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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 identify unsound conditions and violations of laws in banks, and cause bank management to take corrective actions. 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. 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)

00317

UNITED STATES GENERAL ACCOUNTING OFFICE

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STATEMENT OF

ELMER B. STAATS

COMPTROLLER GENERAL OF THE UNITED STATES

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS

COMMITTEE ON BANKING, CURRENCY AND HOUSING

AND THE

SUBCOMMITTEE ON COMMERCE, CONSUMER AND MONETARY AFFAIRS

COMMITTEE ON GOVERNMENT OPERATIONS

UNITED STATE HOUSE OF REPRESENTATIVES

Mr. Chairmen:

We are pleased to be here at your invitation to discuss our report on Federal supervision of State and national banks by the Comptroller of the Currency, the Federal Reserve System, and the Federal Deposit Insurance Corporation.

Our study was made in response to requests from your Subcommittees that we study the effectiveness of the three agencies in carrying out their bank supervisory responsibilities. The Senate Committee on Banking, Housing and Urban Affairs was also interested in having such a study made.

As you are aware, the General Accounting Office does not have statutory authority to audit the Federal Reserve or the Comptroller of the Currency. Although we are authorized to audit the FDIC, our right of access to their bank examination records has long been a matter of dispute between FDIC and GAO.

Because we lacked the statutory authority, we entered into written agreements with the three agencies in April and May of 1976 to obtain access to bank examination reports and correspondence files which were essential to making this study. A principal condition of the agreements was that we would not disclose any information about specific banks, bank officers, or customers. We also agreed that we would not examine any banks ourselves but would accept the facts found by the three agencies' examiners. We made no attempt to independently evaluate the soundness of any of the banks included in our samples. We depended on the examiners' expertise in identifying bank problems and on evidence in the agencies' files showing the followup actions they had taken. We reviewed examination reports and correspondence files for a general sample of 600 banks, 294 problem banks, and 30 failed banks.

Before discussing the results of our study, it might be helpful to recall the events which led up to your requests that we review the performance of the three agencies.

During the months preceding your requests, several large banks had failed, and there had been much publicity about the so-called lists of "problem banks." It was also reported that some of the Nation's largest banks were on these lists. These events evoked concern in the Congress about the banking industry and how well it is regulated by the Federal supervisory agencies.

With this background, we focused our study primarily on determining:

--Whether bank examinations are of sufficient scope to identify banks which are likely to run into serious management or financial difficulties, and

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

The three supervisory agencies were given an opportunity to review a draft of our report and their written comments are included as appendices to the report.

In my statement this morning, I would like to present to you our key observations resulting from:

1. A detailed analysis of 30 banks that failed in the period 1971-1976.
2. Our review of the basic approach and methodology of bank examinations.
3. Our analysis of the actions taken by the three agencies to encourage bank managers and directors to correct problems identified in examinations.
4. A questionnaire mailed to about 1,600 bankers asking their views about the objectives and worth of Federal bank supervision.

Although not specifically addressed in our report, there is a fundamental issue underlying bank regulation which the regulatory agencies must constantly deal with. The issue is how much regulation of banking is necessary to assure a sound banking industry. If carried to the extreme, the regulating agencies could become so zealous in their dealings with the banks that they, in effect, would take over the management of the banks. Thus, the regulating agencies must constantly try to strike a balance between assuring soundness of the banking industry and promoting healthy competition among the banks without becoming involved in day-to-day management decisions.

WHAT LESSONS CAN BE DRAWN FROM RECENT BANK FAILURES?

In our study, we analyzed several of the recent failures to see what lessons might be drawn from them.

In 1976 there were 16 bank failures, the largest number in any one year since 1942. Yet, this number represents only about one-tenth of one percent of all banks. Deposits in those 16 banks totaled almost $900 million, but the vast majority of these deposits were protected either through deposit insurance or by another bank assuming the deposits. In spite of the large failures in recent years, the Deposit Insurance Fund has continued to grow.

