Second Quarter 2003

SRC Insights

FEDERAL RESERVE BANK OF PHILADELPHIA

A newsletter published by the Supervision, Regulation & Credit Department for the institutions that it supervises.

Volume 7 Issue 4

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SVP Commentary on…

Corporate Governance in Financial Institutions

The Sarbanes-Oxley Act of 2002 is perhaps the most visible and far-reaching response to the recent spate of corporate governance failures and accounting irregularities. However, for financial institutions, many of the provisions in Sarbanes-Oxley merely codify the internal controls and corporate governance requirements prescribed for financial institutions through FIRREA, FDICIA, and the Board of Governor's Regulation O, *Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks*.

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Not Just Your Customer: Know Your Employee

by Frank A. Germano, Supervising Examiner

Bank Fraud…The phrase conjures up visions of shady characters and desperate situations that are dramatically depicted on the movie screen. If life were as predictable as it is in the movies, we would be able to recognize criminal activity as soon as it starts and bring it to a screeching halt. But we all know that's not the case.

The sad truth is that a large percentage of fraud is committed by individuals that we would not suspect—the long-term, experienced company officer that everyone gets along with, the bookkeeper who has spent his or her entire professional life with the organization, or the new hot-shot programmer who has an answer for everything. Almost anyone, depending on the circumstances, is capable of committing fraud.

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Bank fraud is not something that happens only in foreign countries or large domestic banks. All institutions, regardless of location and asset size, could become victims of bank fraud if their internal controls are not strong. In addition, since internal controls can be overridden by management and, even in some cases, employees, the internal controls are only as strong as the underlying ethical culture.

A Case Study

In the early 1990s, a de novo Third District community bank was the target of a fraud that was so extensive and pervasive that it eventually resulted in the closing of the bank. In this situation, one of the main participants was a seasoned, well-respected bank officer—the bank's President—who no one would have expected to be involved. This small community organization was, for the most part, "invaded" by a shady borrower from out of the bank's normal market area. This borrower was able to present a steady and copious stream of fraudulent documents to support an extensive volume of borrowings that were never to be repaid. The fraud was aided, perhaps unintentionally at first, by the well-respected President who did not verify the legitimacy of the documents presented and who, at the end of the scheme, hid information from the bank's directors.

The fraud began slowly with two or three sizeable loans to the out-of-market borrower and two of his companies. The borrower's financial information appeared to show a stable, well-to-do individual who owned various real estate properties and a few profitable businesses. In the economy of the late 1980s and early 1990s, these "high quality" loans were a windfall for the President of this de novo bank, who jumped at the opportunity to make the loans. The President did check the legitimacy of the companies at first, but not the validity of the financial information. He also relied on associates of the borrower to verify real estate lien positions instead of contacting an independent organization.

As time went on, additional companies affiliated with the borrower began to emerge, other family members were introduced, and there were more and more borrowings. Before the President knew it, the bank's exposure to the borrower, his companies, and his family exceeded the bank's capital. Not knowing how to extricate the bank from the relationship and perhaps to save face with his Board of Directors, the President began hiding additional borrowings from the Board of Directors and started soliciting Loan Committee approvals over the telephone.

The situation came to a head when the borrower incurred a large overdraft in one of his checking accounts. Unable to cover the overdraft, the pyramid of loans collapsed and the small bank was left holding the bag.

Lessons Learned

The President was the senior and only lending officer of the bank. In this capacity, he was responsible for verifying all of the documentation received in support of loan applications. Since the borrower lived and worked far away from the bank, it may have been inconvenient for the President to find or contact independent organizations in the borrower's area. It is still not known why the President relied on the borrower's recommendations regarding people and businesses from his area that could verify the information provided in support of the loan requests. As it turned out, these people and businesses were established by the borrower for this specific purpose. Because the President was trusted completely by the Chairman and the Board members, he was able to get loan approvals over the telephone with very few questions asked.

