

August 14, 2004

U.S. Senate Committee on Banking,  
Housing, and Urban Affairs  
534 Dirksen Senate Office Building  
Washington, D.C. 20510

House Committee on Financial Services  
Financial Institutions and Consumer  
Credit Subcommittee  
2129 Rayburn House Office Building  
Washington, D.C. 20515

Members of Congress:

I am writing this letter out of concern for both the current condition and planned direction of bank supervision at the FDIC. In summary, the condition is bad and deteriorating rapidly while the direction is ill planned and poorly conceived. This letter compares and contrasts the grave situation at FDIC with the situation in the accounting industry of the 1990's. The following paragraphs detail Chairman Powell's cost cutting obsession, and the various mechanisms he employs, including reducing examination hours budgets much like the reductions that doomed the accounting industry. Finally, this letter discusses risk areas not receiving the necessary regulatory scrutiny and poses the question: Has Mr. Powell's initiatives broken either the letter or intent of the Federal Deposit Insurance Act (FDI Act)?

The parallels between the current regulatory circumstances and those that led to the accounting debacles of recent years are so stark that the membership of your respective committees cannot avoid acting to ensure that similar, yet potentially more devastating, consequences do not befall America's banks. In the decade prior to the accounting fiascos at Enron and Worldcom, both of which occurred under the oversight of, if not with the aid of, the firm's external auditors, the accounting industry underwent significant consolidation. I clearly recall the days of the "Big Eight" accounting firms, which included Arthur Anderson. Now, we are left with the "Big Four". I also recollect conversations with former CPAs from these firms who accepted positions at financial institutions. These CPAs described the competitive pressures during this time of consolidation. The emphasis on reducing client charges to compete with other firms and the subsequent reduction in billable hours to entice potential clients with lower audit bills. Therefore, it should be no surprise that, with fewer billable hours spent auditing, more issues were overlooked or dismissed as immaterial. Similarly, with the added competitive pressures, it is equally unsurprising that some auditors developed relationships with clients intended to retain that client but also compromised audit independence.

Sadly, it seems as if our leadership in bank regulation and even our congressional delegation has not learned from this all too devastating recent example. In the wake of these accounting fiascos brought about by a race to the bottom in terms of billable hours or hours spent auditing, the exact same management philosophy is in place at FDIC and quite probably at other bank regulators. Some theorize that these efforts are an attempt to alter banking supervision policy without consent of congress.

FDIC Chairman Powell emphasizes cost cutting without a financial basis. The financial statements of the FDIC do not offer any indication of impending financial disorder much less disaster. In fact, at a recent San Francisco Regional Training Conference, the FDIC Chief Financial Officer stated that the FDIC had revenues of \$2.2 billion and expenses of \$1.1 billion. That's a net margin any company would enjoy. Seemingly endless cost reduction programs to date include eliminating positions and buyouts, which shifted workloads to remaining staff, reducing examination hours, and reducing training.

In an effort to eliminate Case Managers in Regional Offices, Mr. Powell offered buyouts and shifted much of the Case Manager work, including Report of Examination Review, to Field Offices. In the end, this created surplus staffing at Regional Offices because response to the buyout was less than expected. However, this work load shift also eliminated an important internal control on Report of Examination quality. Putting review of examination reports in the offices where they are produced weakens the segregation of duties control on report quality. Supervisory staff in the office where a report originates is less likely to be critical of their own employees work because it is a reflection on their own supervision. It is ironic that FDIC examiner review segregation of duties at banks, yet we do not employ this fundamental control in our own operations.

In conjunction with shifting work from Regional Offices to Field Offices, Mr. Powell employed one of his more underhanded tactics to date: He required all Field Office Supervisors (FOS) to reapply for their jobs. As part of this process, Mr. Powell eliminated some FOS positions. Many FOSs, knowing positions would be eliminated and wishing to demonstrate solidarity, applied for several positions with their existing position being their first choice. Mr. Powell deliberately moved these employees around the country in an effort to entice them to quit. Unfortunately, many did.

These two processes, shifting work to the Field Offices and eliminating FOS positions, left remaining FOSs and Supervisory Examiners with no time to spend in the field at banks supervising their employees. Compounding this problem is the elimination of some FOS (now called Field Supervisor) positions leaving the remaining FOSs to cover multiple offices, which cuts further into their available time to spend in the field with examiners under their charge.

Potentially the most damaging effort, and the most striking parallel to the scenario that developed in the accounting industry, is the reduction of examination hours budgets. The principal difference between the two situations is that audit hours reductions in the accounting industry were done for competitive reasons while examination hours reductions are done for political reasons. These hours cuts have already reduced the FDIC examination program in the San Francisco Region to a shadow of the former program. While publicly portraying industry consolidation as the culprit for reducing the need for examiners, reducing the amount of allowable hours examiners can spend on any given examination is just as much a factor in excess examiner hours (excess examiners). Therefore, Mr. Powell can lay-off examiners (RIF or reduction in force), which lowers costs and pleases political allies clamoring for less government regulatory burden. All the while, it is easy to convince the casual observer that a reduction in the number of banks nationwide mandates a reduction in the number of examiners.

