DOCUMENT RESUME

00277 - [A0751125]

Highlights of a Study of Federal Supervision of State and National Banks [Vol. I]. OCG-77-1a; B-114831; B-118535; B-168904. January 31, 1977. 56 pp. + appendices (102 pp.).

Report to the Congress; by Elmer B. Staats, Comptroller General.

Issue Area: Internal Auditing Systems (200); Federal Regulatory Activities (3000).
Contact: Office of the Comptroller General.
Budget Function: General Government: Central Fiscal Operations (803).
Organization Concerned: Federal Deposit Insurance Corp.; Federal Reserve System; Office of the Comptroller of the Currency.
Congressional Relevance: House Committee on Banking, Currency and Housing; Senate Committee on Banking, Housing and Urban Affairs; Congress.
Authority: National Banking Act. Edge Act. Financial Institutions Supervisory Act of 1966. Federal Reserve Act of 1913. Banking Act of 1933.

Several congressional committees requested the evaluation of the effectiveness of the supervisory efforts of the three Federal agencies involved in monitoring banking operations, because of the increasing instability of banks. The study objectives were to evaluate the agencies' efforts to (1) identify unsound conditions and violations of laws in banks, and (2) cause bank management to take corrective actions. Examination reports and correspondence files on more than 900 banks supervised by FDIC, Office of the Comptroller of the Currency, and the Federal Reserve Boards were examined, including 30 of 42 banks that had failed, 294 of 787 problem banks, and a general sample of 600 of the banks in the United States. Findings/Conclusions: Adverse economic conditions contributed to some bank failures, but generally embezzlement and poor management of loans were the cause. Problems were not corrected because: (1) the regulatory agencies were reluctant to use their legal authority to force the banks to change, (2) the agencies did not consult with bank boards, (3) examinations were set up on a time basis rather than a problem solving basis, and (4) recommendations were not generally made as to how to solve problems. Examiners have enforcement tools they may use, both informal and formal: (1) informally request that banks make the changes, (2) formal written agreements to confirm correction plans, (3) cease and desist orders, (4) removal of management, (5) financial assistance, (6) cancellation of deposit insurance, (7) cancellation of Federal Reserve membership, and (8) revocation of charter. Federal Reserve Board surveillance of bank holding companies is not adequate. Training of examiners is not adequate. Major improvements of bank supervision include organizational changes, closer bank surveillance, self-dealing and insider transaction monitoring, consumer protection law

enforcement, new examination procedures, closer contact with bank boards, problem solving monitoring, more use of formal powers, experiments on relying on state examinations, and better training of examiners. The agencies involved are not working as closely as they should. Recommendations: The agencies should revise their examination practices and frequencies to better identify problems. Examination reports and meetings with bank boards should follow all examinations. More aggressive policies should be developed for the use of formal actions against problem banks. Better training and screening of potential examiners should be implemented. The three agencies, either through their own initiative or legislation, should coordinate their efforts more closely. More stringent procedures for handling charter applications should be devised. (SS)

00277

REPORT TO THE CONGRESS

BY THE COMPTROLLER GENERAL OF THE UNITED STATES

Highlights of a Study of Federal Supervision of State and National Banks

OCG-77-1a

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COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

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To the President of the Senate and the
Speaker of the House of Representatives

This report highlights our unprecedented study of the effectiveness of State and national bank supervision by the Federal Deposit Insurance Corporation; the Federal Reserve System; and the Office of the Comptroller of the Currency, Department of the Treasury.

This study was made at the request of several congressional committees concerned over large bank failures in recent years and public disclosure that supervisory agencies' lists of "problem banks" had lengthened.

Our Office does not have legislative authority to audit the operations of the Federal Reserve System or the Comptroller of the Currency. Also, our access to the bank examination reports of the Federal Deposit Insurance Corporation has long been a matter of dispute.

In light of the heavy congressional interest in the area, the agencies allowed us to make the study. They agreed, in April 1976, to give us unlimited access to their bank examination reports and other related records, provided we would not disclose any information about specific banks, bank officers, or bank customers.

The focus of the report is on evaluating the agencies' bank examination functions and their efforts to get banks to correct problems identified. Several recommendations for improvements are made.

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The three agencies have reviewed and commented on a draft of the report. Their comments are presented, in full, as appendixes to the highlights. In view of the time constraints placed on us for completing and releasing the study, we have not been able to fully evaluate their comments.

In the past we have supported proposals before the Congress to give this Office continuing legislative authority to review the operations of the bank regulatory agencies and report to the Congress. With such authority, we could be more helpful to the Congress in carrying out its legislative and oversight responsibilities for bank insurance and regulation. In view of the very important part that the three agencies play in the Nation's system of money and credit, we feel that the Congress should provide for GAO audits of the agencies.

We are sending copies of these highlights to the Secretary of the Treasury; the Comptroller of the Currency; the Chairman, Board of Governors of the Federal Reserve System; and the Chairman, Board of Directors of the Federal Deposit Insurance Corporation.

Comptroller General
of the United States

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ABBREVIATIONS

CSC	Civil Service Commission
EDP	electronic data processing
FDIC	Federal Deposit Insurance Corporation
FRB	Federal Reserve bank
FRS	Federal Reserve System
GAO	General Accounting Office
NBSS	National Bank Surveillance System
OCC	Office of the Comptroller of the Currency

INTRODUCTION

Why GAO made this study

The Congress is concerned with the soundness of the commercial banking system. In the past 3 years, several major banks have failed in the U.S. The public has become aware that several major banks are on the supervisory agencies' list of problem banks 1/ and that the number of problem banks is increasing.

In early 1976, several congressional committees asked us to evaluate the effectiveness of the supervisory efforts of the three Federal agencies involved: Federal Deposit Insurance Corporation (FDIC); Federal Reserve System (FRS); and Office of the Comptroller of the Currency (OCC), Department of the Treasury. Specifically, the study was requested by the Chairmen of

--the House Committee on Banking, Currency and Housing;

--the Domestic Monetary Policy Subcommittee, House Committee on Banking, Currency and Housing;

--the Financial Institutions Supervision, Regulation and Insurance Subcommittee, House Committee on Banking, Currency and Housing;

--the Commerce, Consumer, and Monetary Affairs Subcommittee, House Committee on Government Operations; and

--the Senate Committee on Banking, Housing and Urban Affairs.

1/In the context of this report we use the term "problem banks" to refer to banks requiring special supervisory attention. FDIC and FRS also commonly refer to them as problem banks, but OCC considers problem banks as a portion of banks requiring special supervisory attention.

The objective of our study was to evaluate the agencies' efforts to (1) identify unsound conditions and violations of laws in banks and (2) cause bank management to take corrective actions. Our study was directed to determining whether:

--Bank examinations are of sufficient scope to identify banks which are likely to run into serious managerial or financial difficulties.

--Supervisory agencies' efforts to improve their operations are satisfactory.

--Supervisory agencies can and do follow through on their findings of problems in banks to see that corrective actions are taken by bank managers.

--Examiners are qualified and trained to conduct reliable bank examinations.

--OCC considers applications for national bank charters on a fair and consistent basis.

We reviewed examination reports and correspondence files on over 900 banks supervised by the 3 agencies. These included three sample groups:

--30 of the 42 banks which failed from 1971 to mid-1976.

--294 of 787 problem banks as of December 31, 1970, and December 31, 1975.

--A general sample of 600 of the over 14,000 banks in the United States.

The Federal bank regulatory agencies

Government involvement in the American banking industry has consisted of recurring attempts to balance the need for healthy competition among banks with the need for a sound banking system. As history shows, these objectives are not easily reconcilable. Attempts to balance them have led to a banking system which is unique in the contemporary world; Government involvement in the Nation's 14,700 commercial banks is dispersed among 50 States and 3 Federal agencies.

--OCC was established in 1863 by the National Currency Act which was superseded by the National Bank Act in 1864. The Comptroller was authorized to charter and supervise national banks.

--FRS was created by the Federal Reserve Act of 1913. The act established the Federal Reserve banks (FRBs) to carry out monetary policy and to improve the supervision of banking in the United States.

--FDIC was created by the Banking Act of 1933 as an independent Government corporation, to insure small depositors against losses resulting from bank failures.

The Federal agencies, as well as agencies in 50 States, all have some responsibility for bank regulation (the process of interpreting banking legislation and issuing rules and regulations for the banks) and bank supervision (the process of monitoring, examining, and advising individual banks).

The Federal agencies do not examine the same banks. OCC examines national banks, the FRBs examine State banks which are members of the System, and FDIC examines insured State banks which are not members of FRS. State banking authorities also examine State banks.

FDIC examines about 60 percent of all commercial banks, but these banks account for less than 23 percent of total deposits and the majority are small or medium sized. OCC and the FRBs examine most of the large banks as well as many small and medium sized banks.

The agencies receive no congressional appropriations, but rely essentially on the banks they supervise and their investments in U.S. Government securities for operating funds.

Some appreciation for the relative size of the agencies' operations at December 31, 1975, can be derived from the following comparisons.

	FDIC	FRS	OCC
Number of commercial banks supervised	8,594	1,046	4,744
Number of bank examiners	1,700	700	2,000
1975 costs of examinations (millions)	$[illegible]8	$22	$69

Recent trends in the banking industry

About 14,700 commercial banks are chartered to do business in the United States and its possessions. Of these, about two-thirds are chartered by the 50 States and one-third by OCC.

During the period 1971-75, the commercial banking industry underwent significant change. Several trends have become apparent:

--The number of banks with assets over $100 million increased 44 percent, while banks with under $10 million in assets decreased 23 percent.

--The number of banks controlled by holding companies increased 52 percent; assets of these banks increased 83 percent.

--Assets of foreign branches of FRS member banks increased 189 percent. (Nonmember banks hold less than 1 percent of foreign branch assets.)

--Foreign loans of domestic banks and branches increased 122 percent.

From our analysis of banking industry financial data, other observations can also be made:

--Total assets of the commercial banking industry grew by over 50 percent. The number of banks increased only 6 percent.

--Less than 19 percent of the asset growth was financed by demand deposits (checking accounts) while 74 percent came from more costly time deposits (savings accounts) and borrowings from other banks and sources of credit. (The remaining 7 percent came from an increase in capital.)

--Reserves for potential losses on loans and securities increased 41 percent, 7 percentage points less than the overall growth in loans and securities.

--Total capital increased 46 percent. Approximately half of the growth was the result of profits being retained; half, the result of new capital being added.

--Net losses from loans and securities for 1975 were approximately 200 percent greater than for 1971.

The same 5-year period saw unfavorable trends in the Nation's economy. As a result, banks which had placed portions of their resources into higher risk ventures encountered financial difficulties. This was reflected by an increase in the number and size of "problem" banks.

Of 352 problem banks at January 1, 1971, 13 had deposits of over $100 million. At December 31, 1975, there were 607 problem banks, 90 of which had over $100 million in deposits.

The number and size of bank failures also increased during this period. There were more failures in 1975 than in any year since 1943, and the 3 largest failures in history occurred between 1971 and 1975.

WHAT LESSONS CAN BE DRAWN FROM RECENT BANK FAILURES?

For the first time since the massive bank failures of the 1930s, the public is concerned over the health of the banking industry. One direct result was the creation of the FDIC in 1933 to protect depositors and prevent mass withdrawals. Since 1933, banks have continued to fail, but until 1965 these failures involved relatively small banks. (The largest had deposits of $48.8 million.)

The graphs on the following page show the number of failures and the deposits of banks that closed between January 1960 and December 1976. Although the number of failures is still small, several larger banks have failed since 1965.

Placing the figures in perspective, the largest number of failures in any year shown was 16 during 1976. This represents about 0.1 percent of the total number of banks. Although it is apparent that the economy can tolerate the number of failures that have occurred in recent years, we cannot determine at what point an intolerable situation would develop. For example, if the number of large bank failures were to increase, the economy could be seriously affected.

We selected for detailed review 30 of the 42 banks that were closed between January 1971 and June 1976. An additional 27 banks merged with others to avert probable failure.

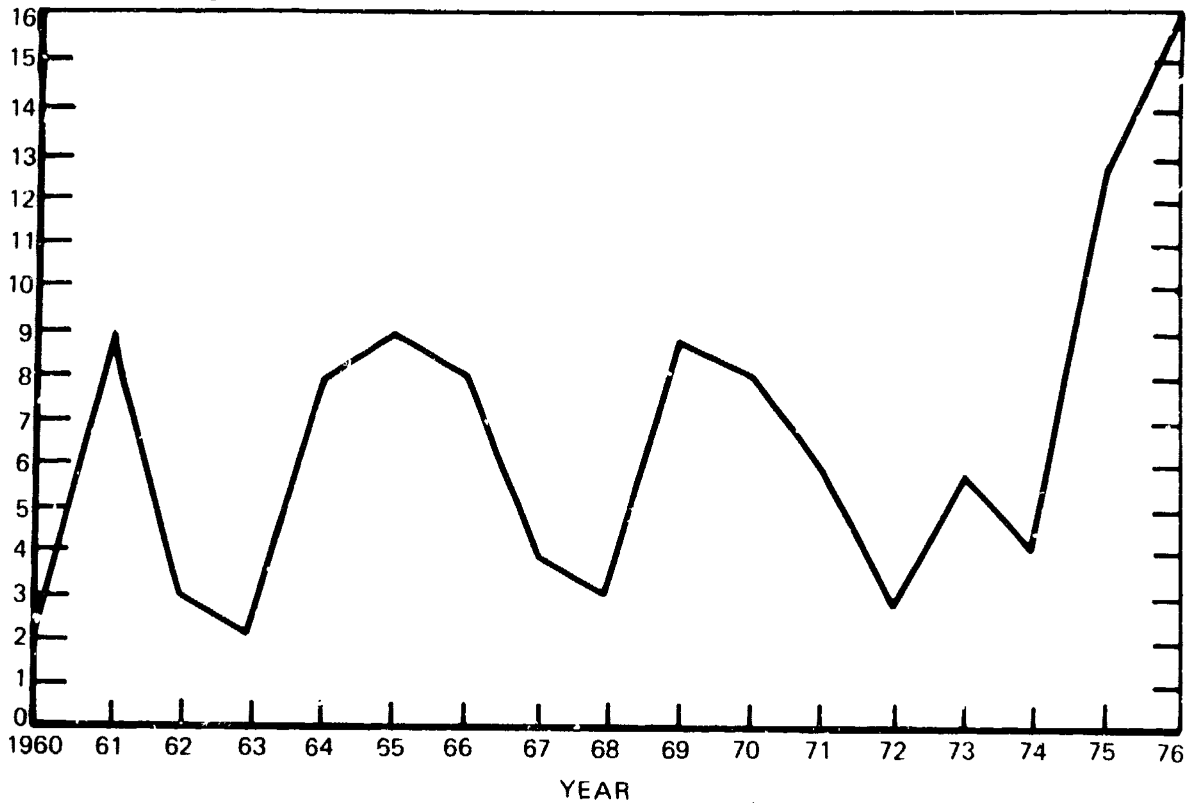
Causes of the bank failures

Adverse economic conditions in the 1970s contributed to some of the bank failures. Banking entails risk, and these risks become greater in periods of general economic decline.

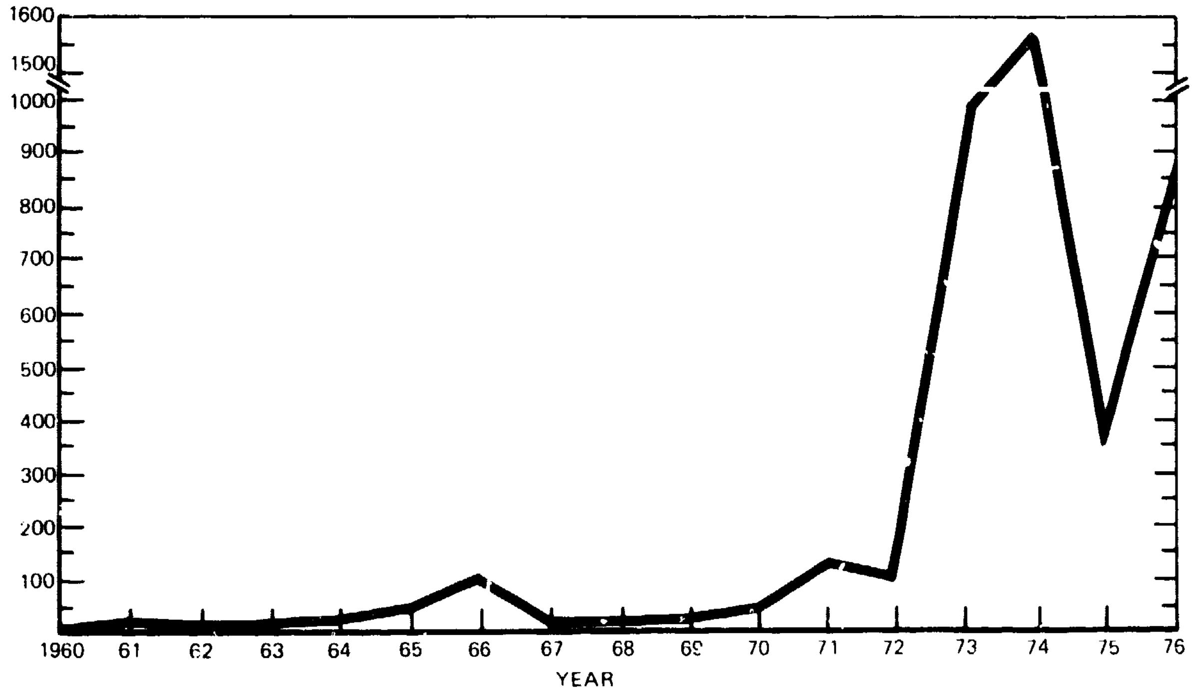
However, the bank examination reports show that the primary cause of each failure was the practices followed by the bank's managers. These practices left the banks more vulnerable to economic fluctuations.

Among the 30 cases we reviewed, 14 banks' problems were related to self-serving loan practices. Illegal acts such as embezzlements caused eight of the failures. The remaining eight banks failed because of general loan mismanagement.

NUMBER OF BANKS CLOSED 1960–1976



TOTAL DEPOSITS OF CLOSED BANKS 1960–1976



Had the problems been identified by bank examiners?

The examiners identified the underlying problems which led to most bank failures. In 21 of the 30 cases we reviewed, the agencies identified the banks' problems at least 2 years before they closed. Moreover, the examiners usually commented to bank managers on the problems in reports or meetings. The difficulty confronting the agencies was not in identifying the problems but in influencing the banks to solve them.

What did the agencies do?

First the agencies attempted to influence bank managers and owners with informal techniques. In some cases they made visits to the banks in addition to regular examinations. Some banks were required to report periodically on progress in solving their problems. OCC even placed examiners in one bank full time.

Although agency personnel said informal persuasive techniques are usually sufficient to convince a bank's managers to solve its problems, persuasion obviously didn't work with the banks that failed. This was usually because the bank officials followed self-serving loan practices or were incompetent, as stated in examination reports and correspondence. In addition, the banks' boards of directors did not meet their responsibilities.

Faced with this situation, the agencies could have turned to their legal powers. However, we noted a tendency by each agency to delay legal action until the banks' problems had become so severe as to be difficult at best to correct. The regulators kept waiting for the banks to take the actions they had promised, and bank managers broke those promises several times before the agencies began legal steps.

In 7 of the 30 cases reviewed, the agencies threatened to either close the banks or terminate deposit insurance. FDIC actually began to terminate the insurance of four banks we reviewed.

The agency removed a bank officer of one bank. However, he owned a controlling interest in the bank and remained influential.

Judging the appropriate time to take formal measures against a bank's management is difficult. Nevertheless, we believe the supervisory agencies did not use their cease and desist authority as effectively as they might have.

ARE FEDERAL BANK EXAMINATIONS OF ADEQUATE SCOPE TO IDENTIFY SIGNIFICANT PROBLEMS IN BANKS?

Basic approach

Bank examinations have placed great emphasis on analyzing the bank's condition at the time of the examination. This approach has been reasonably effective in identifying problems in banks. However, in many cases examiners do not address the underlying causes such as the bank's basic management practices, operations, and controls.

The examination procedures followed by the agencies were much alike. They looked at the same things and did the same kinds of analyses and evaluations. The major emphasis of the agencies' examination efforts was on evaluating quality of assets, adequacy of capital, and quality of management. The examination approaches have emphasized financial ratios and comparisons. The agencies had not established criteria or acceptable levels for these ratios and comparisons. Their views of the condition of banks depended largely on individual judgment.

At each agency the scope of examination was established by the examiner-in-charge within general guidelines provided by agency manuals, standard report formats, and agency training and tradition.

The manner in which a bank was operated and controlled--its policies, procedures, and practices; its internal control system; and its internal and external audit functions--was not normally a leading determinant of examination scope. Thus, the same things were usually looked at from bank to bank.

Examinations should focus more on bank operations that have weaknesses which could cause serious problems. Also, examiners should waive certain procedures if they have been satisfactorily performed by internal auditors, outside auditors, or State examiners.

New approach being developed

We believe the new examination approach, development of which was initiated by OCC in the fall of 1975, will help examiners to focus on and deal with potential causes of problems before the financial soundness of the banks are affected. Under the new approach, examiners will continue to evaluate the financial condition of banks and test for compliance with laws, rules, and regulations. The major change is the depth to which examiners will probe into the workings of banks to determine how well they are being managed on a day-to-day basis.

Many bank problems, such as bad loans and poor-quality investments, are the result of weak policies, poor procedures or practices, or lack of sound control mechanisms. By concentrating on bank policies, procedures, practices, and control mechanisms and by requiring banks to strengthen these areas when weak, the agencies can gain greater assurance that a bank's financial condition will not deteriorate significantly between examinations.

Our review of the new procedures and the results of 10 test examinations, made by OCC in 1976, lead us to conclude that the concepts underlying the new OCC approach are sound and that the new approach offers substantial benefits over the current examination approach. The new OCC approach has not been tested on very small banks, very large banks, or banks known to have significant problems, nor have the costs of the new approach been estimated. Additional testing of the new approach is needed to make sure that it will apply to all classes of banks. Improvements or adjustments in the approach may be appropriate after further tests, particularly if the costs will be much greater than under the old approach.

In our opinion, the concepts could also be applied by FDIC and FRS. The three agencies should jointly evaluate the approaches being developed.

Problems found in examinations

Examiners found some type of problem in nearly all of the banks in our samples. The most frequently found problems were similar among the banks in our general sample and our problem bank sample. The degree of severity between problem banks and banks in general was dramatically different for problems related to loan concentrations, liquidity, loan policy, and capital adequacy.

Banks on the problem list were often cited for inadequate liquidity, inadequate collateral documentation, ineffective management, or excessive insider loans in addition to other problems.

Banks of different sizes had different problems. Large banks were more often criticized for the character of their business (classified loans, inadequate capital) whereas smaller banks were more often criticized for problems related to procedures and operations (inadequate credit files, poor collection procedures).

For banks in general, FDIC examiners clearly cited banks for problems more often than either FRS or OCC examiners. The same was true for problem banks, but differences among agencies were less pronounced.

The relationship between the frequency with which banks were cited for problems related to management effectiveness--such as inadequate internal routines and controls and violations of laws and regulations--and the frequency with which management effectiveness was criticized was not what might have been expected. Far fewer banks were cited for ineffective management than for the related problems with inadequate internal routines and controls and violations of laws and regulations:

--Four percent of the banks in our general sample were cited for ineffective management; 55 percent for violations of laws and regulations; and 44 percent, for inadequate routines and controls.

--Sixteen percent of the banks in our problem bank sample were cited for ineffective management; 81 percent, for violations of laws and regulations; and 55 percent, for inadequate routines and controls.

The agencies rarely criticized a bank's loan policies until loan problems developed. Insider and out-of-territory lending were not frequently mentioned problems for banks in our samples.

Frequency of examinations

The National Bank Act requires that each national bank be examined twice each year, but allows the Comptroller to waive one examination in each 2-year period. During the 1974-75 cycle, OCC examined 75 percent of the national banks the required 3 times. FRS policy is to examine each State member bank at least once a year. In 1975 it examined 97.5 percent of its banks. FDIC, in practice, attempts to examine each of its banks once every 12 months. In 1975 it examined 85 percent of its banks.

