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Report to Congressional Requesters

March 1994

BANK INSIDER ACTIVITIES

Insider Problems and Violations Indicate Broader Management Deficiencies

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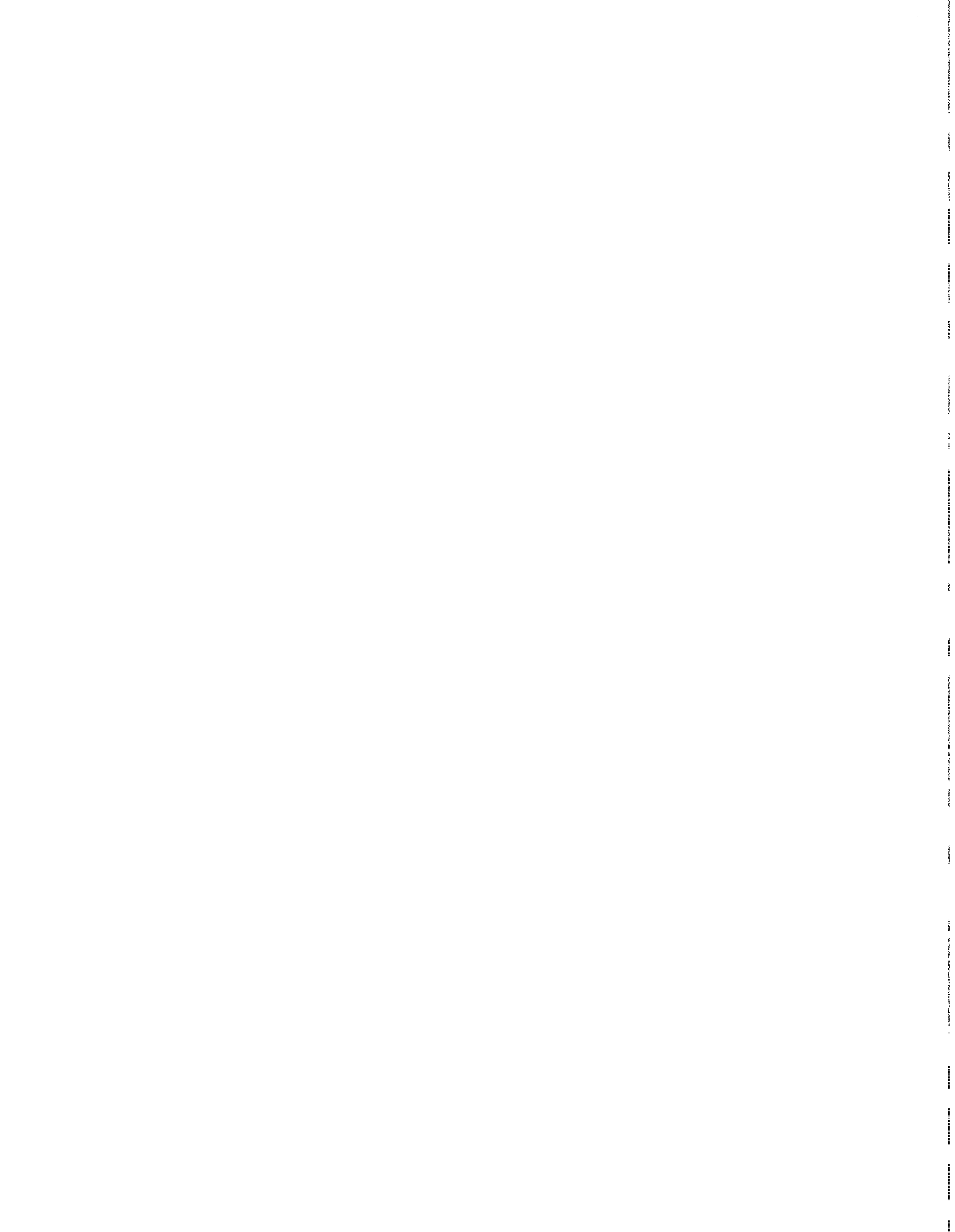

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The Honorable Donald W. Riegle, Jr.
Chairman, Committee on Banking,
Housing and Urban Affairs
United States Senate

The Honorable Henry Gonzalez
Chairman, Committee on Banking,
Finance and Urban Affairs
House of Representatives

This report responds to your separate requests that we review the role of insider activities in, and their effects on the health of, financial institutions. The report discusses the nature of insider problems, such as insider fraud, insider abuse, and loan losses to insiders at failed banks, and violations of insider laws and regulations at both failed and open banks. It also discusses the underlying causes of these problems and ways in which federal bank regulators could improve their oversight of these problems.

We are sending copies of this report to the Chairman of the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, and the Acting Chairman of the Federal Deposit Insurance Corporation. We are also sending copies to members of the banking committees, interested committees and subcommittees, and other interested parties.

This report was prepared under the direction of Mark J. Gillen, Assistant Director. Other major contributors are listed in appendix X. If you have any questions, please call me on (202) 512-8678.

James L. Bothwell, Director
Financial Institutions
and Markets Issues

Executive Summary

Purpose

Officers and directors of a bank have fiduciary responsibilities to the bank, its customers, and its shareholders to ensure the safe and sound management of bank operations. They are also responsible for putting the bank's interests before their own in business dealings affecting the bank. Congress has long recognized in legislation that because of these responsibilities bank insiders, such as officers and directors, who obtain loans from their banks must be treated the same as anyone from the general public obtaining loans. When insider lending violates these laws, the bank may suffer financially. Even without major financial effects, such violations may indicate serious problems with the management and board oversight of bank operations.

This report responds to separate requests from the Chairman of the Senate Committee on Banking, Housing, and Urban Affairs and the Chairman of the House Committee on Banking, Finance and Urban Affairs. Both Chairmen asked that GAO review insider activities at failed and open banks; the underlying reasons for insider problems, such as insider fraud, insider abuse, and loan losses to insiders; and the way federal bank regulators supervise such activities. The Chairman of the House Banking Committee also asked GAO to determine the overall amount of insider lending in the United States banking industry.

Background

Federal Reserve Regulation O generally provides that bank loans to insiders—officers, directors, and principal shareholders—must be made on the same terms that are available to other bank customers. Such loans also must not be any riskier than loans to other bank customers. Regulation O also provides for both individual lending limits for any one insider and aggregate lending limits for all insiders, and it requires prior board approval for loans to insiders. Sections 23A and 23B of the Federal Reserve Act provide rules for transactions between banks and their affiliates. For the purposes of this report, an insider violation is defined as a violation of either Regulation O or sections 23A or 23B of the Federal Reserve Act.

Insider problems, such as loan losses to insiders, may occur with or without insider violations. For example, loans to a director may have been made on the same terms as those available to other bank customers. However, if the insiders' loans go bad, this can potentially affect the financial health of the bank. On the other hand, insider violations can occur—for example, a loan to an officer made at reduced interest rates—even though the loan is current and is not affecting the health of

the bank. In such cases, however, insider violations may indicate a lack of control or effective management of the loan policies set down by the bank's board of directors.

The 3 federal bank regulators—the Federal Deposit Insurance Corporation (FDIC), Office of the Comptroller of the Currency (OCC), and the Federal Reserve System—are each responsible for supervising a portion of the almost 12,000 banks in the United States. Their examinations will often include a review of insider activities to ensure, for example, that insider loans are being made on the same terms and conditions as loans to other bank customers. When the regulators identify insider violations, they may take enforcement actions to get the banks to correct the problems.

Banks may fail for a variety of reasons, including insider problems. When a bank fails, FDIC investigators determine the major reasons for the failure and whether recoveries should be pursued against directors, officers, or others if these individuals were found negligent in overseeing bank operations.

Results in Brief

In reviewing FDIC investigations of 286 bank failures that occurred in calendar years 1990 and 1991, GAO found that investigators cited evidence of insider problems, such as fraud or loan losses, to insiders in 175, or 61 percent, of the banks. Further, GAO found that investigators had cited insider problems as one of the major causes for failure in 74, or 26 percent, of the banks. During the 3 years before these banks eventually failed, federal bank examiners cited the banks for a total of 561 insider violations. Many of these violations were repeated in more than one bank examination. Federal and state regulators also took 235 separate enforcement actions in the 3-year periods. Even though insider violations were cited and enforcement actions were taken, the banks failed.

In a review of federal examination reports for 13 judgmentally selected open and relatively healthy banks, GAO found insider violations similar to those found in the failed banks. In both the failed and open banks, GAO found a strong association between these insider violations and the larger problems of poor administration by bank management and inadequate oversight by bank boards of directors.

In general, GAO found that examiners were not as effective in identifying insider problems at the failed banks when the banks were open as investigators were after the banks had failed. Although there are several

reasons for the examiners identifying fewer insider problems, GAO believes examiners should take steps to improve their abilities to identify problems.

GAO further found that examiners often failed to adequately communicate to bank boards and management the potential seriousness of problems and violations; as a result, the problems went uncorrected and became more serious. At the same time, GAO believes that bank boards of directors and bank management often failed to take steps to understand the depth of the problems examiners were attempting to explain.

Because no comprehensive data sources exist, GAO was unable to identify the aggregate amount of insider lending at failed banks. For open banks, newly required bank data showed the aggregate amount of insider lending for all banks was $24 billion as of March 1993.

Principal Findings

Insider Problems and Insider Violations Existed at Failed Banks

GAO found evidence of insider problems cited in investigations of 175 of 286 banks that failed in 1990 and 1991. Insider fraud, a type of criminal activity, was identified by FDIC investigators in 36 percent of the 286 bank failures. Insider abuse—that is, any abusive action taken for self-gain on the part of insiders that falls short of criminal fraud—was identified by FDIC investigators in 41 percent of the 286 bank failures. Loan losses to insiders were identified by FDIC investigators in 28 percent of the 286 bank failures. Overall, for the 175 banks with evidence of insider problems, losses to the FDIC's Bank Insurance Fund, which insures deposits in commercial and saving banks, were estimated to be $5.4 billion, or about 55 percent of total losses, during the 2-year period. The assets of these 175 banks totaled $33.7 billion, or about 43 percent, of the total assets of all 286 banks that failed in 1990 and 1991. During the 3 years before the 175 banks failed, federal examiners cited the banks for 561 insider violations. The most common violations were exceeding the lending limits for insiders and giving loans to insiders with preferential terms that were not available to the general public. GAO found that small banks (those with assets of less than $100 million) were more likely to be cited for insider violations than were large banks (those with assets of $100 million or more). (See pp. 31-49.)

Insider Violations Were Also Present in Open Banks

In GAO's review of federal examinations of 13 open banks, 10 banks had been cited for insider violations. As they had been in the failed banks, preferential interest rates on loans to insiders and insider loans that exceeded the legal lending limit were the most frequently cited insider violations in the examination reports GAO reviewed. For example, one report cited two loans to insiders that were made at preferential interest rates of 9 and 10.5 percent when regular bank customers were charged 12 and 13.5 percent, respectively, for identical loans. (See pp. 49-51.)

Insider Problems Are Indicative of Poor Management and Oversight

GAO found that insider violations were strongly associated with management problems, such as the failure of management to respond to regulatory criticisms, poor and/or negligent management, and passive or negligent boards of directors. In 141 of the 175 failed banks that were cited by federal regulators for insider violations, GAO found banks cited for insider violations more likely to also be criticized by federal regulators for various management problems. For example, when examiners cited loans to insiders that exceeded the loan limits, they were four times more likely to identify the management problem of a dominant board member than when they did not cite such an insider violation. Also, when examiners cited a bank's failure to maintain records relating to insider activities, they were 2.8 times more likely to identify poor and/or negligent management. (See pp. 52-54.)

Although the federal regulators cited these banks for insider violations and associated management problems, these banks still failed. On the basis of its analysis, GAO believes the failure of a bank's management to correct insider problems and violations indicates a much larger problem of poor management and inadequate oversight by the bank's board and individual directors. (See pp. 54-55.)

Examiners Could Improve Their Ability to Identify Insider Problems

In cases of banks with problems of insider fraud and abuse, FDIC investigators were more likely to have identified the problems after the banks failed than were the examiners when the banks were open. Examiners did a better job in identifying insider loan losses, but they still were not as effective as investigators on identifying other insider issues. One reason for the identification of fewer insider problems is that examiners face many obstacles, and investigators have several advantages in identifying insider problems. For example, former bank employees are more likely to be willing to talk to investigators about insider problems after a bank has failed and their jobs can no longer be jeopardized by such

discussions. Even so, GAO believes that by focusing more on the recordkeeping requirements of Regulation O, examiners could ensure that more information would be available to enable them to spot insider problems when they occur. (See ch. 5.)

Failure to Communicate Problems and Failure of Bank Boards to Understand Problems May Exacerbate Problems

In both failed and open banks, GAO found that problems identified by examiners often went uncorrected from one examination to the next. The problems examiners identified in the open banks were not as severe as those in the failed banks. However, it is troubling that both the federal bank examiners and bank directors and management did not better ensure that problems in both open and failed banks were corrected. When examiners fail to take timely forceful enforcement actions, bank boards of directors may fail to understand the potential seriousness of repeated violations and problems. Even so, bank boards of directors also have major responsibilities to listen to examiners and ensure that bank management takes the necessary steps to correct problems.

In discussions with outside bank directors (i.e., directors who are not employees of their banks), GAO noted that many of the directors expressed frustration about their interaction with their banks' primary federal regulator. These frustrations varied. However, most centered on the directors' need for examiners to work more closely with them to better ensure that they understand the problems examiners identified. Their frustrations also centered on the directors' need for examiners to prioritize the problems they identify.

In its analysis of the 286 banks that failed in 1990 and 1991, GAO found that investigators cited about 90 percent of the banks for having passive or negligent directors as a factor contributing to the banks' failure. In these cases, it appears that directors of some banks seem not to have understood their roles and responsibilities in maintaining or returning the bank to a financially sound position.

In addition, GAO found instances of passive boards of directors cited in the examination reports for several of the 13 open, healthy banks it reviewed. In these instances, federal examiners noted that the boards of directors or individual directors had failed to either understand the seriousness of the examination findings or take corrective actions on identified problems. For directors to fully understand the seriousness of examination findings, training may be appropriate.

Bank directors have a responsibility to carefully listen and fully understand what examiners are informing them about a bank's identified problems. When bank directors do not fully understand examination findings, it is their responsibility to either seek further clarification from examiners or obtain additional knowledge on a particular aspect of banking. Repeated violations or problems should send a sufficient signal to a bank's board of directors that either (1) the bank's management is not taking adequate corrective actions or (2) the directors do not understand what is necessary to correct the problems. (See ch. 6.)

The Aggregate Amount of Insider Lending at Failed Banks Is Unknown

GAO used several approaches but was unable to identify the aggregate amount of lending to insiders at failed banks. One reason for this is that FDIC investigators generally do not seek to identify the aggregate amount of insider lending that occurred in a failed bank or even the full extent of losses caused by insider lending. Until March 1993 all banks were required to file quarterly reports—bank call reports—that included only the amount of lending to officers and shareholders but omitted the amount of lending to bank directors. Consequently, there has been no aggregate reporting of insider lending activities by banks.

Lending to bank directors was added for the March 1993 call report. For this call report, the aggregate amount of insider lending was $24 billion, with an average aggregate amount per bank of $2 million, ranging from no insider lending to $623 million. Historically, it has often taken several reporting cycles for new data to be reliably reported by banks; therefore, with the new reporting requirement future reports should more accurately reflect aggregate insider lending activity. If banks adhere to the reporting requirements, then reporting will eventually enable regulators to determine the aggregate amount of insider lending. This requirement makes it easier for examiners to determine whether banks are violating Regulation O, which governs aggregate lending to insiders. However, such reporting will be only as good as the records kept by banks. Given that 61, or 35 percent, of the 175 failed banks with evidence of insider problems were cited for violations of insider recordkeeping requirements, GAO believes it is important for federal examiners to reemphasize the importance of banks keeping and reporting accurate information on insider activities. (See ch. 4.)

Recommendations

GAO recommends that federal bank regulators include a thorough review of insider activities in their next examination of each bank under their

authority. This review should include a comparison of data that banks provide examiners with information as reported by each bank in its quarterly call report, an evaluation of bank insurance policies, and an increased emphasis on Regulation O recordkeeping requirements. (See ch. 5.)

To improve the communication between examiners and bank directors and increase the likelihood that directors will initiate appropriate corrective actions, GAO is making a further recommendation. GAO also recommends that federal bank regulators direct examiners to better ensure—through examination reports, exit conferences, and other means (including recommending training to directors when appropriate)—that all directors understand (1) the primary issues in need of directors' attention, (2) that the problems facing a bank are most often a consequence of deficiencies in the overall management and oversight by the directors, and (3) that directors must see that effective corrective action is taken. (See ch. 6.)

Agency Comments

GAO requested comments on a draft of this report from OCC, FDIC, and the Federal Reserve. These written comments appear along with GAO's responses in appendixes VII, VIII, and IX.

OCC officials agreed with GAO's recommendations, saying it plans to take corrective actions. These include revising the section of the Comptroller's Handbook for National Bank Examiners for reviewing insider activities and including a discussion of call report requirements and a reemphasis of the importance of recordkeeping and reporting requirements.

FDIC and the Federal Reserve, while in substantial agreement with GAO's findings and conclusions, stated that they already have policies in place to address these recommendations. GAO believes that there are additional opportunities for improving communication between regulators and bank boards and management that are not included in FDIC's and the Federal Reserve's policies. Further, based on GAO's review of federal regulators' examination files for failed and open banks, GAO found that FDIC has not consistently adhered to its policies. In a subsequent letter (see app. VIII), FDIC agreed to reemphasize to its field staff the importance of a thorough analysis of insider activities, effective communication with boards of directors, and adherence to established policies and procedures.

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Abbreviations

AABD	American Association of Bank Directors
BIF	Bank Insurance Fund
CFR	Code of Federal Regulations
CMP	Civil Money Penalties
D&O	Directors and Officers
DCI	Data Collection Instrument
DOL	Division of Liquidation
FDIC	Federal Deposit Insurance Corporation
FDICIA	Federal Deposit Insurance Corporation Improvement Act of 1991
FIRREA	Financial Institutions Reform, Recovery and Enforcement Act of 1989
FRA	Federal Reserve Act
LAMIS	Liquidation Asset Management Information System
MOU	Memorandum of Understanding
NCUA	National Credit Union Administration
OCC	Office of the Comptroller of the Currency
OTS	Office of Thrift Supervision
PCR	Post-Closing Report
PLS	Professional Liability Section
SEC	Securities and Exchange Commission

Introduction

Insider activities at banks, such as loans to bank directors, officers, or principal shareholders, should pose no greater risk to a bank's financial health than transactions with other bank customers when these insider activities are conducted under applicable laws and regulations. However, when insider activities become abusive, they can be among the most insidious of reasons for the deterioration of the health of a bank. When insider fraud,[1] excessive compensation, self-dealing, or other abusive activities occur, the very individuals who have a fiduciary duty to ensure the sound operations of a bank can benefit from violations of laws or regulations and thus may be motivated to conceal these activities. Consequently, such abuses can be difficult for federal bank regulators to detect.

In addition, repeated insider problems and violations of laws and regulations governing insider activities can indicate poor internal controls. They can also indicate the failure of a bank's management and board of directors to effectively ensure that the bank operates in a safe and sound manner. Such problems put the health of individual institutions at risk and pose a threat of loss to the Bank Insurance Fund (BIF), which insures deposits in both commercial and savings banks.

This report responds to separate requests from the Chairman of the Senate Committee on Banking, Housing and Urban Affairs and the Chairman of the House Committee on Banking, Finance and Urban Affairs. The Chairmen requested that we review the role of insider activities in, and their effects on the health of, financial institutions.[2] Both Chairmen were also interested in the efforts of federal financial institution regulators to identify, monitor, and supervise insider activities.

[1]Fraud, a criminal act, generally can be defined as intentional actions, omissions, or concealments meant to deceive and get advantage over another.

[2]As agreed with the requesters, our work concentrated on commercial banks. In appendix II, we present a summary of our prior work that addressed insider issues in thrifts and credit unions, which we updated through discussions with officials at the Office of Thrift Supervision and the National Credit Union Administration.

Congressional Concerns About Insider Problems Prompted Legislation

Sections 22(g) and 22(h) of the Federal Reserve Act (FRA)[3] are two of the key statutory provisions governing loans[4] to bank insiders. A review of the history of these sections demonstrates Congress' long-standing concern about the effects of insider activities on the health of financial institutions. For example, section 22(g) of FRA, as added by the Banking Act of 1933,[5] prohibited loans to executive officers of banks outright and required the officers to submit written reports to the chairman of a bank's board of directors containing the dates and amounts of loans made to those officers by other banks. The Banking Act of 1935 eliminated the absolute bar on loans by a bank to its officers and authorized a bank to extend credit to its executive officers. However, the credit is not to exceed $2,500, without prior approval of a majority of the bank's board of directors.

In 1967, Congress further amended section 22(g) of FRA, increasing the amounts that banks could lend to their executive officers. That legislation authorized banks to make loans of up to $5,000 to executive officers and separately authorized specific-purpose loans for education and home mortgages. However, safeguard provisions were added, including a requirement that such loans be made on terms that were no more favorable than those extended to other borrowers. The provisions also contained a requirement that the borrowing officer submit a detailed financial statement.

Congress substantially increased insider restrictions in the Financial Institutions Regulatory and Interest Rate Control Act of 1978.[6] Before this act, restrictions applied solely to executive officers. This act added a new provision, section 22(h) of FRA, which, in conjunction with section 22(g), expanded the definition of insiders to include officers, directors, and major shareholders and their related interests. Congress was concerned that "[p]roblem banks and insider abuses have been virtually synonymous."[7] As a response to the problems associated with insider abuses at financial institutions and with the "recognition that insiders have a special duty with respect to their institutions," in the same session

[3]12 U.S.C. 375a, 375b.

[4]Law and regulations governing insider transactions refer to extensions of credit to insiders. The term extensions of credit includes loans, standby letters of credit, overdrafts, advances against unearned salary, etc. For purposes of this report, we will use the term loans to insiders to mean all extensions of credit to insiders.

[5]Pub. L. No. 73-66, 48 Stat. 162 (1933).

[6]Pub. L. No. 95-630, 92 Stat. 3641 (1978).

[7]H. Rep. No. 1383, 95th Cong., 2d Sess. 10 (1978).

Congress placed restrictions on insider loans and provided statutory language spelling out the board of directors' responsibilities with respect to insider loans.

Further restrictions and amendments relating to insider transactions were added by the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA).[8] Congress again expressed its concern with reports of "serious abuses by bank and thrift insiders, with resultant costs to the deposit insurance system."[9] In the same session, Congress was also concerned with how such abuses could affect public confidence in the banking industry as a whole. Therefore, Congress added additional provisions, including overall limits on loans to all bank insiders "to help combat such abuses, and prohibitions on excessive compensation."

Sections 23a and 23b: Restrictions on Affiliate Transactions

In addition to improper loans, insider abuse can occur through transactions between a member bank[10] and its affiliates, which generally are any companies that control the member bank and any other company that is controlled by a company that controls the member bank. For example, an officer of a bank may also own, in part, a data processing company that is affiliated with the bank. An abuse would result if the officer used his or her influence to direct bank business to this company and the company then charged exorbitant fees for its data processing services. Congress enacted Section 23A of FRA[11] to (1) restrict transactions between member banks and their affiliates, (2) prohibit the purchase of low-quality assets by banks from affiliates without independent credit evaluation, and (3) require permissible loans or extensions of credit between banks and affiliates to be adequately collateralized. Congress designed section 23A to prevent the misuse of commercial bank resources stemming from nonarm's length financial transactions with affiliated companies.[12]

[8]Pub. L. No. 102-242, 105 Stat. 2236 (1991).

[9]S. Rep. No. 167, 102nd Cong., 1st Sess. 55 (1991).

[10]The term member bank refers to banks that are members of the Federal Reserve System. Sections 23A and 23B of FRA apply with respect to a nonmember insured bank in the same manner and to the same extent as if it were a member bank (12 U.S.C. 1828(j)(2)). Implementing regulations generally subject nonmember banks to Regulation O's controls on credit extensions to insiders (12 C.F.R. section 337.3).

[11]12 U.S.C. 371c.

[12]See S. Rep. No. 536, 97th Cong., 1st Sess. 31 (1982).

Section 23A limits the amount of transactions between a member bank and its affiliates. Transactions with any one affiliate are generally limited to 10 percent of the bank's capital and surplus. An overall limit of 20 percent is applied to all affiliate transactions.

Section 23B of FRA[13] was specifically intended to authorize certain transactions (including loans and purchases of assets) between member banks and their affiliates. However, it was to authorize transactions only if their terms and conditions, including credit standards, were substantially the same as or at least as favorable to the bank as those prevailing at the time for comparable transactions with nonaffiliated companies.[14]

Insider Activities Permitted and Prohibited by Regulation O

Federal Reserve Regulation O[15] implements the provisions of FRA sections 22(g) and 22(h), which concern loans to executive officers, directors, and principal shareholders of member banks. Insiders generally are defined by Regulation O as including bank officers in a major policymaking position, bank directors, and major shareholders and their related interests. Table 1.1 provides more specific information on the definition of insiders. We present the complete text of Regulation O in appendix III.

Table 1.1: Insiders as Defined by Regulation O

Insider	Definition
Executive Officers	Any person who participates in or has the authority to participate in major policymaking functions of a bank. Also includes executive officers of the bank's holding company or of any other subsidiary of the bank's holding company.
Directors	All individuals who serve on the bank's elected board of directors, whether or not they receive compensation. Also includes directors of the bank's holding company and the directors of any other subsidiary of the bank's holding company.
Principal Shareholders	Any bank shareholder who directly or indirectly controls at least 10 percent of the voting shares of any class of stock. Shares owned by a shareholder's spouse, minor children, or adult children who reside at the shareholder's house must be included in the 10-percent calculation. Also includes shareholders meeting the 10-percent criterion of the bank's holding company and/or any individual who controls 10 percent of any subsidiaries of the bank's holding company.

Regulation O defines insiders as a bank's executive officers, directors, principal shareholders, and their related interests. The term related interest refers to any entity that the insider controls. Control is defined as

[13] 12 U.S.C. 371c-1.

[14] S. Rep. No. 19, 100th Cong., 2d Sess. 36 (1987) (Legislative History of the Competitive Equality Banking Act of 1987, Pub. L. No 100-86, 101 Stat. 552 (1987)).

[15] 12 C.F.R. Part 215

ownership, control or the power to vote 25 percent or more of any class of voting securities of the company or bank, control over the election of the majority of the directors of the company or bank, or the power to exercise a controlling interest over the management or policies of a company or bank. Control is presumed to exist if the insider (1) is an executive officer or director of the company or bank and owns or controls more than 10 percent of any class of voting securities, or (2) owns or controls more than 10 percent of any class of voting securities and no other person owns or controls a greater percentage.

Related interests do not automatically by definition include the immediate family of the insider. Entities owned or controlled by these individuals could fall under the umbrella of "related interests" if the insider "controlled" the entity in accordance with the definitions above. For example, if the spouse of a bank director owned 80 percent of the voting stock of a private company not affiliated with the bank or bank holding company, the director owned 20 percent of the stock and served as the spouse's treasurer, the spouse's company would be, by definition, a "related interest" of the director.

Major Provisions of Regulation O

Regulation O contains an assortment of controls on loans to insiders. It prohibits preferential lending, which requires that loans to insiders be made on substantially the same terms and conditions as to noninsiders and not involve more than the normal risk of repayment or present other unfavorable features. Prior approval by a bank's board of directors is required when the aggregate amount of credit extended to an insider and his/her related interests exceeds—whichever is greater—$25,000 or 5 percent of the bank's unimpaired capital and unimpaired surplus. When the aggregate amount of loans extended will exceed $500,000, prior approval is required regardless of whether or not the loan amount exceeds 5 percent of the bank's unimpaired capital and unimpaired surplus balance.

Regulation O also includes both individual and aggregate lending limits to insiders. In general, insiders are subject to the same individual limits as noninsiders.[16] Aggregate lending limits on loans to all insiders generally

[16]This lending limit is an amount equal to the limit of loans to a single borrower established by section 5200 of the Revised Statutes (12 U.S.C. 84). This amount is 15 percent of the bank's unimpaired capital and unimpaired surplus in the case of loans that are not fully secured and an additional 10 percent of the bank's unimpaired capital and unimpaired surplus in the case of loans that are fully secured (12 C.F.R. 215.2(h)). The lending limit also includes any higher amounts that are permitted by section 5200 of the Revised Statutes for the types of obligations listed in the statutes as exceptions to the limit. For more detail, refer to the full text of Regulation O in appendix III.

may not exceed 100 percent of a bank's unimpaired capital and unimpaired surplus.[17] Under certain circumstances, member banks with deposits of less than $100,000,000 may by resolution of their boards of directors increase the general limit on aggregate loans. Such increases must be approved by the bank's board and are limited to two times the bank's unimpaired capital and unimpaired surplus. As of January 30, 1994, the Federal Reserve had received 54 notifications for using the higher aggregate lending limit available for small banks under FDICIA.

Additional restrictions and reporting requirements, particular to loans to executive officers and implementing section 22(g) of FRA, are set out in the Code of Federal Regulations.[18] Overdraft payment limitations that apply to executive officers and directors of a bank are set out in Regulation O.[19] However, these limits are not applicable to payments by a member bank of overdrafts of a principal shareholder or to payments of overdrafts of an insider's related interests.

Banks are required to maintain all necessary records to comply with Regulation O, including records that identify all executive officers, directors, principal shareholders, and their related interests. Banks must also maintain specific information on the amount and terms of each loan to insiders. In addition, at least annually, a bank must ask its executive officers, directors, and principal shareholders to identify their related interests. Other Regulation O provisions set out requirements for public disclosure of credit from member banks to executive officers and principal shareholders. These provisions also require reports on indebtedness of executive officers and principal shareholders to correspondent banks.[20,21] Subpart B of Regulation O deals specifically with correspondent banks and implements requirements set out at 12 U.S.C. 1972(2)(G). A correspondent bank is a bank that maintains one or more correspondent accounts for a member bank during a calendar year that in the aggregate exceed an average daily balance of the smaller of $100,000 or 0.5 percent of such banks' total deposits, as reported on its first quarter call report. (Call report is the common name for the Consolidated Report of Condition and Income, which banks are generally required to file with their primary federal regulator on a quarterly basis.)

[17]Aggregate lending limits to insiders were enacted as part of FDICIA in 1991.

[18]12 C.F.R. 215.5, 215.9 and 215.10.

[19]12 C.F.R. 215.4(e).

[20,21]12 C.F.R. 215.11 and 12 C.F.R. 215.20-215.23, respectively.

For the purposes of this report, an insider violation is defined as a violation of either Regulation O or sections 23A or 23B of FRA.

Bank Regulation and Supervision

There are almost 12,000 federally insured banks in the United States. These banks are supervised at the federal level by three agencies. The Office of the Comptroller of the Currency (OCC) supervises 3,598 nationally chartered banks.[22] OCC-supervised banks include many of the large, money-center banks, such as Citibank, N.A. The Federal Reserve supervises 957 state-chartered banks that are members of the Federal Reserve System. These banks are commonly known as state member banks. The Federal Deposit Insurance Corporation (FDIC) supervises the 7,431 state-chartered banks that are not members of the Federal Reserve. These banks are commonly known as state nonmember banks. State banking agencies are also responsible for supervising state-chartered banks.

Bank Examinations and Reports

Federal bank regulators conduct examinations as a means of supervising banks. The three federal regulators use similar procedures in examining banks. The results of an examination by any of the regulators are summarized in an examination report addressed to the board of directors of the bank. The examination usually results in the examiner assigning a numerical rating to each of these bank components—capital, assets, management, earnings, liquidity (CAMEL). The examiner is to assign a composite CAMEL rating to the bank. CAMEL ratings range from a 1, the best rating and the lowest level of supervisory concern, to a 5, the worst rating and the most serious level of supervisory concern.

