



Office of Inspector General

Statement

**Subcommittee on Transportation, Treasury,
and Housing and Urban Development,
The Judiciary, District of Columbia
Committee on Appropriations
U.S. House of Representatives**

Office of Inspector General Fiscal Year 2007 Appropriation Request

**Statement of Patricia M. Black
Deputy Inspector General**

Mr. Chairman and Members of the Subcommittee:

I am pleased to present the fiscal year 2007 budget request totaling \$26.3 million for the Office of Inspector General (OIG) at the Federal Deposit Insurance Corporation (FDIC). This budget has been possible because of the improved health of the banking industry since the early 1990s, the continued staff downsizing at the FDIC and within the OIG, and our internal efforts to improve our performance and productivity even with reduced budgets.

As you know, the FDIC was established by the Congress in 1933, during the Great Depression, to maintain stability and public confidence in the nation's banking system. Our nation has weathered several economic downturns since that era without the severe panic and loss of life savings unfortunately experienced in those times. The federal deposit insurance offered by the FDIC is designed to protect depositors from losses due to failures of insured commercial banks and thrifts. While the basic insurance coverage of individual deposits remains at \$100,000, as of April 1, 2006 the FDIC raised the deposit insurance coverage on certain retirement accounts to \$250,000 from \$100,000. As of December 31, 2005, the FDIC insured \$3.893 trillion in deposits for 8,845 institutions, of which the FDIC supervised 5,245. The FDIC also promotes the safety and soundness of these institutions by identifying, monitoring, and addressing risks to which they are exposed.

The Corporation reports that financial institutions have recently had record earnings. The rate of bank and thrift failures has remained at a relatively low level over the past 10 years, and the Corporation has substantially reduced its estimates of future losses from failures. In fact, 2005 was the first year in the FDIC's history where no institution has failed, nor has 2006 seen any failures to date. Assets held in receiverships following bank failures are at comparatively low levels, and significant progress has been made in closing older receiverships. These are important indicators of a healthy banking system, and the Corporation can take pride in its positive contributions in these areas.

The FDIC OIG is an independent and objective unit established under the Inspector General Act of 1978, as amended (IG Act). The OIG's mission is to promote the economy, efficiency, and effectiveness of FDIC programs and operations, and protect against fraud, waste, and abuse to assist and augment the FDIC's contribution to stability and public confidence in the nation's financial system.

As the Deputy Inspector General, I have led the office since January 2005 (when Gaston L. Gianni, Jr. retired). I will continue to dedicate myself to carrying out the mission of the OIG until an Inspector General is confirmed. In this capacity, I will support the Congress, the FDIC Chairman, and other corporate management in meeting current and future challenges facing the FDIC and the banking industry.

I am proud of the work the OIG accomplished this past fiscal year. This statement discusses the fiscal year 2005 accomplishments, our assistance to FDIC management, internal management and operational initiatives to improve the OIG, and our new *2006 Business Plan*. I am also providing additional details about our fiscal year 2007 budget and how it will be spent.

A Review of the FDIC OIG's Fiscal Year 2005 Accomplishments

As in past years, during fiscal year 2005, our work resulted in a number of major achievements, as follows:

- \$42.4 million in actual and potential monetary benefits
- 76 non-monetary recommendations to FDIC management
- 42 referrals to the Department of Justice
- 36 indictments/informations
- 27 convictions
- 3 employee/disciplinary actions

More specifically, our accomplishments included 38 completed investigations that led to the above indictments and convictions as well as fines, court-ordered restitution, and recoveries that constitute slightly over \$29.5 million in actual and potential monetary benefits from our work. Also, we issued a total of 40 audit and evaluation reports, which included about \$3.3 million in questioned costs and \$9.5 million in recommendations that funds be put to better use. The audit reports contained 76 non-monetary recommendations to improve FDIC policies, operations, and controls that ultimately are designed to improve FDIC's ability to effectively and efficiently accomplish its mission. A number of these recommendations addressed important cross-cutting corporate issues, e.g., the corporate planning process, the use of consultants, and human capital.