In our view, the number of times a bank is examined should not be based upon a rigid frequency requirement. Rather, the agencies, using the results of previous examinations and information from reports by banks, should schedule examinations based on an evaluation of bank's soundness, and the quality of its policies, procedures, practices, controls, audit, and management.

Under this approach, banks in poor condition would be examined more often than those in good condition. Each agency should have policies to allow it to consider such factors and exercise discretion in determining when to examine banks.

Scheduling of examinations

Agency officials said they tried to preserve the element of surprise in scheduling examinations so banks would not hide adverse conditions or wrongdoing. Therefore, as a matter of policy, they did not disclose examination schedules to banks or outsiders (other than State examiners) and they tried to avoid establishing predictable patterns.

However, in some cases the agencies had established definite examination patterns. FRS examined 70, FDIC examined 56, and OCC examined 79 of the banks in our samples in the same month of 2 or 3 consecutive years. Because the agencies view surprise as an important element of an examination, they should be scheduling their examinations to avoid obvious patterns.

Relationship of Federal and State examinations

FDIC and FRS sometimes conducted their examinations at the same time as the State banking agencies. Both agencies have started very limited experimental programs to rely more on the work of State examiners instead of examining banks in those States.

In our opinion, these approaches are reasonable attempts to eliminate needless duplication of work. If found acceptable, they should be expanded to enable FDIC and FRS to concentrate their efforts more on banks with serious problems. By relying more on State examinations, FDIC and FRS could free their own examiners from relatively routine examinations of "good" banks to examine, reexamine, visit, or monitor banks with major problems. The Federal agencies, of course, should rely on the States' examinations only if they are of acceptable quality.

Consumer protection laws

The Congress has enacted several laws to protect consumers. Certain of these laws affect banks' lending practices, efforts to attract depositors, and billing discrepancies. The agencies are responsible for enforcing these provisions.

In the most recent examinations of banks in our general sample, FDIC examiners cited violations of consumer credit and truth in lending regulations more often than FRS and OCC examiners.

Regulation	Percent of banks in which violations were found by		
	FDIC	FRS	OCC
Consumer credit (regulation B)	3	1	-
Truth in lending (regulation Z)	29	17	14

The agencies were not devoting enough attention to monitoring banks' compliance with consumer protection laws and regulations. Their procedures were not sufficiertly comprehensive or detailed. Thus, the agencies relied heavily upon the individual examiners to find violations; although the examiners were insufficiently trained.

While the agencies reported some violations of consumer protection laws and regulations, they acknowledged that they have not aggressively monitored consumer protection law compliance, and they have begun revising their approaches. They have started new programs to improve their approaches, including more comprehensive procedures, specialized training, and specialized examination staffs.

International operations

FRS and OCC are the primary examiners of international operations because few FDIC-examined banks are internationally involved. International examinations are similar to commercial examinations, in that loan quality, controls, and management are evaluated. However, these examinations are complicated because special risks are involved in foreign loans and foreign currency trading and because the operations are conducted in foreign countries.

FRS examines the international operations of State member banks and all Edge Act corporations 1/, even when the parent bank is a national or nonmember bank. OCC examines the international operations of national banks.

FRS and OCC conduct international examinations at the parent bank's home office, the Edge Act corporation's home office, and the foreign branch or subsidiary. The examiners usually assessed the quality of foreign loans by using information at the home offices.

1/An Edge Act corporation is a domestic business chartered by the FRS solely for the purpose of conducting banking in foreign countries.

Our review of examination reports for 18 national banks and 12 State member banks with substantial international operations revealed 2 cases where State member banks were experiencing problems, some of which were related to subsidiaries of the bank's Edge Act corporations.

Before the problems were noticed in the banks, FRS examiners had stated that the credit information on the foreign activities available at the home office was inadequate. The subsidiaries were not examined onsite until after the banks had begun experiencing problems. Early onsite examinations of the subsidiaries might have disclosed their problems before parent banks were injured.

Foreign loans are more complicated to evaluate than domestic loans, because they are often to foreign governments and in different currencies. A special risk (called country risk) is taken with loans made in different currencies, because the borrower may not be able to obtain the currency borrowed which is needed to repay the loan.

FRS and OCC took different approaches to evaluating loans subject to country risk. OCC and one FRB used a committee approach to evaluating country risk; the other FRBs relied upon individual examiners to evaluate this risk. This difference has caused some banks' loans to a country or a foreign business to be classified differently than other banks' loans to the same country or business.

The method used by most Federal Reserve banks requires individual examiners to keep abreast of economic conditions in many countries and to judge loans in many countries. A team of experts who evaluate economic conditions in each country would produce more accurate and consistent results than numerous individuals evaluating loans case by case.

Recommendations

We recommend that:

--FDIC and FRS establish procedures to base the scope of each examination on the examiner's evaluation of the quality of the bank's controls, policies, procedures, and audit. (See FDIC comments in app. III, p. III-19 and FRS comments in app. II, p. II-12.)

--FDIC and FRS develop standards for preparing, maintaining, and using examination workpapers. (See FDIC comments in app. III, p. III-20 and FRS comments in app. II, pp. II-13.

--OCC invite FDIC and FRS to jointly evaluate its new examination approach and, in the event of a favorable assessment of the new process, FDIC and FRS revise their examination processes to incorporate the concepts of OCC's approach. (See FDIC comments in app. III, p. III-39, FRS comments in app. II, p. II-21, and OCC comments in app. I, p. I-8.)

--FDIC and FRS adopt flexible policies for examination frequency, which would allow them to concentrate their efforts on banks with known serious problems. (See FDIC comments in app. III, p. III-16, FRS comments in app. II, p. II-11, and OCC comments in app. I, p. I-6.)

--The Congress amend the National Bank Act to allow OCC to examine national banks at its discretion. We would be glad to assist the committees in drafting appropriate legislation. (See OCC comments in app. I, p. I-6.)

--FDIC, FRS, and OCC establish examination scheduling policies and procedures to avoid setting patterns. (See FDIC comments in app. III, p. III-15, FRS comments in app. II, p. II-11, and OCC comments in app. I, p. I-6.)

--FDIC and FRS develop minimum standards for examiner training and examination procedures and use reports of State examinations meeting those standards. (See FDIC comments in app. III, p. III-18 and FRS comments in app. II, p. II-12.)

--FRS and OCC, using all available information, develop and use a single approach to classify loans subject to country risk. (See FRS comments in app. II, p. II-13 and OCC comments in app. I, p. I-7.)

--FRS and OCC implement procedures to examine major foreign branches and subsidiaries, including subsidiaries of Edge Act corporations, periodically and whenever adequate information about their activities

is unavailable at the home office. (See FRS comments in app. II, p. II-14 and OCC comments in app. I, p. I-7.)

--FRS and OCC utilize each others examiners to cut expenses when conducting examinations in foreign countries. (See FRS comments in app. II, p. II-15 and OCC comments in app. I, p. I-7.)

ONCE PROBLEMS ARE IDENTIFIED, ARE THEY COMMUNICATED EFFECTIVELY TO BANKS?

The agencies prepared reports of examination which were sent to the examined banks' boards of directors. Each agency organizes its report differently, but they all contain the same basic information.

Examiners described the problems identified during the examination in a summary which was given to the bank.

Detailed schedules, analyses, and listings contained in the "body" of the report were also given to the bank. This section

--supported the examiners' criticisms and conclusions.

--documented some of their work and

--communicated some of the bank's financial data to agency officials.

Examination reports also had "confidential" sections which were not usually given to the banks. Here the examiner expressed his or her opinions regarding the bank's management quality and financial condition. This section allows examiners to comment freely to agency management about a specific bank.

Communicating with banks' directors

The success of the supervisory process depends heavily on how results are disclosed to those responsible for correcting problems--the bank's board of directors.

Although specific duties, responsibilities, and liabilities vary from State to State, generally bank directors are required to be fully aware of the bank's policies, operations, and condition. They are supposed to apply ordinary care and prudence in administering the bank's affairs, and they may be liable for any resulting losses if they do not. Thus, the results of an examination should be important to the board of directors, and the supervisory agencies should be doing their utmost to communicate the examination results to the directors.

The agencies did not require their examiners or regional officials to meet with the banks' boards of directors after all examinations. As shown by the

following chart, the agencies rarely met with the boards of directors of banks in our general sample and very often did not meet with those of banks with major problems.

Agency	Percent of banks in which agencies met with directors	
	Banks in general	Problem banks
FDIC	1	30
FRS	9	53
OCC	6	54

We believe that the agencies should discuss the results of their examinations with the boards of directors or their audit or examining committees after each examination irrespective of the nature of their findings to

--emphasize the importance of examinations,

--insure that the directors, who are ultimately responsible for the bank's operations, are fully aware of the examination results,

--discuss findings,

--establish closer working relationships with the boards, and

--enhance the stature of the examiners.

FDIC and FRS have a general policy of meeting with boards of directors of all problem banks. Officials of one FRB, however, had a policy of meeting with the board of directors of each examined bank and believed that this practice reduced the incidence of serious problems. In January 1976, the OCC implemented a policy of meeting with the boards of directors of all national banks each year.

Communicating needed actions

The examiners generally did not recommend how the banks could correct the problems. For 63 percent of the problems noted in our problem sample banks, the examiners did not recommend corrective actions. In some instances, the required corrective action would have been obvious to the bank.

Although the body section was given to the bank, it contained information, such as the balance sheet and income and expense data, which the bank had furnished to the examiners.

The confidential sections of problem bank reports we reviewed contained criticisms which were not noted elsewhere in the reports. The examiners criticized bank management here more than in the comments section, as shown by the following table.

Problem or criticism	Percent of reports in which problems were noted in: Confidential section			Examiner comment section		
	FDIC	FRS	OCC	FDIC	FRS	OCC
Inadequate or incompetent management	63	45	60	26	10	10
Inadequate capital	43	63	68	61	60	38
Insufficient liquidity	19	35	54	37	30	50
Earnings (excessive or improper)	11	25	26	17	18	8

We believe that the report of examination should present clearly and concisely the results of the examination, the agency's recommendations for corrective action, and information necessary to support the examiners' conclusions. It need not go to great length to provide information which the bank already has. If the agency needs additional information for review or statistical purposes, the report sent to headquarters should be accompanied by a detailed, structured set of workpapers and standard data collection forms. Thus, the bank would not be burdened by a report containing superfluous information and the agencies would be better able to review the examiners' work.

The examination report on electronic data processing (EDP), like the commercial examination report, should state only the deficiencies noted by the examiner and any necessary supporting information.

OCC is now changing its examination report to communicate information more effectively both to OCC management and to the banks.

Recommendations

We recommend that FDIC and FRS:

--Require examiners to meet with the bank's board of directors or audit or examining committee after each examination. (See FDIC comments in app. III, p. III-27 and FRS comments in app. II, p. II-19.)

--Develop and use reports of examination which provide the banks with the results of the examination and any necessary supporting information. (See FDIC comments in app. III, p. III-30 and FRS comments in app. II, p. II-20.)

--Develop reports of EDP examinations which present the problems found, corrective action needed and any necessary explanatory data in a clear and concise manner. (See FDIC comments in app. III, p. III-21 and FRS comments in app. II, p. II-16.)

HAVE THE AGENCIES BEEN EFFECTIVE IN GETTING BANKS TO TAKE CORRECTIVE ACTION?

Examiners find some type of problem in virtually all banks; however, some banks have more serious problems and require more supervisory attention than others. The agencies cannot correct the banks' problems themselves, but they can use many enforcement tools to get banks to correct their problems. These tools include both informal (persuasive) and formal (generally legal) enforcement actions.

Our analysis of enforcement actions taken by the supervisory agencies for almost 900 banks in our samples showed that informal actions were used most of the time and formal actions were seldom used.

Are informal actions effective?

Informal enforcement actions are nothing more than an agency's attempt to persuade bank managers to take corrective action. The supervisory agencies' success in getting bank problems corrected depends heavily on cooperation from bank officials in changing the practices and policies which caused the problems.

To assess the supervisory agencies' effectiveness in getting banks to solve their problems, we analyzed the examination reports on the agencies' problem banks for the 5-year period ending December 31, 1975.

OCC's criteria for identifying problem banks varied during the period, and it could not fully identify for us which banks had been considered problem banks. Its rating system included an overall composite rating of the bank ranging from "1" to "4" --"1" being the best. Officials said that until December 1974, problem banks were mostly those with composite ratings of "3" or "4." We considered those national banks with composite ratings of "3" or "4" as OCC problem banks.

During that period, 718 State nonmember banks, 128 State member banks, and 686 national banks had at some time been in the agencies' problem bank category. Of those banks, 414 (58 percent) of the State nonmember banks, 38 (30 percent) of the State member banks, and 392 (57 percent) of the national banks were removed from problem status by December 31, 1975. Although most returned to nonproblem status within 2 years, 19 percent were problem banks from 2 to 5 years and 5 percent were problem banks for over 5 years.

We reviewed a sample of 149 banks which were on the supervisory agencies' problem lists at December 31, 1970. As of December 31, 1975, the status of the 149 banks was as follows:

	FDIC		FRS		OCC	
	Number	Percent	Number	Percent	Number	Percent
Removed from problem bank list (105)	44	80	15	38	46	84
Converted to a national or State charter (5)	-	-	1	3	4	7
Withdrawn from FRS membership (7)	-	-	7	18		-
Merged with another bank (7)	-	-	6	15	1	2
Failed (4)	2	4	1	3	1	2
Remained on problem list (21)	9	16	9	23	3	5
Total	55	100	39	100	55	100

OCC and FDIC had the most success using informal action, returning 84 and 80 percent respectively of their problem banks to nonproblem status, while FRS was successful with only 38 percent of its problem banks.

For the 105 banks which had been taken off the problem lists we determined the length of time spent in problem status:

	FDIC		FRS		OCC	
Years	Number	Percent	Number	Percent	Number	Percent
Under 1	6	14	1	7	12	26
1 to 2	13	30	1	7	18	39
2 to 3	9	20	2	13	5	11
3 to 4	7	16	4	26	2	4
4 to 5	4	9	1	7	3	7
5 to 10	5	11	6	40	6	13
Total	44	100	15	100	46	100

OCC got problems resolved most promptly. About 65 percent of its banks which returned to nonproblem status did so within 2 years. Only 44 percent of the FDIC banks and 14 percent of the FRS banks which returned to nonproblem status did so within 2 years.

We are concerned by banks which are on problem lists for long periods of time. We believe that the supervisory agencies should have used formal enforcement actions more frequently when dealing with these banks.

How often have the supervisory agencies used their formal enforcement powers?

Formal enforcement actions are threatened or initiated by the supervisory agencies as a last resort for getting problems corrected. Some formal enforcement actions do not help correct problems but result in closing the bank to protect depositors.

Written agreements

The supervisory agencies use formal writtem agreements, sometimes referred to as voluntary agreements or letter agreements, to confirm a bank's plans to correct problems. The agency and the bank both sign the agreement. A violated agreement can be the basis for issuing a cease and desist order against the bank.

The agencies use of written agreements for the period 1971 through 1976, was as follows:

Year	FDIC	FRS (note a)	OCC	Total
1971	1	1	3	5
1972	1	-	4	5
1973	1	3	6	10
1974	-	2	17	19
1975	-	2	18	20
1976	-	1	23	24
Total	3	9	71	83

a/Does not include 12 agreements against bank holding companies.

Cease and desist orders

The supervisory agencies, under authority of the Financial Institutions Supervisory Act of 1966, can issue cease and desist orders against banks to get problems corrected. First, a notice of charges is served upon a bank

--which has engaged or is engaging in unsafe or unsound practices,

--which has violated or is violating a law, a rule, a regulation or a written agreement with the agencies, or any condition imposed in writing by the agencies in connection with the granting of any application or other request, or

--which is about to do either.

The notice of charges presents a statement of facts constituting the alleged violations or unsound practices and establishes a time and a place for a hearing to determine whether a cease and desist order should be issued.

If the bank representatives do not appear at the hearing or if the hearing confirms the violation or the unsafe or unsound practices, the agencies may issue the cease and desist order.

A bank can consent to the cease and desist order, obviating a hearing. The order remains in effect until stayed, modified, terminated, or set aside by the agency or a reviewing court.

The agencies use of cease and desist orders for the period 1971 through 1976, was as follows:

Year	FDIC	FRS (note a)	OCC	Total
1971	7	1	-	8
1972	10	3	2	15
1973	9	-	4	13
1974	4	-	2	6
1975	8	1	5	14
1976	29	4	7	40
Total	67	9	20	96

a/Does not include 12 orders against bank holding companies.

Removal of management

Also under the Financial Institutions Supervisory Act of 1966, FDIC and FRS may order the removal of a director or officer of a State bank which they supervise and OCC may recommend that FRS remove one from a national bank when

--the director or officer has violated a law, a rule, a regulation, or a final cease and desist order; has participated in any unsafe or unsound banking practice; or has committed or engaged in any act, omission, or practice which constitutes a breach of his fiduciary duty and

--as a result, the bank has suffered or will probably suffer substantial financial loss or other damage, or the interests of its depositors could be seriously prejudiced and

--the violation, practice, or breach involved personal dishonesty on the part of the director or officer.

The agency must first serve the director or officer with a written notice of its intention to remove him/her from office. The notice of intention states the grounds for removal and establishes a time and a place for a hearing. As with a cease and desist order, the agency can remove the director or officer if he fails to appear at the hearing or if the charges specified in the notice of intention are substantiated. The removal order, too, remains in effect until stayed, modified, terminated, or set aside by the agency or a reviewing court.

In addition, the agencies have the authority to suspend any bank director or officer indicted for a felony involving dishonesty or breach of trust. The statute provides that such a suspension can be enforced by written notice and remains in effect until the charges are disposed of or the suspension is terminated by the agency. On August 13, 1976, the district court of the District of Columbia held that this statute violates the due process clause of the Constitution. FDIC officials said they are working with the other agencies to prepare and issue regulations in an effort to comply with the due process requirements.

During 1971-76, the agencies took action to remove or suspend management as follows:

Year	FDIC	FRS	OCC	Total
1971	-	-	-	-
1972	3	1	3	7
1973	3	-	8	11
1974	4	-	3	7
1975	6	2	9	17
1976	3	1	3	7
Total	19	4	26	49

Note: Includes 15 FDIC, 2 FRS, and 25 OCC suspensions.

Financial assistance

FDIC has the authority to provide funds to insured banks in danger of closing which are essential for providing banking services to its community or to assist a merger, or sale of assets and assumption of liabilities of a failing or failed bank into or by another insured bank. In providing financial assistance, FDIC can require that bank managers correct their problems.

Such assistance may include

--making deposits in the troubled bank,

--purchasing assets of the failing or failed bank,

--granting a loan secured by the assets of the failing or failed bank, or

--guaranteeing another insured bank against loss in assuming the assets and liabilities of the troubled bank.

FRS has the authority to loan funds to member banks

--to enable them to adjust their asset positions because of developments such as a sudden withdrawal of deposits or seasonal requirements for credit which can not reasonably be supplied from the banks' own resources or

--to assist them in meeting unusual situations which may result from national, regional, or local difficulties.

Cancellation of deposit insurance

FDIC has the authority to terminate a bank's deposit insurance if:

--its officers or directors are engaging in unsafe or unsound banking practices,

--it is in an unsafe or unsound condition, or

--it has violated an applicable law, rule, regulation, or order; a condition imposed in writing; or a written agreement with FDIC.

When FDIC initiates proceedings to terminate insurance, it may give that bank a maximum of 120 days to correct its problems. If the bank corrects all or some of its problems within the time allowed, FDIC may drop the termination proceedings altogether or take other action, for example a cease and desist order. If the bank does not correct its problems, FDIC's Board of Directors can terminate its insurance.

During 1971-76, FDIC initiated termination proceedings as follows:

Year	Number of proceedings
1971	5
1972	5
1973	1
1974	3
1975	5
1976	8
Total	27

Only 1 of the 27 proceedings, in 1976, resulted in termination. Before 1971, FDIC terminated the insurance of 13 banks. Canceling a bank's deposit insurance does not solve its problems.

Cancellation of FRS membership

FRS has the authority to cancel a bank's membership in the Federal Reserve. As far as we could determine, FRS has used this authority only once as a corrective tool. As with terminating deposit insurance, this action does not solve a bank's problems.

Revocation of charter

OCC has the authority to revoke national bank charters and States have the authority to revoke State bank charters, although this too solves no problems. In the last 2 decades, as far as we could determine, OCC has not revoked a bank charter for not correcting its problems.

Once formal actions were taken did the banks correct their problems?

The supervisory agencies used cease and desist orders and/or suspension of managers 18 times against 17 banks in our problem sample. As of November 30, 1976, eight of these banks had been removed from the problem lists by the agencies. Although formal actions were taken against relatively few of the banks in our samples, it appears that, on the average, the sooner the action was taken the sooner the bank was removed from the problem list. We recognize, however, that some problems will take a long time to correct and formal actions will not always solve a bank's problems immediately.

Identifying banks for special supervisory attention

After an examination, the agencies evaluate the effect that the problems identified can have on the bank's soundness. If the problems are serious, the bank is designated for special supervisory attention. Such banks are sometimes referred to as problem banks.

Because the agencies use different criteria to identify problem banks, they often do not agree on which banks require special supervision. Of the 4,744 national banks operating on December 31, 1975, OCC considered 85 as requiring special supervision, FRS 267, and FDIC 52. Among the 1,046 State member banks, FRS identified 65 problem banks and FDIC identified 17. FDIC's rating of national and State member banks, however, is based on financial risk to the insurance fund. We believe there should be some consistency among the supervisory agencies in determining whether or not a bank is a problem bank.

Because the agencies' supervisory responsibilities for banks overlap, and because their interest should intensify as serious problems are identified, we believe they should work towards a common definition of banks requiring close supervisory attention.

Recommendations

We recommend that FDIC, FRS and OCC

--establish more aggressive policies for using formal actions including written guidelines to identify the types and magnitude of problems that formal actions could appropriately correct, (see FDIC comments in app. III, p. III-48, FRS comments in app. II, p. II-23, and OCC comments in app. I, p. I-10 and 11.) and

--develop uniform criteria for identifying problem banks. (See FDIC comments in app. III, p. III-50, FRS comments in app. II, p. II-25, and OCC comments in app. I, p. I-11.)

WHAT OBSERVATIONS DID GAO HAVE ON FRS SURVEILLANCE OF BANK HOLDING COMPANIES?

Bank holding companies are those which own or control one or more banks. They are a major element in the American banking system, owning or controlling one-fourth of all commercial banks in America which control two-thirds of all assets and deposits.

A holding company may be a source of financial and managerial strength to its affiliated bank or banks, or it may be a source of weakness. In 1956 the Congress passed the Bank Holding Company Act to control the concentration of financial resources, and preserve effective competition. FRS was assigned responsibility for supervising and regulating bank holding companies. 1/

The agencies' examiners were expected to review banks' relationships with their affiliates, including bank holding companies and to criticize any relationship which could cause or was causing problems for the bank.

Examiners said that 72 of the 344 banks in our samples which were affiliated with holding companies had problems resulting from that affiliation. According to the examination reports for 50 of these banks, holding company management was not the primary cause of the problems. However, for the remaining 22 banks, 20 holding companies' actions were causing the problems. According to the examination reports for these 22 banks, problems were caused by inept and ineffective holding company management--particularly overexpansion, unsound operations of nonbank subsidiaries, and real estate loans which were unpaid.

Bank holding companies are supervised by FRBs, with the Division of Banking Supervision and Regulation providing general policy guidance and oversight from FRS headquarters.

In 1972, FRS developed a surveillance system to identify and monitor actual and potential problems by gathering and analyzing information. The system includes

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1/As agreed with the Board of Governors of the FRS, we confined our evaluation of holding companies to FRS actions with regard to holding companies affiliated with banks in our samples.

--reviews of examination reports on holding-company-affiliated banks, whether national, State member, or State nonmember,

--reviews of holding companies' registration statements, annual reports, applications, and other financial information, and

--visits to holding companies to review records and operations.

