DIVISION OF SUPERVISION RESPONSE

FDIC
Federal Deposit Insurance Corporation
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Division of Supervision

January 14, 1999

MEMORANDUM TO: David H. Loewenstein
Assistant Inspector General

FROM: James L. Sexton, Director
Division of Supervision

SUBJECT: Draft Report Entitled *Material Loss Review - The Failure of BestBank, Boulder, Colorado*

Pursuant to Section 38(k) of the Federal Deposit Insurance Act (FDI Act), the Federal Deposit Insurance Corporation (FDIC) Office of Inspector General (OIG) conducted a material loss review of BestBank, Boulder, Colorado, which failed on July 23, 1998. The OIG's Draft Report, dated December 11, 1998, contains the OIG's conclusions and recommendations. This memorandum is the Division of Supervision's (DOS) response to the Draft Report. Changes from the text of the Draft Report to the Final Report could materially alter our response. While we believe the opportunity to respond to a Draft Report is absolutely necessary, procedurally we have concerns in responding to a Draft Report that continues to undergo changes. This presents the possibility our response may not be completely germane to comments appearing in a Final Report.

See Comment #1

SUMMARY

OIG's Draft Report findings are fundamentally and substantially flawed due to a basic error in methodology and attribution. Page 12 of the OIG's Draft Report states: "The impact of possible criminal misconduct upon the failure of BestBank is not within the scope of a material loss review." Section 38(k) of the FDI Act states, in part, that material loss reviews are intended to "(i) ascertain why the institution's problems resulted in a material loss to the deposit insurance fund; and (ii) make recommendations for preventing any such loss in the future."

See Comment #2

By not considering the irregular activities at the bank and the bank's outside credit card service organization and the measures undertaken to conceal these activities in arriving at the conclusions and recommendations, we believe the OIG has failed to recognize the reasons for the material loss. Bank officials apparently conducted a scheme to artificially make credit card accounts appear current and thus misrepresented the bank's true financial condition. As more fully described below, the examination process is not specifically designed to detect fraud, and detection is even more difficult if collusion exists.

See Comment #3

See Comment #7

We are disappointed in the Draft Report's overall tone and its focus on negative depictions of the competency and performance of the examination staff instead of advancing recommendations for improving the supervisory process. The environment in which the BestBank examinations were conducted is particularly relevant to the issues of the regulatory performance of DOS.

An example of adverse environmental conditions occurred during the finalization of the February 1996 examination where the bank was accorded a Composite "4" rating. While DOS examiners were exercising their duties and attempting to arrive at an accurate diagnosis of the bank's condition, the chairman of BestBank appealed to then-FDIC Chairman Ricki Helfer for relief from a purported "…multi year pattern of egregious, unethical, possibly unlawful conduct of Dallas and Denver FDIC staff…" Former Chairman Helfer forwarded BestBank's complaint to the OIG for investigation.

See Comment #5

The FDIC offers reasonable appeal processes. The FDIC's Ombudsman is a competent, neutral arbiter of issues arising between examiners and the banks they examine. There also is a supervisory appeals process by which a bank may obtain a higher level review of issues in dispute. These avenues exist to protect banks when disagreements with the regulators or other concerns regarding the supervisory process occur.

In the above mentioned correspondence with former FDIC Chairman Helfer, the chairman of BestBank implied that the FDIC's Ombudsman could not be impartial concerning the issue because she resided in the same building as the Dallas DOS apparatus. The Ombudsman is certainly capable of defending herself against any untoward suggestion that has been made about her or her department. Our only interest in this matter is that DOS relies on the Ombudsman process. We strongly believe that our examiners should be permitted to do their job, as they have since 1934, especially in banks that would profit from distraction of examiners. The Ombudsman is, or should be, key to that freedom; i.e., the examiners get to do their jobs with the full knowledge that they will be held accountable.

See Comment #2

While some of the OIG's recommendations are reasonable and helpful, most are unrelated to the proximate cause of failure and do not clearly communicate the nexus of the recommendations to prevention of future material losses. Inadequate treatment and consideration of the underlying cause of the material loss in the Draft Report is a threshold issue that is addressed throughout this memorandum. Additionally, as most of the recommendations reflect longstanding DOS policies that pre-date the BestBank case and are not pertinent to the BestBank failure, discussion in a forum other than a material loss review would be more appropriate. Nonetheless, in spite of the deficiencies in the Draft Report and the process, we acknowledge that a few of the OIG's recommendations are consistent with the "lessons learned" that DOS has identified through its internal analyses of the supervision of BestBank. As indicated in the Appendix to this memorandum, DOS will take the action necessary to address recommendations, where appropriate.

