other banks out of the 43 failures where claims have been filed. It is likely that the FDIC's actual losses due to insider misconduct are significantly higher in each case than the maximum allowable amount of the claim.

Despite such losses, the FDIC does little to ensure that FDIC-insured banks maintain adequate fidelity coverage.[464] The agency merely instructs banks that they should maintain "adequate" coverage,[465] but has no regulations or guidelines on how much that is for a particular size institution or what action shall be taken against any institution that fails to maintain adequate coverage. Prior to 1981, the FDIC provided examiners with the ABA survey—similar to the one shown below in figure 10—which listed "suggested" ranges of coverage, according to the deposit size of the institution. After the ABA quit publishing this range of coverages in 1981, the FDIC also quit issuing any specific guidelines for its examiners. At present, the FDIC Examination Manual simply states that "an overall assessment of the effectiveness of the bank's internal oper-

[463] Hearings (part 2), pp. 1796–1804.

[464] Under 12 U.S.C. 1828(e), the FDIC has the authority to require that banks carry fidelity bond coverage and, if a bank "refuses to comply", to purchase a bond for the bank and add its cost to the bank's annual assessment.

[465] Hearings (part 1), p. 433. From the failed banks in the subcommittee's survey, size is not a reliable indicator of how much coverage a bank needs. Smaller banks, in fact, may need a proportionally higher amount of coverage than larger ones. This is the type of research the FDIC should perform.

ations must be considered",[466] and lists several subjective criteria. It includes little information on how to determine an "appropriate" amount of coverage, how to compare various policies, how to determine if problem banks need special provisions in order to protect the FDIC's interests, or how to determine what size deductibles are appropriate. In short, the entire evaluation of a bank's coverage is left up to the subjective unguided judgment of the examiners.

The FDIC's failure to require minimum coverage amounts contrasts sharply with the policies of the FSLIC and the National Credit Union Administration. The Federal Credit Union Act, 12 U.S.C. § 1776(h), sets out specific requirements for the bonding of credit union employees. It requires that every employee with access to credit union funds be bonded, and that the bond be approved by the NCUA, and gives the agency authority to set specific amounts for both blanket and excess fidelity bonds.

NCUA has responded to this mandate by promulgating regulations which impose minimum coverage and maximum deductible amounts and by approving a standard bond which (1) covers a broad range of losses, including all "dishonest" acts of employees, as well as those due to a lack of "faithful performance", (2) covers dishonest acts of directors, (3) gives NCUA, as receiver for a failed credit union, 4 months after final distribution of the credit union's assets to request an additional discovery period, (4) allows NCUA 2 years to complete its discovery of losses, and (5) provides that no termination or cancellation of a bond will become effective until 30 days after the NCUA has received written notice of termination.[467] Both agencies have established minimum coverage amounts, depending upon the asset size of an institution. The committee recommends that the FDIC also establish minimum coverage amounts for all FDIC-insured banks, or at least for all banks requiring more than normal supervision.

The FDIC has also failed to review insured banks' fidelity bonds to ensure that they cover losses due to all major types of insider abuse—such as dishonest acts by directors—and to provide the agency with an adequate period to discover fidelity claims after failure. Prior to 1980, the standard blanket bond included a number of features that enabled banks—and the FDIC—to recover for a broader range of losses and to allow the FDIC one year after being appointed receiver to discover losses and file claims.

In 1980, the Surety Association of America and the American Bankers Association negotiated the new standard bond (SF–24), which made major changes in the scope of coverage. Among the many changes in the standard bond, three have had a direct adverse impact on the FDIC's right to recover for insider misconduct. First, the definition of "dishonesty" itself was changed. The old SF–24 covered "loss through any dishonest or fraudulent act of any of the Employees." The new bond is much more restrictive, covering only dishonest acts committed "with the manifest intent a) to cause the Insured to sustain such loss, and b) to obtain financial benefit for the Employee or for any other person. . . ." In effect,

[466] Ibid., p. 434.

[467] 12 CFR 701.20.

the change makes a "dishonest" act as difficult to prove as, if not more so than, certain criminal violations.