The aim is to insure that bank holding companies are operated in a manner that does not jeopardize subsidiary banks.

FRS inspection guidelines state that the frequency and scope of holding company inspections should depend not only on the holding company's size and complexity but also on information gained from other sources, such as registration statements, annual reports, and particularly examination reports on the company's subsidiary banks.

According to responsible FRB officials, of the 12 Reserve banks:

--9 have no written guidelines detailing the scope of inspections.

--5 do not evaluate nonbank subsidiaries' assets and 3 perform limited evaluations.

--4 do not meet with holding company board of directors to discuss findings.

--2 do not submit inspection reports to either holding company managers or directors.

--7 restrict supervisory activities, including inspections, due to budgetary restraints which preclude hiring additional personnel.

FRS did not detect weaknesses in 15 of the 20 holding companies until after they had damaged subsidary banks. Problems in the 20 holding companies were first identified by

--examinations of subsidiary banks of 15 companies,

--the review of financial data of 1 company,

--2 simultaneous bank examinations and holding company inspections, and

--inspection of 2 holding companies.

Nine of the 20 holding companies had not been inspected before problems appeared in their banking subsidiaries. Seven holding companies had been inspected before problems were found in the banks, but these inspections did not discover the potential for problems. Four of the seven had last been inspected 1 to 2 years before the problems were identified in the banks. In one case the inspection was confined to a review of the holding company's financial data. The remaining two inspections occurred less than 3 months before the bank examinations that identified the problems.

The Division of Banking Supervision and Regulation received data from the FRBs on specific holding companies, and Division personnel were in frequent contact with FRB employees. However, Division employees did not completely monitor FRB supervisory activities. For instance, they had no system, such as status reports, to keep track of the number of holding companies inspected and to insure that all holding companies with closely monitored subsidiary banks or leveraging nonbanking subsidiaries had been inspected.

The agencies exchanged information on holding company matters at both headquarters and regional levels. FDIC and OCC provided the FRBs with copies of their examination reports on banks affiliated with holding companies. The FRBs gave their holding company inspection reports to FDIC and OCC.

The agencies did not normally conduct simultaneous holding company inspections and bank examinations, even when the main subsidiary of the holding company was a national or State nonmember bank.

Recommendations

We recommend that FRS implement a system of supervision based on onsite inspections of holding companies and their major nonbanking subsidiaries. We also recommend that the Board of Governors strengthen its oversight of Reserve banks' holding company supervision by establishing

--a systemwide manual of inspection procedures,

--a standard inspection report, and

--periodic onsite evaluations of Reserve bank supervisory activities. (FRS comments in app. II, p. II-17.)

WHAT DID GAO FIND REGARDING EXAMINERS' COMPETENCE AND OBJECTIVITY?

Bankers' opinions

In responding to our questionnaire (see p. 53), commercial bank officials generally reported favorably on the competency of examiners. Senior examiners' understanding of the specialized examination areas of trust and international was rated adequate or more than adequate by 89 percent of the bankers while 11 percent thought it was borderline or less. Toward examinations of electric data processing, however, bankers were less favorable. Here, approximately 25 percent thought senior examiners' understanding was borderline or inadequate. Opinions concerning each of the three agencies were similar.

Personnel policies

The agencies are not legally subject to Civil Service Commission (CSC) rules and regulations governing Federal personnel practices; however, FDIC follows them in recruiting, compensating, and promoting examiners. OCC uses CSC's General Schedule in paying its examiners. For the most part, Federal Reserve district banks set their own personnel policies.

Although the agencies' personnel policies are similar in many respects, there are important differences. FDIC and OCC are more centralized than FRS; therefore, they have more uniform policies and practices. Each Federal Reserve district bank has primary responsibility for recruiting, training, evaluating, and paying examiners, and as might be expected, policies and practices vary considerably.

Source of examiners

Most of the examiners hired by the three agencies have undergraduate degrees in business-related subjects, and some have worked in banks or as bank examiners. During 1971-75, FDIC, FRS, and OCC hired 912, 594, and 1,147 examiners, respectively, from the following sources:

	FDIC	FRS	OCC
	------(percent)------		
College	81	58	71
Commercial Banks	2	12	12
Other	17	30	17

Examiner training

The agencies operate internal schools which instruct examiners in various aspects of bank examination, such as commercial banking, trusts, international banking, and electronic data processing. Since these schools cover generally the same topics, the agencies could (1) realize economies by consolidating their schools and (2) assure high quality instruction by exchanging information and standardizing curriculums.

Bank examiners we questioned generally rated the internal courses as useful or very useful; however, many thought they needed additional training, particularly in law, EDP, and accounting.

In the specialized areas of EDP and international banking operations, FRS has not provided much training in recent years. Its EDP school was not held in 1975 or 1976 though plans have been formulated for a school in 1977. Its international school was held once in 1972, 1974 and 1976. FDIC offers three EDP schools which are available to examiners at various stages of their careers. It does not have an international school; officials said that the banks supervised by FDIC tend to be small and are therefore unlikely to be engaged in international banking. FDIC uses OCC's schools or instructors to provide international training when its examiners need it. OCC annually operates one EDP and three international schools for its examiners.

FDIC's training program seems to be providing its examiners with most of the skills needed to assure high-quality supervision of banks. OCC has recognized problems with its program and has acted to improve it. Although the Federal Reserve Board has improved its program as a result of a recent FRS study, we do not believe that training can receive enough attention as a part-time responsibility of the Board's Division of Banking Supervision and Regulation.

Additional training in subjects such as EDP, law, and accounting would be useful for examiners in the three agencies.

Evaluation and testing of examiners

All three agencies periodically evaluate the job performance of their bank examiners. FDIC and OCC require employees to complete a formal evaluation process before

they can take charge of bank examinations. The process emphasizes the skills needed to analyze a bank's management, assets, and soundness. FRS does not have such a process.

We believe that formally evaluating examiners is a sound practice for assuring that they have received the necessary training and experience to make appropriate decisions and judgments in examining banks.

Safeguards against conflict of interest

All three agencies have policies to guard against actual or potential conflicts of interest among their examiners. The policies generally prohibit examiners from owning stock in banks or bank holding companies, from having loans or credit cards with banks that they may be asked to examine, and from examining banks where their relatives work.

Each agency requires examiners to file statements of financial and personal interests when they are hired, but only FRS requires annual updates. We have been requested by the Chairman, Subcommittee on Commerce, Consumer, and Monetary Affairs of the House Committee on Government Operations to examine, in a separate study, the financial disclosure practices of the three agencies.

Examiner turnover

During 1973-75, the turnover rate of examiners in each of the agencies was approximately 10 percent. Most examiners who leave the three agencies do so either to take jobs with commercial banks, other private firms or organizations, or other government agencies or to continue their education.

Examiners who left for commercial banks accounted for 29, 37, and 41 percent of total departures at FDIC, FRS, and OCC respectively. We checked at the agencies to determine how many full examiners--i.e., those who can be in charge of examinations--were hired by banks which they had examined shortly before resigning.

At FDIC during 1974 and 1975, 19 full examiners went to work for banks which they had examined during the year preceding resignation. Eight had functioned as examiner-in-charge. At two Federal Reserve district banks that we checked, no full examiners left during these 2 years to join banks which they had examined. During 1974 and 1975,

24 full OCC examiners were hired by banks which they had examined in the 3 years preceding their resignation. Nine of these had been in charge of the examinations.

Since few examiners left to work for banks they examined, we see no threat to their objectivity as long as the agencies continue rotating examiners-in-charge among banks examined and reviewing examination reports at regional offices and district banks.

Recommendations

We recommend that

--FDIC, FRS, and OCC, increase their training in EDP, law, and accounting, as desired by their examiners, and, where feasible, combine their examiner schools and standardize their curriculums. (See FDIC comments in app. III, pp. III-55 and 56, FRS comments in app. II, p. II-26 and 27, and OCC comments in app. I, p. I-12.)

--FRS, (1) establish a full-time training office to operate its examiner training program and (2) carry out the revision of examiner school curriculums which it has recognized as needed for some time. (See FRS comments in app. II, p. II-27.)

--FRS establish a formal evaluation process to measure the competence of persons seeking examiner status. (See FRS comments in app. II, p. II-28.)

WHAT PROGRESS HAVE THE AGENCIES MADE IN THE PAST YEAR IN IMPROVING THEIR EXAMINATION AND SUPERVISION OF BANKS?

Major improvements in several areas of bank supervision were going on during 1976.

Organizational changes

OCC altered its organizational structure to implement the recommendations of a 1975 Haskins & Sells study of its operations. The changes resulted in a more functionally oriented organizational structure, clearer lines of authority and responsibility, and more effective lines of communication. An Operations Review Office was also created to review bank examinations and reports for compliance with established policies and procedures.

FRS combined its bank supervision and bank holding company groups to achieve better coordination.

Bank surveillance

All three agencies are developing, or have developed, systems for monitoring the performance of individual banks using data regularly reported to the agencies by the banks. OCC's National Bank Surveillance System (NBSS) maintains data on each bank for the last 5 years and compares the bank's performance with its peer group.

FDIC has developed a new system to monitor bank performance using ratios in certain critical areas relating to balance sheet and income-expense items. In addition, it has other operational systems and is experimenting with several other computer-based analytical techniques.

FRS has developed systems to monitor banks and bank holding companies. In addition, several Reserve banks have been developing their own monitoring systems.

Monitoring self-dealing and insider transactions

In late 1975, OCC issued regulations requiring national banks to adopt certain procedures when lending to directors, officers, employees, and their interests. Boards of directors must approve such loans and record them for examiners to review. In 1976, FDIC issued similar regulations which applied to insured State nonmember banks.

Reviewing compliance with consumer protection laws

FDIC adopted separate compliance reports and consumer credit reviews in September 1974. Currently, it is designating a consumer compliance examination specialist within each region. Compliance reports are prepared by examiners as part of each bank examination.

FRS is beginning to conduct separate reviews of compliance with consumer protection laws and regulations. Specialists will be trained to work concurrently with the commercial examiners.

OCC has recently begun scheduling separate compliance reviews of national banks. Examiners who have expressed an interest in specializing in such reviews are assigned to 6-month tours and given 2-week training courses.

New examination procedures

FDIC adopted a policy in December 1976 permitting examinations to be abbreviated under certain conditions. The policy also provides that banks having supervisory or financial problems be examined more frequently than non-problem banks.

Likewise, FRS adopted a policy permitting its examiners to reduce the scope of examination when a limited review of the bank reveals no sign of deterioration. In March 1976, the Reserve Board authorized an asset-management examination for optional use by FRBs. This examination approach could be used for banks which have historically been well operated and untroubled. The approach focuses on evaluating assets and management.

The most significant changes in the examination process, however, are being made by the Comptroller of the Currency. OCC is implementing a new approach to its fact-finding phase of bank supervision. The scope and approach to their examinations have been revised to place more emphasis on bank policies, practices, procedures, controls, internal audit, and external audit. (See p. 11.)

Modification of examination reports

OCC's new examination approach and procedures involve major changes to the report of examination. The main part of the new report is the examiners' narrative evaluation of the bank and discussion of problems found. Any needed support is contained in an appendix. Although there will still be a confidential section for internal purposes only, its use will be restricted to matters requiring prompt attention of OCC senior staff.

The FRS report of its recently authorized asset-management examination would contain information relevant to those areas.

Effective January 1, 1977, FDIC began using an abbreviated examination which results in a shorter report. Certain schedules and analyses contained in the body of the present report have been eliminated.

Meeting with banks' boards of directors

OCC established a policy, in January 1976, of meeting with each national bank's board of directors annually, preferably at the completion of the bank examination. OCC meets with the directors whether or not the bank has serious problems.

FDIC does not believe meeting with a bank's board of directors is productive if the bank has no problems. Consequently, effective January 1, 1977, each FDIC regional director may decide after an examination whether a bank's problems are serious enough to warrant a meeting with its board.

Monitoring bank problem followup

As part of the new examination approach being implemented during 1976, OCC has developed a computerized system for monitoring bank problems to insure that they are resolved. Called the action control system, it now includes only those problems that NBSS identifies by analyzing regularly reported data, but headquarters officials said the system will be expanded to monitor actions taken to correct deficiencies disclosed in examination reports.

Use of formal enforcement powers

The supervisory agencies have not used their formal powers soon enough or often enough in dealing with problem banks. However, they have begun to use them more in the last year.

The agencies' new attitude was exemplified in a November 11, 1976, speech by FDIC Board Chairman Robert Barnett. He said that FDIC has reached the conclusion that formal methods must be used more. Accordingly, FDIC issued 29 cease and desist orders in 1976. Only seven orders were issued in 1975. OCC issued seven orders as compared with five in 1975 and FRS issued four orders as compared with one in 1975. In addition, OCC increased its use of written agreements in 1976, issuing 23 compared to 18 in 1975.

Experiments in relying on State examinations

During 1974-6, FDIC conducted experimental programs in Georgia, Iowa, and Washington to determine how much FDIC could rely on State agencies' examinations in lieu of their own. As a result of FDIC's evaluation of these programs, they will not be continued in their present form. Iowa and Washington do not wish to continue and Georgia favors a different approach. The Georgia plan calls for independent examination of all problem banks, banks requiring special supervisory attention, and banks with deposits over $100 million; all other banks will be examined by Georgia and FDIC in alternating years. FDIC will make this arrangement available to other States or will consider other plans suggested by them.

Since 1975, FRS has also been conducting an experimental program with the Indiana banking agency to reduce the duplication of examination effort between FRS and State examiners. Under this program a FRS examiner is present as an observer during State examinations. Afterward, he/she prepares a separate examination report for FRS use only. If the program is successful, FRS implies, it will be expanded to other States.

Training

FRS and OCC are improving their examiner training programs as a result of studies made in 1975.

In 1977, OCC will begin a uniform personnel development program of continuing education and career development. The continuing education segment will consist of at least 80 hours of technical training during each of the first several years of employment to assure that examiners acquire needed skills at appropriate stages of their careers. Later career development will include technical and managerial training.

FRS broadened the training available to its examiners by starting two schools in 1976 to cover specialized examinations of bank holding companies and compliance with various consumer protection laws. Officials said they will establish an EDP school and a seminar to update senior examiners on new developments in the banking industry.

HOW CLOSE IS THE WORKING RELATIONSHIP AMONG THE FEDERAL BANK REGULATORY AGENCIES?

The legislation establishing the three agencies created several overlaps in authority. The area with the greatest potential for duplication is bank examination. FDIC has statutory authority to examine all insured banks (including national banks and State-chartered FRS members); FRS has statutory authority to examine all member banks (including national banks and State-chartered member banks that are insured by FDIC); and OCC has statutory authority to examine all national banks.

The three agencies have other interrelated responsibilities:

--OCC is responsible for closing national banks which have become insolvent and FDIC is responsible for liquidating these banks.

--FRS has primary responsibility for inspecting bank holding companies, but FDIC may examine a nonmember insured State bank subsidiary and its parent holding company and OCC may examine a national bank subsidiary and its parent holding company.

--All banks are required, under the Securities Exchange Act of 1934, as amended (15 U.S.C. 78a _et seq._), to report to FRS on extensions of credit for the purchase of stock. If any bank fails to furnish such information, FRS may inspect such bank in order to obtain the information.

There are other reasons why a close working relationship is needed among the three agencies. During our study we noted that in some areas similar activities were being carried out differently by the three agencies. From an overall Federal viewpoint, this did not provide for efficient operation. Moreover, in some cases these differences resulted in treating different classes of banks unequally under similar conditions.

We recognize that each agency has been granted certain authority by the Congress and enjoys considerable independence of action. Nevertheless, the agencies must deal with certain common problems, and in our view, could deal with them better by working together.

We found some evidence of cooperation and coordination among the agencies:

--Since 1938 they have operated under a uniform agreement for classifying bank assets and certain securities during examinations.

--They have agreed not to examine the same banks. OCC examines national banks, the FRBs examine State banks which are members of the System, and the FDIC examines insured State banks which are not FRS members.

--An interagency coordinating committee was established in 1965 to resolve conflicting rules, regulations, and policies.

--The agencies exchange their examination reports. Each agency can request any report of another agency. In addition, as a matter of practice, FRS provides FDIC with all reports on banks composite-rated "3" or "4", and OCC provides FRS with all reports and FDIC with all reports on problem banks.

--They also exchange information on holding company matters both at the headquarters and regional levels. FDIC and OCC provide the FRBs with copies of their examination reports of subsidiary banks. The FRBs give their holding company inspection reports to FDIC and OCC.

We could not ascertain the full extent of coordination and cooperation among the three agencies because such efforts are mostly undocumented. For example, no minutes are taken at the coordinating committee meetings and few records are maintained of telephone conversations and informal discussions between the staffs of the three agencies.

The current framework for coordinating the activities of three regulatory agencies, i.e., the coordinating committee, is primarily a forum for exchanging information about possible conflicting rules, regulations, or policies which might exist among the agencies. It does not provide a mechanism for the three agencies to join forces to improve the bank supervisory process or to resolve common problems.

We identified several areas where, the agencies could have benefited by sharing experiences about innovations in bank supervision and undertaking activities jointly or on a reciprocal basis. These areas include

--developing and testing new examination approaches,

--developing procedures for enforcing consumer protection laws,

--developing bank monitoring systems,

--training bank examiners,

--developing a formal evaluation process for determining whether an examiner has the skill to be in charge of a bank examination,

--evaluating the soundness of loans to foreign governments and their agencies,

--examining foreign branches and subsidiaries of U.S. banks,

--processing bank data reported periodically,

--supervising bank holding companies,

--evaluating the soundness of large loans that are shared by two or more banks, and

--developing criteria for identifying problem banks.

Recommendations

We recommend that either (1) the FDIC, FRS, and OCC jointly establish a more effective mechanism to combine forces in taking significant initiatives to improve bank supervision or in solving common problems or, (2) the Congress enact legislation to establish a mechanism for more effective coordination. We would be glad to assist the committees in drafting appropriate legislation. (See FDIC comments in app. III, p. III-60, FRS comments in app. II, p. II-29, and OCC comments in app. I, p. I-13.)

We recommend also that FDIC, FRS, and OCC:

--Jointly staff a group to analyze shared national credits at State and national lead banks under Federal supervision and that the three agencies use the uniform classification of these loans when they examine the participating banks. (See FDIC comments in app. III, p. III-41, FRS comments in app. II, p. II-22, and OCC comments in app. I, p. I-9.)

--Work together to refine their monitoring systems and their approaches to examining for compliance with consumer credit laws. (See FDIC comments in app. III, p. III-41, FRS comments in app. II, p. II-22, and OCC comments in app. I, p. I-9.)

HOW DOES GAO FEEL ABOUT THE AGENCIES' NEED FOR ADDITIONAL POWERS?

The supervisory agencies have asked the Congress to legislate additional powers fo influencing banks to solve their problems. Their experience has been that current legal powers are not useful for addressing major causes of bank problems exemplified by recent failures.

For example, the agencies contend that to remove a bank official they now must prove he is dishonest. This is sometimes difficult to do; furthermore, bank problems can be caused by persons who are incompetent, but not dishonest. Therefore, the agencies have requested authority to remove bank officers for gross negligence.

They also maintain that cease and desist orders, although useful for some situations, are not always deterrent to bank mismanagement. Orders require a bank either to stop performing an act or to take affirmative action to correct the conditions resulting from any such violation or practice.

One basic contention is that individuals cause bank problems, but available legal powers are not aimed at deterring individuals. Therefore, they have requested authority to levy administrative fines against bank officials who violate certain laws and regulations.

We found that the agencies have not used their available powers as aggressively as they might have, especially cease and desist orders. (Last year the agencies increased the number of orders issued.) Evidence from our sample banks is inconclusive as to the effectiveness of the legal enforcement steps that have been taken. However, most bank failures in the last 5 years were caused by individual bank managers who followed self-serving loan practices or were incompetent as stated in examination reports and correspondence. Further, of the banks on the problem list as of December 31, 1975, 57 percent were cited by examiners for ineffective management.

Therefore, notwithstanding the agencies' underused their current powers, we believe additional powers could enhance their ability to deal with bank problems. We would support legislation empowering FDIC, FRS, and OCC to

- --remove bank officers for gross negligence and
- --levy fines against banks, or against bank officers or directors, for violations of certain laws and regulations.

We would also support legislation to allow OCC to present removal proceedings at adminsitrative hearings conducted by FRS. Under current statutes OCC provides information to FRS, which presents the case at hearings.

HAS THE COMPTROLLER OF THE CURRENCY CONSIDERED APPLICANTS FOR NATIONAL BANK CHARTERS ON A FAIR AND CONSISTENT BASIS?

From January 1, 1970, to April 30, 1976, OCC considered 865 applications for establishing new banks. The Comptroller approved 57 percent of the applications.

In evaluating a charter application, OCC primarily considers the proposed bank's capital structure, future earnings, and management, and the convenience and needs of persons in the area to be served.

The Comptroller had considerable latitude in deciding whether to approve or reject an application and, for the most part, gave no reason for ruling a particular way. According to our interpretations of written comments by each of the five staff reviewers, approval of applications appeared to have been mainly related to the "convenience and needs" factor, broadly interpreted to include need for competition, for new or better services, or for service to a special clientele. Rejections included in our sample seemed to be based largely on the lack of need for a new bank or on expectations of newly approved State banks opening in the community.

There was no practical way to determine whether OCC had been fair and consistent in approving or disapproving new banks because the agency lacked (1) definitive criteria for its staff to use in evaluating applications and (2) an adequately documented decisionmaking process.

The differing opinions of the staff reviewers suggests that more definitive criteria are needed to provide for uniformity in the application review process and insure that all factors are considered and resolved either favorably or unfavorably. Although definitive criteria that would apply to every application may be difficult to develop, we believe the matter warrants further study by OCC.

On November 1, 1976, the Comptroller took several actions to improve the processing of applications and to make charter decisions more consistent. Even with these changes, however, we believe that more definitive criteria and documentation are still needed.

Recommendations

Accordingly, we recommend that OCC (1) develop more definitive criteria for evaluating charter applications and (2) thoroughly document the decisionmaking process, including an identification by reviewers of each factor as either favorable or unfavorable. (See OCC comments in app. I, p. I-5.)

HAVE SOME BANKS CHANGED CHARTERING AUTHORITIES TO AVOID SUPERVISORY PRESSURE?

With the Comptroller of the Currency's approval, State-chartered banks are allowed to convert to national banks. By changing charters in this way, banks become subject to supervision by the Comptroller, instead of by a State authority and either by the Federal Deposit Insurance Corporation or by the Federal Reserve System.

Because such banks are already in operation and usually subject to Federal supervision, decisions on requests to change charters are not as important to the banking industry as initial charter decisions. From OCC's viewpoint, however, approval means entry into the national banking system; therefore, decisions to change charters are equally as important to it as initial charter decisions.

In November 1976, OCC began requiring an applicant to give reasons for wanting to convert to a national bank. It also established policy statements which say that it will ordinarily approve conversions that are consistent with maintaining a sound national banking system but that conversions should not be motivated by supervisory pressures from other bank regulators.

We reviewed the 71 State-to-national conversion applications OCC acted on from January 1972 through April 1976. Sixty-four were approved four were rejected, and three were withdrawn.

Before deciding on the conversion applications, OCC either examined the bank itself or reviewed earlier Federal or State bank examination reports. Most banks converting to national banks were judged by OCC or their previous supervisors as sound in every respect. Only one bank was receiving special supervisory attention when it converted.

Before OCC had policies governing conversion requests, several banks appear to have converted to national charters to avoid another agency's supervisory action. Supervision was usually consistent because OCC addressed the problems identified by the previous regulators.

Other banks converted to obtain more favorable consideration of requests for branches, mergers, or other structural changes. OCC approved many of these requests

after separately considering their merits.

State banks also converted for reasons unrelated to supervisory disagreements, such as to have the same type of charter as affiliated banks or to obtain the prestige and Federal Reserve-related banking powers of national banks.

OCC's recently established policies and its requirements that State banks explain their reasons for wanting a national charter should help it make better informed decisions about whether a bank should be allowed to change supervisors.