BACKGROUND

BestBank had a portfolio of credit card loans operated under an agreement with a service organization, Century Financial Group, Incorporated (Century), Fort Lauderdale, Florida. The portfolio originated in early 1996. Part of the agreement required Century to repurchase certain delinquent loans. BestBank and Century officials participated in an apparent fraudulent scheme to misrepresent the true condition of the credit card portfolio, and thus enabled the bank to wrongly report large profits as well as to allow Century to avoid repurchasing the loans. The apparent scheme was carried out by applying a series of $20 credits to credit card accounts, which were falsely identified as cardholder payments. This activity misrepresented the bank's condition by making the overall quality of the credit card portfolio appear much better than it was.

See Comment #3

Although examiners were unaware of the apparent scheme, re-aging[1] practices were reviewed at both the October 1996 and October 1997 examinations. Bank management denied the practice of re-aging accounts when directly asked at the October 1997 examination. Indications strongly suggest that BestBank and Century officials were aware of the irregular, internally generated credits.

See Comment #4

The Internal Routine & Controls Section of the DOS Manual of Examination Policies (DOS Manual) specifically states "Examinations are not undertaken for the detection of fraud, nor is their sole or primary purpose to assure the complete correctness or appropriateness of records." Furthermore, fraudulent activity is even harder to uncover if collusion exists, as it apparently did at BestBank. This was expressed quite clearly by former FDIC Chairman Helfer in November 27, 1995 testimony before the Senate Banking Committee concerning the Daiwa Bank case, a case involving collusive fraud. Former Chairman Helfer stated "The Examination is based on the books and records of the bank, statements made to the examiner by institution officials, and information obtained from other reliable sources. Where the warning signs are actively concealed, serious problems are less likely to be uncovered."

LESSONS LEARNED

Examiners conducted their duties appropriately and professionally considering the difficult and hostile environment[2] under which the examinations were conducted. However, through our experience with the BestBank matter, we also recognize that there are lessons to be learned and DOS is actively addressing those issues.

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[1] Re-aging is the process by which an account's delinquency status is changed if a cardholder exhibits some degree of performance. The degree of performance varies institution-by-institution, but typically there has to be a willingness to perform and some demonstrated history of that performance. Other criteria usually employed includes limiting re-aging to once every twelve months and limiting re-aging to less severely delinquent loans.

[2] See especially the discussion on pages 8 and 9 of this memorandum under the caption "Statements Regarding Limited Access to Records", as well as pages 4 and 7, for details.

Among other things, the experience has re-emphasized the need for all financial institution supervisors to focus attention on institutions featuring rapid growth, high insider compensation, reliance on outside service organizations, lack of risk diversification, and/or unique business plans. We will reinforce to examiners the appropriate steps to take when faced with such "red flags," including using a prospective approach when reviewing these areas. Going forward, we will continue to review, and supplement when necessary, examiner guidance in these areas, keeping in mind that, as in all examination processes, examiner judgment is of paramount importance in determining the follow-up warranted when potential unusual activity is encountered. We also need to ensure, where appropriate, that senior bank supervisory officials are closely involved in cases that pose severe or unusual problems at the earliest possible date.

MISLEADING STATEMENTS

See Comment #3

The Draft Report contains a number of statements that are misleading, primarily because they lack appropriate context. DOS discussed misleading statements in a meeting with the OIG on January 5, 1999 and in subsequent telephonic contacts. Many have arisen because irregular activities are not taken into consideration in arriving at the Draft Report's conclusions and recommendations. The misleading statements evidence a lack of understanding of the supervision process and the use of enforcement actions. In particular, comments regarding purported deficiencies in the enforcement action process seem to fail to consider the fact that a legal basis is needed to support such actions. In fact, the lack of sufficient legal bases was the reason that certain proposed enforcement actions were not pursued. The failure to properly attribute the material loss to its actual cause while overemphasizing largely unrelated supervision activities results in an entirely false impression as to causation. The following is merely a sampling of misleading statements.