Examinations may be of several types. Examinations that focus on the financial "health" of the institution are called safety and soundness examinations. Safety and soundness examinations are generally done on-site at the bank, although some off-site analysis may be done through the use of quarterly call report data that banks are required to submit to the regulators. The examinations may be targeted (that is, focused on one or more bank activities, such as the loan portfolio), or they may be full-scope.

Federal regulators conduct separate examinations to measure compliance with various consumer protection laws, such as the Truth-In-Lending Act or the Community Reinvestment Act. Regulators review various other

[22]Data for all regulators are as of December 31, 1992.

bank activities either in their safety and soundness examinations, their compliance examinations, or in separate examinations. These activities relate to the Bank Secrecy Act, the bank's trust department, or electronic data processing. For example, OCC reviewed insider activities in the past as part of compliance examinations, but it now reviews them as part of its safety and soundness examinations.

For those banks that are not nationally chartered, state regulators also conduct examinations. For those banks, the Federal Reserve and FDIC may do separate examinations, in addition to these state examinations, or they may do joint or concurrent examinations with the state regulators. In joint examinations, the federal and state supervisory agencies issue one joint report; for concurrent examinations, separate reports are issued.

FDICIA required federal bank supervisory agencies to conduct annual safety and soundness examinations of all banks. However, banks that meet capital and other management and control standards may be examined once every 18 months. In addition, the Federal Reserve and FDIC may rely on state examinations instead of federal examinations in alternate years.

Bank examiners generally notify bank management and directors of financial weaknesses, operational problems, or violations of banking laws or regulations that they identified. Often, examiners notify a bank's management and board of directors at "exit" conferences held at the end of an examination. In addition, a report of examination findings is to be provided to the bank's board of directors. Exit conferences, meetings, and examination reports enable regulators to convey their supervisory concerns as well as to impress upon bank managers and directors the need to address those areas that adversely affect the bank's continued viability.

Enforcement Actions Available to Bank Regulators

An examination may result in the regulator taking informal or formal enforcement actions to get the bank management to correct deficiencies that were identified in the examination. According to agency guidelines, regulators are to use informal actions for banks in which—despite examiner-identified problems and weaknesses—the overall strength and financial condition reduce failure to a remote possibility and bank management has demonstrated a willingness to address supervisory concerns. Regulators are to use informal actions to advise banks of noted weaknesses, supervisory concerns, and the need for corrective action.

Informal actions include

- meeting with bank officers or boards of directors to obtain agreement on improvements needed in the safety and soundness of the bank's activities,
- having banks issue commitment letters to the regulators specifying corrective actions that will be taken,
- having bank boards issue resolutions specifying corrective actions that will be taken, and
- initiating a memorandum of understanding[23] between regulators and a bank's board of directors on actions that are required to be taken.

While informal actions communicate supervisory concerns and actions needed to address those concerns, they are not administratively or judicially enforceable if agreed-upon corrective actions are not taken by bank management.

Regulators are to use formal enforcement actions if (1) informal actions have not been successful in getting bank management to address supervisory concerns, (2) bank management is uncooperative, or (3) the bank's financial and operating weaknesses are serious and failure is more than a remote possibility. Formal actions are legally enforceable tools that regulators can use to compel bank management to take corrective actions in order to address such supervisory concerns as increasing capital and maintaining adequate reserves, discontinuing abusive lending practices, or strengthening underwriting policies. These actions include

- formal written agreements between regulators and bankers;
- orders to cease and desist unsafe practices and/or violations;
- assessments of civil money penalties, of up to $1 million a day, against officers or directors;
- orders for removal, prohibition, or suspension of individuals from bank operations;
- termination of insurance proceedings; and
- capital directives to increase a bank's capital.

Formal actions are authorized by statute and may be taken by all three federal regulators against the banks they supervise. FDIC has the sole legal authority to terminate deposit insurance. If banks do not consent to a formal action or fail to comply with its provisions once they are agreed upon, regulators may enforce the action through administrative or legal proceedings.

[23]A memorandum of understanding is a voluntary agreement by a bank, negotiated with its regulator, to refrain from a particular activity deemed by the regulator to be an unsound banking practice.

Bank Directors' Roles and Responsibilities

A bank, like any other corporation, has shareholders and a board of directors elected by the shareholders. The board is responsible for overseeing the management of the bank's activities. Unlike other corporate board members, however, bank board members, or directors, are subject to additional laws and sanctions, which serve to emphasize that under the law a higher level of performance is expected from bank directors than from other business directors. For example, many bank directors are required to take an oath of office; business corporation directors generally do not. Bank directors can be removed from office for unsound practices and can be held statutorily liable for damages resulting from willful violations of the law. Vague or less automatic procedures, if any at all, for removal of directors of other corporations appear in typical corporation codes. Part of the reason for this higher standard of conduct is that most of the funds the bank puts at risk belong to others, namely depositors. In addition, failure of a bank can result in FDIC using deposit insurance fees collected from other banks.

Each of the regulators has issued comparable guidance on directors' duties and responsibilities. For example, OCC's Handbook for National Bank Examiners states that directors have a responsibility to

- select competent officers;
- effectively supervise the bank's affairs;
- adopt sound policies and objectives;
- avoid self-serving practices;
- be informed of the bank's condition and management policies;
- maintain reasonable capitalization;
- observe banking laws, rulings, and regulations; and
- ensure that the bank has a beneficial influence on the economy of its community.

As part of their responsibilities, bank directors attend board meetings (for which they generally receive compensation), receive and review reports from management on bank performance, review and approve bank policies, and receive and review examination reports from federal bank regulatory agencies.

FDIC Has Several Responsibilities When a Bank Fails

When a bank fails, FDIC, as receiver, may utilize one of a number of methods to resolve the institution. The assets of the bank may be sold as a single transaction or in parcels to other healthy banks. FDIC will also contract out the servicing of some of the larger bank loan portfolios it

retains to outside loan servicers. However, in any case, FDIC is likely to retain some percentage of the failed bank's assets; an acquiring bank generally will not want to purchase all of the problem loans of the failed bank. Except for assets sold and those asset pools[24] FDIC retains but contracts out for servicing, information on all assets FDIC assumes is maintained on the Liquidation Asset Management Information System (LAMIS) of FDIC's Division of Liquidation (DOL).[25] LAMIS is an FDIC automated system designed to support the management and sale of failed bank assets. LAMIS supports such activities as the servicing of loans; collections; the reporting of loan inventories; and disbursements to taxing authorities, insurers, and others.

Within 90 days of a bank's failure, it is FDIC policy to have DOL investigators complete a Post-Closing Report (PCR). A PCR provides more specific information on the causes of the bank's failure and potential sources of recovery of funds. If DOL investigators find evidence of abuse, fraud, or negligence on the part of bank directors, officers, or others, FDIC investigators seek to determine whether there are sufficient sources of recovery to justify the pursuit of a claim against any individuals identified as contributing to the bank's failure. In general, six potential sources of recoveries are available: (1) blanket bond insurance, which covers actual fraud on the part of directors and officers; (2) directors' and officers' (D&O) liability insurance policies, which cover negligence or insider abuse that is not criminal in nature; (3) directors' and officers' personal assets; (4) attorney malpractice suits; (5) appraisers' malpractice suits; and (6) accountants' malpractice suits.

Objectives, Scope, and Methodology

For this review we had five objectives:

- Determine the frequency of various insider activities at selected failed and open banks and the potential impact of insider activities on the safety and soundness of bank operations.
- Evaluate the effectiveness of the federal financial institutions' regulators to identify and supervise insider activities at banks.
- Determine the underlying causes of insider problems—specifically, whether there is an association between insider problems and broader managerial or operational problems in failed and open banks.
- Determine the overall extent of loans to insiders at failed and open banks.

[24]Asset pools are mortgages, commercial loans, real estate loans, or other loans managed as a group.

[25]In October 1993, DOL was reorganized and renamed the Division of Depositor and Asset Services.

- Compare state banking laws and regulations with federal Regulation O and analyze state examination policies and procedures governing insider activities.

Our first objective was **to determine the frequency of various insider activities at selected failed and open banks and the potential impact of insider activities on the safety and soundness of bank operations**.

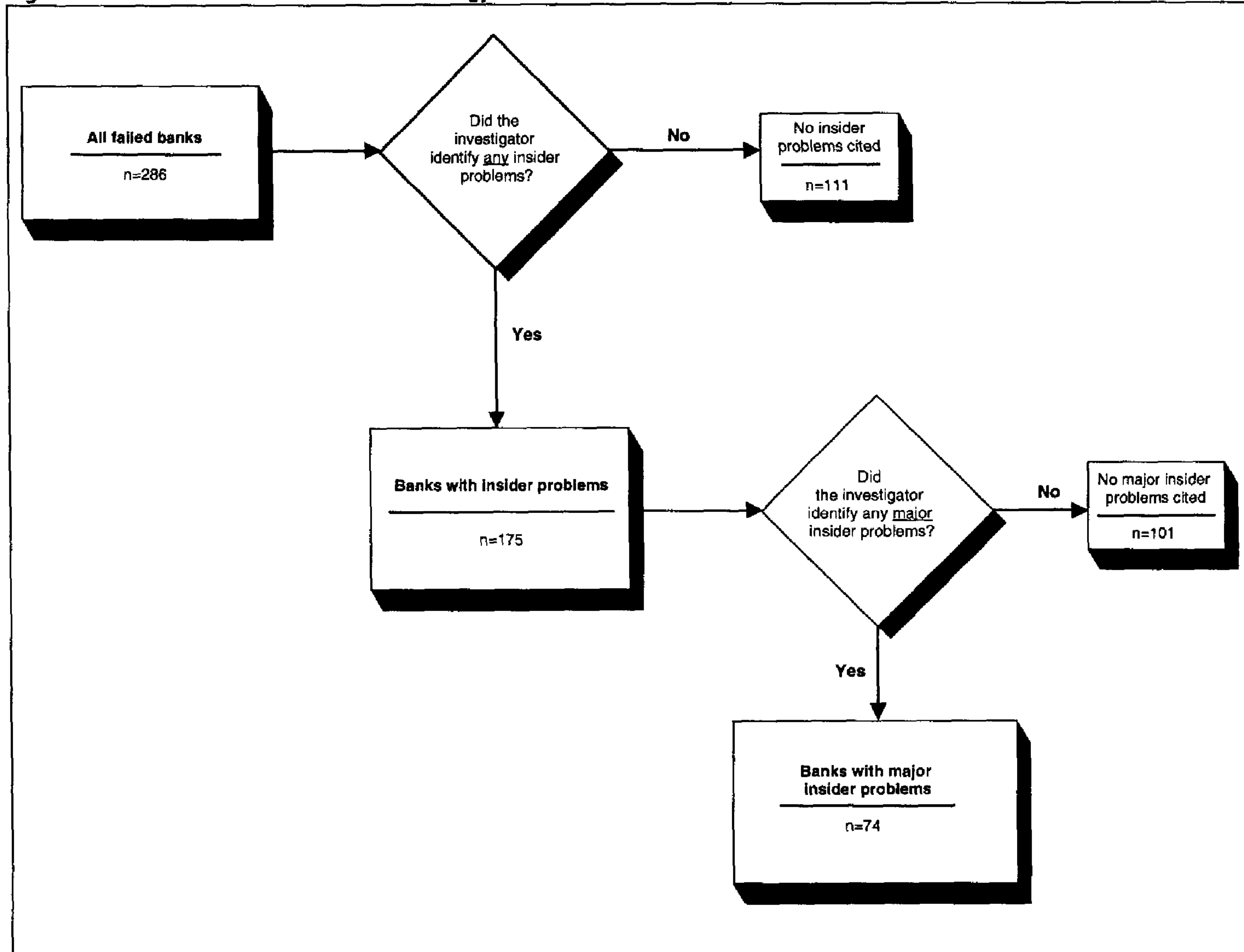
To address this objective, we evaluated insider activities and other problems at both failed and open banks. In chapters 2 and 3 we present the results of our review of these activities. A discussion of the general methodologies we used for the work in both of these chapters follows, and more specific information on our methodologies is presented in appendix I.

Our Evaluation of Failed Banks

To evaluate failed banks, we reviewed information on 286 banks;[26] these are all the banks that failed in calendar years 1990 and 1991 for which DOL had done an investigation. Our objectives were to (1) determine the frequency with which insider problems contributed to the failure of the banks and (2) determine the extent to which the banks' primary regulators had identified and acted upon the same problems when the banks were open. Figure 1.1 explains our approach to examining the failed banks in our review.

[26]FDIC's DOL had a total of 297 cases opened in 1990 and 1991. Two of these were not banks but rather were residual asset pools from failed banks that were sold. Three of the cases were bridge banks that had been created at the time of the failure of the Bank of New England Corporation. The original three Bank of New England Corporation bank failures are included in the cases we reviewed. However, to avoid double counting, we did not include the bridge banks. Normally, DOL conducts one investigation for each bank failure. However, the group of nine NBC bank failures in Texas were represented by three investigations and therefore were treated as three bank failures for purposes of our analysis. Taking into account these adjustments, we reviewed a total of 286 cases of bank failures.

Figure 1.1: Flowchart of Failed Bank Methodology



For each of the 286 banks, we reviewed DOL investigator files and bank- and FDIC-generated financial information. To clarify and confirm the information, when necessary, we interviewed the investigators in charge of the failed banks.

We collected the information on a two-part form, or data collection instrument (DCI), we designed and pretested. To address the requesters'

question about the frequency of insider activities, we completed part I of the DCI for the 286 failed banks. Part I focused on the reasons for a bank's failure. These reasons include an assessment by the investigator as to whether insider problems played a role in the bank's failure; the types and nature of the insider problems identified by the investigator; and the extent to which recoveries from directors, officers, and others are likely. We then completed part II only for those cases where investigators identified insider problems as being a factor in the failure of the bank. Of the 286 cases, 175 (61 percent) required the completion of part II.[27] Part II focused on the federal and state supervisory examinations and related enforcement actions that were taken when the bank was open and the financial information developed by the FDIC investigator from bank records. Of the 286 failed banks, 74 (26 percent) met 1 or both of 2 conditions. The first condition was whether the investigator in his/her own words concluded that insider fraud, abuse, and/or loan losses to insiders were major factors in the bank's failure. The second (when the major factors contributing to failure were not specifically listed) was whether the investigator identified losses from insiders amounting to at least 2.5 percent of assets.[28] If the banks met one or both conditions, we considered them to be banks where insider problems were a major factor in the banks' failure.

We collected specific information on the types of insider activities identified by the investigator and the other management and economic problems that led to the banks' failures.[29] We also collected the same information from the examination reports and accompanying workpapers of the 175 banks for the 3 years before the banks failed. In addition, we collected information on enforcement actions taken through June 1993 by bank regulators while the banks were open and after they failed.

[27]Because of the large amount of documentation and files required to complete part II, we limited our review to only those cases in which the investigator had indicated the presence of insider abuse, insider fraud, or loan losses to insiders. Therefore, part II was completed at the 14 DOL consolidated field offices around the country.

[28]We used this number as a conservative measure. Before the passage of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) (Pub. L. 101-73, Aug. 9, 1989), capital standards were set at a minimum of 6 percent of assets. Therefore, loan losses to insiders totaling 2.5 percent of assets would approach half of the bank's capital. This is probably a conservative estimate, since many of these troubled banks had less than the minimum capital. FDIC DOL officials agreed that the 2.5 percent measure represented a significant amount of losses to insiders.

[29]In addition to wanting to capture all the reasons a bank may have failed, we focused on these problems in addition to the specific problems of insider fraud, insider abuse, loan losses to insiders, and Regulation O violations, because field testing of our DCI indicated they were important.

Our Evaluation of Open Banks

We also reviewed a judgmentally selected sample of 13 open banks. (See app. I for a discussion of our criteria for sample selection.) Our objectives were to determine whether the same types of insider and management problems we found in the failed banks were also present in open banks.

For each bank, we prepared a case study based on our review of the federal regulators' examinations. For each case study, we collected information on insider activities as defined by Regulation O, affiliate transactions, and the efforts of each bank's management and board to operate and manage the bank with due care. We collected this information from the most recent examination and all the examinations completed in the 5 years before the most recent one.

Our second objective was **to evaluate the effectiveness of the regulators to identify and supervise insider activities at banks.** To address this objective, we analyzed the results of our data collection efforts at failed and open banks. We compared the numbers and types of insider problems identified by investigators after the banks failed with the same information identified by examiners when the banks were open. We also analyzed the enforcement actions taken by regulators to get banks' boards and management to correct examiner-identified problems. The results of our analysis for this objective are presented in chapters 2 and 5.

Our third objective was **to determine the underlying causes of insider problems and, specifically, whether there was an association between insider problems and broader managerial or operational problems in failed and open banks.** During our work on the 286 failed banks, we initially concentrated on insider violations, insider fraud, insider abuse, and loan losses to insiders to identify why the banks failed. However, our initial testing of our DCI led us to believe that these problems, particularly when they continued without correction, indicated broader problems of poor bank management and poor oversight of bank management by the board of directors. Consequently, we expanded the scope of our DCI, as we discussed earlier, to collect more details on these management and board problems. To assess the underlying causes of insider problems, we used odds and odds ratios. Odds indicate the tendency for an outcome to occur, and odds ratios show how much that tendency is affected by different factors. The results of our analysis for this objective are presented in chapter 3.

Also, to gain further perspective on insider problems and why they occur, we conducted interviews and focus groups with bank directors. The

interviews and focus groups are discussed in chapter 6. Our methodologies for these interviews and focus groups are discussed in detail in appendix I. We also collected some additional information on training that is available for bank directors. Our approach to collecting this information is also presented in appendix I.

Our fourth objective was **to determine the overall extent of extensions of credit to insiders at failed and open banks.** To address this objective, we compared data that we collected on insider loans in the failed banks with data on FDIC's LAMIS database. By doing this comparison, we expected to be able to estimate the amount of loans to insiders. Specifically, we expected to estimate the amounts of loan losses (as indicated by "charge-offs" on the LAMIS database) due to insiders. Because of the difficulties we encountered in using LAMIS, we were unable to estimate the overall amount of loans to insiders and losses for all failed banks. As an alternative, we then attempted to estimate insider lending at 10 judgmentally selected failed banks. We discuss the results of our analysis for this objective in chapter 4 and appendix IV.

For open banks we relied on quarterly bank call report data. Additional information on our approach is presented in appendix I.

Our final objective was **to compare state banking laws and regulations with federal Regulation O and analyze state examination policies and procedures governing insider transactions.** To address this objective, we surveyed 54 state and territorial banking agencies to determine whether their laws and regulations were more stringent than federal laws and regulations. We then visited 10 state agencies to obtain more in-depth information on their state bank examination procedures, processes, and oversight mechanisms for insider activities. We also conducted in-depth telephone interviews with officials in three additional states. In total, we obtained in-depth information from 13 state banking agencies. The results of our analysis for this objective are discussed in appendix V, and specific methodologies we used are discussed in appendix I.

We did our work for all the objectives at the headquarters and field offices of OCC and FDIC; at the Federal Reserve Board in Washington, D.C.; and the Federal Reserve banks in New York, Philadelphia, and San Francisco; and at the state banking agencies listed in appendix I from January 1992 through June 1993, in accordance with generally accepted government auditing standards. We requested comments on a draft of this report from

OCC, FDIC, and the Federal Reserve. Their written comments along with our evaluation are summarized at the end of chapters 5 and 6 and are presented in appendixes VII, VIII, and IX.

Insider Problems Frequently Contributed to Bank Failures and Were Also Evident in Open Banks

As we discussed earlier, in our analysis of the 286 banks that failed in 1990 and 1991, we found that insider problems—specifically insider fraud, insider abuse, and loan losses to insiders—were contributing factors in 175, or 61 percent, of the bank failures. In addition, we found 74 of these banks had insider problems so severe that they were the major or one of a few major causes of failure. For the 175 banks, federal examiners cited a total of 561 insider violations. Many of these violations were repeated in more than one bank examination. Federal and state regulators also took 235 separate enforcement actions. Even though insider violations were cited and enforcement actions were taken, the banks failed.

In our review of federal examination workpapers and reports of 13 relatively healthy open banks, we found that federal examiners did not identify any instances of insider fraud, insider abuse, or loan losses to insiders. However, federal examiners cited several insider violations that were in most cases quite similar to the insider violations cited in the failed banks. Some of these insider violations were also repeated in more than one bank examination. In addition, enforcement actions similar to those taken in the failed banks were taken by federal examiners in these banks.

286 Banks Failed in Calendar Years 1990 and 1991

As we indicated in chapter 1, when a bank fails, FDIC's DOL conducts an investigation, generally within 90 days of the date of failure, to complete a PCR, which provides specific information on the causes of the bank's failure. We reviewed the PCRs for all 286 banks that failed in 1990 and 1991 to determine the reasons for the failures of the banks.

Table 2.1 provides the reasons cited by FDIC investigators as contributing to the failure of the banks. The table shows the most common types of problems were a passive and/or negligent board, loan losses due to lax lending, poor and/or negligent management, and failure to respond to regulatory criticism.

In most cases FDIC investigators cited several reasons for a bank's failure. For example, while an economic downturn was cited in over 44 percent of the total bank failures, we found it was seldom cited alone; instead, it was cited in conjunction with other management and insider problems.

Table 2.1: Most Common Reasons Cited by FDIC Investigators for the 286 Bank Failures in 1990-1991

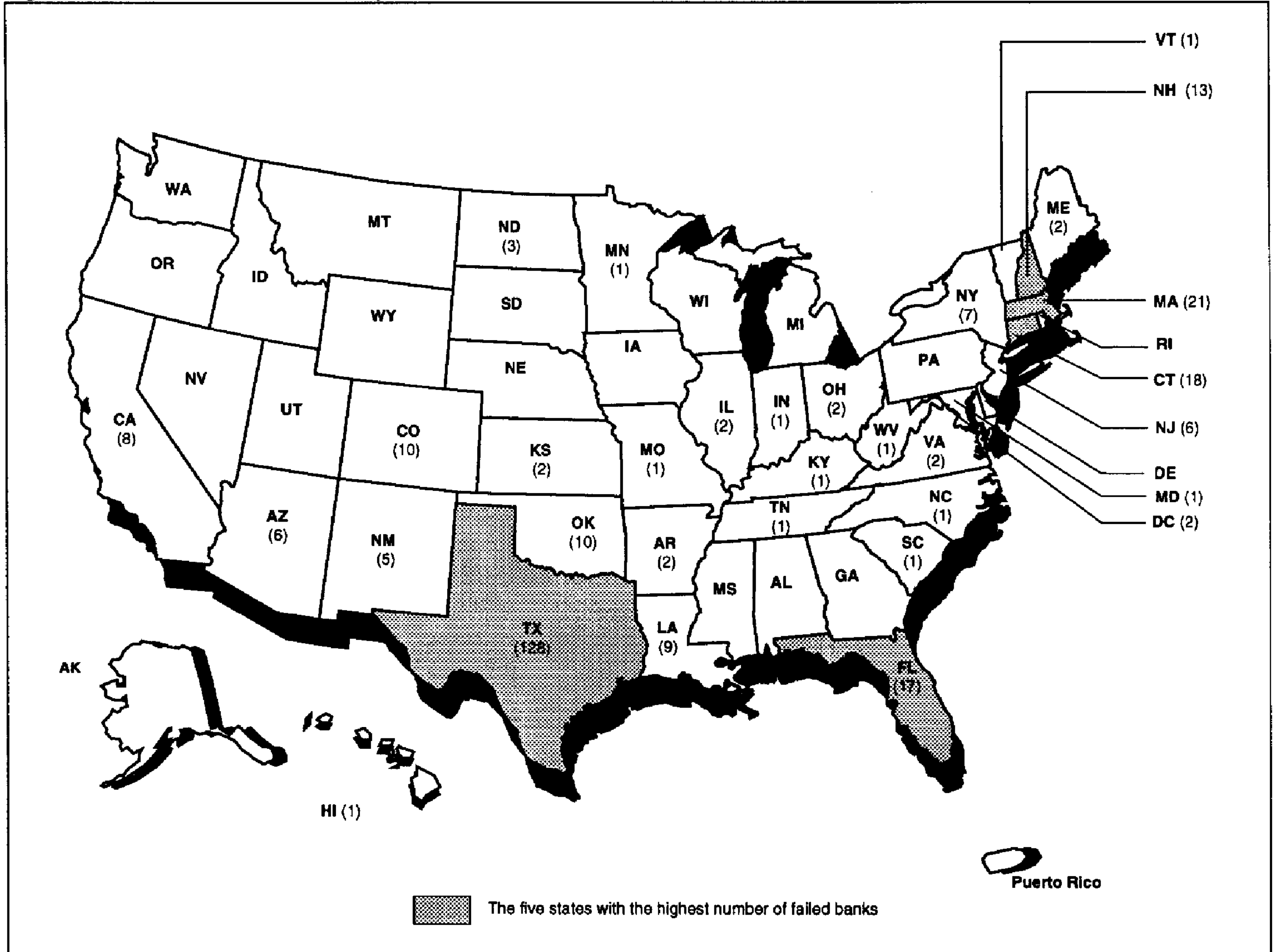
Reasons for bank failures	Number of banks cited	Percentage of total bank failures
Passive and/or negligent board	258	90%
Loan losses due to lax lending practices	236	83
Poor and/or negligent management	230	80
Failure to respond to regulatory criticisms	170	59
Economic downturn	127	44
Inadequate credit administration	125	44
Insider abuse	117	41
Insider fraud	104	36
Lack of or inadequate lending policies	89	31
Loan losses to insiders	81	28
Excessive growth	80	28
Dominant board member(s)	75	26
Operating losses	70	25
High risk exposure	65	23
Dominant executive	63	22
Lack of or inadequate systems to ensure compliance with laws/regulations	55	19
Lack of expertise (officer)	55	19
Lack of expertise (board)	44	15
Ineffective loan workout	34	12
Excessive dividends	33	12

Note: Investigators frequently cited several reasons for each failure.

Source: FDIC PCR data.

Figure 2.1 illustrates the location of the 286 banks that failed in 1990 and 1991. Although Texas had by far the most failures, the map reflects the increasing number of failures in the Northeast in the 1990s.

Figure 2.1: Number of Failed Banks by State for 1990-1991



Source: FDIC PCR data.

General Characteristics of the 286 Failed Banks

The majority of the failed banks were small banks with assets of less than $100 million. The median asset size was $33 million. Table 2.2 shows the general characteristics of all 286 failed banks, the 175 banks with insider problems, and the 74 banks with major insider problems.

Table 2.2: Characteristics of the 286 Banks That Failed

Banks	Percentage of: Small banks	Percentage of: Large banks	Assets: Median size	Assets: Range of size	Assets: Total	Median age	Banks with no D & O insurance	Estimated loss to BIF	Banks with criminal referrals of insiders
All failed	76%	24%	$33MM	$3MM to $14B	**$78B**	15 years	30%	$9.9B	49%
With insider problems	79%	21%	$33MM	$4MM to $14B	**$34B**	11 years	26%	$5.4B	70%
With major insider problems	80%	20%	$30MM	$4MM to $1B	**$7B**	10 years	23%	$1.8B	74%

Note: The median age represents 256 banks; we could not determine the charter dates from the PCRs for 30 of the failed banks.

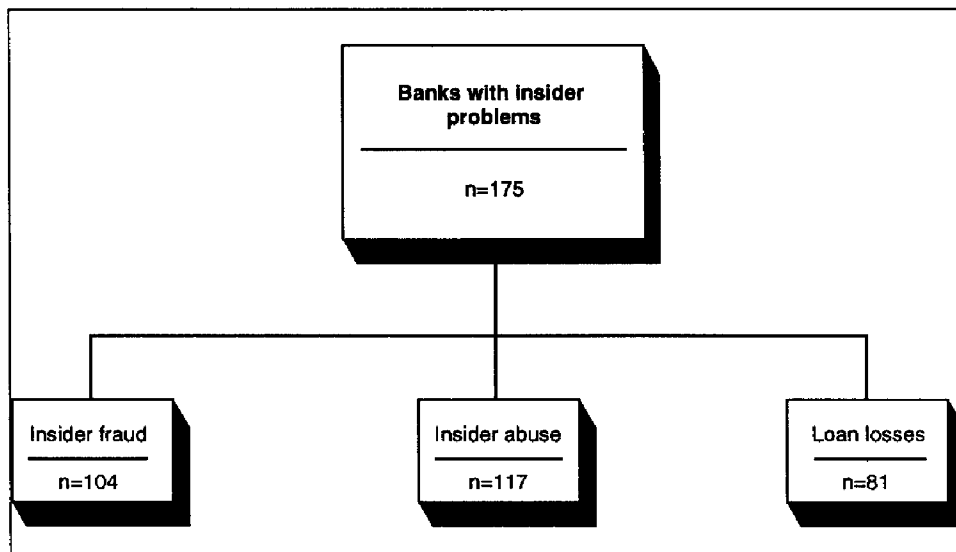
Source: GAO analysis of FDIC data and PCRs.

Of the 175 banks with insider problems and the 74 banks with major insider problems, the majority were small banks with a median age between 10 and 11 years. In addition, these banks had a high percentage of criminal referrals involving the directors and officers. Overall, the assets of the 175 banks with evidence of insider problems totaled $33.7 billion, or about 43 percent of the total assets of all of the 286 banks that failed in 1990 and 1991.

FDIC Investigators Found Evidence of Insider Problems in 175 of the 1990 to 1991 Bank Failures

From our review of the PCRs completed for the 286 banks that failed in 1990 and 1991, we determined that FDIC investigators found evidence of insider problems—specifically, insider fraud, insider abuse, or loan losses to insiders—in 61 percent, or 175, of the bank failures. Of these 175 banks, FDIC investigators found 74 banks with insider problems so severe that they were the major or one of a few major causes of failure. These 74 banks represent 26 percent of the 286 banks that failed in 1990 and 1991.

Figure 2.2: Frequency of Insider Fraud, Insider Abuse, and Loan Losses to Insiders



Note: Each bank could have had more than one insider problem; therefore, numbers do not total 175.

Source: FDIC PCR data.

Insider Problems Comprise Insider Fraud, Insider Abuse, and Loan Losses to Insiders

Insider Fraud

Fraud, a criminal act, can generally be defined as intentional actions, omissions, or concealments meant to deceive and get advantage over another. This includes such acts as embezzling, falsifying documents, and check kiting. Insider fraud was identified by FDIC investigators in 36 percent of the 286 bank failures. In the cases we reviewed, we found a variety of insider fraud. In one case, the chairman of the board and the president of a bank were suspected of granting loans to an international fugitive with strong ties to an organized crime syndicate. This individual would influence public officials to invest in real estate, have the real estate rezoned, allow the taxpayers to pay for upgrading the streets and the water and sewer systems, then sell the upgraded real estate at a profit. Most of the board of directors were county commissioners. The chairman of the board was the mayor and was suspected of receiving payoffs from the real estate deals. The chairman later committed suicide. All of the

board members and several bank officers are currently under FBI investigation for their roles in the allegedly fraudulent activities.

In another case, a fraudulent scheme involving several bank employees, including the vice-chairman, the chief executive officer, the senior vice-president, the controller, and the cashier, was discovered. These employees opened a checking account in the name of a corporation. During the first month of activity, this account was overdrawn on eight different occasions with the largest overdraft exceeding $71,000. From that point to the discovery of the scheme almost a year later, the number of monthly overdrafts in the account never fell below 15. The largest overdraft amount was $312,000. The overdrafts were approved by all of the employees involved in the scheme. These employees concealed the overdrawn status of this account by giving written instructions to the bookkeeper to place the account on "close to posting" status. The significance of this action was that such status meant that subsequent transactions to the account had to be manually posted. As a result, these transactions did not appear on the routine computer-generated reports reviewed by management on the overdrawn status of accounts.