WHAT DO BANKERS THINK OF BANK SUPERVISION?

Historically banks in the United States have always been regulated by some level of government. At a minimum, establishing a bank has depended on a government "blessing" in the form of a charter. Inherent in the power to grant a charter are the power to revoke it and an interest in the soundness of the chartered entity. Protecting this interest has led, historically, to bank supervision. Charters, examinations, and followup actions are central aspects of the Federal Government's relationship to commercial banks.

Regarding this relationship, bankers surveyed 1/ endorsed government intervention in the banking industry. Almost 90 percent indicated that "elimination of bank regulation entirely" would be, to some degree, "detrimental." Other aspects of government intervention received similar endorsements. For example

--70 percent felt eliminating Federal chartering would be detrimental,

--72 percent felt eliminating State chartering would be detrimental, and

--88 percent felt eliminating bank examinations would be detrimental.

Approximately 80 percent of the bankers responding to our questionnaire opposed any bank regulatory arrangement which does not include the States. Bankers clearly favored the dual banking system over a solely Federal system. The present regulatory system was supported by 58 percent of the bankers surveyed. For those who responded to the three alternatives to the present system (three Federal agencies but no State involvement, one Federal agency with State involvement, and one Federal agency with no State involvement) the most favored (42 percent) was one Federal agency with State involvement.

1/ We mailed a questionnaire to 1,678 commercial banks, of which 1,501 or 89.5 percent responded. The sample included banks of varying sizes from each of the three agencies, including both problem and nonproblem classifications.

Officials at large banks considered the present structural arrangement best. Respondents from small banks appeared to be somewhat indifferent to the number of Federal supervisory agencies.

Almost half of the problem banks, as compared with 60 percent of the nonproblem banks, supported the present arrangement. Only 11 percent of problem banks supported the two alternatives which exclude State government participation, and only 48 percent supported the alternative consisting of one Federal agency together with State involvement. Problem banks were clear about what they opposed, but they were not clear about what they supported.

Our data revealed a seemingly contradictory pattern. While bankers from small banks tended to be more supportive of Federal bank examiners and the examination process than bankers from large banks, these same small bankers were less inclined to support the present structure of bank supervision. Bankers from small banks appear to strongly support what is being done, but they are somewhat ambivalent about who does it so long as the dual Federal-State involvement is preserved.

Bankers as a group have a generally favorable opinion of Federal bank examiners and of the bank examination process. Over 90 percent of our respondents rated the senior Federal examiners' competence as "adequate" or better. Also, 84 percent rated the senior Federal examiners' understanding of specialized areas as "adequate" or better. Finally, 67 percent rated the examination process as "effective" or better in achieving various objectives.

Respondents grouped by deposit size and problem classification also generally support the examination process. However, big banks and problem banks were less supportive than others.

Besides asking our respondents to indicate how effectively bank examinations achieve certain objectives, we also asked them to indicate, from a list of 15 possible bank examination objectives, the 5 they believed to be most important. For the respondents as a whole, the five objectives in order of importance were:

--Protection of the safety of depositors' funds.

--Evaluation of asset quality.

--Compliance with laws and regulations.

--Evaluation of management.

--Evaluation of internal control, including internal audit.

We also asked them to indicate from the same list the five objectives that they believed the Federal agencies considered as most important. The five Federal agency objectives in order of importance, as perceived by our respondents, were:

--Compliance with laws and regulations.

--Evaluation of asset quality.

--Evaluation of capital adequacy.

--Protection of the safety of depositors' funds.

--Evaluation of internal control, including internal audit.

The two lists are nearly identical, although the ranking order differs. Although bankers rank "evaluation of management" in the top five, they don't think the agencies do. This is somewhat surprising considering the importance that management evaluation receives in agency rating systems. Also, while the bankers did not place "evaluation of capital adequacy" among the top five objectives, they believe the agencies do.

Regardless of how the data was grouped, except for large banks, our respondents did not believe that the agencies rate "evaluation of management" among the top five. Large banks also rank "compliance with laws and regulations" somewhat lower than small banks.

Comptroller of the Currency
Administrator of National Banks

Washington, D.C. 20219

January 14, 1977

Honorable Elmer B. Staats
Comptroller General of the
United States
General Accounting Office
441 G Street, N. W.
Washington, D. C. 20548

Dear Mr. Staats:

Enclosed find original and one copy of our comments on the recommendations advanced in the draft General Accounting Office Report entitled "Study of Federal Supervision of our Nation's Banks".

I understand that in accordance with the usual procedures our comments will be included _in toto_ in the final report.

Sincerely,

Robert Bloom
Acting Comptroller of the Currency

Enclosures

Note: Page references have been changed to conform to the final report.

PREAMBLE

Bank Examination and the Office of the Comptroller of the Currency

The Office of the Comptroller of the Currency (OCC) commends the General Accounting Office (GAO) for the objective and workmanlike quality of GAO's report and for the positive attitude shown by the GAO staff which prepared the report.

The GAO report correctly states that one important goal of bank regulation is maintaining the soundness of the banking system; achievement of that goal requires minimizing the number of bank failures. We agree with that goal, and suggest that the banking agencies record over the last forty years has been a good one. For example, 1974 witnessed a severe economic recession and the two largest bank failures in the history of the United States -- yet no depositors in these banks lost money and confidence in the banking system was maintained. The average annual bank failure rate since 1937 has been 0.08 percent -- a remarkably low failure rate for any human endeavor.

But it is the other goal of supervision which is not stressed in the GAO report. The ultimate measure of how well a bank supervisory agency operates is how well the banking system operates. The OCC believes that one of its major functions is to preserve a competitive, responsive and innovative system. Bank supervision's role is to ensure that the banking system is able to provide the widest possible array of banking services to both the depositor and the borrower.

Thus, the bank supervisory agency has two contradictory goals: monitoring soundness and sponsoring the competitive, innovative response. It is this dual role which presents the basic paradox for the bank supervisory agency. An intensely competitive industry can never be completely safe.

Striking the balance between these two goals is the basic problem of the bank supervisory agency. According to a former Comptroller of the Currency:

> One regulatory approach is to identify a problem in one area and remedy across the board, taking no notice of the different characteristics, or idiosyncracies 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 failure. But, under that regime, the banking industry would be financing the capital needs of the country and its citizens at about 60% 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 risks that some unit will slip through the supervisory net and founder.

A well known critic of bank supervision, economist George J. Benston, has addressed the question of the costs of bank regulation -- both the direct cost of running the agencies and the indirect costs of limiting competition by the banking industry -- and has suggested that the best solution is improved supervisory techniques. Specifically he recommended:

1. A primary responsibility of the supervisory agencies is to determine the most effective method of examining banks.

2. Supervisory agencies should be able to use bank reporting as a guide to self-examination by the banks and as a preliminary examination tool.

3. Models should be developed that predict possible problems.

4. Banks that are likely to get into trouble should be examined more frequently and in greater depth.

That list, although not complete, is similar to the revisions of examination procedures proposed by the consulting firm of Haskins & Sells and implemented by the Office of the Comptroller of the Currency. Examination of the larger banks has moved from a detailed examination of the bank's assets to an in-depth evaluation of the bank's management, auditing, and control systems. Instead of concentrating on the bank's loan customers, the OCC has moved to an evaluation of the bank itself. During 1976, the OCC began to use bank financial reports as a preliminary examination tool, identifying potential difficulties at individual banks.

GAO reviewed these and other new procedures being adopted by the OCC, and concluded:

> As discussed in Chapter 4, we believe that the traditional examinations of the three agencies have concentrated too much on the review of loans and not enough on bank policies, procedures, practices, controls, and audit. The changes made by FDIC and FRS will not substantially remedy this defect. In our view the new procedures being implemented by the OCC offer the best opportunity for improvement. The OCC's revised commercial examination procedures should provide the agency with more meaningful information regarding the banks it supervises and result in more complete and consistent examinations. More importantly, the new approach should result in early detection of situations which could lead to deterioration in some aspect of banking operations. This approach could help avoid bank problems after they have occurred.

Thus the OCC is not attempting to improve bank supervision through arbitrary regulations which might limit bank services to the public. Instead the OCC is attempting to foster procedures in each bank through which that bank can better manage itself.

The GAO report -- while endorsing the new OCC procedures -- makes the implied criticism of the OCC for not developing its new programs in conjunction with the two other agencies. As pointed out in the OCC responses to the GAO recommendations, the OCC has attempted to share its new ideas with the other two agencies. The

OCC also endorses the GAO recommendation of more formalized communication among the agencies concerning new examination techniques. The OCC takes issue, however, with the apparent GAO assumption that the best way to generate new ideas is through an interagency committee (or, as some have proposed, through a giant monolith combining the three agencies). A primary virtue of three agencies, each with somewhat differing statutory responsibilities, is the ability of a single agency to experiment with a new idea or procedure. It is doubtful that the new OCC examining techniques endorsed by GAO could have been developed otherwise. A unified approach is important and appropriate after a new idea has been proved successful, not when it is being first developed.

In summary, the purpose of the OCC is to operate so that economic progress and change is not inhibited while simultaneously, preventing unsound banking practices. It is that fine line of promoting innovative response while supervising the banking system that makes bank supervision so difficult. The banking system has just come through its first major economic crisis since the world wide depression of the 1930s. There were some casualties. But, in fact, the threatened financial crisis did not develop, and the banking system seems to be stronger today than it was before. New procedures have been developed by the banking system and the continuing dynamic future of American banking is assured. For the first time we are assured that, just as the industry has changed, the tactics and techniques of a major bank supervisor, the Office of the Comptroller of the Currency, has changed in a similar, positive, fashion.

Recommendation (2-21)

Accordingly, we recommend that the Comptroller of the Currency (1) develop more definitive criteria for evaluating charter applications and (2) thoroughly document the decision-making process, including an identification by reviewers of each factor as favorable or unfavorable.

OCC Response:

The OCC is the only federal agency with the responsibility for chartering banks. It charters banks in all of the 50 states and in Puerto Rico and the Virgin Islands. The widely differing banking environments found in the U.S. make it almost impossible to develop definitive criteria which can be universally applied such as in states like Arizona, which has 6 National Banks, and in Illinois which has over 400 National Banks. The diversity of criteria therefore, is a function primarily of the differing political, social and economic environments in which the OCC must operate. The OCC's chartering criteria, of necessity, must be somewhat flexible. That is only to be expected since the OCC does not charter in one environment. Also, under the terms of the McFadden Act, the OCC's actions are often affected by applicable state law.

The new corporate guidelines, development of which began in September, 1975, and which became effective on November 1, 1976 answer many of the criticisms of the GAO. Written opinions containing reasons are now sent to applicants receiving denials. As examples, we quote from three recent letters sent to applicants denying their charters. One letter in part, states:

> Based upon the population and the median income per household, it would appear difficult for many individuals in the primary service area to qualify for a loan. Furthermore, income levels are inadequate to provide a sufficient deposit base for the proposed bank to become a viable institution.

> In another case, we quote in part: In view of the Supreme Court decision in Whitney and the Federal Reserve Board's decision in InterMountain Bank Shares, it would be an exercise in administrative futility for this Office to approve the present charter application...Should West Virginia change its statutes or should the statute be successfully challenged, then this Office could consider a new application in light of these changed circumstances.

> In still another case, the denial letter to the applicants stated: The new guidelines state that a new banking office will not be approved, if its establishment would threaten the viability of a newly chartered independent bank. Such protection will typically not exceed one year. As you are aware, the new bank opened on September 27, 1976. It is the opinion of this Office that this newly chartered independent state bank is entitled to the protection set forth in the Comptroller's policy statement.

Recommendation (2-21) Continued

Every attempt is now made to document thoroughly the decision-making process. Further efforts will be made by our Office to idenfity each factor as favorable or unfavorable.

Our decisions have been subject to judicial review for many years. In the long series of court cases covering our chartering process, the Comptroller's decision on a charter application has never been finally overturned by a reviewing court. See annotations to 12 U.S.C. 21 et seq.

Our Department of Research & Economic Analysis has undertaken a market study of 35 mational banks chartered between 1969 and 1971. The economic study attempts to identify, statistically, those factors which can be identified with the growth or lack of growth of these new banks. The results of that study, if positive, will be incorporated into our decision-making process. We are hopeful that quantification of a sufficient number of pertinent factors applicable to a majority of cases will result.

Recommendation (4-7)

Therefore, we recommend that the Board of Directors, FDIC, the Board of Governors, FRS, and the Comptroller of the Currency establish scheduling policies and procedures which would avoid the setting of examination patterns.

OCC Response:

Historically, the OCC has viewed surprise as an important element of an examination. However, a primary feature of our new examination approach entails the pre-examination analysis wherein the examiner will determine the adequacy of internal control and audit activity. The OCC feels the best deterrent for fraud is not periodic unannounced visits by examiners but rather the existence of sound bank policies, procedures, internal control and audit activity on a continuing basis. The element of surprise is necessary only in those cases where such factors are suspect.

Recommendation (4-9)

We recommend that the Board of Directors, FDIC, and the Board of Governors, FRS, adopt flexible policies for examination frequency which would allow them to concentrate their efforts on banks with significant problems.

We recommend that the Congress amend the National Bank Act to allow the Comptroller of the Currency to examine National Banks at his/her discretion.

OCC Response:

We support the recommendation of legislation to permit OCC discretion in scheduling the frequency of examinations. The current method of adapting the depth of examinations to the needs of each bank, based on NBSS data and pre-examination analysis, fully complies with law. However, greater statutory discretion would enhance our effectiveness in this regard.

Recommendation (4-33)

We recommend that the Board of Governors, FRS, and the Comptroller of the Currency develop and use a single approach to the classification of loans subject to country risk.

OCC Response:

The OCC has a well established procedure using a single approach to the classification of country credits. This procedure makes use of information from many governmental and non-governmental sources and examiners in all fourteen national bank regions.

Copies of the minutes of our committee meetings and any resulting classifications have always been provided to members of the staff of the Board of Governors.

The process of country risk evaluation is more precisely an art than a science. Most of the evaluation process is judgemental. However, the interagency meetings held to date have been beneficial in determining basic differences in philosophies.

Recommendations (4-35)

We recommend that the Board of Governors, FRS, and the Comptroller of the Currency implement procedures whereby major foreign branches and subsidiaries, including subsidiaries of Edge Act corporations, are examined periodically and whenever adequate information about their activities is not available at the home office.

Also, we recommend that the Board of Governors, FRS, and the Comptroller of the Currency exchange each other's examiners' to cut expenses when conducting examinations in foreign countries.

OCC Response:

a) Overseas Examination

National Banks are required by Regulations K & M to provide examiners with whatever credit and financial information the examiner deems necessary to evaluate the condition of the bank's foreign branches and subsidiaries. Those regulations require such information be transmitted to and maintained at the bank's head office. The OCC has for practical purposes defined "head office" to include any foreign or domestic office of the bank which is readily accessible to its examiners. For example, all international credits of one large national bank are examined from two domestic offices and four foreign offices located in London, Caracas, Tokyo and Manila. All of that bank's many branches and subsidiaries located in Europe the Middle East and Africa are examined from duplicate records in London.

Recommendations (4-30) Continued

Supplemental examinations to determine the quality of the bank's operations are made on-site overseas when necessary. For purposes of performing asset and operational examinations, the OCC established in 1972 a London office permanently staffed by six examiners. In fulfilling its overseas examination obligations, the OCC in 1976 examined 141 overseas branches and subsidiaries of 25 banks located in 37 countries; 154 on-site examinations were performed by 215 National Bank Examiners.

b) Joint Examinations

The GAO recommendation has merit. As a bare minimum the physical support of the three agencies could be jointly provided. Further arrangements could be made so that any of the agencies could jointly commission overseas examiners. In this regard, the OCC is willing to seek a cooperative solution with our sister agencies.

Under present statutes, however, such a sharing of examiner forces may be difficult. Section 481 of Title 12 (12 U.S.C. 481) directs the Comptroller of the Currency to appoint examiners who shall examine every national bank. That same section empowers the Comptroller to make a thorough examination of all the affairs of the banks under his jurisdiction including the affairs of all affiliates of National banks "other than member banks", in order to disclose fully the relations between the bank and its affiliates and the "effect of such relations upon the affairs of such bank". (Emphasis added.)

Recommendation (7-25)

We recommend that the Comptroller of the Currency invite FDIC and FRS to jointly review and evaluate its new examination approach. Further, we recommend that, in the event of a favorable assessment of the new process, the Board of Directors, FDIC, and the Board of Governors, FRS, revise their examination processes to incorporate the features of OCC's new examination approach.

OCC Response:

Examination Approach

On November 23, 1976 OCC staff members made a presentation to approximately 20 FRS and FDIC staff members on the revised examination procedures. Copies of our draft Handbook of Examination Procedures were furnished. Their review and evaluation on an ongoing basis is welcomed. The Acting Comptroller has proposed to the Interagency Coordinating Committee that a permanent staff group be set up for this purpose.

Recommendation (7-25)

Additionally, we recommend that the Board of Directors, FDIC, the Board of Governors, FRS, and the Comptroller of the Currency jointly staff a group to analyze shared national credits at State and National lead banks under Federal supervision and that the three agencies use the uniform classification of these loans when they examine the participating banks.

OCC Response:

Shared National Credits

In 1974, meetings were held with representatives of the OCC, FRS and FDIC present to discuss the possibilities of using a uniform program for the review of selected large shared loans. Both the FRS and the FDIC found merit in the program but they believed sufficient pitfalls existed to delay their participation in the program. Also, in March of 1974 this Office met with representatives of the Conference of State Bank Supervisors to discuss the proposed program. They indicated interest and agreed to work out arrangements with various bank supervisors.

In 1975, the Office of the Comptroller of the Currency conducted uniform reviews of shared national credits in applicable National Banks. The loan write-ups generated by these reviews were made available to both the FRS and the FDIC. In March, 1975 FRS expressed their continued interest in the program and hoped they could participate if the "pitfalls" could be overcome. In November, 1975 FRS revealed they were instituting a test review program involving state member banks paralleling our methods and procedures. In July, 1975 FDIC again expressed interest and a meeting was held in September, 1975 with representatives of the FDIC. This Office indicated FDIC involvement would be welcomed in whatever way they deemed appropriate.

During May, 1976 the second uniform review was conducted and again the data generated was made available to the FRS and FDIC.

In July, 1976 the Comptroller of the Currency and the Vice Chairman of the Federal Reserve Board met to discuss the approaches of the two agencies to shared national credits. It was agreed that the OCC should continue to provide FRS with the information developed under its program and to explore at a staff level whether uniform procedures could be developed between the two agencies which would be acceptable to all of the Federal Reserve Banks. It is our understanding that the New York Federal Reserve Bank is conducting a pilot project involving shared credits which may assist in resolving some of the anticipated problems associated with a combining of the approaches of the two agencies.

Recommendation (7-25)

We also recommend that the Board of Directors, FDIC, the Board of Governors, FRS, and the Comptroller of the Currency work together in refining their monitoring systems and their approach to consumer credit compliance examinations.

OCC Response:

Monitoring

The OCC has met on several occasions with officials of the other two federal supervisory agencies to present its NBSS system. Those orientations were given both orally and with complete submission of all relevant documents. Further, we have offered the other supervisory agencies computer programs and technical knowledge to implement the programs.

Consumer Credit Compliance

With reference to consumer credit compliance examinations the draft report does not fully recognize that our new program is already operational. Over 6% of our field staff is currently allocated to the consumer area. We have conducted three two week schools which trained over 140 examiners in the new procedures; a second series of three schools is scheduled for March and April, and a third series will take place in the Fall. The schools stress examination techniques and feature heavy reliance on case studies to give experience in examining for compliance. The procedures are tailored to spot problems most likely to result in harm to consumers. We make use of sophisticated advanced financial calculators, specially programmed for banking applications, and sampling techniques designed to increased our effectiveness.

Eleven percent of the country's 4,700 national banks have been examined under the new procedures. Preliminary analysis of these reports indicates that our expanded efforts in this area are both justified and effective.

The draft report also does not reflect the extent to which other agencies have cooperated in developing our new program. The Federal Reserve Board and H.U.D. aided in reviewing our procedures. Speakers from the Federal Reserve Board, H.U.D. and the Justice Department participated in our schools. Observers from the Federal Reserve Board, FDIC, N.C.U.A. and H.U.D. attended the schools to assess the new procedures. As a result many of our examination procedures and teaching materials have been adopted by these four agencies. This experience has reinforced our awareness of the benefits of such cooperative efforts.

Recommendation (8-18)

a). We recommend that the Board of Directors, FDIC, the Board of Governors, FRS and the Comptroller of the Currency establish more aggressive policies for using formal actions.

OCC Response:

We believe that in supervising the vast majority of national banks, our most effective remedy continues to be the examination process and the meetings held as part of that process between the board of directors of the bank and OCC personnel. Since December 23, 1975, the OCC has required meetings with boards of directors of each national bank at least once every calendar year and, in certain cases, following every examination. We believe that the increased use of such meetings together with our new examination procedures and early warning system will make our first-line, informal supervisory techniques even more effective.

Recommendation (8-20) Continued

As the GAO report elsewhere notes, our informal supervisory techniques even without the improvements noted above, have proven effective in rehabilitation of most of the so-called problem bank situations. For example, over the period reviewed by GAO informal procedures utilized by OCC were successful 84% of the time. Nonetheless, we agree that increased use of formal agreements and cease and desist orders under the Financial Institutions Supervisory Act may accelerate correction of problems in the more recalcitrant institutions.

OCC use of such formal agreements and orders has increased tenfold from 1970 to 1975. The OCC has originated slightly more than half of the combined total (179) formal agreements and cease and desist orders issued by all three agencies during the last five years. The OCC, however, supervises fewer than half the number of banks supervised by the other two agencies combined. When compared to the number of banks supervised, the OCC over the past five years has used the formal enforcement tools of Financial Institutions Supervisory Act about two and one half times as often as the other two agencies.

It should also be noted that the three banking agencies jointly requested Congress in 1975 to refine and increase the agencies' formal enforcement powers. Congress failed to pass the necessary legislation.

b). Written criteria should be developed to identify the types and magnitude of problems that formal actions appropriately could correct.

OCC Response:

The OCC has developed as part of its National Bank Surveillance System a severity anomaly ranking system which identifies every three months the national banks most likely to require special supervisory attention. A computerized action control system is designed to assure that the OCC responds promptly and appropriately to these situations. The criteria built into these systems identifies more systematically and promptly those cases in which formal enforcement action is appropriate.

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Recommendation (8-47)

We recommend that the Board of Directors, FDIC, the Board of Governors, FRS, and the Comptroller of the Currency develop uniform criteria for identifying problem banks.

OCC Response:

The term "problem bank" is banking agency jargon for many different fact patterns. To an outsider, it appears reasonable and logical to expect a uniform definition of the term. The agency staff person recognizes the difficulty of reducing all the variables to a single definition. At the same time, he has little difficulty in communicating with colleagues in other banking agencies on particular bank situations.

OCC's approach is to computerize to the greatest extent possible the many variables which characterize a bank's condition and management from time to time. This results in a capability to rank all banks in relation to their peers. The final selection of banks needing special supervision can only be done subjectively by trained personnel using all the tools available and the results of our revised examinations. The dividing line on the spectrum between "problem" and "non-problem" status is hard to define but OCC is more than willing to consult and cooperate with the other agencies in seeking such dividing lines.

Recommendation (10-6)

We recommend that where feasible the Comptroller of the Currency, Board of Directors, FDIC, and Board of Governors, FRS, combine their examiner schools and standardize their curricula.

OCC Response:

The OCC recognizes that a common training effort and a combined examiners' school would be highly desirable both in terms of expense and coordination of examination policy. Our Office stands ready to cooperate fully with all such efforts. Indeed, our Office is in receipt of a letter from Chairman Barnett of the FDIC asking our cooperation and financial support for a combined training facility to be constructed at a Rosslyn, Virginia site. This matter is receiving serious attention.

