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"THE BROADENING SCOPE OF BANK EXAMINATION"

ADDRESS BY

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BEFORE THE

SOUTHEASTERN CHAPTER - ROBERT MORRIS ASSOCIATES

① POINT CLEAR, ALABAMA

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## INTRODUCTION

THE FEDERAL DEPOSIT INSURANCE CORPORATION CAME INTO BEING DURING THE ECONOMIC AND BANKING CRISIS OF THE EARLY 1930s WHEN THOUSANDS OF BANKS CLOSED THEIR DOORS, MILLIONS OF PEOPLE LOST THEIR FUNDS DEPOSITED IN THEM, AND STOCKHOLDERS LOST THEIR INVESTMENTS. ITS PRIMARY MISSION INITIALLY WAS AND STILL IS THE PROTECTION OF DEPOSITORS FROM LOSSES THROUGH BANK FAILURES WITH CONCOMITANT CONTRIBUTIONS TO THE STABILITY OF THE BANKING SYSTEM. TO ATTAIN THOSE OBJECTIVES, THE CORPORATION FROM THE START HAS EXAMINED BANKS TO PROMOTE THEIR SAFETY AND SOUNDNESS WHILE ASSURING THAT THEY ALSO MET THE NEEDS AND CONVENIENCE OF THEIR COMMUNITIES.

IN THIS CONTEXT THE FIRST BANKS WERE ADMITTED TO THE TEMPORARY DEPOSIT INSURANCE FUND OF FDIC SOLELY ON A SHOWING OF SOLVENCY. THIS REQUIRED VERIFICATION AND EVALUATION OF A BANK'S ASSETS AND DETERMINATION OF THE ADEQUACY OF ITS CAPITAL ACCOUNTS.

SAFETY AND SOUNDNESS: ROLE OF EXAMINATION IN  
SUPERVISORY ACTIVITIES

BANK EXAMINATION PROCEDURES HAVE CHANGED MUCH SINCE THOSE EARLY DAYS, BUT THE SAFETY AND SOUNDNESS OF BANKS HAS CONTINUED TO BE THE MAIN CONCERN OF THE EXAMINATION PROCESS. THE DETERMINATION OF SAFETY AND SOUNDNESS HAS BECOME A MORE SOPHISTICATED PROCESS, HOWEVER, AND INCREASING EMPHASIS HAS BEEN PLACED ON THE QUALITY OF BANK MANAGEMENT. ADDED TO THIS HAS BEEN A BROADENING OF OBJECTIVES AS CONGRESS HAS ASSIGNED ADDITIONAL DUTIES TO THE REGULATORY AGENCIES. THE PROLIFERATION OF STATUTES AND REGULATIONS IN PURSUIT OF DIFFERENT SOCIAL GOALS -- SUCH AS PROTECTION OF CONSUMERS, ELIMINATION OF DISCRIMINATION, AND DISCLOSURE OF IMPORTANT INFORMATION -- HAVE ADDED TO THE RESPONSIBILITIES OF EXAMINERS AS BANKS HAVE BEEN MADE THE INSTRUMENTS OF SOCIAL POLICY.

BANK EXAMINATION CONTINUES AS THE PRIMARY VEHICLE BY WHICH THE FDIC ASCERTAINS THE OVERALL CONDITION OF THE BANKS IT SUPERVISES, THE QUALITY OF THEIR MANAGEMENT, AND THE EXTENT OF THEIR COMPLIANCE WITH APPLICABLE LAWS AND REGULATIONS. WE

VIEW THE EXAMINATION PROCESS NOT ONLY AS A TOOL FOR CARRYING OUT OUR STATUTORY RESPONSIBILITIES, BUT ALSO AS A CONSTRUCTIVE EDUCATIONAL FORCE PROMOTING SAFETY AND SOUNDNESS, EFFICIENCY, AND RESPONSIVENESS IN THE BANKING SYSTEM.

BANK EXAMINERS AND BANKERS SHARE A COMMON INTEREST IN MAINTAINING A SOUND AND PROFITABLE BANK. THIS IS NOT TO SAY THAT THEY ARE PARTNERS IN THIS ENDEAVOR, FOR THEY ARE RESPONSIBLE TO DIFFERENT MASTERS. THE INTERESTS AND RESPONSIBILITIES OF THE EXAMINER ENCOMPASS THOSE OF THE BANKER, AND EXTEND BEYOND INTO BROADER PUBLIC INTEREST AREAS. NEVERTHELESS, THE MAJOR INTERESTS OF BANKERS AND OF EXAMINERS ARE COMPLEMENTARY RATHER THAN ANTITHETICAL. AND, THE EXAMINER CAN BE ESPECIALLY HELPFUL TO THE BANKER BY FOCUSING ON THE OPERATIONS OF THE INDIVIDUAL BANK THE KNOWLEDGE AND EXPERIENCE GAINED IN MANY BANKS.