Not only did the President underwrite the loans, he also was responsible for overseeing backroom activity and funds disbursement. As such, he booked the loan, ordered the funds, and signed the check, all without meaningful third party operational oversight.

One of the primary breaches of security within the bank was to invest the President with full and complete access to all of the computer systems and programs. The rationalization was based on the size of the institution (less than $50 million), the limited number of employees, and the trust placed in the individual, since he was one of the founders of the bank. However, the Chairman of the Board, the other founder of the bank, was salaried, active in bank management, and presumably worked closely with the President. Shared access, or joint access, with the Chairman might have prevented some of the President's covert actions.

Where Were the Internal Controls?

Several internal control deficiencies contributed to the fraud and the ultimate failure of the bank. As stated in the recently released *Interagency Policy Statement on the Internal Audit Function and its Outsourcing*, effective internal control is a foundation for the safe and sound operation of a banking organization.[1] The board of directors and senior managers of an institution are responsible for ensuring that the system of internal controls is effective and this responsibility cannot be delegated.

Segregation of Duties. Segregation of duties is one of the basic and most successful methods of achieving internal control. Because the bank was small (under $50 million in assets), it reasoned that it did not have the depth of employees to effectively segregate duties. However, it appears that there were no processes or procedures implemented to segregate any duties or authorities related to loan underwriting, documentation, and disbursement, allowing the fraud to continue and grow.

Internal Audit. The *Interagency Guidelines Establishing Standards for Safety and Soundness*, issued pursuant to section 39 of the *Federal Deposit Insurance Act* (FDIA) (Appendix D-1 to Regulation H, *Membership of State Banking Institutions in the Federal Reserve System*), require each state member bank to have an internal audit function that is appropriate to its size and to the nature and scope of its activities.[2] In those situations where the institution is small, is not a public company, and staff resources are limited, as was noted in this case, management is encouraged to follow the same requirements applicable to larger public institutions, balancing cost and risk. When properly structured and conducted, internal audit will provide directors and senior management with vital information so that management can take appropriate and timely remedial action when needed. Further guidance for administering both internal and external audit programs can be found in *The Sarbanes-Oxley Act of 2002*.

Guidance on Internal Controls. While by no means all inclusive, §1010.1 of the Federal Reserve's *Commercial Bank Examination Manual* discusses the objectives of

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[1] The press release and the *Interagency Policy Statement on the Internal Audit Function and Its Outsourcing* are available on the Board of Governors web site at <www.federalreserve.gov/boarddocs/press/bcreg/2003/20030317/default.htm>.

[2] Appendix D-1 to Regulation H, *Membership of State Banking Institutions in the Federal Reserve System*, can be found on the Board of Governors web site at <www.federalreserve.gov/regulations/title12/sec208/208.101.pdf>.

The Sarbanes-Oxley Act of 2002: The Task of Restoring Public Confidence

by Jennifer M. McCune, Examiner and Jacqueline P. Fenton, Assistant Examiner

The constant reporting in news headlines of corporate scandals and failures, and the subsequent revelations regarding a lack of transparency in accounting practices and loose standards of auditor independence, have left the average person wary of investing in public companies. From this chaos has come the most sweeping corporate governance law since 1934—*The Sarbanes-Oxley Act of 2002* (the Act). The Act, which is designed to restore confidence in financial presentations, disclosures, and oversight of public companies, was signed into law by President George W. Bush on July 30, 2002. How will this law restore confidence in corporate America, and what does it mean for banking organizations? To answer these questions, this article will address the Act's foremost points.

The Public Company Accounting Oversight Board

Because of the numerous charges of conflicting interests among public companies and their external accountants, the Act established the Public Company Accounting Oversight Board (PCAOB). Although the PCAOB is an independent not-for-profit organization, it is subject to SEC oversight. The four members and the chair will be appointed by the SEC, in consultation with the Secretary of Treasury and the Chairman of the Federal Reserve System. On April 15, 2003, the SEC announced that it had selected William J. McDonough, current President of the Federal Reserve Bank of New York, as its nominee to chair the PCAOB.