Further, the OIG accomplished many of its organizational goals during the fiscal year as outlined in our annual performance plan. Our 2005 Performance Report shows that we met or substantially met 31 of our 37 goals, or 84 percent. This compares to 76 percent met or substantially met in 2004. In a measurable way, this achievement shows the progress we continue to make in adding value to the Corporation with our audits, investigations, and evaluations in terms of impact, quality, productivity, and timeliness.

Audits, Investigations, and Evaluations

Examples of the OIG's audit, investigation, and evaluation work that contributed to these accomplishments follow:

Bank Fraud in Connection with BestBank Failure

After a 3-week trial in the U.S. District Court, District of Colorado, a jury found the owners of Century Financial Services, Inc. and its successor Century Financial Group, Inc. (Century), guilty on charges of conspiracy, bank fraud, wire fraud, and operating a continuing financial crimes enterprise that contributed to the 1998 failure of BestBank in Boulder, Colorado.

By way of background, the owners owned and operated Century, a company that marketed and sold travel club memberships to subprime borrowers. Subprime credit card borrowers are high-risk borrowers with poor credit histories. The subprime borrower would finance a membership by charging it to a new BestBank unsecured VISA card. In 1998, the largest asset of the bank was the portfolio of subprime credit card accounts containing more than 500,000 credit card accounts with a reported value of more than \$200 million.

From 1996 through July 1998, the defendants, through Century, applied \$20 credits to the accounts of numerous cardholders who did not pay their credit card bill and whose accounts otherwise would have grown increasingly delinquent. These payments made the portfolio appear to be performing better than it was. During this same period of time, BestBank continued to fund the growing credit card portfolio with insured deposits. In July 1998, the Colorado State Banking Commissioner and the FDIC determined that the value of the subprime credit card portfolio, the primary asset of BestBank, was overstated because delinquent loans were fraudulently made to appear current. BestBank was found to be severely undercapitalized, with losses exceeding \$200 million, resulting in one of the largest adverse impacts to the Bank Insurance Fund in the last 10 years.

While Century earned in excess of \$460 million in gross receipts, the owners each derived more than \$11 million from the offenses. Each of them faces a possible mandatory minimum sentence of 10 years to life in federal prison and fines of up to twice the amount gained from committing the offenses. Sentencing has not yet been scheduled by the Court.

Also charged in the same indictment for offenses relating to the failure of BestBank are the dissolved bank's Chief Executive Officer and Chairman of the Board, the Chief Financial Officer, and the President. The jury trial against the remaining three defendants is scheduled to begin in July 2006.

We investigated the case jointly with the FBI and the IRS Criminal Investigative Division. The U.S. Attorney's Office for the District of Colorado and the U.S. Department of Justice are prosecuting the case.

Investigation into Misapplication of Bank Funds at Connecticut Bank of Commerce

The former chairman of the board of directors of Connecticut Bank of Commerce was sentenced in January 2005, to 51 months' incarceration and 36 months' supervised release after pleading guilty to one count of misapplication of bank funds. No criminal restitution was ordered by the court because the parties agreed that the former chairman's payment of \$8.5 million to the FDIC, as part of his settlement of the agency's administrative charges, satisfied all losses directly related to his criminal conduct.

We conducted this investigation jointly with the FBI. The U.S. Attorney's Office for the District of Connecticut prosecuted the case.

FDIC's Supervision of an Institution's Compliance with the Bank Secrecy Act (BSA)

We conducted this audit in response to a congressional request for our independent assessment of the circumstances related to an institution's BSA violations. We reported that responsibilities to ensure compliance with BSA were not adequately fulfilled by either institution management or the FDIC. In addition, FDIC examinations lacked sufficient follow-up on corrective measures to address BSA violations. Further, the FDIC needed to more thoroughly consider the impact of BSA compliance violations when qualifying potential acquirers of a failed institution. As a result of our recommendations and its own initiatives, the FDIC has made significant improvements in, and is devoting substantially more resources to, its supervision of institution BSA compliance programs.