The practical difficulty is that our Office has implemented the Haskins and Sells Report which has created fundamental changes in our examination process. These changes are so basic to our examination process that it would be difficult to coordinate a curriculum. A combined examiners' school is viable only if the other agencies modernize their techniques in line with those being implemented at the OCC. It would be possible, however, to offer jointly courses in more generalized subjects such as Economics and Accounting.

Recommendation (10-11)

We recommend that the Board of Governors, FRS (1) establish a full-time training office to operate its examiner training program and (2) carry out the revision of examiner school curricula which it has recognized as needed for some time.

We also recommend that the Comptroller of the Currency, Board of Directors, FDIC, and Board of Governors, FRS, increase their training in EDP, Law and Accounting as desired by their examiners.

OCC Response:

As part of our acknowledged need for specialized training, and consistent with the advice of our consultants, the Training Division of the Personnel Management Department has identified a multitude of different specialized courses which selected examiners will take: they include 7 different commercial examination schools, 3 trust examination schools, an EDP school, and International school and a consumer examination school. That program has now been implemented and is in full operation. The schools are programmed for examiners at different stages of their professional development. Among the many courses that will be offered by skilled personnel, both from within the OCC and, where necessary, from outside, are ones in EDP, Law and Accounting. Among the other areas that will be covered in that curriculum development will be specialized work in Economics, Bank Marketing, Finance, Auditing and similar topics.

APPENDIX I

Recommendation (11-8)

We recommend that the Board of Directors, FDIC, the Board of Governors, FRS, and the Comptroller of the Currency either (1) jointly establish a more effective mechanism for the three agencies to combine their forces in undertaking significant new initiatives to improve the bank supervisory process or in attacking and resolving problems common to the three agencies, or (2) the Congress enact legislation to establish a mechanism for more effective coordination.

OCC Response:

The OCC has always stood for the strongest possible working relationships between federal supervisory authorities. At the December, 1976 meeting of the Interagency Coordinating Committee, Mr. Robert Bloom, Acting Comptroller of the Currency, asked that the committee take up at its next meeting the subject of strengthening coordination of examination procedures. It will be proposed that a permanent staff group be set up for this purpose. We anticipate modification and refinement of our newly implemented examination approach on an ongoing basis. Review and evaluation of such changes as they affect problems common to the three agencies would be most useful.

CHAIRMAN OF THE BOARD OF GOVERNORS
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

January 16, 1977

The Honorable Elmer B. Staats
Comptroller General of the United States
Washington, D. C. 20548

Dear Mr. Staats:

We appreciate the opportunity to review the General Accounting Office's draft report on the "Study of Federal Supervision of our Nation's Banks."

The data contained in the report reflect favorably on the Federal Reserve's supervisory performance with respect to both banks and bank holding companies. However, the report does suggest a number of refinements in examination procedures and urges more uniformity of standards among the Federal bank regulatory agencies. In most instances, the Federal Reserve had already taken steps to accomplish the objectives of the recommendations.

The Board's specific comments concerning individual recommendations and its general comments concerning the GAO report are enclosed. It is our understanding that our responses to specific recommendations will appear verbatim in the report immediately following the applicable recommendation and that our general comments entitled "Statement by the Board of Governors of the Federal Reserve System" will appear in the Highlight Section of the final report.

Sincerely yours,

Arthur F. Burns

Enclosures

STATEMENT BY
THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
ON THE GAO REPORT

The agreement between the General Accounting Office and the three bank regulatory agencies, pursuant to which the special GAO review of the bank supervisory process was commenced in May, 1976, provided that each of the agencies involved would have an opportunity to comment on the conclusions and recommendations set forth in that report. In addition to its specific comments on individual recommendations which are set forth throughout the main body of the report, the Board also believes that some introductory comments are appropriate.

--The report confirms the basic health and soundness of the banking system. The number of banks requiring special supervisory attention is a small percentage of the total number and the percentage which have in fact failed is much smaller still.

--The report confirms the basic soundness of the current system of supervision. Refinements, rather than basic revisions in the current system, are recommended. In most instances, the Federal Reserve Board had already taken steps to implement such refinements and we believe the same to be true of the other agencies.

--The report confirms the necessity for the legislative improvements in the bank supervisory and regulatory area which the Board recommended to Congress as early as September, 1975, as well as the Board's proposals for a Federal Bank Examination Council.

The bulk of the GAO review focuses on banking institutions which have required special supervisory attention and the responses of the various agencies to this requirement. Despite this limitation, the report establishes that, at any one time, the percentage of banking

institutions in the country which for various reasons can be considered to require special supervisory attention is extremely small, in the neighborhood of 5 per cent. The data in the report show that between 1970 and 1975, encompassing an exceptionally difficult economic period for the country, only 42 of the approximately 14,000 commercial banks in the country failed. Most of those institutions were relatively small and aggregate losses to depositors were minimal.

Also relevant to an evaluation of the supervisory process is the conclusion of the report that the group of banks identified as requiring special supervisory attention is fluid. The composition of the problem lists changes with some frequency as the regulatory agencies identify problems and the banks respond to the need for corrective action.

The recommendations made throughout the report indicate that no need was found for any basic revisions in the country's present system of bank regulation. Rather, the report identifies a number of areas which GAO believes need further attention by the agencies. As noted in our specific comments on the recommendations, in most instances the Federal Reserve and the other regulatory agencies had already taken actions in harmony with the basic thrust of the recommendations. For example, the Board was already focusing more of its supervisory resources on institutions with known problems and less on those thought to be in good condition.

The majority of the recommendations in the area of bank examination and supervision relate to a desire for greater uniformity in supervisory

treatment among the agencies. These recommendations support the Board's conclusions and initiatives in this area. In December, 1975, Governor Holland testified before the Senate Committee on Banking, Housing and Urban Affairs and in that testimony made reference to the concept of a joint bank examination council which at that time had received substantial support within the Board. In that regard, he stated:

> Such a Council would be focused on the areas that we believe are most in need of improvement; that is, efficient and uniform modernization of bank examination and vigorous and consistent follow-up procedures when bank weaknesses are revealed. Such a Council could be established administratively or by statute. Its statutory authorization would undoubtedly give more impetus to the establishment of such a Council, and would also provide it with more clear-cut authority to take definitive action within its statutorily defined areas of administration.
>
> The Federal Bank Examination Council should have authority to establish standards and procedures for bank surveillance, examination and follow-up, applicable to all the Federal banking agencies, and it should review significant problem cases when and as they develop. All three Federal banking agencies should be represented on the Council.

Subsequently, at the Board's request, Senator Stevenson introduced the Federal Bank Examination Council Act (S. 3494). Such a council would establish mandatory uniform standards and procedures for Federal examination of banks as well as uniform reporting systems and conduct joint schools for examiners. The Board strongly supports such legislation and believes a proposal along those lines could accomplish most of the objectives set out in the report's recommendations in the examination area.

The report focuses extensively on the method by which the agencies deal with problem bank situations and makes a number of recommendations for improvements in this area which will be discussed later. Further, in a number of instances the report specifically supports enactment of various legislative proposals made by the Board on behalf of the regulatory agencies. As Chairman Burns stated in a letter of September 5, 1975 proposing such legislation, "All of these recommendations arise from the agencies concern over 'problem bank' situations and are designed to help prevent or correct such situations." H.R. 9743 and S. 2304, which embodied these recommendations, would have provided civil penalties for violations of various provisions of Federal law by banks and bankers; imposed new restrictions on a bank's transactions with insiders; and placed the agencies in a position to make more effective use of the Financial Institutions Supervisory Act of 1966. The Board believes that the report provides strong support for this legislation. In this regard, we note that Senator Proxmire has just introduced a bill in the 95th Congress which encompasses these recommendations.

The GAO report stated that "Examiners found problems in nearly all of the banks in our samples, including those not on the agencies' problem lists . . . ." The tables contained in the review of this element of bank supervision showed that examiners applied strict standards; e.g., in 70 per cent of the banks the examiners criticized the volume of classified loans; violations of law and regulations, whether merely technical or substantive, were identified in 55 per cent of the banks;

inadequate routines and controls were noted in 44 per cent of the banks. We agree with the GAO and believe the report readily confirms that bank examiners are effective in identifying problem areas in commercial banks.

We believe that the study also demonstrates that the supervisory agencies are effective in resolving significant problems once they have been identified by the examiners. We are not convinced that analysis of the dynamics of so-called "problem lists" -- one of the techniques employed by the GAO -- is a proper basis for measuring supervisory effectiveness. Thus, we are somewhat concerned with the report's focus on the length of time an institution remains subject to special supervisory attention as being an indication of whether or not the supervisory process is, in fact, working. We believe that substantial weight should also be given to the percentage of banks which fail as an indication of whether or not the process works. During the period examined by the GAO, only two State member banks failed, and they were relatively small.

However, we believe that even the focus of the report on the dynamics of the list of institutions subject to special supervisory attention demonstrates the effectiveness of the present system. The report shows that the composition of the lists changes with some frequency as problems are identified by the regulators and resolved by the institutions in conjunction with the regulators. During the period examined by the GAO, 1,180 banks were added to these lists and 897 were removed. Furthermore, as set forth in more detail in our specific responses to individual recommendations, we believe the data gathered in chapter 8

demonstrate that the performance of the three agencies is roughly the same and, in fact, good for all three agencies.

In addition to the recommendations for greater uniformity in examination and follow-up among the agencies, the report makes a number of recommendations relating to examination techniques and training. As more specifically set forth in our responses to the particular recommendations, the Board has taken, or is in the process of taking, effective action compatible with the major thrust of most of the recommendations. For instance, a major portion of the recommendations deal with the desire that the agencies focus more of their resources on institutions with known problems. In this regard, the Board requires all problem banks to be examined at a minimum of six-month intervals. Further, the Board has recently adopted limited scope Asset Quality and Management Performance Examinations to be used on banks thought to be in relatively good condition. The Board believes that these procedures give us the needed flexibility while at the same time minimizing the likelihood that problems will be overlooked.

In the area of training, the Board has, among other things, recently revised curricula for its various examiner schools and has instituted new schools in the areas of consumer regulations and bank holding company analysis.

The Board would also like to comment on the broad purposes of the bank examination process lest the sum of the report's recommendations be misconstrued. We believe that bank examination and supervision should

be directed at securing compliance with banking laws and regulations and determining that a bank is operated soundly so as to assure, to the greatest extent possible, safety and soundness of depositors' funds and continued banking services to the community. A system of bank regulation which goes beyond these goals imposes certain social costs and dangers. It is not the job of the supervisors to determine whether specific loans should or should not be extended or whether a bank's resources should be used in a particular manner unless such decisions contravene law or affect the safety and soundness of the bank. Rather, private initiative should be encouraged to the greatest extent possible.

Finally, the report also comments on the Board's supervision of bank holding companies. The data in the report confirm that, as in the case of banks, the percentage of problem institutions is relatively small. Even utilizing a sample biased toward problem institutions, there were limited instances in which bank holding companies were found to have caused problems in the subsidiary banks. Out of the sample of 344 which were affiliated with bank holding companies, there were 22 banks in which the report stated that the problem was caused by the parent holding company. This constitutes 6.5 per cent of the sample banks affiliated with bank holding companies. However, the Board's examination of the parent bank holding company in each of these instances demonstrates that, in fact, the actions of only five holding companies could be said to have caused any serious problem in the subsidiary banks. In addition, the Board believes that it is taking effective supervisory

action in those cases where holding companies are causing problems for the subsidiary banks. In October, 1974, the Board's request for cease-and-desist authority over bank holding companies was granted. Since that time, the Board has significantly expanded its supervisory efforts with respect to bank holding companies, concentrating primarily on those exhibiting problems. With respect to formal actions, in the 26 months the Board has had the authority, it has issued 12 cease-and-desist orders and 12 written agreements against holding companies.

In concluding our general statement, we wish to note once again that our banking system has weathered an extremely difficult period successfully. The bank supervisory process of this country, which by no means is perfect, has materially contributed to this achievement.

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The Board's further responses to individual recommendations may be found throughout the body of the main report as follows:

Recommendations relating to	Page
-- Scheduling of examinations ----------------	4- 7
-- Flexible examination policies -------------	4- 9
-- Use of State examinations -----------------	4-13
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-- Supervision of holding companies ---------- 4-51

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-- Evaluation of the Comptroller of the Currency's examination procedures --------- 7-25

-- Analysis of shared national credits ------- 7-25

-- Policies for formal enforcement actions --- 8-18

-- Criteria for identifying problem banks ---- 8-49

-- Combined examiner schools ----------------- 10- 6

-- Separate training office ------------------ 10-11

-- Evaluation of examiners ------------------- 10-15

-- Uniformity in the supervisory process ----- 11- 8

Recommendation

Therefore, we recommend that the Board of Directors, FDIC, the Board of Governors, FRS, and the Comptroller of the Currency establish scheduling policies and procedures which would avoid setting examination patterns.

Comments

This recommendation is based upon the premise that the agencies view surprise as an important element of an examination. The Board believes that, in many cases, there is serious doubt as to the benefits to be gained and hence the desirability of surprise examinations. In those instances where surprise is considered important, it has been, and will continue to be, our practice to schedule examinations so that they cannot be predicted in advance.

Recommendation

We recommend that the Board of Directors, FDIC, and the Board of Governors, FRS adopt flexible policies for examination frequency which would allow them to concentrate their efforts on banks with known serious problems.

We recommend that the Congress amend the National Bank Act to allow the Comptroller of the Currency to examine national banks at his/her discretion. We would be glad to assist the committees in drafting appropriate legislation.

Comments

The Board already has established policies that are flexible enough to allow us to concentrate our efforts on banks with known serious problems. Some years ago, the Board adopted the policy, which was reaffirmed in 1975, that all banks considered to be in a problem status be examined at a minimum of six-month intervals. However, we will continue to schedule periodic examinations of all banks under our supervision since a bank may deteriorate with the passage of time. As pointed out in the GAO

report, the Board recently approved the usage of Asset Quality and Management Peformance Examinations in the case of banks thought to be relatively free of major problems. If this limited scope examination detects major changes or deterioration, a full scale examination is then commenced. These procedures give us flexibility while at the same time insuring that problems are not overlooked.

Recommendation

We recommend that the Board of Directors, FDIC, and the Board of Governors, FRS, extend their current efforts to use State examinations and, if they do, we also recommend that they

--develop minimum standards for acceptable State examiner training and examination procedures and

--use only reports of State examinations meeting those standards.

Comments

The report recognizes our current extensive efforts to eliminate unnecessary duplication by utilizing State examiners and State examination reports. If experience with our existing program in Indiana should indicate that expansion of this program is desirable, GAO's recommendations regarding standards would be appropriate. Indeed, the purpose of the existing experimental program is to develop such standards. In this connection, however, it should be recognized that written standards alone will not insure the success of any program.

Recommendation

We recommend that the Board of Directors, FDIC and the Board of Governors, FRS, establish procedures to base the scope of each examination on the examiners' evaluation of the quality of the bank's controls, policies, procedures, and audit.

Comments

This recommendation encompasses what we are already doing. We review the policies, procedures, and controls in connection with all bank examinations. In most large banks, our examiners currently perform a preexamination review specifically focusing on controls, policies, and procedures. The results of such review are used to determine the amount of scrutiny given to each area. In smaller banking institutions, a review of the controls, policies and procedures in effect at the last examination is used to develop the scope of the examination.

Recommendation

We recommend that the Board of Directors, FDIC, and the Board of Governors, FRS, develop standards for the preparation, maintenance, and use of examination workpapers.

Comments

We believe that, in the vast majority of examinations, the examination workpapers and line sheets prepared are adequate to meet the System's needs. The manner in which examination workpapers should be prepared and maintained is extensively covered in connection with the training of our examiners.

Recommendation

We recommend that the Board of Governors, FRS, and the Comptroller of the Currency, using all available information, develop and use a single approach to classify loans subject to country risk.

Comments

The evaluation of the country risk element in international loans calls for difficult analysis and judgment at the time lines of credit are established or loans extended since "country risk" involves

an estimate of a country's political, economic, and social fortunes over the life of the loan as they may affect the collectability of such loans. There is serious question as to the validity of generalized characterizations of credits based on the country of residency of the borrower, particularly where the characteristics of the credit may well vary with the borrower - private or governmental - as well as the nature and extent of external resources available to support the loan. For a number of months now, the Federal Reserve has had underway a review of country risk problems in international lending as well as appropriate supervisory treatment of the problem. This review has included an on-going appraisal of the system employed by the Comptroller of the Currency. In this regard, we believe that, while there may be general agreement on the desirability of uniform evaluation of the country risk element in individual international credits, there is a real question as to the desirability of rating individual countries. It might be noted, for instance, that the Comptroller's system focuses almost exclusively on credits to individual governments. In any event, we believe that we should strive toward uniform treatment. Of course, as with respect to many of the recommendations, the Federal Bank Examination Council proposal would accomplish this.

Recommendation

We recommend that the Board of Governors, FRS, and the Comptroller of the Currency implement procedures to examine (where permitted by the country involved) major foreign branches and subsidiaries, including subsidiaries of Edge Act corporations, periodically and whenever adequate information about their activities is not available at the home office.

Also, we recommend that the Board of Governors, FRS, and the Comptroller of the Currency utilize each others examiners to cut expenses when conducting examinations in foreign countries.

Comments

The development of widespread networks of foreign branches and subsidiaries by the major banks has brought the question of the supervision of the banks' international operations to the forefront in recent years. We concur with the principle that examinations, wherever conducted, should be adequate to provide the necessary supervisory information. However, one constraint with which the Board has had to deal is, as noted in the report, that, in many cases examinations of foreign subsidiaries are not possible because of host country laws which preclude direct examinations by other governmental authorities of banks chartered in those countries regardless of the ownership. The System has not only required that banks maintain records at the head office adequate to appraise the risk and exposure of the banks through their foreign operations, but the System has also provided for direct visitations of examiners to major foreign branches in those cases where such visitations have been legally possible.

The Board believes that, on the whole, this system has worked well. The information available at head offices has, in general, been adequate to assure that the banks were not unduly exposed to loss or serious financial difficulties. At the same time, there has been a continual search for better and more efficient ways of satisfying the Federal Reserve's supervisory responsibilities in the international field.

Beginning in the fall of 1976, on-site examinations were made of foreign branches of State member banks where we had previously utilized on-site inspections by State examiners or information at the head office. Moreover, a number of foreign subsidiaries were directly examined for the first time with the agreement of the host government. A full evaluation of those examinations has not yet been completed. One preliminary result of that exercise has been to provide assurance that a large portion of the material needed for proper supervision of foreign branches and subsidiaries is in the management information systems at head offices. In this connection, it should be noted that consultations are continuing with foreign bank superisory authorities about the ways in which access to foreign subsidiaries may be broadened to accommodate on-site reviews. These consultations are part of a wider effort of international cooperation in bank supervision.

Recommendation

We recommend that the Board of Directors, FDIC, and the Board of Governors, FRS develop reports of examination for EDP operations which present the problems found, corrective action needed and any necessary explanatory data in a clear and concise manner.

Comments

The Board wishes to note that it believes its present EDP examination report adequately presents the major problems found and corrective action needed. Furthermore, the System has already undertaken a review of EDP examination procedures to determine whether there are possible improvements, particularly in the review of internal controls, and, in connection with that review, is preparing a revised examination report.

Recommendation

We recommend that the Board of Governors, FRS implement a system of supervision which is based on onsite inspections of holding companies and their major nonbanking subsidiaries. We also recommend that the Board strengthen its oversight of holding company supervision by establishing

--a systemwide manual of inspection procedures,

--a standard inspection report, and

--periodic onsite evaluations of Reserve bank supervisory activities.

Comments

The System has for some time conducted on-site inspections of selected holding companies. Partly as a result of these inspections and problems which came to its attention, the Board in late 1974 requested and was granted legislative authority to impose the same supervisory remedies on holding companies that were applicable to banks under the Financial Institutions Supervisory Act of 1966. In early 1976, the Board directed that this inspection program be significantly expanded with initial efforts directed toward holding companies requiring special supervisory attention.

In addition, in 1975 the Board commenced work on a computer based monitoring system in order to identify those holding companies which might require special attention. This program is partially operational at the present time and is expected to be fully operable within the next few months.

A manual of inspection procedures is currently under development. However, completion of such a manual has of necessity awaited experience

gained from the direct on-site inspections which have been carried out. We believe that the recommendations relating to a standardized inspection report as well as periodic on-site evaluations of Reserve Banks supervisory activities warrant further consideration. We might note that the initial steps to set up such periodic evaluations already have been commenced by the Board.

While we see no difficulty with the thrust of the recommendations, the Board is concerned that the method used in the GAO report may lead to unwarranted fears as to the general health of bank holding companies. The sample chosen was one in which problem banks were at least six times more likely to occur than in the industry as a whole. A sample biased toward problem banks is naturally biased toward problem holding companies.

Under the heading "Unsound Holding Companies' Expansion Applications Approved" the report states that the Board approved applications by 15 of 20 "detrimental holding companies" to acquire additional banking and nonbanking subsidiaries. Our review of these companies indicates that the problems of over two-thirds of these companies were problems centered in the banking subsidiaries as opposed to problems in either the parent holding company or a nonbanking subsidiary. As such, these problems would be most effectively handled by the primary examining authority of the bank involved. Furthermore, the majority of the applications involving these institutions which are referred to were acted on in the early 1970's, long before any of the institutions had experienced difficulty or had been identified as requiring special supervisory attention.

In fact, only three applications were approved at a time when any of the institutions involved was considered to be in a problem condition. Two of these applications consisted of corporate reorganizations having no financial impact on the institution whatsoever. The third application involved permission to engage in a nonleveraged, potentially profitable, operation which was considered to be a positive factor to improve the condition of the company involved.

The Board regards its policy, adopted in June 1974, of curbing bank holding company expansion into nonbanking activities, particularly with respect to bank holding companies with financial problems, as being an effective supervisory tool. In fact, the Board has acted to deny a significant percentage of applications on financial and managerial grounds since this policy was introduced, and many more have been withdrawn by applicants after discussions with staff. The Board believes it has applied this policy responsibly and it remains in effect.

Recommendation

Therefore, we recommend that the Board of Directors, FDIC, and the Board of Governors, FRS require their examiners to meet with the bank's board of directors or audit or examining committee after each examination.

Comments

The System has for many years been concerned that the board of directors be particularly aware of the results of an examination. Thus, the System has historically required that the examination report be considered and discussed at a meeting of the board of directors. To insure that this is done, directors are required to sign a statement

attached to the report that it has been so read and considered. Further, examiners are instructed to review the minutes of board of director meetings to insure that the spirit of these requirements has been fully carried out.

With respect to meetings, the Board in 1975 directed that an earlier existing policy for most of the System be expanded to all Reserve Banks. This policy requires that Reserve Bank staff meet with the board of directors of all so-called problem banks. The Board believes that such meetings are important where significant problems are revealed.

Recommendation

We recommend that the Board of Directors, FDIC, and the Board of Governors, FRS, develop and use reports of examination which provide the banks with the results of the examination and any necessary supporting information.

Comments

We believe the bank examination report presently provides the banks with the results of an examination and necessary supporting information. We also believe it should provide the System with the information it needs to carry out its supervisory functions. The present examination report adequately carries out these needs. It should not be forgotten that the System also uses other methods of communicating its views to its member banks, such as correspondence, informal meetings, and consultations on applications. Of course, the System is continually exploring methods of improving communications.

Recommendation

We recommend that the Comptroller of the Currency invite FDIC and FRS to jointly evaluate its new examination approach. We further recommend that, in the event of a favorable assessment of the new process, the Board of Directors, FDIC, and the Board of Governors, FRS revise their examination processes to incorporate the concepts of OCC's approaches.

Comments

The Comptroller's new procedures are based in large part on the Haskins and Sells report. At the time that report was prepared, the Comptroller furnished it to the other banking institutions in the belief that some of the recommendations might be jointly applicable. A task force at the Federal Reserve reviewed the report shortly after its issuance and concluded that, in most instances, the System had already implemented those recommendations involved which would have been applicable to the System. Subsequent to that time, the development of new examination procedures at the Comptroller's office has been substantially completed. Recently, senior members of the Board's staff attended a briefing by the Comptroller's office on these new examination procedures and the report form to be used by that agency. The Board believes that the Comptroller has been most cooperative in sharing his new systems with us and fully intends to use whatever benefits may be derived from the Comptroller's efforts in this area in our on-going review of our examination procedures.