The PCAOB is designed to protect the interests of investors in the preparation of accurate and independent external audit reports. As such, it will establish auditing, quality control, ethics, independence, and other standards; register, regulate, oversee, and discipline accounting firms that audit public companies; and enforce compliance with the Act. As a result, accounting firms that prepare audit reports for public companies must register with the PCAOB.

Independence and Corporate Responsibility

In restoring public confidence, one must first look to those who are most accountable for the oversight of a corporation—the board of directors. As such, the Act requires that a majority of a corporation's directors be independent; however, the Act has no requirement that the chairperson be a non-executive of the company. It is important to understand that the Act has not changed the fiduciary responsibilities or other fundamental tenets of corporate law applicable to boards of directors. Likewise, the Act did not weaken the structures that insulate directors from personal liability for non-negligent corporate actions, since without those structures competent people might be discouraged from serving as directors. Instead, the Act imposes greater independence and oversight responsibilities on corporate directors.

Generally, an independent director should have no material relationship with the company (whether directly or as a partner, shareholder, or officer of any organization that has a relationship with the company), and the basis for determining a relationship to be immaterial must be discussed in the corporation's proxy statement. The SEC's final rule 33-8183 provides detailed guidance on the SEC's expanded definitions of independence and lack thereof.[1]

To further improve corporate responsibility, the Act requires that each public company have an audit committee composed of independent directors of the company. In order to improve the effectiveness of a company's audit committee, each member of the audit committee must be "financially literate," and at least one member must be an "audit committee financial expert." For many banking organizations, these concepts may not be new since the FDIC has required that audit committee members of banking organizations be independent of management and not "large customers" of the institution. In addition, the FDIC has required that at least two members of the audit committee of large institutions

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[1] The SEC's January 28, 2003 release 33-8183, *Strengthening the Commission's Requirements Regarding Auditor Independence*, and subsequent correcting release 33-8183a are available on the SEC's web site at <www.sec.gov/rules/final.shtml>.

have "banking or financial management expertise."

On January 23, 2003, the SEC released its final rule on "audit committee financial experts" and codes of ethics applicable to the company's principal officers.[2] The SEC determined that the term "audit committee financial expert" better described the desired characteristics of the member of the audit committee filling that role than did the originally proposed term "financial expert." As defined in the final rule, an "audit committee financial expert" is someone who has:

- an understanding of generally accepted accounting principles and financial statements;
- the ability to assess the general application of such principles in connection with the accounting for estimates, accruals, and reserves;
- experience in preparing, auditing, or analyzing financial statements for generally comparable companies or experience actively supervising one or more persons engaged in such activities;
- an understanding of internal controls and procedures for financial reporting; *and*
- an understanding of audit committee functions.

The final rules contain guidance to assist companies in determining whether an audit committee member meets the above requirements. In addition, the final rules require that the board of directors disclose annually whether it has at least one audit committee financial expert serving on its audit committee. If there is an audit committee financial expert, his or her name must be disclosed. If there is no audit committee financial expert, the board of directors must explain why.

To further prevent harm to a company from insider misconduct, the Act requires the audit committee to establish a reporting procedure for receiving anonymous employee complaints regarding misconduct. In addition, the Act provides for greater protection for employees who fear retaliation for reporting evidence of fraud.

Other requirements under the Act designed to promote greater independence and corporate responsibility among directors and senior officers include the following.

- Adopting a code of ethics for senior financial officers.
- Requiring senior officers to reimburse the company for any bonuses received if, as a result of that officer's misconduct, the company is required to restate its financial statements due to material noncompliance.
- Restricting trading by directors and executive officers during blackout periods for employees holding company stock in company benefit plans.
- Banning personal loans from public companies to their executive officers and directors that are not made in the ordinary course of business. (Banking organizations will continue to be governed by Regulation O.)