#### LOAN EVALUATION

LET US CONSIDER FIRST THE SAFETY AND SOUNDNESS ASPECTS OF AN EXAMINATION. LOAN EVALUATION IS ONE OF THE MOST IMPORTANT

PARTS OF THIS ASPECT OF THE EXAMINATION PROCESS BECAUSE THE QUALITY OF THE LOAN PORTFOLIO IS A MAJOR DETERMINANT OF SAFETY AND SOUNDNESS. THE EXAMINER'S REACTIONS TO THE LOAN PORTFOLIO WEIGH HEAVILY IN HIS FINAL EVALUATION OF THE CONDITION OF THE BANK, THE QUALITY OF ITS MANAGEMENT, ITS SERVICE TO THE COMMUNITY, AND NECESSARY CORRECTIVE ACTIONS. CONSEQUENTLY, LOAN EVALUATION CONSUMES ABOUT 40 PERCENT OF EXAMINER TIME IN AN AVERAGE EXAMINATION AND EVEN MORE IN BANKS WITH LARGE AMOUNTS OF NONPERFORMING AND CLASSIFIED LOANS.

LOAN DECISIONS ARE NOT AN EXACT SCIENCE; NEITHER IS THE EVALUATION OF A LOAN PORTFOLIO BY A BANK EXAMINER. THE BROAD SCOPE OF THE LENDING FUNCTION, AND CHANGING PATTERNS IN ECONOMIC, BANKING, AND CREDIT ACTIVITIES PRECLUDE THE USE OF A SIMPLE, SINGLE FORMULA IN THE APPRAISAL OF LOANS. THE ABILITY TO REACH SOUND CREDIT JUDGMENTS DEPENDS ON THE LOAN OFFICER'S AND THE EXAMINER'S KNOWLEDGE, EXPERIENCE, ENGERGY, ANALYTICAL TECHNIQUES, AND RESOURCEFULNESS. THESE ATTRIBUTES CAN BE UTILIZED FULLY AND A SOUND EVALUATION OF INDIVIDUAL LOANS MADE ONLY IF THE LOAN HAS BEEN FULLY DOCUMENTED BY THE LOAN OFFICER TO BEGIN WITH.

CONSIDERATION IS GIVEN IN APPRAISING INDIVIDUAL CREDITS TO THE ECONOMIC AND OTHER RISKS INVOLVED IN THE PROJECT BEING FINANCED; THE CHARACTER, CAPACITY, FINANCIAL RESPONSIBILITY AND RECORD OF THE BORROWER; THE NATURE AND DEGREE OF COLLATERAL PROTECTION; AND THE FEASIBILITY AND PROBABILITY OF ORDERLY LIQUIDATION OF THE LOAN IN ACCORDANCE WITH A PREVIOUSLY ESTABLISHED SCHEDULE.

BESIDES EVALUATING THE LOAN ACCOUNT, THE EXAMINER ALSO LOOKS AT OTHER ASPECTS OF THE LENDING FUNCTION. RECENTLY WE HAVE INCREASED EMPHASIS ON FORMAL WRITTEN LOAN POLICIES. EXAMINERS NOT ONLY EVALUATE THE ADEQUACY OF THESE POLICIES BUT ALSO DETERMINE MANAGEMENT'S ADHERENCE TO THEM. AREAS OF SPECIAL INTEREST IN JUDGING THE ENTIRE LOAN ACCOUNT -- AS DISTINGUISHED FROM INDIVIDUAL LINES OF CREDIT -- ARE THE BANK'S LIQUIDITY NEEDS, ADHERENCE TO APPLICABLE LAWS AND REGULATION, CONCENTRATIONS OF CREDIT, LOANS TO OUT-OF-TERRITORY BORROWERS, THE NATURE AND EXTENT OF DELINQUENCIES, AND POTENTIAL INSIDER ABUSES.

HOW MUCH CONFIDENCE CAN BANKERS, ESPECIALLY LOAN OFFICERS, PLACE IN THE COMMENTS AND OBSERVATIONS BY EXAMINERS?

TWO RECENT STUDIES BY THE FDIC PROJECTS AND PLANNING BRANCH AND BY THE OFFICE OF THE COMPTROLLER OF THE CURRENCY INDICATE THAT THE EXAMINATION PROCESS WORKS AND THAT EXAMINERS' EVALUATIONS OF LOANS ARE REASONABLY ACCURATE. BOTH STUDIES TRACED THE HISTORY OF LOANS WHICH WERE CLASSIFIED SUBSTANDARD, DOUBTFUL, AND LOSS IN ONE EXAMINATION TO A PERIOD SEVERAL EXAMINATIONS LATER. OUR STUDY ("THE CLASSIFIED COMMERCIAL LOAN SURVEY: A STUDY OF THE PERFORMANCE AND DISPOSITION OF ADVERSELY CLASSIFIED LOANS," AUGUST 30, 1977) FOUND THAT 10 PERCENT (BY DOLLAR AMOUNT) OF THE SUBSTANDARD LOANS, 47 PERCENT OF THE DOUBTFUL, AND 73 PERCENT OF THE LOANS CLASSIFIED AS LOSS WOUND UP AS LOSSES. IT ALSO SHOWED THAT 68 PERCENT OF THE SUBSTANDARD LOANS HAD BEEN COLLECTED OR IMPROVED ENOUGH IN CREDIT QUALITY TO WARRANT REMOVAL FROM CLASSIFICATION DURING THE THREE-EXAMINATION CYCLE OF THE STUDY. THE COMPTROLLER'S STUDY (RESEARCH PAPER 77-5 OF THE DIVISION OF ECONOMIC RESEARCH AND ANALYSIS: HSIU-KWANG WU, "EFFECTIVENESS OF BANK EXAMINER LOAN CRITICISMS: SOME NEW EVIDENCE") USED A DIFFERENT FORMAT BUT CONCLUDED "THAT

BANK EXAMINER CRITICISMS ARE REASONABLY ACCURATE AND ARE A GOOD EX ANTE MEASURE OF LOAN QUALITY."

