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Savings and Loan Crisis: Federal Response to
Fraud in Financial Institutions

Statement of
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Before the Committee on Banking,
Housing and Urban Affairs
United States Senate



Savings and Loan Crisis: Federal
Response to Fraud In Financial Institutions

SUMMARY OF STATEMENT BY
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GAO estimates that losses from thrift failures could be as much as \$500 billion in the next 40 years. Though the extent to which fraud contributed to or caused thrift and bank failures is not known, fraud has played a significant role.

Our review to date indicates that the Justice Department and other federal agencies have been actively pursuing this fraud. U.S. attorneys, for example, are in the process of prosecuting thousands of financial institutions' officers, directors, major borrowers, accounting firms, law firms, and others. The number of successful prosecutions is growing.

Furthermore, on its own initiative and in response to congressional action, Justice is stepping up its efforts by adding and redeploying resources to concentrate more on financial institution fraud. Initiatives recently announced by Justice and the financial regulatory agencies are promising. New task forces are being established. Priority lists have been developed. A Special Counsel for Financial Institution Fraud has been appointed in Justice.

It is too early to tell what impact these actions will have. Moreover, GAO's assessment raises some concerns. One concern is that, although Justice is focusing more systematically on financial institution fraud, it may not be giving sufficient attention to two areas:

- Justice lacks a mechanism that would allow the newly appointed Special Counsel for Financial Institution Fraud to readily access the key information needed to determine how well the efforts are proceeding, what more needs to be done, where it needs to be done, and what further resources are actually needed.
- Justice and the agencies referring instances of suspected fraud need to ensure that their newly expanded coordination initiatives are actually leading to the concentration of resources on top priority targets and in determining the best way to proceed against these targets.

GAO is also concerned that the number, magnitude, and complexity of fraud cases may demand further infusion of resources. The Congress should continue to monitor new initiatives and require Justice to report regularly on the results achieved. Congress could then better assess the investigative and prosecutorial resources needed and the effectiveness of interagency coordination for this critical effort.

Mr. Chairman and Members of the Committee:

We are pleased to participate in your hearing on the federal response to fraud in depository institutions. As you requested, my testimony today will cover (1) what we have learned about the extent of fraud in failed and open depository institutions; (2) what the federal response has been to the fraud, including recent Justice Department initiatives; and (3) our assessment of the response to fraud in depository institutions as we see it today.

EXTENT OF FRAUD IN FAILED AND
OPEN DEPOSITORY INSTITUTIONS

During the last 4 1/2 years, 831 banks and 515 thrifts have failed and have been resolved. Another 247 thrifts were in the Resolution Trust Corporation's (RTC) conservatorship program as of June 30, 1990. These failures have been attributed to economic problems; deregulation of the thrift industry and inadequate supervision; poor management in the institutions; and fraudulent activities on the part of officers, directors, borrowers, accounting and law firms, and others associated with the depository institutions. Many of these same factors threaten the solvency of many open institutions and will probably result in additional failures.

No one knows exactly how great the role of fraud has been in the failure of thrifts and banks, nor the extent to which it is

occurring in open institutions. RTC suspects that fraud or criminal activity on the part of directors, officers, or senior managers contributed to the failure of 40 percent of the thrifts it has investigated. Ely and Co., savings and loan consultants, have offered a rough estimate that 3 percent, or \$5 billion of the \$147 billion in thrift losses have been caused by "crooks." The Federal Deposit Insurance Cooperation (FDIC) estimates that fraud on the part of directors, officers, or senior managers contributed to 13 to 18 percent of bank failures. One of the difficulties with estimating the extent of fraud in depository institutions is determining if and when suspect activities crossed the fine line between poor business judgment and fraud.

Financial institution fraud cases typically involve complex transactions that must be thoroughly investigated.

