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STATEMENT ON

REGULATORY AND EXAMINATION PROCESS

PRESENTED TO

SUBCOMMITTEE ON GENERAL OVERSIGHT AND RENEGOTIATION  
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS  
HOUSE OF REPRESENTATIVES

BY

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Room 2128, Rayburn House Office Building

I appreciate this opportunity to testify at your oversight hearings on the regulatory and examination process of the various federal financial institution regulators.

You have asked for specific comments on uniformity in the examination process and overlap and duplication of the activities of the various agencies.

This is a very timely issue. It gives me the opportunity to talk about a very successful cooperative effort -- the divided examination program. Few programs have done so much, so well, so fast.

The concept of the program is simple: the FDIC and the States jointly identify banks not of supervisory concern and divide them equally for the purpose of examination. The State examines one-half, the FDIC the other, and we exchange reports. The next year we switch halves.

Today we have 19 States participating and 3,116 of our better rated banks covered by the program. This represents about one-third of all banks supervised by the FDIC, an increase of almost 60 percent in covered banks since June, 1980.

	<u>Number of Banks Covered</u>		<u>Number of Banks Covered</u>
Alabama	164	Missouri	533
Delaware	8	Nebraska	331
Georgia	332	Nevada	5
Idaho	15	New Jersey	79
Illinois	567	New York	151
Kansas	47	North Carolina	42
Massachusetts	30	North Dakota	124
Michigan	145	South Dakota	80
Minnesota	500	Utah	41
		West Virginia	15

Mr. Chairman, we have an excellent working relationship with Bud Bianchi, the Banking Commissioner in your home State of New Jersey. Our program in New Jersey is now into its third year with excellent results. We have an outstanding program in Georgia, another of our charter States. The Illinois program, which dates to 1979, covers the largest number of banks in any State. Our program in New York is very successful. We are off to a good start in Massachusetts.

We were delighted to see that Texas and Maryland last month enacted laws that make the divided programs statutorily possible in those States. The Governors of those States May 25 and May 19 respectively signed into law measures that permit the State banking departments to accept FDIC examination reports in lieu of State reports. Ohio at present is precluded from joining the divided examination program because of the working of State law.

We believe that all Members of Congress should ask their State banking commissioners if they are participating with the FDIC in the divided examination program, and if not, why not.

The returns in economy and efficiency for both the States and the FDIC are enormous, and the benefits to the covered banks in reduced burden

are substantial. The economics become increasingly important as we continue to feel the pinch of budget and manpower constraints arrayed against ever increasing workload, new responsibilities imposed by law and massive growth and changes in the banking industry.

The Federal Reserve System also is now going to a divided examination program for its State member banks, and Georgia has become the first State to join this program.

The FDIC and State banking departments have long enjoyed cooperative working relationships; however, the divided examination program offers substantial benefits in terms of reduced costs to both the States and FDIC and a substantial lessening of regulatory burden on the industry which had not been achieved before.

The FDIC joined with three States -- Georgia in 1977, and Missouri and New Jersey in 1978 -- in arrangements in which we alternated examinations of better managed banks. We entered into similar agreements with Illinois, Michigan and North Dakota in 1979 and then with Nebraska and New York in 1980.

In the spring of 1980, we had a very productive meeting with the Commissioners of those eight States. In June of 1980, the Chairman followed up with a letter to all State Commissioners inviting them to investigate the possibility of a similar arrangement for their States. From this nucleus the divided examination program grew.

In the past year, these other States have joined in divided examination programs with the FDIC: Alabama, Delaware, Idaho, Kansas, Massachusetts, Minnesota, Nevada, North Carolina, South Dakota, Utah and West Virginia. We

participate with a few other States in the same type of program; however, written agreements have not yet been signed. Still other States are expected to join the program before year end, 1981.

The program's keynote from the beginning has been flexibility. There is no single, rigid nationwide structure to which all States must conform. States have negotiated with us on cooperative efforts of various kinds that suit their individual needs and accommodate the needs of the FDIC. The program is voluntary. Not all States possess qualifications to enter into it. We must consider all reasonable ideas and adopt only those programs which offer the State and FDIC the greatest economies and highest quality of supervision.

We are also undertaking other initiatives with States in the divided examination program to streamline our application forms and processes, to share computer data, to participate jointly in enforcement actions, to provide typing assistance for reports of examination and to offer technical assistance to States seeking to change State law for the purpose of improved Federal/State cooperation. We also offer very attractive training opportunities to States participating in the program.