Hours budget reduction programs impair the scope of examinations to the point where compliance with the Federal Deposit Insurance Act comes into question, and it is through these hours reduction programs where Mr. Powell is, intentionally or unintentionally, subverting the authority of Congress. Section 10(b)(6)(A) of the FDI Act states, in part, that each examiner shall have power to make a thorough examination of any insured depository institution; however, these ever increasing hours limitations, indirectly yet deliberately, limit an examiner's ability to make a thorough examination of a bank as directed by Congress in the FDI Act.

It is easy to see how hours budget limits impede an examiner's ability to perform a thorough examination of a bank once examination management is understood. An examiner-in-charge (EIC) supervises the overall examination process, develops conclusions, and delivers findings, both in written and oral reports, to bank management. During the examination process various facts and circumstances come to the attention of the EIC. These facts or circumstances, call them leads or red flags, are not findings in and of themselves, but rather, items that indicate further investigation is necessary. Based on training and experience, the EIC should investigate these red flags, and this is where the problem starts. You see, the way the examination hours budget caps or limits are set is by the overall rating of the institution, known as the composite CAMELS rating. The hours budget for a satisfactorily rated bank, say one rated a composite "2", would be less than that for a less than satisfactory rated bank, or one rated a composite "3". It takes more hours to examine a "3" rated bank because it has more problems. Because the hours budget cuts to date have been so severe, examiners do not have enough time to examine the known material risks much less those that are unknown prior to beginning the examination. Therefore, an EIC will begin an examination with enough examiners to utilize the examination hours budget with little room to spare. Consequently, as red flags surface during an examination, there are no hours to dedicate to the investigation. At this point, the EIC has to make a decision: should he or she discontinue examination procedures already ongoing or planned in favor of investigating a red flag? Or should he or she ignore the red flag and what could potentially be a significant risk? Choices are limited to these two simply because the only way the EIC can get more hours to investigate is to downgrade the bank from, in the example above, the "2" to the "3". However, because the EIC does not know the outcome of any potential investigation of any red flag when the decision to investigate must be made, the EIC has no way of knowing if the outcome of any investigation of the red flag will result in findings sufficient to downgrade the composite rating. Therefore, absent another negative finding, there is no basis to downgrade. Again, without a downgrade in the overall composite rating, there are no more hours allowed. Without the additional hours there is no time to investigate anything unplanned or unexpected that might come up during the examination. Therefore, many of these red flags go uninvestigated unless the EIC is willing to accept the wrath of management for exceeding budgeted hours.

The preceding example demonstrates how Mr. Powell indirectly limits examiners from performing a "thorough examination" of an insured depository institution, and this is how the spirit if not the letter of the FDI Act is violated. No, no one has ever told any examiner not to investigate anything which the examiner believes needs investigating, and no one ever will. Management will just erect barriers to that process so no one will ever have to tell an examiner not to investigate anything. Therefore, if something is missed on an examination, it must be the examiner's fault. Management never told anyone not to look at something. John Brennan, a

member of Mr. Powell's staff reiterated this position at the recent San Francisco Regional Training Conference when he stated, "I can't believe that an examiner is not free to investigate anything that he or she feels the need to investigate".

Examination hours budget caps now cover virtually all institutions regardless of condition or size, but Mr. Powell is not done. His latest endeavor is to completely alter the entire examination program with the ultimate result of further reductions in hours budgets through the recently devised Relationship Manager Program. In the wake of the Riggs Bank fiasco, the Relationship Manager Program should set off alarm bells throughout Congress because this program is similar, if not identical, to the examination protocol the OCC employed at Riggs. The report of the Subcommittee on Investigations describes an examination program at Riggs where one EIC led the examinations of Riggs over a period of years; that is, he was in charge for more than one consecutive examination and was a principal point of contact for supervision of the bank. A critical flaw in this program is that it allows one examiner to get too close to senior bank management thereby losing objectivity. Sound familiar? Again, this is another parallel with the shortcomings in the accounting industry. However, this also put the EIC in a position to control the information flow between Riggs and OCC management. This control of information and his "cat bird seat" at the bank allowed him to sway senior OCC management away from appropriate supervisory action against Riggs. After all, who at OCC knew more about the bank than the EIC. There is no reason why similar circumstances would not develop at an FDIC supervised institution under the Relationship Manager Program.

What are the consequences? Examiners are already cutting back beyond what is prudent. Since money laundering was discussed in the foregoing paragraphs and has the attention of Congress, let's stay with that theme. **Some examiners are saying that they don't even have enough time to check for minimum Bank Secrecy Act compliance as outlined in part 326.8 of the FDIC Rules and Regulations and are not performing the lengthier Anti Money Laundering procedures instituted post 9/11.** Are you comfortable with that? I'm not, and neither are my colleagues.

I will follow your actions in the coming weeks to ascertain your course relative to the contents of this letter. Should I believe you wish to contact me, I will make efforts to facilitate that contact. In the mean time, I will compose another letter explaining how Chairman Powell plans to dispose of any detractors, including those who write their Congress, using the new "broader" personnel powers he seeks from Congress.

Thank You,

Anonymous

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