Investigators and prosecutors often must sift through thousands of documents just to determine whether a criminal offense has occurred. Thus, these investigations are labor intensive and a great deal of time (sometimes several years) is required to complete a thorough investigation and obtain an indictment. The more creative criminals are in covering the "paper trail" of their crimes, the more arduous this task becomes. Also, prosecutors are faced with the task of proving that the paper trail establishes beyond a reasonable doubt that a criminal violation was committed and that the accused was guilty.

FEDERAL RESPONSE: BASELINE

ACTIVITY LEVELS

The federal bank and thrift regulators--FDIC, the Office of the Comptroller of the Currency (OCC), the Federal Reserve System, and the Office of Thrift Supervision (OTS)--are the federal government's first line of defense against illegal activities and/or wrongdoing associated with banks and thrifts. The regulators are responsible for examining and supervising banks and thrifts to ensure that they are operating in a safe and sound manner and in compliance with applicable laws and regulations. The nature of the institution's charter determines which regulatory agency has federal oversight responsibility for the institution. RTC also plays a role in identifying fraud and wrongdoing in failed thrifts.

FDIC and RTC are authorized to initiate civil suits in instances where improper conduct of professionals associated with failed institutions is uncovered. The agencies are responsible for investigating all failed institutions to determine the merit of pursuing civil professional liability suits. As of July, 1990, FDIC and RTC were involved in about 500 civil professional liability suits, which include actions against directors, officers, other professionals, and their insurers, as well as interventions in shareholder actions.

In instances where criminal activities are suspected, the regulators and the financial institutions they regulate are to refer these activities to the FBI for investigation and to a U.S. attorney for possible prosecution. These referrals are submitted on a standardized criminal referral form. The regulatory agencies use different criteria for keeping records on the criminal referrals they and the institutions make, so we could not get an accurate count of the number of referrals.

Nevertheless, we found that:

-- OTS logs all referral forms. OTS logs showed 5,014 referrals in 1989 and 2,785 through June 1990.

-- The Federal Reserve System logs referrals by individual suspects as opposed to the number of referral forms. They logged referrals on 3,239 individuals in 1989 and 1,445 individuals through June 30, 1990.

-- OCC logs referral forms involving an estimated loss of over \$200,000, a bank insider, or some other significant circumstance. OCC logs showed 824 referrals in 1989 and 637 referrals through June 30, 1990.

-- FDIC logs referral forms involving estimated losses exceeding \$10,000 or a bank director, officer, or principal shareholder. FDIC logs showed 938 referrals in 1989 and about 798 referrals through July 11, 1990.

-- The RTC system for maintaining criminal referral data is not yet operational. RTC estimates that it has submitted about 200 referral forms since August 1989.

Within the Justice Department, the FBI investigates and U.S. attorneys prosecute those criminal referrals having merit. The FBI also begins investigations based on information from other sources (informants and other members of the public).

The FBI headquarters tracks all investigations field offices have underway, but there is no accounting for the criminal referral forms received. In October of this year the FBI plans to begin keeping a record of each referral and providing feedback to the regulatory agencies on any action taken. The FBI had 7,097 financial institution fraud investigations underway as of February 1990.

Of the investigations underway as of February 1990, 3,027 were major investigations involving potential dollar losses of \$100,000 or more. Further, of the major investigations, 2,278 involved banks (276 were failed banks), 654 involved thrifts (234 were failed thrifts), and 95 involved credit unions (20 were failed credit unions).