FDIC's Investment Policies

We issued a report on the results of an audit conducted by PricewaterhouseCoopers, LLP to determine whether the FDIC's investment strategy and portfolio management procedures provided the highest possible investment returns for the FDIC. This audit concluded that the FDIC's Division of Finance performed well in managing the FDIC's investment portfolio in the context of the applicable legal and regulatory framework, stated investment strategy, interest rate environment, and assessment of certain insured institutions undergoing financial stress.

The audit identified opportunities for the FDIC to improve the return on its investments through two broad courses of action. First, in certain market environments, the FDIC should decrease holdings in overnight certificates and increase holdings in longer-maturity securities. Second, the FDIC should explore the possibility of changes in its investment approach, such as expanding the universe of allowable investments. We recommended that the Corporation perform an internal review of its investment policies, adopt certain performance measures and goals, and obtain periodic independent reviews of the investment program. All recommendations in the report were resolved.

Our semiannual reports to the Congress provide many other examples of OIG work that has contributed to fiscal year 2005 accomplishments. These reports can be found on our Web page at <http://fdicig.gov> or obtained by contacting our office.

Assistance to FDIC Management

In addition to 2005 audits, investigations, and evaluations, the OIG made contributions to the FDIC in several other ways. We strive to work in partnership with Corporation management to share our expertise and perspective in certain areas where management is seeking to make improvements. Among these contributions were the following activities:

- Reviewed 35 proposed corporate policies and offered comments and suggestions when appropriate.
- Provided advisory comments on the FDIC's 2005 Annual Performance Plan and 2005 Annual Report.
- Participated in division-level conferences and meetings to communicate our audit and investigation work and processes.
- Provided technical assistance and advice to several FDIC groups working on information technology issues, including participating at the FDIC's information technology security meetings. We also participated in an advisory capacity on the Information Technology Subcommittee of the Audit Committee.

OIG Management and Operational Initiatives

An important part of our stewardship over the funding we receive includes our continuous efforts to improve OIG performance and plans. We provide objective, fact-based information and analysis to the Congress, the FDIC Chairman, other FDIC officials, and the Department of Justice. Our key efforts typically involve our audits, evaluations, or criminal investigations conducted pursuant to the IG Act and in accordance with applicable professional standards. We also make contributions to the FDIC in

other ways, such as reviewing and commenting on proposed corporate policies and draft legislation and regulations; participating in joint projects with management; providing technical assistance and advice on various issues such as information technology, strategic planning, risk management, and human capital; and participating in internal FDIC conferences and seminars.

The OIG has continued to downsize with the Corporation through reorganization, closing two field audit offices, and offering buyouts and retirement incentives to impacted employees under an FDIC-wide program. The OIG will continue to carry out several key initiatives to implement our human capital strategic plan and ensure that the OIG is a results oriented high-performance organization. Many of the planned initiatives relate to staff development and include: the establishment of a mentoring program; providing training and development related to the OIG core competencies and business knowledge needs; and developing a strategy to improve the supervisor-staff feedback process.

Other internal initiatives included our hosting an interagency symposium on the Federal Information Security Management Act (FISMA) of 2002. Representatives from more than 18 federal agencies attended the symposium to share information, ideas, and best practices related to the implementation of FISMA. The OIG also hosted an “Emerging Issues” conference with participants from other OIGs of financial regulatory agencies, GAO, regulatory agency officials, and congressional staff. The conference brought together distinguished speakers who shared their perspectives on the banking and financial services community with Inspector General staff in the interest of enhancing the value that OIGs can add to their agencies by successfully addressing risk areas. We also sponsored the annual conference of the Federal Audit Executive Council, a working group comprised of the heads of federal audit organizations. This forum helps ensure that federal audit organizations keep current with auditing standards, practices, priorities, and issues of concern.

Business Plan

The OIG developed a new business plan that explains what we are about, what we want to accomplish, and how we will get there. It also provides a means to assess our performance. Our *2006 Business Plan* represents the results of concerted efforts over time, especially during the past year, to improve our planning process and demonstrate the value added by our office to sound FDIC governance and to executive and legislative branch decision-makers.