In our study, we reviewed the examination reports and correspondence relating to 30 of the 42 banks that failed between January 1971 and June 1976. We found that 14 of those failures were caused by improper or self-serving loans to bank employees or directors. Eight others were caused by frauds or other defalcations, and the remaining eight by general loan mismanagement.

Although economic conditions in the early 1970's did contribute to the failures, the basic underlying causes were the management practices of the banks. Further details of our analysis of failed banks are included in chapter 9 of our report including specific case studies. One factor common to most of the failures was that the banks' boards of directors failed to fulfill their responsibilities for overseeing bank operations.

Bank examination records showed that examiners had readily identified the poor practices that eventually led to the bank failures well before the banks closed. The agencies' major difficulty was in getting the banks to correct those problems.

The supervisory agencies usually relied on informal methods to influence bank managers to solve problems. These methods--such as meeting with bank officials, requiring progress reports from the banks, and scheduling more frequent bank examinations--obviously were not effective in the cases of failed banks. Their managers and directors did not respond to these techniques.

The agencies then could have turned to their formal legal powers, such as removing bank officials, issuing cease and desist orders, and others which I shall discuss later. Of the 30 cases we studied, formal action was taken in only 8 of them--and then only after the banks' problems had become quite serious.

We believe that the supervisory agencies did not make effective use of their formal powers in dealing with the banks that failed. Notwithstanding this fact, we think certain additional powers would help the agencies in cases like these, and I shall elaborate on that later.

ARE BANK EXAMINATIONS OF ADEQUATE SCOPE?

We reviewed the agencies' bank examination practices for the 1971-75 period. We found that

--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.

--Also examinations have placed great emphasis on analyzing the bank's condition at the time of the examination.

While this approach has been reasonably effective in identifying problems in banks, it often did not address the underlying causes of the problems, such as poor loan policies or weak internal controls.

--FDIC and the Federal Reserve have attempted to examine the banks they supervise at least once a year. The Comptroller of the Currency is required by law to examine national banks at least three times in each 2-year period. 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 submitted by banks, should schedule examinations based on an evaluation of a bank's soundness, and the quality of its policies, procedures, practices, controls, audit, and management.

--Examination reports also showed that the agencies only rarely reported 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. There were many new laws enacted in this area in the past few years and it has taken the agencies some time to gear up their enforcement program and develop special training programs for their examiners.

The banks examined by FDIC and the Federal Reserve are also examined by State examiners. Sometimes FDIC and the Federal Reserve conducted their examinations at the same time as the State banking agencies. Both agencies are conducting limited experimental programs to determine if they can rely more on the work of State examiners instead of examining banks independently in those States. We believe that the agencies should expand these programs to as many States as possible. Of course, the quality of State examinations must be taken into consideration in such a program.

The agencies' reports of examination were not effectively communicating the examination results to the banks, because:

--Many problems and criticisms were stated in the confidential sections of the reports but not disclosed to the banks.

--The examiners generally did not recommend how the banks could correct the problems.

The reports of examination should tell the banks, in a concise and straightforward fashion, the results of the examination and include recommendations for corrective action.

Many of the banks in our samples were controlled by bank holding companies. While we did not review the Federal Reserve's overall regulation of bank holding companies, we did check on the problems in our sample banks which were related to holding companies. We found that 22 of 344 banks had problems caused by their holding companies. In most of these cases, the holding companies' actions were not uncovered until problems had been identified in the banks. As you are aware, we were limited by the study agreement to reviewing only the supervisory aspects of holding companies which contributed to problems of affiliated banks in our samples.

HAVE THE AGENCIES BEEN EFFECTIVE IN GETTING BANKS TO RESOLVE PROBLEMS?

I would now like to summarize our views on the agencies' efforts to encourage banks to correct problems.

