Statement by

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I am pleased to appear before this Subcommittee to discuss the examination process and recent efforts to make examinations more cost effective and more uniform among the Federal supervisory agencies. Concerns about the efficiency and effectiveness of the examination process are quite understandable, given the complex governmental structure that our nation has devised for the supervision and regulation of depository institutions. There are now five federal agencies directly responsible for the supervision and regulation of commercial banks and thrift institutions, and under the "dual banking system" concept all 50 states also have direct oversight responsibilities. It is important to note, however, that over a long period of time interagency arrangements have been directed to achieving uniformity where appropriate and to avoid duplication and overlap whenever possible. These interagency efforts are an ongoing process, since new accommodations are required as our financial system evolves.

In 1978, the Congress, with the Board's endorsement, reviewed the need for a more formal coordination structure and created the Examination Council to promote greater uniformity in examination procedures and supervisory policy among the five federal supervisory agencies. So far the Examination Council has made good progress in carrying out this Congressional mandate. Among its achievements have been the development of a uniform system for rating the financial condition of banks and thrift institutions and the creation of a uniform bank performance report that will be used in monitoring the situation of individual institutions by the three banking agencies. The Council also has developed a uniform
policy for coordinating the examination of holding companies and their major bank subsidiaries where the organization either is very large or is experiencing financial difficulties or deterioration.

Currently, the Examination Council has an interagency task force studying additional ways to bring greater uniformity to the examination process. Of course, achieving complete uniformity in examination procedures and techniques is not practical or desirable. For example, the supervisory agencies obviously would not want to employ the same methods in examining large multinational commercial banks as they would use in examining credit unions. Also, we must expect differences in bank examination procedures between the Comptroller of the Currency on one hand and the Federal Reserve and the FDIC on the other, because the latter two agencies supervise state banks and must coordinate and communicate with state bank supervisors who are the chartering authority. Our objectives are already much the same, however, and allowing for practical differences such as these, we will continue to strive for greater procedural uniformity through the work of the Examination Council.

In recent months the GAO has issued two reports to the Congress relating to the examination of depositary institutions. The first report made a number of recommendations relating to current agency examination procedures and techniques. Some of these recommendations have already been implemented by the Federal Reserve and the other agencies, while others are presently being considered by the Examination Council. The second report involved a GAO proposal for interchanging examiners among the three federal banking agencies.
As part of its earlier report, the GAO recommended that the Examination Council develop uniform procedures for evaluating state banking agencies, then having the federal banking agencies accept the examination reports of those states given acceptable ratings. The rationale for this proposal was to economize on examiner resources by terminating both federal and state examinations of state chartered banks. While the Board endorses the objective of the GAO proposal, it cannot support the specific recommendation. First, we do not believe that the federal agencies could adequately carry out their supervisory responsibilities for state banks if they completely withdrew from the examination process, since this is a key element in effective supervision. In addition, we believe that any ongoing evaluation of state banking agencies by a federal agency would inevitably prove to be awkward and could damage existing federal-state agency relationships if a number of state agencies were judged to have inadequate examination capabilities.

While the Board cannot endorse this GAO recommendation, we are anxious to continue and expand our current close working relationships with state banking authorities. At present the Federal Reserve has joint examination arrangements with 16 states and concurrent examination arrangements with 15 states. Joint examinations entail a sharing of the workload between federal and state examiners and the preparation of a single report. Concurrent examinations involve a similar sharing of workload and resources with the preparation of separate federal and state reports. As a result of these cooperative reexamination programs, over one-half of all state member banks, including most of our largest ones, are now examined on a
joint or concurrent basis. In states where such cooperative programs are not utilized, the Federal Reserve attempts to coordinate timing with the states in order to space examinations more effectively. The Federal Reserve also receives and analyzes state examination reports, and the Board has permitted the Reserve Banks to substitute an examination conducted by a state for one of the two annual examinations that we require of problem banks.

In addition to these efforts, the Federal Reserve is expanding federal-state cooperation through the initiation of an alternate year examination program with state banking authorities. Under this program, relatively trouble-free banks selected by the Reserve Banks and the states will be examined by the agencies in alternate years. This program will lessen the burden of examinations on commercial banks and economize on the use of examiner resources, which will permit both the Federal Reserve and the states to target more of their examination efforts at those banks most in need of supervisory attention. An alternative year program has already been arranged with the State of Georgia, and we are now in the process of establishing programs with a number of other state banking departments.