SPECIALIZED COMPLIANCE EXAMINATIONS FOR CONSUMER LAWS

BESIDES SAFETY AND SOUNDNESS, CONGRESS HAS ASSIGNED TO THE FDIC RESPONSIBILITY FOR CHECKING COMPLIANCE BY INSURED STATE NONMEMBER BANKS WITH A NUMBER OF CONSUMER PROTECTION, CIVIL RIGHTS, DISCLOSURE AND OTHER MISCELLANEOUS LAWS AND REGULATIONS. INCLUDED ARE THE TRUTH IN LENDING ACT, FAIR CREDIT REPORTING ACT, FAIR HOUSING ACT, EQUAL CREDIT OPPORTUNITY ACT, HOME MORTGAGE DISCLOSURE ACT, FAIR DEBT COLLECTION PRACTICES ACT, REAL ESTATE SETTLEMENT PROTECTION ACT, AND COMMUNITY REINVESTMENT ACT. A MERE RECITAL OF LAWS IS ALL THAT IS NEEDED TO ALERT YOU LOAN OFFICERS, FOR MANY RELATE DIRECTLY TO YOUR LENDING ACTIVITIES.

THE FDIC CARRIES OUT THIS RESPONSIBILITY PRIMARILY THROUGH THE EXAMINATION PROCESS. FORMERLY, FDIC EXAMINERS USUALLY CHECKED FOR COMPLIANCE WITH THESE LAWS AND RELATED REGULATIONS DURING THE COURSE OF REGULAR BANK EXAMINATIONS.

IN MAY 1977, HOWEVER, THE FDIC BEGAN A NEW PROGRAM OF CONDUCTING SEPARATE SPECIALIZED EXAMINATIONS DIRECTED SOLELY AT DETERMINING COMPLIANCE WITH CONSUMER LAWS AND REGULATIONS. THESE SEPARATE COMPLIANCE EXAMINATIONS ARE CONDUCTED BY A CORPS OF SPECIALISTS CONSISTING OF TRAINED EXAMINERS ASSIGNED FOR A SIX-MONTH PERIOD ON A ROTATING BASIS. UNDER THIS PROGRAM, EACH INSURED NONMEMBER BANK IS SCHEDULED FOR A COMPLIANCE EXAMINATION AT LEAST ONCE EVERY 15 MONTHS. IN ADDITION, FOLLOW-UP EXAMINATIONS OR VISITATIONS ARE SCHEDULED AS THE CIRCUMSTANCES DICTATE. IN ADDITION TO A VARIOUS ASPECTS OF CONSUMER PROTECTION, COMPLIANCE EXAMINATIONS ALSO COVER THE BANK PROTECTION ACT, THE CURRENCY AND FOREIGN TRANSACTIONS REPORTING ACT, AND EMERGENCY PREPAREDNESS MEASURES.

EXAMINERS CONDUCTING THE SEPARATE COMPLIANCE EXAMINATIONS ARE AVAILABLE TO BANK MANAGEMENT AND LOAN OFFICERS DURING THE COURSE OF EXAMINATIONS FOR ADVICE AND GUIDANCE ON THE REQUIREMENTS OF THE VARIOUS LAWS AND REGULATIONS AND ON PROCEDURES TO ASSURE COMPLIANCE. WE WANT TO HELP, BUT YOU NEED TO RECOGNIZE

THAT THE PRIMARY RESPONSIBILITY FOR USING APPROPRIATE PROCEDURES, PRACTICES AND FORMS RESTS WITH BANK MANAGEMENT.

EXPANSION OF EXAMINATION ACTIVITY

THE EXAMINATION PROCESS IS A DYNAMIC ONE EVOLVING FROM CHANGES IN BANKING, ECONOMIC AND TECHNOLOGICAL CONDITIONS AND IN SOCIAL, POLITICAL AND BANK SUPERVISION PHILOSOPHIES. WE HAVE TAKEN AT LEAST SEVEN NEW INITIATIVES IN THE EXAMINATION PROCESSES IN THE PAST TWO OR THREE YEARS. THE THRUST OF BANK EXAMINATION, HOWEVER, CONTINUES TO BE DIRECTED TO SAFETY AND SOUNDNESS AND COMPLIANCE WITH CONSUMER MEASURES, BUT THE MECHANICS OF THE PROCESS ARE CHANGING. THE INCREASED SIZE OF BANKS, EXPANSION INTO WORLD FINANCIAL MARKETS, OPERATIONAL CHANGES BROUGHT ABOUT BY THE DEVELOPMENT OF COMPUTERS AND IMPROVEMENTS IN COMMUNICATION, AND NEW LAWS HAVE CHANGED THE NATURE OF BANKING AND CONSEQUENTLY OF BANK REGULATION. THEY HAVE INCREASED OUR SUPERVISORY ACTIVITIES BOTH QUANTITATIVELY AND QUALITATIVELY. AND, THE RECESSION, FROM WHICH WE HAVE EMERGED, HAS PLACED ADDED STRAINS ON BANKS AND ON BANK REGULATORS.