The *2006 Business Plan* combines the OIG Strategic Plan and Performance Plans. This plan contains six strategic goals to help accomplish our mission. In carrying out the key efforts of our plan, we will strive to demonstrate to the Congress, the public, the FDIC, and the banking industry that the OIG is doing the right things and generating results that are a worthy return on the investment made in us.

The complete *2006 Business Plan* is available at www.fdicig.gov. We have begun the process for developing performance goals and key efforts for fiscal year 2007, which will continue building on this strategic framework. Our six 2006 strategic goals and selected key efforts follow:

Strategic Goal 1: Assist the FDIC to ensure the nation’s banks operate safely and soundly

Bank supervision is a cornerstone of the FDIC’s efforts to ensure stability and public confidence in the nation’s financial system. The OIG’s role under this strategic goal is targeting audits and evaluations

that review the effectiveness of various FDIC programs aimed at providing continued stability to the nation's banks. The OIG also conducts investigations of fraud at FDIC-supervised institutions, fraud by bank officers, directors, or other insiders; obstruction of bank examinations; fraud leading to the failure of an institution; fraud impacting multiple institutions; and fraud involving monetary losses that could significantly impact the institution. Below are selected key efforts representing ongoing work or work envisioned in support of this goal.

- Conduct material loss reviews of failed banks, as needed
- Review bank examination procedures for addressing bank sensitivity to interest rate risks
- Investigate criminal obstruction of bank examinations
- Review bank examination procedures for addressing electronic banking risks
- Review whether bank examinations adequately consider the reliability of property appraisals
- Investigate financial institution fraud
- Review the FDIC's use of the Financial Crimes Enforcement Network (FinCEN)
- Review the use of Bank Secrecy Act examinations for foreign transactions

Strategic Goal 2: Help the FDIC maintain the viability of the deposit insurance funds

FDIC deposit insurance remains a central component of the federal government's assurance to the public that it can be confident in the stability of the nation's banks and savings associations. Since its establishment in 1933, the FDIC has insured deposits up to the legally authorized threshold, which historically was at \$100,000. For almost two decades following bank crises in the late 1980s and early 1990s, the FDIC has managed two deposit insurance funds—one for banks with about \$35 billion, and one for savings and loans with about \$13 billion. These funds, which are primarily an accumulation of premiums that insured depository institutions have paid the FDIC and interested earned, have been used to pay FDIC operating expenses and insured depositors, as necessary. On February 1, 2006, the Congress enacted deposit reform legislation that will create a deposit insurance system that is more focused on risk and better able to adapt to rapidly changing industry. The new deposit insurance reform legislation:

- Merges the two deposit insurance funds into a single Deposit Insurance Fund.
- Maintains deposit insurance coverage for individual accounts at \$100,000, but provides for indexing for inflation every 5 years beginning in 2010.
- Increases deposit insurance coverage for retirement accounts to \$250,000 and provides for indexing for inflation every 5 years beginning in 2010.
- Replaces the current Designated Reserve Ratio of 1.25 percent of estimated insured deposits by permitting the reserve ratio to move within a range of 1.15 percent to 1.50 percent of estimated insured deposits.
- Requires the FDIC to provide cash rebates in amount equaling 50 percent of the amount in excess of the amount required to maintain the reserve ratio at 1.35 percent. Requires the FDIC to provide cash rebates in amount equaling the total amount in excess of the amount required to maintain the reserve ratio at 1.50 percent.
- Provides financial institutions with a one-time transitional premium assessment credit based on the assessment base of the institution on 12/31/96 as compared to the combined aggregate assessment base of all eligible depository institutions.

The Corporation has begun the process for implementing the provisions of the new legislation. To date, the FDIC has merged the two deposit insurance funds into a single Deposit Insurance Fund and raised the deposit insurance coverage on certain retirement accounts to \$250,000 from \$100,000. As insurer, the FDIC must evaluate and effectively manage how changes in the economy, the financial markets, and the banking system affect the adequacy and the viability of the deposit insurance funds. The OIG has a responsibility to evaluate the FDIC's programs and operations to ensure that the agency has adequate information to gauge the risks inherent as financial institutions consolidate, enter into new business areas, and become more global. In support of this goal, we have planned the following key efforts.