Second, the new bond explicity eliminated the FDIC's right to discover and file claims after its appointment as receiver for a failed institution. Since most fidelity bonds are written on a "discovery", rather than a "loss-sustained," [468] basis, it is necessary to discover losses during the term of the bond, not after it has expired. The new bond provides that termination shall be effective automatically upon takeover of the institution by a Federal receiver or by another institution.

Third, the old SF-24 provided that all insured banks could request an additional 12-month discovery period at any time during the term of the bond, by paying an additional premium for such coverage, even if the policy were subsequently cancelled or terminated. The FDIC often "inherited" this 12-month discovery period if the institution had requested it prior to closing. Under the new bond, this prepaid discovery period also terminates immediately upon takeover.

The FDIC was aware in 1979 that such charges were being contemplated by the Surety Association and the ABA. Agency officials met with representatives from the Surety Association of America and the ABA, and the FDIC agreed to abide by the new terms, effectively limiting FDIC's future right to recover for dishonest acts. In a letter dated June 25, 1979, FDIC Assistant General Counsel Myers N. Fisher specifically approved these changes, after consultation with FDIC's board of directors.[469]

The 1982 FDIC Examination Manual acknowledges that the FDIC no longer has the right of discovery after a bank fails. Both the Manual and the agency's directives to its regional directors [470] suggest that an examiner of a failing bank should take steps to ensure that the bonding company is promptly notified of potential losses prior to failure, including calling a special meeting of the bank's board of directors to instruct them to give notice. Although agency officials claim that the new SF-24 has not made a practical difference in the filing of claims because the insurance companies have "allowed" the FDIC to discover claims after a bank fails, unquestionably the new policy has placed the insurance companies on a superior legal footing if the provisions are ever tested.

C. THE FDIC'S LAX SETTLEMENTS OF FIDELITY BONDS CLAIMS

Another reason that the FDIC suffers uneccessarily large fidelity losses in failed banks is that its Liquidation Section is too lax in its negotiation and settlement of bond claims. A review of the 14 failed institutions in the subcommittee's survey in which the agency has settled bond claims [471] shows that the agency recovers about 33 percent of the amount of its claims. This is surprisingly low, in view of the fact that most of these claims arose out of con-

[468] A "discovery" bond means that the insured can file a claim if the loss is discovered at any time during the term of the bond, even if the dishonest act occurred prior to the bond's effective date. A "loss-sustained" bond only applies prospectively.
[469] Hearings (Part 1), p. 438.
[470] Memo from Jim Sexton, Director of Supervision, to all regional directors, dated March 1, 1982. Hearings (Part 1), pp. 431-32.
[471] Hearings (Part 2), pp. 1796-1848.

duct which has resulted, in almost every case, in criminal convictions. The following chart shows that out of $30.9 million in claims, the FDIC recovered only $11.6 million, for a net loss due to low settlements of $7.21 million. If inadequate coverage amounts are added, the total loss to the FDIC is roughly $19.2 million.

FIGURE 9.—FDIC RECOVERIES ON FIDELITY BOND CLAIMS FILED IN FAILED BANKS, 1980-83

	Amount of bond claim	Total fidelity coverage	Amount actually recovered	Recoverable balance
1	$900,000	NA	$600,000	$300,000
2	1,300,000	1,300,000	1,300,000	0
3	1,578,949	1,675,000	800,000	778,949
4	7,000,000	2,025,000	687,500	6,312,500
5	1,300,000	1,500,000	375,000	925,000
6	1,250,000	1,250,000	1,237,000	11,000
7	1,176,000	1,375,000	325,000	846,000
8	300,000	NA	60,000	240,000
9	1,250,000	1,250,000	350,000	900,000
10	10,000,000	4,500,000	3,500,000	1,000,000
11	1,250,000	1,250,000	875,000	374,000
12	18,266	375,000	8,266	0
13	3,000,000	1,525,000	1,525,000	0
14	577,500	500,000	0	500,000
Total	30,900,715		11,642,766	7,212,449

Although every insurance claim is unique, it seems that the agency's overall settlement record is too low. This view is substantiated by the FDIC's admission that, as of October 1983, it was not involved in a single lawsuit with an insurance carrier over fidelity bond claims. If the agency were vigorously pursuing claims against insurance companies involving such large sums, it would certainly have at least several suits pending at any one time. (In contrast, during the same period in October 1983, the NCUA indicated that it had 10 pending lawsuits with fidelity carriers. According to FDIC agency staff, the Liquidation Section very rarely litigates any bond claims.[472]