THE NUMBER AND SIZE OF BANKS SUPERVISED BY THE FDIC INCREASED SIGNIFICANTLY IN THE PAST DECADE. THE NUMBER INCREASED BY 1,300, OR 17.4 PERCENT AND THEIR ASSETS HAVE TRIPLED IN SIZE. LOANS AT THESE SAME INSTITUTIONS INCREASED AT A SLIGHTLY FASTER RATE THAN TOTAL ASSETS, BUT ANNUAL LOAN CHARGE-OFFS INCREASED MORE THAN SIX TIMES. THIS DRAMATIC INCREASE CORRESPONDS CLOSELY WITH THE PERCENTAGE INCREASE IN ASSETS CLASSIFIED BY EXAMINERS.

ALL OF THESE DEVELOPMENTS HAVE EXPANDED THE CORPORATION'S SUPERVISORY AND EXAMINATION DUTIES. BECAUSE OF INCREASED DEMANDS ON EXAMINER TIME, THE CORPORATION HAS TAKEN STEPS TO USE EXAMINERS MORE EFFICIENTLY BY CONCENTRATING THEIR RESOURCES IN AREAS WHERE THEY APPEAR TO BE NEEDED MOST. IN 1976 AND 1977 THE DIVISION OF BANK SUPERVISION MODIFIED POLICIES RELATING TO THE PRIORITIES, FREQUENCY, AND SCOPE OF EXAMINATIONS. GENERAL MEMORANDUM NO. 1, INCREASES THE DISCRETION OF THE FDIC REGIONAL DIRECTORS IN CONDUCTING EXAMINATIONS WHILE STILL MAINTAINING A UNIFORM APPROACH. IT DEFINES TWO TYPES OF EXAMINATIONS. THE

MODIFIED EXAMINATION EMPHASIZES MANAGEMENT POLICIES AND PERFORMANCE. THE FULL-SCALE EXAMINATION, ON THE OTHER HAND, IS MORE COMPLETE, BUT IT ALSO IS TAILORED TO THE SIZE AND THE COMPLEXITY OF THE BANK. IN ALL EXAMINATIONS WE TRY TO MAKE FULL USE OF THE BANK'S OWN REPORTING CAPABILITIES.

IMPROVEMENTS IN THE EXAMINATION PROCESS

TOP PRIORITY IN EXAMINATION IS GIVEN TO BANKS WITH KNOWN SUPERVISORY OR FINANCIAL PROBLEMS. THESE BANKS RECEIVE FULL-SCALE EXAMINATIONS BY THE FDIC AT LEAST ONCE EVERY 12 MONTHS, WITH FOLLOW-UP EXAMINATIONS OR VISITATIONS AS DEEMED NECESSARY. FOR SOME QUALIFYING BANKS, LIMITED EXAMINATIONS ALTERNATE WITH FULL-SCALE ONES. COMMERCIAL BANKS WITH ASSETS OF LESS THAN \$100 MILLION AND MUTUAL SAVINGS BANKS WITH ASSETS OF LESS THAN \$500 MILLION MAY QUALIFY IF THEY DO NOT HAVE SUPERVISORY OR FINANCIAL PROBLEMS AND IF THEY MEET CERTAIN MANAGEMENT, CAPITAL, FIDELITY COVERAGE, EARNINGS, AND INTERNAL ROUTINE AND CONTROL STANDARDS. LARGER COMMERCIAL BANKS AND MUTUAL SAVINGS BANKS RECEIVE FULL-SCALE EXAMINATIONS EVERY TIME.

THE NORMAL TIME FRAME BETWEEN EXAMINATIONS FOR THOSE INSTITUTIONS NOT PRESENTING FINANCIAL PROBLEMS HAS BEEN STRETCHED FROM 12 TO 18 MONTHS, BUT AT NO TIME MAY THE INTERVAL BETWEEN EXAMINATIONS EXCEED 24 MONTHS.

(1) THESE STEPS TO UTILIZE OUR MANPOWER RESOURCES MORE EFFECTIVELY ALLOW EXAMINERS TO SPEND MORE TIME EVALUATING THE ADEQUACY AND OBSERVANCE IN PRACTICE OF THE BANK'S WRITTEN POLICIES, PARTICULARLY THOSE RELATING TO LOANS AND SECURITIES. WE ARE PLACING INCREASED EMPHASIS ON THE BANK'S POLICIES AND MANAGEMENT, AND LESS TIME IS SPENT INDEPENDENTLY CHECKING MATTERS THAT ARE CHECKED BY INTERNAL OR EXTERNAL AUDITORS OF THE BANK AND THAT DO NOT THREATEN THE BANK'S SOLVENCY. THEREFORE, THE BANKS WITH MORE COMPETENT MANagements, AS DEMONSTRATED BY THEIR CONDITIONS AND EARNINGS RECORDS, CAN EXPECT TO SEE EXAMINERS LESS FREQUENTLY AND POSSIBLY WILL HAVE EXAMINATIONS OF LIMITED SCOPE.