- Review the FDIC's approach to risks posed by large or multiple bank failures
- Review the FDIC's risk-based premium program
- Review the insurance application process for industrial loan companies (ILCs)
- Review FDIC methods for maintaining adequate insurance fund reserves

Strategic Goal 3: Assist the FDIC to protect consumer rights and ensure community reinvestment

The FDIC oversees statutory and regulatory requirements aimed at protecting consumers from unfair and unscrupulous banking practices. The FDIC has recognized the importance of its role in this regard by establishing its own strategic goal to ensure that consumers' rights are protected and supervised institutions invest in their communities. The FDIC's bank examiners conduct examinations in FDIC-supervised banks on a scheduled basis to determine the institutions' compliance with laws and regulations governing consumer protection, unfair lending, and community investment. When problem institutions are identified, primarily through the examination process, the FDIC attempts using reason and moral suasion to bring about corrective actions; however, the Corporation possesses broad enforcement powers to correct situations that threaten an institution's compliance with applicable laws. The OIG's role under this strategic goal is targeting audits and evaluations that review the effectiveness of various FDIC programs aimed at protecting consumers, fair lending, and community investment. Additionally, the OIG's investigative authorities are used to identify, target, disrupt, and dismantle criminal organizations and individual operations engaged in fraud schemes that target our financial institutions. Our planned 2006 work towards this goal includes the following key efforts:

- Investigate misrepresentations of deposit insurance coverage
- Work with Congress and FDIC management to strengthen enforcement against misrepresentations of deposit insurance
- Investigate "phishing," "pharming," and other identity theft schemes
- Review multiple FDIC efforts to ensure financial data privacy
- Evaluate the FDIC's approach to examining fair lending and community reinvestment
- Review risks posed to institutions and the FDIC by predatory lending
- Assess how the FDIC makes use of data required by the Home Mortgage Disclosure Act
- Review how the FDIC addresses deficiencies reported in compliance examinations

Strategic Goal 4: Help ensure that the FDIC is ready to resolve failed banks and effectively manages receiverships

When a bank that offers federal deposit insurance fails, the FDIC fulfills its role as insurer by either facilitating the transfer of the institution's insured deposits to an assuming institution or by paying insured depositors directly. Although there have been far fewer failures in recent years than occurred during the years of crisis in the banking industry, the FDIC's responsibility for resolving troubled institutions remains a challenge. The FDIC reports that failures in today's economy would differ in nature, size, and cost from the record failures of the 80s and early 90s. Nonetheless, the FDIC could potentially have to handle a failing institution with a significantly larger number of insured deposits than it has had to deal with in the past or have to handle multiple failures caused by a single catastrophic event.

The OIG's role under this strategic goal is targeting audits and evaluations that assess the effectiveness of the FDIC's various programs designed to ensure that the FDIC is ready to and does respond promptly, efficiently, and effectively to financial institution closings. Additionally, the OIG investigative authorities are used to pursue instances where fraud is committed to avoid paying the FDIC civil settlements, court-ordered restitution, and other payments as the institution receiver. Our office is focusing on the following key efforts.

- Assess the FDIC's planning for large or multiple bank failures
- Review the recovery of unclaimed deposits in failed banks
- Review the development framework for a new technology-driven asset servicing project
- Identify and investigate instances of assets fraudulently concealed from the FDIC

Strategic Goal 5: Promote sound governance and effective stewardship of financial, human, information technology, and procurement resources

The FDIC must effectively manage and utilize a number of critical strategic resources in order to carry out its mission successfully, particularly its financial, human, information technology (IT), and procurement resources. Financial resources are but one aspect of the FDIC's critical assets. The Corporation's human capital is also vital to its success. The FDIC appreciates the importance of its people, with four of its six values, integrity, competence, team work, and fairness specifically referencing the workforce.

Information technology drives and supports the manner in which the public and private sector conduct their work. At the FDIC, the Corporation seeks to leverage IT to support its business goals in insurance, supervision, consumer protection, and receivership management, and to improve the operational efficiency of its business processes. Along with the positive benefits that IT offers comes a certain degree of risk. In that regard, information security has been a long-standing and widely acknowledged concern among federal agencies. A key effort for all agencies must be the establishment of effective information security programs.