D. CASE STUDIES

The following case studies of failed banks offer typical examples of how the FDIC fails to properly supervise fidelity bond coverage and to pursue claims in failed banks:

1. The Des Plaines Bank of Des Plaines, IL

In late 1979, the bank filed fidelity bond claims on two employees, causing the bank's insurer, St. Paul Fire & Marine Insurance Co., to cancel the bank's policy in January 1980. The bank continued to operate for more than a year without any fidelity coverage at all, until its failure in March 1981. Although the FDIC knew that the bank was suffering serious problems and that its bond had been cancelled,[473] it did nothing to compel the bank to secure re-

[472] Memos of subcommittee staff interviews with FDIC and NCUA officials are on file in the subcommittee's offices.
[473] Hearings (Part 2), pp. 1872-88.

placement coverage. Moreover, despite the agency's criminal referral on one of the bank's officers in June 1980, the agency made no attempt—until a few months before the bank failed—to remove the officer responsible for the criminal activity.

After the bank failed, its former president, Anthony G. Angelos, and one of the bank's customers was convicted of racketeering, misapplication of bank funds, mail and wire fraud, interstate transportation of stolen property, and making false statements to a bank examiner. Since the bank had no fidelity coverage, the FDIC was never able to file a fidelity claim and therefore has not even estimated how much was lost in this case due to criminal misconduct. In short, the agency took no effective action to reduce fidelity losses which it could see were coming.

2. The First National Bank & Trust Co. of Tuscola, Tuscola, IL

A former director of this bank, Mr. James F. Sullivan, pleaded guilty on March 7, 1983, to forgery in the handling of installment sales contracts prior to the bank's failure in February 1982. However, because SF-24 explicitly excludes criminal conduct by outside directors,[474] the FDIC was unable to file a claim to recover its losses due to Sullivan's dishonesty.

3. Mohawk Bank & Trust Co., of Greenfield, MA

After this bank failed on February 16, 1980, the FDIC filed a $95,000 claim for losses caused by a bank customer who secured bank funds by false pretenses and settled the claim for $28,000. However, the FDIC apparently was unaware that the bank's former president, Richard Saccone, had also engaged in dishonest conduct. On December 3, 1981, Saccone was convicted of conspiracy, misapplication of bank funds, issuing Treasury checks without authority, and submitting false statements in connection with loans totaling $720,000. The FDIC was unable to recover anything on this potential claim because it never filed a claim.

4. Tri-State Bank of Markham, IL

The FDIC suspected that criminal activity was afoot in this bank as early as June 1982, when it made a criminal referral to the Justice Department concerning an officer of the bank. However, when the bank eventually closed in October 1982, the FDIC discovered that the insurance company had specifically excluded the people who had stolen the money, as well as all bank shareholders and insiders. (The FDIC even had a difficult time obtaining a copy of the policy from the insurer for months after the bank failed.) As a consequence, the FDIC never filed a claim to recover its estimated $577,500 losses.

[474] Section 2(d) of SF-24 excludes any "loss resulting directly or indirectly from any acts of any director of the Insured other than one employed as a salaried, pensioned or elected official or an Employee of the Insured, except when performing acts coming within the scope of the usual duties of an Employee, or while acting as a member of any committee duly elected or appointed by resolution of the board of directors of the Insured to perform specific, as distinguished from general, directorial acts on behalf of the Insured." See Hearings (part 1), p. 420. Since directors are often involved in illegal and dishonest acts which injure institutions, the FDIC should require all banks to carry bonds which cover directors' dishonest acts.