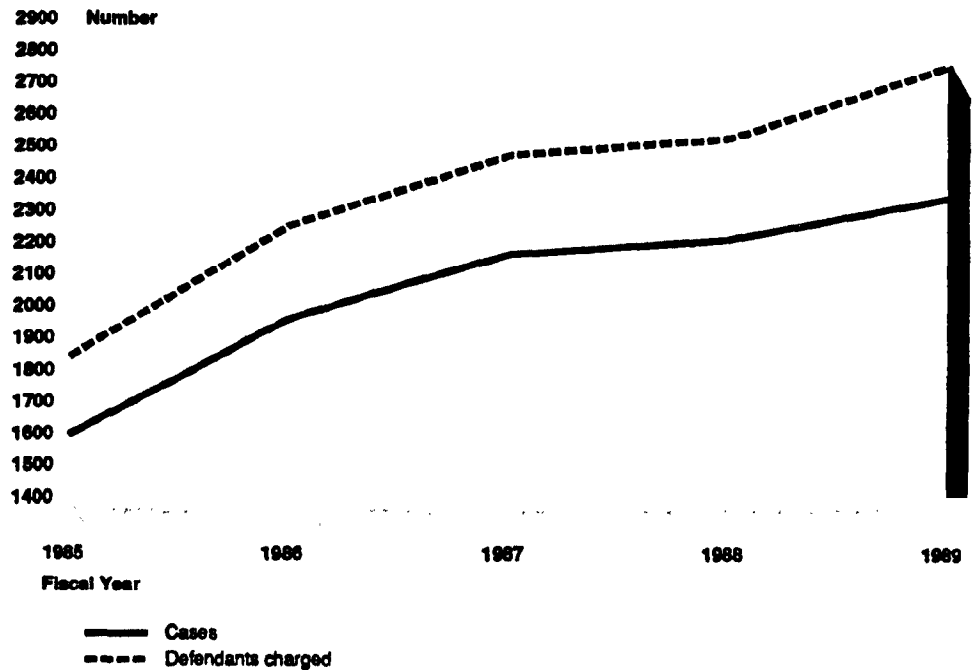
FBI field offices determined through a manual search that as of February 1990, they had 21,147 criminal referrals relating to financial institution fraud on file that the FBI calls

"unaddressed referrals." Unaddressed referrals (1) may not meet the U.S. attorneys' priorities for investigation, (2) may need further investigation to determine whether they involve a federal violation, or (3) await a determination concerning whether they should be prosecuted under a specialized prosecution program for simple cases. Furthermore, some of these referrals may replicate or relate to other referrals or relate to ongoing investigations. Some of these referrals may be worth pursuing. The FBI plans to review these referrals this month to determine what action to take on them.

I would like to turn to the prosecution of these violations. Although the U.S. attorneys receive information on all referrals, they are generally not brought into the case until the FBI believes it has determined criminal activities have occurred. As of February 28, 1990, the U.S. attorney offices had 5,862 matters and 1,489 cases pending involving 7,992 and 1,920 defendants, respectively. (A matter is an item being reviewed to determine if an indictment or information should be filed.)

As shown in figure 1, in fiscal year 1989 the U.S. attorney offices filed criminal charges in 2,336 cases relating to financial institution fraud against 2,749 defendants. The figure also shows that U.S. attorney activities have been increasing steadily between fiscal years 1985 and 1989. In addition, U.S. attorneys filed charges in 794 cases against 970 defendants in the first 5 months of fiscal year 1990.

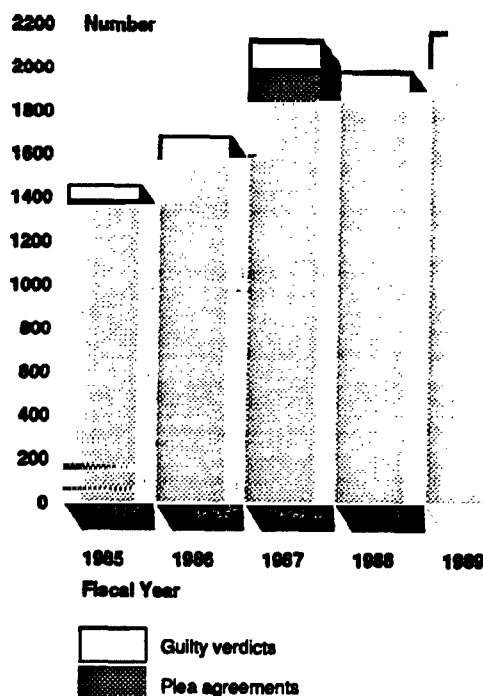
Figure 1: Criminal Charges Filed by U.S. Attorneys in Financial Institution Fraud Cases



Source: Executive Office for United States Attorneys.