Independence Within the Accounting Profession

The Act also establishes new ground rules for external auditors of public companies, and prohibits an external auditor from providing a number of non-audit services to the public companies it audits. Again, the focus is on maintaining the auditor's independence from the entity that it is auditing. A list of prohibited services appears in Exhibit 1. Of note, the SEC has backed away from restrict-

Exhibit 1.

Prohibited Non-Audit Services for External Auditors

- Bookkeeping or other services related to the accounting records or financial statements of the audit client
- Financial information systems design and implementation
- Appraisal or valuation services, fairness opinions, or contribution-in-kind reports
- Actuarial services
- Internal audit outsourcing services
- Management functions or human resources
- Broker or dealer, investment adviser, or investment banking services
- Legal services and expert services unrelated to the audit

[2] The SEC's January 23, 2003 release 33-8177, *Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002*, and subsequent correcting release 33-8177a are available on the SEC's web site at <www.sec.gov/rules/final.shtml>.

ing auditors from providing tax services.

Although the PCAOB is authorized to adopt rules restricting other types of consulting service, to date it has not done so. However, the audit committee must approve in advance an external auditor providing such non-audit services, and the arrangements must be disclosed in the company's SEC filings.

To further ensure independence from its clients, every five fiscal years an audit firm must rotate both its lead audit partner and the audit partner responsible for reviewing the audit. While there is no requirement that the audit firm be rotated, the NYSE recommends that each audit committee consider whether, in the interest of assuring continuing auditor independence, there should be regular rotation of the audit firm.

Accountability and Disclosure

To enhance transparency and restore investor confidence in financial statements, the Act also places strong emphasis on accountability and disclosure. Section 302 of the Act requires a company's chief executive officer (CEO) and chief financial officer (CFO) to certify the accuracy of financial statements. Among other issues, this certification must indicate that the statements were (i) reviewed by the CEO and CFO, (ii) fairly state the financial condition of the company, and (iii) contain no material misstatements or omissions. The CEO and CFO are also required to certify that an internal control system has been designed, documented, and evaluated for effectiveness, and that any weaknesses have been reported to the audit committee. They must also certify that any fraud—material or immaterial—that involves management or employees who have a significant role in internal controls has been reported to the company's auditors and the audit committee of the board of directors.

Ignorance is not an acceptable defense for violation of these requirements, and certifying officers who violate this section of the Act will face criminal prosecution with punishment of up to 20 years in prison and/or a fine of $5 million.

In addition to financial statement certification, the Act requires the disclosure of numerous items. Disclosure should level the playing field for all investors and better protect employees, pension holders, and investors from management fraud. The list in Exhibit 2 is not all-inclusive, but represents an overview of some of the new areas of disclosure required by the Act.

Exhibit 2.

Required Public Disclosures

- All material off-balance sheet transactions and other relationships with unconsolidated entities, also known as Special Purpose Entities (SPEs)
- Aggregate contractual obligations
- Accelerated reporting of insider transactions

The required disclosures about off-balance sheet arrangements and aggregate contractual obligations in Exhibit 2 must be made in a separately captioned subsection of the *Management's Discussion and Analysis*. Disclosures about SPEs should include the nature and business purpose of the arrangement; the financial impact of the arrangement; and any known events, demands, commitments, trends, or uncertainties related to the SPEs.[3] To enhance transparency and level the playing field between inside investors and the general public, insider transactions must be disclosed within 2 business days, not within 40 days as previously required. In addition, all financial statements filed with the SEC must reflect all material correcting adjustments identified by a registered public accounting firm in accordance with generally accepted accounting principles and SEC rules and regulations.

Accelerated and new disclosure requirements are not limited to company directors and senior officers, but also apply to securities analysts and attorneys. To address the widespread lack of faith in securities analysts and their research reports, the Act included tougher guidelines for stock research analysts to better ensure honest and unbiased evaluations.