E. THE AGENCIES' FAILURE TO COMPILE FIDELITY BOND STATISTICS

Despite their huge losses in recent years due to insider abuse and criminal misconduct, the FDIC and FSLIC fail to compile adequate statistics on 1) the amount of their total losses in failed institutions that are attributable to insider abuse and criminal misconduct, 2) the amounts of coverage carried by open financial institutions, or 3) the numbers or types of fidelity claims involving top officials filed by open institutions. The only useful statistics on financial institution fidelity bonds are compiled by the American Bankers Association, which conducts an annual survey of its member banks to determine the amounts of coverage they carry, the average premiums paid, and the types of losses incurred. The 1982 ABA Survey[475] lists the median basic bond coverage carried by banks, according to deposit size:

FIGURE 10.—SUMMARY OF BANKERS BLANKET BOND COVERAGE[1] BY DEPOSIT SIZE

[Dollars in thousands]

Deposits	Number of banks	Range of coverage	Median coverage	Most frequent coverage
Less than $750	11	$50 to $250	[2]$250	$250
$750 to $1,500	26	$80 to $250	[2]250	250
$1,500 to $2,000	38	$80 to $250	[2]250	250
$2,000 to $3,000	130	$90 to $250	[2]250	250
$3,000 to $5,000	473	$120 to $1,250	[2]250	250
$5,000 to $7,500	764	$150 to $1,250	[2]250	250
$7,500 to $10,000	781	$180 to $1,250	250	250
$10,000 to $15,000	1,273	$200 to $1,300	380	380
$15,000 to $20,000	953	$250 to $1,300	450	450
$20,000 to $25,000	705	$300 to $1,350	500	450
$25,000 to $35,000	986	$350 to $1,500	680	680
$35,000 to $50,000	779	$450 to $2,000	830	830
$50,000 to $75,000	526	$550 to $3,000	1,050	1,050
$75,000 to $100,000	272	$850 to $5,000	1,700	1,050
$100,000 to $150,000	188	$850 to $5,000	2,000	1,800
$150,000 to $250,000	122	$1,200 to $10,000	3,000	5,000
$250,000 to $500,000	86	$2,500 to $10,000	4,000	5,000
$500,000 to $1,000,000	36	$4,000 to $15,000	5,000	5,000
$1,000,000 to $2,000,000	53	$5,000 to $15,000	7,500	10,000
$2,000,000 and over	46	$10,000 to $25,000	20,000	20,000

[1] The Summary of Bankers Blanket Bond Coverage is not a recommended amount of coverage. It is a statistic summary by deposit size for such coverage.

[2] Banks in these groups must purchase $250,000 of blanket bond insurance to qualify for excess fidelity coverage.

SOURCE: 1982 Bank Insurance Survey, Insurance and Protection Division, American Bankers Association.

This chart does not include excess fidelity coverage. Since a majority of banks carry such additional coverage, the total coverage for insider abuse is considerably higher than the amounts shown above. Although the ABA Survey shows that a majority of banks carry at least $1 million in total coverage for insider abuse and criminal misconduct, many do not.

The banking agencies' have no accurate idea how much average coverage a bank or thrift should have to cover potential losses for a bank or thrift of that size, either to protect itself or to protect the

[475] Hearings (Part 1), pp. 387–399.

deposit insurance funds.[476] The ABA guide, while useful, only indicates how much coverage most banks *want* to carry and *do* carry.

It is clear from the subcommittee's survey of failed institutions and the ABA statistics that a significant number of institutions do not carry adequate fidelity coverage. If the FDIC and FSLIC kept records of what their average fidelity losses were in failed institutions, it would be much easier to determine whether the institutions or the deposit insurance funds had adequate protection. The subcommittee's survey suggests that many of the fidelity losses in these failed banks were between $1-4 million, an amount of coverage that many banks lack.[477]

The agencies are unable to effectively follow trends in fidelity losses or anticipating future losses because of their lack of records. If they kept records, the FDIC and FSLIC could operate more like private insurance companies, which routinely analyze their loss experiences to determine (1) where their losses are coming from, (2) what types of conduct or transactions cause the losses, (3) how to structure their policies to reduce unreasonable losses, and (4) what other steps can be taken to minimize losses, such as raising rates.

The subcommittee estimates that total FDIC/FSLIC losses will be at least $1 billion for these institutions that failed between 1980–83 where criminal misconduct was a "major contributing factor" to the failures. It is hard to fathom why the agencies—and the FDIC, in particular—would make no systematic effort to quantify these losses, to determine their origin, and to reduce them through various supervisory steps, including a requirement that open institutions maintain adequate bond coverage.

F. THE FSLIC'S RECORD

Until recently, the FSLIC did not have within its jurisdiction nearly as many failed institutions involving insider abuse as did the FDIC and therefore did not suffer significant fidelity losses. Although such losses have recently increased substantially, the agency has not increased its focus on fidelity bond coverage and claims.