#### COORDINATION AMONG THE FEDERAL SUPERVISORS

I would like to turn now to the matter of coordination among the federal supervisors. We have made substantial progress in our joint efforts through the Federal Financial Institutions Examination Council which now has been in operation for 27 months.

The FFIEC already has a number of accomplishments to its credit: a uniform rating system for financial institutions; a policy statement on

coordination of bank holding company inspections and subsidiary lead bank examinations; a policy statement on supervision of U.S. branches and agencies of foreign banks; a uniform supervisory policy for the classification of delinquent consumer installment loans; standardized instructions for the quarterly reports of condition and income filed by U.S. commercial banks; uniform guidelines on internal control for foreign exchange activities in commercial banks; a new "Policy Guide" for the Truth in Lending Act, as amended; an interagency supervisory policy regarding the assessment of civil money penalties; a uniform bank performance report; a uniform consumer compliance rating system; elimination of the "Report on Security Devices"; uniform examination procedures under statutes governing community reinvestment (initially developed by the agencies before the advent of FFIEC), electronic fund transfers and financial privacy; adoption of examination procedures and reporting format for the Financial Recordkeeping and Reporting of Currency and Foreign Transactions Act, and adoption of a policy statement on coordination of enforcement actions.

The uniform financial institution rating system, particularly, represents an example of a substantial and far reaching achievement. The system was adopted by the banking agencies in May, 1978, before the establishment of the FFIEC, and by the FFIEC itself in modified form in November, 1979. The system has promoted uniformity among the federal agencies in rating the condition of the various institutions we supervise. At the FDIC, the new system has had a substantial effect on our day-to-day operations. The uniform rating system is now the major basis on which we make our determinations on priority and scope of bank examinations. The system is an integral part of the framework of the divided examination program since only banks rated one and two under

the system -- that is, banks in the categories of least concern -- are eligible for the program. Our problem bank definitions have been changed to accord with the new rating system. Finally, the system provides much of the framework for our policy on the use of formal and informal administrative actions.

#### UNIFORM EXAMINATION PROCEDURES

The FFIEC continues to work on the difficult problem of uniform bank examination standards. A special subcommittee has been making a study of several factors bearing on the question: agency characteristics which influence the agency's examination program, broad policy directives, examination planning and control, use of sampling in the examination, and the structure and use of examination workpapers. The subcommittee has submitted to FFIEC its preliminary findings concerning ways to achieve more uniformity in examinations, taking into consideration the implications for the FFIEC training programs, and is continuing its study of the many functional areas of the examination.

The undertaking is complex and sensitive. The examination function constitutes a major part of the mission of each of the federal agencies. The exercise of this function also influences an agency's training activities, methods of supervision, allocation of resources to other programs and even the organizational framework of the agency. Examination objectives and policies of the agencies are reasonably similar. However, each agency over the years has developed an examination program aimed specifically at the types and sizes of institutions supervised by the agency and designed to carry out the individual laws and regulations which the agency administers. Inevitably, each agency's program has developed its own characteristics, its own operational

routine, its own nuance suited to meet its specific needs. For example, the nature and character of a large bank and a small bank differ considerably, as do the operational characteristics of a savings and loan association and a credit union. The examination techniques of the various agencies reflect those differences. Further, the agencies vary in the extent to which they coordinate their examination activities with States. Major changes in the way an agency performs its examination activities can have tremendous ramifications for its resource needs and how they are allocated and can involve substantial costs in the design and implementation of new techniques.

The April 24, 1981, report of the General Accounting Office entitled, "The Federal Structure for Examining Financial Institutions Can Be Improved," makes recommendations that would lead toward the consolidation of the examination forces of the respective financial agencies. A key recommendation is that the FFIEC establish a special task force to consider ways to effect such a consolidation.