[3] The SEC's January 27, 2003 release 33-8182, *Disclosure in Management's Discussion and Analysis about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations,* is available on the SEC's web site at <www.sec.gov/rules/final.shtml>.

Analysts are required to disclose conflicts of interest that may cloud their judgement as well as compensation arrangements based on winning business for their employers.

In addition, attorneys appearing and practicing before the SEC are required to report evidence of a material violation of the securities laws or a breach of fiduciary responsibility to the company's CEO or general counsel. Outside attorneys must take appropriate action when they discover evidence of wrongdoing and can no longer use attorney-client privilege when the best interest of the public may be compromised.

Interagency Regulatory Guidance

The most anticipated regulatory guidance related to the Act within the banking community was released on March 17, 2003 in the *Interagency Policy Statement on the Internal Audit Function and Its Outsourcing*.[4] This policy statement emphasizes that each FDIC-insured depository institution with total assets of $500 million or more is required to have an annual audit performed by an independent public accountant and that these institutions must meet the auditor independence requirements under the Act. Therefore, the financial institution must ensure that its external accounting firm remains independent and is not performing any prohibited non-audit services.

Institutions not subject to these laws are encouraged to follow the Act's prohibition regarding internal audit outsourcing. The policy statement does provide guidance for small pub-

[4] The *Interagency Policy Statement on the Internal Audit Function and Its Outsourcing* is available as an attachment to SR 03-5, *Amended Interagency Guidance on the Internal Audit Function and its Outsourcing*, on the Board of Governors web site at <www.federalreserve.gov/boarddocs/SRLETTERS/2003/sr0305.htm>.

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New Supervisory Guidance on Corporate Governance: SR 03-8 and FIL 17-2003

On May 5, 2003, the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision (the agencies) issued a *Statement on Application of Recent Corporate Governance Initiatives to Non-Public Banking Organizations*. In general, the agencies do not expect to apply the board composition, director independence, audit committee, auditor independence and other corporate governance requirements of *The Sarbanes-Oxley Act of 2002* to non-public organizations that are not otherwise subject to them. Rather, the Statement encourages non-public banking organizations to review their policies and procedures relating to corporate governance and auditing to ensure that they are consistent with applicable law, regulations, and supervisory guidance and are appropriate in light of the institution's size, operations, and resources. The Statement is available in the Board's SR Letter 03-8 of the same name at <www.federalreserve.gov/boarddocs/srletters/2003/sr0308.htm>.

On March 5, 2003, the FDIC issued guidance addressing the interrelationships between *The Sarbanes-Oxley Act* and Part 363 of the FDIC's regulations, which applies to all insured depository institutions with $500 million or more in assets. This guidance is available in the FDIC's Financial Institution Letter 17-2003 *Corporate Governance, Audits, and Reporting Requirements* at <www.fdic.gov/news/news/financial/2003/fil0317.html>.

"Corporate Governance" *continued from page 1*

Although banks will need to comply with the legal provisions associated with Sarbanes-Oxley, most financial institutions already have the fundamentals of corporate governance entrenched in their operations. The significant majority of financial institutions already have rigorous processes to select qualified directors, ensure that the directors can devote an adequate commitment of time to the bank, provide continuous director training, provide solid management information, and balance the power of the CEO and directorate. However, notwithstanding the general strength of corporate governance in financial institutions, they too have been exposed to an increasing number of shareholder resolutions, most of which relate to corporate governance issues. In financial institutions, shareholder resolutions and questions have addressed issues such as executive compensation, expensing stock options, and the composition of the board of directors.