See Comment #1 Comment #6

See Comment #5

Statements Regarding the 1996 OIG Investigation - The Draft Report mischaracterizes the impact of the 1996 OIG investigation, where the OIG reviewed allegations of examiner wrongdoing made by BestBank's chairman to then-Chairman Helfer, by not considering its effect on the examination process. The investigation left the impression with the examiners that the bank's chairman possibly had an unusual influence in Washington in that he was able to involve the OIG in the supervisory process. This was an unusual occurrence in our experience. The normal channel for banks seeking redress of concerns regarding the supervisory process is through the Office of the Ombudsman or the formalized supervisory appeals procedures.

At a minimum, the possibility of unusual "influence" by BestBank Chairman Mattar was a distraction and served as a source of intimidation. Additionally, the OIG investigation, which occurred in early 1996, very likely emboldened Chairman Mattar to impose formal examination guidelines during the October 1996 examination. While the bank's chairman later rescinded these actions, prompted by the FDIC's initiation of legal action, the OIG investigation likely increased the bank chairman's confidence that he could use his "influence" again if the examiners began to delve too deeply into bank practices.

Pages 10 and 42 of the Draft Report criticize the manner in which the results of the 1996 OIG investigation were communicated to examiners. Page 42 states:

> "the OIG did not fully substantiate any of the allegations, found several of the allegations to be entirely without merit, and generally concluded that examiners followed applicable FDIC policies and procedures. Although the details of the OIG's findings were provided to DOS management in Washington, the examiners stated that these details were not provided to the DOS staff. According to the examiners, DOS management only conveyed that the OIG's report 'exonerated' the examiners."

See Comment #5

We disagree with the implied meaning of the OIG's comments. At the outset, the Draft Report incorrectly paraphrases the 1996 OIG investigation in that conclusions in the 1996 Report do not mention that several of the allegations were found to be "entirely without merit." Additionally, there is some question of whether DOS managers in fact used the term "exonerate" when communicating the results of the 1996 OIG investigation. Nevertheless, regardless of what terminology was used to inform the examiners about the OIG's findings – "exonerate" or "did not fully substantiate the allegations" - it would not have reversed the perception of the bank chairman's unusual "influence" nor the adverse effects of having the OIG inserted into the examination process. DOS management has been and continues to be supportive of the examination staff. We will certainly acknowledge and respond appropriately to constructive, substantiated criticism of their performance and professionalism. We are compelled, however, to defend them against unwarranted and erroneous criticisms.

See Comment #7

See Comment #6

<u>Statements Regarding Supervision of BestBank</u> - The Draft Report implies that appropriate supervisory action was not taken in several instances, or that supervisory tools were not used in a timely or effective manner (See pages 8-10, 15, 29). We disagree. DOS and the Colorado Division of Banking (State) worked closely and diligently to develop an appropriate supervisory strategy for the bank, but it must be noted that bank management apparently engaged in collusive activities to misrepresent the true condition of the bank. A meaningful analysis of supervision can not be achieved when this issue has failed to be addressed, as in the OIG Draft Report.

Moreover, comments in the Draft Report contain some improper conclusions regarding the supervisory process. The OIG criticizes DOS (See pages 8-10, 39-41) for accepting bank Board Resolutions in lieu of a Memorandum of Understanding (MOU)[3], without an analysis of the underlying problems or the effectiveness of the Board Resolutions in achieving correction. Additionally, the OIG states that an MOU is a "stronger" supervisory action, when in fact MOUs and Board Resolutions are both administrative actions, either could be effective depending on the circumstances, and neither is legally enforceable.

[3] A Board Resolution is a commitment for specific corrective action adopted unilaterally by a bank's board in response to specific supervisory criticisms or concerns, usually disclosed during the course of a bank examination. An MOU is a written agreement outlining corrective actions signed by both the bank's board and the Federal and/or State bank supervisory authorities.

The OIG further implies that the FDIC has the power to impose an MOU, which is incorrect. The Draft Report also does not address the fact that formal enforcement actions can not proceed unless legally supportable bases and documentation exist, and that interim events, such as capital injections and policy improvements, sometimes obviate the need for action. Both of these issues arose at various times when determining appropriate supervisory actions for BestBank.