The FSLIC does set minimum coverage amounts for all federally insured savings and loans.[478] However, the agency failed to object to, or take any action against, the new standard fidelity bond (SF-22) that was formulated in 1980. Instead, it adopted a new regulation which tacitly allowed associations to adopt the new bond with-

[476] The FDIC does compile statistics on fidelity bond coverage for certain purposes. From its centralized filing system on all bank defalcations, the agency is able to compare the amount of the defalcations with a bank's fidelity bond coverage. For example, if a defalcation is reported in an open institution, the FDIC compiles the following information: 1) the size of the bank; 2) the amount of the defalcation; 3) the amount of the bank's blanket bond; and 4) the amount of the bank's excess fidelity bond.

However, such records appear to be incomplete. The subcommittee requested the FDIC to furnish the amounts of the blanket bond coverage, excess coverage, and deductible amounts for all failed institutions since 1980 and the agency was unable to provide this information for many of the institutions. The information the agency compiles does not appear to be utilized for any monitoring purposes or to conduct research on fidelity bond claims. See Hearings (Part 1), pp. 202–12.

[477] Hearings (Part 1), pp. 387–399. For specific cases in which the banks had insufficient coverage for defalcations by employees or insiders, see Ibid., pp. 202–26.

[478] Ibid., pp. 442–44.

out advance approval by FSLIC, as the old regulations had required.[479]

The agency has also missed opportunities to pursue legitimate bond claims in recent thrift failures. For example, in the unnamed Texas case described above in Section VI.B., the agency conducted a formal examination of insider abuse and made a criminal referral on the president and chairman of the board prior to the institution's failure, but failed to pursue a fidelity bond claim to help reduce the $46 million in losses the agency suffered.[480]

When questioned by Chairman Barnard at the May 2 hearing about this failure to pursue an excellent claim, the FHLBB attorney acknowledged that the agency failed to file a claim because:

> Mr. CHAPMAN. For the most part the transactions engaged in that we uncovered here dealt with breaches of fiduciary duty on the part of the chairman and the president. Those are not covered by the standard blanket bond.[481]

This, however, is not accurate. The transactions involved in the case were clearly "dishonest acts" within the definition of the standard bond, not merely "breaches of fiduciary duty."

G. THE OTHER BANKING AGENCIES' SUPERVISORY USE OF FIDELITY BOND CLAIMS

Fidelity bond claims filed by open financial institutions can serve as a useful supervisory tool. Such information could help the agencies to identify institutions which are poor fidelity risks and to target their resources on such institutions. However, none of the agencies currently uses these claims or cancellation notices filed by bonding companies for such purposes.[482]

For example, it would be very useful for the OCC to know that a particular national bank has had its fidelity bond canceled by its insurance carrier. Possibly Mr. Jones, the president of the bank, has been the source of recent claims, which, under current regulations, the agency may not find out about until a year or two later. Likewise, it could be useful for the agency to know that a particular claim had been filed and paid by the bonding company since that would verify that dishonest activity had occurred. At present, the bank is required only to inform the OCC that it has given notice to its bonding company that a claim *may* be filed.

Information on settled claims could also be useful if the banking agency has made a criminal referral involving Mr. Jones. If the referral is still pending 6 months later with no civil or criminal enforcement action having been taken against Mr. Jones and the agency learns that the bank's bonding company has paid a $75,000 claim, such information would serve to strengthen the basis for some type of civil action against Mr. Jones.

[479] Ibid., pp. 445–9.

[480] Hearings (Part 2), p. 210.

[481] Ibid.

[482] The FHLBB and NCUA do require prior notice that any association's bond is being canceled; the FDIC does not.

The committee recommends that the agencies require all institutions to notify their appropriate supervisory agency promptly when the institutions file bond claims based upon insider abuse, when such claims are settled, and when their bonds are terminated.

ADDITIONAL VIEWS OF HON. GLENN ENGLISH

The report includes a finding about the Right to Financial Privacy Act's requirement that financial records about a customer obtained from a financial institution pursuant to grand jury subpoena must be returned and "actually presented" to the grand jury. The report finds that this requirement causes significant delays and unnecessary expense and recommends that the requirement be repealed.