Examiners find problems in virtually all banks; however, some banks have more serious problems and require more supervisory attention than others. From our review of examination reports, we summarized the nature and frequency of problems disclosed in them. Chapter 5 of our report includes tabulations of the problems identified by examiners for various size banks and between agencies.

The agencies cannot correct the banks' problems themselves but they do have several tools to get banks to correct their problems.

Earlier I alluded to the methods used by the supervisory agencies to influence banks to solve problems. These include both informal and formal actions.

The agencies prefer to use informal methods as much as possible to persuade bank managers to take corrective action.

These include:

--discussing the problems with bank managers;

--requiring the banks to submit progress reports on corrective actions taken,

--visiting the banks to see if progress is being made, and

--meeting with the banks' boards of directors to make sure they are aware of the problems.

We believe the success of the supervision process depends heavily on how results of bank examinations are communicated to the boards of directors of the banks. We found that the agencies generally did not meet with the boards. In a general sample of 600 banks, we found that examiners met with boards of directors in less than 10 percent of the cases we studied. Even when banks had major problems, examiners met with the boards of directors in only about half the cases. We believe that the agencies should discuss the results of their examinations with the boards of directors or with the directors' audit or examining committees.

When a bank's managers do not take corrective action in response to the agencies' informal methods, the agencies have several formal actions available to them.

--The Comptroller of the Currency can revoke a bank's charter.

--The Federal Reserve can expel a member bank.

--FDIC can terminate a bank's deposit insurance.

--All three agencies can enter into written agreements with banks, requiring that certain corrective actions actions be taken.

--All three agencies can issue cease and desist orders.

--All three can initiate efforts to remove or suspend bank officials, but the Comptroller of the Currency must rely on the Federal Reserve to conduct hearings and present evidence.

Our analysis of enforcement actions taken by the supervisory agencies for the banks included in our samples showed that informal actions were used most of the time and that formal actions were seldom used. Even though the same types of problems existed from one examination to another, the agencies often did not change the type of enforcement actions used or intensify the use of an enforcement action to get the problems corrected. For example, from 1971 through 1975 the agencies made limited use of written agreements and cease and desist orders--probably their most effective tools. FDIC used written agreements 3 times, the Federal Reserve 8 times, and the Comptroller of the Currency 48 times. Cease and desist orders were used by FDIC 38 times, by the Federal Reserve 5 times, and by the Comptroller 13 times. During 1976, the agencies were taking a tougher line with the banks and began using their legal enforcement power more frequently.

All of us have read a great deal in recent months about the agencies' lists of problem banks. In our study, we analyzed those lists in detail to see how long banks remained in problem status and how the agencies dealt with those banks.

During the 5-year period ending December 31, 1975, a total of 1,532 commercial banks were on the agencies' problem bank lists. Fifty-five percent of those banks were returned to nonproblem status by December 31, 1975.

Although most of the banks returned to nonproblem status in 2 years or less, 24 percent remained problem banks over 2 years. We found that some banks were considered to be problems for longer than 5 years.

We believe that the supervisory agencies should have used their formal enforcement powers more frequently when dealing with these banks, and that they should establish guidelines for the types and magnitudes of problems where formal actions could be taken.

The supervisory agencies have requested additional statutory authority to remove a bank official whose acts stem from either personal dishonesty or gross negligence and to assess civil penalties against banks and/or individual officers for specific violations. Our study of failed and problem banks showed that these powers could have been helpful in dealing with the officials of those banks. We would, therefore, support legislation giving the agencies this authority.

PROGRESS MADE IN THE PAST YEAR TO IMPROVE BANK SUPERVISION

I would like to comment at this time on the major improvements made by the agencies during 1976 in several areas of bank supervision. The most significant improvements which I would like to discuss with you today were those related to the bank examination process. All three agencies revised their examination approaches to give greater priority to examining the weakest banks and less emphasis to examining the relatively trouble-free banks.