In recent years, the Federal Reserve has implemented a number of initiatives to save resources in its own examination program. For example, the Federal Reserve is employing limited scope examinations in certain cases where it is not deemed necessary to collect the detailed information resulting in a full-scale examination. Also, Federal Reserve
examiners are relying more on information supplied by the banks where the information is verified through testing and statistical sampling techniques.

In order to improve the allocation of examiner resources, the System has recently reviewed its examination frequency policy and has adopted a more flexible approach that extends the time between examinations for sound banks. In relating examination frequency to a bank's financial condition, the Federal Reserve can target more resources to companies that warrant close supervisory attention. The Federal Reserve is also reviewing the possibility of limiting the time spent by examiners at a bank to those tasks—such as asset evaluation, assessment of management and internal controls and compliance with law and reporting requirements—which can best be conducted on-site. Such an approach would make maximum use of surveillance and financial analysis techniques that can be employed on an ongoing basis off the bank's premises. This approach also would economize on examiner salary and travel expense and lessen the burden of on-site examination for the banks.

In addition to these Federal Reserve efforts, a number of ongoing interagency programs have proven to be successful in saving resources as well as increasing uniformity. Both the shared national credit program and the uniform country exposure examination procedures, which have been in place for several years, have produced considerable savings and increased interagency consistency in examination findings and conclusions. While these programs were originally established at the federal level, they have been expanded to include some state banking authorities.
In an apparent attempt to improve the structure of the federal examination forces, the GAO has recommended the interchange of examiners among the federal agencies as an interim step to a possible eventual consolidation of the federal examination forces, which the GAO appears to favor. It is asserted that an interchange or "pooling" of federal examiners would reduce travel costs by allowing banks to be examined by personnel from the nearest agency office, even if that agency is not the primary supervisor. The GAO suggests that reducing travel by examiners would also improve morale and lower personnel turnover, thereby improving the quality of examination staffs.

The Board strongly opposes this GAO recommendation. As the GAO report itself points out, the proposal would entail a number of statutory, administrative and procedural problems. Also, the proposal gives little weight to the fact that the federal agencies necessarily use somewhat different examination techniques and are responsible for enforcing somewhat different banking laws. Given these differences, the use of examiners interchangeably would require costly and time consuming retraining efforts and would tie up resources that could be better spent in the supervisory process. In sum, the Board disagrees that the potential savings from the GAO proposal would outweigh the additional training costs and substantial coordination problems that would be created by a large-scale examiner interchange.

The GAO's proposal also would raise problems regarding examiner accountability and control. If an examiner from one agency were to spend substantial time examining banks under the primary supervision of other
agencies it is no longer clear to which agency the examiner would in fact be accountable or how that examiner's performance could be fully evaluated.

The GAO's proposal implicitly assumes that the examination function and the supervisory function are separate. As a practical matter, it seems to me extremely difficult to separate the examination function from overall supervision. This is so because examiners are instrumental in many important supervisory activities, including the timely identification of problems, meeting with management to discuss supervisory concerns and monitoring bank compliance with corrective action programs and formal enforcement actions. The accurate identification of supervisory problems and the implementation of remedial actions are largely dependent on the clear lines of authority, communication and control that currently exist between supervisory agencies and their field forces. The GAO proposal would obviously threaten this constructive relationship and in the process could weaken the quality of federal supervision.

Another shortcoming of the GAO's interchange or pooling concept is that it would muddy existing relationships between banking institutions and those agencies responsible for supervising them. In disrupting these supervisory relationships, the proposal also could impair ongoing corrective action programs that had been implemented and were being monitored by the primary authority.

Finally, the Board believes that the GAO proposal would fail to achieve what is claimed to be an important benefit—the reduction of examiner turnover. Separating examiners from the supervisory process and
committing them instead to a large, impersonal professional pool having no clear identification with a primary regulator surely would erode examiner morale and increase the dissatisfaction of people possessing highly marketable skills.

While the Board opposes the examiner interchange proposal, we do believe that examination resources might be saved in some cases by geographically relocating examiners of a given agency. Indeed, the Federal Reserve has now established five examination field offices, two within the last two years. These 5 fields offices, together with the 12 Reserve Banks, give the Federal Reserve 17 examination facilities throughout the country. Other geographic locations for additional field offices are under preliminary review.

In concluding, I want to reaffirm the Federal Reserve's commitment to performing examinations in the most efficient manner possible consistent with meeting our supervisory responsibilities. We are also committed to working toward greater interagency uniformity in examination procedures and supervisory policy through the Examination Council. But we do not support any sweeping changes in examiner organization or accountability. Such changes would be totally unwarranted in the current difficult economic environment when a close and continuing oversight of the nation's depositary institutions is of vital importance.

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