The OIG's role in this strategic goal is to perform audits, evaluations, and investigations that identify opportunities for more economical, efficient, and effective corporate expenditures of funds; recommend actions for more effective governance and risk management practices; foster corporate human capital strategies that benefit employees, strengthen employees' knowledge, skills, and abilities; ensure employee and contract integrity; inspire employees to perform to their maximum capacity; help the

Corporation to leverage the value of technology in accomplishing the corporate mission; promote the security of both IT and human resources; and ensure that procurement practices are fair, efficient, effective, and economical. The key efforts below are some of the ongoing work or work to be undertaken in support of this goal.

- Evaluate selected FDIC efforts to operate efficiently, effectively, and economically
- Review the FDIC's personnel discrimination complaint tracking system
- Investigate FDIC employee or contractor misconduct, as needed
- Review succession planning initiatives
- Review safeguards over sensitive employee information
- Review the FDIC's information security, privacy, and data protection programs
- Review selected procurement practices

Strategic Goal 6: Continuously enhance the OIG's business and management processes

The OIG's final strategic goal has an internal focus on continuous improvement. Our aim under this goal is to:

- Enhance our own business and management practices
- Enhance strategic and annual planning and performance measurement
- Strengthen human capital management
- Ensure the continued quality and efficiency of audits and investigations
- Foster good relationships with clients, stakeholders, and OIG staff

The OIG's Fiscal Year 2007 Budget Request

The proposed fiscal year 2007 OIG budget includes funding in the amount of \$26,256,000, or \$4,434,000 less than fiscal year 2006 (after a one-percent rescission). This budget will support an authorized staffing level of 130—a 19-percent reduction from the 160 staff authorized in fiscal year 2006. The FDIC has continued a downsizing effort over several years in response to changes in the banking industry, information technology, and fewer bank failures. Consequently, we have conducted a thorough review of our workload and determined that we can reduce the number of audits to be performed and some other aspects of our workload because of certain decreased elements of risk, fewer assets under FDIC receivership management, and fewer bank failures experienced and anticipated. However, the OIG's investigative workload is increasing, with a substantial caseload of financial institution fraud because Federal Bureau of Investigation resources have been redirected to the war on terrorism.

The FDIC OIG has been operating under an appropriated budget since fiscal year 1998 in accordance with Section 1105(a) of Title 31, United States Code, which provides for “a separate appropriation account for appropriations for each Office of Inspector General of an establishment defined under Section 11(2) of the Inspector General Act of 1978.” The FDIC OIG is the only appropriated entity in the FDIC, and this funding approach is part of the statutory protection of the OIG's independence. As in past years, the funds for the OIG budget would be derived from deposit insurance funds and the

FSLIC Resolution Fund. The insurance funds are funded by assessments on deposits held by insured banks and thrifts and from the interest on the required investment of fund reserves held in government securities. These funds are the ones used to pay for other FDIC operating expenses.

Budget by Strategic Goals

For fiscal year 2007, the OIG developed the budget based on the six strategic goals that I discussed earlier. The six strategic goals, along with their associated portion of budget dollars follow:



Strategic Goal 1: Assist the FDIC to Ensure the Nation's Banks Operate Safely and Soundly

Strategic Goal 2: Help the FDIC Maintain the Viability of Deposit Insurance Funds

Strategic Goal 3: Assist the FDIC to Protect Consumer Rights and Ensure Community Reinvestment