The Federal Reserve revised its examination policies in March 1976, to provide some flexibility to their examiners to concentrate on banks with problems. In January of this year the Federal Deposit Insurance Corporation adopted a new examination policy to provide more flexibility to schedule and scope examinations based on bank soundness and the quality of policies and controls.

The Comptroller of the Currency has developed detailed examination procedures which place greater emphasis on early identification of weaknesses in bank policies, practices, procedures, controls, and audit. If the Comptroller can effectively influence the banks to correct these weaknesses promptly, many of the types of problems now being disclosed by the traditional examination approach may be prevented or, if they occur, corrected before they develop to the point of seriously threatening the soundness of the bank.

The new procedures were incorporated into a new manual of examination procedures and were field tested at 10 banks by mid-1976. OCC began phasing in the new approach in the Fall of 1976 and expects to complete the transition by mid-1977.

In our view, the most important facet of OCC's new examination procedures is that they will center more on identifying the underlying causes of problems rather than on the results of operations. The traditional examination has focused primarily on identifying poor results of operations such as bad loans, concentrations of credit, excessive insider loans, risky investments, inadequate capital, inadequate liquidity, and violations of laws.

Under the traditional examination approach examiners were instructed to examine and evaluate bank policies, controls, and audit, but were provided little or no detailed guidance on how deeply they should examine these areas or how they should document their work and support their conclusions. As a result, many examiners had developed their own informal examination procedures, which differed from examiner to examiner and from bank to bank.

The new procedures are intended to provide greater assurance that indepth analysis of policies, practices, procedures, controls, and audit would be made during each examination. Additionally, it provides documentation of examination procedures followed, tests performed, information obtained, and conclusions reached. This documentation can assist the examiner-in-charge in judging the overall condition of the bank and in planning subsequent examinations.

Neither we nor the agency were able to fully evaluate the practical problems that may be encountered in implementing the new procedures, such as the resource implications and the usefulness of the procedures to all types of banks. Undoubtedly, many practical problems will be encountered and further refinement of the process will be necessary. But we feel that this new approach can be a big step forward and the three agencies should jointly test and evaluate the approach.

THE WORKING RELATIONSHIP AMONG THE FEDERAL BANK REGULATORY AGENCIES

How well the three bank regulatory agencies work together has been one area of concern to your Subcommittees and we have several observations in this area.

The legislation establishing the three agencies created several overlaps in authority. However, the Federal agencies do not examine the same banks. The Federal Reserve could, but does not, examine banks examined by the Comptroller, and FDIC could, but does not, examine banks that are examined by the other two agencies.

We recognize that each agency has been granted certain authority by the Congress and that each enjoys considerable independence of action. Nevertheless, from an overall Federal viewpoint it is important that the agencies work closely together to promote efficient operation and insure that banks in similar circumstances be treated uniformly regardless of which agency is their primary supervisor.

We found that some coordination occurs between the agencies through formal and informal means. An interagency coordinating committee was established at President Johnson's request in 1965 to resolve conflicting rules, regulations, and policies. It includes representatives of each of these three agencies, as well as a representative of the Federal Home Loan Bank Board. During the past two years the committee has met 17 times.

The coordinating committee provides a forum for exchanging information about possible conflicting rules, regulations, or policies which might exist between the agencies. However, it does not provide a mechanism for the three agencies to combine their forces in undertaking significant new initiatives to improve the bank supervisory process or in resolving problems common to the three agencies.

Coordination also occurs through meetings and discussions with senior management at the three agencies. In addition, the Comptroller of the Currency is by law a member of the FDIC Board of Directors and thus has direct involvement with that agency. However, 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 discusssions between the staffs of the three agencies.

In our report we identified several areas where the agencies could benefit by sharing experiences about innovations in bank supervision and undertaking activities jointly or on a reciprocal basis. For example, in the fall of 1975, OCC began developing its new examination procedures which were field tested in mid-1976. The three agencies did not work together in developing and field testing the new procedures. It was not until November 1976 that OCC met with the other agencies to present in any detail its new approach.