See Comment #5

Specifically, we take exception to comments implying that the so-called “chilling effect” of the 1996 OIG investigation prevented DOS from taking specific enforcement actions in the wake of the February 1996 joint examination. Pages 42-43 state:

> “FDIC officials also were concerned that bank management would perceive any supervisory action as retaliation for the allegations. Accordingly, DOS decided to re-evaluate the need for supervisory action depending on the results of the 1996 examination. In our opinion, DOS should not have allowed the CEO’s allegations, the FDIC Chairman’s request that the OIG review the allegations, or the OIG’s subsequent inquiry to influence DOS’s decision to pursue supervisory action on a “4” rated institution.”

The above comment incorrectly attributes the lack of enforcement action to the “chilling effect” of the 1996 OIG investigation. In fact, no action was taken as DOS adjudged that the report did not support an enforcement action. Furthermore, the bank changed the nature of its business between the February 1996 and October 1996 examinations. A substantial portion of criticisms in the February 1996 report of examination were related to the bank’s merchant processing activities. Once the bank disengaged from this business, the criticisms were no longer valid. Thus, the reason for not pursuing an enforcement action is not the “chilling effect”of the OIG investigation, but the correction of the bank’s objectionable practices. There appears to be an inaccuracy on pages 42-43, as these pages imply that the bank received a Composite “4” rating after the October 1996 examination. The bank was assigned a Composite “3” rating.

See Comment #6

We also take particular exception to the comment on page 40 of the Draft Report that reads “Although DOS contemplated an MOU and subsequently a C&D (Cease and Desist Order) based on the results of the October 1997 joint examination, DOS did not take either action before the bank was closed in July 1998.” In fact, during the pursuit of enforcement action to correct deficiencies noted in the October 1997 examination, we discovered the irregular activity and initiated PCA provisions, a much more severe supervisory response, within one month of this discovery. Additionally, the bank was rated a Composite “3” at both the October 1996 and October 1997 examinations. A timeline of this action follows.

A joint FDIC/State examination commenced on October 14, 1997. In accordance with an agreement providing for alternating examinations to be led by the State and FDIC, the State was in the lead on this examination.

The on-site portion of the examination was completed on November 7, 1997, and additional time was spent off-site completing the draft examination report. Still unaware of the apparent scheme, examiners found that the bank warranted heightened supervisory concerns as at the previous examination, but did not yet determine that the bank's condition posed potential viability concerns.

Examiners attempted to present findings to bank management at the close of the examination, but the bank's chairman abruptly ended the meeting when tentative ratings were revealed and refused to meet again until the report had been finalized. As is standard practice in the Dallas Region, the lead agency initially processes the examination report. In this case, initial processing was done by the State, and the report was then transmitted to the FDIC on December 23, 1997. The FDIC reviewed the report, discussed the appropriate supervisory response with the State, and on January 29, 1998, transmitted the report back to the State for transmittal to the bank. The State transmitted the examination and a proposed MOU to the bank on February 2, 1998. Although the FDIC and State continually attempted to establish a meeting date with the bank, the bank continued to resist – for example, providing a one-day notice of meeting availability in Colorado, which precluded regulatory officials from Dallas from accepting several meeting dates. Given the lack of responsiveness, the State and FDIC discussed the possibility of issuing a C&D, but determined that a revised MOU would be more appropriate. A revised MOU was transmitted to the bank on March 13, 1998.

The bank responded to the examination on March 23, 1998 and refused to sign the MOU. Despite FDIC and State efforts, bank management also continued to forestall a meeting, claiming scheduling problems and trying to impose unreasonable logistics. Due to bank management's stalling tactics, the State and FDIC were unable to meet with the bank's board until April 20, 1998. At that meeting, concerns about the credit card portfolio were discussed at length, as well as the possibility for formal enforcement action. The bank claimed to have information that would indicate they could operate profitably without the outside service organization. This voluminous information was subsequently received on May 1, 1998.

See Comment #6

The information raised concerns and questions, and a visitation to verify the information was scheduled for May 26, 1998. Supporting documentation reviewed on-site over the next few weeks, and a concurrent review of consumer complaints, led examiners to believe that these unusual credits were being applied to make accounts appear current. Examiners expanded the visitation into a full-scope examination on June 24, 1998 and went on-site to perform examination procedures at the outside service organization's credit card processor. Over the next few weeks, examiners gathered information that disclosed the existence of the apparent scheme and quantified the level of potential losses. Once examiners had the evidentiary material to support an enforcement action, it was determined that utilizing Prompt Corrective Action (PCA) provisions pursuant to Section 38 of the FDI Act would be appropriate. Such provisions were initiated on July 22, 1998, and mandated various restrictions. The State closed the bank on July 23, 1998.