Insider Abuse

Insider abuse is abuse that falls short of being a criminal act. It occurs when an insider receives personal benefit from some abusive action he/she takes as part of his/her position at the bank. FDIC investigators identified insider abuse in 41 percent of the 286 bank failures. We found a variety of insider abuses in the cases we reviewed. In one case, the chairman of a bank and the bank's holding company used the bank for his own benefit. He introduced borrowers to the bank and then used his position with these borrowers to help develop personal relationships and referrals to his other business ventures. The bank experienced heavy loan losses as a result of lending to these borrowers. Although the chairman did not draw a salary from the bank, he did receive director fees. He also benefited by charging the bank legal fees, consulting fees, capital raising commissions, finders fees, expense allotments, auto allowances, and travel expenses. His spouse also drew legal fees from the bank. They drew a total of $400,000 annually from the bank for these fees. In another case, the executive officers of a bank used the nonexecutive officers to enhance their personal investments in two interrelated activities. Once a week the nonexecutive bank officers would perform various services at a property owned by the chairman of the board, the president, and other executive officers of the bank. These duties included mending fences, clearing fields, picking up rocks, and tending cattle. All of these services were performed with no financial remuneration to either the nonexecutive officers or the

bank, even though these duties were performed by bank employees during normal business hours. During these work details, the most unpleasant tasks were assigned to the newest employee, much like a fraternity hazing. These services were all part of the chairman of the board's management theory, which was that if he could successfully order an individual to do menial tasks, this person would be an obedient employee. The second activity involved additional harassment by the chairman of the board. In this activity, the chairman forced the nonexecutive officers to become owners in an entity that was previously owned by several of the executive officers. The investments appear to have consisted of interest in rental properties, apartments, and houses in need of repair. The nonexecutive officers understood clearly that a decision to participate in these investments would be advantageous to their careers at the bank and a refusal could prove detrimental. The nonexecutive officers were required to make contributions of $40 to $80 per month to an entity that as far as they were concerned was nothing more than a mere shell. In addition, because of the poor condition of the properties, the nonexecutive officers were required to leave the bank at noon 1 day a week for 3 months to perform repair work on the subject properties. The bank was never reimbursed for the loss of these employees' services; the officers never asked the board for permission to perform these tasks, nor was the board ever informed such activities were taking place.

Loan Losses to Insiders

Loan losses to insiders refers to loan losses to individuals defined as insiders by Regulation O. FDIC investigators identified loan losses to insiders in 28 percent of the 286 bank failures. In our review we found a variety of cases involving loan losses to insiders. In one of the cases we reviewed, federal regulators cited a bank for several Regulation O violations involving the legal lending limit to insiders in 1985. At that time, loans to directors, officers, and their related interests were excessive at $1.6 million, or 104 percent of the banks's capital and reserves. In 1986, the cochairman resigned from the board because of classified loans (i.e, that were at risk) at the bank, including a foreclosure on a deed of trust to him for $750,000. In 1987, the bank was again cited for violations of the legal lending limit because it extended a credit line to a related interest of a member of the board of directors. In 1988, adversely classified assets represented 250 percent of total capital and reserves; $1.3 million, or 79 percent, was attributed to directors and officers. In another case at a 1985 board meeting, a bank adopted the policy of authorizing its directors to borrow up to 10 percent of their unsecured net worth. The bank was first examined by federal regulators later in 1985 and was cited for several Regulation O violations. In an explanation of the numerous Regulation O

violations cited, one of the bank's directors said that because of low loan demand, some directors received loans to create needed income for the bank. The bank was examined again in 1986, and examiners cited the bank for lack of corrective action on weaknesses disclosed at the previous examination. Regulators again examined the bank in 1987. At that time, the examiner noted that three directors' lines of credit were classified,[1] and that lending 10 percent of a director's unsecured net worth was "not considered a prudent practice." In the next two examinations, the bank still had not corrected the Regulation O violations cited in previous examinations. In 1990, another examination was completed, and Regulation O violations were still not corrected. In addition, at that time examiners asked bank management to submit a reimbursement plan for losses sustained on one director's line of credit, as it had exceeded the legal lending limit. The bank closed in 1991 with loan losses to insiders totaling $299,000.

Criminal Referrals Involving Insiders Were Made in 70 Percent of the 175 Banks With Insider Problems

FDIC investigators identified criminal referrals made by bank employees or examiners or recommended criminal referrals themselves related to insider activities in 49 percent of all 286 failed banks. Of the 175 banks with evidence of insider problems, 70 percent had criminal referrals involving insiders. Of the 74 banks with major insider problems, 74 percent had criminal referrals involving insiders. Those criminal referrals included referrals made throughout the history of the banks and therefore may have included referrals made several years before the banks' failures. We did not contact the Department of Justice to request information about the results of any investigations initiated based on these referrals. We did not do so because some of our other studies of such investigations suggest that they take years before results are finalized.

An Estimated $5 Billion in Losses to the BIF for Those Banks With Insider Problems

FDIC estimates its corporate insurance obligation, or its initial insurance outlay, will be about $59.4 billion for all of the 286 failed banks. An estimated $25.2 billion will be obligated for the 175 banks with insider problems, and $6.6 billion will be obligated for the 74 banks with major insider problems. In resolving the 1990 and 1991 bank failures, FDIC will recover money from the sales of bank assets and as a result, the ultimate losses generally will be less than the corporate insurance obligation. The final losses are estimated to be about $9.9 billion for all of the failed banks, $5.4 billion for the 175 banks with insider problems, and $1.8 billion for the

[1]Classified loans are loans that are at risk to some degree. Such loans fail to meet acceptable credit standards.

74 banks with major insider problems.[2] The $5.4 billion for the 175 banks with evidence of insider problems is about 55 percent of total estimated losses for the 286 banks during the 1990 to 1991 period. FDIC's estimates, however, are not broken down by bank activities, so we could not determine the amount related to insider activities. These loss estimates are subject to change as additional assets are sold.

Small Banks Had a Higher Incidence of Loan Losses to Insiders

We found no significant differences between small and large banks where FDIC investigators identified insider abuse or insider fraud. However, investigators found loan losses to insiders at a much higher rate in small banks than in large banks. In the small banks, loan losses to insiders were identified in 32 percent of the banks, while in the large banks they were identified in only 16 percent of the banks.

Federal Examiners Cited Insider Violations and Took Enforcement Actions When the 175 Banks Were Open

Examination Histories of the 175 Failed Banks

To further our analysis of activities at the 175 banks, we collected additional information from federal and state examinations that were completed the 3 years before the banks failed.[3] In general, we collected information on the type of examination, the composite CAMEL rating, the date of the examination report, and the types of management and insider problems identified, insider violations cited, and enforcement actions taken.

[2] In our report, Bank and Thrift Criminal Fraud: The Federal Commitment Could Be Broadened (GAO/GGD-93-48, Jan. 8, 1993), we found that in major financial institution fraud cases between October 1988 and June 1992, losses to the federal government were estimated to be more than $11.5 billion. See the report for additional information on criminal referrals and fraud in financial institutions.

[3] Of the 175 banks, OCC supervised 82 banks, FDIC supervised 81, and the Federal Reserve supervised 12.

We reviewed a total of 656 examinations that were completed for all 175 banks, with an average of 4 examinations completed for each bank. Table 2.3 shows the type and number of examinations completed by regulator.

Table 2.3: Type and Number of Examinations by Federal and State Regulators in the 175 Banks With Insider Problems

		Number of examinations by type						
Federal regulator	Number of banks supervised	Safety and soundness	Average number of safety and soundness exams per bank	Consumer compliance	State	Federal/state concurrent	Off-site	Total
OCC	82	236	2.9	20	1[a]	0	21	278
FDIC	81	146	1.8	18	114	36	1	315
FRS	12	30	2.5	2	27	4	0	63
Total	**175**	**412**		**40**	**142**	**40**	**22**	**656**

Note: The data in this table include those from all examinations completed in the 3 years before the banks failed.

[a]OCC-supervised banks are nationally chartered. Therefore, they are normally not also supervised by state banking agencies. In this one case, a nationally chartered bank was planning to convert to a state charter. In preparation for this conversion, the state banking agency conducted an examination of the bank. After the examination, the state charter was disapproved.

Source: Federal bank regulator examination report data.

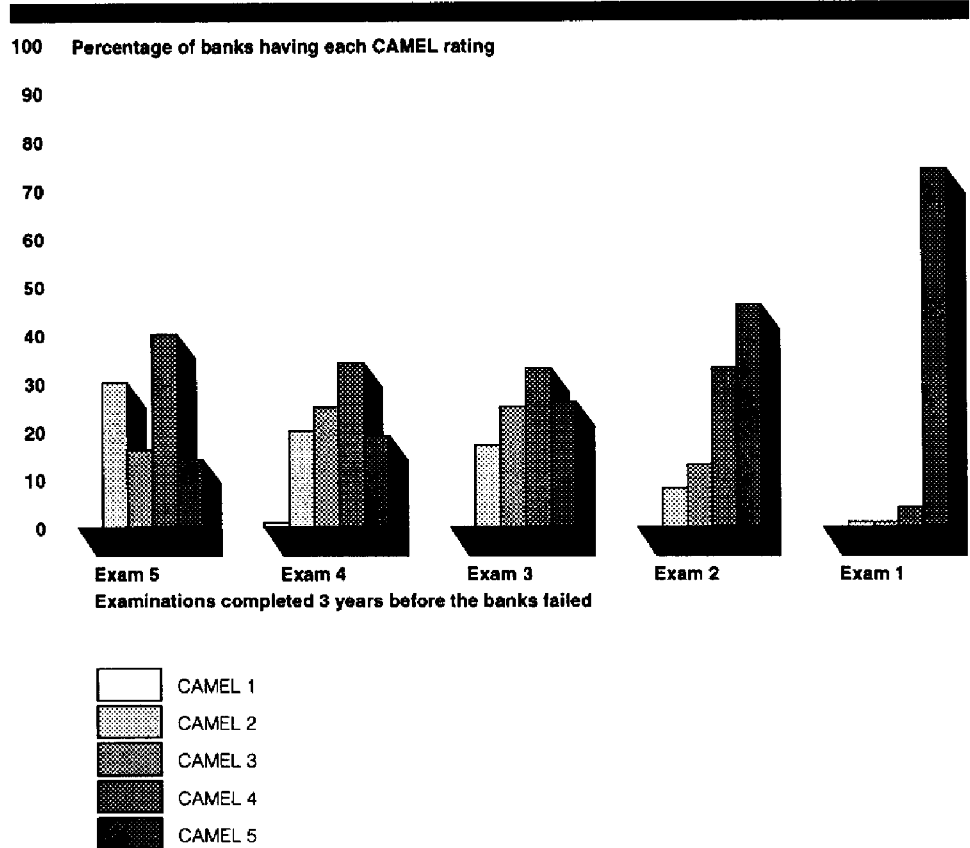
Most of the examinations that regulators completed were federal safety and soundness examinations, of which we reviewed a total of 412. Other examinations we reviewed included state examinations, concurrent federal and state examinations (where both the state and federal regulators are conducting examinations simultaneously), and examinations not completed at the bank location (referred to as off-site examinations). We also reviewed 40 consumer compliance examinations.[4]

Distribution of Composite CAMEL Ratings Among the 175 Banks With Insider Problems

Figure 2.3 shows how the CAMEL ratings were distributed among the 175 banks with insider problems in the 3 years before the banks failed. Seventy-four percent of the banks had a composite CAMEL rating of 5 from the examination preceding the failures.

[4]As we noted in chapter 1, in some instances reviews of a bank's insider activities may have been done as part of a consumer compliance examination.

Figure 2.3: Distribution of CAMEL Ratings 3 Years Before the Banks Failed



Note 1: Percentages do not total to 100 for each examination because several examinations were in process at the time of failure and some CAMEL ratings for prior examinations were not available.

Note 2: Because there were so few banks with more than five examinations completed in the 3 years before they failed, we included for each bank only the five examinations preceding failure. Some banks had less than five examinations.

Note 3: The examination numbers refer to the chronological placement of the examinations. For example, examination 1 refers to the last examination completed before the bank's failure, examination 2 refers to the second to last examination completed before the bank's failure.

Overall, most of the banks followed a predictable pattern of steadily worsening CAMEL ratings. Most of the banks received a rating of 5 in the examination preceding their failure, 6 percent never received a composite CAMEL rating better than 5, and 30 percent never received a composite CAMEL rating better than 4.

We found a few anomalies. For example, two banks received a composite CAMEL rating of 3 without any intervening examinations before they failed, and two additional banks went from a rating of 2 to failure. For example, although examiners cited many problems in one bank's loan portfolio 2 years before the bank failed, they apparently had not realized the severity of the conditions at the bank. When they returned 2 years later, the bank was insolvent.

Federal Regulators Cited 561 Insider Violations in the 175 Banks With Insider Problems

We focused our review of insider violations on the following six major provisions:

- loans to insiders exceeding loan limits,[5]
- loans to insiders with preferential terms,
- failure to maintain required records,
- failure to obtain required prior board approval for loans,
- overdraft payments exceeding limits, and
- exceeding restrictions on transactions to affiliates.[6]

Table 2.4 shows the number and type of insider violations cited by the federal regulators in the 175 banks with insider problems.

[5]Before FDICIA, which was passed in 1991, there was no aggregate lending limit for insiders. Thus, these violations, which were pre-FDICIA, were violations of the individual lending limits for any one insider as we described in chapter 1.

[6]As we explained in chapter 1, restrictions on transactions with affiliates are not a part of the Federal Reserve's Regulation O but are located in sections 23A and 23B of FRA. The five other provisions we focused on are part of Regulation O.

Table 2.4: Type and Number of Regulation O Violations Cited by Federal Regulators in the 175 Banks With Insider Problems

Regulation O violations	Number of banks	Number of Regulation O violations
Loans to insiders exceeding loan limits	82	148
Loans to insiders with preferential terms	70	103
Failure to maintain required records	61	81
Failure to obtain prior board approval for loans	52	83
Overdraft payments exceeding limits	52	68
Exceeding restrictions on transactions to affiliates[a]	49	78
Total		**561**

Note 1: The number of banks does not total 175 because 1 bank could have more than 1 type of Regulation O violation.

Note 2: The data included in this table include those from all examinations completed in the 3 years before the bank failed.

[a]As we explained in chapter 1, these rules are not a part of the Federal Reserve's Regulation O but are located in sections 23A and 23B of FRA.

Source: Federal bank regulator examination report data.

As table 2.4 shows, the most common insider violation cited by federal regulators was loans to insiders exceeding the loan limits. Examiners cited this violation 148 times in 82 of the 175 banks. In addition, this was the most repeated insider violation cited by examiners. The second most common insider violation cited was loans to insiders with preferential terms. This violation was cited 103 times in 70 of the 175 banks.

Overall, of the 175 banks, federal regulators cited 141 banks, or 81 percent, for a total of 561 insider violations with an average of 4 violations per bank. One hundred twenty-six, or 72 percent, of the banks had insider violations that occurred in more than one examination. This high percentage of repeated insider violations may be attributable to bank management not having developed effective internal controls to prevent recurrent violations.

Insider Violations Were Cited More Frequently in Small Banks

Our analysis showed that federal regulators more frequently cited small banks with assets of less than $100 million for insider violations than large banks with assets of $100 million or more. Federal regulators cited 464 insider violations in the small banks, with an average of 3.36 violations per

bank. Regulators cited 97 insider violations in the large banks, with an average of 2.62 violations per bank. Table 2.5 shows the number of insider violations in small banks compared with those in large banks.

Table 2.5: Insider Violations by Small and Large Banks for the 175 Banks With Insider Problems

	Small banks		Large banks	
Insider violations	**Percentage of all small banks**	**Total number of violations**	**Percentage of all large banks**	**Total number of violations**
Loans to insiders exceeding loan limits	49%	125	37%	23
Loans to insiders with preferential terms	43	89	30	14
Failure to maintain required records	36	65	30	16
Failure to obtain prior board approval for loans	29	60	32	23
Overdraft payments exceeding limits	31	55	24	13
Exceeding restrictions on transactions to affiliates[a]	32	70	14	8
Total (561)		**464**		**97**

Note 1: Small banks are those banks with assets less than $100 million. Large banks are those banks with assets greater than $100 million. Of the 175 banks with insider problems, 138 were small banks and 37 were large banks.

Note 2: The percentages do not add up to 100 percent because one bank could have more than one type of insider violation.

Note 3: This table includes those data from all examinations completed the 3 years before a bank failed.

[a]As we explained in chapter 1, these provisions are not a part of the Federal Reserve's Regulation O but are located in sections 23A and 23B of FRA.

Source: Federal bank regulator examination report data.

Federal regulators may be citing insider violations more frequently in smaller banks for a number of reasons. First, because of the lower absolute dollar amount of their capital, small banks may be more susceptible to exceeding the limitations set for insider loans. Second, because there are fewer loans to review in small banks they may be subject to a higher level of scrutiny by the federal regulators and, therefore, more vulnerable to criticism.

Our Regulation O Findings Support Continued Strong Regulatory Mechanisms for Oversight of Insider Activities

One of the purposes of sections 22(g) and 22(h) of FRA and the implementation of Regulation O was to give a higher degree of regulatory scrutiny to insider activities because such activities have a greater chance of affecting the safety and soundness of the bank compared with other bank activities. As we discussed in chapter 1, Congress has at various times strengthened laws and regulations on insider activities. For example, in FDICIA, enacted in 1991, Congress provided for an aggregate lending limit for loans to insiders of 100 percent of capital for well-capitalized banks and authorized the Federal Reserve to make regulatory exceptions to this aggregate lending limit, up to a maximum of 200 percent of capital for qualifying smaller banks.

Our work indicates that several key provisions of Regulation O are crucial for maintaining strong oversight of insider activities. First, we found that the most commonly violated provision of Regulation O was the violation of lending limits. Second, we found that the second most violated provision was preferential terms on loans to insiders. Finally, because so much of the oversight of insider activities depends on accurate recordkeeping and reporting by banks, the recordkeeping requirements of Regulation O are critical for the enforcement of other Regulation O provisions.

Federal Regulators Took 187 Federal Enforcement Actions for the 175 Banks With Insider Problems

We reviewed the enforcement actions taken by federal regulators when the banks were open. For the 175 banks with insider problems, federal regulators took a total of 187 federal formal and informal enforcement actions.[7] We show the types and number of actions in table 2.6.

[7]Overall, federal and state regulators took 235 enforcement actions; 187 actions were federal enforcement actions, and 48 were state enforcement actions. We focused on the 187 federal enforcement actions because we did not have access to complete information on state enforcement actions.

Table 2.6: Type and Number of Enforcement Actions Taken by Federal Regulators in the 175 Banks With Insider Problems

Type of action	Number of actions taken by federal regulators
Formal actions	
Cease and desist orders	74
Written agreement	30
Temporary cease and desist orders	9
Civil money penalties	8
Removal/prohibition	7
Subtotal	**128**
Informal actions	
MOU	33
Board resolution	13
Commitment letter	13
Subtotal	**59**
Total	**187**

Note: The data included in this table include those from all examinations completed in the 3 years before the bank failed.

Source: Federal bank regulator examination report data.

In table 2.7 we show the types and number of federal enforcement actions that were taken by each of the federal regulators. OCC was more prone to initiate a formal enforcement action against bank management than were the other federal regulators. Of the enforcement actions taken by OCC examiners, 76 percent were formal actions, 64 percent of FDIC's enforcement actions were formal actions, and 57 percent of the Federal Reserve's enforcement actions were formal actions.

Table 2.7: Types of Enforcement Actions Taken by Federal Regulators in the 175 Banks With Insider Problems

	Federal regulator							
	FDIC		Federal Reserve		OCC		Combined	
Type of enforcement action	Number of actions	Percent of actions	Number of actions	Percent of actions	Numbers of actions	Percent of actions	Number of actions	Percent of actions
Formal	62	64%	8	57%	58	76%	128	68%
Informal	35	36	6	43	18	24	59	32
Total	97	100	14	100	76	100	187	100

Note: The data in this table include those from all examinations completed in the 3 years before the banks failed.

Source: Federal bank regulator examination report data.

In 79 percent of the banks where insider violations were discovered, the federal regulators took some type of enforcement action. We found only a few cases in which the enforcement actions specifically included provisions that related to insider activities. However, enforcement actions may contain general provisions requiring the bank to correct all violations of law or regulations. Such provisions would include the correction of insider violations.

Regardless of the actions that were taken, regulators may have been able to take stronger enforcement actions, considering that 126, or 72 percent, of the banks had repeated insider violations. For example, in a 1991 report,[8] we cited an example of a bank with repeated Regulation O violations to illustrate the impact insider violations could have on a bank's financial condition. We also wanted to illustrate the importance of effective enforcement action to protect banks against such adverse impacts. We stated that "according to the regulator's guidelines, civil money penalties would have been in order, particularly in light of the pattern of repeat violations."

For the 126 banks in our failed bank analysis that were cited for repeat insider violations, civil money penalties (CMP) by federal examiners were brought against officers or directors in only 6 of these banks. Overall, only 8 CMPs were brought against individuals in all 175 banks.

[8]Bank Supervision: Prompt and Forceful Regulatory Actions Needed (GAO/GGD-91-69, Apr. 1991).

Federal Regulators Also Took Post-Failure Enforcement Actions

The three federal bank regulators can also take post-failure enforcement actions against former bank officers and directors of failed banks. FDIC, as the federal bank insurer, has the authority to pursue post-failure enforcement actions against any of those officers and directors who are found to be negligent in discharging their fiduciary responsibility, regardless of the failed banks' primary regulator. Some of these actions against the former officers and directors have involved the pursuit of financial recoveries. FDIC has pursued and ultimately received some financial recoveries in about 25 percent of the banks that failed.

The post-failure enforcement actions available to primary federal bank regulators include supervisory letters, letters of reprimand,[9] CMPS, and removal and/or prohibition orders banning officers or directors from the banking industry.

For the 286 banks that failed in 1990 and 1991, we found that primary federal regulators took 167 post-failure enforcement actions against 167 officers and directors. The most common enforcement action taken was a letter of reprimand. As shown in table 2.8, there were 68 letters of reprimand, 42 CMPS, and 35 supervisory letters.

[9]Letters of reprimand and supervisory letters are issued only by OCC. According to officials in OCC's Enforcement and Compliance Division, a letter of reprimand is a substitute for a CMP when it has been determined that the CMP is not cost-effective to pursue. A supervisory letter is a less formal letter highlighting the need for corrective action. However, in the case of failed banks, a supervisory letter informs former officers and directors that certain banking practices are considered unsafe and unsound and should not be continued at other financial institutions. The continuance of such practices can warrant formal enforcement actions, such as CMPs.

Table 2.8: Post-Failure Enforcement Actions Taken Against Individuals in the 286 Bank Failures in 1990-91

	Regulator			
Type of post-failure enforcement action	FDIC	OCC	Federal Reserve[a]	Total
Supervisory letter	[b]	35	[b]	35
Letter of reprimand	[b]	68	[b]	68
CMPs	8	34	0	42
Removal and/or prohibition	8	3	0	11
CMP and removal and/or prohibition	1	10	0	11
Total	**17**	**150**	**0**	**167**

Note 1: The Securities and Exchange Commission, although not a bank regulator, has initiated post-failure enforcement actions when it has been determined that bank insiders and other parties violated antifraud, reporting, internal accounting, and other provisions of federal securities laws.

Note 2: As of March 31, 1993, federal regulators had proposed, but had not yet taken, an additional 26 enforcement actions.

[a]The Federal Reserve did not take any post-failure enforcement actions but had actions under consideration at the time of the bank failures.

[b]OCC is the only federal regulator that issues supervisory letters and letters of reprimand.

Source: Federal bank regulator data.

The number of post-failure enforcement actions that were taken varied by regulator. OCC took 90 percent of the post-failure enforcement actions. OCC also was more likely to issue several enforcement actions against individual former officers and directors. For example, on the basis of our analysis, we found that OCC issued CMPs and removals and/or prohibitions simultaneously against 10 individuals.

Similar Insider Violations and Enforcement Actions Were Identified by Federal Examiners in Our Sample of Open Banks

When we reviewed the case studies of 13 generally financially safe and sound open banks, we found that federal examiners identified insider violations and took enforcement actions that were similar to those identified in our analysis of the failed banks. Although these problems were not severe enough to have affected the banks' financial health, such problems—if left uncorrected—could, in time, have major negative effects on the viability of these banks.

Review of Federal Examinations Found Insider Violations in Sampled Open Banks

Although we did not find that the examiners identified evidence of insider fraud, insider abuse, or loan losses to insiders in our review of open banks, we found 10 of the banks in our sample had insider violations. The most common insider violation cited was preferential terms on loans to insiders, which was reported in six of the open banks. For example, an examination report cited two insiders as being granted automobile loans at preferential interest rates of 9 percent and 10.5 percent when regular bank customers were charged 12 percent and 13.5 percent, respectively, for identical automobile loans. (See table 2.9.)

Table 2.9: Insider Violations Found in the Open Banks as Identified by Bank Examiners

	Bank case study													Number of
Insider violations	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**11**	**12**	**13**	**banks**
Loans to insiders with preferential terms	XX		X		XX	X		XX			X			6
Loans to insiders exceeding loan limits								XX			X			2
Failure to obtain prior board approval for loans			X					XX					X	3
Failure to maintain required records	X				XX			XX	X					4
Overdraft payments exceeding limits			X		X		X	XX		X	X		XX	7
Exceeding restrictions on transactions to affiliates[a]														

Legend:

X = Violation
XX = Repeated violations

Note: Empty cells indicate that no violations were found.

[a]As we explained in chapter 1, the provisions that apply to these transactions are not a part of Regulation O but are located in Sections 23A and 23B of the Federal Reserve Act.

Source: Federal bank regulator examination report data.

Of the 13 open banks we reviewed, 4 had insider violations repeated in more than 1 bank examination. The most common repeated insider violation cited was again preferential terms on loans to insiders.

Enforcement Actions in Open Banks We Reviewed

In the 13 open banks we reviewed, regulators took 6 enforcement actions and recommended 4 others at 7 banks. Almost all of the enforcement actions taken or recommended were commitment letters or MOUs. The remaining six banks we reviewed had no enforcement actions for the

5-year period before and including the most recent examination for each bank.

Conclusions

On the basis of our analysis of the 286 banks that failed in 1990 and 1991, we found that FDIC investigators frequently identified banks with insider problems, such as insider fraud, insider abuse, and loan losses to insiders. We also found that federal regulators cited many insider violations and took many enforcement actions before and after these banks failed. Federal regulators may have been able to act more forcefully or in a more timely manner to compel bank management to address safety and soundness problems. However, such actions may be effective only when bank management is both capable and willing to address those problems identified by regulators. In chapter 3, we discuss how insider problems can indicate broader managerial problems.

Insider Problems Are Indicative of Poor Management Practices

On the basis of our analysis of the 175 failed banks that had insider problems, we believe that the failure of the banks' management and boards of directors to effectively address insider violations and other problems identified by examiners indicate a much larger problem. We believe the problem is poor administration by bank management and inadequate oversight by the boards of directors. Further analysis of the failed banks showed that a bank was more likely to be cited for a problem of poor management when it was also cited for an insider violation in the same examination.

In our review of 13 open banks, we found that examiners frequently identified management problems in those banks that were also cited for insider violations. We found negligent management and poor bank oversight to be the most significant problems in our analysis of both failed and open banks.

Banks Cited for Insider Violations Were More Likely to Be Cited for Problems Related to Poor Management

Of the 175 failed banks that were cited by federal examiners for insider violations, banks cited for insider violations were also more likely to be identified by federal regulators for having various management problems. To assess the underlying causes of insider problems, we used odds ratios. Odds indicate the tendency for an outcome to occur, and odds ratios show how much that tendency is affected by different factors. If there is no difference in the odds across the factors that are compared, the odds ratio will equal 1.0. The extent to which odds ratios are greater or less than 1.0 indicates how sizable the difference is across the factors that are compared. Table 3.1 shows the ratios of the likelihood that a management problem is cited given that an insider violation is also cited in the same examination. A ratio greater than 1 means that it is more likely that a particular management problem is cited when a particular insider violation is cited than when an insider violation is not cited. Some of the odds ratios are statistically significant.

For example, in our analyses we looked at the odds of a bank being cited for a dominant board member and then calculated odds ratios to determine how much those odds differed for banks that were also cited for excessive insider loans. One of the more significant findings is that when examiners cited loans to insiders exceeding the loan limits, they were four times more likely to cite the management problems of a dominant board member than when they did not cite loans to insiders

exceeding loan limits.[1] Further, when examiners cited a bank's failure to maintain records, they were about 2.7 times more likely to cite it for poor and/or negligent management. They also were 2.6 times more likely to cite it for passive and/or negligent boards than when they did not cite the Regulation O violation of failure to maintain records. Finally, when examiners cited a failure to obtain prior board approval, they were about 6.8 times more likely to cite a lack of board expertise than when they did not cite a failure to obtain prior board approval.

Table 3.1: the Likelihood That a Management Problem Is Cited Given That an Insider Violation Is Also Cited

Insider violations	Loans to insiders exceeding loan limits	Loans to insiders with preferential terms	Failure to maintain required records	Failure to obtain prior approval for extension of credit	Exceeding overdraft payment limits	Exceeding restrictions on transactions to affiliates
Management problems						
Failure to respond to regulatory criticisms	1.69	3.24[a]	1.15	3.31[a]	2.66[a]	0.87
Poor and/or negligent management	2.50[a]	1.51	2.75[a]	2.58	2.58	0.76
Passive and/or negligent board	2.02	1.43	2.63[a]	2.47	1.98	1.21
Lack of expertise (board)	2.75	1.91	0.87	6.83[a]	1.14	0.93
Lack of expertise (officer)	2.65[a]	2.40[a]	1.33	2.70[a]	1.51	0.81
Dominant board member(s)	4.00[a]	3.57[a]	0.39	1.91	1.23	1.00
Loan losses due to lax lending practices	1.09	2.97	1.70	0.98	0.98	0.54
Dominant executive	0.75	1.07	1.31	2.18	0.87	0.39
Lack of or inadequate systems to ensure compliance with laws and regulations	3.04[a]	2.24[a]	1.54	6.13[a]	1.61	1.24

[a]Significant at the 0.05 level.

Although the federal examiners cited these banks for insider violations and associated management problems, the banks still failed. On the basis of our analysis, we believe the failure of bank management to correct

[1]The odds ratios are derived as follows. We calculated the odds of being cited for dominant board member given that loans to insiders exceeding loan limits was also cited (16/66 = 0.24 odds). We then calculated the odds that dominant board member was cited when loans to insiders exceeding loan limits was not cited (5/88 = 0.06 odds). The final result is the ratio of the odds or 0.24/0.06 = 4.00. The other odds ratios were calculated in a similar manner.

insider violations and problems with insiders indicate much broader problems related to management and inadequate board oversight.

Negligent Management and Inadequate Board Oversight Were the Most Significant Management Deficiencies in the 1990 to 1991 Bank Failures

Competent bank management is critical to the successful operation of a bank and must be performed in a manner that will ensure the bank's safety and soundness. According to FDIC's Manual of Examination Policies, the primary responsibility of bank management is to implement in the bank's day-to-day operations the policies and objectives established by the board of directors. FDIC defines the board of directors as the source of all authority and responsibility, including the formulation of sound policies and objectives of the bank, the effective supervision of its affairs, and the promotion of its welfare.

Additional responsibility has been placed on bank directors and officers through the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA), which gave regulators additional authority to take enforcement actions against individual bank officers and directors when the gross negligence of those officers and directors threatens the financial safety of the bank. Bank directors and officers can be held personally liable, in certain instances, for their performance.

Our analysis of failed banks shows that both the FDIC investigators and the federal examiners cited management and board deficiencies as the most significant factors in the failure of the banks. As shown in table 3.2, the most common management problems identified by both were a passive and/or negligent board, loan losses due to lax lending practices, poor and/or negligent management.