When one agency plans major changes in its activities which may be applicable to the other agencies, early consultation and exchange of views would benefit all agencies concerned. We believe that the three agencies should jointly participate in developing and testing the new approach.

We believe that a better mechanism is needed to insure effective interagency coordination. We believe that the Congress should enact legislation establishing such a mechanism and give consideration to identifying those areas where it feels effective interagency coordination is essential.

WHAT DO BANKERS THINK OF BANK SUPERVISION?

We sent a questionnaire to more than 1,600 commercial bankers, of which about 90 percent responded. A copy of the questionnaire and a summary of the responses are included as an appendix of our report. The bankers indicated that they endorse Government intervention in the banking industry. Almost 90 percent felt 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.

We also asked bankers whether they supported or opposed the current regulatory system of three Federal agencies together with State supervision. A majority (58 percent) indicated that they supported the present system.

We also asked for their opinion on three possible alternatives to the present system. Of the three, the most favored alternative consists of one Federal agency with continued State supervision. The two alternatives which did not include State involvement were opposed by large majorities.

As a group the responding bankers had a generally favorable opinion of Federal bank examiners. For example, we asked bankers to rate the competence of the senior Federal examiners in 10 areas covered by the examination. In all 10 areas the examiners' competence was rated very favorably. For instance, in the area of determining the quality of loans

--28 percent said competence was "more than adequate";

--66 percent said it was "adequate";

--5 percent said it was "borderline", and

--1 percent said it was "inadequate" or "very inadequate."

The pattern of responses was similar for the other nine areas.

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I have only discussed the principal message in our report this morning. The report also comments on other aspects of bank supervision such as chartering new national banks and maintaining examiner competence and independence. I have attached to my statement a list of all the recommendations in our report.

This concludes my statement, Mr. Chairmen. If you have questions about our study I will be happy to try to answer them.

GAO RECOMMENDATIONS TO IMPROVE BANK SUPERVISION

Chartering national banks

GAO recommends that the Comptroller of the Currency (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 favorable or unfavorable. (See p. 2-26.)

Scheduling bank examinations

GAO recommends 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. (See p. 4-7.)

GAO recommends 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. (See p. 4-9.)

GAO recommends 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. (See p. 4-9.)

Determining the scope of bank examinations

GAO recommends 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. (See p. 4-17.)

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

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

--use only reports of State examinations meeting those standards. (See p. 4-13.)

Bank examination procedures

GAO recommends 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. (See p. 4-33.)

GAO recommends 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. (See p. 4-35.)

GAO recommends 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. (See p. 4-35.)

GAO recommends 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 extablishing

--a systemwide manual of inspection procedures,

--a standard inspection report, and

--periodic onsite evaluations of Reserve bank supervisory activities. (See p. 4-51.)

GAO recommends that the Board of Directors, FDIC, and the Board of Governors, FRS, develop standards for the preparation, maintenance, and use of examination workpapers. (See p. 4-19.)

Communicating examination results

GAO recommends 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. (See p. 6-5.)

GAO recommends 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. (See p. 6-13.)

GAO recommends 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. (See p. 4-29.)

Encouraging banks to correct problems

GAO recommends 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. (See p. 8-18.)

GAO recommends that the Board of Directors, FDIC, the Board of Governors, FRS, and the Comptroller of the Currency develop uniform criteria for identifying problem banks. (See p. 8-49.)

Examiner capability and independence

GAO recommends 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. (See p. 10-6.)

GAO recommends 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. (See p. 10-11.)

GAO recommends 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. (See p. 10-11.)

GAO recommends that the Board of Governors, FRS, also establish formal evaluation process to measure the competence of persons seeking advancement to examiner status. (See p. 10-15.)

Improving interagency cooperation

GAO recommends 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.

GAO recommends 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 approach. (See p. 7-25.)

GAO recommends 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. (See p. 7-25.)

GAO recommends 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. (See p. 7-25.)