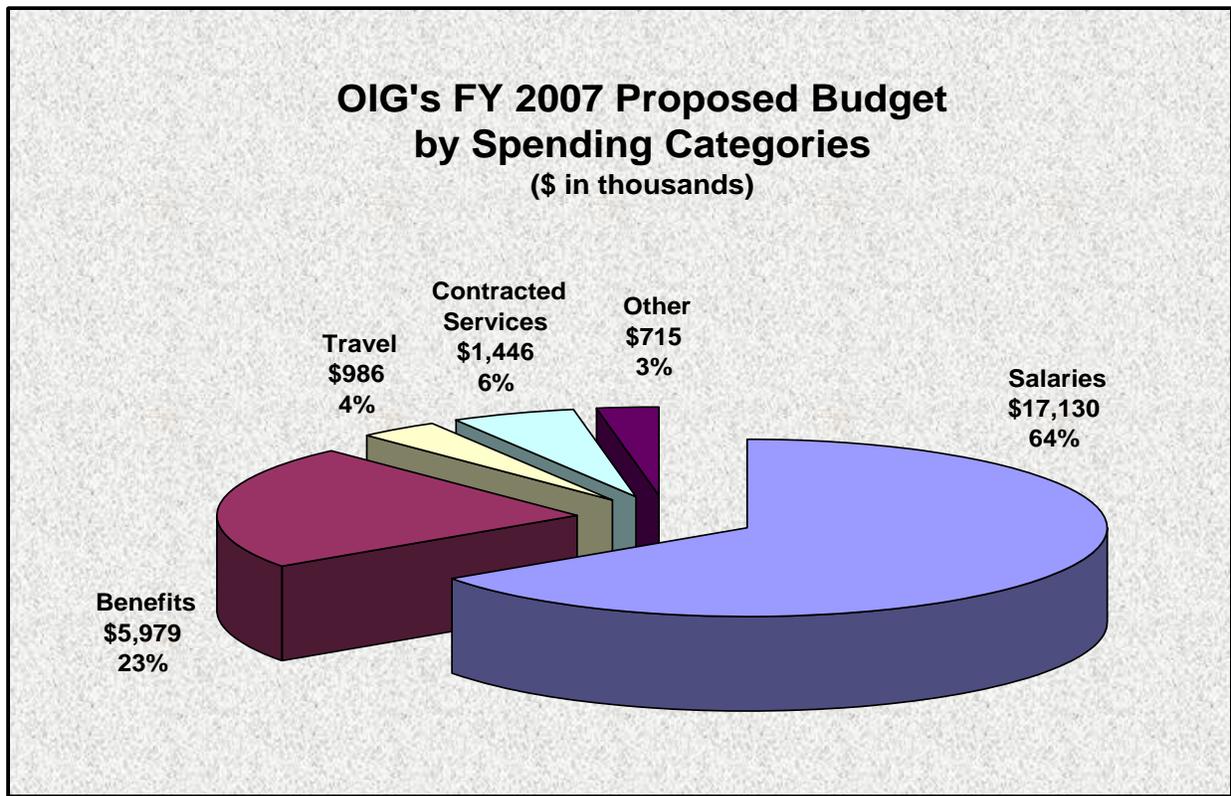
Strategic Goal 4: Help Ensure the FDIC is Ready to Resolve Failed Banks and Effectively Manages Receiverships

Strategic Goal 5: Promote Sound Governance and Effective Stewardship of Financial, Human, Information Technology, and Procurement Resources

Strategic Goal 6: Continuously Enhance the OIG's Business and Management Processes

Fiscal Year 2007 Budget by Major Spending Categories

The following chart shows the distribution of the OIG's budget by major spending categories. Mostly, the OIG budget is comprised of salaries and benefits for its employees and the necessary funding for travel and training expenses. Our fiscal year 2007 budget also includes funds to replace our staff's laptop computers, which will be over 3 years old and due for replacement, in accordance with the Corporation's computer replacement schedule.



Concluding Remarks

Mr. Chairman and Members of the Subcommittee, I appreciate the support and resources we have received through the collaboration of the President, the Congress, and the FDIC. As a result, the OIG has continued to make a real difference in FDIC operations in terms of financial benefits and improvements, and by strengthening our own operations and efficiency. I look forward to continue working with this Subcommittee and working with the new Inspector General when appointed. I believe our fiscal year 2007 budget strikes an appropriate balance between the mandate of the Inspector General Act, other legislative requirements, our judgments of OIG workload needs, the changing conditions in the banking industry, and the FDIC's downsizing. We continue to seek your support so that we will be able to effectively and efficiently conduct our work on behalf of the Congress, the FDIC, and the American public.