During the same time period, the U.S. attorney offices obtained convictions for financial institution fraud against 9,374 defendants (8,763 plea agreements and 611 guilty verdicts). Figure 2 shows that convictions, like charges being filed, appear to be increasing. It should be noted that only 150 defendants were acquitted. In addition, the U.S. attorneys obtained convictions against 787 defendants (745 plea agreements and 42 guilty verdicts) in the first 5 months of fiscal year 1990.

Figure 2: Convictions Obtained by U.S. Attorneys in Financial Institution Fraud Cases



Source: Executive Office for United States Attorneys.

It should also be noted that Justice tracks the results of the Criminal Division's Dallas Bank Fraud Task Force separately from those of the U.S. attorney offices. Between August 1987 and June 1990, the Dallas Bank Fraud Task Force brought charges against 77 defendants and obtained convictions of 54 defendants. For the remaining 23 defendants, 2 were acquitted, and charges are still pending against 21 individuals. As of June 1990, the task force had 42 separate thrifts under investigations; these investigations involved 560 suspects.

With regard to criminal restitution, we were unable to obtain complete, reliable data on restitution recoveries for financial institution fraud. However, FDIC provided us with data on such recoveries for thrifts for 1987 through April 1990. The data

showed \$202.8 million in restitution ordered during this period, while approximately \$15 to \$16 million was recovered. Since restitution often is not due until years after conviction, these recoveries are not necessarily a result of restitutions ordered during the period and therefore can not be used to calculate a percentage of restitution recovered. FDIC staff are currently developing methods to collect more detailed and accurate information on recoveries of criminal restitution.

JUSTICE DEPARTMENT RESPONSE TO
PRESSURE FOR INCREASED ACTIVITY

The full cost of thrift failures, including interest costs, could be as much as \$500 billion. The taxpayers will have to pay for most of it.

Moreover, significant portions of the total cost are yet to be fully established. One category of losses where the potential exists for significant additional losses, for example, is the likely fallout from past transactions made with acquirers of failed thrifts, in particular the group of transactions concluded in 1988.

Some \$50 billion of the total estimated loss from failed thrifts is for assistance to the acquirers of some 181 failed thrifts sold to 79 acquirers by the Federal Savings and Loan Insurance Corporation (FSLIC) in 1988 and early 1989.

You and other members of this Committee first asked us in October 1988 to examine the structure and costs of these transactions, as well as the bidding and selection process.

We reported to you in early 1989 that we had serious concerns about the cost and risk exposure to the government of these costly transactions. One of our major concerns was that the selection process was not adequately documented; we could not assure your Committee that the most cost-effective resolutions were reached. You asked us to further review the circumstances of the selections. We subsequently confirmed that the lack of documentation prevented us from giving you such assurances, given the limited nature of our work. (A chronology of our work on these transactions is attached.)

The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) requires RTC to study the bidding and negotiation processes for these transactions, determine whether they were "sufficiently competitive," and report to Congress. It is extremely important that this RTC study, which is presently ongoing, be well done. It must be comprehensive, be given high priority, and be appropriately coordinated with Congress and Justice.

The potential for still further increases in the total losses resulting from thrift and bank failures of the 1980s has contributed to pressure on Justice to expand its efforts.

Congress and the administration have increased the resources allocated to financial institution fraud, although the full effects of these additional resources have not yet been felt.

In March 1989, Justice surveyed the FBI and U.S. attorney offices to determine what additional resources those offices needed for dealing with financial institution fraud. The survey identified the need for 425 additional FBI agents and 231 additional assistant U.S. attorneys. Before FIRREA was passed, the FBI spent about 400 work years annually investigating financial institution fraud. U.S. attorneys estimated that they were devoting about 200 work years annually to prosecute financial institution fraud cases.