David H. Loewenstein January 14, 1999

While we agree that, in hindsight, we might have been more persistent in pursuing a follow-up meeting with management and in processing the report, it must be noted that the State and FDIC believed at that point that the bank was rated a Composite "3" and the condition did not pose viability concerns or heighten risk to the Bank Insurance Fund, as its true condition was masked. As such, quicker meetings or report processing would not have materially altered the outcome.

See Comment #8

Statements Regarding Lack of Information on Century – The Draft Report suggests that examiners had inadequate information and relied only on the repurchase agreement when evaluating Century-related credits and asset quality in general. It also suggests that if examiners had reviewed audited financial statements on Century, they would have been able to identify that Century did not have the wherewithal to continue repurchasing delinquent accounts (See pages 3, 14, 24, 29, and 43-45). Examiners did not rely solely on the repurchase agreement. They reviewed various other documentation, including quarterly CPA-reviewed financial statements on Century, and discussed the credit card program at length with bank management and the board.

Century's quarterly financial statements showed that it had the wherewithal to honor the repurchase of **reported** delinquent accounts. However, we believe management was concealing true delinquencies. Audited financial statements would not have revealed this concealment, and in fact did not when December 31, 1997 audited financial statements were received in
April 1998.

It is important to note that lack of audited financial statements on Century was criticized by examiners at the October 1996 and October 1997 examinations. DOS then attempted to obtain these statements through supervisory actions, and in fact, obtaining audited financial statements was one of the provisions of the proposed MOU emanating from the October 1997 examination. Examiners exercised their judgment using the best information available at the time (without knowing records had been falsified) and determined that the examination report could be completed without this information. Criticizing the examiner's judgment without taking the record falsifications into account is misleading and an unfounded criticism of the examination staff. Requiring examiners, who are in the best position to understand the bank being examined, to exercise judgment has long been a cornerstone of sound bank supervision.

See Comment #9

Statements Regarding Limited Access to Records – The Draft Report (See pages 36-38) incorrectly suggests that examiners "accepted" the formal examination guidelines that bank management initially tried to impose during the October 1996 examination. Bank employees were generally following the formal guidelines, and as such were mostly uncooperative, but examiners did not accept nor follow the guidelines. The bank's chairman attempted to inhibit the FDIC's examination process by instituting a detailed list of restrictions to be imposed on FDIC examiners. Although the examination started on October 15, 1996, the FDIC determined that without full access to the bank's premises, books and records, and employees, the examination could not continue and was terminated.

Discussions and correspondence between FDIC officials and the bank's chairman failed to resolve this problem and resulted in the FDIC filing a temporary restraining order and a preliminary injunction against the bank and the bank's chairman on October 24, 1996. After these documents were filed, the bank rescinded their formal restrictions document.

Statements Regarding Noncompliance with DOS Policy – Pages 53-55 of the Draft Report list four areas where examiners did not comply with FDIC policy. While technically accurate, we note that the areas of noncompliance were unrelated to the cause of the bank's failure and that full compliance in these areas would not have affected the actual outcome.

For example, page 54 states that examiners did not prepare a pre-examination planning memorandum for the October 1996 examination, although such memoranda are required by the DOS Manual. While it is correct that a memorandum was not prepared, the examiners did conduct pre-planning activities. Preparation of a pre-examination planning memorandum would not have reduced the material loss.

CONCLUSION

See Comment #10

OIG recommendations are generally not relevant to the proximate cause of BestBank's material loss – irregular activities. The absence of this cause and effect relationship discredits the conclusions drawn and recommendations offered.

Implementing OIG's recommendations would not have prevented BestBank's failure nor reduced exposure to the insurance fund. Clearly, BestBank evidenced peripheral weaknesses in addition to the credit card portfolio, but irregular activity in this portfolio ultimately caused the bank's downfall. From a supervision perspective, the overriding issue is whether the apparent fraud could have been detected earlier. On this question, the Draft Report offers little illumination.

Despite the foregoing discussion, DOS realizes BestBank's failure affords an opportunity to learn and strengthen our supervisory processes and procedures. To that end, DOS recognizes that there have been important "lessons learned" from this situation. While the examination is not designed to specifically uncover fraud and is not a substitute for a bank audit, we will reemphasize the importance of being vigilant for fraudulent activities and continue to look for improvements in our process.