Recommendation

We recommend that the Board of Directors, FDIC, the Board of Governors, FRS, and the Comptroller of the Currency jointly staff a group to analyze shared national credits at State and national lead banks under Federal supervision and that the three agencies use the uniform classification of these loans when they examine the participating banks.

We recommend that the Board of Directors, FDIC, the Board of Governors, FRS, and the Comptroller of the Currency work together to refine their monitoring systems and their approaches to examining for compliance with consumer credit laws.

Comments

A joint approach to shared national credits is clearly desirable. In fact, in June 1976 the Board and the Office of the Comptroller of the Currency entered into a preliminary agreement which provides for a sharing by each agency of examiners' classifications of a national credit.

The second portion of this recommendation deals with the desirability of uniform refinement of consumer credit enforcement and compliance policies. In the report, the GAO states that some agencies believe there is a possible "conflict between a bank's objective of financial soundness and strict compliance with consumer credit laws." The Board does not agree with this statement. On the contrary, we believe that stringent enforcement of consumer laws and regulations will achieve compliance and thereby reduce the likelihood that banks will incur substantial liability as a result of consumer suits.

The Federal Reserve has had the major responsibility for drafting regulations to implement the explosion of legislation that has taken place in this area over the past two years. In this connection, the

Board's Division of Consumer Affairs has worked very closely with the other agencies. It has formed a Federal Reserve task force to develop approaches to the enforcement of newly enacted consumer credit laws. A cadre of examination specialists who will concentrate on inspection and compliance is being trained. Two schools on consumer regulations were conducted in 1976 and four have been planned for 1977.

Additionally, examination manuals that deal with the full array of consumer regulations have recently been prepared. A new examination report form dealing exclusively with this area has been prepared and is expected to be in use in the near future.

Recommendation

We recommend that the Board of Directors, FDIC, the Board of Governors, FRS, and the Comptroller of the Currency establish more aggressive policies for using formal actions. Written guidelines should be developed to identify the types and magnitude of problems that formal actions could appropriately correct.

Comments

In this section, the report notes that each problem situation has to be evaluated on a case-by-case basis and formal action would not always be appropriate. The report goes on to recommend that more aggressive policies be used for formal actions and that written guidelines be developed to identify the types and magnitude of problems that formal actions could appropriately correct. In this regard, we note that the report confirms that all of the agencies have already markedly expanded their formal enforcement activities. On November 3, 1975 the Board issued a policy statement emphasizing its intention to take formal action where appropriate in connection with violations of the Bank Holding Company Act.

Further, we do not believe that adequate weight has been given in the report to existing hindrances to formal action under the Financial Institutions Supervisory Act of 1966. This chapter does, however, support the Board's existing recommendations for changes to the Financial Institutions Supervisory Act which would enable the supervisory authorities to remove bank officers for gross negligence and to assess civil penalties for violations of laws and regulations. These legislative recommendations were made in response to procedural and substantive problems inherent in making effective use of the present formal procedures set forth in the Financial Institutions Supervisory Act. In this regard, the Board's letter of September 5, 1975, to the banking committees of both Houses of Congress setting forth the legislative proposals made it clear that there were a number of situations in which the existing formal regulatory remedies would have little or no value in preventing or ameliorating problem bank situations. We believe that those recommendations, embodied in H.R. 9743 and S. 2304, would help to substantially reduce the incidence of problem banking situations. Further, the Board has continued to review areas in which it appears that changes may be of substantial aid. The Board intends to submit further legislative proposals to this end in the very near future. In this regard, Chairman Proxmire has introduced legislation in the 95th Congress which encompasses the earlier recommendations.

The Board is further concerned that the discussion in this chapter of the manner in which the agencies are handling problem bank situations may not present an accurate view in all respects. The major

shortcoming in this regard stems from the fact that the different agencies utilize problem bank lists for varying purposes. Furthermore, even between agencies with similar goals, different judgments may occur as to the severity of an institution's problems and the length of time monitoring is required. Meaningful comparison between agencies' enforcement activities in this area is therefore impossible. We would, however, note that the report's conclusions relating to the agencies' effectiveness in returning institutions to nonproblem status are not supported by the tables since the percentages used excluded institutions withdrawing from membership and merging. Presumably, the approving agency found in the case of the mergers, as required by the Bank Merger Act, that the financial and managerial condition of the resulting bank was satisfactory and, in the case of withdrawals from membership, supervisory pressure may well have contributed to such withdrawals. Further, as noted in the table, withdrawals and mergers are disproportionately high in the sample for the Federal Reserve.

Recommendation

We recommend that the Board of Directors, FDIC, the Board of Governors, FRS, and the Comptroller of the Currency develop uniform criteria for identifying problem banks.

 APPENDIX II

Comments

As previously noted in earlier responses, the rating systems are utilized for different purposes within different agencies. However, we believe there is certainly room for much common ground in this area. The legislative proposals for a Federal Bank Examination Council referred to earlier would aid in this development, though judgmental evaluation of any common criteria will likely lead to some diversity.

Recommendation

We recommend that where feasible the Comptroller of the Currency, the Board of Directors, FDIC, and the Board of Governors, FRS, combine their examiner schools and standardize their curriculums.

Comments

The examiner schools were a combined effort of the three agencies when they were established in 1952 by the Federal Reserve. However, in 1962 the Office of the Comptroller of the Currency withdrew from the program, believing it preferable to operate its own school. In the early 1970's the number of FDIC students necessitated some sessions held for FDIC examiners only and, when the FDIC enrollment needs continued at this high level, it was decided that the only practical course of action for the FDIC and the Federal Reserve System was to establish separate schools.

The Board believes that a joint effort in this area would be appropriate and desirable. This is among the reasons the Board supports the concept of a Federal Bank Examination Council. Short of this proposal, the Board will explore with other agencies the feasibility of conducting joint schools.

Recommendation

We recommend that the Board of Governors, FRS, (1) establish a full-time training office to operate its examiner training program and (2) carry out the revision of examiner school curriculums which it has recognized as needed for sometime.

We also recommend that the Comptroller of the Currency, the Board of Directors, FDIC, and the Board of Governors, FRS, increase their training in EDP, law, and accounting, as desired by their examiners.

Comments

One individual currently administers the various Federal Reserve examination schools held in Washington. In addition, one full time staff member is assigned to handle preparatory and procedural aspects such as registration, printing and distribution of instructional materials and day-to-day dealings with instructors and students. Other responsibilities for the different schools have been assigned to various members of the Board's staff who are experts in each field of training. For instance, the curriculum for the newly established Holding Company School was devised by members of the Federal Reserve staff expert in matters relating to holding companies and the new Consumer Regulations School is handled by individuals who have been actively involved in implementing the recent consumer legislation. The Board believes that this system has met its needs.

If the report's recommendation for a joint school is adopted, this would reduce the need to consider a separate office at the Board. However, if such arrangements cannot be worked out, the Board will consider establishing such an office.

We might note that the portion of this recommendation relating to a revision of examination curricula had been started prior to the report. At the direction of the System Education Committee, the curricula for the schools for assistant examiners and examiners were updated and revised in the spring and summer of 1976 and the curriculum for the EDP school was revised in the fall. The Holding Company School and the Consumer Regulation School have been recently established and therefore have new curricula.

With respect to that portion of the recommendation relating to additional training in specific areas, the Board has a previously scheduled session of the EDP school set for 1977 which will use a recently updated curriculum. The laws relating to consumer affairs are extensively covered in schools developed by the Office of Consumer Affairs now conducted in Washington as part of the overall examination program. The Board will study the question whether additional training in the areas of law and accounting should be provided to examiners.

Recommendation

We recommend that the Board of Governors, FRS also establish formal evaluation process to measure the competence of persons seeking advancement to examiner status.

Comments

We note that this recommendation is not based upon a conclusion that the examiners of any one agency are more or less competent than those of another agency. Standardized tests are merely one way of arriving at a formal evaluation, and we would not want to rely on them exclusively.

However, there is something to be said in favor of formal tests as a supplementary evaluation device, and the Board intends to investigate their feasibility.

Recommendation

We recommend that either (1) the Board of Directors, FDIC, the Board of Governors, FRS, and the Comptroller of the Currency jointly establish a more effective mechanism to combine their forces in undertaking significant initiatives to improve the bank supervisory process or in attacking and resolving common problems, or (2) the Congress enact legislation to establish a mechanism for more effective coordination. We would be glad to assist the committees in drafting appropriate legislation.

Comments

The Board is pleased that this portion of the report supports its previous conclusions and initiatives in this area and favors the legislative approach.

In December, 1975, Governor Holland testified before the Senate Committee on Banking, Housing and Urban Affairs and in that testimony made reference to the concept of a joint Bank Examination Council which at that time had received substantial support within the Board. In that regard, he stated:

> Such a Council would be focused on the areas that we believe are most in need of improvement; that is, efficient and uniform modernization of bank examination and vigorous and consistent follow-up procedures when bank weaknesses are revealed. Such a Council could be established administratively or by statute. Its statutory authorization would undoubtedly give more impetus to the establishment of such a Council, and would also provide it with more clear-cut authority to take definitive action within its statutorily defined areas of administration.

> The Federal Bank Examination Council should have authority to establish standards and procedures for bank surveillance, examination and follow-up, applicable to all the Federal banking agencies, and it should review significant problem cases when and as they develop. All three Federal banking agencies should be represented on the Council.

Subsequently, at our suggestion, Senator Stevenson introduced the Federal Bank Examination Council Act (S. 3494). Such a Council would establish mandatory uniform standards and procedures for Federal examination of banks and uniform reporting systems and conduct joint schools for examiners. The Board believes that a proposal along these lines could accomplish most of the objectives set out in the report's recommendations in the examination area.

FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, D.C. 20429

OFFICE OF THE CHAIRMAN

January 17, 1977

Honorable Elmer B. Staats
Comptroller General of the United States
Washington, D.C. 20548

Dear Mr. Staats:

I appreciate the opportunity to comment on the draft of your report to Congress on federal supervision of the commercial banks in this country.

In general, I believe that the General Accounting Office has done a workmanlike job with an extremely difficult task, made more difficult by a relatively tight time frame. We feel that your comments as an impartial professional observer should be studied carefully by us in an atmosphere of cooperativeness and receptiveness. In that vein, I would like to comment on a few points in the draft.

1. The day-to-day relationship which the FDIC has with state banking supervisors is extremely important in our supervisory effort. Unlike the Comptroller of the Currency, we supervise banks who are operating under 50 state laws as well as the Federal Deposit Insurance Act. Those banks are chartered by 50 different state supervisory authorities and the manner of supervising those banks at the federal level differs as a result from state to state.

2. It is important to realize that the FDIC is the sole federal regulator for the entire mutual savings bank industry, a $100 billion industry. While I appreciate that your report is directed only to commercial banks, I believe it is essential to take into account its activities with respect to the mutual savings bank industry in order to understand the supervisory effort of the FDIC.

3. Your report emphasizes the need for flexibility in examination techniques. We wholeheartedly concur and as a result of a continuing study going back a number of years, we amended in early November of 1976 our basic memorandum which governs our examination policy. This amended General Memorandum No. 1 is quite consistent with the thrust of your report and I am sorry that you did not include it and a full discussion of it in your report. We like to think that the philosophy outlined in this memorandum, which we have tested during the past few years by experimenting in different

Honorable Elmer B. Staats
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regions, is the best philosophy for the FDIC to pursue in the examination of nonmember banks. Since it is so central to our operations, and since it is a relatively new statement of a flexible examination policy, I would personally have liked to have seen your in-depth comments about it.

4. We believe, as your report recommends, that more formal actions should be taken in the supervisory process by federal regulators. We have attempted to pursue that policy, particularly since late spring and early summer of 1976, and have requested from the Congress additional supervisory powers.

5. The report notes the large number of violations of the law during a typical examination. I was pleased to note that you point out that some of the laws and regulations are complex and that some of the violations were of a technical nature that would in no way affect the soundness of a bank. Rightfully, you also point out that other types of violations, such as a loan in excess of a bank's legal lending limit, could result in losses to a bank. In our experience, the major portion of violations of laws set forth in reports of examination do not affect the safety and soundness of a bank. All violations of laws or regulations are a matter of concern, of course, but it is the particular responsibility of the bank regulator to consider each violation in terms of whether it was intentional or willful, the consequences flowing therefrom, the likelihood of continued violations, and other similar matters, and to then take the appropriate corrective action.

6. Finally, the report implicitly argues that Corporation examiners should be criticizing loan policies before bad loans are made. I certainly agree that a closer review of loan policies is important, and criticism of such policies in advance of their implementation be made where the policies will obviously lead to an unsafe and unsound condition for the bank or to violations of law. Most written loan policies will be stated in such a way, however, that a reasonable examiner will find it extremely difficult to find something significant in them to criticize. I suspect that the written policies themselves are not the problem but rather the implementation of those policies. I certainly see no expertise in our Corporation for drafting standard written policies that banks we supervise should pursue. The FDIC was not created to manage banks, nor do I believe that it is your intention to have your report suggest that. Nevertheless, it does suggest it, and I do feel obliged to make these comments about that implication.

Honorable Elmer B. Staats
January 17, 1977
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Finally, the FDIC Division of Bank Supervision has prepared extensive detailed comments concerning recommendations and comments made in your report which I enclose for your consideration. Please excuse the length and the detail of those comments; I believe they reflect, however, the thoughtfulness with which we have reviewed your report.

Thank you for permitting us the opportunity to comment on the draft of your report.

Very truly yours,

Robert E. Barnett
Chairman

Enclosure

FEDERAL DEPOSIT INSURANCE CORPORATION

DIVISION OF BANK SUPERVISION

Staff General Comments and Agency Recommendations

Note: Page references have been changed to conform to the final report.

CHAPTER 4

The GAO report indicates that the agencies have not established criteria or levels of acceptability with respect to financial ratios and comparisons used in the examination process. FDIC uses financial ratios as general guidelines for initial screening purposes. In banking and in finance, ratios are only indicators, and as such need to be individually assessed. The key element in banking, as in a number of other industries, aside from management, is the quality and turnover rate of the inventory. In banking, of course, inventory is principally made up of loans and securities. Since no two banks have identical inventories, it logically follows that where the relevant ratios for two banks are identical or in the same range, further analysis is required before a meaningful evaluation of a bank's condition can properly be made.

The examination is designed to and does enable the FDIC to ascertain the overall condition of the bank, the quality of its management, and the extent of compliance with applicable laws and regulations. Moreover, the examination report, including the examiner's recommendations, is thoroughly reviewed and analyzed at the appropriate Regional Office. During these reviews, the reviewer also considers the Statements of Condition and Reports of Income and Dividends filed by the bank; the bank's complete correspondence file, showing its history and the attitudes and abilities of the bank's management; reports of loans to the bank's

officers at other banks, reports of loans against the bank's stock at other banks, and any supervisory programs which are in effect; and, computerized monitoring systems which subject the bank to a number of financial checks. The major purpose of this review is to determine the extent and type of supervision which may be needed, not just "...for arithmetic accuracy, grammar, logic, support for statements, and internal consistency," as the GAO report states.

After review of the examination report as well as other relevant data at the Regional level, another review process is conducted at the Washington level for each bank. Corrective and follow-up programs are initiated at the conclusion of the examination, and in addition to possible on-site visitations or follow-up examinations, the bank's "vital signs" are monitored via an automated monitoring system fed by data from call reports, Reports of Income and Dividends, and examination data.

The GAO report also states that examinations have not given enough emphasis "to the bank's basic management practices, operations, and controls." Both from a policy standpoint and the practical application of that policy, the FDIC has been and is in the forefront of stressing the need to review, analyze and evaluate the policies and controls of a bank under examination. Thus, the following quotations from the Manual of Examination Policies typify our basic approach to this phase of the examination process:

"The Examiner's evaluation of the loan portfolio involves much more than merely appraising the individual loans therein. Present management and administration of the overall loan account, including the establishment of sound lending and collection policies are of vital importance if the bank is to be continuously operated in an acceptable manner." (Section H, page 3, paragraph III.)

"Management of a bank's securities portfolio is facilitated by the adoption of a definite investment policy. *** Details of the investment policy, expressed in writing, should establish standards for selection that thoroughly consider: (a) Quality, (b) Maturity, (c) Diversification, (d) Marketability, and (e) Income." (Section G, page 1, paragraph I.)

"Sound portfolio management dictates that procedures be established and adhered to relative to the execution of purchases and sales, review of portfolio and maintenance of credit information." (Section G, page 3, paragraph III.)

"An important part of the Examiner's duties is the appraisal of the bank's internal controls to determine their adequacy for assuring both the necessary degrees of accuracy in recorded information and reasonable protection of the bank's assets." (Section P, page 7, paragraph III. A.)

In addition, the essential thrust of the examination is premised on the concept that the entire posture of the bank rests on its management practices, operations and controls and these areas of concern are carefully reviewed and evaluated in the course of an examination and at other key points in the supervisory process. For example, the examination report, which, by necessity, must be limited to essentials, includes 13 schedules dedicated to the practices, operations and controls of the bank's management out of a total of approximately 30 schedules in the report.

The GAO report states, in part:

> "While the agencies reported some violations of consumer protection laws and regulations, they acknowledged that they have not aggressively monitored consumer protection law compliance, and they have begun revising their approaches. (See Ch. 7.)"

While we do not argue with the implication of the above statement, the FDIC has expended considerable resources in the area of consumer protection. It is estimated that about 10% of our supervisory effort is taken up with examining for compliance with consumer laws and other matters not related to safety and soundness. We recognize, however, that additional efforts will be necessary to enforce the many recently enacted consumer laws and regulations. Some of the major activities of the Corporation in the area of consumer protection are: (1) adoption of a separate compliance report for reporting examinations for compliance with consumer laws, which has significantly increased the volume of violations cited over the former method used; (2) establishment of the Office of Bank Customer Affairs which serves as a focal point within FDIC for protecting the legitimate interests of bank customers; (3) expanded training for examiners and assistant examiners in consumer laws and regulations, including an orientation in consumer laws for assistant examiners, a week of training for senior assistant examiners, and case problems and additional training for commissioned examiners; and (4) providing information and education to bankers and to a lesser extent to consumers (e.g., FDIC has under active consideration issuance of a series of pamphlets to consumers covering consumer laws and banking and FDIC's role in that area).

In 1972, the FDIC considered issuing regulations and held hearings on regulatory proposals dealing with the subject of discrimination in granting home loans. However, for a number of reasons, including that there was a paucity of data needed to write effective regulations, final regulations were not issued. However, a major undertaking conducted jointly by the FDIC and the OCC has been undertaken to develop a program to insure that the banks under their jurisdiction are complying with federal laws prohibiting discrimination in the granting of home loans. During the test phase, approximately 300 banks will use a specially designed form in connection with their home mortgage lending activity. The FDIC expects that the new systems of data retention and analysis will provide a reliable indication of where discriminatory lending is taking place and serve as an adjunct to the examination and complaint mechanisms already used by the Corporation.

The GAO report implies that the FDIC has the authority to examine routinely all insured banks, including member and national banks. In point of fact, the legislative history of the Federal Deposit Insurance Act of 1950 quite clearly indicates that the intent of Congress was to circumscribe the FDIC's examination of member and national banks in the following manner (H.R. Rep. No. 3049, 81st Cong., 2d Sess. 3 and 4):

> "In providing direct authority to the Corporation to make a special examination of any national bank, District bank, or State member bank, the conferees were firmly of the opinion that such authority is not to be utilized by the Corporation to embark upon a program of regular

> periodic examinations of such banks, which would only result in a needless duplication of effort. Such special examination authority is to be utilized by the Corporation only in a case where, in the judgment of the Board of Directors, after a review of the Federal Reserve or Comptroller of the Currency examination reports, there are indications that the bank may be a problem case, or that it is in a condition likely to result in loss to the depositors or to the Corporation."

Unless otherwise directed by Congress, the FDIC feels constrained to exercise its examination authority in accordance with the above statement of Congressional intent. In addition, the further implication in the GAO report of overlapping examination authority having to be parceled out through voluntary agreement between the three agencies is not, at least with respect to the FDIC, completely accurate.

The GAO report lists four criteria for scheduling examinations. We simply note in passing that the list of criteria for scheduling examinations fails to mention the primary criteria employed by FDIC, namely the overall condition, compliance posture, and needs of the bank about to be examined.

The following comments are directed to the statements in the GAO report relating to Electronic Data Processing (EDP) matters:

The FDIC has recognized the need to devote additional attention to EDP operations and to expand EDP expertise within our examiner and supervisory staffs. Efforts are continuing to develop more EDP field examiners and provide an interim career path position for a select cadre of our commercial examiner force. While our commercial examination effort addresses all aspects of bank

EDP, including the developments in electronic funds transfer, we also recognize the need for the development of EDP expertise in trust operations and will be devoting attention to that area during 1977. We are planning to provide EDP review examiner positions for each of the 14 Regional Offices, as appropriate, to accommodate EDP examination needs.

The Corporation offers an introductory course in EDP for assistant examiners, entitled Course in Examining a Computerized Bank-I (CECB-I), which is designed to prepare them to evaluate EDP input/output controls and reconcile the automated applications to the general ledger control accounts. Approximately 150 FDIC assistant examiners are processed through this school each year. In addition, a Course in Examining a Computerized Bank II (CECB-II) is offered for senior assistant and commissioned examiners to train them in basic automation concepts and computerized examination techniques. Approximately 125 examiners complete this course each year. Finally, an eight-week advanced course entitled Field Examiner Advanced Automation Training (FEAAT) was commenced in 1974 to provide in-depth technical training in EDP matters. Through 1976, 59 examiners have completed this course and two sessions have been scheduled for 1977 for approximately 28 more examiners. Accordingly, all of the FDIC's EDP training needs are provided in-house.

The FDIC has developed and implemented an instalment loan retrieval package for the use of examiners in conducting examinations. This package not only eliminates menial data-gathering

efforts and saves considerable manhours, but it has improved the quality of examinations, uncovering some practices which may have gone undetected heretofore. Further, during 1976 three other deposit EDP capabilities were added to the examiners' software package and a mortgage loan capability will be implemented early in 1977. Other applications of EDP for use in conducting examinations are in various developmental stages and software will be considered for trust examinations during 1977.

EDP techniques and capabilities are also being used within the Washington Office to seek and project solutions to problem and failing bank situations.

While it is true that many banks do not have enough data processing activity to justify purchasing an in-house computer and satisfy their data processing needs through contract servicers, a number of small banks have acquired so-called mini-computers and perform their own data processing on-premises. The evaluation (examination) of contract servicers presents no unusual problems for our trained EDP examiners and the evaluation procedures employed parallel those used for bank-operated data centers. However, the evaluation of mini-computer operations presents unusual control considerations and our experience in this area has not matured. We are continuing in our efforts to develop a sound examination approach in this area.

The Division of Bank Supervision Manual of Examination Policies, Appendix C, provides guidance for the preparation of EDP

checklists, questionnaires, summary comments and report of examination treatment for banks with their own computers. Memorandums to Regional Directors, EDP examiner conferences, and EDP seminars provide communication and input for the redesign of examination practices and training courses. Each Region adopts its own EDP examination program and some variance does occur, depending on the EDP sophistication found in the banks supervised. The provisions for the interim EDP examiner career path and EDP review examiner positions for each of the Regions during 1977 should result in improved examination efforts as the circumstances and need dictate.

The average number of man-days per EDP evaluation in 1975 was 3.9 and year-to-date 1976 is 4.1. Our experience indicates that Regional Offices with the more sophisticated banks tend to devote more manpower to EDP evaluations and to develop more expertise in EDP matters than Regional Offices with less sophisticated banks. Further, it seems, within certain limits, the more knowledgeable the EDP examiner, the more time expended in conducting evaluations.