We doubt strongly that the separation of examination and supervision implicit in the GAO proposal is feasible. We believe that such a separation would be detrimental to bank supervision. Examination and supervision are integral and complementary parts of the same function. The examiner discovers a weakness; the regional office decides on a course of corrective action for the bank; another examination is performed to determine whether the corrective actions have been accomplished. If we separate the functions, we would be asking management of the three agencies to make key decisions based on the recommendations of pool examiners chosen at random who would be struggling to make their assessments under varying requirements and criteria. It would be impractical to require the same corps of examiners to be equally

familiar with federal law, the law of several States, and the supervisory procedures of three agencies so that the same examiner could shift readily from the examination of a State bank to a national bank and vice versa. In bank supervision, the viability of an institution frequently depends on timely and accurate evaluation and effective supervisory action. Here the difference in acting on the recommendation of your own people or on that of an outside entity is crucial. We believe that in this vital area agency commitment is essential. We do not believe that a recommendation from an interchangeable examiner, if we were to succeed in developing one, could ever be so strong as that of an agency examiner who reports directly to the managers of the agency for which he or she works.

We believe that our present course of interagency cooperation is a better route than that proposed in the GAO report. Coordination and communication among the agencies have been increased substantially through the medium of the FFIEC. From a dollar standpoint, we do not believe that savings through consolidation of field offices would be so great as the GAO report estimates; in fact, it might net out to a loss after costs of adjustment are figured in. It is important to consider that under the present system there is no duplication of function among the federal agencies, except in the bank holding company area. Generally, we each examine and supervise separate categories of institutions.

Finally, we believe that a reorganization of the magnitude contemplated by the GAO report should not be undertaken at this crucial period when we are proceeding under the deregulation mandate enacted last year. Such a reorganization could have a substantial unsettling effect on an industry beset with major challenges on other fronts.

Our current system of bank supervision has served the nation well for many years. It has in the past adjusted to changes and growth in the industry. We are confident that it can do so again. The banking industry today is seeking to cope with unsettled economic conditions, high interest rates, competition from unfamiliar quarters, massive new technology and other pressures. We continue to monitor these developments closely. We do not close our eyes to the prospect that changing circumstances may well make major changes in bank supervision imperative, including changes in supervisory structure. We will be prepared to meet that challenge.

#### HOLDING COMPANY SUPERVISION

One area which we believe definitely requires improved coordination is bank holding company supervision. The FFIEC adopted a policy statement providing for inter-agency coordination on all large holding company systems and other systems where the holding company or the lead bank exhibit weak financial characteristics. While the policy statement has been helpful and is about all the FFIEC can do, we still do not believe it effectively addresses the substance of this problem. In the past we have supported legislation to place examination and supervisory responsibilities for the holding company and its nonbank affiliates with the supervisor of the lead bank and to authorize the lead supervisor to coordinate the examination of other bank affiliates by their respective supervisors. We continue to feel this would be a more effective approach to the supervision of holding company systems.

#### INTERNAL INITIATIVES

In addition to our divided examination program with the States and our cooperative work with our partner federal agencies on the FFIEC, we are

also undertaking internal initiatives within the FDIC in our continuing efforts to improve our own bank examination operations.

One of these initiatives is the Integrated Monitoring System, which we also make available to states in the divided examination program. Our Division of Bank Supervision and the Division of Management Systems and Financial Statistics developed the IMS program for the primary purpose of monitoring banks between examinations. The system can help us decide where best to allocate our examiner time and resources. The system is also valuable in enabling us to plan and conduct the examination and saves examiner time by providing information which the examiner otherwise would have to assemble at the bank. We continue to work on refinements of the system for both commercial and mutual savings banks. I might add that an outgrowth of this system was a performance report which we provide to each State nonmember bank and which has been favorably received by the industry.

Two other steps intended to help the FDIC make better use of examiner time and resources are the development of a modified examination concept and the condensing of the content of reports of examination.

The modified examination criteria and procedures were issued in May, 1979, after two and a half years of development. A modified examination provides for the review of the safety and soundness essentials of a bank rated one or two without requiring the comprehensive detail of a full examination that would be given to banks of greater supervisory concern.

The effort to trim the length of our reports of examination and improve their substance took new impetus January 1, 1979, when the FDIC made significant changes in the content of all reports, eliminating a number of pages

from both the open and confidential section of the report. The FDIC had begun its effort to condense its reports two years before, beginning with the reports of modified examinations. Our policy now generally is to limit reports of both kinds of examinations to only the length needed to show the essential condition of the bank. We are continuing to work on refinements and improvements in both our procedures and report forms.

The aim of these efforts is to save examiner time and resources, particularly with regard to well operated banks, so that these scarce resources may be diverted to areas of greater need.