SR Letter 02-20, *The Sarbanes-Oxley Act of 2002*, discusses some of elements of Sarbanes-Oxley that might apply most directly to financial institutions.[1] SR 02-20 includes discussions of:

- Publicly Held Banking Organizations
- Audit Committee Structure and Responsibilities
- Insider Lending
- Outside Auditors
- Financial Disclosure and Reporting Obligations
- Other Provisions Affecting Banking Organizations
- Foreign Banking Organizations
- Non-Publicly Held Banking Organizations
- SEC Regulations and Federal Reserve Supervisory Guidance

A removal, suspension, or debarment under section 36 would limit an accountant's or accounting firm's eligibility to provide audit services to insured depository institutions with total assets of $500 million or more.

One of the more visible changes to financial institution guidance related to Sarbanes-Oxley is the new *Interagency Policy Statement on the Internal Audit Function and Its Outsourcing* that was issued on March 17, 2003. The revised policy statement, which replaces the policy statement issued in 1997, also reflects the agencies' experience with the 1997 policy and incorporates recent developments in internal auditing.[2] *The Sarbanes-Oxley Act* and SEC rules prohibit an accounting firm from acting as the external auditor of a public company at the same time that the firm provides internal audit services to the company. The revised policy statement discusses how this prohibition applies to (i) financial institutions that are public companies; (ii) insured depository institutions with $500 million or more in assets that are subject to the annual audit and reporting requirements of section 36 of the *Federal Deposit Insurance Act* (FDIA); and (iii) non-public institutions that are not subject to section 36. The new policy statement is discussed in the article "The Sarbanes-Oxley Act of 2002: The Task of Restoring Public Confidence" that appears in this issue of *SRC Insights*.

Another highly visible announce-

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[1] SR 02-20, *The Sarbanes-Oxley Act of 2002*, is available on the Board of Governors web site at <www.federalreserve.gov/boarddocs/SRLETTERS/2002/sr0220.htm>.

[2] The press release and the *Interagency Policy Statement on the Internal Audit Function and Its Outsourcing* are available on the Board of Governors web site at <www.federalreserve.gov/boarddocs/press/bcreg/2003/20030317/default.htm>.

ment was the December 17, 2002 interagency proposal that would provide for removal, suspension, or debarment of accountants or accounting firms from performing the audit services required by section 36 of the FDIA.[3] Congress gave the federal banking supervisory agencies authority to remove, suspend, or debar accountants from performing the audit services required by section 36 if there is good cause to do so. The proposal reflects the increasing concern with the quality of audits of and internal controls over financial reporting at insured depository institutions. As proposed, a removal, suspension, or debarment under section 36 would limit an accountant's or accounting firm's eligibility to provide audit services to insured depository institutions with total assets of $500 million or more, but would not restrict its ability to provide audit services to financial institutions with less than $500 million in total assets or its ability to provide other types of services to all financial institutions. The Board of Governors and other federal banking supervisory agencies are reviewing the comments on the proposal and will be issuing final rules in the near future.

As apparent in the revised policy statement on internal audit, regulators will continue to factor the size and complexity of the organization when assessing risk management processes and analytic capability. While size and complexity will also be considered when assessing internal controls, there still may be a need for small banks to ensure that they implement effective compensating controls in areas where more traditional controls, such as segregation of duties, are less effective due to the institution's size. This became painfully apparent in one de novo Third District bank failure in the 1990s, as discussed in the article "Not Just Your Customer: Know Your Employee" that appears in this issue of *SRC Insights*.

A large number of companies, including a majority of financial institutions, have sound governance processes. However, corporate governance and internal controls have the most obvious impact on a company when they prove to be seriously lacking. Due to the potential disastrous consequences of ineffective corporate governance and internal controls, each and every financial institution would be well served if its management, with strong board of director involvement, reviews its governance and control structures with an open and unbiased eye. ■

[3] The press release and original request for comment are available on the Board of Governors web site at <www.federalreserve.gov/boarddocs/press/bcreg/2002/20021217/attachment.pdf>.