APPENDIX

RECOMMENDATIONS AND RESPONSES

As stated earlier, the recommendations generally are not relevant to BestBank's proximate cause of failure; however, several are reasonable and helpful. DOS's responses follow and are categorized as satisfied through existing policy or regulation, requiring follow-up with other Divisions, and other recommendations.

Recommendations Satisfied Through Existing Policy or Regulations

Recommendation Four

We recommend that the Director of the Division of Supervision establish a remedy for the FDIC to gain immediate, unfettered access to an insured depository institution that attempts to impede the examiners' access to bank employees or records.

Response

DOS wholeheartedly embraces the notion of "immediate, unfettered access" to records and always has. Existing powers granted in Sections 10(b) and 10(c) of the FDI Act already provide a means for access to bank employees and records. In the extremely rare case where access is denied, DOS has in the past and will continue to employ enforcement powers under Section 8 of the FDI Act. We also have access to other forms of injunctive relief such as the Temporary Restraining Order pursued in the BestBank matter. These are far from the "immediate" access that OIG suggests and DOS concurs in this recommendation.

Recommendation Five

We recommend that the Director of the Division of Supervision modify existing policies to require the Regional Director to provide a written justification for taking no supervisory action on a "3," "4," or "5" rated institution.

Response

Written justification is already captured and has been DOS's written policy since 1979. The written justification requirement is presently contained in the DOS Case Managers Procedures Manual. This manual requires policy exception justification to be included in either the Problem Bank Memorandum or Summary Analysis of Examination Report comment; however, justification is also often provided in either a Rating Change Memorandum or routine file memorandum.

Recommendation Seven

We recommend that the Director of the Division of Supervision develop and implement a policy where examiners take prompt action to address allegations of potential wrongdoing, including referring such allegations to the Regional Director, Regional Counsel, and, in certain circumstances, the OIG.

Response

DOS practice has long included prompt response to allegations of potential wrongdoing. The scope of the response varies based upon the identity and credibility of the source, as well as the specificity of the allegations and documentation provided. Therefore, discretion and judgment are needed when determining an appropriate response. Nevertheless, we will issue a written reminder to examiners via a Regional Director Notice by the second quarter of 1999. We do not agree that such allegations should be forwarded to the OIG, and our examiners are under no instructions to do so. If it is a regulatory problem, DOS and the Legal Division can handle it; if it is a criminal problem, the FBI is set up to handle that. This process has existed with or among all the Federal banking regulators for at least several decades and we see no reason for altering the process. The investigation of alleged wrongdoing by banks or institution-affiliated parties, including appropriate referrals to the U. S. Attorney, is a program responsibility of DOS.

Recommendation Nine

We recommend that the Director of the Division of Supervision develop and implement a policy that requires examiners to document significant examination obstacles, such as impeded access to bank employees and records or unrealistic time constraints, including the Regional Director's resolution of such obstacles.

Response

The practice of documenting significant examination obstacles is a longstanding fundamental examination concept. These obstacles are typically documented in the examination report's Confidential Supervisory Section; however, a separate memorandum is also often used. It should be noted that external examination obstacles were documented in the BestBank situation, as further discussed on page 7 of this memorandum.

Recommendation Eleven

We recommend that the Director of the Division of Supervision issue policy reminders to DOS examiners and supervisors related to assessing compliance with outstanding supervisory actions, identifying concentrations of credit, preparing the pre-examination planning memorandum, and scheduling board meetings.

Response

These items are already included in the DOS Manual. As indicated previously, instances of noncompliance with policy cited in the Draft Report are noted, but they did not contribute to the bank's failure. We will continue to amplify these policies at management meetings, and compliance with the policies will continue to be reviewed at periodic Regional Office reviews.

Recommendations Requiring Follow-up With Other Divisions

Recommendation One

We recommend that the Director of the Division of Supervision work with the Federal Reserve to expand its interpretations under section 23A of the Federal Reserve Act to include any entity whose business relationship with an uninsured depository institution has the ability to significantly affect the safety and soundness of the institution in the definition of "affiliate."