We have been able to adjust our standard for periodic examinations so that problem banks are examined on a full scope basis at least once every 12 months, banks of lesser supervisory concerns are examined in depth at least every 18 months, and banks presenting no financial or supervisory problems are examined using more limited scope techniques every 18 months, or in the case of divided examination States, every 24 months. Despite our advances, we continue to believe in the need for periodic on-site examination of banks. No automated monitoring system or other procedure can substitute for the on-site examination as a means of determining a bank's condition. Such an examination is our strongest supervisory tool. We are convinced that even healthy banks must receive on-site examinations on an on-going basis and within a prescribed time span to assess their condition and protect the Corporation's insurance risk and continue the necessary dialogue with bank managers, particularly with respect to managers' reactions to changing economic conditions and industry practices.

CAPITAL ADEQUACY

In addition to our efforts in the examination area, we continue to grapple with several regulatory and supervisory issues. One such issue that arises in connection with the evaluation of bank safety and soundness is the standard of capital in banks supervised by the various agencies.

We agree that small banks tend to maintain equity capital ratios which are higher than ratios for large banks. Indeed, the June 1980 staff study by the Federal Financial Institutions Examination Council on "Capital Trends in Federally Regulated Financial Institutions" reported such a pattern. That report also noted that with the exception of the very largest bank size categories (\$500 million to \$1 billion and over \$1 billion in assets), the other size groups did not experience any noteworthy downward trends in capital ratios since 1970. In light of the volatile economic environment over the last few years, we tend to be somewhat more concerned about the declining capital ratios of larger banks than the more stable capital ratios of smaller institutions.

Higher capital ratios of small banks are the result of the combined decisions of the regulators and the institutions and are based upon several factors indicating the risk exposure of the institutions.

Our conclusions regarding capital adequacy of banks is based on case-by-case analysis, relying upon guidelines which take into account such factors as the quality of management, quality of assets, adequacy of liquidity, level and stability of earnings, and the general economic and competitive climates in the markets in which the bank operates. The institutions make similar judgments, also taking into account their own considerations, including the extent to which they are able to diversify their risk exposure through

flexible asset and liability management and their ability to service a number of diverse economic markets. Because the opportunities to diversify are more limited for smaller institutions, they sometimes tend to be more conservative in their decisions regarding capital maintenance.

We are currently working closely with our sister regulatory agencies under the auspices of the Federal Financial Institutions Examination Council in reviewing current policies and exploring alternative policy positions on various bank capital issues. These include the proper role of subordinated debt in capital analysis; setting numerical capital standards and establishing an enforcement policy for banks that fail the standard; and the adequacy of bank capital in consolidation with its parent holding company.

#### CONSUMER AND CIVIL RIGHTS COMPLIANCE

A considerable part of our examination function is devoted to checking for compliance with consumer and civil rights laws. Again, the FFIEC serves as the principal forum for cooperation among the federal agencies. We have made substantial progress toward achieving uniformity in the compliance area. We have a number of further cooperative initiatives underway.

The FFIEC's Consumer Compliance Task Force, since its organization in 1979, has produced uniform examination procedures for Electronic Fund Transfer Regulation E and for the Right to Financial Privacy Act, uniform enforcement standards for the Truth in Lending Act and its implementing Regulation Z, and uniform rating systems for Community Reinvestment Act compliance and for the consumer compliance examination as a whole.

The FFIEC is working on a uniform enforcement approach to the Equal Credit Opportunity Act and its implementing Regulation B.

Before establishment of the task force, the agencies cooperated on the development of uniform examination procedures for the Community Reinvestment Act.

Currently, under the task force, the agencies have under way projects to develop uniform examination procedures for Truth in Lending Regulation Z, the Real Estate Settlement Procedures Act, the Fair Credit Reporting Act and the National Flood Disaster Protection Act. The Regulation Z procedures, which will include uniform sampling techniques, are expected to be drafted by this summer.

The task force is undertaking other initiatives to analyze the complaint handling procedures of the agencies and to address a variety of interpretive technical issues arising from the implementation of policies and procedures produced earlier by the task force.

We will continue these efforts, under the FFIEC, to develop and administer a consistent, effective consumer law compliance examination program at the federal level. When a law authorizes exemptions for States with substantially similar State law, as in the case of the Truth in Lending Act, we have ceased examinations for compliance with such laws in favor of State enforcement.

#### CONCLUSION

I have sought to give you a broad survey of our activities that aim toward uniformity, effectiveness and the avoidance of duplication in the examination process. We have achieved a significant measure of success, and we are looking forward to continued progress in the future.