Breakdowns in Corporate Governance: The Indirect Effects

Financial institutions are in a rather unique position of indirectly—but perhaps significantly—being affected by breakdowns in corporate governance in other companies. Several financial institutions held large credit exposures to firms that followed questionable accounting practices and/or had weak corporate governance practices. The ramifications of those breakdowns negatively affected the collectiblity of the debt and caused additional provisioning for loan losses and/or charge-offs. The revelation of those credit problems related to corporate governance highlighted the need for expanded firm-wide MIS and risk management practices in commercial loan underwriting.

"Know Your Employee" *continued from page 3*

internal control, director and senior management responsibilities related to internal control, and means to ensure the adequate functioning of internal controls.[3] Even a cursory review of the guidance in the *Commercial Bank Examination Manual* would uncover many more breakdowns in the internal control environment in the case study. The *Commercial Bank Examination Manual* will soon be updated to reflect the recently released *Interagency Policy Statement on the Internal Audit Function and it Outsourcing*, discussed above, which supercedes some previously issued guidance.

Why Fraud Occurs When Internal Controls Are Strong

Even companies that have strong, effective systems of internal controls are sometimes targets of fraud, whether by insiders or customers. Three factors contribute to the commission of a fraudulent act—situational pressure, opportunity, and personal integrity. Situational pressure could be internal to the perpetrator, such as financial pressures, or could be from an external source, such as pressure to achieve unrealistic financial results. Likewise, opportunities can be self-created, such as when the perpetrator actively seeks ways to defraud the company, or can be created by an environment of weak internal controls. Finally, people with low personal integrity, put in a pressure situation and given the opportunity, will more likely commit fraud than people with high personal integrity.

In the case study, the confluence of the situational pressure to rapidly increase the asset size and earnings of a de novo bank, the opportunity for the President to control the entire underwriting and loan disbursement process, and a crack in the President's personal integrity lead to the President's participation in a fraud that resulted in the failure of the bank. It is presumed that, in the borrower's mind, the high growth situational pressure on a de novo bank presented the perfect opportunity to relieve the borrower's personal situational pressures, weak finances.

While strong internal controls can aid in the deterrence of fraud, detecting fraud is particularly difficult when an insider in a position to conceal his or her actions is one of the participants. Therefore, every financial institution should institute specific controls designed to deter internal fraud, which could include the following.

- Requiring employees to avoid and disclose conflicts of interest
- Requiring employees to follow a code of ethics
- Requiring employees to maintain good credit ratings
- Requiring adherence to policies for rotation of duties and mandatory vacations
- Requiring use of employee identification cards for access to secure areas
- Restricting access to controlled areas
- Developing and implementing computer security techniques

Reporting and Investigating Fraud

Once fraud has been committed, it is critical that it be quickly detected and promptly investigated to minimize loss. This is no easy task, particularly when the perpetrator is an insider. One tool to aid in the investigation of suspected frauds and the prevention of future frauds is the Suspicious Activity Report (SAR). Section 208.62 of Regulation H discusses the requirements for completing and filing SARs with the Financial Crimes Enforcement Network (FinCEN). Ensuring that bank management and staff are aware of the requirements of §208.62 allows for the prompt and correct reporting of known or suspected violations of Federal law and/ or suspicious transactions. It also puts management and staff on notice that by filing a SAR they are complying with a Federal law, and not merely telling tales on a co-worker, supervisor, or customer.

In the case study above, as the prospect of fraudulent activity became apparent during the examination, bank management was directed to prepare a Suspicious Activity Report to document the suspicious activity of the borrower. This was but the first step in the investigation and prosecution of those involved.

The Final Lesson

The over-riding lesson from the failure of this de novo institution is that a strong system of internal controls is

[3] The *Commercial Bank Examination Manual* is available on the Board of Governors web site at <www.federalreserve.gov/boarddocs/supmanual/cbem/0211cbem.pdf>.

a critical element in ensuring the health, if not the very existence, of a company. Internal controls coupled with a strong ethical environment not only protect the company, they also serve to protect staff. Internal controls provide a blueprint for acceptable and unacceptable behavior and are a tool for employees to refer to when considering the appropriateness of their actions. Neither the size of the company nor the trustworthiness of staff should be used to rationalize weak controls.