(2) WE BELIEVE THAT OUR GOAL OF MORE EFFICIENT UTILIZATION OF RESOURCES AND A MORE EFFECTIVE EXAMINATION IS

FURTHERED BY THE USE OF SPECIALIZED COMPLIANCE AND ELECTRONIC DATA PROCESSING EXAMINATIONS. WITH INCREASED EMPHASIS ON THESE AREAS, THE UTILIZATION OF SPECIALISTS IN THE RESPECTIVE FIELDS PROVIDES A MORE EFFECTIVE MEANS OF SUPERVISION.

(3) ANOTHER NEW INITIATIVE IN THE EXAMINATION FIELD IS THE INTEGRATED MONITORING SYSTEM (IMS) AS IT IS CALLED AT FDIC. THIS IS THE COMPUTERIZED FINANCIAL DATA ANALYSIS SYSTEM WHICH HAS BEEN TESTED FOR SOME TIME. IMS IS AN "EARLY WARNING" SYSTEM DESIGNED TO ALERT THE CORPORATION TO THE PRESENCE OF A DETERIORATING SITUATION BETWEEN EXAMINATIONS BEFORE IT ASSUMES SERIOUS PROPORTIONS, THEREBY FACILITATING A TIMELY RESPONSE. IT SHOULD IDENTIFY THOSE BANKS OR THOSE PARTICULAR ASPECTS OF A BANK'S OPERATION THAT ESPECIALLY MERIT CLOSER SUPERVISORY ATTENTION.

AS LOAN OFFICERS YOU WILL BE ESPECIALLY INTERESTED IN ANOTHER SIGNIFICANT CHANGE IN LOAN EVALUATION PROCEDURES MADE DURING THE PAST TWO YEARS. THE FEDERAL DEPOSIT INSURANCE CORPORATION NOW PARTICIPATES WITH THE OFFICE OF THE COMPTROLLER

OF THE CURRENCY AND THE FEDERAL RESERVE SYSTEM IN AN ANNUAL REVIEW OF SHARED NATIONAL CREDITS. THESE ARE DEFINED AS THOSE LOANS AGGREGATING \$20 MILLION OR MORE TO ONE BORROWER THAT ARE PARTICIPATED IN OR SHARED BY TWO OR MORE BANKS. THE REVIEW AND CLASSIFICATION OF THESE CREDITS IS CONDUCTED INDEPENDENTLY OF REGULAR BANK EXAMINATIONS. IT IS THE RESPONSIBILITY OF SPECIALLY SELECTED COMPTROLLER OF THE CURRENCY OR FEDERAL RESERVE AND FDIC EXAMINER TEAMS ASSIGNED TO THE LEAD BANKS OR AGENTS FOR SUCH CREDITS. ORDINARILY, SUCH CREDITS ARE REVIEWED AND ANALYZED ANNUALLY; HOWEVER, BANKS INVOLVED MAY REQUEST THAT THE REVIEW AND ANALYSIS BE MADE MORE OFTEN. THE APPRAISAL OF THE CREDIT ASSIGNED AT THE LEAD BANK, INCLUDING ANY SUBSTANDARD, DOUBTFUL, OR LOSS CLASSIFICATION OR SPECIAL MENTION, IS APPLIED TO ALL PARTICIPATIONS OR SHARES OF THOSE CREDITS HELD BY ANY NATIONAL, STATE MEMBER, OR STATE NONMEMBER INSURED BANK. THE APPRAISAL REMAINS IN EFFECT UNTIL THE NEXT REGULAR ANNUAL REVIEW UNLESS CHANGED IN AN INTERIM REVIEW REQUESTED BY AN AFFECTED BANK.

(4) EXAMINATION PROCEDURES ALSO HAVE BEEN ENHANCED AND UPDATED THROUGH THE USE OF AUTOMATED BANK EXAMINATION PROGRAMS AND SAMPLING TECHNIQUES. THESE ENABLE EXAMINERS TO CONDUCT EXAMINATIONS IN LESS TIME THAN WAS NEEDED BEFORE WITHOUT LOWERING STANDARDS. IN BANKS THAT HAVE AUTOMATED ACCOUNTING SYSTEMS OUR AUTOMATED PROGRAMS PERMIT EXAMINERS TO USE THE BANK'S COMPUTER TO SELECT AND EVALUATE LOAN DATA. NEEDLESS TO SAY, THIS SAVES CONSIDERABLE TIME OVER TRADITIONAL MANUAL PROCEDURES. IN ADDITION, WHERE FEASIBLE, SAMPLING TECHNIQUES ARE BEING USED TO SELECT LOANS FOR CREDIT ANALYSIS.

(5) ANOTHER ASPECT OF THE CHANGING EXAMINATION PROCESS IS PLACING THE RESPONSIBILITY FOR THE SOUND OPERATION OF THE BANK WHERE IT BELONGS: SQUARELY ON THE SHOULDERS OF THE BOARD OF DIRECTORS. OUR CONCERN RESULTS PRIMARILY FROM THE FAILURE OF SOME BOARDS OF DIRECTORS TO PROVIDE AN ELEMENT OF SELF-DISCIPLINE WHICH HAS BEEN LACKING IN SO MANY OF THE RECENT BANK FAILURES. THE FDIC HAS HANDLED SLIGHTLY MORE THAN 100 BANK FAILURES SINCE 1960, 106 TO MAY 5, 1978, AND IN ABOUT 60 PERCENT OF THE CASES,

WE HAVE SEEN THAT INSIDER ABUSES HAVE PLAYED A SIGNIFICANT PART, WHILE ONLY ABOUT 15 TO 20 PERCENT OF THE BANK FAILURES RESULTED FROM ERRORS IN JUDGMENT. THE BALANCE OF THE FAILURES WERE DUE TO FIDELITY LAPSES SUCH AS EMBEZZLEMENT AND FRAUD.