The FDIC furnishes the results of data center evaluations to the bank's management or to the independent data servicer of a state nonmember insured bank. Where a data center evaluation is conducted as part of a bank examination, the findings of the evaluation are incorporated into the report of examination. Where the data center evaluation is conducted independently of a bank examination, the findings are transmitted under separate cover. These evaluations findings may consist of the EDP examiner's

summary comments with or without the questionnaire. Where the questionnaire is included, appropriate explanation is provided to ensure that the reader understands that a negative response to a particular question does not necessarily constitute an unsatisfactory finding with respect to that part of the EDP operation covered by that section of the questionnaire. Our experience indicates that many data center managements have requested the entire questionnaire for their review and we feel that it serves as a useful educational tool for management. However, the questionnaire is viewed by the FDIC as a formal workpaper. The results of an evaluation of servicer data centers are available to serviced state nonmember insured banks on request or at the option of the Regional Director without any request. They are also available to any other federally insured serviced institution upon request. All data center evaluation reports developed by the FDIC are considered to be confidential and the property of the FDIC and appropriate statements to that effect accompany each such report released.

The creation of EDP review examiner positions at the Regional Office level should provide the capacity to communicate more effectively with all data centers and help to achieve more uniform correction of operational deficiencies.

Recommendation (page 4-7)

Therefore, we recommend that the Board of Directors, FDIC, the Board of Governors, FRS, and the Comptroller of the Currency establish scheduling policies and procedures which would avoid setting examination patterns.

FDIC Response

We believe that our recently adopted General Memorandum #1, which has been under consideration and extensively tested for several years prior to adoption, largely satisfies this recommendation. For more extensive comments on our General Memorandum, please refer to our comments on the recommendations contained on page 4-9 of the GAO Report.

Recommendations (page 4-9)

We recommend that the Board of Governors, FDIC and the Board of Governors, FRS adopt flexible policies for examination frequency which would allow them to concentrate their efforts on banks with known serious problems.

We recommend that the Congress amend the National Bank Act to allow the Comptroller of the Currency to examine national banks at his/her discretion. We would be glad to assist the committees in drafting appropriate legislation.

FDIC Response

Although it was FDIC's long-standing policy to examine each bank once a year, it is inaccurate and misleading to suggest that that time-frame was the only guideline used by the FDIC in scheduling examinations, or, to state it another way, that examinations were not scheduled and conducted by the FDIC based upon the "bank's soundness; and the quality of its policies, procedures, practices, controls, audit, and management."

During 1975, FDIC conducted 213 follow-up examinations and a number of on-site visitations at banks presenting either financial or supervisory problems. Further, those banks which were not examined in 1975 largely consisted of banks which would not fall within the one-year time-frame guideline under General Memorandum #1. Although General Memorandum #1 was formally adopted in November 1976 and implemented on January 1, 1977, the concepts and practices embodied in it are not of recent origin. Those concepts and practices have been under consideration at FDIC since

early 1974. Furthermore, the concepts and practices have been experimented with and tested in five of the FDIC's 14 Regional Offices prior to formal adoption of General Memorandum #1. We might add parenthetically that FDIC policy is to experiment on a regional basis with major policy changes before implementation for the entire Corporation.

Accordingly, while the recently issued General Memorandum #1 expresses more definitively that scheduling of examinations is not based on time-frame priorities alone, nevertheless, we feel that the criticism of past scheduling practices expressed in the GAO recommendation is misplaced. The FDIC has followed and continues to follow a policy so aptly stated in the said General Memorandum #1, namely:

> "The first priority has been and will continue to be, effective surveillance and supervision of the institutions which present either supervisory or financial problems."

Recommendations (page 4-13)

We recommend that the Board of Directors, FDIC, and the Board of Governors, FRS, extend their current efforts to use State examinations and, if they do, we also recommend that they

--develop minimum standards for acceptable State examiner training and examination procedures and

--use only reports of State examinations meeting those standards.

FDIC Response

The FDIC has determined that the Experimental Withdrawal Program conducted in three states during the past three years will not be continued in its present form. However, agreement to examine nonproblem banks on an alternate-year basis has already been consummated with one state and the possibility of entering into similar arrangements with other states is being explored. Furthermore, termination of the Experimental Withdrawal Program should not be construed as a decline on the part of the FDIC to cooperate to the fullest extent possible with the various states or to place less reliance on the efforts of the state supervisors. The guidelines set forth in General Memorandum #1 provide a workable framework for increased cooperation with the states. Thus, almost by definition, if the program expressed in General Memorandum #1 proves workable and if a state banking department performs in an acceptable manner, the frequency and scope of FDIC examinations in that state will be reduced.

Recommendation (page 4-17 ~~13 and 4-14~~)

We recommend that the Board of Directors, FDIC and the Board of Governors, FRS, establish procedures to base the scope of each examination on the examiners' evaluation of the quality of the bank's controls, policies, procedures, and audit.

FDIC Response

With respect to FDIC examinations, the findings and conclusions expressed by GAO are not accurate. The primary factor influencing the scope of the examination is not size, but the known history of strengths and weaknesses of the particular institution. Furthermore, FDIC examiners do pre-plan the scope of an examination, by studying applicable files and previous examination reports, and noting any material changes in the management or style of operations since the last examination.

FDIC examiners have in recent years reviewed a bank's internal controls, policies and procedures prior to actual commencement of the examination in order to establish the scope of the examination within the minimum standards prescribed. With respect to smaller banks, however, such a review tends to be less formal, hence harder for GAO to detect than with larger banks. Considerable leeway in this respect is provided for in the recently adopted General Memorandum #1, and we reiterate that these procedures were considered and extensively tested in five of the FDIC's 14 Regional Offices for several years prior to formal adoption.

Recommendation (page 4-19)

We recommend that the Board of Directors, FDIC, and the Board of Governors, FRS, develop standards for the preparation, maintenance, and use of examination workpapers.

FDIC Response

The standards for the preparation, maintenance, use and importance of examination workpapers are included in the course of study at the various schools operated by the Corporation and in our on-the-job training program. The examination workpapers do, in fact, cover a number of items other than the details relating to specific loans and securities in support of comments contained in a Report of Examination. We believe our examination workpapers will permit a determination that appropriate examination procedures have been followed, provide support for the preparation of the Report of Examination, and are utilized at the next examination.

Recommendation (page 4-39)

We recommend that the Board of Directors, FDIC and the Board of Governors, FRS develop reports of examination for EDP operations which present the problems found, corrective action needed and any necessary explanatory data in a clear and concise manner.

FDIC Response

The summary comments page of the FDIC EDP questionnaire provides clear and concise descriptions of the results of a data center evaluation. In our judgment, a new evaluation report is not necessary at this time and our form, if effectively used, is comparable to the new one recently adopted by the OCC. However, we view our questionnaire as a constantly evolving tool which will be revised frequently in order to stay abreast of industry developments and to meet the burgeoning needs of our field personnel. See also our comments regarding EDP evaluation reports included with our general comments.

CHAPTER 5

GAO stated, in relevant part, that:

"The relationship between the frequency with which banks were cited for problems with internal routines and controls and violations of laws and regulations--both of which are related to management effectiveness--and the frequency of criticism of management effectiveness was not what would have been expected."

* * *

"While the examiners frequently cited banks for having problems in two areas indicative of management effectiveness--internal controls and violations of laws and regulations--they did not often criticize management effectiveness. As shown below, management effectiveness was most often criticized in problem banks with less than $500 million in deposits even though 30 to 50 percent of larger banks in the general and problem samples were also criticized for violations of laws and regulations and poor internal routines and controls."

* * *

"Violations of laws and regulations reflect on management's capability."

Generally, the size and character of the operation engaged in by a bank defines the scope and requirements of sound internal controls for that particular bank. Clearly, the internal controls deemed appropriate for a large, sophisticated operation are, in most cases, not appropriate for a smaller, less complicated one. Management is charged with the responsibility of deciding the internal controls best suited for its bank in order to provide adequate protection for its assets and a meaningful flow of information to senior management. Recognizing the practicalities of the situation, FDIC closely monitors the various internal controls

employed by banks und... our direct supervision and our examiner personnel may comment on apparent weaknesses observed. However, if the particular system has worked with reasonable effectiveness for a given bank, is within the general bounds of prudence, and does not constitute an unsafe or unsound practice, corrective measures are not aggressively pursued, notwithstanding the critical comment in the examination report.

Banking is a highly controlled industry and, thus, is subject to a plethora of laws and regulations on both the federal and state levels. It is, therefore, not unexpected that banks will on occasion be found to have violated, intentionally or unintentionally, a particular statute or regulation. It is the job of the bank regulator to consider each violation in terms of whether it was intentional or willful, the consequences flowing therefrom, the likelihood of continued violations, and management's history of compliance and attitude toward taking appropriate corrective measures. Accordingly, if the violation is unintentional or merely technical in nature and not recurring, criticism of management effectiveness would not seem warranted. If otherwise, of course, criticism of management is probably appropriate. In short, in this area as well as all areas of its supervisory responsibility, the FDIC attempts to follow a rule of reason. Overreaction to technical, unintentional violations of law or regulations could, in our judgment, impact adversely on the entire enforcement posture of the Corporation.

GAO stated that:

> "The agencies rarely criticized a bank's loan policies until loan problems developed. For example, if a bank's managers had not adequately diversified the bank's risks, examiners did not criticize the inadequate diversification policy until those lines of credit actually became classified."
>
> * * *
>
> "For example, inadequate loan policies were not cited by examiners until the banks had large amounts of classified loans, as shown by data for banks in our general and problem samples combined."

The FDIC, of course, encourages banks under our direct supervision to adopt sound written loan policies. Furthermore, in virtually every formal enforcement action, FDIC routinely requires the offending bank to provide written loan policies acceptable to the Corporation and the appropriate state authority. However, oversight of a bank's written loan policies does not, and is not intended to, extend to writing the loan policies for the bank or specifically prescribing how, when and to whom the credit facilities of the bank are to be used. We view such action by the FDIC as objectionable on two grounds: (1) as encroaching on management's prerogatives, and (2) perhaps constituting a form of credit allocation. Our task is to review the policies to determine that they are within the bounds of safe and sound banking practices. However, it may be somewhat naive to assume that a review of the written loan policies of a bank will, in most cases, reveal imprudence. Typically, it is the implementation of such policies which generates criticism.

It is not accurate to suggest that the failure to diversify risk is only criticized when "those lines of credit became classified." It is both FDIC policy and practice to comment on a failure to diversify (concentration of credit) without regard as to whether or not the assets involved have been adversely classified. The Division of Bank Supervision Manual of Examination Policies states in relevant part:

> "...the inclusion of a concentration of credit in a report implies criticism of a bank's policies amenable or susceptible to management control." (Section H, page 6, paragraph IV. C.)

GAO note: Omitted comments pertain to material in the draft report but omitted from the final report.

CHAPTER 6

The thrust of Chapter 6 may be summarized as follows: examiners seldom meet with bank directors, the examination reports do not convey the bank's problems in a clear and concise manner to the directors, and the material in the confidential section should be furnished to the banks. The recommendations are that the FDIC and the FRS require examiners to meet with the directors or audit or examining committee after each examination and that the FDIC and FRS develop and use reports of examination "which provide the banks with the results of the examination and any necessary supporting information." As we view it, the implication is that FDIC and the FRS redesign the report of examination along the lines of the OCC's new format.

We believe that the statements and recommendations stem from a misconception, or perhaps a misunderstanding, of the policies and practices of the FDIC in the matters covered in Chapter 6. The following responses to the GAO recommendations represent a brief summary of the FDIC's policies and practices, and efforts to improve those policies and practices, regarding the supervisory areas dealt with in Chapter 6.

Recommendation (page 6-5)

Therefore, we recommend that the Board of Directors, FDIC, and the Board of Governors, FRS require their examiners to meet with the bank's board of directors or audit or examining committee after each examination.

FDIC Response

FDIC conducted approximately 7,900 examinations in 1975. Senior officials from the various Regional Offices met with bank management on approximately 1,750 occasions, representing 22% of all examinations. Throughout 1975, there was an average of 224 banks under our supervision which were formally designated as financial problems. FDIC policy is to meet with bank directors at least where problem situations exist.

FDIC staff has in the past year been reconsidering the question of how often meetings with bank directors should be held. In consideration of this subject, the responsibilities of bank directors, the Corporation's responsibility to bank directors, and our past and present practices in holding board meetings were weighed.

In a broad sense, the board of directors of a bank is responsible for the formulation of sound policies and objectives of a bank, the effective supervision of its affairs, and promotion of its welfare. In discharging these responsibilities, a director's duty is to exercise due care or be exposed to a charge of negligent performance of his duty.

To insure that bank directors are aware of the contents of examination reports, the Corporation requires that a receipt accompanying each report be signed by the bank's executive officer stating that the report "...was duly considered by the directors...and a record of the action taken thereon by the Board has been entered in the minutes." Moreover, at each examination, the examiner is charged with the responsibility of determining that the bank's board minutes reflect a thorough consideration of examination reports and correspondence received from supervisory authorities since the last examination.

To enable bank managements to begin work on problem areas prior to receipt of the completed examination report, a list of adversely classified assets and other major criticisms is provided to the executive officer at the completion of each examination and most of the FDIC Regional Offices have implemented deadlines for receipt of completed examination reports in the Regional Office--usually 10 calendar days after the close of the examination.

The FDIC Manual of Examination Policies states, with respect to examiners holding meetings with directors (Section Q, page 3, paragraph I.E.):

> "Except in instances where authority has been delegated by the Regional Director, the Examiner should consult with the Regional Office before calling a board meeting. Ordinarily, meetings with the board of directors should be held at the conclusion of all examinations of problem banks. A meeting of the board may also be required when experience and instinct tells the Examiner a likelihood exists that the bank will be added to the problem list or will be earmarked for other special supervision. Additionally, where there is a substantial volume of classified assets, low capital or other areas of important criticism, a board meeting may be desirable. This is particularly true when the trend has been unfavorable and previous admonitions have gone unheeded."

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In keeping with this policy, it is in fact the practice in most regions for the examiner to hold a meeting with bank directors if problems of consequence are found at the examination, or if significant adverse trends are noted since the last examination. In virtually all instances involving problem banks, a representative from the Regional Office will meet with the directors, and in most cases an invitation is extended to the state authority to participate in the meeting.

The FDIC is cognizant of the benefits flowing from more frequent meetings with the boards of directors of banks under our direct supervision and anticipates holding such meetings with increased frequency in the future. We are also actively reviewing the posture of the FDIC in this regard with a view of improving upon the timeliness and conduct of such meetings.

Recommendation (page 6-10)

We recommend that the Board of Directors, FDIC, and the Board of Governors, FRS, develop and use reports of examination which provide the banks with the results of the examination and any necessary supporting information.

FDIC Response

FDIC conducted an intensive study in 1965 to assess the impact of its examination report on banks. As a result in 1969, a new examination report format was put into use. We believe this report format, and the guidelines under which it is used, provides a clear, concise picture of problem areas to bank managements. Various FDIC staff members have attended familiarization sessions on the OCC's new examination report format. The OCC has tested his new format in only ten banks and the impression of the FDIC staff members is that the report format is somewhat cumbersome, especially in problem situations.

There appears to be some misunderstanding with respect to the purpose and thrust of the confidential (supervisory) section of the report of examination. The purpose and thrust of the confidential section are to allow the examiner to comment on matters uncovered during the course of the examination which may not lend themselves to complete substantiation, but which may serve to alert his superiors that further investigatory or supervisory efforts may be necessary. For obvious reasons, such material is not, and should not, be provided to the management of

the bank. However, a thorough study of the role and use of the confidential section was started some months ago and, when completed, will probably result in significant changes in its thrust, format and content, or in its elimination.

CHAPTER 7

As is indicated in the FDIC comments to the recommendations made by GAO in this chapter, we view the impact of the changes in the FDIC examination process set forth in General Memorandum #1 as significant and vital to an understanding of the Corporation's examination philosophy and practices. We believe the entire General Memorandum should be included in the GAO report. However, in the absence of that we offer the following excerpts from General Memorandum #1, with emphasis added:

> "The first priority has been, and will continue to be, effective surveillance and supervision of those institutions which present either supervisory or financial problems."

* * *

> "Emphasis at these modified examinations should be placed on management policies and performance; the evaluation of asset quality, alignment and liquidity; capital adequacy; and, compliance with applicable laws and regulations."

> "In those banks with assets of $100 million or more, all report schedules which are presently in use and are applicable to the given bank will continue to be included in the examination report. Where the fixed asset investment is moderate in relation to capital, there are no statutory violations with respect to fixed assets, and absent other problems of significance, fixed asset schedules may be omitted from these examination reports. Further, examiners are instructed to assess the quality of management systems and reports as well as audit and control functions, and where it is permissible to do so without compromising the integrity of the examinations, utilize the output of those systems. Cash counts and proof and verification procedures may be omitted in those banks where it is appropriate to do so, and branch offices which do not have a significant volume of important assets need not be examined; however, in the latter instance, conditions at these offices should be reviewed with management prior to the conclusion of the examination."

"If believed desirable in the opinion of the Regional Director, simultaneous examinations may be arranged of all closely related banks or subsidiaries of bank holding companies, requiring coordination with other bank regulatory agencies. The type of examination employed in each bank at simultaneous examinations will be at the discretion of the Regional Director unless precluded by the guidelines for modified examinations."

* * *

"It is expected that the Corporation's automated bank examination programs and monitoring systems will be used wherever possible in an effort to provide increased efficiency and conserve manpower. This use should include the scheduling of examinations as well as their conduct. Further, sampling techniques should be used wherever possible."

"It is expected that visitations will be frequently used as an investigatory and supervisory tool for those banks which show adverse trends, either at examinations or through a monitoring system, and to gauge compliance with provisions of cease and desist orders. Further, visitations subsequent to management or ownership changes should be used to assess the attitudes and abilities of the new management/ownership if the principals are not already known to the Regional Office."

"In addition to the required periodic examinations, it will be the policy to conduct a visitation at each new bank quarterly during the first two years of operation (visitations need not be held during the quarter in which an examination, either by the Corporation or the state authority, is conducted). The purpose of these visitations is to gain some measure of the performance of management and the direction in which the bank is headed. At the discretion of the Regional Director, findings of the visitation may be reported in either memorandum form or examination report format."

The GAO comments on the status of monitoring systems in the Office of the Comptroller of the Currency and in the Federal Deposit Insurance Corporation set forth in chapter 7 of the report have served a useful purpose in that they focus on an aspect of bank supervision which has grown in importance in the recent past few years and may be of even greater importance in the future. Some clarification is needed of the fundamentals

of analysis of bank reports, of the various systems which have been developed to facilitate such analysis for supervisory purposes, and of a framework for evaluation of the efficiency of the programs. For purposes of illustration, the following comments are based upon a comparison of the National Bank Surveillance System (NBSS) and the systems in use at FDIC.

a) An essential element of any monitoring system is a data collection system. The quarterly Reports of Condition and the quarterly, in the case of large banks, and semi-annual, in the case of smaller banks, Reports of Income comprise the primary data base for both the NBSS and the FDIC systems. Data from reports of examination are important supplements to the data base; at the present time FDIC probably relies more heavily than the NBSS on this source of information. Obviously, a monitoring system that depends on regular financial reports submitted by banks is only as good as the information in the reports. The information items must be meaningful; they must be accurate; and they must be available on a timely basis. Given that the OCC and the FDIC use the same format of the Reports of Condition and Income, their divergence appears to be in the areas of accuracy and timeliness.

The OCC has put into effect an editing system which requires less stringent tests for mathematical accuracy and internal consistency in the national bank reports than that used by the FDIC in processing reports for all insured banks. FDIC

has worked from another angle. The Corporation has begun to levy fines on banks that get their reports in late. All three federal bank regulatory agencies have cooperated in an effort to upgrade the quality of the bank reports so that less correction and revision are required; clearly much more needs to be done. While this process is moving forward, both the OCC and the FDIC have had to modify their analytical systems in order to utilize bank reports that are sufficiently accurate for monitoring purposes.

b) Another essential of a monitoring system is a computer based program that compiles individual bank ratios of balance sheet and income and expense items and compares the ratios of each bank with the same ratios for comparable banks. Most monitoring systems use a technique known as "outlier analysis," flagging banks if its ratios deviate substantially from the average of ratios for comparable banks. The presumption is that such analysis can provide clues as to banks with financial problems, current or prospective.

In a banking system as diverse as that in the U.S., differences in operations among banks can be expected to be substantial. A very large money market bank's ratios may appear to be unusual or atypical of averages based upon ratios for all the banks, large and small. When its ratios are compared with those of banks of comparable size, doing a comparable business, i.e., ratios of its "peers," such a bank may not be atypical or an outlier.

Neither the OCC nor the FDIC could afford to wait for the completion of definitive studies on how to sort banks into peer groups. Such work is continuing on a theoretical level as well as on an empirical level. Currently, however, the OCC has established peer groups on the basis of bank asset size.

At FDIC, the effort has been made to allow the Regional Director to specify the banks within his region that are "peers." For analytical purposes of the Washington Office staff, peer groups have been defined primarily on the basis of asset size of bank within Region or state.

With the large number of items in the Reports of Condition and Income and the frequency with which such reports are filed, the number of ratios that can be constructed for a particular period or as measures of change between periods is extremely large. Selection of the key indicator or indicators has consumed a considerable amount of time at FDIC. One approach, the Early Warning System (EWS), examined literally hundreds of ratios to determine which were the best discriminators between known problem banks and control groups of banks with no known serious problems. The result was a winnowing down to 7 ratios, 2 based upon income and expense items and 5 based upon balance sheet items. EWS is run annually to produce a list of banks whose seven ratios indicate the similarity to banks with known problems. A second approach (JAWS) selected 6 ratios (plus an additional 2 for large banks)

which have proven to be indicators of basic changes in a bank's operations. These indicators have been incorporated into on-line system available in the Regional Offices which flags banks with ratios atypical of peer group averages, and displays five important ratios based upon the latest report of examination of each of these banks.

The OCC system includes certain ratios which have been designated as "key indicators," i.e., that provide the best general measures of unusual or changed circumstances in a bank. The process is sequential in that analysis of banks with atypical values for key indicators is extended to additional financial ratios that round out the picture of a bank's condition in the critical area.

c) A third essential element of a monitoring system is the development of a method for evaluating its effectiveness or results.

The crux of the monitoring systems is the review of the output of the computer based systems by trained financial analysts and the FDIC has been using experienced examiners in this important function who have flagged "watch lists" of banks which should be examined earlier or more often than other banks. In the final analysis, however, no monitoring system has yet been developed which is 100% efficient in signaling banks with unusual problems.

Thus, some flagged banks turn out, on further analysis, to be perfectly sound while some banks with serious problems are not flagged. Presently, the most any system does is suggest that a bank examination should be scheduled and the aspect or aspects of a bank's operation which requires special scrutiny.

d) The fourth or final element of a monitoring system is implementation. At the present time, the monitoring exercise leads up to an examination of banks singled out by the financial analysts. Optimally, the examiner receives a profile of the bank to be examined and a blueprint of the areas to be focused on with the most care.

The GAO report states, in essence, that the FDIC has recently established trust examiner specialist positions. Although the FDIC historically was the only one of the three federal bank regulatory agencies that did not designate trust examiner specialists as such, some FDIC bank examiners devoted a major portion of their examining time to trust work. However, it is correct that the FDIC has now established 14 trust examiner specialist positions and is in the process of filling these positions.

Recommendations (page 7-25)

We recommend that the Comptroller of the Currency invite FDIC and FRS to jointly evaluate its new examination approach. We further recommend that, in the event of a favorable assessment of the new process, the Board of Directors, FDIC, and the Board of Governors, FRS revise their examination processes to incorporate the concepts of OCC's approaches.

FDIC Response

In light of the limited testing that has been conducted (10 banks) of the OCC's new process, we believe it is premature to consider that process a success either for large or small banks. Representatives of the OCC admitted that, while the new procedures are workable in banks with assets between $50 million and $1 billion, they do not appear feasible for banks with assets of less than $25 million. We therefore question the logic and wisdom of GAO's recommendation that FDIC adopt such process, either for the large or small banks under our direct supervision, especially when it is recalled that 91% of the banks we directly supervise have assets of less than $50 million and 77% less than $25 million. Since the number of large banks directly supervised by the FDIC has and continues to increase, our examination process is necessarily designed to handle small, medium and large-sized banks. However, we shall follow closely OCC's experience with the new examination process as it undergoes further testing, and we remain receptive to further revision in our own examination approach which will be beneficial to and improve our supervisory capabilities.