While it is apparent the examiners cited these management problems less frequently than the FDIC investigators, some of the discrepancy may be due to the differences in the timing and focus of their respective review processes. Investigators clearly are to pursue management problems for financial recoveries. However, bank examiners may be somewhat reluctant to be critical of bank management and boards, particularly of those managers and boards who assure examiners of their willingness and ability to cooperate in addressing bank safety and soundness problems. We discuss these issues further in chapter 5.

Table 3.2: Management and Insider Problems Cited by FDIC Investigators (Post-Failure) and by Examiners (When the Banks Were Open)

	Number of banks cited by investigators[a]		Of those banks cited by investigators, number of banks cited by examiners[b]	
Management problems	**Number**	**Percent of 175 banks**	**Number**	**Percent of 175 banks**
Passive and/or negligent board	160	91%	129	74%
Loan losses due to lax lending practices	152	87	137	78
Poor and/or negligent management	138	79	112	64
Insider abuse	117	67	65	37
Failure to respond to regulatory criticisms	105	60	84	48
Insider fraud	104	59	28	16
Loan losses to insiders	81	46	36	21
Dominant board member(s)	56	32	11	6
Dominant executive	43	25	8	5
Lack of or inadequate systems to ensure compliance with laws and regulators	38	22	28	16
Lack of expertise (officer)	30	17	21	12
Lack of expertise (board)	26	15	5	3

[a]Data are only for the 175 banks that had evidence of insider problems.

[b]The examination data included in this table include data from examinations completed 3 years before the failure of the bank.

Source: FDIC PCRs and federal bank regulator examination report data.

Management Problems Identified by Federal Examiners in Open Banks Were Similar to Those Identified in Failed Banks

From our review of the 13 open banks, we found that in about half of the banks, the federal regulators cited problems of poor and/or negligent management and passive and/or negligent boards of directors.

Table 3.3: Insider Violations and Management Problems Found in the Open Banks as Identified by Bank Examiners

	Bank case study													Number of
Violations/problems	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**11**	**12**	**13**	**banks**
Insider violations														
Loans to insiders with preferential terms	XX		X		XX	X		XX			X			6
Loans to insiders exceeding loan limits								XX		X	X			3
Failure to obtain prior board approval for loans			X					XX					X	3
Failure to maintain required records	X				XX			XX	X					4
Overdraft payments exceeding limits			X		X		X	XX		X	X		XX	7
Exceeding restrictions on transactions to affiliates[a]														
Management problems														
Poor and/or negligent management	X			XX		X		XX		X	X		X	7
Passive and/or negligent board	X		X	X				XX		X			X	6
Failure to respond to regulatory criticisms	X	X									X			3
Lack of board/management expertise				X	X			X					X	4
Dominant board member/executive								X	X	X			X	4
Insider fraud, insider abuse, loan losses to insiders														
Excessive compensation								X						1
Excessive dividends														

Legend:

X = Violation
XX = Repeated violations

[a]As we explain in chapter 1, the provisions that apply to these transactions are not a part of Regulation O but are located in sections 23A and 23B of FRA.

Source: Federal bank regulator examination report data.

For example, an examiner cited a bank for poor management because the bank's management team did not provide the bank's board of directors with the necessary management reports about bank operations. Federal examiners also cited the bank's board of directors for inadequate oversight because the board failed to request the same reports from the bank's management.

In another example, the examiners stated in an examination report that the board of directors lacked an active involvement in the supervision of the bank. In this case, the federal examiner identified 17 areas where the board's attention was needed to evaluate or incorporate existing committees or policies in its overall supervision of the bank. One of the areas needing the board's attention was the development of and adherence to an insider compliance program.

Problems of poor management and inadequate board oversight are not explicitly violations of banking laws and regulations; however, safety and soundness problems are and, therefore, federal examiners can take enforcement actions to compel bank management and directors to address potential safety and soundness problems. It is critical that a bank's management and board of directors work together as a team to ensure the financial viability of the bank.

Examiners Expressed Concern Regarding Poor Management-Related Practices in Open Banks With Insider Violations

From our review of examination reports for the 13 open and relatively healthy banks, we found instances when examiners expressed concern that poor management practices could lead to certain insider problems and/or insider violations. We found two banks where the examiners expressed concern over the banks' insufficient policies relating to loans to insiders and inadequate monitoring of insider activities. For example, in one of the banks, examiners found that the bank's internal controls to ensure the accuracy of the Regulation O recordkeeping requirements for loans to insiders needed to be improved. On the basis of his review of the bank's system, the examiner determined that the system did not account for insider loans from overdraft protection or installment loans. This bank had been previously cited for other Regulation O violations.

In another examination report, examiners expressed a concern over the interaction of a bank's management with two other banks. The examiner cited these relationships as having the potential for Regulation O violations and a possible conflict of interest involving a director and his business interests. However, no Regulation O violations were cited. In another example, an examiner found one bank with a tradition of lending money based on borrowers' character. The examiner determined that insider abuse could easily occur at this bank because of such lax lending practices. In all of the examples we have discussed, the examiners identified problems with management and board oversight and the potential for insider violations.

Conclusions

On the basis of our analysis of the 175 banks that failed in 1990 and 1991 in which insider problems were identified by FDIC investigators, we found poor bank management and inadequate board oversight were the predominant reasons for the failures. We also found that a pattern of repeated insider violations and noncompliance with enforcement actions are clearly symptomatic of broader management and board failures.

In 10 of the 13 relatively healthy banks we reviewed, examiners found insider violations, deficiencies in bank management and boards of directors, and failures of bank management and boards to respond to repeated regulatory criticisms. It is critical that violations and problems are corrected before they jeopardize a bank's financial viability. The correction of these violations and problems is particularly critical because the same problems, although more severe, led to most of the 175 bank failures with insider problems in 1990 and 1991.

The Extent of Insider Lending at Failed and Open Banks

In pursuit of one of our objectives, we attempted to determine the overall extent of insider lending at failed and open banks. We initially attempted to do this for the 286 banks that failed in 1990 and 1991. We did so by obtaining information on the extent of insider lending from investigators' PCRs and other materials (e.g., loan lists developed by examiners and the minutes from meetings of boards of directors). Because FDIC's database of the assets of failed banks did not allow us to estimate the amount of insider lending at such banks, we attempted to identify manually insider lending at 10 judgmentally selected failed banks. We were able to estimate the amount of insider lending at 8 of these 10 banks. However, because of some uncertainties of the data we do not know if these estimates are valid.

For open banks, we used bank call report data to estimate insider lending. These data became available in March 1993. The March data show the aggregate amount of insider lending at all open banks to be $24 billion.

FDIC's Professional Liability Section Generally Does Not Consider Insider-Specific Data Necessary in Pursuing a Successful Claim

A primary function of FDIC investigators is to determine whether there are sufficient sources of recovery to warrant the pursuit of a claim against those responsible after a bank has failed. To fulfill this function, investigators do not necessarily have to develop or have a complete accounting of or comprehensive data on the extent of losses stemming from insider problems. In discussions with senior DOL and Professional Liability Section (PLS) officials, we were told that in most cases, investigators do not treat insider loans differently from loans to others. It is not necessary for investigators to tie losses sustained by the bank directly to insiders or their interests. Instead, investigators need only to establish that it was the management or oversight of the insiders that either led to or failed to avert the bank's losses for PLS to establish grounds for a negligence claim.

In pursuing potential claims, DOL works with PLS to establish the extent of losses stemming from the negligence of those involved with the management of a bank. In general, FDIC investigators and attorneys seek to determine at what point those associated with the bank may reasonably have been expected to recognize the deficiencies that led to the bank's losses. For example, a claim against a bank's outside directors may result if the post-failure investigation discloses that a deficiency that was identified in a regulatory examination or bank audit report remained uncorrected and resulted in the bank suffering further losses.

After determining the primary reasons for a bank's failure, DOL investigators may develop a target loan list consisting of loan losses that stem from deficiencies identified in the bank's lending practices. If, for example, a bank was criticized by its primary regulator for having a loan concentration in commercial real estate development but took no corrective action and later failed, investigators would review the bank's loan losses and compile a target loan list consisting of commercial real estate loans that were extended or renewed after the bank had been criticized for the concentration. If losses were substantial enough, a claim against outside directors may be warranted. The case against the directors is not changed substantially if some of the losses involved insider loans. Therefore, DOL investigators generally do not establish the extent of lending to insiders.

FDIC's Database Proved Inadequate in Identifying the Extent of Insider Lending at Failed Banks

After determining that investigators do not often develop complete information on the extent of lending to insiders, we turned to DOL's LAMIS database, which tracks loans from failed banks, to see whether it could provide data on the extent of insider lending at the 286 banks that failed in 1990 and 1991. To determine whether it was feasible to identify insider-related loans through LAMIS, we provided FDIC with an extensive list of insiders and their related interests from bank failures associated with the James Madison Limited holding company. This list had been developed for one of our previous reports on the failures of the Bank of New England and Madison.[1] In preparing that report, we reviewed data developed by OCC, which indicated that loans to Madison insiders totaled $83 million, or 17 percent of all loans. We then attempted to match the names of the Madison's insiders and their related interests to the names on the LAMIS database for Madison. If the match program produced results that were generally in agreement with the OCC data, we felt we could be reasonably confident that the match had been effective.

After numerous attempts by DOL and our staff, we were unable to complete an automated match that accounted for a reasonable percentage of the loans to insiders we had previously identified by manual means. Through additional manual manipulations, we were able to use the LAMIS database to approximate the total amount of loans we had identified in our prior work. From our manual manipulations, we identified 127 insider-related loans involving amounts of $10,000 or more. Our analysis of these insider-related loans showed the aggregate loan amount to be $71 million

[1]Bank Supervision: OCC's Supervision of the Bank of New England Was Not Timely or Forceful (GAO/GGD-91-128, Sept. 1991).

dollars. This amount represented approximately 18 percent of the Madison loans of $10,000 or more listed on LAMIS. As this amount was in line with the level of insider lending activity identified by OCC shortly before Madison's failure, we believe our approach resulted in a reasonable estimate of the insider lending activity at this bank.

However, the manual manipulations required to come up with this estimate of insider lending were extremely labor-intensive and time-consuming and, therefore, impractical for application to each of the 286 failed banks we reviewed. We present the details of our attempts to identify the extent of insider lending using LAMIS data in appendix IV.

Identifying Insider Lending at Open Banks

Until recently, only very limited data on lending to insiders were available. The Securities and Exchange Commission (SEC), for example, requires all companies with publicly traded securities to report all transactions of more than $60,000 in which certain insiders are involved.[2] SEC also requires all such companies to report the names and specified related interests of directors or nominees for directors. However, SEC does not require companies to report the names of officers and principal shareholders. Under Section 12 of the Securities Exchange Act of 1934, banks are subject to substantially similar requirements under regulations made by federal banking agencies.

We believed examination reports might also provide data on the extent of insider lending at open banks. In our review of open bank examinations, however, we found examiners generally did not document the extent of lending to insiders. In their review of loans to insiders, examiners typically attempt to identify violations of Regulation O, such as loans with preferential terms. However, unless the amount of lending to insiders is considered a problem, examiners are unlikely to document the extent of insider loans in the examination report.

In addition, we attempted to use call report data to estimate the overall level of insider lending. Before March 1993, call reports required banks to report insider lending only for officers and principal shareholders and their related interests but not for directors. As of the March 1993 call report, the requirements were changed so that banks would also report aggregate insider lending to directors. As of March 1993, the aggregate amount of insider lending was reported as $24 billion, with an average

[2]SEC's definitions for insiders and related interests differs somewhat from those in Regulation O. For example, SEC includes family relationships in its definition of related interests.

aggregate amount per bank of $2 million within a range of no insider lending to $623 million. Historically, it often takes several reporting cycles for new data to be reliably reported by banks. As banks become more familiar with new call report requirements, future reports should more accurately reflect aggregate insider lending activity.

The New Requirement May Provide Comprehensive Data

Because of the lack of data on loans to directors in prior call reports, we contacted the organization responsible for requiring changes in the call reports, the Federal Financial Institutions Examination Council, to determine the impetus behind this change. We were told the addition of data on loans to directors was advocated by the Federal Reserve to address changes to Regulation O required under FDICIA. FDICIA established an aggregate lending limit on loans to insiders. It also required directors to adhere to the same individual limit on loans to individuals and their related interests that had previously applied only to executive officers and principal shareholders.

The addition of this requirement will make available to regulators and the public the total amount of insider lending at banks if banks accurately report the amounts of loans to officers, directors, and major shareholders. To respond to the new requirement, banks must have or develop systems to collect and maintain this information. Accuracy in call report data is required under provisions 12 U.S.C. 1817 and 12 U.S.C. 161, and banks are instructed to maintain the records needed to generate the figures they provided in the call reports. We further discuss reporting requirements in chapter 5.

Conclusions

Until recently there was no comprehensive source of data for identifying the total amount of lending to bank insiders. Therefore, we were not able to determine the extent of insider lending for our failed bank analysis. As of March 1993, the aggregate amount of insider lending at open banks was reported as $24 billion. The new requirement for additional reporting of insider lending on call reports has the potential to provide an accounting of all insider loans. However, as a solution, it is dependent on the accuracy of the information reported by banks and the diligence of examiners to ensure accurate bank reporting.

Agency Comments and Our Evaluation

In its comments on a draft of this report (see app. IX), the Federal Reserve said that our inability to quantify the specific amount of insider lending

and losses calls into question our conclusion in chapter 2 that insider problems are a significant contributing factor to bank failures. As discussed in this chapter, we do not believe it is necessary to demonstrate exact dollar losses to conclude that insider problems were a significant factor; according to FDIC investigators, 26 percent of the banks we reviewed failed because insider fraud, insider abuse, or loan losses to insiders was a major factor contributing to the failures.

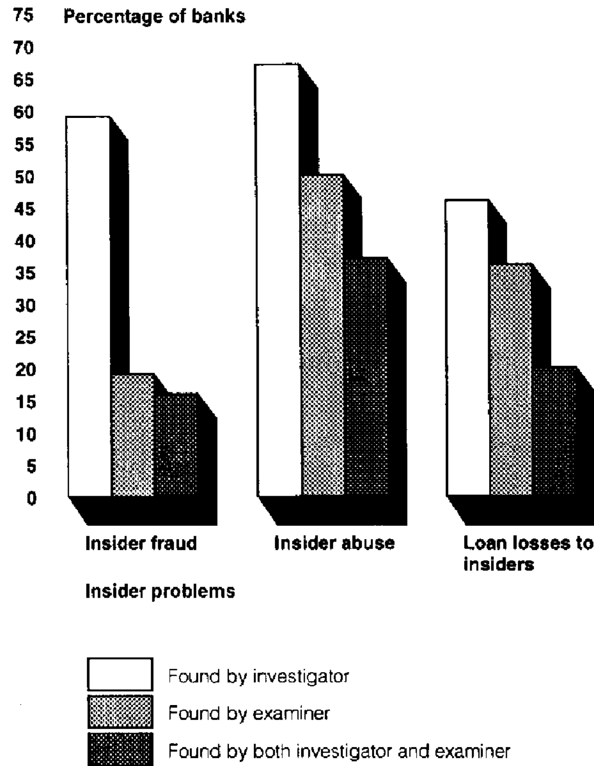
Examiners Often Did Not Identify Insider Problems

In our review of the examination reports of 175 failed banks from 1990 and 1991, we found that when the banks were open examiners were less likely to identify insider problems than were investigators after the banks failed. There are a number of reasons for this. Overall, examiners face many more obstacles than investigators in identifying insider fraud, insider abuse, or loan losses to insiders. Nonetheless, we believe there are some tools examiners could consider using to improve their abilities to detect these insider problems.

Examiners Are Less Likely Than FDIC Investigators to Identify Insider Problems

We reviewed the examination reports of the 175 failed banks for the 3 years before they failed. On the basis of our review, we believe examiners may often fail to identify insider fraud, insider abuse, and loan losses to insiders. In many cases, both the FDIC investigator and the examiner identified insider problems in the bank. (See fig. 5.1.) However, in general, investigators were better able to identify these activities after the banks failed than the examiners were when the banks were open.

Figure 5.1: Identification of Insider Problems by Investigators and Examiners



Note 1: We counted the number of failed banks that were cited for insider fraud, insider abuse, or loan losses to insiders in those examination reports completed in the 3 years before the banks failed.

Note 2: We counted the number of banks in which the investigator stated in the PCR that insider fraud, insider abuse, or loan losses to insiders was a contributing factor in the failures of the banks.

Source: Federal examination report and PCR data.

Examiners were less likely to identify instances of insider problems in banks than were investigators. Investigators were substantially more likely to identify instances of insider fraud and abuse than were examiners. However, examiners were closer to investigators in identifying instances of loan losses to insiders. This makes sense in that one of the primary focuses of the safety and soundness examinations is the loan portfolio. Examiners concentrate much of their resources on the loan portfolio review. Because the loan portfolio typically represents the majority of a

bank's assets and the greatest potential risk to its health, such scrutiny is necessary.

Differing Circumstances and Focus Affect the Outcome of Examiner and Investigator Reviews

Two factors appear to largely account for the varying rates with which investigators and examiners identify various problems. These factors are (1) the different circumstances under which investigators and examiners conduct their reviews and (2) the disparate focus of examiners and investigators.

Concerning the first factor, several investigators told us that after a bank has failed, interviews with bank personnel often aided their investigation of insider problems. Investigators also told us that bank employees are generally more willing to discuss a bank's problems after it has failed. Bank employees are more willing to do so because they are no longer restrained by concern over their positions at the bank and are, therefore, more willing to speak freely about the bank's management and board. Unfortunately, examiners find that bank employees, who rely on the bank for their livelihood, are less likely to discuss the bank's management and board.

Investigators also have greater access to bank documents than do examiners. Although examiners may request all documents necessary to conduct their examinations, they are unlikely to receive documents from bank officials involved in abusive or fraudulent acts in which the officials are self-incriminated. After a bank fails, however, investigators have full access to all records (both manual and automated) on the bank's premises. To ensure that all pertinent documents are obtained, investigators will use desk audits, in which they examine the contents of desks and files belonging to key bank personnel. Through this effort, investigators may produce documents that were unavailable to examiners. However, this approach is of little use to examiners, as such an intrusion would probably be viewed as inappropriate without due cause.

Examiners are primarily concerned with the safety and soundness of an institution, while investigators are primarily concerned with determining the culpability of those associated with the bank. Because examiners and investigators have different concerns, the way they perform their duties and the outcome of their efforts differ. Although examiners strive to maintain or improve the condition of open banks and investigators to identify potential recoveries from failed banks, it is important to note that both examiners and investigators ultimately serve a similar purpose—to

minimize losses to the BIF. Given the high incidence of management and insider problems at failed banks we discussed in chapters 2 and 3, we believe examiners may prove better able to minimize such losses by increasing their scrutiny of insider activities.

Deficiencies Can Sometimes Be Difficult for Examiners to Identify

Some deficiencies—insider problems and violations—may be difficult for examiners to identify. For example, if a bank's system for ensuring that the bank complies with Regulation O fails to identify certain related interests of an insider, examiners may have little opportunity to detect the omission. To identify such an omission the examiner would need evidence of the existence of the unreported related interests. If the omission was inadvertent, the examiner may identify the related interests through the insider's financial statement. This scenario assumes the insider is a borrower and the bank has obtained a complete financial statement. Here again, problems can arise because the bank's system may lack data that identifies the insider as a borrower. Therefore, the examiner may be unaware that a financial statement is available. If a financial statement is not available or its accuracy is questionable, the examiner may interview bank staff to help identify unreported related interests. However, interviewing would require the examiner to ask the right questions and the staff to be aware of and be willing to disclose the insider's related interests.

By itself, the omission of an insider's related interests may have little effect on the bank's overall condition. However, it also may mask other potentially abusive problems, such as the failure of a director to abstain from voting on loans to his or her interests or approving loans that exceed the bank's aggregate insider lending limit. Regardless of whether such management deficiencies have a direct detrimental effect or demonstrable financial impact on the bank, they may indicate broader internal control weaknesses in need of corrective action.

Regulators Could Improve Their Abilities to Identify Insider Problems

We believe our data show that the relationship between insider problems and the overall health of a bank warrants greater attention by examiners in terms of identifying and countering such deficiencies. We also recognize that identifying such activities is often more difficult than identifying poor lending or credit administration practices. Several tools or approaches may aid examiners in improving their abilities to identify these activities.

Existing Data Systems and Recordkeeping Requirements Could Help Examiners to Oversee Insider Activities

Examiners rely largely on bank records to identify insider problems. In our review of examination files for 13 open banks, we found that examiners generally accepted the information provided by the banks as truthful when they assessed insider activities. In other areas of bank operations, examiners can readily determine whether a bank is operating within the confines of regulations. For example, an examiner can identify a bank's failure to maintain current appraisals by pulling a sample of the bank's credit files and reviewing the appraisals they contain. For an examiner to identify a bank's failure to report all of its insiders and their related interests is more complex.

If an examiner requests and is provided with a bank's records required under Regulation O, he or she cannot be certain that the information is complete. For example, in the case of the James Madison National Banks, there were approximately 500 insiders and their related interests involved. Our review of documents from Madison revealed that its directors and officers had submitted information on their related interests. However, we found the information was not always complete. We believe that if an insider does not report a related interest, whether intentionally or not, an examiner may have little opportunity to identify the omission. If credit is extended to an unreported interest or if such credit extension is not reported, again an examiner has little chance of identifying such omissions. This is because examiners must rely largely on their manual reviews of a bank's loan portfolio and other bank documents to identify unreported loans or related interests. If, as in the case of Madison, the bank has a large loan portfolio and its insiders have a number of related interests, this task is extremely burdensome.

We found the guidance in regulators' examination manuals vague concerning how examiners are to determine the extent to which a bank's compliance systems for Regulation O are complete. For example, OCC's manual states only that "examiners should be alert for any relationship with insiders which are not included on the list." While it appears to be largely true that examiners must rely primarily on the veracity of data provided by a bank, we believe this only underscores the need for examiners to place greater emphasis on ensuring the bank has appropriate reporting systems in place. We believe that aggressive enforcement of existing reporting requirements will place examiners in a better position to identify insider problems. Conversely, failure to enforce those few safeguards that currently exist creates an environment that allows abuse.

Full Compliance With Regulation O Recordkeeping Requirements Would Aid Identification of Insider Problems

Regulation O has several recordkeeping requirements. If banks adhered to these requirements, examiners would have sufficient information to allow them to determine the bank's compliance with the regulation's lending provisions. Doing so would help examiners identify potential insider problems.

Regulation O's basic reporting requirements are contained in section 215.8,[1] which requires each bank to maintain records that

- identify all executive officers, directors, and principal shareholders and their related interests; and
- specify the amount and terms of each loan to these entities.

In addition, section 215.8 requires each bank to request, at least annually, that each officer, director, or principal shareholder identify his or her related interests.

If banks fully complied with the provisions of section 215.8, examiners would be able to readily determine whether other key provisions of the regulation, such as the limits on insider lending and the prohibition against preferential terms, were being followed. In addition, the recordkeeping requirements can aid examiners in their review of other potential insider problems, such as insider abuse.

For example, if a bank director has a financial interest in a real estate management corporation that leases office space to the bank, an examiner may be unaware of the relationship. However, if the director complies with the section 215.8 reporting requirement, the examiner can readily identify the management corporation as a related interest and review the lease agreement for potential self-dealing. If the management corporation is receiving excessive fees for the space being leased to the bank, the examiner can identify the possibility of insider abuse.

Using data we reviewed from the examination histories of the 175 failed banks, we found examiners had identified violations of the Regulation O recordkeeping requirements in only 81 (or about 12 percent) of the 656 examinations done at these banks at any time during the 3 years before the banks failed. We believe that this may underreport the true extent of such violations. In our discussions with DOL officials and our review of the PCRS for the 1990 and 1991 bank failures, we found investigators often do not

[1]While other provisions of Regulation O also contain certain recordkeeping requirements, Section 215.8 includes those requirements most directly related to the issues addressed in this report.

find adequate records on hand at the time of failure to permit the ready identification of loans to insiders. Our finding appears to conflict with data from the examinations of these banks. The examination data suggest that the banks generally maintained adequate records before they failed and therefore were not cited for failing to maintain such records.

In addition to our failed bank analysis, our review of examination findings for our sample of 13 open bank case studies also indicated a potential underreporting of these violations. In the examinations of the open banks, examiners reported a violation of section 215.8 provisions in only 1 of the 13 banks we reviewed. However, our review of these examinations and our discussions with the examiners in charge revealed that violations existed in at least three other institutions; examiners either failed to recognize these violations as such or judged them not severe enough to warrant citing them in the examination report. In addition, recordkeeping problems appeared in the case studies of two other banks, although the information available was insufficient for us to say with certainty that a violation of Regulation O recordkeeping requirements had occurred.

One of the case studies was particularly illustrative of violations existing. The most recent examination for that bank focused on insider lending because of violations of the preferential terms provisions of Regulation O that had been cited in the bank's previous examination.[2] The most current examination report noted that the bank had complied with Regulation O. However, the examiner suggested the bank develop an insider loan list that included information on the terms of the insider loans. Because Regulation O requires such a list, the bank is, in fact, in violation of the regulation. Yet, even though such a list is intended to guard against the very violations for which the bank had been cited previously, the examination report fails to cite the lack of such a list as a violation.

The failure of examiners to aggressively pursue compliance with Regulation O's recordkeeping requirements was also mentioned by investigators. Many investigators told us that examiners do not commonly criticize banks for having poor systems in place to track insider activities, or if the examiners do, they treat such violations lightly.

Without complete records, examiners may encounter substantial difficulty in trying to identify banks' insider problems and their violations of Regulation O's lending provisions. To improve their abilities to identify these insider activities, we believe examiners need to place greater

[2]Section 215.4(a).

emphasis on ensuring that a bank is maintaining the appropriate records. Examiners could do this by periodically cross-checking insider reports produced by the bank with other information, such as known lists of major shareholders, officers, and directors that appear in annual reports and SEC filings. In addition, examiners could periodically check bank systems for producing insider information for reasonableness and the existence of good internal controls in connection with other reviews of major bank information systems when warranted.

The New Reporting Requirement May Improve Oversight of Insider Lending

As we discussed in chapter 4, as of the March 1993 call report, banks were required to report loans to directors in addition to loans to officers and principal shareholders. The new requirement now requires data on all loans made to bank insiders as defined by Regulation O.

The addition of this requirement should assist examiners in their effort to ensure that all insider loans are identified. To respond to the new requirement, banks must have or develop systems to collect and maintain this information. Accuracy in call report data is required,[3] and banks are instructed to maintain the records needed to generate the numbers they provide in the call reports. If banks properly report their information on insider lending, examiners will now be able to cross-check the totals of insider lending that are reported on call reports with the totals produced by banks' systems for examination purposes. The addition of data on loans to directors should make it easier for examiners to detect incomplete or sloppy recordkeeping. However, willful misrepresentation would still be a problem because examiners would largely rely on the information reported by the bank to be truthful. Nonetheless, the new requirement should provide examiners with a substantial new tool to use in their assessment of insider lending activities.

Bond and Directors and Officers Liability Insurance Lapses Can Also Indicate Insider Problems

Bank officers and directors can be held personally liable for negligence in meeting their fiduciary responsibilities. In doing our work, we reviewed FDIC investigator files. Our review showed that of the 286 banks that failed in 1990 and 1991, 201, or 70 percent of the banks, had no directors and officers (D&O) liability insurance at the time of failure. D&O liability insurance protects bank directors and officers. Of the 201 banks without D&O insurance, 84 percent had no known coverage for more than a year before the banks failed. The remaining 16 percent of the 201 banks allowed their D&O insurance to lapse within 1 year of the banks' failure.

[3]Under provisions including 12 U.S.C. 1817 and 12 U.S.C. 161.

Within the same 201 banks, 60 percent had bond insurance coverage at the time the banks failed, 17 percent had let their bond insurance lapse in the year before the banks failed, and 23 percent had no known coverage for more than a year before the banks failed.

In many of these banks, management may have allowed the banks' insurance to lapse because it could not afford the high cost of D&O liability or bond insurance given the financial condition of the bank. However, in some cases, insurance companies that issued the D&O liability insurance policies may have refused to renew coverage because of problems they identified at the banks. Officials of such companies told us that before issuing or renewing a policy they carefully review the bank's soundness and look for any indicators that there are problems, including insider problems. Thus, a lack of insurance or exclusions under a bank's policy could be an indicator to federal examiners that the bank is experiencing financial, management, or insider problems.

For example, FDIC investigators wanted to file a bond insurance claim because of the abusive insider activities of three executive officers of a bank. The abuses directly contributed to the failure of the bank. However, a review of the bond insurance policy by the investigator found the same three executive officers were excluded from coverage because of their classified loans. Although we found no evidence in our review of the examinations and workpapers of that bank that the examiners had made themselves aware of this exclusion by examining the bond policy, we cannot say with certainty that they had not done so.

Nonetheless, in our review of the failed bank examination reports for the 175 failed banks, we did not find any evidence that examiners determined the existence of, or exclusions from, a bank's bond or D&O liability insurance policy. Given the apparent carefulness with which insurance companies make decisions on whether and under what conditions to offer insurance, such a review of a bank's policies—or the circumstances under which coverage was declined—may be useful for examiners in helping them identify insider problems.

Conclusions

Examiners were less likely to identify insider problems when banks were open than were investigators after banks failed. Examiners face numerous impediments to determining the full extent of insider problems at banks. Records that would assist examiners' efforts are sometimes missing or incomplete. One reason for this is that insiders involved in abusive or

fraudulent activity will often attempt to conceal their activities. Another reason is that bank personnel may be disinclined to provide information on those to whom they report. Still, we believe improvements can be made in the examination of insider activities.

An examiner's greatest resource in the effort to identify and deter insider problems is information. We recognize that examiners can do little to get beyond their reliance on the truthfulness of bank documents. However, we believe this reliance only increases the need for examiners to insist that banks comply with the Regulation O recordkeeping requirements. If banks comply, they would provide examiners with, among other things, the names of all insiders and their related interests. If complete, this information would allow examiners to review a bank's loan portfolio and other transaction records (e.g., office leases or appraisal contracts) to determine whether potential abuses exist. Without this information, examiners may be kept from identifying potential insider problems. If such problems go undetected, they create an environment that could encourage insider abuse. One way examiners could increase their confidence in the reliability of a bank's data on insiders would be to compare call report data, which now includes loans to directors as well as other insiders, with bank records. In addition, a review of a bank's insurance policies—or the circumstances under which coverage lapsed or was declined—may be useful to examiners in identifying insider problems.

Recommendations

We recommend that the Board of Governors of the Federal Reserve, the Comptroller of the Currency, and the Chairman of the FDIC direct examiners to include, as part of their next full-scope examination of each bank under their authority, a review of the insider lending information as reported by each bank in their call reports. This review should include a study of the accompanying documentation to ensure the numbers reported are supportable. Further, we recommend that Regulation O recordkeeping requirements be given higher priority by examiners to ensure that bank boards and management understand the importance of proper reporting and to improve examiners' abilities to identify potential insider problems.

We also recommend that the Board of Governors of the Federal Reserve, the Comptroller of the Currency, and the Chairman of the FDIC direct examiners to include in their examinations a brief review of a bank's insurance policies. Such a review could determine whether insurers have identified any reasons—such as insider problems—to deny coverage or write exclusions into the policies.

Agency Comments and Our Evaluation

In written comments on a draft of this report, OCC officials agreed with our recommendations, saying they plan to improve the related examination process. This includes revising the section of their Comptroller's Handbook for National Bank Examiners for reviewing insider activities and including a discussion of call report requirements and a reemphasis of the importance of recordkeeping and reporting requirements. (See app. VII.)

The Federal Reserve agreed with our findings and conclusions but stated that it already has policies in place to address our recommendations. On the basis of our review of the Federal Reserve's examination files for failed and open banks, we agree that in almost all cases we found these policies were adhered to. However, we believe that an increased emphasis by the Federal Reserve on Regulation O recordkeeping requirements and an analysis of directors and officers liability insurance policies may provide additional opportunities for identifying insider problems. (See app. IX.)