In addition, no matter how much management trusts and believes in staff, experience shows that people do not always follow established procedures, whether intentionally or inadvertently. Therefore, compliance with internal controls cannot be taken for granted, and bank management must ensure that management, internal audit, and external audit all review compliance with and the effectiveness of the system of internal controls. Only then can fraud be detected, if not completely deterred.

If you have questions about the application of internal controls in a financial institution, please contact your primary banking regulator. If you are supervised by the Federal Reserve Bank of Philadelphia, please contact your institution's central point of contact or assigned manager at the Reserve Bank. Alternatively, you can contact Frank Germano, Supervising Examiner (frank.germano@phil.frb.org) at (215) 574-4154, Jennifer M. McCune, Examiner (jennifer.m.mccune@phil.frb.org) at (215) 574-7214, or Jacqueline P. Fenton, Assistant Examiner (jacqueline.p.fenton@phil.frb.org) at (215) 574-6234. ■

2002 Costs of Deposits[1]

At a recent Bankers' Forum, a question was asked concerning the relative cost of deposits in the Third Federal Reserve District. This table illustrates the mean average cost of interest bearing deposits at commercial banks headquartered in each of the Federal Reserve Districts in 2002, as reported in the individual institution's Reports of Condition. Since the pricing of deposits for commercial banks with a nationwide presence is reflected only in their home districts, the second column of data shows the pricing of deposits at banks with less than $1 billion in assets. Those institutions most likely have obtained the majority of their deposits within their home district.

District	Mean Cost of Deposits All Banks / Rank	Mean Cost of Deposits Banks < $1 Billion in Assets / Rank
Boston	2.217% / (12)	2.278% / (10)
New York	2.260% / (10)	2.229% / (12)
Philadelphia	2.794% / (4)	2.806% / (5)
Cleveland	2.890% / (2)	2.931% / (2)
Richmond	2.680% / (8)	2.718% / (8)
Atlanta	2.792% / (5)	2.816% / (4)
Chicago	2.865% / (3)	2.887% / (3)
St. Louis	2.916% / (1)	2.936% / (1)
Minneapolis	2.764% / (6)	2.781% / (6)
Kansas City	2.703% / (7)	2.718% / (7)
Dallas	2.400% / (9)	2.410% / (9)
San Francisco	2.227% / (11)	2.272% / (11)

[1] Data is for the full year 2002 and is based on average interest-bearing deposits. Rank is based on highest cost to lowest cost.

"The Sarbanes-Oxley Act of 2002"

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lic companies with less complex operations and limited staff, which, in certain circumstances, can use the same accounting firm to perform both an external audit and some or all of the institution's internal audit activities. When a small non-public institution decides to hire the same firm to perform internal and external audit work, the audit committee and the external auditor should pay particular attention to preserving the independence of both the internal and external audit functions.

Conclusion

As with all effectively developed and implemented corporate policies, the first step in assuring compliance with the Act is to establish a culture of sound business practices and ethics. A company's board of directors and senior management should set the tone regarding the expectations and quality of financial reporting. In doing so, institutions should ensure the independence of the board of directors and internal and external auditors and the adequacy of financial statement disclosures.

Restoring the public's confidence begins with a return to corporate integrity.

If you have questions on the application of *The Sarbanes-Oxley Act* or the *Interagency Policy Statement on the Internal Audit Function and Its Outsourcing* to your institution, please contact your primary banking regulator. If you are supervised by the Federal Reserve Bank of Philadelphia, please contact your institution's central point of contact or assigned manager at the Reserve Bank. Alternatively, you can contact Jennifer M. McCune (jennifer.m.mccune@phil.frb.org) at (215) 574-7214 or Jacqueline P. Fenton (jacqueline.p.fenton@phil.frb.org) at (215) 574-6234.

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