I take no exception to the finding. However, I think that the recommendation fails to take into account the main purpose of the requirement that records subpoenaed by a grand jury be actually presented.

The Right to Financial Privacy Act grew out of recommendations made by the Privacy Protection Study Commission, a temporary commission established by the Privacy Act of 1974. The Commission made its recommendations in a 1977 report entitled "Personal Privacy in an Information Society." Chapter 9 of the report deals with government access to personal records and private papers.

Many of the Commission's concerns about government access to private papers grew out of the 1976 decision of the Supreme Court in *U.S.* v. *Miller,* 425 U.S. 435. In *Miller,* the Court held that an individual had no legitimate expectation of privacy in his bank records and no protectible interest in the event that the records were subpoenaed. The decision meant that checking accounts and other records containing detailed personal information about individuals could be obtained from third-party record keepers without any opportunity for the individual to intervene to protect his own interest in privacy. The Court reached this result even though when the government seeks the same records directly from the individual, full due process rights would be available.

The Privacy Protection Study Commission recommended legislation to overturn the *Miller* decision, and the Right to Financial Privacy Act was the result. The Act provides that customers of financial institutions have a right to be notified of government subpoenas for records of their accounts. The Act includes a number of exceptions designed to permit law enforcement agencies to carry out investigations without excessive interference.

One of these exceptions is for grand jury subpoenas. The Act permits financial records to be obtained from financial institutions by grand jury subpoena without notice to the customer. This is a major "loophole" in the law, and there are several reasons why this exception was included in the Act. First, it allows grand juries to carry out their historical investigative functions without interference. Second, because grand juries operate under special secrecy rules, the threat of improper or unnecessary disclosure of personal financial records is diminished. Records obtained by a grand jury

and not later used in court are, at least in theory, protected from other uses by Rule 6(e) of the Federal Rules of Criminal Procedure.

The purpose of the requirement that financial records obtained under grand jury subpoena be returned and actually presented to the grand jury is to make sure that these records are in fact covered by the grand jury secrecy rules. The Privacy Protection Study Commission found that there was some doubt about whether records acquired by grand jury subpoena but not actually presented to the grand jury become subject to the secrecy provisions in Rule 6(e).

I think that it is worthwhile to quote at some length from the report of the Privacy Protection study Commission on this issue:

> It is the attorney for the government who decides when a Grand Jury subpoena will be issued and who issues it. The evidence gathered by the subpoena is then organized by government attorneys and Federal agents before being presented to the Grand Jury. Indeed, documents obtained by Grand Jury subpoena ordinarily pass through the hands of investigative agents who prepare reports for the government attorneys describing the contents of the subpoenaed documents. In most cases a copy of such a report also goes into the files of the investigative agency. FBI agents, for example, prepare an "Agent's Report 92" describing the contents of documents obtained by Grand Jury subpoena in certain organized crime investigations. A copy usually, though not always, goes to the strike force attorney, as well as to the investigative files of the Bureau.
>
> When documents obtained pursuant to a Grand Jury subpoena are presented to the Grand Jury, they, and presumably the information in them, come under the seal of secrecy. When documents are not presented, as often happens, however, they become part of an investigative record which some argue is not under the requirements of secrecy and thus is open to less restricted use by the government. In any case, the reports which are made part of an investigative file are not considered information maintained under the Grand Jury seal. Even information presented and sealed is generally available to government attorneys and any Federal agents assisting them, though they may not disclose the information except by court order or in the course of criminal prosecution based on an indictment issued by the Grand Jury.
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> In essence, the Grand Jury subpoena *duces tecum* has become little more than an administrative tool, its connection with the traditional functions of the Grand Jury attenuated at best. One might characterize its current use as a device employed by investigators to circumvent the stringent requirements which must be met to obtain a search warrant. Documents are subpoenaed without the knowledge, not to mention approval, of the Grand Jury. Documents summoned in the Grand Jury's name may never be presented to it. Indeed, the evidence obtained may not even reach an attorney for the government; it may simply be examined and retained by investigative agents for unspecified future uses. The unique powers of inquiry and compulsion, theoretically justified by the secrecy and limited effect of Grand Jury deliberations, have become a generalized resource for Federal investigative activities. Privacy Protection Study Commission, Personal Privacy in an Information Society 376–77 (1977) (footnotes omitted).