FDIC officials agreed with the substance of our recommendations, but officials stated they already have policies in place to address these recommendations. On the basis of our review of FDIC's examination files for failed and open banks, we found these policies are not consistently adhered to. In a subsequent letter, FDIC agreed to reemphasize to its field staff the importance of a thorough analysis of insider activities, effective communication with boards of directors, and adherence to established policies and procedures. (See app. VIII.)

Improved Communications Between Bank Regulators and Boards of Directors Are Essential

As we discussed in chapter 2, some examination findings went uncorrected between bank examinations. These findings went uncorrected in both the failed and open banks we reviewed. While the problems identified by examiners in the open banks were clearly not as severe as those identified by investigators in the failed banks, the failure of both the federal bank examiners and bank boards to ensure that problems were corrected is troubling. In some instances, bank boards may have failed to understand the potential seriousness of repeated insider violations and management and insider problems.

Effective communication between bank regulators and bank officers and directors is essential. We believe bank examiners need to place greater emphasis on helping, to the extent possible, bank management and boards of directors to understand the seriousness of deficiencies identified by examiners. Examiners also need to help directors understand their responsibilities to correct these deficiencies. Also, bank boards need to listen to examiners and ensure that management takes the necessary steps to correct problems.

We identified several steps that both examiners and bank boards can take to better ensure that problems are effectively communicated and promptly corrected.

Focus Group Participants Believe Examiners Ineffectively Communicate Examination Findings

As we discuss in chapter 1 and appendix I, we conducted six focus groups with outside bank directors (directors who are not employees of their banks) of small and large banks.[1] Many of the focus group participants described their interactions with regulators in generally favorable terms. However, the focus group participants also expressed frustration concerning their interactions with their banks' primary federal regulator. Most often their frustrations centered on their need for examiners to prioritize examination findings and work more closely with the boards of directors to ensure that the boards understand the findings.

The participants of the focus groups implied that directors view dealing with the examiners as challenging and confusing. The participants expressed frustrations with both the consistency of examination findings and the way in which the examiners communicated these findings to bank management and the boards. Several of the participants believed that examiners often take an adversarial approach in communicating

[1]Small banks are banks with less than $100 million in assets. Large banks are banks with more than $100 million in assets.

examination findings. For example, one participant said that instead of helping the bank's management and directors to understand a new policy, examiners are quick to criticize the bank's management and place the bank under an enforcement action because the management and directors fail to understand a new policy. In another example, a participant said that examiners appear to have a "chip on their shoulders—almost a little hostility." In addition, another participant said examiners were vague in communicating the deficiencies identified, and therefore boards were sometimes unconvinced that corrective action was needed.

Many of the participants of the focus groups expressed concern over the lack of consistency among examiners and the lack of communication with their federal regulator. In one focus group, a participant said that before her bank opened, its loan policy was reviewed by an examiner. The bank made the requested changes and the regulator approved the revised loan policy. At the bank's first examination, the examiners reviewed the loan policy and found it to be inadequate. The bank consulted with the regulator and fixed these problems. Six months later a different examination team came in and found a completely new set of problems with the bank's loan policy.

Participants said examiners sometimes meet with a bank's board but more often they meet only with bank management. In such cases, the board, particularly its outside directors, is likely to get management's version of the examination findings. For example, one participant said his board members have "no interface" with examiners. Instead, an audit committee reviews the examination report and presents the findings to the board. In another example, a participant said that he was concerned because in his bank examiners give oral briefings only to bank management. Another participant said the directors at his bank do not have an on-going relationship with their bank examiner, but instead hear from the bank's president, who deals with the examiners during their examination review. However, another participant reported that sometimes examiners would meet with the board and sometimes they would not. This participant felt that the regulator should have a uniform policy of having the examiners meet with the board after all examinations. We believe that these situations may prevent bank boards from tasking management to implement satisfactory corrective actions.

We believe the regulators could consider several steps for improving the effectiveness of their communication with bank boards and management. These steps would more explicitly connect insider and broader

management problems. Examiners should recognize that repeated insider violations can indicate broader management problems. In addition, examiners should clearly communicate their findings to the boards of directors. They also should prioritize any deficiencies they found in their examinations. Finally, examiners should ensure the directors understand their roles and responsibilities to correct the identified deficiencies.

Repeated Violations Should Signal to Examiners Problems With Bank Management and Oversight Function

As we discussed in chapter 3, continuing or repeated deficiencies such as insider violations can indicate broader management problems. In our review of the failed banks, we found that 141 of the 175 failed banks that were cited for insider violations were also cited for various management problems. Combined, these problems jeopardized the financial health of the banks, and the banks eventually failed.

On the basis of our review of examination reports for both the failed and open banks, we found that violations, such as those involving insiders and examiners' assessments of management, were listed in two separate places in the reports. Examiners often communicated violations to the boards as separate issues requiring the board's attention. On the basis of our interviews with directors and our review of the examination reports, we cannot say with certainty that examiners were connecting repeated insider violations and possible problems related to the effectiveness of the bank management and overall supervision by the boards of directors. Even repeated insider violations were generally treated by examiners as instances of noncompliance with regulations, but not as significant as unsafe or unsound banking practices. As a result, we believe the boards of directors may not usually have perceived the insider violations as potentially serious and therefore may not always have taken prompt and necessary corrective action.

Examination Findings Should Be Prioritized When Communicated to Boards of Directors

In our review of examination reports for failed and open banks, we noted that examiners frequently cited several problems without distinguishing the relative importance of these problems. Although we believe banks should correct all identified deficiencies, the participants in our focus groups expressed frustration because examiners often failed to prioritize their findings. Some participants pointed out that some identified deficiencies appeared to be "nit picky," while others appeared to be more serious. We believe that when examiners feel that the correction of specific problems is crucial for the continued financial soundness of a bank, it would be appropriate for the examiners to prioritize the

deficiencies needing correction. Such prioritization would also serve to reduce some of the frustrations bank directors feel in dealing with examiners.

Examiners Should Better Ensure Directors Understand Their Roles and Responsibilities

In our review of examination reports from the failed banks, we found examiners generally failed to hold boards responsible for identified deficiencies until the bank was in poor condition. We also found many instances in which examiners took an "impersonal" approach to communicating their findings. By impersonal we mean that generally examiners do not specifically hold bank boards and management directly responsible for the problems identified, until the problems become quite severe. For example, in a 1987 examination report of a 1990 failed bank, an examiner cited repeated deficiencies in the bank's lending practices and asset growth. In the report, the examiner cited that "the bank is especially vulnerable to conditions in the market..." However, by 1989, conditions at the bank had substantially worsened. In the 1989 examination report, the examiner directly blamed the bank's supervision and administration by the board of directors for failing to correct the identified deficiencies.

We discussed this impersonal approach with FDIC and OCC officials who generally agreed that their examiners are prone to use such an approach in examination reports unless a bank's problems go uncorrected, are repeated, or become severe. Officials also told us that examiners do not need to personally direct their findings toward a board in the examination report of banks with limited problems. Officials also told us that boards are responsible for seeing that corrective actions are implemented.

Although we recognize that examiners address reports to banks' boards of directors, we believe examiners should make all of their implicit examination findings explicit in all written and oral communications. Examiners should clearly state in their findings—for banks that warrant corrective action—that a bank's board is responsible for ensuring that such action is taken.

The Federal Reserve's bank examination manual outlines that by communicating problems to bank boards examiners can

> "ensure that each director of a [bank] considered to be a 'problem' organization or identified as having a significant weakness, will clearly understand the nature and dimension of their organization's problems and the responsibilities of its board of directors to correct them."

In our interviews with Federal Reserve officials and in documents we reviewed, we found the Federal Reserve requires that examiners send a separate summary of their examination findings to each director of a bank with a composite CAMEL rating of 3 or worse.[2] These summary reports focus on key issues needing the board's attention. To acknowledge the contents of the summary examination report, each director is to sign his or her copy of the summary and return it to the bank.

We believe all examiners should better communicate with boards and directors. Such communication would help to ensure that directors understand the nature of problems and their responsibilities to correct such problems.

Bank Boards of Directors Have a Responsibility to Correct Identified Problems

In our review of failed banks, we found directors were often not actively involved in the supervision of their banks' operations and management. In addition, in our review of open banks, we found instances where directors appeared passive in their oversight function and nonresponsive to deficiencies found by federal examiners. In several instances, directors failed to understand the seriousness of examination findings.

From our review of the examination reports for the open banks and on the basis of our conversations with the participants in our focus groups, we found three possible reasons boards of directors can be passive in their oversight of banks. These reasons are as follows: (1) a lack of understanding regarding examination findings, (2) a lack of assistance from the regulators, and (3) limited training opportunities available specifically for bank directors.

Some Directors Failed to Understand the Seriousness of Examination Findings

In our review of the banks that failed in 1990 and 1991, we found that investigators cited that about 90 percent of the banks had passive or negligent directors. In addition, in an OCC report on national banks that failed from 1979 to 1987, OCC noted that 60 percent of these failed banks had uninformed or passive boards of directors.[3] Both OCC and we found directors' negligence contributed to the failure of the banks. The directors of the banks seem not to have understood their roles and responsibilities

[2]The summary examination report is also sent to directors of banks that receive a CAMEL rating of 1 or 2 and show a significant deterioration in condition or violations of law.

[3]Bank Failure: An Evaluation of The Factors Contributing to The Failure of National Banks Office of the Comptroller of the Currency Report (Washington, D.C.:June 1988).

or how to effectively maintain or return the banks to a financially sound position.

In our review of federal examination reports of 13 open banks, we found instances of passive or uninformed directors. In these instances, federal examiners noted that some boards of directors and individual directors failed to understand the seriousness of the examination findings; in some instances, they also failed to take corrective actions on the identified deficiencies.

Better Assistance From Regulators Can Aid Directors

The participants in our focus groups expressed a need for better assistance from regulators to aid them in their responsibilities as bank directors. According to their comments, they believe better assistance from the regulators could consist of providing thorough explanations of examination findings, offering suggestive corrective actions to alleviate the identified deficiencies, and providing clarifications on the constantly changing and complex banking laws. However, assistance from the regulators would only be most effective when boards of directors are willing to work with the examiners.

Limited Training Opportunities Available Specifically for Outside Bank Directors

We found the directors in our focus groups and those in the meetings we held with the boards of directors appeared knowledgeable of their responsibilities as directors and the banking laws and regulations, such as Regulation O and FDICIA.

However, we believe additional training opportunities could increase directors' knowledge and effectiveness in their supervision of banks, particularly in today's banking regulatory environment. For example, since 1986 new federal banking laws have been enacted, such as FIRREA and FDICIA, which have resulted in a number of new regulations, set additional supervisory guidelines, and required additional regulatory reports from banks. Participants of our focus groups expressed a need for training—such as banking seminars and conferences—to keep them informed of these changes in the banking industry. In addition, officials from the Office of Thrift Supervision (OTS) told us that many directors of thrifts refuse to make insider loans because of the complexity of federal regulations governing insider activity. Also, OTS' General Counsel receives a number of requests daily from directors for interpretations of banking laws and regulations, particularly Regulation O.

Federal Regulators Could Recommend Training as Corrective Measure

In our review of the examination reports of both the failed and open banks, we found no instances where federal examiners recommended training or educational courses as a corrective measure when examination findings suggested bank management and directors lacked knowledge or skills to effectively supervise their banks. However, in some of these reports it was clear that some form of training could have enhanced the overall performance of the board of directors. We believe that in instances where examiners determine that directors do not understand banking operations or what actions are needed to correct identified deficiencies, training may be a helpful resource.

Federal regulators told us they do not recommend training for directors as a corrective measure. Each of the federal regulators believes it is ultimately the responsibility of a bank director to obtain the skills and knowledge of banking needed to effectively supervise banks. Officials from the federal bank regulators told us the agencies' main function is to evaluate the financial safety of banks. They also said that although federal bank regulators have recognized the importance of knowledgeable and responsible bank directors, federal regulators do not have a formal or structured training program for the directors. We found that some training opportunities exist for bank directors. We discuss these training opportunities in appendix VI.

Conclusions

In our analysis of failed banks, we found that repeated insider violations and management and insider problems caused the banks to deteriorate and ultimately to fail. We believe the failure to correct repeated violations may result, in part, because examiners do not always effectively communicate the seriousness of examination findings and the role the board is to play in correcting deficiencies.

We believe directors, individually, need not possess all of the skills and abilities necessary to understand the specific activities of the bank. However, each board, collectively, has a responsibility to have sufficient expertise to effectively oversee bank management's activities. Directors also have to understand their responsibilities when presented with examination findings. In instances where the board appears to not understand the identified deficiencies or possible corrective actions, training may be useful, especially with the frequent changes in federal banking laws.

Recommendations

To improve the communication between examiners and bank boards and increase the likelihood that boards will initiate appropriate corrective actions we have a recommendation. We recommend that the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, and the Chairman of the FDIC direct examiners to better ensure—through examination reports, exit conferences, and any other appropriate means—that all directors understand (1) the primary issues in need of the board's attention, (2) that the problems facing a bank are most often a consequence of deficiencies in the overall management and oversight by the boards of directors, and (3) that the board must see that effective corrective action is taken. In addition, when directors do not understand the problems examiners identify or potential corrective measures, federal regulators should, when appropriate, recommend training to improve the directors' abilities to oversee the management of banks.

Agency Comments and Our Evaluation

OCC officials agreed with our recommendation and said that it will reinforce its guidance for examiners to better ensure that bank boards understand the issues they must address. OCC is also considering additional changes to its guidance to draw examiner attention to the possible need for them to recommend training for directors. (See app. VII.)

The Federal Reserve officials agreed with our findings and conclusions but stated it already has policies in place to address our recommendations. We believe the Federal Reserve could take additional steps to communicate the need for corrective actions and provide more assistance to bank directors and management in accomplishing the corrections. The Federal Reserve's written examination summary, which is provided to each director, is a good step in this direction. However, we believe the steps we outline in this chapter would provide additional assurances that identified deficiencies are understood and corrected before they negatively affect a bank's financial health. (See app. IX.)

FDIC officials agreed with our findings and conclusions, but stated FDIC already has policies in place to address these recommendations. On the basis of our review and our discussions with bank directors, we found that these policies are not consistently adhered to. In addition, we believe there are additional opportunities for improving communication between FDIC and bank boards and management. In a subsequent letter, FDIC agreed to reemphasize the importance of effective communication with boards of

directors and adherence to established policies and procedures. (See app. VIII.)

Objectives, Scope, and Methodology

As discussed in chapter 1, we had the following five objectives for this review:

- Determine the frequency of various insider activities at selected failed and open banks and the potential impact of insider activities on the safety and soundness of bank operations.
- Evaluate the effectiveness of the regulators of federal financial institutions to identify and supervise insider activities at banks.
- Determine the underlying causes of insider problems, specifically whether there is an association between insider problems and broader managerial or operational problems in failed and open banks.
- Determine the overall extent of loans to insiders at failed and open banks.
- Compare state banking laws and regulations with federal Regulation O and analyze state examination policies and procedures governing insider activities.

More detailed information on our scope and the methodologies we used to address the first, third, fourth, and fifth objectives follows.

For our first objective, we collected the information on the 286 banks that failed in calendar years 1990 and 1991 on a two-part form, or data collection instrument (DCI), that we designed and pretested. To address the requesters' question about the frequency of insider activities, we completed part I of the DCI for 286 bank investigations. Part I focused on the reasons for a bank's failure. These reasons include an assessment by the investigator as to whether insider problems played a major role in the bank's failure; the types and nature of the insider problems, as identified by the investigator; and the extent to which recoveries from directors, officers, and others are likely. We then completed part II only for those cases where investigators identified insider problems as being a factor in the failure of the bank.

We collected specific information on the types of insider activities identified by the investigator and the other management and economic problems that led to the failure of the banks.[1] We also collected the same information from the examination reports and accompanying workpapers of the 175 banks for the 3 years before the banks failed.

To design part I of the DCI, we reviewed examination reports from prior studies to develop a comprehensive list of insider activities and

[1]In addition to wanting to capture all of the reasons a bank may have failed, we focused on other problems. We also focused on specific problems of insider abuse, insider fraud, loan losses to insiders, and insider violations because field testing of our DCI indicated they were important.

management problems. We field tested this DCI at two FDIC field offices. FDIC officials at these offices reviewed our list of insider activities and management problems. On the basis of their comments, we refined our list as necessary. Our explanations of insider activities are generally consistent with those discussed in the Office of the Comptroller of the Currency's (OCC) study of bank failures.[2] Explanations of the major insider activities and management problems we focused on are as follows.

Operating Losses. Operating losses refer to losses associated with the pricing of products, the processing of bank transactions, or unusually high personnel costs. For example, a bank that has an antiquated computer system may experience delays in processing transactions, which increases costs to the bank when cash cannot be deposited immediately.

Excessive Growth. For a bank, growth generally refers to its loan portfolio, either through increased lending or through acquisitions of other banks' assets (i.e., loans). A bank may grow rapidly without experiencing excessive growth if the bank's systems and staffing also grow to keep pace with the growth of the loan portfolio.

Excessive Dividends. Dividends paid to shareholders are excessive when the bank has insufficient profits to pay them.

High-Risk Exposure. High-risk exposure occurs when a bank's loan portfolio is concentrated in high-risk loans, such as those in commercial real estate made on land alone.

Poor and/or Negligent Management. This is failure of management to exercise due care in the management of the bank.

Passive and/or Negligent Board. This is caused by failure of the board to properly oversee management's operation of the bank.

Failure to Respond to Regulatory Criticism. This condition is present when the regulator repeatedly has cited the same problems at a bank and the bank's directors took only partial, little, or no action to correct the problems.

Lack of Expertise of the Board or Management. Although individual board directors need not have a thorough knowledge of the intricacies of

[2]Bank Failure: An Evaluation of the Factors Contributing to the Failure of National Banks Office of the Comptroller of the Currency, (Washington, DC: 1988).

banking, the board as a whole should have sufficient expertise to oversee management's operations. Management should have the expertise to manage the lines of business of the bank. For example, if the management of a small bank decided to enter the derivative products market but the bank had no staff experienced in this complex product line, the bank could have problems because of the staff's lack of expertise.

Dominant Board Member/Dominant Executive. This term refers to a director, officer, or small group who unduly influences the decisionmaking process within the bank to the extent that dissenting voices were either not allowed or not heard.

Insider Abuse/Insider Fraud. There are clear distinctions between insider abuse and insider fraud. Insider abuse is abuse that falls short of being a criminal act. It occurs when an insider (as defined by Regulation O) benefits personally from some abusive action he/she takes as part of his/her position at the bank. Not all insider violations are necessarily abusive; the violation must be accompanied by personal gain to the insider to be considered abusive. Insider fraud is a criminal act. Such action includes embezzlement, falsifying documents, and check kiting. The actions must have been perpetrated by an insider, as defined in Regulation O. However, unlike insider abuse, insider fraud does not have to benefit the individual perpetrating the crime. For example, if a bank president falsifies loan documents to improve the apparent creditworthiness of a borrower, this is fraud—even if no personal gain by the president can be identified.

Lack of or Inadequate Systems to Ensure Compliance With Laws and Regulations. This is present when the bank is criticized for lacking a system or program to identify and avert potential violations of law or regulation. Also, this may indicate a failure of the board or management to properly assign responsibility for correcting deficiencies cited by examiners.

Lack of or Inadequate Lending Policies, Lax Lending Practices, and Inadequate Credit Administration. There are clear distinctions among these terms. A bank should have in place specific lending policies to cover the various types of lending it does. The policies serve as instructions for the lending officers. Lax lending practices deal with the issuance of loans, whether they are made on a sound basis, and whether the bank obtained adequate credit information on the borrower before deciding to lend. The composition of a bank's loan portfolio can also indicate lax lending

practices. For example, if a bank's loan portfolio is highly concentrated in a specific type of loans (e.g., commercial real estate) or if there are a lot of loans to uncreditworthy borrowers, it indicates that the bank has lax lending practices. Inadequate credit administration refers to how the bank manages its loans after they have been made. Such criticisms as failure to maintain current appraisals, failure to obtain periodic credit information on borrowers, and inadequate documentation in the loan files all point to inadequate credit administration.

Loans to Insiders. Loans to insiders refer to loan losses to individuals defined as insiders by Regulation O. Tellers and loan officers generally do not meet the definition of insider for Regulation O purposes.

Excessive Compensation. This refers to compensation to officers or board members that an investigator or examiner has identified as beyond what is typical for the bank, considering its financial situation and comparing it to other similarly sized and located banks.

Improper Affiliate Transactions. These are violations of section 23A and 23B of the Federal Reserve Act.

As part of our review of the examination histories of the 175 banks with insider problems, we also reviewed any enforcement actions taken by the regulators against the banks. So that we could have complete information, we also obtained from FDIC, OCC, the Federal Reserve, and the Securities and Exchange Commission (SEC) information on the enforcement actions they had taken against the former officers and directors after the failures of all 286 banks.[3]

To better understand the issues related to potential recoveries from negligent officers and directors, we also talked with representatives of insurance companies that offer directors and officers (D&O) liability insurance policies.

After we had completed our data collection efforts on the failed banks, we contacted the DOL investigators in charge for 18 randomly selected banks to verify that as their investigations continued, the conclusions they presented in the post-closing reports as to the reasons for the banks' failures had not changed.

[3]SEC, although not a bank regulator, can propose post-failure enforcement actions when it determines that such parties violated the antifraud, reporting, and internal accounting provision of federal securities laws.

We did our work on the failed banks in Washington, D.C., and the 14 FDIC-DOL consolidated field offices located in Irvine and San Jose, California; Denver, Colorado; East Hartford, Connecticut; Orlando, Florida; Atlanta, Georgia; O'Hare (Rosemont), Illinois; Bossier City, Louisiana; Franklin, Massachusetts; South Brunswick, New Jersey; Oklahoma City, Oklahoma; and Addison, Houston, and San Antonio, Texas.

We also reviewed a judgmentally selected sample of 13 open banks. Our objectives were to determine whether the same types of insider and management problems we found in the failed banks were also present in open banks. The 13 banks included banks supervised by all 3 federal bank regulators and were located in various geographic parts of the country. We selected only banks with a composite CAMEL rating of 3 or better because we did not want to purposely select banks with a higher likelihood of having problems. In addition, we did not want to select banks where the level of regulatory activity might be higher and our presence at the regulatory agency might impede the supervisory process. All of the 13 banks we selected had recent federal bank examinations. We used this criterion because we wanted to interview the current examiner in charge about the history and most current conditions at the banks.

For each bank, we prepared a case study in which we focused on the efforts of the federal regulators to review insider and management problems. We collected information on insider activities as defined by Regulation O, affiliate transactions, and the efforts of management and the bank's board to operate and manage the bank with due care. We also collected general financial information and some bank history for each bank. We used examination reports for the 5 years prior to our review, available financial information, and bank publications obtained by the examiners. Finally, we conducted in-depth interviews with the examiner in charge of the most recent federal bank examination.

We did our work on open banks at FDIC, OCC, and the Federal Reserve headquarters in Washington, D.C., and at the FDIC field offices in New York and Syracuse, New York; Rolling Meadows and Burr Ridge, Illinois; and San Francisco, California; at the OCC field offices in Great Neck and New York, New York; Bensalem, Pennsylvania; Rockford and Chicago, Illinois; and Evansville, Indiana; and at the Federal Reserve banks in Philadelphia, Pennsylvania, and San Francisco, California. We discuss the overall results of our work on insider and management problems in failed and open banks in chapters 2 and 3.

To determine the underlying causes of insider problems, we conducted focus groups and interviews with bank directors. We also collected information on training opportunities for bank directors. Additional information on our interviews and focus groups with bank directors and training for bank directors follows.

The analysis of our results from the failed and open bank work led us to consider further the key role played by the board of directors in ensuring that a bank is managed properly, that problems requiring correction receive attention, and that insider problems do not occur. As a result, we decided to obtain additional information directly from bank directors. We used two approaches to do this. First, we met with four boards of directors of the open banks we reviewed who were willing to meet with us. Second, we conducted six focus groups with randomly selected bank board members from a variety of large and small banks in the Washington, D.C., New York, and Chicago metropolitan areas. With both the full bank boards and the focus groups we discussed the following general issues:

- the roles and responsibilities of bank directors;
- how directors actually discharge their duties;
- how the regulators work with board members and management to ensure the safe and sound operation of a bank;
- the effects of recent legislative and regulatory changes (most notably the Federal Deposit Insurance Corporation Improvement Act) on the environment in which they operate; and
- information, guidance, and training available to directors.

We present the results of this work in chapters 5 and 6.

We did our work for this segment of the evaluation in Washington, D.C., New York, and Chicago, and at four selected open banks around the country.

Evidence from our failed bank work indicated that in some cases bank directors had little knowledge about their duties and responsibilities or had received little training regarding their corporate governance responsibilities. In our meetings with the directors of the open banks and our focus groups bank directors also said they had received little training when they accepted invitations to become board members, and some of them expressed concerns about their ability to keep up with rapidly changing banking laws, regulations, and regulatory directives. As a result

of the directors' comments, we decided to obtain information on the nature and types of educational programs available for directors.

To do the work for this objective, we interviewed officials of federal and state bank regulatory agencies, insurance companies that supply banks with D&O insurance coverage, bank trade associations, and private sector firms involved in the banking industry. We interviewed these officials to collect information on how they inform or educate bank directors on corporate governance responsibilities or other aspects of banking. When available, we reviewed the educational materials, such as pamphlets and handbooks, supplied to directors. We also reviewed the educational materials used in various conferences, seminars, and workshops held for bank directors. We discuss the results of this work in chapter 6.

We did this work in Washington, D.C. We also obtained information to satisfy this objective at various state banking agencies we visited (see objective 4 for specific locations).

Our fourth objective was to determine the overall extent of loans to insiders at failed and open banks. One section of part II of the DCI required the GAO evaluator to develop an extensive list of insiders—officers, board members, major shareholders, and their related interests—using all of the available documents at the DOL office. These documents include examination reports and enforcement actions, investigative files, and asset searches ordered by investigators. In some cases, investigators had developed lists that we supplemented with other available information; in others, we had to do much more extensive research to develop these lists. We developed these lists to match the names on them against those on the loans of DOL's Liquidation Asset Management Information System (LAMIS) database. Using these matches along with additional matches with other databases —principally pools of loans being managed by servicers for FDIC —we expected to be able to estimate the amount, at a minimum, of loans to insiders; the amounts charged off, or lost; and the amounts that could be lost (i.e., loans to insiders that were classified as substandard or doubtful). We tried to compile a list of loans to insiders and their related interests that may have resulted in losses to Bank Insurance Fund. Because of difficulties we encountered in using the LAMIS database for these purposes, we alternatively decided to attempt to match our loan lists to LAMIS data for 10 selected failed banks. We selected these banks on the basis of the availability of insider-related data, asset size, and geographical location. We discuss the results of our work in chapter 4 and appendix IV.

For open banks, we relied on data available in call reports to determine the total amount of insider lending in open banks. We used the most recently reported call report data, dated March 1993.

In his request letter, Chairman Gonzalez specified 10 states whose banking laws and regulations he wanted us to review. These states were California, Florida, Illinois, Massachusetts, New Jersey, New York, North Carolina, Ohio, Pennsylvania, and Texas. For our fifth objective, to compare state banking laws with Regulation O, we requested information on the state laws and regulations regarding insider activities, state examination procedures for reviewing these activities, and any special programs for review of insider activities at banks or programs related to educational outreach for boards of directors. We then visited the state banking agencies of 6 of these 10 states. We also conducted telephone interviews with knowledgeable officials in three other of these states. We were unable to visit or conduct a telephone interview with officials of the New Jersey Department of Banking.

To ensure that we were capturing information on any state laws that might be more stringent than federal law and regulations, we surveyed the banking agencies of the remaining 40 states, the District of Columbia, the Commonwealth of Puerto Rico, and two territories (Guam and the U.S. Virgin Islands) about their state laws and regulations that related to 5 key provisions of Regulation O. Those provisions were the definition of insiders, preferential terms, lending limits, prior board approval, and overdrafts. (See ch. 1 for information on these provisions in Regulation O.) We conducted our survey with the assistance of the State Conference of State Bank Supervisors, who received and forwarded to us 40 responses out of 44 surveys sent out under its cover letter. On the basis of our analysis of the survey results, we also visited and collected information from state banking agencies in Montana, Iowa, Minnesota, and Virginia.

We discuss the results of our review of state laws and regulations and state examination policies and procedures in appendix V. We discuss the results of our work on state banking agency educational efforts in appendix VI.

We did this work in Washington, D.C., and at the state banking agency headquarters in San Francisco, California; Springfield, Illinois; Des Moines, Iowa; Boston, Massachusetts; St. Paul, Minnesota; Helena, Montana; New York, New York; Harrisburg, Pennsylvania; Austin, Texas; and Richmond, Virginia.

Insider Activities at Thrifts and Credit Unions

Insider Activities at Thrifts

The Office of Thrift Supervision (OTS) is responsible for supervising the 1,954 active, federally insured thrifts. OTS conducts both safety and soundness and compliance examinations as part of this supervision process. During 1991, OTS adopted a policy of annual examinations for all thrifts. Before 1991, OTS conducted biannual examinations. In 1991, OTS conducted an on-site, risk-focused examination of every institution it regulates. In addition, OTS conducted 793 compliance examinations that included assessments of how well thrifts complied with consumer laws, such as the Community Reinvestment Act.

Affiliate transactions and insider loans at thrifts generally are subject to FRA 23A and 23B and FRA 22(g) and 22(h) to the same extent as if they were banks. Transactions between savings associations and their affiliates are subject to restrictions set forth in 12 C.F.R. 563.41 and 563.42. Loans to insiders or their related interests are governed under 12 C.F.R. 563.43, which generally incorporates Regulation O by reference. This regulation became effective on November 5, 1992.

The following are examples of general insider lending restrictions under Regulation O, incorporated by 12 C.F.R. 563.43, as they apply to thrifts:

- General loan requirements: Loans must be approved in advance by a majority of the entire board of directors, not be on preferential terms, and not exceed aggregate individual and overall lending limits.
- Lending limits: The aggregate amount of all transactions with insiders and their related interests generally may not exceed 100 percent of an institution's unimpaired capital and unimpaired surplus. Individual lending limits for loans that are not fully secured are limited to 15 percent of unimpaired capital and unimpaired surplus, with an additional limit of 10 percent of unimpaired capital and unimpaired surplus for loans that are fully secured.

OTS uses the same enforcement powers as bank regulators to get thrifts to correct identified problems. The Financial Institutions Reform, Recovery and Enforcement Act of 1991 expanded OTS' authority to issue civil money penalties to make it identical to that of the bank regulatory agencies. OTS has issued numerous (1) cease and desist orders requiring restitution and other affirmative relief, (2) supervisory agreements, (3) orders of removal and prohibition, (4) civil money penalties, (5) debarments of professionals from agency practice, and (6) capital directives and other remedial measures. OTS has also imposed restitution orders on individuals who

abused thrifts. For example, in 1991, OTS obtained restitution of $43 million.

OTS reported that while the total number of initiated or completed enforcement actions decreased in 1992 compared to 1991, the overall level of enforcement activity remained high. In addition, OTS reported that the decrease in the number of actions reflected the continuing improvement in the quality of management in the industry and the decrease in the number of problem institutions.

Historically, insider abuses have been relatively common in the thrift industry. In the 1980s, several particularly egregious and well-publicized insider abuse cases were discovered. For example, the Lincoln Savings and Loan Association case involved prohibited affiliate transactions. Although OTS has reported that the thrift industry is steadily recovering from past abuses, a 1993 OTS report documents one of the largest fraudulent "daisy chain" networks ever discovered by OTS. This case uncovered more than a dozen transactions involving self-dealing and improper insider loans to a group of officers and directors.