FIRREA authorized \$75 million each year for fiscal years 1990, 1991, and 1992 to enhance Justice's efforts against financial institution fraud. Of the \$75 million, \$65 million was for investigation and prosecution of financial institution fraud. The other \$10 million was for civil proceedings. In December 1989, Congress appropriated \$49 million, as requested by the administration, for strengthening Justice's investigation and prosecution of financial institution fraud. According to Justice officials, the \$49 million appropriated in December 1989 was used to support

-- 153 FBI agents (49 additional positions were allocated to financial institution fraud using other FBI funds),

- 118 assistant U.S. attorneys,
- 24 Fraud Section attorneys,
- 100 FBI accounting technicians, and
- 6 Tax Division attorneys.

As of June 1990, most of the positions were filled.

For fiscal year 1991, Justice asked for an increase of 68 FBI positions and 60 positions in the Civil Division for financial institution fraud, but no increase in assistant U.S. attorney positions. In total, the 1991 Justice budget seeks about \$55 million of the \$75 million authorized for financial institution fraud. This will cover the persons added in fiscal year 1990 and the new positions requested. Various legislative proposals currently being considered by Congress call for authorizing from \$25 million (this is in addition to the \$75 million already authorized by FIRREA) to as much as \$162.5 million for additional investigators and prosecutors targeted at financial institution fraud.

The federal government has responded in a variety of other ways to punish those who have defrauded financial institutions.

Dallas Bank Fraud Task Force--In October 1986, the U.S. Attorney in Dallas said he needed more resources to address the massive thrift and bank fraud crisis. In August 1987, Justice established the Dallas Bank Fraud Task Force, using existing Criminal Division resources and the resources of other agencies to supplement the work of the U.S. attorney office. This task force is directed by Justice's Fraud Section. As of July 1990, the task force included 16 Fraud Section attorneys, 7 assistant U.S. attorneys, 3 Tax Division lawyers, 41 FBI agents, 17 IRS agents, and 3 OTS examiners. I have already noted above the accomplishments of the task force.

Creation of a Special Counsel for Financial Institution

Fraud--Justice recently created the position of Special Counsel for Financial Institution Fraud to be the focal point for Justice's efforts in this area. The role of the Special Counsel, who reports to the Deputy Attorney General, is to ensure that resources are allocated to the most significant cases, ensure good coordination between Justice and the thrift and bank regulatory agencies, and track and maintain data on civil and criminal enforcement actions.

As part of his efforts to achieve these goals, the Special Counsel plans to meet with U.S. attorney office officials to discuss the status of their financial institution fraud cases. The Special Counsel expects that through this review, he will identify cases that need more attention by the U.S. attorney or

that would be more appropriately pursued through civil litigation. He also expects to gain a better understanding of where resources are needed.

To effectively oversee and coordinate the government's efforts to pursue financial institution fraud, the Special Counsel needs to have access to detailed and timely information on enforcement activities. Currently, there is no centralized system that maintains these data. To obtain such information as the type and number of financial institutions involved, estimated losses, number of defendants charged, sentences and restitution ordered, and fines imposed, each U.S. attorney office had to do a manual search of its files. The Special Counsel then had to tabulate this information. The Special Counsel said he may computerize data on priority cases to facilitate his review.

27 City Task Force Attack--On December 7, 1989, the Attorney General announced the allocation of resources to establish task forces in 27 cities across the country for investigating and prosecuting financial institution fraud. He allocated over 300 FBI agent and assistant U.S. attorney positions to the task forces, most of which were from increased staffing levels authorized under FIRREA. The task forces were to be modeled after the Justice Department's Dallas Bank Fraud Task Force.

We spoke with officials in U.S. attorney offices in five of the cities where these task forces were to be established. All had

been notified of their increased allocations through a Telex issued by the Executive Office for U.S. Attorneys on December 7, 1989. (Most of these positions have been filled.) Officials in four offices told us that they had established task forces of some form on their own initiatives.

The Special Counsel may also assume supervision of some task forces. According to the Special Counsel, in the unlikely event that a U.S. attorney fails to aggressively pursue financial institution fraud--and is unresponsive to headquarters' insistence on stepped-up efforts--the Special Counsel may take control of task force resources to ensure financial institution fraud cases are properly pursued.