IF MECHANISMS FOR SELF-DISCIPLINE ALWAYS WORKED PROPERLY AND EFFECTIVELY, AS THEY USUALLY DO, WE WOULD NEED ONLY A MINIMAL AMOUNT OF GOVERNMENTAL CONTROLS OVER BUSINESS AFFAIRS OR BUSINESS DECISIONS. FOR THIS REASON, THE FDIC HAS SOUGHT TO STRENGTHEN THE BOARD OF DIRECTORS AS A SELF-REGULATORY BODY. I BELIEVE THAT RELYING ON THE STRENGTHS OF THE BOARD OF DIRECTORS IS BETTER THAN ANY OTHER STRATEGY. NOT ONLY IS IT LESS COSTLY, BUT IT ALSO DRAWS UPON OUR FREE MARKET TRADITION OF PRIVATE RESPONSIBILITY FOR PRIVATE BUSINESS DECISIONS.

OUR APPROACH TO INSIDER ABUSES IS PARTICULARLY IMPORTANT TO YOU AS LOAN OFFICERS, FOR MANY OF THE ABUSES INVOLVE LOANS IN SOME MANNER. OUR FIRST BILLION-DOLLAR BANK FAILURE DID. IT WAS THE U.S. NATIONAL BANK IN SAN DIEGO WHICH HAS BEEN CHARACTERIZED AS A "RIOT IN SELF-DEALING." WE FOUND THAT OVER

60 PERCENT OF THE LOAN PORTFOLIO WAS IN LOANS TO C. ARNHOLT SMITH AND COMPANIES IN WHICH HE HAD AN INTEREST. THIS LED TO A REVIEW OF OUR PROTECTIONS AGAINST INSIDER ABUSES. WE REALIZED THAT WE NEEDED TO TAKE FURTHER ACTION. BUT WE ALSO WERE AWARE THAT INSIDER TRANSACTIONS ARE NOT BAD PER SE -- TO THE CONTRARY, TRANSACTIONS WITH INSIDERS AND THEIR RELATED INTEREST ARE USUALLY IN THE BANK'S BEST INTEREST. A BANK'S MOST PROFITABLE BUSINESS OFTEN COMES FROM ITS BOARD OF DIRECTORS OR OTHER INSIDERS; AND IN MANY CASES -- PARTICULARLY IN SMALL OR RURAL COMMUNITIES -- SUCH TRANSACTIONS ARE DIFFICULT TO AVOID. OUR VIEW AT FDIC IS THAT INSIDER CONDUCT IS ABUSIVE AND CONSTITUTES UNSAFE AND UNSOUND BANKING PRACTICES WHEN (A) AN INSIDER OBTAINS A BENEFIT WHICH IS NOT AVAILABLE TO A NON-INSIDER OTHERWISE SIMILARLY SITUATED; AND (B) WHEN THE RESULT OF THE INSIDER'S OBTAINING THAT BENEFIT IS DETRIMENTAL TO THE BANK. IN LIGHT OF THESE CIRCUMSTANCES, WE HAVE NOT PUT A FLAT BAN ON INSIDER TRANSACTIONS. INSTEAD, WE RELY ON THE TWO MAJOR SAFEGUARDS WE ALREADY HAVE: SELF-DISCIPLINE BY THE BOARD OF DIRECTORS IN SUPERVISING THE BANK'S ACTIVITIES AND

REGULATORY OVERSIGHT THROUGH THE BANK EXAMINATION PROCESS. WE REQUIRE THE BOARD TO CONDUCT A SERIOUS, IN-DEPTH REVIEW OF INSIDER TRANSACTIONS AND TO APPROVE SPECIFICALLY ANY INVOLVING ASSETS OR SERVICES HAVING A FAIR MARKET VALUE ABOVE A CERTAIN AMOUNT. THAT AMOUNT VARIES WITH THE SIZE OF THE BANK. INFORMATION CONCERNING THESE TRANSACTIONS, INCLUDING A RECORD OF THE DISSENTING VOTES CAST BY DIRECTORS, IS RECORDED IN THE MINUTES OF THE MEETING.

THIS APPROACH IS ADVANTAGEOUS BECAUSE IT DOES NOT FORCE THE BANK TO KEEP ANY NEW KINDS OF RECORDS OR TO ESTABLISH NEW FILES. THE MINUTES OF BOARD MEETINGS CAN PROVIDE AN APPROPRIATE LISTING OF ALL INSIDER TRANSACTIONS, WHILE THE BANK'S REGULAR FILING SYSTEM FUNCTIONS AS THE DEPOSITORY FOR THE DETAILED INFORMATION. JUST KEEPING THE RECORDS AS REQUIRED BY THE REGULATION IS NOT ENOUGH THOUGH. WE WANT TO SEE THE SPIRIT OF NON-PREFERENTIAL TREATMENT OBSERVED. WHEN WE BELIEVE A BOARD IS NOT DOING SO, WE SHALL TAKE WHATEVER ACTION WE BELIEVE IS APPROPRIATE.