It is worth mentioning that the Commission's recommendations for restrictions on the operation of grand juries were not limited to financial records. The Commission recommended that the same standards apply to any use of a grand jury to obtain documentary evidence. The Right to Financial Privacy Act implemented the Commission's recomendations for records maintained by financial institutions. General application of the same standards to other grand jury operations will have to await additional legislation.

The problems identified by the Subcommittee on Commerce, Consumer, and Monetary Affairs with the requirement that records be actually presented to a grand jury appear to be well documented. However, the solution proposed does not take into account the purpose of the requirement. It seems to me that the application of grand jury secrecy rules could be secured in some fashion without requiring actual presentation to the grand jury.

However, simply eliminating the "actual presentation" requirement without addressing the need for maintaining the secrecy of the grand jury process is throwing the baby out with the bath water.

GLENN ENGLISH.

ADDITIONAL VIEWS OF HON. JUDD GREGG, HON. FRANK HORTON, HON. THOMAS N. KINDNESS, HON. ROBERT S. WALKER, HON. LYLE WILLIAMS, AND HON. TOM LEWIS

We agree that the Federal agencies which regulate financial institutions should pay increased attention to the problems of insider abuse in those establishments. We also agree that implementation of the report's recommendations would serve that objective.

We are not certain, however, of the extent to which those recommendations should be carried out. Bank and thrift institution examiners, U.S. Attorneys' personnel, Federal Bureau of Investigation agents, and computerized information systems are all valuable law enforcement resources. They are scarce and expensive as well, and agencies should employ them in the most cost effective manner. The report does not evaluate whether more of these resources should be reallocated from other activities to the tasks of detecting and prosecuting insider abuse, or whether tax dollars should be spent to provide new resources for these functions.

We should add, in this regard, that the report cogently describes how statutory restrictions make difficult both the reporting of misdeeds to the Justice Department and the prosecution by that department of criminal insider abuse cases. The benefit which would be derived from greater concentration on such cases would be increased by enactment of the measures recommended by the report. Unless those legislative changes are made, however, the merit of making some of the administrative changes suggested may be low.

In addition, we should point out, the report makes no assessment of the connection between moving more forcefully against insider abuse in problem banks and the failure of those banks. If the regulatory agencies could demonstrate that a causal relationship exists between these two actions, the value of the former would be lessened.

In more general terms, we find the report lacks proper documentation at several important junctures. For example, it is asserted that the FDIC "has suffered significant cutbacks in its field examining staff in the past few years." We find it difficult to assess the implications of such assertions where the information has been provided solely on the basis of subcommittee staff telephone conversations with nameless agency officials (see footnote III).

Moreover, we believe the report places undue reliance upon the opinions of anonymous witnesses. Criticisms directed toward the Federal agencies under review here would have been more persuasive if the Members of the Subcommittee had been in a position to make informed judgments about the competence and disinterestedness of specific individuals (see, for example, Sections VI–B–2 and VI–C–1). We note as well a certain measure of dependence on staff opinion for conclusions reached in the body of this report; we would prefer to rely on information and views developed in the

context of the formal hearing process (see Section VII–B–1 and Hearings (Part 2), pp. 859–62).

Finally, we recoginze that the American financial landscape has experienced a profound and rapid transformation in recent years. Our Federal regulatory agencies have struggled to keep abreast of those changes and their attendant problems, often in the absence of sorely needed guidance from the Congress. Therefore we are unable to accept the report's characterizations of Federal agency attitudes toward those problems as having any basis in "neglect," or "indifference," or similar terms (see Section I, *passim*).

We also wish to register our objection to the time constraints which the majority has placed on our ability to review this report. This lengthy study was presented to the Members of the full Committee only three legislative days before we were asked to approve. Members of the investigating subcommittee were given only four additional days for review. The 2,044-page hearing record on which the report is based was not released until the study was sent to subcommittee members. Given the size of these documents and the seriousness of the subject they address, we believe that the Members had inadequate time to consider the report before being asked to approve it.

JUDD GREGG,
FRANK HORTON,
THOMAS N. KINDNESS,
ROBERT S. WALKER,
LYLE WILLIAMS,
TOM LEWIS.

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