BK Div/stat
Spch
FDIC-Misc
Smith

FOR RELEASE ON DELIVERY
September 22, 1975

Library
SEP 23 1975
FEDERAL DEPOSIT INSURANCE
CORPORATION

REMARKS OF
JAMES E. SMITH
COMPTROLLER OF THE CURRENCY
BEFORE THE
FINANCE CLUB
WHARTON SCHOOL - GRADUATE DIVISION
THE UNIVERSITY OF PENNSYLVANIA
September 22, 1975

"An Effort at Improvement"

When the Wharton School of Finance and Commerce was established in 1881 as the first formal collegiate school of business education in this country, the Office of the Comptroller of the Currency was nearing its third decade.

At its founding, Wharton's curriculum consisted mainly of traditional academic subjects. As a shortage of certified public accountants developed, more subjects of a business bent were added. The acuteness of the shortage, however, caused business school entrance standards to be lowered, and as one reference work relates, "lower standards of performance led to a degree of complacency on the part of the administrations of collegiate schools of business."[1]

Years followed in which there was no critical examination of the internal problems which had developed. Then, in the 1950s, complacent administrators finally were jolted from their reverie by the publication of two books[2] which severely criticized the prevailing attitude.

The reaction to these works brought about radical changes in the courses and philosophy of business schools with the result that they are now able to adapt to the volatile changes in the business world.

The processes of analysis and adaptation are inherent in organizations which remain relevant. Just as business schools were liberated from their lethargy by well-founded criticism, the Office of the Comptroller of the Currency has been in need of an objective and knowledgeable assessment.

---

1. Encyclopedia Americana, International Edition, "Business Education," by Herbert A. Tonne
2. Gordon, R.A., and Howell, J.E.; Higher Education for Business; Columbia University Press; 1959.

   Pierson, F. C., et al; Education of American Businessmen; McGraw-Hill Publishing Co. ; 1959.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

An Office which has been in existence for more than a century as the Nation's oldest regulatory agency is particularly obligated to reassess its role and the performance thereof.

As Peter Schuck of the Washington Office of Consumer's Union writes in Harper's of this month, Federal regulation by its nature creates a protected situation for its regulated charges. This obviously can be counterproductive to the consumer who confronts a limited market.

I am in accord with Mr. Schuck that the burden of justification lies heavy on the regulator, for government regulation is fundamentally at variance with the philosophic assumptions underlying the American political system.

For over 100 years, the Office had regulated, as had other bank regulators in this country, its constituency in much the same manner. The banking environment had changed so radically - yet our examination methods seemed to yield begrudgingly to change. Given our power both to limit entry into the banking system and to control subsequent activity, it seemed to me that we were obliged to reassess our mission to insure that we were fulfilling our charge.

Additionally, I felt it best to look to expertise outside this Office. The massive task involved would have demanded too much time from my senior personnel. I also wished to enhance objectivity.

So in the summer of 1973, I decided to contract for an outside study that would determine what the Office was doing, what it should be doing, and how to do it. I felt that by taking this step, I could make sure the heavy burden which rests on us as the regulators is justified.

It is my hope that the study which has just been made will help us to do for bank regulation what the critics of the 1950s did for business schools.

The work of the Study began in the late Spring of 1974, when we commissioned a consortium headed by Haskins & Sells, an accounting and consulting firm, to scrutinize the Office and develop specific recommendations for improving its effectiveness and efficiency.

Not incidentally, that consortium included two professors from Wharton: Dean Samuel Sapienza, who aided in our professional development program; and Dr. Jack Guttentag, who aided the technical review committee of the study, and who had significant input in the area of corporate activity. Corporate activity refers to the issuance or denial of charters, branches, mergers, conversions, capital changes,

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

name and location changes, trust powers, non-bank subsidiaries and ownership and management changes.

Haskins & Sells immediately proceeded to review our current policies, practices and procedures. They interviewed our personnel in Washington and in our 14 Regional Offices around the country to determine just how well these policies, practices and procedures were achieving their stated goals.

In addition to opinions gleaned from our Washington and Regional Office personnel, the team sent out a questionnaire to the Chief Executive Officer of each of the more than 4700 national banks as well as a questionnaire to each member of the examining staff, consisting of more than 1800 people. The questionnaries were designed to ensure anonymity. The inquiries to bankers included such questions as the following: "How can the Office of the Comptroller of the Currency improve its services to national banks?"; "What objective criteria should be given the most emphasis in evaluating the performance of bank management (in order of importance)?"; "Could reports of examination be changed to be more helpful in the operation of the bank? If Yes,' list the suggested changes in order of importance to the bank."

We felt it imperative to have feedback from bankers and examiners throughout the country for two reasons: (1) we could find no better critics than the national banks which we regulate, and (2) no one has a better grasp of the connection between the policies we make in Washington and the practical limitation of them in the field than the examiner.

Corresponding to the two principal activities of the Office, the review concentrated on two areas: the corporate regulatory function and the examination function.

The Study was released to the press in August. We also sent a copy to the Chief Executive Officer of every national bank, to each member of our examining staff, to each member of Congress and various other interested parties. Even now we are continuing to fill requests for copies of the Study from state chartered banks, accountants, lawyers, students, Federal agencies, libraries and others.