Compilation of Priority Lists--The regulatory agencies recently compiled lists of those institutions they believe Justice should focus on. The aim of the lists is to identify certain institutions for priority investigation and prosecution.

I would like to talk about OTS' "Top 100" list for a moment, since it has received considerable publicity. According to an OTS official, OTS compiled the list on the basis of a review of its most significant referrals and gave it to Justice on July 5, 1990. U.S. attorney and FBI officials we spoke to said the OTS list and the lists compiled by the other regulatory agencies would probably not have a significant effect on their ongoing investigations and prosecutions because most of the institutions

on the list already had high priority. However, they also said that they would reevaluate cases involving the institutions appearing on the lists that have not been given high priority in their offices.

IS THE FEDERAL RESPONSE ENOUGH?

Determining whether the federal response to financial institution fraud has been sufficient is difficult. The extent to which fraud has occurred is not easily ascertained, nor is a clear picture readily available showing what impact current efforts are having. We do see strong indications that the Justice Department is gearing up to and deploying resources for increased effort against financial institution fraud. However, we are concerned that in focusing more systematically on this fraud, Justice may not be giving sufficient attention to two areas:

-- Justice lacks a mechanism that would allow the newly appointed Special Counsel to readily access the key information needed to effectively oversee and coordinate the federal government's efforts to pursue financial institution fraud. This information is needed to determine, overall as well as by type of financial institution, how well the efforts are proceeding, what more needs to be done, where it needs to be done, and what further resources are actually needed. The new Special Counsel relied on each of the U.S. attorney offices to manually collect data on closed and ongoing cases addressing

thrift fraud and bank fraud. For information on unaddressed criminal referrals, he would have to have the FBI field offices manually search their files.

-- Justice and the regulatory agencies need to pay close attention to whether their newly expanded coordination initiatives are having the intended results by concentrating resources on the top priority targets and determining the best way to proceed against these targets. Justice and the regulatory agencies have long recognized the need for coordination, given the significant differences in their respective roles and responsibilities. Still, no clear picture has yet emerged depicting how well the agencies are doing overall to identify, investigate, and prosecute financial institution fraud. Over the past several months, however, a number of efforts to improve coordination have been launched. Priority lists of institutions targeted for investigation and prosecution have been developed by the regulatory agencies. The new Special Counsel has recently begun efforts to enhance coordination between the regulatory agencies, the FBI, and the U.S. attorneys. The FBI plans to begin providing feedback to the regulatory agencies on any action taken on each criminal referral submitted by these agencies. While these initiatives are a start, it is too early to determine whether they will be sufficient.

In any event, the number, magnitude, and complexity of fraud cases may demand further infusion of resources. Congress should

continue to monitor these initiatives and require Justice to report regularly on the results achieved. Congress could then better assess the adequacy of both investigative and prosecutorial resources and the effectiveness of interagency coordination.

This concludes my testimony. I would be pleased to answer any questions.

