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Administrative Office
c/o Professor George Kaufman
Loyola University Chicago
820 North Michigan Avenue
Chicago, Illinois 60611
Tel: (312) 915-7075
Fax: (312) 915-8508
E-mail: gkaufma@luc.edu

Statement No. 157
For information contact

Paul Horvitz
410.250.8829
Peter Wallison
202.862.5864
George G. Kaufman
312.915.7075
George Benston
404.727.7831

Statement of the Shadow Financial Regulatory Committee

On

The Failures of BestBank and First National Bank of Keystone

September 27, 1999

Two recent bank closures have raised serious questions about the effectiveness of bank regulators and supervisors in dealing with failing banks. BestBank, a Colorado state chartered bank, was closed in July 1998, and The First National Bank of Keystone was closed in August, 1999—both with exceedingly large losses relative to their size (over 50% of their assets). Although these were small banks, the losses were large enough to rank among the most costly in the FDIC's history.

Bank failures and closings cannot be entirely avoided, of course, but the size of the losses in these two cases is troubling for several reasons. First, these are not distressed times in the banking industry, and the resources of the supervisors at the OCC or the FDIC have not been stretched; both agencies should have had plenty of personnel and time to devote to institutions that are exhibiting evidence of financial weakness or mismanagement. Second, the FDICIA reforms—which emphasized prompt corrective action based on regulators' monitoring the capital positions of banks—should result in supervisory steps that substantially reduce the losses in banks that are headed for failure.

Although all the facts concerning these two banks are not yet known, it seems reasonable to conclude at this point that there can be only two explanations for what occurred—extraordinary supervisory incompetence or fraud. If there were no fraud, we need an explanation from the federal supervisory agencies—the FDIC and the OCC—for how such a breakdown in the supervisory process could have occurred. In the absence of fraud and coverup, such losses take time to occur, and typically generate visible signals that should have alerted examiners and supervisors.

The system contemplated by FDICIA assumes that the supervisors can act promptly on indications of trouble at insured banks. If they are unable to recognize the problems or unwilling to act on them when recognized, then the FDIC is not effectively protected against large losses. It is important to keep in mind that BestBank and the First National Bank of Keystone were relatively small institutions; if they had been large ones, and the losses had been allowed to build up in the same proportion, the consequences for the Bank Insurance Fund could have been of historic proportions.

Fraud is difficult for supervisors to deal with, and fraud has been alleged as a cause of failure in both of these cases. Bank supervisors have traditionally downplayed their ability and responsibility to detect fraud. They have often emphasized the difference between examinations and audits. Fraud by its nature is difficult to discover in the course of an ordinary bank examination which relies on a sharing of the bank's information with the examiner. However, there were indications that more than an ordinary examination was called for in the case of these banks. Both had grown at enormous rates over several years, relied on large amounts of brokered funds, and had unusual portfolios for institutions located in small communities. These facts should have alerted supervisors to the possibility that something highly unusual was occurring at both banks, and should have induced the supervisors to do more than is usually required by a bank examination.

It is true that bank examinations do not ordinarily involve the kinds of procedures that would detect fraud. Bank examiners normally look for documentary support for a bank's assets—whether, for example, a borrower appears to be creditworthy from the information in the bank's files—not whether those assets in fact exist. However, given the fact that substantial losses can occur as the result of fraud, these two cases suggest that it is time for bank supervisors to change their procedures so that bank examiners carry out fraud audits in cases where certain indicators of mismanagement are present. At a subsequent meeting, the Committee will expand on this concept. Historical evidence on bank failures suggests that fraud is often the primary factor in bank failures – it occurs too often to be ignored by bank supervisors or left entirely to the outside auditors to detect.