Insider Activities at Credit Unions

Laws and regulations governing insider activities at credit unions are similar to those applicable to banks. For example, the Federal Credit Union Act provides for board approval for loans of more than specified dollar amounts to directors or members of the supervisory or credit committees. Regulations also prohibit specific conflicts of interest and insider self-dealing. Article XIX, section 4, of the Federal Credit Union bylaws provides that no official shall

> "participate in the deliberation upon or the determination of any question affecting his pecuniary interest or the pecuniary interest of any corporation, partnership or association in which he is directly or indirectly interested."

The National Credit Union Administration (NCUA) is responsible for supervising the 7,916 active,[1] federally insured credit unions. As part of this supervision, NCUA conducts examinations of credit unions, and each credit union receives a CAMEL rating. As of December 31, 1992, 4,582 credit unions had a rating of 1 or 2, 2,945 had a rating of 3, and 389 had a rating of 4 or 5. NCUA examination policy states that examiners need to be alert for any potential insider dealings or conflict-of-interest problems. The NCUA Examiner's Guide discusses types of insider problems, including

[1]As of December 31, 1992.

loans to insiders at preferential terms and the ownership of fixed assets by officials who borrow from a credit union to purchase an asset, lease it back to the credit union, and receive commissions or a fee from the credit union or its members. Because insider lending is the most common area for insider problems, the guide includes specific directives for evaluating lending to insiders. NCUA has available to it enforcement powers similar to those used by bank regulators. FIRREA broadened NCUA's authority to issue civil money penalties.

An NCUA official told us that NCUA has improved training for examiners in this area. For example, senior examiners are required to take a 5-day course on fraud and abuse. In addition, NCUA has a fraud hotline that anyone can use to report suspected fraud at credit unions to the General Counsel's office. The official told us that all calls are investigated. About 10 percent turn out to be fraud or abuse. An NCUA official told us that NCUA receives an average of three calls per month on the hotline.

In our comprehensive review of credit unions,[2] we studied insider activities. In general, we found that insider problems were not a major cause of credit union failures. NCUA officials told us that in the last half of the 1980s, insider abuse was more prevalent than it is now. The officials emphasized that during the late 1980s, the instances of insider problems were few but when they occurred, they were usually very costly. For example, the failure of the Franklin Community Credit Union in 1989, which was caused by massive fraud, cost the Share Insurance Fund about $40 million. NCUA officials told us that in the past few years the proportion of losses due to insider problems has decreased substantially compared to losses due to other factors. However, the largest single loss to the Share Insurance Fund in recent years, $19 million, was due to the 1991 failure of the Barnstable Community Federal Credit Union, which occurred because of massive fraud. NCUA officials told us that this was the only major case of insider fraud they had uncovered in recent years.

[2]Credit Unions: Reforms for Ensuring Future Soundness (GAO/GGD-91-85, July 10, 1991).

Federal Reserve Regulation O

Part 215—Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks (Regulation 0)

Part 215 (Regulation O) of Title 12, Code of Federal Regulations, as revised November 28, 1979, 44 *Federal Register* 67973. See ¶ 98,043. Heading revised September 28, 1993, 58 *Federal Register* 50512.

Subpart A—Loans by Member Banks to Their Executive Officers, Directors, and Principal Shareholders

[¶ 32,001]

§ 215.1 Authority, purpose, and scope.

(a) *Authority.* This subpart is issued pursuant to sections 11(i), 22(g) and 22(h) of the Federal Reserve Act (12 U.S.C. 248(i), 375a, 375b), 12 U.S.C. 1817(k)(3), and section 306 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (Pub. L. No. 102-242, 105 Stat. 2236 (1991)).

(b) *Purpose and scope.* This subpart governs any extension of credit by a member bank to an executive officer, director, or principal shareholder of (1) the member bank, (2) a bank holding company of which the member bank is a subsidiary, and (3) any other subsidiary of that bank holding company. It also applies to any extension of credit by a member bank to (1) a company controlled by such a person and (2) a political or campaign committee that benefits or is controlled by such a person. This subpart also implements the reporting requirements of 12 U.S.C. 375a concerning extensions of credit by a member bank to its executive officers and of 12 U.S.C. 1817(k) concerning extensions of credit by a member bank to its executive officers and principal shareholders.

[Sec. 215.1 as amended May 18, 1992, 57 FR 21199 (¶ 88,915); effective date revised May 28, 1992, 57 FR 22417.]

[¶ 32,002]

§ 215.2 Definitions.

For the purposes of this subpart, the following definitions apply unless otherwise specified:

(a) *Company* means any corporation, partnership, trust (business or otherwise), association, joint venture, pool syndicate, sole proprietorship, unincorporated organization, or any other form of business entity not specifically listed herein. However, the term does not include:

(1) An insured depository institution (as defined in 12 U.S.C. 1813); or

(2) A corporation the majority of the shares of which are owned by the United States or by any State.

(b)(1) "Control of a company or bank" means that a person directly or indirectly, or acting through or in concert with one or more persons:

(i) Owns, controls, or has the power to vote 25 percent or more of any class of voting securities of the company or bank;

(ii) Controls in any manner the election of a majority of the directors of the company or bank; or

(iii) Has the power to exercise a controlling influence over the management or policies of the company or bank.

(2) A person is presumed to have control, including the power to exercise a controlling influence over the management or policies, of a company or bank if:

(i) The person is (A) an executive officer or director of the company or bank and (B) directly or indirectly owns, controls, or has the power to vote more than 10 percent of any class of voting securities of the company or bank; or

(ii) (A) The person directly or indirectly owns, controls, or has the power to vote more than 10 percent of any class of voting securities of the company or bank, and (B) no other person owns, controls, or has the power to vote a greater percentage of that class of voting securities.

(3) An individual is not considered to have control, including the power to exercise a controlling influence over the management or policies, of a company or bank solely by virtue of the individual's position as an officer or director of the company or bank.

(4) A person may rebut a presumption established by paragraph (b)(2) of this section by submitting to the appropriate Federal banking agency (as defined in 12 U.S.C. 1813(q)) written materials that, in the agency's judgment, demonstrate an absence of control.

(c) *Director of a member bank* includes:

(1) Any director of a member bank, whether or not receiving compensation;

(2) Any director of a company of which the member bank is a subsidiary; and

(3) Any director of any other subsidiary of that company. An advisory director is not considered a director if the advisory director—

(i) Is not elected by the shareholders of the company or bank;

(ii) Is not authorized to vote on matters before the board of directors; and

(iii) Provides solely general policy advice to the board of directors.

(d)(1) *Executive officer* of a company or bank means a person who participates or has authority to participate (other than in the capacity of a director) in major policymaking functions of the company or bank, whether or not: the officer has an official title; the title designates the officer an assistant; or the officer is serving without salary or other compensation.[1] The chairman of the board, the president, every vice president, the cashier, the secretary, and the treasurer of a company or bank are considered executive officers, unless: the officer is excluded, by

[1] The term is not intended to include persons who may have official titles and may exercise a certain measure of discretion in the performance of their duties, including discretion in the making of

resolution of the board of directors or by the bylaws of the bank or company, from participation (other than in the capacity of a director) in major policymaking functions of the bank or company; and the officer does not actually participate therein.

(2) For the purpose of §§215.4 and 215.8 of this part, an executive officer of a member bank includes an executive officer of: a company of which the member bank is a subsidiary; and any other subsidiary of that company, unless the executive officer of the subsidiary is excluded (by name or by title) from participation in major policymaking functions of the member bank by resolutions of the boards of directors of both the subsidiary and the member bank and does not actually participate in such major policymaking functions.

(e) *Foreign bank* has the meaning given in 12 U.S.C. 3101(7).

(f) *Insider* means an executive officer, director, or principal shareholder, and includes any related interest of such a person.

(g) "Immediate family" means the spouse of an individual, the individual's minor children, and any of the individual's children (including adults) residing in the individual's home.

(h) The *lending limit* for a member bank is an amount equal to the limit of loans to a single borrower established by section 5200 of the Revised Statutes.[2] 12 U.S.C. 84. This amount is 15 per cent of the bank's unimpaired capital and unimpaired surplus in the case of loans that are not fully secured, and an additional 10 per cent of the bank's unimpaired capital and unimpaired surplus in the case of loans that are fully secured by readily marketable collateral having a market value, as determined by reliable and continuously available price quotations, at least equal to the amount of the loan. The lending limit also includes any higher amounts that are permitted by section 5200 of the Revised Statutes for the types of obligations listed therein as exceptions to the limit. A member bank's unimpaired capital and unimpaired surplus equals the sum of:

(1) The "total equity capital" of the member bank reported on its most recent consolidated report of condition filed under 12 U.S.C. 1817(a)(3);

(2) Any subordinated notes and debentures approved as an addition to the member bank's capital structure by the appropriate federal banking agency; and

(3) Any valuation reserves created by charges to the member bank's income reported on its most recent consolidated report of condition filed under 12 U.S.C. 1817(a)(3).

(i) *Member bank* means any banking institution that is a member of the Federal Reserve System, including any subsidiary of a member bank. The term does not include any foreign bank that maintains a branch in the United States, whether or not the branch is insured (within the meaning of 12 U.S.C. 1813(s)) and regardless of the operation of 12 U.S.C. 1813(h) and 12 U.S.C. 1828(j)(2).

(j) "Pay an overdraft on an account" means to pay an amount upon the order of an account holder in excess of funds on deposit in the account.

(k) "Person" means an individual or a company.

(l)(1) *Principal shareholder* means a person (other than an insured bank) that directly or indirectly, or acting through or in concert with one or more persons, owns, controls, or has the power to vote more than 10 percent of any class of voting securities of a member bank or company. Shares owned or controlled by a member of an individual's immediate family are considered to be held by the individual.

(2) A principal shareholder of a member bank includes:

(i) a principal shareholder of a company of which the member bank is a subsidiary, and

(ii) a principal shareholder of any other subsidiary of that company.

(3) A principal shareholder of a member bank does not include a company of which a member bank is a subsidiary.

(m) *Related interest* of a person means:

(1) A company that is controlled by that person; or

(2) A political or campaign committee that is controlled by a person or the funds or services of which will benefit that person.

(n) "Subsidiary" has the meaning given in 12 U.S.C. 1841(d), but does not include a subsidiary of a member bank.

[Sec. 215.2 as amended October 20, 1983, 43 FR 42805 (¶99,725); May 18, 1992, 57 FR 21199 (¶88,915); effective date revised May 28, 1992, 57 FR 22417; amended December 17, 1992, 57 FR 60979 (¶89,218).]

[¶32,003]

→ For proposed amendment of §215.3, modifying the definition of "extension of credit" and to clarify that the definition of "tangible economic benefit" contained in the definition of extension of credit does not cover bona fide extensions of the credit to third parties to finance acquisitions of property, goods, or services for insiders, see 58 FR 47400, September 9, 1993 (¶89,542). Comments must be received by October 12, 1993. CCH.

§215.3 Extension of credit.

(a) An extension of credit is a making or renewal of any loan, a granting of a line of credit, or an extending of credit in any manner whatsoever, and includes:

(Footnote Continued)

loans, but who do not participate in the determination of major policies of the bank or company and whose decisions are limited by policy standards fixed by the senior management of the bank or company. For example, the term does not include a manager or assistant manager of a branch of a bank unless that individual participates, or is authorized to participate, in major policymaking functions of the bank or company.

[2] Where State law establishes a lending limit for a State member bank that is lower than the amount permitted in section 5200 of the Revised Statutes, the lending limit established by applicable State laws shall be the lending limit for the State member bank.

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(1) A purchase under repurchase agreement of securities, other assets, or obligations;

(2) An advance by means of an overdraft, cash item, or otherwise;

(3) Issuance of a standby letter of credit (or other similar arrangement regardless of name or description) or an ineligible acceptance, as those terms are defined in § 208.8(d) of this chapter;

(4) An acquisition by discount, purchase, exchange, or otherwise of any note, draft, bill of exchange, or other evidence of indebtedness upon which an insider may be liable as maker, drawer, endorser, guarantor, or surety;

(5) A discount of promissory notes, bills of exchange, conditional sales contracts, or similar paper, whether with or without recourse; but the acquisition of such paper by a member bank from another bank, without recourse, shall not be considered a discount by the member bank for the other bank;

(6) An increase of an existing indebtedness, but not if the additional funds are advanced by the bank for its own protection for (i) accrued interest or (ii) taxes, insurance, or other expenses incidental to the existing indebtedness;

(7) An advance of unearned salary or other unearned compensation for a period in excess of 30 days; and

(8) Any other similar transaction as a result of which a person becomes obligated to pay money (or its equivalent) to a bank, whether the obligation arises directly or indirectly, or because of an endorsement on an obligation or otherwise, or by any means whatsoever.

(b) An extension of credit does not include:

(1) An advance against accrued salary or other accrued compensation, or an advance for the payment of authorized travel or other expenses incurred or to be incurred on behalf of the bank;

(2) A receipt by a bank of a check deposited in or delivered to the bank in the usual course of business unless it results in the carrying of a cash item for or the granting of an overdraft (other than an inadvertent overdraft in a limited amount that is promptly repaid, as described in § 215.4(e) of this part);

(3) An acquisition of a note, draft, bill of exchange, or other evidence of indebtedness through (i) a merger or consolidation of banks or a similar transaction by which a bank acquires assets and assumes liabilities of another bank or similar organization or (ii) foreclosure on collateral or similar proceeding for the protection of the bank: *Provided*, That such indebtedness is not held for a period of more than three years from the date of the acquisition, subject to extension by the appropriate Federal banking agency for good cause;

(4)(i) An endorsement or guarantee for the protection of a bank of any loan or other asset previously acquired by the bank in good faith or (ii) any indebtedness to a bank for the purpose of protecting the bank against loss or of giving financial assistance to it; or

(5) Indebtedness of $5,000 or less arising by reason of any general arrangement by which a bank:

(i) Acquires charge or time credit accounts; or

(ii) Makes payments to or on behalf of participants in a bank credit card plan, check credit plan, interest bearing overdraft credit plan of the type specified in § 215.4(e) of this part, or similar open end credit plan: *Provided*:

(A) The indebtedness does not involve prior individual clearance or approval by the bank other than for the purposes of determining authority to participate in the arrangement and compliance with any dollar limit under the arrangement; and

(B) The indebtedness is incurred under terms that are not more favorable than those offered to the general public.

(c) Non-interest-bearing deposits to the credit of a bank are not considered loans, advances, or extensions of credit to the bank of deposit; nor is the giving of immediate credit to a bank upon uncollected items received in the ordinary course of business considered to be a loan, advance or extension of credit to the depositing bank.

(d) For purposes of § 215.4(b) and (c) of this part, an extension of credit by a member bank is considered to have been made at the time the bank enters into a binding commitment to make the extension of credit.

(e) A participation without recourse is considered to be an extension of credit by the participating bank, not by the originating bank.

(f) An extension of credit is considered made to a person covered by this part to the extent that the proceeds of the extension of credit are used for the tangible economic benefit of, or are transferred to, such a person.

[Sec. 215.3 as amended May 18, 1992, 57 FR 21199 (¶ 88,915); effective date revised May 28, 1992, 57 FR 22417.]

[¶ 32,004]

➠ For proposed amendment of § 215.4, providing an exception to the aggregate insider lending limit for the purchase of certain consumer installment paper which is identical to the exception for such paper for national banks, see 58 FR 47400, September 9, 1993 (¶ 89,542). Comments must be received by October 12, 1993. CCH.

§ 215.4 General prohibitions.

(a) *Terms and creditworthiness*. No member bank may extend credit to any of its executive officers, directors, or prinicipal shareholders or to any related interest of that person unless the extension of credit:

(1) Is made on substantially the same terms (including interest rates and collateral) as, and following credit underwriting procedures that are not less stringent than, those prevailing at the time for comparable transactions by the bank with other persons that are not covered by this part and who are not employed by the bank; and

(2) Does not involve more than the normal risk of repayment or present other unfavorable features.

(b) *Prior approval*. (1) No member bank may extend credit (which term includes granting a line of credit) to any of its executive officers, directors, or principal shareholders or to any related interest of that person in an amount that, when aggregated with the amount of all other extensions of credit to that person and to all related interests of that person, exceeds the higher of $25,000 or 5 percent of the member bank's unimpaired capital and unimpaired surplus, unless:

(i) The extension of credit has been approved in advance by a majority of the entire board of directors of that bank; and

(ii) The interested party has abstained from participating directly or indirectly in the voting.

(2) In no event may a member bank extend credit to any one of its executive officers, directors, or principal shareholders, or to any related interest of that person, in an amount that, when aggregated with all other extensions of credit to that person, and all related interests of that person, exceeds $500,000, except by complying with the requirements of this paragraph.

(3) Approval by the board of directors under paragraph (b)(1) of this section is not required for an extension of credit that is made pursuant to a line of credit that was approved under paragraph (b)(1) of this section within 14 months of the date of the extension of credit. The extension of credit must also be in compliance with the requirements of § 215.4(a) of this part.

(4) Participation in the discussion, or any attempt to influence the voting, by the board of directors regarding an extension of credit constitutes indirect participation in the voting by the board of directors on an extension of credit.

(c) *Lending limit.* No member bank may extend credit to any of its executive officers, directors, or principal shareholders or to any related interest of that person in an amount that, when aggregated with the amount of all other extensions of credit by the member bank to that person and to all related interests of that person, exceeds the lending limit of the member bank specified in § 215.2(h) of this part. This prohibition does not apply to an extension of credit by a member bank to a company of which the member bank is a subsidiary or to any other subsidiary of that company.

(d) *Aggregate lending limit—(1) General limit.* A member bank may not extend credit to any insider unless the extension of credit is in an amount that, when aggregated with the amount of all outstanding extensions of credit by that bank to all of its insiders, does not exceed the bank's unimpaired capital and unimpaired surplus (as defined in § 215.2(h) of this part).

(2) *Member banks with deposits of less than $100,000,000.* A member bank with deposits of less than $100,000,000 may by resolution of its board of directors increase the general limit specified in paragraph (d)(1) of this section for the 21-month period ending February 18, 1994, to a level not to exceed two times the bank's unimpaired capital and unimpaired surplus, if:

(i) The Board of directors determines that such higher limit is consistent with prudent, safe, and sound banking practices in light of the bank's experience in lending to its insiders and is necessary to attract or retain directors or to prevent restricting the availability of credit in small communities;

(ii) The resolution sets forth the facts and reasoning on which the board of directors bases the finding, including the amount of the bank's lending to its insiders as a percentage of the bank's unimpaired capital and unimpaired surplus as of the date of the resolution;

(iii) The bank has submitted the resolution to the appropriate Federal banking agency (as defined in 12 U.S.C. 1813(q)) with a copy to the Board of Governors; and

(iv) The bank meets or exceeds, on a fully-phased in basis, all applicable capital requirements established by the appropriate Federal banking agency.

(3) *Exceptions.* The general limit specified in paragraph (d)(1) of this section does not apply to the following:

(i) Extensions of credit secured by a perfected security interest in bonds, notes, certificates of indebtedness, or Treasury bills of the United States or in other such obligations fully guaranteed as to principal and interest by the United States;

(ii) Extensions of credit to or secured by unconditional takeout commitments or guarantees of any department, agency, bureau, board, commission or establishment of the United States or any corporation wholly owned directly or indirectly by the United States;

(iii) Extensions of credit secured by a perfected security interest in a segregated deposit account in the lending bank; or

(iv) The exceptions in this paragraph (d)(3) apply only to the amount of such extensions of credit that are secured in the manner described herein.

(e) *Overdrafts.* No member bank may pay an overdraft of an executive officer or director of the bank [3] on an account at the bank, unless the payment of funds is made in accordance with (1) a written, preauthorized, interest-bearing extension of credit plan that specifies a method of repayment or (2) a written, preauthorized transfer of funds from another account of the account holder at the bank. This prohibition does not apply to payment of inadvertent overdrafts on an account in an aggregate amount of $1,000 or less: *Provided,* (1) The account is not overdrawn for more than 5 business days, and (2) the member bank charges the executive officer or director the same fee charged any other customer of the bank in similar circumstances.

[Sec. 215.4 as amended October 20, 1983, 48 FR 42804 (¶ 99,725); May 18, 1992, 57 FR 21199 (¶ 88,915); effective date revised May 28, 1992, 57 FR 22417; May 3, 1993, 58 FR 26507 (¶ 89,423); May 18, 1993 (comment deadline: July 15, 1993), 58 FR 28492 (¶ 89,435); November 18, 1993, 58 FR 61803 (¶ 89,592).]

[3] This prohibition does not apply to the payment by a member bank of an overdraft of a principal shareholder of the member bank, unless the principal shareholder is also an executive officer or director. This prohibition also does not apply to the payment by a member bank of an overdraft of a related interest of an executive officer, director, or principal shareholder of the member bank.

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[¶ 32,005]

§ 215.5 Additional restrictions on loans to executive officers of member banks.

(a) No member bank may extend credit to any of its executive officers,[4] and no executive officer of a member bank shall borrow from or otherwise become indebted to the bank, except in the amounts, for the purposes, and upon the conditions specified in paragraphs (c) and (d) of this section.

(b) No member bank may extend credit in an aggregate amount greater than the amount permitted in paragraph (c)(3) of this section to a partnership in which one or more of the bank's executive officers are partners and, either individually or together, hold a majority interest. For the purposes of paragraph (c)(3) of this section, the total amount of credit extended by a member bank to such partnership is considered to be extended to each executive officer of the member bank who is a member of the partnership.

(c) A member bank is authorized to extend credit to any executive officer of the bank:

(1) In any amount to finance the education of the executive officer's children;

(2) In any amount to finance the purchase, construction, maintenance, or improvement of a residence of the executive officer, if the extension of credit is secured by a first lien on the residence and the residence is owned (or expected to be owned after the extension of credit) by the executive officer; and

(3) For any other purpose not specified in § 215.5(c)(1) and (2), if the aggregate amount of loans to that officer under this paragraph does not exceed at any one time the higher of 2.5 per cent of the bank's capital and unimpaired surplus or $25,000, but in no event more than $100,000.

(d) Any extension of credit by a member bank to any of its executive officers shall be:

(1) Promptly reported to the member bank's board of directors;

(2) In compliance with the requirements of § 215.4(a) of this part;

(3) Preceded by the submission of a detailed current financial statement of the executive officer; and

(4) Made subject to the condition in writing that the extension of credit will, at the option of the member bank, become due and payable at any time that the officer is indebted to any other bank or banks in an aggregate amount greater than the amount specified for a category of credit in paragraph (c) of this section.

[Sec. 215.5 as amended November 1, 1982, 47 FR 49342; October 20, 1983, 48 FR 42804 (¶ 99,725); May 18, 1992, 57 FR 21199 (¶ 88,915); effective date revised May 28, 1992, 57 FR 22417.]

[¶ 32,006]

§ 215.6 Prohibition on knowingly receiving unauthorized extension of credit.

No executive officer, director, or principal shareholder of a member bank shall knowingly receive (or knowingly permit any of that person's related interests to receive) from a member bank, directly or indirectly, any extension of credit not authorized under this part.

[Sec. 215.6 as added May 18, 1992, 57 FR 21199 (¶ 88,915); effective date revised May 28, 1992, 57 FR 22417.]

[¶ 32,007]

§ 215.7 Extensions of credit outstanding on March 10, 1979.

(a) Any extension of credit that was outstanding on March 10, 1979, and that would, if made on or after March 10, 1979, violate § 215.4(c) of this part, shall be reduced in amount by March 10, 1980, to be in compliance with the lending limit in § 215.4(c). Any renewal or extension of such an extension of credit on or after March 10, 1979, shall be made only on terms that will bring the extension of credit into compliance with the lending limit of § 215.4(c) by March 10, 1980. However, any extension of credit made before March 10, 1979, that bears a specific maturity date of March 10, 1980, or later, shall be repaid in accordance with its repayment schedule in existence on or before March 10, 1979.

(b) If a member bank is unable to bring all extensions of credit outstanding on March 10, 1979, into compliance as required by paragraph (a) of this section, the member bank shall promptly report that fact to the Comptroller of the Currency, in the case of a national bank, or to the appropriate Federal Reserve Bank, in the case of a State member bank, and explain the reasons why all the extensions of credit cannot be brought into compliance. The Comptroller or the Reserve Bank, as the case may be, is authorized, on the basis of good cause shown, to extend the March 10, 1980, date for compliance for any extension of credit for not more than two additional one-year periods.

[Sec. 215.7 as redesignated from Sec. 215.6, May 18, 1992, 57 FR 21199 (¶ 88,915); effective date revised May 28, 1992, 57 FR 22417.]

[¶ 32,008]

→ For proposed amendment of § 215.8, to modify the recordkeeping requirements to allow banks greater latitude in devising procedures to ensure compliance with Regulation O, see 58 FR 47400, September 9, 1993 (¶ 89,542). Comments must be received by October 12, 1993. CCH.

§ 215.8 Records of Member Banks.

Each member bank shall maintain records necessary for compliance with the requirements of this part. These records shall (a) identify all executive officers, directors, and principal shareholders of the member bank and the related interests of these persons and (b) specify the amount and terms of each extension of credit by the member bank to these persons and to their related interests. Each member bank shall request at least annually that each executive officer, director, or principal shareholder of the member bank identify the related interests of that person.

[The next page is 15,095-3.]

[4] Sections 215.5, 215.9 and 215.10 of this part implement section 22(g) of the Federal Reserve Act. For the purposes of those sections, an executive officer of a member bank does not include an executive officer of a bank holding company of which the member bank is a subsidiary or any other subsidiary of that bank holding company.

[Sec. 215.8 as redesignated from Sec. 215.7, May 18, 1992, 57 FR 21199 (¶ 88,915); effective date revised May 28, 1992, 57 FR 22417.]

[¶ 32,009]

§ 215.9 Reports by executive officers.

Each executive officer[5] of a member bank who becomes indebted to any other bank or banks in an aggregate amount greater than the amount specified for a category of credit in § 215.5(c) of this part, shall, within 10 days of the date the indebtedness reaches such a level, make a written report to the board of directors of the officer's bank. The report shall state the lender's name, the date and amount of each extension of credit, any security for it, and the purposes for which the proceeds have been or are to be used.

[Sec. 215.9 as amended October 20, 1983, 48 FR 42804 (¶ 99,725); as redesignated from Sec. 215.8, May 18, 1992, 57 FR 21199 (¶ 88,915); effective date revised May 28, 1992, 57 FR 22417.]

[¶ 32,010]

§ 215.10 Report on credit to executive officers.

Each member bank shall include with (but not as part of) each report of condition (and copy thereof) filed pursuant to 12 U.S.C. 1817(a)(3) a report of all extensions of credit made by the member bank to its executive officers[6] since the date of the bank's previous report of condition.

[Sec. 215.10 as amended October 23, 1973, 48 FR 42804 (¶ 99,725); as redesignated from Sec. 215.9, May 18, 1992, 57 FR 21199 (¶ 88,915); effective date revised May 28, 1992, 57 FR 22417.]

[¶ 32,011]

§ 215.11 Disclosure of credit from member banks to executive officers and principal shareholders.

(a) *Definitions.* For the purposes of this section, the following definitions apply:

(1) *"Principal shareholder* of a member bank" means any person[7] other than an insured bank, or a foreign bank as defined in 12 U.S.C. 3101(7)), that, directly or indirectly, owns, controls, or has power to vote more than 10 percent of any class of voting securities of the member bank. The term includes a person that controls a principal shareholder (e.g., a person that controls a bank holding company). Shares of a bank (including a foreign bank), bank holding company, or other company owned or controlled by a member of an individual's immediate family are presumed to be owned or controlled by the individual for the purposes of determining principal shareholder status.

(2) "*Related interest*" means: (i) Any company controlled by a person, or (ii) any political or campaign committee the funds or services of which will benefit a person or that is controlled by a person.

For the purpose of this section and Subpart B, a related interest does not include a bank or a foreign bank (as defined in 12 U.S.C. 3101(7)).

(b) *Public disclosure.* (1) Upon receipt of a written request from the public, a member bank shall make available the names of each of its executive officers[8] and each of its principal shareholders to whom, or to whose related interests, the member bank had outstanding as of the end of the latest previous quarter of the year, an extension of credit that, when aggregated with all other outstanding extensions of credit at such time from the member bank to such person and to all related interests of such person, equaled or exceeded 5 percent of the member bank's capital and unimpaired surplus of $500,000, whichever amount is less. No disclosure under this paragraph is required if the aggregate amount of all extensions of credit outstanding at such time from the member bank to the executive officer or principal shareholder of the member bank and to all related interests of such a person does not exceed $25,000.

(2) A member bank is not required to disclose the specific amounts of individual extensions of credit.

(c) *Maintaining records.* Each member bank shall maintain records of all requests for the information described in paragraph (b) of this section and the disposition of such requests. These records may be disposed of after two years from the date of the request.

[Sec. 215.11 as amended December 31, 1983, 48 FR 56943 (¶ 99,810); corrected January 24, 1984, 49 FR 2902; as redesignated from Sec. 215.10, May 18, 1992, 57 FR 21199 (¶ 88,915); effective date revised May 28, 1992, 57 FR 22417.]

[¶ 32,012]

§ 215.12 Reporting requirement for credit secured by certain bank stock.

Each executive officer or director of a member bank the shares of which are not publicly traded shall report annually to the board of directors of the member bank the outstanding amount of any credit that was extended to the executive officer or director and that is secured by shares of the member bank.

[Sec. 215.12 as added May 18, 1992, 57 FR 21199 (¶ 88,915); effective date revised May 28, 1992, 57 FR 22417.]

[¶ 32,013]

§ 215.13 Civil penalties.

Any member bank, or any officer, director, employee, agent, or other person participating in the conduct of the affairs of the bank, that violates any provision of this subpart (other than § 215.11) is subject to a civil penalties as specified in section 29 of the Federal Reserve Act (12 U.S.C. 504).

[5] [6] See footnote 4 to § 216.5(a).

[7] The term "stockholder of record" appearing in 12 U.S.C. 1972(2)(G) is synonymous with the term "person."

[8] For purposes of this section and Subpart B, an executive officer of a member bank does not include an executive officer of a bank holding company of which the member bank is a subsidiary or of any other subsidiary of that bank holding company unless the executive officer is also an executive officer of the member bank.

[Sec. 215.13 as redesignated from Sec. 215.11 and amended May 18, 1992, 57 FR 21199 (¶ 88,915); effective dated revised May 28, 1992, 57 FR 22417.]

[¶ 32,015]

APPENDIX—SECTION 5200 OF THE REVISED STATUTES TOTAL LOANS AND EXTENSIONS OF CREDIT

(a)(1) The total loans and extensions of credit by a national banking association to a person outstanding at one time and not fully secured, as determined in a manner consistent with paragraph (2) of this subsection, by collateral having a market value at least equal to the amount of the loan or extension of credit shall not exceed 15 per centum of the unimpaired capital and unimpaired surplus of the association.

(2) The total loans and extensions of credit by a national banking association to a person outstanding at one time and fully secured by readily marketable collateral having a market value, as determined by reliable and continuously available price quotations, at least equal to the amount of the funds outstanding shall not exceed 10 per centum of the unimpaired capital and unimpaired surplus of the association. This limitation shall be separate from and in addition to the limitations contained in paragraph (1) of this subsection.

DEFINITIONS

(b) For the purposes of this section—

(1) The term "loans and extensions of credit" shall include all direct or indirect advances of funds to a person made on the basis of any obligation of that person to repay the funds or repayable from specific property pledged by or on behalf of the person, and to the extent specified by the Comptroller of the Currency, such term shall also include any liability of a national banking association to advance funds to or on behalf of a person pursuant to a contractual commitment; and

(2) The term "person" shall include an individual, sole proprietorship, partnership, joint venture, association, trust, estate, business trust, corporation, sovereign government, or agency, instrumentality, or political subdivision thereof, or any similar entity or organization.