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In our judgment, the discussion of changes in FDIC's examination approach does not reflect sufficiently the impact and significance of those changes, especially with respect to our review of the management policies and internal controls of a bank under examination. We believe that the changes made by the FDIC represent, at the present time, the most logical, beneficial, and prudent improvements in the examination process. We have blended the proven techniques and practices with a new approach which we feel should enable FDIC to focus more directly on, and devote more time and effort to, problem and near-problem situations, and concomitantly less on healthy banks. We refer to excerpts from our General Memorandum #1, included with our general comments.

Recommendations (page 7-25)

We recommend that the Board of Directors, FDIC, the Board of Governors, FRS, and the Comptroller of the Currency jointly staff a group to analyze shared national credits at State and national lead banks under Federal supervision and that the three agencies use the uniform classification of these loans when they examine the participating banks.

We recommend that the Board of Directors, FDIC, the Board of Governors, FRS, and the Comptroller of the Currency work together to refine their monitoring systems and their approaches to examining for compliance with consumer credit laws.

FDIC Response

Although--as the GAO report points out--of the 183 participations in shared national credits traced by GAO only 19 were to state nonmember insured banks, the FDIC is now a participant in the Shared National Credits Program.

We are, of course, in favor of the three federal bank regulatory agencies sharing and working together in the important area of consumer credit compliance. However, in many instances healthy competition in the area of consumer credit compliance as well as in other areas of banking supervision between the three federal bank regulatory agencies can lead to a better system of supervision than complete uniformity. Thus, the development of an independent approach by one or more of the agencies may lead to a better end result.

CHAPTER 8

Our comments here cover the general theme of the chapter, namely the supervisory and enforcement practices of the three agencies and their "problem bank" criteria. We feel discussion of these vital subjects is desirable in order to place them in their proper perspective.

The FDIC serves the dual roles of bank supervisor and insurer. Accordingly, the FDIC "problem bank" definitions are based on those banks which pose the greatest degree of financial risk to the Corporation, with fine tuning of the designations into various gradations of risk. The three problem bank categories used are analagous to the three adverse classifications of Substandard, Doubtful, and Loss which the federal bank regulatory agencies utilize to designate assets of greater than normal risk.

There are no simple mechanical formulae that can be universally applied to determine whether or not an operating bank warrants FDIC problem bank status. Indeed, we believe a problem bank designation should only be imposed on a case-by-case basis after a comprehensive, in-depth analysis of the entire bank. Among the more important elements requiring analysis and evaluation are asset quality and liquidity, the margin of capital protection, the degree of stability or volatility in the bank's liability structure, the character and ability of its management, the bank's earnings performance, and its adherence to applicable laws and regulations. These elements are closely interrelated and, depending on the circumstances, each element may be

weighted differently. Accordingly, the FDIC disseminates general criteria--not specific guidelines--for the designation of problem banks to our Regional Directors in order to encourage independent judgment and provide some flexibility to meet the new areas of regulatory concern as they arise. The Washington Office of the Division of Bank Supervision then applies more standardized analysis and evaluation to the recommendations of our Regional Directors before determining whether to add a particular bank to or delete it from our list of problem banks. The listing themselves are not subject to approval by the Corporation's Board of Directors, although the Board regularly receives extensive information about all problem banks and may be directly involved in the imposition and enforcement of a corrective program with respect to particular banks.

FDIC also reviews examination reports of the FRS and the OCC, assesses the risk exposure which the banks examined by those agencies pose to the deposit insurance fund, and, where appropriate, designates state member and national banks as Other Problem, Serious Problem or Serious Problem-Potential Payoff. Although FDIC does not directly supervise these banks, we do follow closely the supervisory efforts of the other agencies, largely because of our financial stake in the outcome.

It should be noted that, with respect to banks under the direct supervision of the FDIC, an inferior financial condition is not the sole cause for more intense supervisory activity. Causes for concern

may be reflected in violations of laws or regulations, marginal management and policies, or a subpar financial condition which had not yet reached a level presenting an undue risk to the FDIC fund, and thus, does not warrant a formal prolbem designation. For example, the various Regional Offices maintain informal listings of banks which pose supervisory--but not financial--problems, and the Washington Office uses a computerized screening device which serves as an additional test for uncovering financial as well as non-financial supervisory problems.

The fundamental approach of FDIC to banks exhibiting supervisory problems or trends in that direction is to exercise preventive measures, that is to take necessary and appropriate measures early enough to keep the bank from deteriorating to a level requiring the assignment of a formal problem designation. As the GAO report points out, informal methods are generally relied upon, and experience indicates that these methods have largely been successful. One of the more useful methods of informal supervision which FDIC frequently employs has been effectively overlooked or ignored in your report. The method we refer to involves the use of the so-called "Letter Agreement." The Letter Agreement is used by our Regional Directors following an examination to confirm with bank directors a program which the Regional Director feels will, if adhered to, correct the situation. The Letter Agreement is not intended, and is not used, as a substitute for a formal written agreement entered

into under Section 8 of the Federal Deposit Insurance Act or cease and desist or termination of insurance proceedings, although the letter agreement may serve as a basis for such subsequent action. Its use is generally confined to corrective measures agreed to by a bank's board of directors when a bank first shows problem or near problem characteristics.

In addition to the foregoing, the GAO report discusses the use of termination of insurance proceedings and states, in part, that canceling "a bank's deposit insurance does not solve its problems."

While this statement is perhaps literally true, it could be misleading. Termination of insurance authority has, through the years, proven to be an effective and useful remedial enforcement tool. The threat of instituting and the institution of such a proceeding has, in the vast majority of cases, been the vehicle for forcing a recalcitrant and/or poorly managed bank to take effective corrective measures.

The table in the report dealing with the GAO sample of 54 FDIC-supervised problem banks shows that a request for a formal response to reported deficiencies was made in 44 of the cases, that progress reports were requested in 41%, that a meeting with the bank's directors was requested in 30%, that there were written communications with 54%, 6% of the banks were visited, and that no credit is given for special examinations. We do not believe that the table presents an accurate picture of FDIC supervisory efforts. In point of fact, the Regional Director transmits a letter to each bank, reiterating the problems

disclosed, and requesting appropriate corrective efforts. Frequently, in the letter to bank management, the Regional Directors request periodic progress reports which often lead to other exchanges of correspondence or meetings with respect to progress, or lack of it, shown in the reports, a board meeting may be scheduled, or visitations or a follow-up examination may be held.

We note that the table shows that meetings with directors were held in only 30% of the banks. It is the FDIC's policy to have a board meeting in all problem situations. As indicated previously, in 1975, conferences were held with the management of banks on approximately 1,745 occasions, and 1,750 in 1976.

The GAO report, among other things, questions whether banks that remain on the problem list for a period of time are indeed problems.

At year-end 1974, 76% of the FDIC supervised banks on our problem list had been on the list for less than two years, and at year-end 1975, 82%. In addition, at year-end 1975 only 16 banks had been on the problem list in excess of three years (out of a total of 8,925 FDIC-supervised banks.) To summarize, some form of formal supervisory action was taken in seven, or 44%, of the sixteen cases and informal supervisory actions achieved improvements in another seven, or 44%, of the sixteen cases. Correction of the problems in the remaining two banks is to a large degree dependent upon improvement in the severely depressed economy of the banks' market area. In calendar year 1976, two of the sixteen banks were rehabilitated and, since they

no longer warranted problem designation, were removed from the FDIC problem list. In addition, two others were removed from the list--one through merger into a healthy institution and the other was closed.

We also note in passing that a limited number of banks may present financial and/or supervisory problems of a continuing nature which, despite aggressive corrective efforts, do not lend themselves to a permanent and wholly acceptable solution. In such cases, the banks are not in serious enough condition to warrant either termination of their insured status or of their charter. It seems clear, however, that these banks should be continued as problem banks and receive special supervisory attention.

Recommendations (page 8-~~20~~ 15)

We recommend that the Board of Directors, FDIC, the Board of Governors, FRS; and the Comptroller of the Currency establish more aggressive policies for using formal actions. Written guidelines should be developed to identify the types and magnitude of problems that formal actions could appropriately correct.

FDIC Response

Congress granted cease and desist powers in 1966 with the enactment of Section 8(b) of the Federal Deposit Insurance Act. For several years thereafter, there was some reluctance to utilize Section 8(b) powers due mainly to a general misunderstanding of its purpose and usefulness. Prior to enactment of Section 8(b), the FDIC's only experience with formal administrative corrective measures was the termination of insurance proceedings, a severe form of action which could result in the removal of the deposit insurance coverage of a bank. Because of its severity, the Section 8(a) proceeding was used judiciously and only after all other means for accomplishing correction were exhausted. Apparently, albeit erroneously, that same rationale was largely applied to Section 8(b) proceedings. In addition, there was to a lesser extent an unwillingness to try something new. Commencing in 1970, a program to educate FDIC personnel as to the usefulness of Section 8(b) action was begun. The FDIC first used its cease and desist authority in 1971 and between 1971 and 1975 issued 38 cease and desist orders and three formal written agreements. In contrast, in a recent renewed effort to

foster the use and to test the effectiveness of cease and desist powers, in calendar year 1976 alone FDIC issued 24 such orders and five emergency orders. In addition, at year-end 1976, 18 more cease and desist actions were in various stages of process.

While cease and desist action is in most cases effective as a corrective measure, there are some instances where it may be of little or no use and could perhaps be counterproductive. For example, the recently experienced worst economic period since the great depression caused severe problems to the banking industry, many of which did not lend themselves to correction through use of the cease and desist powers. In short, it is not a panacea for the removal of all problems experienced by the banking community.

The recommendation for adoption of criteria for use in formal actions, contained in the last sentence of the recommendation, is troublesome. We would recommend against adopting formal criteria for use of Section 8, because the statutory criteria are adequate. The facts and circumstances of bank problems seem so varied, and the remedial actions can differ so much according to the problem, it would be inhibiting to have to work within the confines of additional written criteria. The adoption of such criteria could give the banks additional bases for contesting Section 8 actions.

Recommendation (page 8-49)

We recommend that the Board of Directors, FDIC, the Board of Governors, FRS, and the Comptroller of the Currency develop uniform criteria for identifying problem banks.

FDIC Response

We believe our general comments clarify the posture of the three federal bank regulatory agencies with respect to problem banks, including those which pose supervisory problems as well as those which present inordinate financial risk to the FDIC. Moreover, we do not believe there is confusion or wide disagreement among the bank regulatory agencies as to which banks should be accorded close surveillance and supervision by the respective agencies and that, except in a failing bank, and to a limited extent in a bank holding company situation, there is virtually no overlap of regulatory jurisdiction at the federal level. Furthermore, the need to develop common criteria for problem banks is not obvious and indeed may not be appropriate.

It is, we believe, appropriate and useful for the FDIC as an insurer to view what constitutes a problem bank from a somewhat different perspective than the other two federal bank regulatory agencies. In addition, the extent to which the three federal bank regulatory agencies use somewhat different approaches to the issue of banks in need of increased and intensified supervision could foster a greater degree of innovation in this area of supervisory endeavor and could serve as a

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check and balance in the promotion of the widest coverage of such banks. Finally, the objectives and detached review process conducted by FDIC of all types of examinations, in order to assess the degree of financial exposure to the insurance fund, provides an overall review of all banks without imposing across-the-board guidelines which may not be suitable for the three agencies on an individual basis.

CHAPTER 9

The GAO report states:

"A recent FDIC study of 92 banks that failed between 1960 and September 1976 showed that 57.6 percent were caused by improper loans to officers, directors or owners, or by loans to out-of-territory borrowers...."

The experience noted above led to the issuance by FDIC in 1976 of a regulation entitled "§337.3 Insider Transactions," as part of the Corporation's "Unsafe and Unsound Banking Practices" regulations.

CHAPTER 10

The following is a brief summary of the operation of the FDIC Training Facility:

The Division of Bank Supervision (DBS) Training Center located in Rosslyn, Virginia, was established in February 1970 and presently has a permanent staff complement of seventeen. The training programs which it conducts are directed toward achieving professional proficiency and the maintenance of a highly qualified bank examination staff.

Career training is accomplished, in balance with field examination experience, primarily through our bank examination schools which are comprised of seven different schools or courses of study. Each school has a duration of two to three weeks. Subject schools include the basic examination schools: School for Assistant Examiners, designed for newly employed examining personnel; the School for Senior Assistant Examiners, which provides training in accounting, EDP, and consumer protection laws; the School for Examiners, which is designed for the development of the commissioned examiner; and the Basic Trust School, which deals with the basics of trust department examination. In addition, more senior training is provided through the Advanced Trust School, the Course in Examining a Computerized Bank, and the School for Commissioned Examiners. Subject matter within the various bank examination schools is well structured both with respect to material to be covered in the daily presentations as well as the pre-course study expected. Students ordinarily spend eight hours a day Monday through Friday in classroom and related work.

During the six-year period 1970 through 1975, 189 school sessions were held involving nearly 5,100 students. For the 1976 school year, we held 46 school sessions with approximately 1,200 students attending. Training is directed primarily towards FDIC personnel. However, during the period 1970 through 1975, training was provided for 549 state bank examiners, 28 students nominated by foreign government banking authorities, and 13 FRB examiners. The related figures for 1976 are 157, 22, and 7, respectively.

An additional and important operation of the Training Center is the Progress Evaluation Program for senior assistant examiners who are being considered for career advancement to the status of commissioned examiner. This program assesses a candidate's knowledge and proficiency in rules, regulations, and policies; loan analysis; and development of conclusions and recommendations after review of a report of examination. The program includes both written and oral portions. Findings of the progress evaluation are weighed as one of several factors in considering a senior assistant examiner for promotion to commissioned examiner status. Between 100 and 200 such candidates are evaluated annually. The evaluation utilizes a three-member panel of examiners over a three-day period for each candidate.

Recommendation (page 10-6)

We recommend that where feasible the Comptroller of the Currency; the Board of Directors, FDIC; and the Board of Governors, FRS, combine their examiner schools and standardize their curriculums.

FDIC Response

Although we find the comments and recommendations contained in the report on examiner training provocative, on balance we believe they did not afford sufficient treatment or depth to the various examiner training and educational programs offered by the FDIC.

We are especially dismayed by the fact that the GAO study largely ignores the operation of the FDIC Division of Bank Supervision (DBS) Training Center. The FDIC Training Center is undoubtedly the best bank examiner training program in the country. Nevertheless, because of our burgeoning training needs, the FDIC is considering constructing its own, larger facility with resident dormitory quarters. The FDIC has approached the FRS and the OCC to join with the Corporation in a cooperative training facility. Both the FRS and the OCC have evidenced interest in this project and discussions on a cooperative training effort are going forward. A brief summary of the operation of the FDIC DBS Training Center is included with our general comments.

Recommendations (page 10-11)

We recommend that the Board of Governors, FRS, (1) establish a full-time training office to operate its examiner training program and (2) carry out the revision of examiner school curriculums which it has recognized as needed for sometime.

We also recommend that the Comptroller of the Currency; the Board of Directors, FDIC; and the Board of Governors, FRS; increase their training in EDP, law, and accounting, as desired by their examiners.

FDIC Response

We plan to give further attention to this apparent need. It is worth pointing out in passing, however, that, at least with respect to EDP training, in addition to the regular basic EDP courses (Course in Examining a Computerized Bank (CECB) I and II), an advanced eight-week technical EDP school, known as Field Examiner Advanced Automation Training (FEAAT), is presently offered to examiners who have a desire to become highly proficient technically in EDP matters.

CHAPTER 11

The GAO report indicates that a cooperative effort among the federal bank regulatory agencies in the development of monitoring systems may have "speeded development" and mentions the need for continued coordination.

Each agency is in the process of developing or has developed monitoring systems and each has learned from its own experiences. We agree that there should be coordination among the agencies in these efforts and would point out that a significant amount of sharing and exchange of concepts and ideas has already been effected. However, as pointed out previously, there is also merit to the three agencies developing systems independent of one another. Innovation is fostered and a healthy competition to have the best system available could be beneficial to all the agencies. In addition, although the major objectives of the three federal bank regulatory agencies are similar, there are unique characteristics of each which may render the development of a system common to all inappropriate. While we do not presume to comment on the unique needs of the OCC and FRS, central to the FDIC's needs is the development of a system to cope with the substantial number of small and medium sized as well as a significant number of large sized banks under our direct supervision. Thus, in the case of FDIC, a system that is sufficiently flexible to meet the needs of supervising large sophisticated banks, as well as smaller less complicated banks, is apparently what is required.

Of course, adequate staffing and gathering accurate data on a timely basis are two vital elements in the development, implementation, and maintenance of any monitoring system. The FDIC is moving forward in its efforts to satisfy these essential elements. Finally, FDIC has, in the main, completed the testing phase of our monitoring systems and is in the process of integrating them into our examination process.

The GAO report states that an OCC official indicated that the interagency system for processing bank data was inadequate because banks were not meeting established reporting deadlines and FDIC took approximately four months to keypunch and computer-edit the system.

The FDIC does maintain the bank reported financial data for all insured banks supervised by the OCC, FRS and FDIC. Data submitted by the national and state member banks are initially processed by the FRS and submitted to the FDIC for edit testing and acceptance into the finalized data base from which all of these agencies draw information. The OCC is correct in asserting that the FDIC has taken up to four months to process all of the reports from some 15,000 insured banks and to produce a final data base. However, delays in receipt of correction data from the OCC and FRS where edit tests have failed on banks under their respective supervision have been a major factor in the finalization of the data base. Efforts are being made to

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obtain agreement among the agencies on edit-check criteria so that corrections can be made on a more timely basis.

In order to meet both the monitoring and other needs dependent on bank reported financial data, it would, of course, be to the benefit of all agencies to derive a set of editing criteria which would produce an acceptable financial data base with greater alacrity.

Recommendation (page 11-8)

We recommend that either (1) the Board of Directors, FDIC; the Board of Governors, FRS; and the Comptroller of the Currency jointly establish a more effective mechanism to combine their forces in undertaking significant initiatives to improve the bank supervisory process or in attacking and resolving common problems; or (2) the Congress enact legislation to establish a mechanism for more effective coordination. We would be glad to assist the committees in drafting appropriate legislation.

FDIC Response

We recognize the merit of resolving common problems of the three agencies through closer coordination and cooperation. Indeed, there is at the present time a substantial exchange of information between the agencies' headquarters as well as at the field levels. However, if there is any merit to the concept of separate federal supervisory agencies, and to a dual banking system with state and federal supervision of banks, the benefit would seem to be the opportunity to try different approaches and to have a diversity of examination and supervisory procedures. The possibility of useful innovation and improvement in the bank examination and supervisory processes is greater if there are several agencies trying different approaches than if every change in examination methodology required approval of all the agencies. Nevertheless, the possibility of establishing a particular vehicle for the agencies to resolve common problems and take joint efforts in new initiatives will receive serious consideration.

FDIC ADDENDUM

We note that the draft GAO report is silent with respect to the planning and modernization efforts undertaken by FDIC in recent years to keep our supervisory activities abreast of economic, technical, and social developments. We have attached a digest of our planning and implementation of those planning efforts.

In 1965, an exhaustive analysis of the examination and supervision functions of the Corporation, similar in many respects to the Haskins and Sells study of the OCC, was undertaken by a committee of three experienced field examiners who were detailed to the Washington Office. Some of the recommendations flowing from that study were:

- Increased emphasis on examination-by-exception techniques with at least an annual visitation to each bank under our supervision
- Mutual interchange of (non-confidential) data with state banking departments
- The establishment of effective guidelines for the volume of loans which should be analyzed in given bank
- Development of a program of procedural audits of certain banks and furnishing audit assistance by the Corporation to some banks upon request
- Revision of the report of examination to make it more usable to bank managements and the supervisory functions of the Corporation
- Adoption of recommended policies by the Corporation in regard to asset reserves, common capital stock, classification of assets, and utilization of termination of insurance proceedings
- Publication of the Corporation's policies
- Limitation of field investigations of statutory applications to those which are of significance in respect to competitive and bank soundness considerations
- Development of more efficient application and investigation forms

- Streamlining and expediting of application processing within the Corporation
- Delegation of authority to the Regional Directors for acting on certain statutory applications
- Restructuring of the geographic and managerial composition of the Regions
- Internal revisions designed to follow a specialized, functional approach promoting better communications and training
- Utilization of automated systems to aid in scheduling examinations, the review of examination reports, and gathering information in connection with statutory applications
- Expansion of EDP training programs, and the selection and training of examiner personnel in the managerial aspects of computer operations
- Strengthening of requirements for commissioned examiners as well as revisions of the centralized evaluating process
- Expansion and intensification of training of examiner personnel, including the executive levels
- Conducting periodic staff meetings to include both Regional and Washington Office senior personnel
- The interchange of senior examining personnel with other Federal agencies for short periods of time
- The revision and enhancement of expense allowances for travel and relocations.

Long range planning programs have been continuous since the 1965 study. The Projects and Planning Branch of the Division of Bank Supervision was established in 1971, and the Board of Directors created the Office of Corporate Planning in 1974. Developments at the Corporation within the past five years or so, flowing from planning efforts, and paralleling recommendations in the Haskins and Sells study, include:

- Implementation of completely revised examination report formats for commercial banks (late 1969) and mutual savings banks (late 1972)
- Development in 1970 of an extensive training center for our personnel as well as those of the Federal Reserve, Comptroller, State Banking Departments, and some foreign students
- Reorganization of the Washington Office of the Division of Bank Supervision along functional lines and the addition of a legal counsel to our Regional structure in 1971
- Extensive revision of the Manual of Examination Policies was begun in 1972
- New forms for filing and investigating statutory applications were developed and implemented between 1971 and 1973
- Delegation in 1973 of specifically defined authority to the Regional Directors for approval of all statutory applications except those involving mergers and the granting of deposit insurance
- Limitation on actual field investigations of statutory applications to those situations where the competitive or overall bank soundness considerations made them necessary

- Dissemination of the Corporation's policy statements and decision guidelines was begun in 1970
- The development of automated early warning, trend analysis, consumer loan evaluation, and review-by-exception systems was initiated in 1971
- Emphasis was substantially increased on training programs and specialization, particularly in the areas of automation, trust, and international activities (although FDIC has limited direct involvement in the international field)
- The development of guidelines and the initiation of experimentation with an examination-by-exception program which emphasizes the evaluation of management and systems
- Study, experimentation, and implementation of statistical sampling as part of the examination process
- More widespread application of disclosure requirements in connection with securities offerings by banks
- The development of a new examination report for trust departments and a complete revision of the Manual of Examination Policies relating to trust activities, and selection of Trust Specialists in order to provide more expertise in this complex area of bank examination.

Other FDIC planning efforts include reviewing considerations of overlapping regulatory functions resulting in the development of a recommendation for regulatory reform, the experimental Selective Withdrawal

from Examination Program, and an experiment in conducting separate compliance examinations, aimed largely at measuring adherence by banks with consumer-oriented laws, regulations and policies.

A separate Office of Bank Customer Affairs was created in early 1975 to oversee a variety of depositor and consumer-oriented functions. In addition, a Consumer Affairs Unit within the Division of Bank Supervision was established in 1971 and continues in operation.

Additionally, our examination staff has been expanded from about 900 in 1960 to approximately 2,000 at year-end 1975, and we expect to add approximately 150 more examination personnel annually during the next few years, spaced so as to allow efficient assimilation into our examination corps.

Considerable effort has been expended on the development of information systems, and data contained in Call and Income and Dividend Reports have been available to the public since 1972.

Along with the development of early warning systems, the Corporation has increased its emphasis on the potential risks to the insurance fund flowing from larger banks, liquidity, earnings performance as an indicator of overall bank soundness, and failure to use or untimely use of enforcement measures. Early and more detailed review of problem and near-problem situations at the Board level has led to an expanded review staff, and our experiences in problem situations prompted issuance of a regulation governing insider transactions in banks under our direct supervision.