Response

In the instant case, it is highly questionable whether earlier access to records at Century would have revealed the apparent scheme. An on-site review of Century's data processing affiliate was one of the methods used to confirm the extent of the apparent scheme. Century's data processing affiliate was not an affiliate of the bank, but it voluntarily submitted to the review. Nevertheless, and while DOS would welcome the widest possible definition of "affiliate," there are countervailing views that cause DOS to not always get everything it wants.

Increased regulatory powers via a revised Section 23A would require Congressional action, which seems unlikely given the current perceived strength of the banking industry and continued expansion of banking powers. Proposals in the most recent Congressional session actually contemplated reducing or eliminating the FDIC's ability to examine presently defined affiliates. Additionally, Section 10(c) of the FDI Act already grants authority to examine non-affiliates which in any way affect the bank's affairs or ownership.

We nevertheless will continue to work closely with the Legal Division to assess the effectiveness of current statutes and regulations. This issue is further discussed in the response to Recommendation Two.

Recommendation Two

We recommend that the Director of the Division of Supervision work with the Legal Division to pursue alternative means of obtaining access to third party servicers.

Response

Once again, no argument here. In our view, access to more information is better. DOS continues to review the entire supervisory process regarding these types of entities, particularly independent service organizations, and will continue to work with the Legal Division to determine the need for changes to existing statutes and regulations. However, as discussed in the response to Recommendation One, changes would require Congressional action.

Recommendation Eight

We recommend that the Director of the Division of Supervision develop and implement a policy where examiners, as part of DOS's quarterly off-site review and pre-examination planning work, review DCA and State consumer complaint files on financial institutions that have been identified as a supervisory concern.

Response

DCA already has a mechanism in place to forward consumer complaints to DOS on all institutions if the complaints pose a safety and soundness concern. To change the process and require the examiner to review the complaint file as part of the pre-examination process would result in a duplication of effort.

However, DOS will work closely with DCA to determine whether the system for forwarding consumer complaints can be improved and to encourage DCA to be sure that complaints pass through the hands of an individual who, by training, would recognize traces of bank safety and soundness issues in certain types of complaints.

Other Recommendations

Recommendation Three

We recommend that the Director of the Division of Supervision modify DOS's Manual of Examination Policies to address how examiners should handle situations where access to bank employees and records is impeded during an examination.

Response

Existing powers granted in Sections 10(b) and 10(c) of the FDI Act already provide for access to bank employees and records; however, we will develop examination guidance to address this situation and implement same via an update to the DOS Manual and related Report of Examination Instructions by the third quarter of 1999. This is more fully discussed in the response to Recommendation Six.

Recommendation Six

We recommend that the Director of the Division of Supervision develop and implement a policy regarding how examiners should address scope limitations during an examination. For instance, the policy could provide that significant scope limitations during an examination will be considered an unsafe and unsound practice justifying a composite "5" rating for the institution.

Response

Obtaining appropriate information to complete an examination is already a cornerstone of examination procedures. Nevertheless, we will re-emphasize this through written guidance addressing how examiners should handle restricted access and scope limitations. Procedures will be implemented through a revision to the DOS Manual and related Report of Examination Instructions by the third quarter of 1999. Written guidance will stress that the examiner should make all reasonable efforts to obtain the needed information and should not close the on-site portion of the examination or the examination report until same is received. We consider this approach more meaningful to effective supervision than to close the examination and assign an arbitrary component or composite rating.

Recommendation Ten

We recommend that the Director of the Division of Supervision expand DOS's Credit Card Specialty Bank Examination Guidelines to include policies and procedures for examining subprime credit card lending.

Response

DOS has historically viewed the underlying principles of loan quality as being identical regardless of the loan type. We also note that the area of "subprime" lending is evolving and that the subprime loan category is not well defined. Although subprime loan quality can be assessed using existing procedures, we recognize that these loans differ from other loans due to the borrower profile, loan performance characteristics, and expected documentation. Consequently, these loans present unique risks.

DOS issued Financial Institution Letter (FIL) 44-97 dated May 2, 1997, *Risks Associated with Subprime Lending*. Currently, the Policy Branch is working with the other Federal regulators to issue another subprime lending FIL to incorporate issues that have come to light since the original FIL was issued. DOS estimates that the revised, interagency FIL will be completed within the next few weeks and be presented for review. Once the FIL is issued, we will supplement the Credit Card Specialty Bank Examination Guidelines accordingly. The estimated completion date is the third quarter of 1999.