EXCEPTIONS

(c) The limitations contained in subsection (a) of this section shall be subject to the following exceptions:

(1) Loans or extensions of credit arising from the discount of commercial or business paper evidencing an obligation to the person negotiating it with recourse shall not be subject to any limitation based on capital and surplus.

(2) The purchase of bankers' acceptances of the kind described in section 372 of this title and issued

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by other banks shall not be subject to any limitation based on capital and surplus.

(3) Loans and extensions of credit secured by bills of lading, warehouse receipts, or similar documents transferring or securing title to readily marketable staples shall be subject to a limitation of 35 per centum of capital and surplus in addition to the general limitations if the market value of the staples securing each additional loan or extension of credit at all times equals or exceeds 115 per centum of the outstanding amount of such loan or extension of credit. The staples shall be fully covered by insurance whenever it is customary to insure such staples.

(4) Loans or extensions of credit secured by bonds, notes, certificates of indebtedness, or Treasury bills of the United States or by other such obligations fully guaranteed as to principal and interest by the United States shall not be subject to any limitation based on capital and surplus.

(5) Loans or extensions of credit to or secured by unconditional takeout commitments or guarantees of any department, agency, bureau, board, commission, or establishment of the United States or any corporation wholly owned directly or indirectly by the United States shall not be subject to any limitation based on capital and surplus.

(6) Loans or extensions of credit secured by a segregated deposit account in the lending bank shall not be subject to any limitation based on capital and surplus.

(7) Loans or extensions of credit to any financial institution or to any receiver, conservator, superintendent of banks, or other agent in charge of the business and property of such financial institution, when such loans or extensions of credit are approved by the Comptroller of the Currency, shall not be subject to any limitation based on capital and surplus.

(8)(A) Loans and extensions of credit arising from the discount of negotiable or non-negotiable installment consumer paper which carries a full recourse endorsement or unconditional guarantee by the person transferring the paper shall be subject under this section to a maximum limitation equal to 25 per centum of such capital and surplus, notwithstanding the collateral requirements set forth in subsection (a)(2) of this section.

(B) If the bank's files or the knowledge of its officers of the financial condition of each maker of such consumer paper is reasonably adequate, and an officer of the bank designated for that purpose by the board of directors of the bank certifies in writing that the bank is relying primarily upon the responsibility of each maker for payment of such loans or extensions of credit and not upon any full or partial recourse endorsement or guarantee by the transferor, the limitations of this section as to the loans or extensions of credit of each such maker shall be the sole applicable loan limitations.

(9)(A) Loans and extensions of credit secured by shipping documents or instruments transferring or securing title covering livestock or giving a lien on livestock when the market value of the livestock securing the obligation is not at any time less than 115 per centum of the face amount of the note covered, shall be subject under this section notwithstanding the collateral requirements set forth in subsection (a)(2) of this section, to a maximum limitation equal to 25 per centum of such capital and surplus.

(B) Loans and extensions of credit which arise from the discount by dealers in dairy cattle of paper given in payment for dairy cattle, which paper carries a full recourse endorsement or unconditional guarantee of the seller, and which are secured by the cattle being sold, shall be subject under this section, notwithstanding the collateral requirements set forth in paragraph (a)(2) of this section, to a limitation of 25 per centum of such capital and surplus.

(10) Loans or extensions of credit to the Student Loan Marketing Association shall not be subject to any limitation based on capital and surplus.

AUTHORITY OF COMPTROLLER OF THE CURRENCY

(d)(1) The Comptroller of the Currency may prescribe rules and regulations to administer and carry out the purposes of this section, including rules or regulations to define or further define terms used in this section and to establish limits or requirements other than those specified in this section for particular classes or categories of loans or extensions of credit.

(2) The Comptroller of the Currency also shall have authority to determine when a loan putatively made to a person shall for purposes of this section be attributed to another person.

SUBPART B—REPORTS ON INDEBTEDNESS OF EXECUTIVE OFFICERS AND PRINCIPAL SHAREHOLDERS TO CORRESPONDENT BANKS

[¶ 32,020]

§ 215.20 Authority, purpose, and scope.

(a) *Authority.* This subpart is issued pursuant to section 11(i) of the Federal Reserve Act (12 U.S.C. 248(i)) and 12 U.S.C. 1972(2)(F)(vi).

(b) *Purpose and scope.* This subpart implements the reporting requirements of Title VIII of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 (FIRA) (Pub. L. 95-630) as amended by the Garn-St Germain Depository Institutions Act of 1982 (Pub. L. 97-320), 12 U.S.C. 1972 (2)(g). Title VIII prohibits (1) preferential lending by a bank to executive officers, directors, and principal shareholders of another bank when there is a correspondent account relationship between the banks, and (2) the opening of a correspondent account relationship between banks where there is a preferential extension of credit by one of the banks to an executive officer, director, or principal shareholder of the other bank.

[Sec. 215.20 as amended December 31, 1983, 48 F.R. 56932 (¶ 99,810).]

[¶ 32,021]

§ 215.21 Definitions.

For the purposes of this subpart, the following definitions apply unless otherwise specified:

(a) "Bank" has the meaning given in 12 U.S.C. 1841(c), and includes a branch or agency of a foreign bank, or a commercial lending company controlled by a foreign bank or by a company that controls a foreign bank, where the branch or agency is maintained in a State of the United States or in the District of Columbia or the commercial lending company is organized under State law.

(b) "Company," "control of a company or bank," "executive officer," [10] "extension of credit," "immediate family," and "person" have the meanings provided in Subpart A.

(c) "Correspondent account" is an account that is maintained by a bank with another bank for the deposit or placement of funds. A correspondent account does not include:

(1) Time deposits at prevailing market rates, and

(2) An account maintained in the ordinary course of business solely for the purpose of effecting federal funds transactions at prevailing market rates or making Eurodollar placements at prevailing market rates.

(d) "Correspondent bank" means a bank that maintains one or more correspondent accounts for a member bank during a calendar year that in the aggregate exceed an average daily balance during that year of $100,000 or 0.5 per cent of such member bank's total deposits (as reported in its first consolidated report of condition during that calendar year), whichever amount is smaller.

(e) "Principal shareholder" and "related interest" have the meanings provided in § 215.10 of Subpart A.

[Sec. 215.21 as amended October 20, 1983, 48 F.R. 42804 (¶ 99,725).]

[¶ 32,022]

§ 215.22 Report by executive officers and principal shareholders.

(a) *Annual report*. If during any calendar year an executive officer or principal shareholder of a member bank or a related interest of such a person has outstanding an extension of credit from a correspondent bank of the member bank, the executive officer or principal shareholder shall, on or before January 31 of the following year, make a written report to the board of directors of the member bank.[11]

(b) *Contents of report*. The report required by this section shall include the following information:

(1) The maximum amount of indebtedness of the executive officer or principal shareholder and of each of that person's related interests to each of the member bank's correspondent banks during the calendar year;

(2) The amount of indebtedness of the executive officer or principal shareholder and of each of that person's related interests outstanding to each of the member bank's correspondent banks as of ten business days before the report required by this section is filed;[12] and

(3) A description of the terms and conditions (including the range of interest rates, the original amount and date, maturity date, payment terms, security, if any, and any other unusual terms or conditions) of each extension of credit included in the indebtedness reported under paragraph (b)(1) of this section.

(c) *Definitions*. For the purposes of this section:

(1) "Indebtedness" means an extension of credit, but does not include:

(i) Commercial paper, bonds, and debentures issued in the ordinary course of business; and

(ii) Consumer credit (as defined in 12 CFR 226.2(p)) in an aggregate amount of $5,000 or less from each of the member bank's correspondent banks, provided the indebtedness is incurred under terms that are not more favorable than those offered to the general public.

(2) "Maximum amount of indebtedness" means, at the option of the reporting person, either (i) the highest outstanding indebtedness during the calendar year for which the report is made, or (ii) the highest end of the month indebtedness outstanding during the calendar year for which the report is made.

(d) *Retention of reports at member banks*. The reports required by this section shall be retained at the member bank for a period of three years. The Reserve Bank or the Comptroller, as the case may be, may require these reports to be retained by the bank for an additional period of time. The reports filed under this section are not required by this regulation to be made available to the public and shall not be filed with the Reserve Bank or the Comptroller unless specifically requested.

(e) *Member bank's responsibility*. Each member bank shall advise each of its executive officers and each of its principal shareholders (to the extent known by the bank) of the reports required by this section and make available to each of these persons a list of the names and addresses of the member bank's correspondent banks.

[Sec. 215.22 as amended by October 20, 1983, 48 F. R. 42804 (¶ 99,725).]

[¶ 32,023]

§ 215.23 Disclosure of credit from correspondent banks to executive officers and principal shareholders.

(a) *Public disclosure*. (1) Upon receipt of a written request from the public, a member bank shall make available the names of each of its executive officers and each of its principal shareholders to whom, or to whose related interests, any correspondent bank of the member bank had outstanding, at any time during the previous calendar year, an extension of credit that, when aggregated with all other outstanding extensions of credit at such time from all correspondent banks of the member bank to such person and to all related interests of such person,

[10] For purposes of this section and Subpart B, executive officers of a member bank do not include an executive officer of a bank holding company of which the member bank is a subsidiary or of any other subsidiary of that bank holding company unless, of course, the executive officer is also an executive officer of the member bank.

[11] Persons reporting under this section are not required to include information on extensions of credit that are fully described in a report by a person they control or a person that controls them, provided they identify their relationships with such other person.

[12] If the amount of indebtedness outstanding to a correspondent bank ten days before the filing of the report is not available or cannot be readily ascertained, an estimate of the amount of indebtedness may be filed with the report, provided that the report is supplemented within the next 30 days with the actual amount of indebtedness.

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equaled or exceeded 5 percent of the member bank's capital and unimpaired surplus or $500,000, whichever amount is less. No disclosure under this paragraph is required if the aggregate amount of all extensions of credit outstanding from all correspondent banks of the member bank to the executive officer or principal shareholder of the member bank and to all related interests of such a person does not exceed $25,000 at any time during the previous calendar year.

(2) A member bank is not required to disclose the specific amounts of individual extensions of credit.

(b) *Maintaining records.* Each member bank shall maintain records of all requests for the information described in paragraph (a) of this section and the disposition of such requests. These records may be disposed of after two years from the date of the request.

[Sec. 215.23 as amended December 31, 1983, 48 F. R. 56934 (¶ 99,810).]

[The next page is 15,111.]

GAO's Attempt to Use LAMIS Database to Identify the Extent of Insider Lending at Failed Banks

When a bank fails, FDIC receives and services all of the bank's loans that are not sold to an acquirer or transferred to an outside loan servicer. Of the 286 banks that failed in 1990 or 1991, FDIC contracted out loans from 8 of the largest banks to 7 outside loan servicers. FDIC officials told us that they do not maintain automated data on individual loans that they are not servicing. However, for those loans that FDIC does retain, DOL maintains individual loan data on its LAMIS database. Thus, we could access only varying portions of each bank's loan portfolio. LAMIS was the only automated source available through which we could access significant portions of the loan portfolios of failed banks.

In preliminary meetings with senior DOL officials, we were told that LAMIS could provide us with data on the extent of lending to insiders for all loans maintained on LAMIS (i.e., all loans that were not sold or transferred to an outside servicer). Although LAMIS contains a broad range of data on the assets retained by FDIC, it does not contain a data field that identifies insider loans. However, DOL officials told us such data could be derived from LAMIS if we could provide DOL staff with a list of names and related interests for the insiders at a given bank. To do so, DOL would need to develop a computer program that would match borrowers listed on LAMIS with our list of insiders and their related interests.

To determine whether it was feasible to identify insider-related loans through LAMIS, we provided FDIC with an extensive list of insiders and their related interests from bank failures associated with the James Madison Limited holding company. This list had been developed for one of our prior reports on the Bank of New England and Madison failures.[1] To prepare for that report, we reviewed data developed by the Office of the Comptroller of the Currency (OCC), which indicated that loans to Madison insiders totaled $83 million (or 17 percent of all loans). We then attempted to match the names of the Madison's insiders and their related interests to the names on the LAMIS database for Madison. If the match program produced results that were generally in agreement with the OCC data, we felt we could be reasonably confident that the match had been effective.

[1]Bank Supervision: OCC's Supervision of the Bank of New England Was Not Timely or Forceful (GAO/GGD-91-128, Sept. 16, 1991).

Test Case of LAMIS Match Proves Problematic but Yields Some Encouraging Results

LAMIS contained the names of more than 8,000 Madison borrowers,[2] and our list contained the names of more than 500 insiders and their related interests. Given the extensive lending to Madison insiders described in our prior report, we anticipated the match would identify a significant number of insider-related loans. Unfortunately, the computer matching program developed by DOL staff did not identify any insider-related loans.

DOL staff told us that one of the principal difficulties they encountered was the inability of DOL's program to compensate for various derivations of names. For example, if LAMIS listed a borrower as Smith & Co. and our list identified the same organization as Smith and Company, the computer would not recognize this as a match and the loan would not be identified as insider-related. Still, given the extensive amount of lending to insiders that occurred and the large number of borrowers and known insiders, we believed it highly implausible that no two names were identical.

We requested and DOL agreed to provide computer tapes of the LAMIS data for Madison. We developed a computer program that identified a small number of loans to insiders in which the name on LAMIS and the name on our list were identical. Later, we realized this effort was inadequate given the extent of insider lending at Madison banks.

We next devised a computer program that matched names using only the first four characters of the borrower's name with the first four characters of the insider's name. Using the same example presented earlier, the name on our list (Smith and Company) would now match the name as it appears on LAMIS (Smith & Co.). However, the name would also match with every other "Smith" listed on LAMIS. The result of this program was a listing of nearly 1,200 potential matches, each needing manual review to determine whether it was, in fact, an insider-related loan.

To reduce the amount of manual review needed to identify loans that were insider-related, we eliminated all loans of less than $10,000 and ran the program again. Using this approach, we reduced the number of potential matches to 695. From these, we manually identified 153 matches. These matches were further reviewed to eliminate double counting of loans for which more than one insider had been listed as a borrower. In our final count, we identified 127 insider related loans involving amounts of $10,000 or more.

[2]This number represents the number of entries listed on the LAMIS "Borrower Query File" for Madison. It overstates the number of borrowers (i.e., borrowers, co-signers, and guarantors) because those involved with a number of loans are listed repeatedly.

Our analysis of these insider-related loans showed the aggregate loan amount to be $71 million dollars. This amount represented approximately 18 percent of the Madison loans of $10,000 or more listed on LAMIS. Because this percentage was in line with the level of insider lending activity identified by OCC shortly before Madison's failure, we believe our approach resulted in a reasonable estimate of the insider lending activity at Madison.

Finally, we ran an analysis of the insider-related loans to determine the extent to which these loans were nonperforming.[3] We found that 85 percent of insider loans and 83 percent of Madison's entire loan portfolio were nonperforming loans. Because we had not anticipated such a high percentage of nonperforming loans,[4] we asked DOL staff to review our approach and results to determine whether they found them reasonable. DOL staff had no concerns with our approach and said they reached a similar percentage of nonperforming loans when they tested data from Madison on LAMIS.

Applying the Match Program to a Large Number of Banks Is Impractical

Although we were generally satisfied that the results from the test match were a fair approximation of the extent of insider lending at Madison, we recognized that there were several impediments to applying this approach to a large number of failed banks. For example, developing a comprehensive list of insiders and their related interests involved a significant amount of work. Even when a bank maintained records on insiders and their related interests, it was difficult to determine whether the records were comprehensive. Often, we found numerous documents had to be reviewed to develop lists of insiders.

In addition, to effect the match, the names of all insiders and their identified related interests must be entered into an automated system. There is also programming time involved to generate the match for each bank, and more significantly, time is needed to manually review the potential matches from each bank to determine the actual number of loans made to bank insiders. Although we believe few banks would approach the extensive number of insiders and related interests found at Madison,

[3]In general, these were loans that were more than 90 days past due or for which the terms of the original loan agreement were renegotiated.

[4]Although we had not developed data specifically on nonperforming loans at Madison before it failed, we found that 43 percent (i.e., about half of what is now nonperforming) of Madison's loans were criticized by OCC as having a less than satisfactory likelihood of repayment.

the resources needed to develop insider databases for the nearly 300 failures in our universe of matches was prohibitive.

In addition to the resources involved, we were concerned about the accuracy and completeness of the data produced by the matches. Unlike Madison, where we had data on the extent of insider lending identified before the bank failed, we had no measure by which to gauge the success of these matches. Further, as we noted earlier in this section, the percentage of a bank's loan portfolio that is captured on LAMIS varies from bank to bank. This variation makes it impossible to obtain complete data on the extent of insider lending for all failed banks.

Given all these impediments and our concern about the accuracy of the results, we decided to expand the match to only nine other failed banks. These banks were selected on the basis of (1) an assessment by our regional office staff on the extent to which documents held by FDIC provided complete information on a bank's insiders and their related interests, (2) the number of borrowers listed on LAMIS for each bank, and (3) geographic distribution. The results from the matches for all 10 banks are provided in table IV.1.

Table IV.1: Insider Lending at 10 Failed Banks

Dollars in thousands

Bank	Percentage of bank's loans on LAMIS	Loan category	Borrowers		Insider loans as a percentage of all loans
			All	Insiders	
Everman National Bank of Forth Worth	30%	Performing	$ 1,005	$ 0	0%
		Nonperforming	11,628	0	0%
		Subtotal (active loans)	12,633	0	0%
		Nonperforming as a percentage of active loans	92%	0	
		Charge-offs	1,788	0	0%
		Total (all loans)	14,421	0	0%
		Charge-offs as a percentage of all loans	12%	0	
First National Bank of Desoto	65%	Performing	667	204	31%
		Nonperforming	10,372	65	1%
		Subtotal (active loans)	11,039	269	2%
		Nonperforming as a percentage of active loans	94%	24%	

(continued)

Dollars in thousands

Bank	Percentage of bank's loans on LAMIS	Loan category	Borrowers		Insider loans as a percentage of all loans
			All	Insiders	
		Charge-offs	1,617	0	0%
		Total (all loans)	12,656	269	2%
		Charge-offs as a percentage of all loans	13%	0%	
First National Bank of Kendale	37%	Performing	612	48	8%
		Nonperforming	6,900	560	8%
		Subtotal (active loans)	7,512	608	8%
		Nonperforming as a percentage of active loans	92%	92%	
		Charge-offs	1,031	47	5%
		Total (all loans)	8,543	655	8%
		Charge-offs as a percentage of all loans	12%	7%	
Pontchartrain State Bank	59%	Performing	6,117	0	0%
		Nonperforming	46,835	1,271	3%
		Subtotal (active loans)	52,952	1,271	2%
		Nonperforming as a percentage of active loans	88%	100%	
		Charge-offs	4,262	0	0%
		Total (all loans)	57,214	1,271	2%
		Charge-offs as a percentage of all loans	7%	0%	
Southcoast Bank Corporation	77%	Performing	1,601	0	0%
		Nonperforming	12,960	1,007	8%
		Subtotal (active loans)	14,561	1,007	7%
		Nonperforming as a percentage of active loans	89%	100%	
		Charge-offs	2,465	330	13%
		Total (all loans)	17,025	1,337	8%
		Charge-offs as a percentage of all loans	14%	25%	
Madison National Banks	76%	Performing	63,437	10,101	16%
		Nonperforming	318,177	56,897	18%
		Subtotal (active loans)	381,614	66,998	18%

(continued)

Dollars in thousands

Bank	Percentage of bank's loans on LAMIS	Loan category	Borrowers		Insider loans as a percentage of all loans
			All	Insiders	
		Nonperforming as a percentage of active loans	83%	85%	
		Charge-offs	22,956	4,013	17%
		Total (all loans)	404,570	71,011	18%
		Charge-offs as a percentage of all loans	6%	6%	
The Landmark Bank	89%	Performing	18,417	242	1%
		Nonperforming	147,629	14,523	10%
		Subtotal (active loans)	166,046	14,765	9%
		Nonperforming as a percentage of active loans	89%	98%	
		Charge-offs	23,284	2,618	11%
		Total (all loans)	189,330	17,383	9%
		Charge-offs as a percentage of all loans	12%	15%	
Enfield National Bank	87%	Performing	688	0	0%
		Nonperforming	14,464	250	2%
		Subtotal (active loans)	15,152	250	2%
		Nonperforming as a percentage of active loans	95%	100%	
		Charge-offs	726	34	5%
		Total (all loans)	5,878	284	2%
		Charge-offs as a percentage of all loans	5%	12%	
First Pacific Bank	83%	Performing	4,142	0	0%
		Nonperforming	53,054	632	1%
		Subtotal (active loans)	57,196	632	1%
		Nonperforming as a percentage of active loans	93%	100%	
		Charge-offs	6,925	0	0%
		Total (all loans)	64,121	632	1%
		Charge-offs as a percentage of all loans	11%	0%	
Citizens National Bank of Limon	43%	Performing	138	0	0%
		Nonperforming	2,124	0	0%

(continued)

Dollars in thousands

Bank	Percentage of bank's loans on LAMIS	Loan category	Borrowers		Insider loans as a percentage of all loans
			All	Insiders	
		Subtotal (active loans)	2,262	0	0%
		Nonperforming as a percentage of active loans	94%	0	
		Charge-offs	683	0	0%
		Total (all loans)	2,945	0	0%
		Charge-offs as a percentage of all loans	23%	0	

Note 1: These 10 banks were selected on the basis of (1) our assessment of the completeness of FDIC's records concerning insiders and their related interests for each bank, (2) the number of each bank's borrowers listed on LAMIS, and (3) geographic distribution.

Note 2: Performing loans are loans that are 97 days or less past due (a 7-day grace period has been added to the usual threshold of 90 days to allow for data entry lag time in the LAMIS system) and have not been renegotiated or charged-off.

Note 3: Nonperforming loans are loans that are more than 97 days past due or have been renegotiated.

Note 4: Charge-offs are loans that have been written off as uncollectible.

Source: GAO analysis of FDIC data.

State Laws and Regulations That Govern Insider Activities

In addition to Federal Reserve Regulation O, state laws and regulations govern insider activities for state-chartered banks. By surveying state banking laws and regulations governing insider activity, we found that the majority of states have banking laws comparable to Regulation O. However, some states have laws that are more stringent than Regulation O concerning the definition of insiders, preferential terms, lending limits, prior board of directors approval, and overdrafts.

We obtained information on state banking laws and regulations from almost all of the states through a survey we made with the cooperation of the Conference of State Bank Supervisors. We also conducted in-depth interviews with officials from state banking departments in 10 states to obtain information on the examination policies and procedures they used to detect insider activity. From these interviews, we found that a few state banking agencies consistently included a review for insider activity in their examinations of state-chartered banks. Two state banking agency officials told us they incorporate a review of insider activity on a periodic, or as-needed, basis. One state, Texas, has developed, implemented, and incorporated examination modules to specifically evaluate the effectiveness of bank management.

Some State Banking Laws Are More Stringent Than Regulation O

Regulation O places certain restrictions on loans to insiders that are applicable to all federally insured state banks. In addition, on the basis of responses we received from our survey of state banking agencies regarding the comparison of their banking laws and regulations to Regulation O, we found that 12 of the 50 states and territories that responded to our survey have state banking laws and regulations about insiders with some provisions that are more stringent than Regulation O. Prior board of directors approval and the overall lending limits were the two provisions that we most often found to be more stringent than the corresponding provisions outlined in Regulation O.

For example, Kansas banking law requires that any insider loans to bank officers resulting in total liability of the officer to the bank of over $10,000 receive prior approval from a bank's board of directors. Regulation O stipulates that any insider loans which when aggregated with all other extensions of credit to an insider exceed 5 percent of a bank's unimpaired capital and unimpaired surplus or $25,000, whichever is greater, must be approved in advance by the board of directors. In addition, Kansas appears to have more stringent provisions on lending limits to insiders with a

5-percent lending limit on loans to bank officers and employees.[1] In comparison, Regulation O sets the lending at 15 percent of a bank's capital on loans that are not fully secured and an additional 10 percent of loans that are fully secured. Hawaii's definition of insiders is more stringent than Regulation O because it also includes bank employees; agents; and any company, firm, partnership, or association in which the officers or directors have an indirect or direct interest. We found that other states also include various bank employees in their definition of insiders. For example, West Virginia considers a bank's assistant treasurer, assistant secretary, assistant cashier, and assistant comptroller to be bank officers subject to insider-related restrictions.

In one state that responded to our survey, various provisions of its banking laws are written broadly, but the implementation of the banking laws is stringent. On the basis of our survey and interview with the Virginia Banking Commissioner, we found that most of the state's banking laws about insiders are written to allow for the judgment and interpretation of the banking commissioner. For example, the Virginia banking provision on the aggregate lending on insider loans allows the commissioner to set the aggregate lending rate at an amount that is "not . . . excessive." In many cases, the commissioner has set the limit more stringently than that set by Regulation O.

State Bank Examinations Include a Review of Insider Activity

Similar to federal examinations of banks, state examinations of state-chartered banks also evaluate the financial safety and soundness of banks. According to state banking officials in several states where we conducted our interviews, the majority of the state examinations include a review to determine the extent of insider activity and how well that activity complied with federal and state banking laws. From our discussions with the officials, we noted that state bank examination procedures for insider activity focus mainly on loans to insiders. These provisions include reviews of loans for preferential terms; prior approval by boards of directors; and other insider-related activities, such as overdraft violations.

Some state banking agencies include a very detailed review for insider activity in every examination. According to officials in the Florida, Massachusetts, and North Carolina state banking agencies, a review for insider activity is included in every examination. Their examination procedures consist of the examination of the banks' loan portfolios for

[1]Percentages are of the bank's unimpaired capital and unimpaired surplus funds.

insider lending and the compliance of insider lending with applicable state and federal banking laws.

According to banking officials in two states, the scope of their examinations includes a review for directors and officers (D&O) liability insurance. Officials said that the review for D&O liability insurance includes a determination of whether banks have the insurance and how adequate the insurance coverage is. As we discussed in chapter 5, we also believe a review to determine the presence of D&O insurance could be very beneficial. As we found in our analysis of failed banks, 70 percent of the banks had either let their D&O insurance lapse before they failed or never had D&O insurance coverage.

A Few State Examination Programs Review the Effectiveness of Bank Management

Our review of failed and open banks revealed that insider problems are indicative of management problems in banks. According to officials in state banking departments, the effectiveness of bank management is important and plays a vital role in the overall financial health of banks. A few states have included in their bank examinations an additional module to independently evaluate bank management. Many officials we spoke with in the state banking departments believe an independent evaluation of bank management is important because it often provides information on aspects of banks' overall operation, financial performance, and condition. For example, officials in Minnesota's banking department evaluate bank management because they believe weak and ineffective management tends to be the single most significant reason for bank failures.

Because of their belief in the fundamental importance of management, officials in the Texas banking department implemented and incorporated into their bank examinations a management evaluation program that assesses the management of state-chartered banks. The Texas management evaluation program evaluates management's performance in five functional areas of bank operations: (1) lending and credit administration, (2) investments, (3) asset-liability and funds management, (4) audit and operations, and (5) planning and budgeting. Each area is reviewed and evaluated on the following five components: policies, procedures, internal controls, performance, and prospects. A numeric rating of 1 to 5, with 1 being excellent and 5 being totally unacceptable, is given to each functional area based on the review of the five components. An overall management rating is then derived on the basis of the relative rankings given each of the five functional areas. On the basis of the overall

management rating, appropriate comments are provided on the strengths, weaknesses, future plans, and recommendations for each of the five areas.

Texas officials told us they feel strongly that this program has reduced the number of bank failures due to managerial incompetence, director neglect, and insider abuse.

Training Opportunities for Bank Directors

We interviewed federal and state regulatory agencies and some bank trade associations to determine the various kinds of training available for bank directors. We found that some training opportunities are available for bank directors; however, much of the training available is geared more to bank managers than directors. Federal regulators have implemented some training for bank directors.

Federal and State Regulators Sponsor Some Training

Federal bank regulators do not have extensive training programs for bank directors. However, they do sponsor training programs on a periodic basis, participate in conferences, seminars, and other forums sponsored by other groups, including bank trade associations. For example, each of OCC's district offices is responsible for developing seminars and workshops for directors of banks in their vicinity. In another example, the Federal Reserve Bank of Philadelphia sponsors a seminar on regulatory compliance and holds annual meetings with all bankers in its district. Officials told us that many outside directors attend these training sessions.

FDIC, the Federal Reserve, and OCC provide to bank directors a handbook entitled the Pocket Guide for Directors: Guidelines for Financial Institution Directors. This publication was developed by FDIC and endorsed by the Federal Reserve, OCC, and the Federal Home Loan Bank Board. In addition, each federal regulator distributes its own publications to directors. OCC distributes The Director's Book: The Role of A National Bank Director. The Federal Reserve also distributes publications. For example, the Federal Reserve Bank of Atlanta has published guidance for directors called The New Bank Director's Primer: A Guide to Management Oversight and Bank Regulation for directors of newly chartered financial institutions. Each of these publications outlines the responsibilities of the board, highlights areas of concerns, and addresses in broad terms the duties and liabilities of individual directors.

State Regulatory Agency Efforts

Some state bank regulatory agencies we reviewed also sponsor training programs. Three of the 13 state banking departments we reviewed offer seminars, workshops, and discussion forums for bank directors. For example, the North Carolina and Ohio state banking departments have sponsored annual banking conferences for directors. The conferences sponsored by North Carolina included such topics as directors' duties and responsibilities, effective bank management, and proper board oversight.

Banking Trade Associations Sponsor Training Programs

The banking trade associations and other industry groups, such as the providers of directors and officers liability insurance and law firms, have provided training opportunities designed mainly for bank managers. More recently, however, those in the banking industry have provided some training specifically for bank directors. In addition, the trade associations also provide journals, informational pamphlets, and other written materials to directors to keep them informed and knowledgeable about various banking subjects.

Director Certificate Program

In October 1992, the American Association of Bank Directors (AABD) established an educational foundation to promote the professional development of bank and thrift directors. The foundation offers a director certificate training program through the completion of continuing education requirements. Directors who complete a 6-hour core education program and participate in an annual 6-hour supplemental educational program receive certificates from the foundation. AABD officials believe the certificate program will enhance directors' ability to fulfill their oversight responsibilities.

Comments From the Office of the Comptroller of the Currency

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

Comptroller of the Currency
Administrator of National Banks

Washington, D.C. 20219

February 2, 1994

Mr. James L. Bothwell
Director, Financial Institutions and Market Issues
General Government Division
United States General Accounting Office
Washington, DC 20548

Dear Mr. Bothwell:

We have reviewed your draft audit report titled **BANK INSIDER ACTIVITIES: Actions Needed to Address Significant Insider Problems Indicative of Broader Management Deficiencies.** Your review was conducted in response to Congressional requests that you review the role of insider activities in, and their effects on the health of, financial institutions. Your conclusions and recommendations are based on your review of 286 reports prepared by FDIC investigators on banks that failed in 1990 and 1991. Investigators reported evidence of insider problems in 61 percent of the failed banks. To determine if similar conditions exist in open banks, you reviewed examination reports for 13 judgmentally sampled open banks.

Based on your review of the sampled banks, you concluded that examiners were not as effective in identifying insider problems at the failed banks when they were open as investigators were after the banks had failed and that examiners often fail to adequately communicate to bank boards and management the potential seriousness of insider problems. The draft report recommends that examiners review the insider lending information provided in call reports at the next full-scope examination of each and every bank, that examiners give recordkeeping requirements high priority, and that examiners review insurance policies. With respect to examination reports, exit conferences and other communications with boards of directors, you recommend that examiners ensure that board members understand the primary issues in need of attention, that examiners ensure that board members understand that problems are a consequence of deficiencies in their oversight, and that effective correction action is taken. Finally, you urged that examiners recommend training for directors, where appropriate, to improve their ability to oversee management operations of banks.