CHRONOLOGY OF MAJOR EVENTS IN GAO'S WORK FOR THE SENATE
BANKING COMMITTEE ON THE FSLIC 1988 DEALS

- 10/20/88 Senators Riegle, Graham, Wirth, Sasser, Chiles, and Proxmire ask GAO to select five FSLIC-assisted transactions and to examine them with respect to the (1) bidding and selection process and (2) terms and structure of the transactions (including related cost, viability analyses, and FSLIC risk exposure). GAO is also asked to provide comparable data on the background and experience of the senior officials of the Federal Reserve Board, OCC, FDIC, and FHLBB.
- 11/03/88 GAO sends a confirmation letter in response to the six Senators' 10/20/88 letter identifying the five transactions selected and detailing the issues to be addressed.
- 12/30/88 Senator Riegle asks GAO to examine FSLIC's December 1988 transactions, focusing on the bidding and selection process, the structure of the transactions, and the tax costs.
- 01/89 GAO and Senate Banking Committee agree to merge the October and December 1988 requests and to focus the GAO work in response to the latter request on 5 Southwest Plan transactions and 2 other transactions. GAO is to testify on the results of this work in March 1989.
- 03/03/89 GAO writes to the six Senators with information on the background and experience of senior officials at the FRB, OCC, FDIC, and FHLBB in response to their 10/20/88 request letter.
- 03/14/89 GAO testifies before the Senate Banking Committee on "Failed Thrifts: GAO's Analysis of Bank Board 1988 Deals."
- 03/14/89 During the hearing, the Committee Chairman, in reaction to GAO's comments on the lack of adequate documentation, asks GAO to continue work on the selection of acquirers.
- 03/14/89 Senators Riegle and Cranston jointly ask GAO to answer 11 questions relating primarily to FDIC.

Question 8, however, asks GAO to compare the strengths and weaknesses of a FSLIC and an FDIC assisted transaction.

03/89

The Committee Chairman asks GAO to respond for the March 14 hearing record to 17 questions related to the FSLIC transactions and the administration's proposal to resolve the thrift crisis and restructure the thrift industry.

Question 6 asked: "Do you observe any patterns of favoritism in the deals made last year. I am particularly interested in cases where former insiders from the Federal Home Loan Bank System purchased failed thrifts or acted in some capacity to help arrange the deals. In how many of last year's deals were former senior Bank Board officials involved? Did they benefit from inside information in those deals?"

Question 7 asked: "Please suggest standards and offer guidelines for the maintenance of adequate records regarding the deals."

Question 15 asked: "FSLIC contends that the thrift institutions resulting from FSLIC's December 1988 assisted acquisitions are adequately capitalized -- despite having a low ratio of capital to total assets -- because much of the institutions' assets consist of FSLIC notes and FSLIC-guaranteed assets, which are categorized as involving little or no credit risk. Do you agree? Has FSLIC succeeded in banishing the moral hazards of low capital, such as the incentives to take excessive risks?"

04/07/89

GAO responds to Senators Riegle's and Cranston's 3/14/89 request. The response to question 8 provides a summary description of FDIC's NCNB Texas transaction and FSLIC's First Gibraltar transaction. (The GAO response is included in the hearings record--S. HRG. 101-127, Part IV, pp. 320-333.)

04/07/89

GAO responds to the 17 questions for inclusion in the testimony record. (The GAO response is printed in the hearings record--S. HRG. 101-127, Part IV, pp. 334-353.)

05/31/89

GAO officials brief Senate Banking Committee staff on the results to date of GAO's Office of Special

Investigations work on FSLIC's sale of thrifts to acquirers.

08/09/89 FIRREA requires GAO to monitor the FSLIC deals and to estimate their cost. GAO subsequently initiated these studies.

01/25/90 GAO testifies before the House Banking Committee on the preliminary results of its FIRREA-required monitoring work. GAO says that FDIC is not giving sufficient attention to its management of the FSLIC deals and identifies three areas where improvements are needed.

03/29/90 GAO refers items related to failed S&Ls to the Department of Justice. (Office of Special Investigations field work on the FSLIC deals ended in late 1989.)

04/02/90 GAO testifies before the House Banking Committee on differences between the RTC and FSLIC 1988 resolutions in terms of bidding and selection approaches and structure.

04/06/90 GAO testifies before the Senate Banking Committee on the cost of the S&L crisis resolution. Estimated costs of the FSLIC Resolution Fund, which includes the cost of the FSLIC 1988 deals, are included. The FIRREA-required report on cost of 1988 FSLIC deals will be issued this summer.

04/26/90 GAO writes Senator Riegle summarizing past and on-going work on the FSLIC deals for the Senate Banking Committee, as well as the status of the two RTC studies of these deals that were required by FIRREA.

07/19/90 GAO issues report "Failed Thrifts: FDIC Oversight of 1988 Deals Needs Improvement"