Perhaps some of you may have seen some of the stories in the press generated by this Study. A number of the headlines contained the word "critical" and that is exactly what we wanted Haskins & Sells to do - criticize - constructively, of course. We did not look to this Study to be

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

an audit document, but rather to be an internal document that would spot weaknesses and simultaneously suggest methods to strengthen those areas. It was not our wish to have Haskins & Sells compliment us on those areas in which we were reaching our goal.

Haskins & Sells came up with significant recommendations in each of the two areas of concentration. These changes required a drastic altering of our internal organizational and operational structure. They were designed not to help us run banks better, but to enable us to better analyze how well banks are running themselves. Don't mistake me. This is not a semantic difference.

In line with the recommendations, the organizational structure of the Office has been redesigned on a functionally-oriented basis. This approach not only permits efficiency but it also allows for the formation of a senior policy group consisting of the Comptroller and senior executive level personnel. Under the new structure, this group will be relieved of daily line responsibilities so that it can consider more important but less perceptible changes in the banking environment and formulate policy accordingly.

In accordance with other recommendations by Haskins & Sells in the area of internal organization and operations, the Office is formalizing a structure to ensure ongoing analysis, implementation, and review of changes in our metamorphic industry. To accomplish this, we have inaugurated a program of strategic studies, which has the responsibility to discern possible changes affecting the industry, and present findings to our senior policy making group.

Much of the discerning of change will emanate from discussions with the chief planning officers of the larger institutions in the country. While the examination process, by its nature, deals with the here and now, there clearly is the need for review and analysis of bank planning. Examiners tangentially discuss this function with management; however, it is normally related directly to a present activity, such as loan policy, liability management, liquidity, and so on. This Office has not joined in dialogue, though, with the individuals who actually plan the long range development for the big banks. From this source, we can often garner information which can be used in our own planning process.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

As an example, if this organizational structure had been in place in the early 1960s, the senior policy group might well have been informed that American banks would be drawing much of their earnings from abroad and that as a result, our manpower and training activities in the international area would need substantial strengthening. Another example of the sort of issue which might have arisen as a result of early study by strategic planning would be in the electronic funds transfer area. For example, strategic planning might well have discussed with the senior group the necessity of training examiners to study bank systems for preventing criminal intervention with CBCTs.

The purpose of this new arrangement is to enable us to act, not react, in response to the dynamic changes taking place in the banking industry.

The senior policy group will discuss the situations and possible alternatives presented by strategic studies, and determine the merit of suggestions made. If it is felt warranted, further research will be done by the economics division.

Once any suggestions are adopted by the senior policy group, the Deputy Comptroller for Planning will supervise the implementation.

A new Deputy Comptroller for Operations Review has been appointed with the duty of providing an audit function for our traditional duties as well as supervising and ensuring proper implementation of the plans adopted by the senior policy making group. This function will rely heavily on feedback from field examiners. Thus, ideas will spring from the field, will be brought into Washington for study, and then developed and placed back in the field for implementation. Here, once again, the examiner will have an opportunity to feed back his impressions to the Deputy Comptroller for Operations Review.

Bankers also will be encouraged to discuss with the Deputy Comptroller for Operations Review any situations in which they feel they have been fundamentally aggrieved. This procedure should not be used for individual complaints, such as loan classifications, but it will give the industry a person within the Office who is responsible for ensuring that the Office's approach is a realistic one.

Though the Deputy for Operations Review is one of the most important members of the senior policy group, he reports directly to the Comptroller, as is absolutely necessary with any respectable audit system.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

With the alteration of the examining and corporate functions, an additional area that Haskins & Sells felt needed attention was that of Human Resources. Obviously, the Office of the Comptroller of the Currency is labor intensive. In this area, Haskins & Sells has delegated the function to a special unit which initially will determine the requirements of the Office, identify new or changed needs, and then determine position descriptions and responsibilities. There will be an updated employee evaluation, taking into consideration development, continuing education and career paths.

Also, we will implement a national recruiting program. The effectiveness of the Civil Service Test now given to applicants for examination positions is of doubtful utility and education and background will play a more important role. We will become more flexible in the staffing level of a Region to permit employment of truly exceptional individuals when there might currently be no job openings in that particular Region.

Having attracted quality people, we will stress continual professional education to allow individuals to further their knowledge and be of more value to the Office and the banks.

In the examination and supervision area, updating and streamlining are the order of the day, and we have made a lot of progress toward that end. The revision of the handbook and reports used by examiners is almost complete. New sections have been added, including guidelines which banks should follow with their internal audit procedures.

One example of technical change in examination affects our analysis of investment securities. Previously, our examiners would analyze the portfolio by 100% direct verification. In the future, they will review a bank's internal control and management policies, and evaluate previous internal and external audits. If satisfied, they will accept previous conclusions or apply statistical methods to analyze the degree of reliability of previously performed audits.