The OCC takes seriously its responsibilities to examine for and enforce compliance with the laws and regulations governing insider activities of directors, officers and employees of national banks. In fact, the OCC has taken significant steps to enhance its ability to both combat insider violations and improve communications with bank boards of directors, including actions fully consistent with the recommendations in your report. The OCC, however, agrees with your overall conclusion that additional actions can be undertaken to identify and address insider problems.

The first recommendation in your report sought an increase in examiner review of bank insider activities. As is detailed more fully below, the OCC is in the process of revising its internal procedures for dealing with insider activities. These changes to the Comptroller's Handbook for National Bank Examiners (Handbook), the primary guide used by examiners in the conduct of examinations of national banks, will expand the tools available to examiners to review insider activities. Consistent with your recommendations, these procedures will provide for a comparison of bank-provided data with information reported by the bank in its most recent call report. Examination procedures and internal control questionnaires will ensure that examiners determine that bank reports are accurate and supportable. In addition, these new examination procedures will reemphasize the importance of proper recordkeeping and the need for examiners to focus on insider activity, especially as it relates to Regulation O compliance. The OCC will also reemphasize the importance of reviewing bank insurance coverage to determine whether insurers have identified any reasons to deny coverage or write exclusions into the policy.

The second series of recommendations in your report addresses communication with, and training of, bank boards of directors. The OCC fully concurs with your conclusion that improved communications between bank regulators and board members will increase the likelihood that boards will become more fully aware of their responsibilities and initiate appropriate corrective actions. The OCC has taken numerous steps consistent with that conclusion. In 1987, the OCC published The Director's Book. The Role of a National Bank Director to provide in-depth, practical guidance for meeting the duties and responsibilities of a national bank director. The next year, we published supplemental information through the issuance of A Director's Guide to Board Reports, Red Flags and Other Points of Interest. That publication assists board members in their review of information and identification of "red flags" indicating existing or potential problems, such as insider abuses.

OCC efforts also focus on the enhancement of examiner communication skills. Since 1988, the OCC revised or created at least four sections of the Handbook dealing expressly with communication with boards of directors. Among other things, the Handbook revisions provide examiner guidance on the general duties and responsibilities of directors, the assessment of management and board processes, examiner communication of examination findings, and examination procedures to test for compliance with Regulation O.

The OCC has also enhanced its examiner training efforts in this area. The OCC regularly provides training on conducting effective board meetings and recently added a three and one-half day course entitled "Communicating Effectively with Boards of Directors" to our standard training curriculum. Based, in part, on your recommendations, we may further revise the Handbook to provide additional

- 2 -

guidance on agency efforts to encourage and/or compel training for directors to improve their ability to oversee management operations.

See comment 1.

In your recommendations, you also noted that improved communications with boards of directors could be achieved through changes or enhancements to agency examination reports. In December 1993, the OCC revised significantly its report of examination format and emphasis. The purpose of those revisions was to improve communication of supervisory results to bank boards of directors. The revised report of examination is results-oriented and focuses on telling the board of directors what corrective action is needed and why. Two new pages were added to the report that will ensure findings are clearly and succinctly communicated to boards of directors in a manner that directs their attention to the most pressing concerns. An "Examination Conclusions and Comments" page summarizes the major examination findings and conclusions regarding the bank. A "Matters Requiring Board Attention" page presents significant problems identified during the examination and documents bank management's commitment to take appropriate actions. Information is presented in priority order, with the most important concerns, or areas of greatest risk, first.

We appreciate the opportunity to respond to the draft report. If you have questions regarding this letter, please contact me directly.

Sincerely,

Judith A. Walter
Senior Deputy Comptroller for Administration

- 3 -

The following is GAO's comment on the Comptroller of the Currency's letter dated February 2, 1994.

GAO Comment

1. After receiving OCC's comments we reviewed the new report of examination format. The format includes a page entitled Matters Requiring Board Attention, which describes the most significant problems identified during an examination. We agree that the addition of this information should help board members identify the most serious problems requiring correction. We believe, and OCC agrees, that the additional steps we have recommended are also necessary to improve communications between examiners and boards of directors.

Comments From the Federal Deposit Insurance Corporation

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

FDIC
Federal Deposit Insurance Corporation
Washington, DC 20429

Division of Supervision

December 9, 1993

James L. Bothwell, Director
Financial Institutions and Markets Issues
General Accounting Office
Washington, D.C. 20548

Dear Mr. Bothwell:

We have received the advance draft report prepared by your office, dated November 1993 and titled "BANK INSIDER ACTIVITIES: Actions Needed to Address Significant Insider Problems Indicative of Broader Management Deficiencies." We appreciate the opportunity to review the advance draft and offer comments.

While the Federal Deposit Insurance Corporation ("FDIC") generally takes no exception to the findings and conclusions embodied in the draft report, there are a number of areas which we may be able to clarify and/or amplify.

See comment 1.

In order to balance the report, it may be beneficial to note that loans to and transactions with bank insiders are not inherently problematic. On the contrary, a bank directorate is often composed of the most reputable and creditworthy individuals in the community. Loans necessitated by insiders' business operations are in many instances among a bank's better assets.

See comment 2.

Since the GAO study was performed, the FDIC has promulgated Part 363 of the FDIC Rules and Regulations, 12 C.F.R. § 363, "Annual Independent Audits and Reporting Requirements," implementing section 112 of the FDIC Improvement Act. This regulation specifically names insider lending as one area of safety and soundness law on which bank management must prepare an annual assessment of the degree of compliance achieved. These management assertions must be attested to by an independent public accountant, applying procedures agreed upon by the FDIC objectively and in accordance with generally accepted standards for attestation engagements. This is a major development, and should result in increased scrutiny of insider transactions.

James L. Bothwell -2-

The FDIC has developed examination policies which call for a thorough review of insider transactions and identification of "red flags" signaling potential fraud and abuse. We have enclosed excerpts from the Division of Supervision's Manual of Examination Policies for your convenience. Even in those rare instances where the limited scope of a particular supervisory activity does not include a documented review of insider dealings, FDIC examiners are keenly aware of these indicators and alert for any signs of inappropriate activity. The recommendations contained in the executive summary of the draft report relating to a comparison of bank-provided data to Call Report information, review of bank insurance policies and a review of Regulation O recordkeeping requirements are already standard procedures for FDIC examinations.

See comment 3.

Our policies address communication of examination findings to bank management based on the perceived level of problems at the institution. Examinations of problem banks are normally concluded by a meeting with the institution's board of directors, with a representative of the FDIC's regional office present. Every effort is made at these meetings to ensure that all board members understand the problems facing the institution, the issues which need to be addressed, and the consequences of inaction. The examiner's comments and conclusions are further presented in order of importance on the first pages of an FDIC Report of Examination, which is transmitted to the bank's board. In addition, the FDIC typically sends individual letters to each director of emerging problem banks highlighting the need for corrective action and active involvement in bank affairs.

See comment 4.

As would be expected, post-closing investigations of failed banks frequently uncover more potential insider problems at closed banks than were identified by pre-closing examination activities. There are a number of factors at play. First, investigators preparing post-closing reports have the benefit of the information developed by examination teams and can build upon that data. Second, while an attempt is made to filter out insignificant matters and areas where the likelihood of proving a claim appears remote, post-closing reports are drafted with an eye towards identifying all matters worthy of further investigation. Where insider abuse or criminal misconduct may be involved there is a tendency to include even remote possibilities. Such reports are not typically reviewed in advance by attorneys responsible for litigating professional liability claims and do not constitute a final conclusion that misconduct has actually occurred. Conversely, apparent violations are not included in examination reports based on speculation. Apparent violations are cited with extreme care, as the erroneous designation of a violation could tend to discredit the report of examination. A recitation of the facts upon which

See comment 5.

James L. Bothwell -3-

the conclusion is based provides a documented basis for the citation.

See comment 6.

The draft report explores the enforcement actions taken against failed banks with identified insider problems and notes that despite such enforcement actions and the citation of multiple and repeated violations the banks still failed. The unfortunate fact of life is that once loan proceeds have been disbursed, if there is genuinely no source of repayment or additional bank capital, no degree of enforcement action will succeed in salvaging a problem loan or a dying institution. There is frequently no means of correcting certain insider violations once the cash has left the bank, and the mere correction of violations will generally not be sufficient to save the bank. Frequently, the most that can be done is to institute steps to ensure that no new problems emerge.

It is pointed out that small banks tend to be cited more frequently for insider violations than large banks. In addition to the possible causative factors listed for this in the draft report, it should be noted that small banks are more easily controlled by one individual or a small group of individuals. Such domination, while not necessarily detrimental, may eliminate some of the checks and balances inherent where the organizational power-base is diversified.

See comment 7.

Although the GAO was unable to satisfactorily utilize the LAMIS data base to identify the aggregate amount of insider lending at failed banks, there is some question as to the analysis value of the information being sought. The insider credits still being serviced by the FDIC do not represent the universe of insider loans generated by the failed banks. A more enlightening statistic might be the level of insider debt which was on the banks' books at the time of failure, with this data presented in a meaningful relationship to other data (such as a percentage of total loans, total assets, etc.) This information is typically available from FDIC examination reports (particularly on problem institutions) and may be readily available from the other federal banking agencies where the FDIC is not the primary federal regulator.

Some page-specific comments follow:

Now on p. 2.

Page	Comment
3	The first paragraph should note that Regulation O also requires prior board approval.
	In last paragraph, you may want to parenthetically indicate that performing insider loans at reduced rates

James L. Bothwell -4-

may affect the health of a bank by virtue of foregone income.

Now on p. 3. See comment 8.

4 In second sentence - examinations "almost always" include a review of insider activities is more accurate than use of the word "often."

Now on p. 16.

21 May want to mention that FDICIA also places prohibitions on excessive compensation.

Now on p. 16.

22 The Section 23A definition of affiliates is somewhat misrepresented. Affiliates are companies which control a bank or any other company controlled by the company that controls the bank. Company is defined to include a corporation, partnership, business trust, association or similar organization. As a general rule, subsidiaries of a bank are excluded.

Now on p. 20.

28 The OCC supervises Citibank, N.A. which is a subsidiary of Citicorp, a multibank holding company.

Now on p. 23.

32 A Memorandum of Understanding is entered into with a bank's board of directors, not its officers.

Examples of supervisory concerns typically addressed by formal actions should probably include "increasing capital and maintaining adequate reserves" in addition to "discontinuing abusive lending practices or strengthening underwriting policies."

Examples of possible formal actions should also include Termination of Insurance proceedings, Capital Directives and actions taken pursuant to Prompt Corrective Action laws and regulations.

Now on p. 22.

33 Not all states may require directors to take an oath of office.

Now on p. 38.

51-52 The term "criminal referrals" should probably be clarified to avoid confusion on the part of readers unfamiliar with the process.

Now on p. 39.

58 The first two sentences appear to draw inconsistent conclusions.

Now on p. 45.

68 Citation in second paragraph should be sections 22(g) and 22(h).

Now on p. 47.

70-71 It should be mentioned that the FDIC works closely with state bank supervisors and will not normally duplicate

James L. Bothwell -5-

enforcement actions taken by state authorities.

Now on p. 49.

74 Where there is value available in a post-closing claim, the FDIC tends to have a bias towards claims which flow to the receivership, rather than a civil money penalty which goes to the U.S. Treasury.

Now on p. 54.
See comment 9.

83 Examiners do not have a reluctance to be critical of bank management and boards; however, any criticism must be appropriately documented and fully justified. Post-closing reports and Reports of Examination are prepared for different purposes and audiences. See comments above.

Now on p. 59.
See comment 10.

92-93 The report slightly misstates the situation when it says that "in most cases, investigators do not treat insider loans differently than loans to others." Rather, in looking for professional liability claims, while the FDIC does not normally find it useful to determine the universe of insider transactions, abusive insider transactions that produce substantial losses tend to yield strong claims, since they normally involve violations of directors' "duty of loyalty" as well as the "duty of care." Page 93 of the report states a somewhat different conclusion.

Now on p. 62.

97 Accuracy in Call Report data is required under 12 U.S.C. § 1817.

Now on p. 68.
See comment 11.

105 While examiners may generally accept the veracity of the information provided by the bank when assessing insider activities, they are constantly on the alert for unreported interests while working the bank's loan files and other records.

Now on p. 71.

111 Same comment as for page 97.

Now on p. 71.
See comment 12.

115 Review of fidelity coverage is a standard FDIC examination procedure, which is documented on page A of each Report of Examination and on the Summary Analysis of Examination Reports page. It should be noted that the financial information that causes a bank to be assigned a CAMEL rating of 4 or 5 will often cause insurers to refuse to provide coverage without any special insight on the insurer's part concerning bank management. Lack of fidelity coverage is frequently a result of regulator-identified problems, not a leading indicator of such problems.

Now on p. 79.
See comment 13.

126 An additional factor in passive board oversight may be

James L. Bothwell -6-

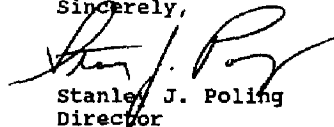
the natural human tendency to rely upon the "experts" - management officials who are paid to know about banking. To do otherwise may require real effort on the part of a director who may be receiving only limited compensation for serving on the board.

Now on p. 112.

175 In second paragraph, "under $10,000" should be "over $10,000."

I hope the above commentary is helpful. Please let me know if we may be of further assistance.

Sincerely,



Stanley J. Poling
Director

Enclosures

FDIC
Federal Deposit Insurance Corporation
Washington, DC 20429 Division of Supervision

December 23, 1993

James L. Bothwell, Director
Financial Institutions and Markets Issues
General Accounting Office
Washington, D.C. 20548

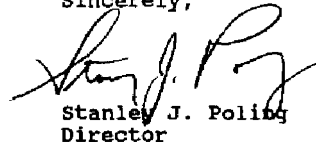
Dear Mr. Bothwell:

We would like to take this opportunity to supplement our December 9, 1993 comments regarding the November 1993 advance draft report prepared by your office, titled "BANK INSIDER ACTIVITIES: Actions Needed to Address Significant Insider Problems Indicative of Broader Management Deficiencies."

I think it is safe to say that the Federal Deposit Insurance Corporation, more than any other agency, is keenly aware of the potential ill effects bank insider activities may pose to financial institutions. It is for this reason many of our examination procedures and policies are targeted toward the identification of potential problems in this area. As indicated in our previous correspondence, the FDIC is in general agreement with the findings embodied in the draft report. Once your report has been finalized, it is our intention to provide copies to our field staff. This will afford us an opportunity to highlight the General Accounting Office's recommendations and reemphasize the importance of a thorough analysis of insider activities, effective communication with boards of directors, and adherence to established policies and procedures.

We look forward to receiving your final product. Please let me know if we may be of further assistance.

Sincerely,



Stanley J. Poling
Director

The following are GAO's comments on FDIC's letters dated December 9, 1993, and December 23, 1993.

GAO Comments

We address FDIC's substantive comments on the following pages. FDIC also included technical comments in their response letter. We have made suggested changes where appropriate. We have also responded to selected technical comments where appropriate.

1. We agree that an insider transaction, conducted in accordance with applicable laws and regulations, is a perfectly reasonable banking practice. We acknowledge this in chapter 1. (See p. 14.)

2. We agree that Part 363 of the FDIC Rules and Regulations, 12 C.F.R. 363, "Annual Independent Audits and Reporting Requirements," which implements section 112 of the FDIC Improvement Act, may result in increased scrutiny of insider transactions by federal regulators. This provision requires management of banks to prepare an annual assessment of the degree of compliance with safety and soundness regulations, including those related to insider activities. We agree that this assessment may be useful to examiners in reviewing such activities. However, this assessment will not fundamentally change the way in which examiners do their work. The effectiveness of this regulation depends on the accuracy of management's assessment. It also depends on the examiners' increased scrutiny of insider transactions and their effectiveness in getting management and bank boards to make necessary changes to correct identified deficiencies in this area. Our recommendations were designed to accomplish these objectives.

3. While FDIC's examination policies call for a thorough review of insider transactions and the identification of "red flags" signaling potential fraud and abuse, on the basis of our review of open bank examinations we noted instances in which a separate review of insider transactions was not part of the scope of an examination. In some of these cases, selected insider loans were only reviewed as part of the overall review of the loan portfolio. Though FDIC states that a review of Regulation O recordkeeping requirements is standard procedure for FDIC examinations, as we discuss in chapter 5, we found instances where examiners did not cite banks for recordkeeping violations even though violations were apparent. FDIC also states that a review of a bank's directors and officers liability insurance policy is also standard practice. However, we found only a few instances where FDIC verified the presence of a bank's directors and officers liability

insurance policy and no evidence that any analysis of the policy had been done.

4. In our analysis of failed banks we did not find it to be a common practice for FDIC to send individual letters to directors of banks highlighting the need for corrective action. In addition, from our review of open banks and from our interviews with the examiners-in-charge of these banks, we found that FDIC examination procedures conclude with the FDIC examiners meeting with bank management and the board of directors. Examination findings are presented and discussed at this meeting. However, the directors of our focus groups told us that the examiners' presentation of examination findings was not informative, leaving the board with the sense, in some instances, that corrective actions were not warranted. (See ch. 6.)

5. We agree, as outlined in our report, that post-closing reports frequently uncover potential insider problems at closed banks, more so than routine bank examinations. We also agree that investigators have the benefit of information developed by examination teams as well as the availability of information from other sources. While there may be a tendency for investigators to include instances of insider problems more frequently in their post-closing reports, the basic finding that insider problems contributed to a bank's failure seldom change. While conducting our audit, we reviewed a statistically valid sample of FDIC status reports, which are completed quarterly to update the investigators' findings. We did this in anticipation of some potential concerns of agency officials about the accuracy of investigator findings in post-closing reports. We found that the initial findings of insider abuse, insider fraud, and loan losses to insiders as identified by the investigators had not changed and were still considered to be contributing factors toward the failure of the banks.

6. As we noted in chapter 2, regardless of the actions that were taken, regulators may have been able to take stronger enforcement actions, considering that 72 percent of the banks had repeated insider violations. By taking stronger enforcement actions sooner, regulators may have been able to reduce the number of banks in which repeated insider problems led to failure.

7. We acknowledge that the insider credits being serviced by FDIC on its LAMIS database do not represent the universe of insider debt at any given bank. Because of the limitations of the LAMIS database, we attempted to use it to identify some minimum amount of insider lending. However, as

explained in chapter 4, we were unable to do so. In our work on this report and our other work in bank supervision, we found that the information available on the level of insider debt varied from bank to bank depending on the quality of the bank's recordkeeping system for insider transactions.

8. We did not find in our review of federal regulators' examination reports that examiners "almost always" reviewed insider activities. On the basis of our analysis, we believe a review of insider activities was done most often when it was brought to the attention of the examiner by other sources.

9. On the basis of our analysis of failed bank enforcement actions (see ch. 2) and our prior work on bank supervision,[1] we believe bank examiners have, at times, been reluctant to be critical of bank management, particularly in cases where bank management assures examiners that deficiencies would be corrected.

10. On the basis of our review of post-closing reports and conversations with FDIC and DOL staff, we believe the language in the report accurately portrays that FDIC does not usually establish the extent of insider lending when pursuing a liability claim.

11. While examiners may be on the alert for insider problems, we believe they could take additional steps that would help them identify these problems. (See ch. 5.)

12. We are not suggesting that the absence of directors and officers liability insurance is a leading indicator of problems at banks. Nonetheless, we believe a review for the presence of such insurance and an analysis of any exclusions under the policy may be a useful additional tool for examiners in some situations. We found only a few instances where FDIC examiners had determined the presence of directors and officers liability insurance and the adequacy of coverage. In addition, we found no evidence that any analysis of the policy had been done.

13. We agree that it may be a natural human tendency for some directors to rely upon bank management for information concerning their banks. However, this only reinforces the need for examiners to emphasize to directors their responsibilities in ensuring that identified deficiencies are corrected.

[1]See for example, Bank Supervision: Prompt and Forceful Regulatory Actions Needed (GAO/GGD-91-69, Apr. 15, 1991).

Comments From the Federal Reserve System

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D.C. 20551

DIVISION OF BANKING
SUPERVISION AND REGULATION

December 28, 1993

Mr. James L. Bothwell, Director
Financial Institutions and Markets Issues
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Bothwell:

Thank you for the opportunity to comment on the GAO's draft report (Report) regarding insider activities at federally regulated financial institutions and the effect that insider activities have on the health of these institutions. The report addresses, among other things, the nature of insider problems, including insider fraud and abuse, and the role that federal regulators have played in identifying and supervising insider activities of banks. The Report also contains recommendations that outline steps examiners can take to enhance their oversight of insider issues.

While the Federal Reserve has reservations regarding some of the conclusions presented in the Report, we certainly agree with the general premise of the Report that insider transactions, and problems attendant thereto, are an important aspect that should continue to be addressed by bank regulators in a full and thorough fashion. We also agree with the fundamental finding that the failure of bank management to correct insider violations and deficiencies can be indicative of a much broader problem of poor management and inadequate oversight by bank directors.

Based primarily on the post-closing analyses conducted by FDIC investigators of the 286 bank failures that occurred during 1990 and 1991, the Report suggests that insider problems were excessive at these failed banks, and concludes that this link evidences a strong correlation between insider problems and bank failures. The Report's statistical analysis centers on 175 failed banks, the number of banks out of the 286 bank failures in 1990 and 1991 that were determined by the FDIC investigators to have had insider problems that were contributing factors in their failure. Within that universe of 175, a sub-category consisting of 74 banks was created, all having as a common thread, the determination by the FDIC investigators that insider problems were one of the major factors in their failure.

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If the FDIC's post-closing analyses regarding the frequency and impact of insider problems on bank failures is reasonably accurate, these statistics would seem to suggest that insider problems are quite prevalent, contributing to 61 percent of the bank failures during the 1990-1991 period, and in 26 percent of the failures, serving as one of the major causes of failure. However, the GAO, because the appropriate records do not exist, was unable to reach conclusions on two important objectives the GAO had established for its study. These objectives were to determine (1) the amount of credit extended to insiders at the failed banks reviewed, and (2) the cost to the FDIC Bank Insurance Fund directly related to insider problems at the failed banks reviewed. By failing to determine the amounts and, therefore, the materiality of these two important objectives, the Report is unable to demonstrate adequately a significant correlation between the high incidences of insider problems and the subsequent failure of the banks reviewed, nor are there any findings as to the correlation of insider problems and losses incurred by the FDIC Bank Insurance Fund. Although we agree that insider transactions have likely occurred at a large number of failed institutions, we are unable to agree that the statistical findings regarding insider problems are as meaningful as that suggested in the Report. This belief is based on what is in the Report and on what has been the Federal Reserve's experience with the small number of failed banks under our jurisdiction.

See comment 1.

Moreover, it is not possible to ascertain from the Report many material facts concerning each of the failed banks reviewed, including, among others, the dollar amount of the insider transactions in question, the materiality of the transactions, the legality of the transactions, and the loss, if any, attributable to the particular insider transactions or violations. Also, the scope of the definition of insider problems relied upon by the GAO is so broad as to capture some transactions that are normally not viewed as abusive.

See comment 2.

The statistics that are presented in the Report, together with the lack of documentation to demonstrate a causal relationship between insider misdeeds and costs to the FDIC, might convey a misleading impression. Likewise, they could suggest that more strict controls are required to address insider activities. We would like to comment on these points.

See comment 3.

First, the following may help to better quantify the degree of insider lending that exists, compared to that suggested in the Report. Aggregate insider lending to officers, shareholders, and directors of the nation's 11,800 banks as reported on the June 30, 1993 Call Report was $28 billion, or

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approximately 0.73 percent of total banking assets. On this same date, only 43 of the 11,800 banks reported aggregate loans to insiders greater than 100 percent of their equity capital.

Also, lending to directors, officers and shareholders is an acceptable and permissible banking practice that can be conducted within the lending limitations, reporting requirements and preferential lending prohibitions of Regulation O. As stated in the Report, one of the primary purposes of Regulation O is to ensure that insider lending receives adequate regulatory scrutiny, and we submit that it does. Regulations and examination practices should not unduly restrict a bank's ability to service the legitimate credit needs of insiders. Most are creditworthy business leaders in their respective communities, and many in turn are relied upon and entrusted to be directors of our financial institutions. It is in this context that the regulators strive to establish safe and sound supervisory practices and procedures that allow banks to make extensions of credit to insiders that pose minimal risk of loss. To this end, the Federal Reserve's monitoring of insider transactions is founded on a principle of safe and sound banking practices, and not on the belief that the volume of insider transactions within the commercial banking system is so pervasive as to be a principal cause of bank failures.

See comment 4.

The Report also states that insider problems seem to be more prevalent in banks with assets of less than $100 million, particularly in regards to violations of the insider lending limitations. We think it important to note that this segment of the banking industry has long advocated a relaxation of the lending restrictions of Regulation O, in that it causes the smaller banks in many instances to turn away high quality insider loans. Also, small banks express difficulties in attracting competent and qualified directors because of the insider lending limits that are imposed by Regulation O. The Federal Reserve has recently sought comments on whether it should retain, modify or terminate the small-bank aggregate lending limit provision of Regulation O. The Board will be fully apprised of the findings, conclusions and recommendations of the Report when this matter is deliberated.

See comment 5.

Based on the GAO's assessment of both the underlying causes of insider problems and of the examination practices of the banking agencies, the Report makes two broad recommendations that outline steps the bank regulators can take to enhance their oversight of insider activities. We embrace the elements of these recommendations, most of which are based on safe and sound banking principles. However, I would point out that many of the specific steps recommended in the Report have long been utilized by the Federal Reserve in its existing examination program, and

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that the Federal Reserve is already spending considerable time and effort at each examination to review bank compliance with Regulation O and Sections 23A and 23B of the Federal Reserve Act.

The Report first recommends that bank regulators include a thorough review of insider activities in their next examination of each bank under their review, including placing a greater emphasis on ensuring that banks have appropriate reporting systems in place to detect insider abuses and violations. We concur that the Federal Reserve should continue to emphasize the importance of verifying the accurate and timely reporting of insider transactions; and, as noted previously, many steps are currently being taken by Federal Reserve examiners to address this point. A full scope Federal Reserve examination includes a review of all applicable banking laws and regulations, specifically Regulation O and Sections 23A and 23B of the Federal Reserve Act. A list of all bank insiders, their related interests, and the amount of credit extended to them is regularly requested. This information then provides verification for the reports required by Regulation O. We also conduct off-site surveillance based on quarterly Call Reports, which allows for a measurement of the volume of insider lending reported for each bank we supervise.

See comment 6.

The Report also concludes that examiners do not always effectively communicate to bank management and the boards of directors the importance and ramifications of insider violations and problems, and that these types of problems are normally indicative of much broader managerial problems and a lack of director oversight. We agree that effective communication to directors on issues of insider violations and problems is key to resolving these issues. For a number of years, Federal Reserve examiners have conducted meetings with bank management and boards of directors after an examination, and a copy of the examination findings is provided. Moreover, in 1986, we strengthened this policy and established specific guidelines for follow-up meetings with boards, especially those banks in less than satisfactory condition. Also introduced at that time were requirements that a written summary of examination findings be distributed to each director. This practice was favorably acknowledged in the Report. Senior Reserve Bank officials are also required to be present when examination findings assess the condition of the bank as being unsatisfactory or, when management and the directorate are required to address issues of a serious nature, including material violations of law. This is done to ensure that the directors of a bank clearly understand the nature and the seriousness of the organization's problems and their responsibility to correct them.

See comment 7.

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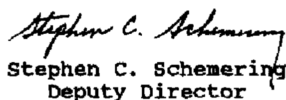
We believe the Federal Reserve's examination program has been effective in monitoring insider transactions and placing the appropriate emphasis on the correction of insider violations and deficiencies. We will continue, as we have in the past, to be attentive to insider transactions, consistent with the procedures recommended in the Report.

Sincerely,



Stephen C. Schemering
Deputy Director

The following are GAO's comments on the Federal Reserve System's letter dated December 28, 1993.

GAO Comments

1. The Federal Reserve believes that our inability to quantify the specific amount of insider lending and losses calls into question our conclusion that insider problems are a significant contributing factor to bank failures. As discussed in chapter 4, it is not possible and we do not believe it is necessary to demonstrate exact dollar losses due to insider problems to say that insider problems were significant. Twenty-six percent of the banks we reviewed failed because insider fraud, insider abuse, or loan losses to insiders was a major factor contributing to the failures. In some cases, it was the only factor that caused failure. The banks in this 26 percent cost the BIF an estimated $1.8 billion. We do not believe losses of this magnitude are insignificant.

2. Throughout the report we used the term insider problems to refer specifically to insider fraud, insider abuse, and loan losses to insiders. We characterized other problems, such as poor and/or negligent management, as management problems. Our finding that insider problems were a major contributing factor to 26 percent of the banks that failed in 1990 and 1991 is independent of the fact that these banks may also have had management problems. The Federal Reserve is incorrectly asserting that we are using the term insider problems to include all of the problems we identified in failed banks. The specific definitions we used for insider problems and management problems were consistent with those used by FDIC in its investigation of failed banks and with OCC's report on bank failures (see fn. 2 in report, p. 85).

3. As we discuss in chapter 4, we believe some banks may be underreporting insider transactions. We identified many recordkeeping violations and many instances in which it was not possible to identify insider transactions. Even so, while $28 billion as a percentage of all bank assets may be small, this amount is not insignificant.

4. We acknowledge (see p. 14) that insider transactions conducted in accordance with applicable laws and regulations, are a perfectly reasonable banking practice. We also agree that the intent of monitoring insider transactions is to help ensure safe and sound banking practices. We believe our finding that insider problems were a major contributing factor in 26 percent of the banks that failed in 1990 and 1991 clearly

demonstrates that insider problems pose a major safety and soundness issue for the banking industry.

5. We believe it is very important to maintain Regulation O rules on insider lending limits. Violation of individual lending limits was the single most common Regulation O violation in our review of failed banks. The argument that small banks have difficulty attracting directors because of insider lending limits does not appear to be consistent with our information. As we point out on page 19, only 54 banks had notified the Federal Reserve that they were taking advantage of the small bank exception to the aggregate lending limits. This exception is available to the 8,484 banks with deposits of $100 million or less (as of September 30, 1993). In addition, directors of small banks (those with assets of $100 million or less) we talked to generally did not believe that access to credit at their banks was a primary reason for becoming a director. In fact, many suggested they would be less likely to seek a loan from their banks than from a bank on whose board they did not serve.

As we have discussed with Federal Reserve officials, we are more concerned about changes to Regulation O that may relax a bank's recordkeeping requirements related to identifying extensions of credit to insiders, including related interests. A sound system of records is critical for accurate quarterly reporting of insider activity and for examiners to be able to assess the bank's internal controls over those activities. For these reasons, we believe examiners need to be diligent in ensuring that banks' related recordkeeping produces complete and accurate information.

6. In general, we agree that the Federal Reserve's full-scope examinations include a review of insider activities. However, we noted instances in which a separate review of insider transactions was not part of the scope of an examination. In some of these cases, selected insider loans were only reviewed as part of the overall review of the loan portfolio. In addition, we noted instances in which information on insiders and their transactions was accepted by the examiner with minimal or no attempt at verification. We agree that Federal Reserve examination policies call for a thorough review of insider activities. The purpose of our recommendation is to highlight the need for the scrutiny of insider transactions in practice consistent with the examination policy.

7. The focus group participants and bank boards in our open bank sample included individuals from banks supervised by all three federal bank regulators. In general, as we discuss in chapter 6, bank boards and focus

group participants felt frustrated in their interactions with examiners and regulators. As we acknowledge, bank directors have a responsibility to ensure that bank management makes changes to correct identified deficiencies. However, we believe federal bank regulators could take additional steps to communicate the need for corrective actions and provide more assistance to bank directors and management in accomplishing the corrections. The Federal Reserve's written examination summary, which is provided to each director, is a good step in this direction. However, we believe the steps we outline in chapter 6 would provide additional assurances that identified deficiencies are understood and corrected before they negatively affect a bank's financial health.

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