(6) TO STRENGTHEN THIS SELF-REGULATORY PROCESS, WE ALSO HAVE INCREASED THE NUMBER OF TIMES THAT WE MEET WITH EACH BANK BOARD. IN THE PAST, AS YOU KNOW, WE HAVE MAINTAINED THAT EACH DIRECTOR SHOULD REVIEW HIS BANK'S EXAMINATION REPORT. WHEN WE FOUND ANY MAJOR PROBLEMS IN THE EXAMINATION, OR WHEN WE DISCOVERED ANY ADVERSE TRENDS, WE MET WITH THE DIRECTORS TO REVIEW THE REPORT. TO INCREASE THE EFFECTIVENESS OF DIRECTOR PARTICIPATION IN THE MANAGEMENT PROCESS, OUR EXAMINERS WERE INSTRUCTED IN 1977 TO MEET MORE FREQUENTLY WITH BANK DIRECTORS. GENERAL MEMORANDUM NO. 2, SETS THE CRITERIA FOR SUCH MEETINGS. THE EXAMINER IN CHARGE WILL MEET WITH EITHER THE BOARD OF DIRECTORS OR AN APPROPRIATE COMMITTEE OF THE BOARD AT EACH FULL-SCALE EXAMINATION, AND MORE OFTEN IF NECESSARY. THE REGIONAL DIRECTOR OR A MEMBER OF HIS STAFF WILL PARTICIPATE IN MEETINGS WITH THE BANK'S BOARD OR COMMITTEE IF THE BANK HAS BEEN OR MAY BE DESIGNATED AS A PROBLEM BANK. BEGINNING IN 1978 THE REGIONAL DIRECTOR WILL FORMALLY NOTIFY BANK DIRECTORS WHEN HE RECOMMENDS THAT THEIR BANK BE PLACED ON THE FDIC'S PROBLEM BANK LIST.

(7) ANOTHER NEW EXAMINATION INITIATIVE IS THE DIVIDED EXAMINATION PROGRAM WITH THE STATE OF GEORGIA WHICH IS BEING EXTENDED TO NEW JERSEY AND MISSOURI. UNDER THE PROGRAM, PROBLEM BANKS, OTHER BANKS IN NEED OF SPECIAL SUPERVISION, AND BANKS WITH ASSETS OF \$100 MILLION OR MORE ARE EXAMINED AT LEAST ONCE EACH YEAR BY BOTH THE FDIC AND STATE SUPERVISOR. ABOUT ONE-HALF OF THE REMAINING BANKS ARE EXAMINED BY THE STATE AND THE REMAINDER ARE EXAMINED BY FDIC. WE SHALL ALTERNATE EXAMINATION OF THESE BANKS ANNUALLY. IN ADDITION, IN MANY STATES THE FDIC AND STATE EXAMINERS CONDUCT JOINT OR CONCURRENT EXAMINATIONS. THE PRINCIPAL DIFFERENCE BETWEEN THE TWO TYPES IS THAT ONE REPORT IS PREPARED FOLLOWING A JOINT EXAMINATION AND TWO SEPARATE REPORTS ARE PREPARED FOLLOWING A CONCURRENT EXAMINATION. IN BOTH TYPES, FDIC AND STATE EXAMINERS DIVIDE SOME OR ALL OF THE EXAMINATION RESPONSIBILITIES AND SHARE THEIR FINDINGS. HIGHLY TRAINED, QUALIFIED STATE EXAMINERS ARE NEEDED IN THESE COOPERATIVE UNDERTAKINGS WHICH ENABLE FDIC TO MAXIMIZE THE PRODUCTIVITY OF ITS OWN EXAMINER FORCE. TO THIS END FDIC IS PROVIDING TRAINING

FOR 190 STATE EXAMINERS AT ITS DIVISION OF BANK SUPERVISION TRAINING CENTER LOCATED IN ROSSYLN, VIRGINIA, DURING 1978.

FEDERAL BANK EXAMINATION COUNCIL

A FEDERAL BANK EXAMINATION COUNCIL IS PROPOSED IN TITLE IX (FEDERAL BANK EXAMINATION COUNCIL ACT OF 1978) OF H. R. 12208. IT WOULD HAVE POWER TO PRESCRIBE UNIFORM EXAMINATION STANDARDS AND PRINCIPLES FOR ALL INSURED BANKS AND TO MAKE RECOMMENDATIONS FOR UNIFORMITY IN BANK SUPERVISION. THE COUNCIL WOULD CONSIST OF THE COMPTROLLER OF THE CURRENCY, THE CHAIRMAN OF FDIC, AND THE CHAIRMAN OF THE FEDERAL RESERVE BOARD. THE FEDERAL HOME LOAN BANK BOARD CHAIRMAN AND THE ADMINISTRATOR OF THE NATIONAL CREDIT UNION ADMINISTRATION ARE PROPOSED AS ADVISORY MEMBERS.

I PREFER THIS PROPOSAL, WITH CERTAIN MODIFICATIONS, TO THE ONE FOR A CONSOLIDATED FEDERAL BANK REGULATORY AGENCY. FIRST OF ALL, I DO NOT BELIEVE THAT UNIFORM EXAMINATION AND SUPERVISORY STANDARDS SHOULD BE ESTABLISHED. ONE OF THE GREAT VIRTUES OF THE EXISTING REGULATORY STRUCTURE IS THE OPPORTUNITY FOR CREATIVITY AND INNOVATION. THE EXAMINATION PROCESS IS ONE OF

THOSE ACTIVITIES THAT BENEFITS MOST FROM COMPETITION AND EXPERIMENTATION AMONG BANK REGULATORS. A STUDY OF BANK EXAMINATION PROCEDURES WOULD REVEAL THAT NUMEROUS INNOVATIONS, CHANGES AND IMPROVEMENTS HAVE BEEN ADOPTED DURING THE PAST FOUR YEARS. I, FOR ONE, BELIEVE THAT THIS WOULD HAVE BEEN LESS LIKELY TO OCCUR IF UNIFORMITY HAD BEEN MANDATED. FOR THIS REASON, I STRONGLY RECOMMEND THAT THE COUNCIL HAVE ONLY ADVISORY, COORDINATING AND WATCHDOG FUNCTIONS AND THAT IT NOT BE REQUIRED TO SET UNIFORM STANDARDS.

SECONDLY, I WOULD ASSIGN TO THE COUNCIL, IF CREATED, THE FUNCTIONS OF THE EXISTING INTERAGENCY COORDINATING COMMITTEE. THIS COMMITTEE INCLUDES THE MEMBERS PROPOSED FOR THE FEDERAL BANK EXAMINATION COUNCIL PLUS THE DEPUTY SECRETARY OF THE TREASURY. PRESIDENT JOHNSON DIRECTED ITS ESTABLISHMENT IN 1965 TO ENSURE THAT FEDERAL AGENCIES CHARGED WITH THE SUPERVISION OF FINANCIAL INSTITUTIONS ACTED IN CONCERT. THE COMMITTEE AT PRESENT HAS NO POWER TO SET STANDARDS. CURRENTLY IT FUNCTIONS AS A COMMUNICATIONS MEDIUM THROUGH WHICH THE VARIOUS AGENCIES

CAN DISCUSS COMMON PROBLEMS AND AIR INFORMALLY THEIR VIEWS ON SUPERVISORY SOLUTIONS. I DO NOT BELIEVE THAT BOTH THIS COMMITTEE AND THE EXAMINATION COUNCIL WOULD BE NEEDED. AND, BETWEEN THE TWO, I PREFER THE EXISTING COMMITTEE.

SUMMARY

IN SUMMARY, BANKING IS DYNAMIC AS IS THE ECONOMY IN WHICH WE LIVE. CONSEQUENTLY, BANK SUPERVISION AND THE EXAMINATION PROCESS WHICH IS SUCH A KEY ELEMENT IN SUPERVISION MUST "CHANGE WITH THE TIMES" IN ORDER TO BE MOST EFFECTIVE. I HAVE BEEN ABLE THIS MORNING ONLY TO SKETCH OUR MAJOR INITIATIVES IN THE EXAMINATION AREA, BUT THEY SHOW SOME MAJOR CHANGES IN EMPHASIS AND TECHNIQUES. OUR EXAMINERS NOW CONCENTRATE MORE THAN THEY EVER HAVE ON MANAGEMENT POLICIES, CAPABILITIES, AND PERFORMANCE.

EVALUATION OF THE BANK LOAN PORTFOLIO REMAINS A MAJOR ASPECT OF THE EXAMINATION PROCESS. INDEED, OUR EXAMINERS CONTINUE TO DEVOTE APPROXIMATELY 40 PERCENT OF THEIR TIME TO EVALUATION OF THE LOAN PORTFOLIO AND CREDIT RECORDS. THIS

SHOULD BE VERY BENEFICIAL TO YOU LOAN OFFICERS, FOR THE QUALITY OF YOUR LOAN PORTFOLIO CAN BE ENHANCED WHEN YOU AND THE EXAMINERS WORK TOGETHER.

WE ARE AWARE THAT EXAMINATION PROCEDURES OF THE THREE FEDERAL BANK REGULATORY AGENCIES ARE NOT IDENTICAL; NOR IS IT DESIRABLE FOR THEM TO BE. ROOM TO INNOVATE, EXPERIMENT, AND TEST DIFFERENT APPROACHES TO SIMILAR REGULATORY PROBLEMS SHOULD RESULT IN A MORE EFFICIENT SUPERVISORY SYSTEM. FOR THIS REASON I PREFER THE FEDERAL BANK EXAMINATION COUNCIL PROPOSAL, WITH SOME MODIFICATIONS, TO ITS PREDECESSOR PROPOSALS FOR CONSOLIDATION OF THE AGENCIES INTO ONE SUPER-AGENCY WITH JURISDICTION OVER ALL FINANCIAL INSTITUTIONS. I BELIEVE REGULATION WILL BE MORE EFFECTIVE AND IMAGINATIVE, AND RESPONSIVE IF THERE ARE TWO OR MORE BANK SUPERVISORY AGENCIES AT THE FEDERAL LEVEL.