A much needed change in the examination process will be uniformity. Until now, examiners from 14 offices, with their regional biases, have conducted the exams. In Washington, the Operations Review team will be charged with ensuring uniform compliance among the regions.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

In addition, our national recruitment plan should attract talented individuals who will be evaluated by merit and exposed to similar Career Planning, Personnel Development, and Continuing Education opportunities. We expect this to result in the surfacing of the most able examiners, who will analyze banks uniformly--nationwide.

Now concerning the general thrust of the Comptroller's examinations, over the years this Office has developed a staff of borrower specialists. Their forte has been in analyzing loan portfolios and the ability of borrowers to repay loans. The shift in approach is fundamentally to train the staff to be <u>bank</u> analysts rather than <u>borrower</u> analysts. The analytical talents are there now and we are merely broadening the scope of review.

Perhaps one of the most important recommendations made by Haskins & Sells in the examination and supervision function is the creation of a National Bank Surveillance System.

Using a group of key indicators, specially trained personnel will be able to detect unusual or significantly changed circumstances which could adversely affect a bank or group of banks.

Ratio calculations for a particular bank would be compared with the same data for that bank in prior periods. They also would be compared with the same data from a peer group for current and prior periods. A bank's peer group will be determined by size and other factors.

We are experimenting with these ratios right now to determine the combinations that will produce the most useful results.

The comparison of data will be designed to point up variances that might show trends developing within the industry that should be brought to the attention of the Office's senior policy making committee.

In addition, the data are expected to disclose anomalies in individual banks. These quirks, if you will, will be referred to the National Bank Surveillance System staff in Washington during the initial stages of the system's operation. As the system is more fully developed, variances in individual banks will be examined by NBSS specialists.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

The National Bank Surveillance System is not meant to be a warning system which operates on the "red flashing light" approach. Rather, it will rapidly provide our senior personnel with the best bank data available. Even though the data will be compiled by a computer, human experience and perception will make the final analysis of the information. This is why the essential link in implementation is not just deciding what kind of information is needed for the system, but insuring that our best senior personnel are involved in interpreting the System's output.

It is important to realize that the National Bank Surveillance System is designed to be a growing, functional tool. It is not a hypothetical model but a viable system which will be introduced shortly. Initially, there will be banks that the system will not be equipped to analyze, such as the giant banks. They may have to be analyzed as a separate group, or even individually. But as the system is improved and modified, their eventual incorporation into the system will evolve.

I would like to emphasize that full implementation of the recommendations contained in the Haskins & Sells study is going to take a long time--probably years. In their documentation of the implementation phase of the study, Haskins & Sells has plotted an almost frightening number of man-hours that will be required--from both their staff and ours--to meet the demands of this project.

But more importantly, let me stress that we are not going to abandon procedures and practices that have served us well to adopt new systems unless we are absolutely certain that the new ones are better. That is why a large part of the implementation exercise is going to be devoted to market and field testing.

A new procedure will be implemented much like the introduction of a new computer software package: it will run parallel to, with the results tested against, the existing method. Only after we are sure of the new procedure's unqualified success, will we eliminate the old method.

For example, in our reporting requirements, we will not increase the burden on banks without looking long and hard at the value of the information to be gained. It also might be possible to eliminate some data-gathering as we have to increase reporting by banks in other areas.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

We may find that what looked great on paper just won't fly in practical application. If it doesn't, we'll discard it, perhaps try an alternative, and maybe even revert to the old method if it turns out to produce the best results.

Now, maybe it sounds like the National Bank Surveillance System and all these other revisions are going to give us such tight control over the more than 4700 banks we supervise that a completely healthy banking system will result just by virtue of intense policing and prompt diagnosis of the sick.

I want to go on record right now as totally opposed to that approach, and I want to assure you that this is not the philosophy behind this entire effort.

What we are attempting to do is to improve the supervisory sector of our organization--that side which deals with 4700 national banks as separate and distinct corporate entities. These entities have different characteristics--different in both financial and human capacities. We must take cognizance of those differences and improve the defects as we find them.

This is in contrast to the regulatory approach under which you identify a problem in one unit or area and apply remedies or palliatives across the board, taking no notice of the different characteristics, or idiosyncrasies, of the components of the whole.

That approach is acceptable if the object is to produce a "fail-safe" banking system. Believe me, I can screw down the national banking system with enough regulations to prevent bank failures. But under that regime, the banking industry would be financing the capital needs of the country and its citizens at about sixty per cent of capacity, and that is not in the public interest. Equally important, it is contrary to the economic principles of our nation.

Instead, I would advocate that we free up the system to manage itself, loosen the bonds, and take the quite limited risk that no unit will slip through the supervisory net and founder.

As a result of the Haskins & Sells study, the Office of the Comptroller of the Currency will undergo various changes. There will be changes in the emphasis of our direction through changes in organizational structure. There will be changes in techniques through the examination process and corporate function area.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

To the degree that these steps produce a better job on our part, we will be able to abandon the old blanket approach to supervision. The blanket approach may be the easy way, but it is not the right way.

The published criticism of business schools in the 1950s led to their improvement to such a degree that today they are highly regarded, and widely recognized as doing a very creditable job.

I expect the forces that are moving toward improving the Office of the Comptroller of the Currency to produce the same results.

##################

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis