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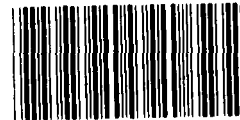
BY THE COMPTROLLER GENERAL

Report To The Congress

OF THE UNITED STATES

Federal Reserve Could Improve The Efficiency Of Bank Holding Company Inspections



The activities of bank holding companies can affect the soundness of their subsidiary banks. This is especially true when a bank holding company controls nonbanking subsidiaries that extend credit. Although the Federal Reserve has made progress in supervising bank holding companies, additional improvements could be made.

This report recommends that the Federal Reserve

--implement a more flexible policy to vary inspection frequency on the basis of perceived risk,

--improve the information available for computerized surveillance and provide more effective program control over district level activities, and

--request Federal bank regulators to obtain information on many companies as part of subsidiary bank examinations.

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AUGUST 18, 1981

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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 discusses the Federal Reserve's bank holding company supervision program and offers a number of recommendations for improvement. These recommendations primarily deal with the scope and frequency of holding company inspections, the use of financial information to monitor the condition of holding companies, and the use of other Federal bank regulators to perform inspections of low-risk holding companies at the Federal Reserve's request.

We undertook this review because the number of bank holding companies has grown rapidly, and the Federal Reserve has made a number of changes to improve its supervision and accommodate the increasing workload. We wanted to determine whether further revisions in holding company inspection procedures were needed.

We are sending copies of this report to the Chairman, Board of Governors of the Federal Reserve System; the Chairman, Board of Directors of the Federal Deposit Insurance Corporation; the Comptroller of the Currency; and the Chairman, Federal Financial Institutions Examination Council.

Milton J. Socolar

Acting Comptroller General
of the United States

COMPTROLLER GENERAL'S
REPORT TO THE CONGRESS

FEDERAL RESERVE COULD IMPROVE THE EFFICIENCY OF BANK HOLDING COMPANY INSPECTIONS

D I G E S T

Seventy-five percent of all bank assets are controlled by bank holding companies--a form of bank ownership by which individuals own a company that controls one or more banks or another bank holding company. Although most bank holding companies have no nonbank subsidiaries, some are extensively involved in activities such as insurance, mortgage lending, leasing, and consumer finance. The Federal Reserve System is primarily concerned that a bank holding company's activities do do not adversely affect the soundness of the company's subsidiary banks.

INSPECTION PROCEDURES

The Federal Reserve conducts periodic onsite inspections of holding companies, supplemented by the monitoring of company reports and by reports of subsidiary bank examinations. Separate examinations of the subsidiary banks are generally made by either the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the Federal Reserve, or the State supervisory agency.

The Federal Reserve was not very active in inspecting holding companies until the mid-1970s. Since then it has taken steps to improve its supervision. In the last 3 years it has adopted a standard inspection report, a manual of inspection procedures, and a central computerized monitoring program. It has also improved the training courses for its holding company inspectors.

Because the number of bank holding companies has grown rapidly, the Federal Reserve has made a number of changes to improve its supervision and accommodate the increasing

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workload. GAO undertook this review to evaluate the Federal Reserve's supervision program and develop suggestions on policy and procedural changes to make the program more efficient.

CHANGES IN INSPECTION PROCEDURES NEEDED

GAO found indications that certain operating characteristics of bank holding companies were related to the degree of risk to which the company might be exposed. (See p. 7.) The risk seemed particularly high if the holding company had credit-extending nonbank activities. GAO found that the Federal Reserve may not be adequately addressing this risk in determining

--what information holding companies should be required to report to permit effective monitoring and inspection of these activities,

--when to make inspections because of potential problems, and

--how much examination coverage should be given to these activities.

Moreover, GAO found that in some districts more information and expertise may be needed to properly evaluate nonbank activities.

GAO also found that the Federal Reserve's holding company supervision policy encourages full-scope onsite inspections in most situations, whereas a more efficient policy would encourage flexibility to limit the scope of onsite procedures that do not address the potential problems which led to the decision that an inspection was needed.

Routine monitoring and analysis of holding company data can be a useful tool for identifying potential problems and for directing the use of onsite inspection resources. GAO found that the surveillance actions taken by district banks varied significantly and lacked central guidance and control. The Federal Reserve has taken some steps to address this problem but results have been limited and more needs to be done. (See p. 18.)

GAO believes that the Federal Reserve could further increase the efficiency of onsite inspections by relying on bank examiners, in many cases, to obtain needed bank holding company data during subsidiary bank examinations.

The Federal bank regulators have legal authority to perform certain holding company inspection tasks, their examiners have the essential qualifications and experience needed to perform many such tasks, and it would seem to require little additional effort in many cases for them to collect the needed holding company data, particularly in those many instances where bank and holding company management are the same. (See p. 25.)

RECOMMENDATIONS

GAO recommends that the Chairman, Board of Governors of the Federal Reserve System:

--Clarify inspection frequency guidelines to encourage district banks to inspect holding companies whenever there is a perceived need, regardless of inspection schedules. In assessing perceived need, the district banks should place greater reliance on surveillance and give more emphasis to companies which have nonbank subsidiaries that extend credit. (See p. 31.)

--Increase expertise in nonbank industries and improve training and control mechanisms to ensure that the risk of holding companies' nonbanking operations is uniformly and adequately considered in the surveillance and onsite inspection processes. (See p. 31.)

--Reassess reporting requirements to improve the information available on the activities of holding companies' nonbank subsidiaries, including peer group data for comparative financial analysis. This reassessment should attempt to minimize any increased reporting burden by concentrating on collecting only that data required for effective holding company supervision. (See p. 31.)

--Establish procedures for evaluating district bank surveillance activities. Such evaluations should prompt establishment of more definitive guidelines and criteria for district bank surveillance activities and should assure that the most appropriate practices, from a programmatic and economic standpoint, are adopted. (See p. 31.)

--Revise the inspection manual to limit onsite inspection tasks to those which are needed in each circumstance. (See p. 32.)

--Develop the concept under which the Federal Reserve would request the Federal bank examiners from each agency to perform needed holding company tasks in the course of their bank examinations. GAO recognizes that this concept will not be appropriate in all cases and its use will depend upon timing, examiner availability, and the economics of each situation. GAO anticipates that this concept will be most appropriate for holding companies that do not conduct nonbanking activities and where the holding company and subsidiary bank management are essentially the same. (See p. 32.)

AGENCY COMMENTS

The Federal Reserve has already taken action in some areas addressed by GAO's recommendations and is reviewing its policies and procedures in the other areas GAO noted as needing improvement.

Specifically, the Board has clarified its inspection policy to permit greater flexibility in scheduling inspections and to encourage better use of surveillance results to determine the scope of necessary onsite inspection procedures. The Federal Reserve disagrees that it needs better information and examiner expertise to assess the risk of bank holding companies' nonbanking activities and that more definitive guidelines and evaluation procedures are needed for district bank surveillance activities. However, it plans improvements in both areas. The Federal Reserve did not comment specifically on GAO's recommendation that

it consider requesting the other Federal bank regulators, where appropriate, to perform inspection tasks during scheduled bank examinations, but it did say it is considering a number of alternatives for gathering information on these companies.

OCC and FDIC suggest that the use of bank examiners to collect information for the Federal Reserve, as recommended by GAO, falls short of addressing the more important issue of divided supervision of holding company systems. Both agencies recommend that the Federal supervisor of the lead bank assume responsibility for the holding company and all its subsidiaries. This approach would require a significant legislative restructuring of supervisory responsibilities. In a prior review, GAO found problems requiring better interagency coordination but not evidence strong enough to support the suggested legislative changes.

In its comments OCC states that it has had considerable success in testing new multibank holding company examination procedures. GAO is concerned that significant issues relating to duplication of effort and conflicting advice to bank holding companies be addressed before permanent procedures are adopted.

The full text of the agencies' comments are included in appendixes II to IV.

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ABBREVIATIONS

FDIC	Federal Deposit Insurance Corporation
GAO	General Accounting Office
OCC	Office of the Comptroller of the Currency

CHAPTER 1

INTRODUCTION

This report evaluates the Federal Reserve System's bank holding company supervision approach. Bank holding companies are organizations which control banks, and they may also control other companies engaged in activities closely related to banking. The Congress and others have long been concerned with the safety and soundness of banks and with the increased risk banks may experience because of their association with holding companies.

In response to this concern, the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the Federal Reserve have been tasked to directly supervise banks, 1/ and the Federal Reserve has been separately tasked to supervise bank holding companies. 2/ The Federal Reserve's holding company supervision goal is to assure compliance with applicable laws and regulations and to minimize adverse impacts on bank safety through early detection and remedy of holding company associated problems. It has made several changes to its supervision program in the last 3 years to help it better meet this goal.

WHAT ARE BANK HOLDING COMPANIES AND WHY ARE THEY FORMED?

A bank holding company is a form of bank ownership by which individuals own a company that controls one or more banks or another bank holding company. People may choose to indirectly control banks through holding companies because holding companies:

--Enjoy certain tax advantages.

--Can often own more than one bank in States which prohibit branch banking.

1/National banks are supervised by the Comptroller of the Currency. State banks which are members of the Federal Reserve System are supervised by the Federal Reserve. State nonmember banks which are insured by the Federal Deposit Insurance Corporation are supervised by that agency.

2/See our report to the Congress "Federal Supervision of Bank Holding Companies Needs Better, More Formalized Coordination," (GGD-80-20, Feb. 12, 1980) for more information on the evolution of this supervisory structure.

--Enjoy a wider market for obtaining capital than do individual banks.

--Can also own nonbanking subsidiaries and can extend these activities across State lines. 1/

As of December 1979, 2,480 bank holding companies controlled 4,257 of the Nation's 14,364 insured commercial banks. The holding company banks, however, held more than 70 percent of all banking assets. About 86 percent of the holding companies control only one bank, and 75 percent have no nonbank subsidiaries. A few companies, however, have dozens, even hundreds, of nonbank subsidiaries, including activities such as insurance, mortgage lending, leasing, factoring, and consumer finance.

BANK HOLDING COMPANY ACTIVITIES ARE RESTRICTED BY LAW

There are advantages and disadvantages to allowing bank holding company formations. Positive attributes might include:

--An ability to spread risk both geographically--when multiple banks are controlled in different areas--and by product line--when banking and nonbanking activities or companies are controlled.

--A potential for economies of scale through shared management, facilities, and other support activities among the holding company and its subsidiaries.

--A potential for improved competition when holding companies are used to, in effect, establish branch offices in States which do not allow direct bank branching.

--A potential for improved customer convenience when the holding companies, through their nonbanking subsidiaries, offer a broader range of customer services.

--A potential for greater financial stability where the holding companies are in a position to provide financial aid directly through asset

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1/The permitted nonbanking activities are largely the same as those that national banks are permitted to participate in directly.

distribution or indirectly through holding company borrowing.

On the negative side, holding companies have several potential disadvantages. For example:

--By demanding excessive dividends or management fees, holding companies can drain their subsidiary bank resources.

--A problem in one bank of a holding company or in a nonbank subsidiary can result in a loss of customer confidence followed by withdrawal of funds from otherwise healthy subsidiary banks.

--A holding company can use its greater financial flexibility to limit competition through more aggressive pricing or by acquisition of competing banks in the same geographical area.

The Congress has weighed the pros and cons of bank holding company formations and, although it has allowed them to continue, has passed a series of laws 1/ restricting their activities and providing for their regulation and supervision by the Federal Reserve.

The Federal Reserve's administrative authority under these laws includes:

--Approval or disapproval of proposed bank holding company formations, as well as proposed bank or nonbank acquisitions by approved holding companies.

--Determining the types of nonbank activities that holding companies are permitted to control.

--Supervising holding companies and their subsidiaries, including the powers to require financial reporting and to examine each affiliate.

--Restricting unlawful or otherwise undesirable interaffiliate financial transactions.

1/Principally the Banking Act of 1933 (48 Stat. 168), the Bank Holding Company Act of 1956 (70 Stat. 133) as amended in 1966 (80 Stat. 236) and 1970 (84 Stat. 1760), and the Financial Institutions Regulatory and Interest Rate Control Act of 1978 (92 Stat. 3683).

THE FEDERAL RESERVE'S HOLDING COMPANY SUPERVISION PROGRAM IS EVOLVING

The Federal Reserve 1/ had not been very active in examining bank holding companies until the mid-1970s. In 1975, for example, only 13 percent of the holding companies were inspected, and most of these inspections were made by 3 of the 12 Federal Reserve district banks.

Since then, the Federal Reserve has taken steps to improve its supervision. It has standardized its holding company inspection procedures, reports, and rating system. It has implemented a computerized surveillance system and has designed special training courses for holding company inspectors. Most recently, it revised the frequency criteria for making onsite inspections to improve flexibility.

At the conclusion of our review, the Federal Reserve's program for monitoring bank holding companies incorporated the following principal features:

--A headquarters staff responsible for suggesting holding company monitoring policies and procedures and for coordinating and evaluating district bank activities.

--A headquarters-level computer-based system for monitoring certain financial data reported by holding companies.

--Uniform criteria concerning the timing, performance, and reporting of periodic onsite inspections of bank holding companies.

--Some form of organizational subgroup at each of the 12 Federal Reserve district banks with staff responsible for making onsite holding company inspections and

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1/As used in this report, Federal Reserve refers to the Federal Reserve System, which includes the Board of Governors of the Federal Reserve along with its Washington, D.C., staff (referred to as the Board and headquarters, respectively) and the 12 Federal Reserve district banks located throughout the country (referred to as the districts or district banks). Each of the 12 district banks is an incorporated institution with a board of directors that is responsible for overseeing each bank's operations under the overall supervision of the Board of Governors.

for performing additional holding company monitoring activities considered to be appropriate by district bank management.

OBJECTIVES, SCOPE, AND METHODOLOGY

We made this review to evaluate the Federal Reserve's expanded approach to holding company supervision and to explore the potential for improvements through use of alternate approaches. We focused on

--the criteria used in selecting bank holding companies for onsite inspection,

--the procedures used to obtain and monitor relevant data on the condition of holding companies and their subsidiaries,

--the coordination between the data monitoring (surveillance) function and the onsite inspection function, and

--the utilization of other bank regulator personnel to increase the efficiency of the onsite inspection function.

We conducted our review at Federal Reserve headquarters in Washington, D.C.; and at the Dallas, Kansas City, Minneapolis, New York, Richmond, and San Francisco Federal Reserve Districts. We selected these districts to provide a full range of the supervisory approaches used within the Federal Reserve and the best range of holding companies in terms of size, number supervised, and type (such as multibank and one-bank companies).

We studied the agencywide and local policies and procedures for monitoring the condition of holding companies and for conducting holding company inspections. We also interviewed appropriate management and operating personnel at the headquarters and district levels.

At Federal Reserve headquarters, we reviewed various holding company supervision documents, such as listings of potential problem institutions, inspection reports, and computer listings showing the size and other organizational and financial characteristics of each supervised company. At the field locations, we reviewed selected documents supporting the supervision procedures employed--including a limited number of inspection workpapers--and at the Richmond Federal Reserve District we attended parts of a holding company inspection.

At our request, the Federal Reserve, OCC, and FDIC each provided us with legal opinions concerning the extent of the non-Federal Reserve agencies' authority for obtaining holding company data on the Federal Reserve's behalf.

We interpreted and weighed the relevance of the source data to reach conclusions about the merits of the Federal Reserve's holding company supervision approach. Although we relied in part on judgment samples of source records, we have recognized the limitations of this approach in drawing our conclusions, which we believe are completely valid in the context presented.

We did not use a systematic case analysis or other statistically valid approach, for two reasons. First, because the holding company universe is not large and would have to be stratified to address major differences among companies, the resulting sample size would be disproportionately large relative to the universe. Second, we would have to research the sample cases at their respective district offices, and we could not be certain of identifying the inspection procedures or other actions employed in each case because appropriate documentation is not always prepared or retained. Thus, considering the broad nature of our objective and the high cost and uncertainty associated with the case analysis alternative, we opted for the less scientific approach.

The Federal Reserve's computer data base does not readily identify the nonbanking subsidiaries directly held by holding companies. Also, some of the computer-produced data was found to be inaccurate. The Federal Reserve worked closely with us to overcome these problems and has since taken action or made plans to improve the accuracy and usefulness of the data. Although we and the Federal Reserve agree that the numerical values presented in this report are reasonably accurate for the purposes intended and in the context presented, the reader is cautioned to observe the written qualifications which appear with the data in the text of the report.

This chapter has provided background information on bank holding companies, the legal restrictions on their activities, and the Federal Reserve's evolving supervision program. Chapter 2 discusses the risks holding companies pose to subsidiary banks and evaluates the frequency and scope of inspections in relation to these risks. Chapter 3 discusses supervisory approaches to improve the use of onsite inspection resources. In chapter 4 we present our overall conclusions and recommendations as well as agency comments on a draft of this report.

CHAPTER 2

MORE EMPHASIS IS NEEDED ON

INSPECTING HIGHER RISK COMPANIES

The major thrust of bank holding company supervision is to protect the safety and soundness of affiliated banks. Since all banks are supervised by one or more of the bank regulators, the emphasis in holding company supervision should be on the other parts of the organization. The nature and degree of risk in holding companies varies significantly, yet the Federal Reserve's supervision program does not seem to provide the necessary flexibility for inspectors to concentrate their efforts on areas of potential shortcomings.

BANK HOLDING COMPANY RISK VARIES

As a form of bank ownership, holding companies exhibit a variety of risk characteristics based on their size, structure, and nature of activities. But despite the great diversity within the industry, holding companies can be segmented into categories that help to identify high-risk companies. Upon analysis it becomes apparent that holding-company-related risks to affiliated banks are distinctively different for various categories. It is also apparent that affiliation with nonbanking activities can be particularly risky. A summary of inherent risk characteristics by selected categories follows, and a more comprehensive analysis is included in appendix I.

Most bank holding companies are small, rural organizations which control one bank, have less than $50 million in consolidated assets, and have no nonbank subsidiaries. The vast majority control only 1 bank, others control 2 or more, and two companies control more than 80 banks. Only about one-fourth of the companies engage in activities other than banking, but some of these companies have dozens, even hundreds, of nonbank subsidiaries. Only 382 holding companies have assets greater than $300 million, but these companies account for nearly 80 percent of all holding company assets.

Size, structure, and operating characteristics are potential risk factors

Bank holding company subsidiary banks comprise a cross section of the banking industry and account for part of the risk in a bank holding company organization. Activities of other organizational components, the parent company and nonbank affiliates, are also important in determining the level of risk in a holding company organization. But in 1,848 of 2,480 bank holding companies, one or more banks are the only

active organizational components. Experience shows that if holding companies of this type are experiencing problems, they are generally the result of problems in the subsidiary banks and that this kind of risk can be effectively addressed by the regulator of the subsidiary bank. The Federal Reserve recognizes this and makes use of the bank regulators' examination reports in its supervision of bank holding companies.

Both large and small holding companies present risks to their bank affiliates, but the large-company risk is considerably more complex and thus more difficult to evaluate. Most small companies are tax shells and operate essentially as banks. The risk in small companies results primarily because they cannot afford to (1) retain sufficient management expertise, (2) operate with the soundest internal controls, or (3) diversify their assets. In addition, a small company is dependent on the local economy and has limited funding outlets.

The risk of large bank holding companies to subsidiary banks is generally more complex than the risk posed by small companies because a greater percentage of their operations is financed through debt. A ratio comparing the amount of holding company debt to the stockholders' investment is an important factor in evaluating the solvency of a financial institution. Because large companies have access to broader capital markets, they generally have a high ratio of debt to stockholders' equity. The risk to bank subsidiaries increases when the holding company has to rely too heavily on the bank for funds to cover these debts. The Federal Reserve addresses the complexity of large company risk with more frequent and extensive onsite inspections.

The level of management expertise is a potential risk factor in any company. In general, large companies can more easily afford a team of highly qualified managers while small companies are often a one-person operation, with the owner serving as chief officer of the bank and the holding company. Federal Reserve officials feel that the management expertise of large companies will better enable them to survive crisis periods, such as the recent period of record high interest rates. In a small, closely controlled company one error in judgment by the owner could adversely affect the affiliated bank.

Internal controls are strengthened in larger companies by dividing related tasks among several officers. This segmentation of duties and other stronger internal controls reduce the opportunity for improper transactions. In addition, large companies generally have better recordkeeping and are audited by outside certified public accountants. Larger companies are also more able to diversify the nature and associated risk of investments and loans. In contrast, they also engage in more complex activities, such as issuing commercial paper, which can result in increased risk.

Holding company nonbank activities, especially credit extending activities such as mortgage or consumer lending, present a potential risk to affiliated banks. The risk exists because holding companies often fund their investment in nonbank activities by borrowing from outside sources. As a holding company's nonbank activities increase in size, the risk to the company also increases--the larger a nonbank subsidiary, the greater the need for financing its loans and operations. If the nonbank affiliates are not profitable, the holding company may turn to the bank for funds to meet its debt repayment obligations.

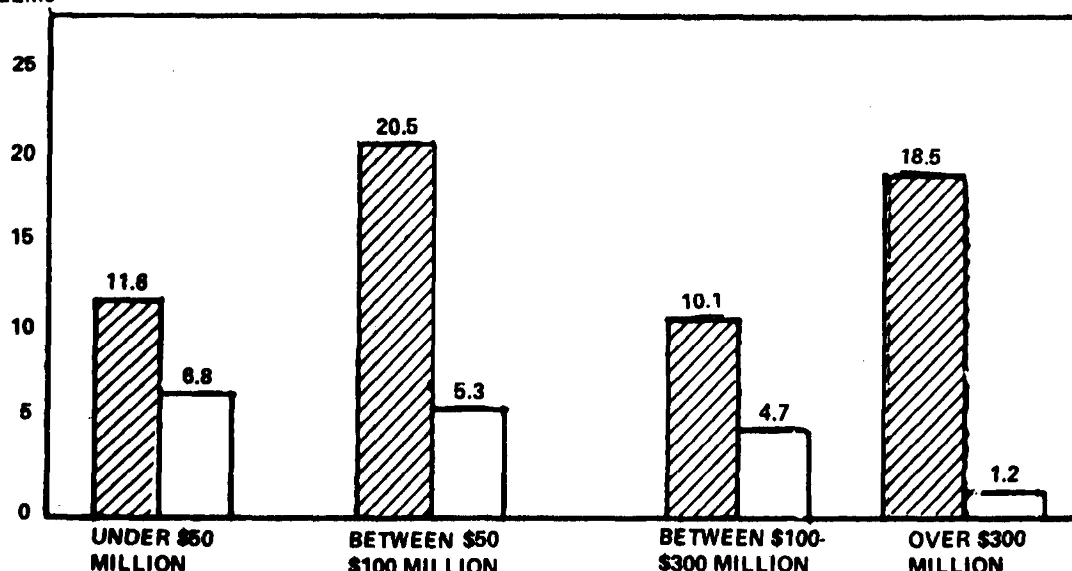
Companies with nonbank subsidiaries are more likely to have problems

The Federal Reserve maintains two lists of holding companies experiencing problems: a "Watch List" of companies rated composite "3" and a "Special Supervisory Attention" list of companies rated composite "4" or "5." 1/ Companies rated 3 were experiencing a combination of weaknesses termed unsatisfactory to moderately severe. Companies rated 4 or 5 were experiencing more severe problems requiring prompt corrective action or constant supervisory attention.

We compared how frequently all bank holding companies that had nonbank subsidiaries experienced problems with the frequency at which all bank holding companies without nonbank subsidiaries experienced problems. Overall, 15.7 percent of companies with nonbank subsidiaries were experiencing problems, while only 6.2 percent of companies without nonbank subsidiaries were having problems. As shown in the following chart, the relationship between nonbank subsidiaries and companies experiencing problems is demonstrated in each size category. For example, of those companies with assets less than $50 million and which had nonbank subsidiaries, 11.6 percent were experiencing problems, but only 6.8 percent of the companies without nonbank subsidiaries were experiencing problems.

1/These numbers relate to the Federal Reserve's five point holding company rating system. This system yields a single, composite rating for each inspected company based on standardized criteria for assessing each of five rating elements.

INCIDENCE OF PROBLEMS FOR COMPANIES
WITH NONBANK SUBSIDIARIES VERSUS COMPANIES
WITHOUT NONBANK SUBSIDIARIES



Holding company inspectors told us that nonbank activities, especially credit extending ones, present a significant holding company risk. According to the inspectors we interviewed, nonbank activities have contributed to major earnings problems in some companies. Lending for real estate development was generally cited as the cause of many mid-1970s problems. Mortgage lending and consumer finance were also cited as particularly risky activities. The inspectors generally believed that many holding companies have a lack of experience in operating these activities and are not attuned to industry changes. As a result, many companies have difficulty running these activities profitably.

District bank officers agreed with the opinions of their inspection staff and cited examples of nonbank problems. One official referred to a company where the nonbank activities caused such severe problems that the Federal Reserve considered requiring divestiture of the bank subsidiary. Working with FDIC, the subsidiary bank's regulator, an arrangement was made to sell the bank to another institution, thus removing it from any association with the perilous nonbank activity. Officials

at other district banks made the general observation that nonbank activities have often been the cause of holding company problems.

Board officials concur with the district bank inspectors that nonbank subsidiaries are risky. One Board official said that even a small percentage of nonbank activities may pose a threat to the holding company. For example, in one instance, the nonbank activity made up less than one-tenth of 1 percent of the holding company assets; however, when the activity experienced a heavy loss, it resulted in cash flow problems for the holding company. The holding company's earnings were used to cover the subsidiary losses, thus weakening the overall financial position.

Although nonbank activities are recognized as particularly risky, the Federal Reserve does not maintain adequate information on these activities--by individual company or for the industry as a whole. As part of our review, we requested information on directly owned nonbank subsidiaries from the Board, including the number of nonbank subsidiaries directly owned by all holding companies, nonbank subsidiary asset size, and percentage of nonbank subsidiary assets to total holding company assets. Initially, the information system could not differentiate between a nonbank subsidiary directly controlled by the parent holding company and a subsidiary indirectly owned through a subsidiary bank. After repeated attempts to satisfy our request, Board staff produced data which they represented as the best currently available. Board staff told us some data base weaknesses are due to the fact that holding company reporting requirements were initially predicated on research needs rather than supervisory needs and supervisory staff were reluctant to place additional reporting requirements on the holding companies. Staff members discussed with us several planned improvements to the system which may overcome some of these deficiencies.

Another problem with the holding company data base involved the computation of the holding company's investment in loans and leases. In comparing data base information on loans and leases to inspection reports, large differences were found. Further analysis suggested that the problem was due to the inability of the data base to distinguish between intracompany loans to affiliates and loans to nonaffiliated parties.

Conclusion

Bank holding companies exhibit various degrees of risk on the basis of their size, structure, nature of activities, and operating characteristics. Affiliation with nonbank activities, especially those which extend credit, is especially risky and a potential cause of problems.

SCHEDULING OF INSPECTIONS SHOULD RECOGNIZE RISK

The Federal Reserve's supervision policy does not provide adequate flexibility to address the varying risks in holding companies. Current supervision policy emphasizes size as the main priority in scheduling holding company inspections. Although inspections are further prioritized on the basis of financial condition or perceived risk, routine inspections of all companies are still required. The January 7, 1981, policy on inspection frequency is an improvement over the prior inspection requirements. Board staff told us the guidelines are intended to be flexible and allow districts to respond to potential problems, but district staff believed they had little flexibility to vary from established inspection schedules.

Some districts are presently unable to meet the minimum frequency requirements of this policy, and more companies are being formed each year. With the outlook for an austere budget, the Federal Reserve System could become overloaded with an excessive number of routine inspections of low-risk companies. To the extent that additional resources are devoted to routine inspections, the ability to give adequate attention to high-risk areas, such as nonbank activities, is diminished.

Supervision policy mandates routine inspections based on size

The bank holding company supervision manual provides different sets of instructions and frequency guidelines for companies with consolidated assets greater or less than $100 million. Companies with consolidated assets greater than $100 million are subject to inspection every 12, 18, or 36 months, depending on certain characteristics. In contrast, all companies with consolidated assets less than $100 million are subject to inspection every 36 months. Companies with evident financial weaknesses or those experiencing a change in management are subject to annual inspection, regardless of size.

For companies with consolidated assets greater than $100 million, the frequency cycle is 12 months if the company has (1) credit-extending nonbank assets greater than $10 million or 5 percent of total company assets, or (2) a debt-to-equity ratio of at least 30 percent.

The 12-month cycle can be extended to 18 months when (1) the company was rated 1 or 2 at the last inspection, (2) the company is not characterized by financial weaknesses and material deterioration in financial condition, and (3) there was no change in ownership or significant change in senior management since the

last inspection. Companies with consolidated assets in excess of $100 million not meeting the requirements for an annual or 18-month cycle are to be inspected every 3 years.

Supervision policy requires inspection at least once every 3 years of companies with consolidated assets less than $100 million. Priority is given to companies with (1) significant financial weaknesses, (2) a debt-to-equity ratio of 30 percent or greater, or significant nonbank subsidiaries, and (3) companies whose financial condition or surveillance results suggest an adverse change in condition.

Frequency guidelines should be more flexible

Board staff have been critical of district bank attempts to extend the established minimum frequency cycles. Criticism by Board staff has been both formal and informal, resulting in an unwillingness on the part of district bank management to vary the frequency of inspections even when convinced that scarce resources should be allocated differently.

The Board's Operations Review Program, its most formal review of district bank activities, has been used by Board staff to promote adherence to required inspection cycles. As a method of encouraging compliance with Board policy, an Operations Review team composed of Board and district bank staff reviews each district bank's operations once every 3 years. As part of each Operations Review, certain operations of the district bank's department responsible for holding company supervision are reviewed. Instructions for Operations Review participants direct them to determine the actual number of holding companies inspected by the district bank and comment in the report to district bank management on the success or failure in meeting Board frequency goals.

In commenting on the prior requirement to inspect companies with total assets over $300 million every 12 or 36 months depending on certain characteristics, 4 of the 10 Operations Reviews conducted over the past 3 years commented on the district bank's failure to meet Board frequency goals. One report stated:

> "Due to the present staff complement and low experience level, emphasis has been placed upon inspecting lower priority bank holding companies. As a result, some shortfalls in the mandated [required annual] bank holding company inspection program will occur."

In noting the district bank's limited inspection resources, the report acknowledged that companies of concern are being monitored by means other than onsite inspections.

District bank officials believed that they were using their limited resources in the most efficient manner and inspecting companies with the greatest supervisory need. They responded to the review team's report by stating "We believe we are providing responsible supervision to all district bank holding companies in substantial conformance with the Board's guidelines." District bank officials added that inspection staff levels will be set at the level considered necessary to provide for responsible, cost-effective inspections.

Another Operations Review report criticized a different district bank for not complying with Board guidelines regarding frequency of inspection. The review team recommended that mandated companies be inspected on an annual basis (the requirement at that time). This district bank was unable to inspect all mandated companies due to a high turnover of inspectors. Bank management made a decision to forego the required annual inspection of a company they felt was in sound financial condition, choosing to use their limited resources to inspect another company which had never been inspected. Officials at the bank in charge of the inspection program were criticized by Board staff for skipping an annual inspection. The bank officials expressed a need for more flexibility in allocating their scarce inspection resources on the basis of their assessment of the inherent risk in companies they supervise.

Several of the districts we visited had insufficient staff to inspect all the companies as often as required by the Board's policy. The district officials did not want to increase the number of inspectors, however, preferring instead to limit the inspections of low risk and financially strong companies. The Board's new policy allows more flexibility than previous Board policy but falls short of the discretion district bank officials want.

District bank officials would like the flexibility to determine which companies in their district need inspection and how often inspections should be conducted. We were cited several situations where district bank officials preferred "skipping" the required inspection of a financially strong company and using the resources in a way they believed was more effective. Officials in several districts did not feel they had the flexibility to waive required inspections without risking criticism from Board staff.

Board officials told us that the 12-month frequency requirement was intended to allow district bank flexibility in responding to potential problems identified by surveillance or from other sources. They stated that the frequency guidelines drive the scheduling of inspections but should not be interpreted by

the districts as requiring a rigid schedule which cannot be interrupted to inspect a company with potential problems. According to Board staff, the recent modification to the inspection frequency requirements allowing the 12-month cycle to be extended to 18 months in certain circumstances is intended to provide more flexibility.

At the conclusion of our field work, no Operations Reviews had been completed under the modified frequency requirements. Our concern still exists, however, that the Operations Review Program does not encourage district banks to be flexible when necessary. The prior frequency requirements were intended to be flexible, but, partially due to Operations Review reports, district bank management did not perceive the policy as allowing the intended flexibility.

Conclusion

The Federal Reserve should schedule holding company inspections on the basis of the perceived risk presented by companies and limit resources devoted to inspections of low-risk companies. Although the Board's inspection frequency policy may have been designed with this concept in mind, district banks have been reluctant to forego scheduled inspections to permit inspecting companies with potential problems. The Operations Review Program has not fostered the concept of a flexible scheduling system that the Board apparently envisioned.

SCOPE OF INSPECTIONS SHOULD RECOGNIZE RISK

The specific tasks performed during an onsite inspection should be directed primarily to those holding company activities with the greatest perceived risk. This objective was not being achieved because (1) inspection guidelines encourage inspectors to perform tasks which may not be necessary, and (2) the inspectors may not have sufficient data and expertise to adequately inspect nonbanking activities--an inherently high risk holding company element. In the latter regard, the Board's quality control mechanism does not permit a reasonable assessment of how well the nonbanking element is being covered.

Inspection guidelines may be excessive

In the summer of 1980, the Federal Reserve adopted a standardized holding company inspection manual which prescribes procedures that all inspectors should follow. The procedures are cross indexed to sections of standardized inspection reports which inspectors are required to complete after each onsite examination.

Current Board policy requires a full-scope examination in most situations, and inspectors must perform the required standard procedures regardless of the companies' risk characteristics or financial condition. As a result, inspection resources may be expended on procedures which are not actually necessary.

Standardized inspection procedures and reports serve a useful purpose by encouraging district banks to communicate information in a uniform format. The existence of the standard reports, however, should not result in the performance of unnecessary procedures. District banks need some flexibility to determine, on the basis of available information, the inspection procedures necessary in each circumstance. For example, some inspectors felt certain onsite procedures relating to financial analysis were only recreating information already available through various monitoring systems.

More information and expertise may be needed to properly evaluate nonbank activities

Nonbank activities should be a major focus of bank holding company supervision since they are often a risk to affiliated banks. The Federal Reserve, however, does not maintain enough information on nonbank activities (see p. 11) to allow the district banks to adequately prejudge when inspections should be scheduled because of nonbank-related problems within a company. Some district bank inspectors, furthermore, may not have adequate expertise for reviewing the nonbank activities.

District bank capabilities and approaches for reviewing nonbank activities vary. Officials at some district banks believe special training and experience are necessary for inspectors who review nonbank activities, and one district bank has established a separate group which reviews only nonbank activities. Most district banks, however, do not provide specialized training for inspectors reviewing nonbank activities, nor do they have a special group for this purpose. At another district bank, officials encourage relying on the holding company's internal audit function to determine the extent of the inspector's review of nonbank activities. Inspectors at a different district bank informed us that they do not adjust their scope of review in the nonbank area on the basis of the holding company's internal audit activities.

Officials of several district banks stated that their staffs were not fully competent to review all nonbank activities. Inspectors at these district banks favor adding nonbank expertise at the Board level. Individuals with expertise in various industries could (1) provide training to inspectors, (2) assist in analyzing complex nonbank subsidiaries, and (3) provide advice to Board staff on current industry trends which bear close

attention. Periodic peer group analysis of nonbank subsidiaries, where information is available, would be valuable in directing inspectors' efforts.

The scope of nonbank inspection coverage cannot be reasonably determined

The Board is responsible for oversight of district bank inspections but does not have an adequate quality assurance program to verify that nonbanking activities are appropriately reviewed. Presently, Board staff evaluate a district bank's thoroughness in reviewing nonbank activities by reviewing the inspection report's scope section.

We do not believe that the inspection reports prepared by the district banks form a complete or reasonable basis from which Board staff can assess the scope of nonbank reviews. Although data on nonbank subsidiaries is always presented, it does not clearly convey the extent of work performed. For example, we reviewed 58 inspection reports of companies controlling nonbank subsidiaries to determine if the nonbank subsidiaries were visited. The Board's Bank Holding Company Supervision Manual states that this information should be included. In 46 reports, however, there was no indication of a site visit or comment that necessary records were obtained from the parent company.

The Board's Operations Review Program does not emphasize reviewing the scope of procedures relating to nonbank activities. A review team goes to each district bank once every 3 years. The Operations Review procedures do not emphasize nonbank activities. Current procedures only require the review group to determine if nonbank subsidiaries are reviewed relative to holding company capabilities to manage the subsidiaries. There are no specific procedures, such as assuring that inspectors make site visits where necessary and assessing the scope of reyiew.

Conclusion

Current Federal Reserve policy encourages full-scope inspections in most situations rather than performance of only those procedures determined necessary on the basis of perceived risk presented by companies. Although nonbank activities should be a major focus of holding company inspections, district banks do not always have the information or expertise needed to make adequate reviews of nonbank activities, nor does the Board have a reasonable basis for judging if appropriate nonbanking review procedures are being included in each onsite inspection.

CHAPTER 3

THE USE OF ONSITE INSPECTION RESOURCES

CAN BE IMPROVED

The number of bank holding companies has grown significantly in recent years, and this trend is expected to continue. Given budgetary and political realities, the inspection staff is not likely to grow significantly in the foreseeable future. If the Federal Reserve is to effectively carry out its supervisory responsibilities, it must emphasize new supervisory techniques and set priorities for its efforts.

There are alternatives to the present system which we believe deserve consideration. More effective control of surveillance activities at the district banks would provide better assurance that the surveillance system could identify when companies should be inspected and what areas should be concentrated on during the inspection. In addition, information needed by the Federal Reserve should be obtained during subsidiary bank examinations, where doing so is both feasible and economical.

SURVEILLANCE SYSTEM: MORE EFFECTIVE PROGRAM CONTROL IS NEEDED

A major objective of the Federal Reserve's supervision of bank holding companies is the early identification and correction of activities which significantly increase the risk to subsidiary banks. The Federal Reserve relies primarily on onsite inspections of bank holding companies to identify problems but supplements onsite inspections with its surveillance or early warning system.

The agency has a central computer-based monitoring system that is designed to identify potential problem holding companies and provide for followup action at both the district bank and Board levels. Our tests indicated that this monitoring system has significant potential for identifying problems. The district banks supplement the Board's computerized monitoring system with surveillance activities of their own. Although many of the district banks' systems show significant potential for identifying problems, we noted that additional benefits might be gained through greater Board-level direction and control over the districts' separate programs.

The Federal Reserve relies predominantly on the district banks to determine what data will be analyzed, how it will be analyzed, who will perform the analysis, and what use will be made of the data. The Board does not systematically monitor the districts' activities or otherwise obtain feedback on the

effectiveness of the separate monitoring systems. As a result, there is little assurance that the surveillance program is being administered in the most efficient and effective manner.

Surveillance can be a valuable tool for identifying potential problems

Bank holding company surveillance is the ongoing gathering, timely monitoring, and financial analysis of submitted holding company reports and other related data, including Securities and Exchange Commission filings, subsidiary bank examination reports, stock prices indices, and newspaper releases. It is a supervisory tool which can provide an early warning signal for identifying holding companies that may be having problems and may be vulnerable to financial difficulties.

The main feature of the Federal Reserve's surveillance system is a centralized computer program which became operational in August 1978. The program produces financial ratios, composite scores, and peer group comparisons based on a report companies are required to submit. Essentially, the system highlights trends of emerging financial problems through the analysis of changes; for example, companies for which key financial ratios have been deteriorating over time are identified as problem companies.

With the Board's assistance, we tested the effectiveness of the system by applying it against 1977 data submitted by holding companies. We then compared the list of potential problem companies produced by this process with the companies which had appeared on the Board's December 8, 1977, Special Supervisory Attention List. We found that, had the computerized program been available in 1977, it would have been 97.5 percent accurate in identifying the known problem companies. Although this does not conclusively demonstrate a predictive ability, our test showed that the surveillance system was effective in identifying the types of problems it was designed to detect.

The New York Federal Reserve Bank conducted a much more comprehensive and in-depth test of surveillance systems for monitoring banks and reported that there is "* * * a remarkable degree of consistency in the extent to which bank vulnerability can be detected through statistical techniques that employ regularly reported financial data." 1/ The authors suggested that these techniques could be used to improve the efficiency

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1/A Nationwide Test of Early Warning Research in Banking, Federal Reserve Bank of New York Quarterly Review/Autumn, 1977, page 38.

of bank supervision by concentrating on banks classified as vulnerable and by limiting the frequency or scope of onsite examinations at banks considered strong. They concluded that the same methodology could be applied to screen banks for vulnerability in other areas, including the activities of bank holding companies. Other research on this subject has not conclusively demonstrated the predictive ability of surveillance systems. There seems to be little disagreement, however, that surveillance is a valuable tool in supervising financial institutions.

Difference in district practices

The Federal Reserve Board's surveillance program, as mentioned above, centers on a computerized financial analysis of certain data reported by holding companies. Additional activities include monitoring of holding company stock prices, quarterly monitoring of reported holding company earnings, and reviews of other required holding company reports. The data is analyzed by the Board staff who recommend to the appropriate district bank staff that action be taken whenever there is an indication that a problem might exist. Additional output from the Board system includes a performance report on each holding company which is forwarded to the cognizant district bank for further analysis and use in conducting the inspection of the holding company.

The district banks use their own discretion in deciding what additional monitoring activities are necessary to supplement the Board's minimum surveillance program requirements. Each of the System's 12 district banks is an incorporated institution with its own nine-member Board of Directors and exercises significant autonomy in determining its own organizational structure, allocation of resources, and operational priorities. The types of holding companies that each district supervises may vary considerably from one district to another. There is little central direction over the amount and type of surveillance that should exist at the district level.

To get an understanding of local surveillance operations, we contacted all 12 district banks and followed up with visits to 6 banks. We found that the district banks vary considerably in staffing, organization, data collection, data analysis, and uses made of surveillance in the supervisory processes. For example, local organizations for supervising holding companies ranged from three separate units that performed applications reviews, onsite inspections, and surveillance tasks in some districts to a single pool of examiners responsible for all three supervisory functions in other districts. One district bank distinguished between computerized and manual surveillance of holding company reports and assigned these responsibilities to two separate departments.

Staffing levels were also diverse, ranging from a low of 5 inspector/analysts at one district to a staff of 41 employees performing the same functions at another district. District staffing levels varied considerably for holding companies of the same size. For example, at the Federal Reserve Bank of Dallas, which has about 125 companies with less than $100 million in consolidated assets, 14 employees were engaged in the inspection and financial analysis functions. In contrast, at the Federal Reserve Bank of Minneapolis, which had over twice as many similar small companies, only five employees were responsible for the same two supervisory functions.

The following are examples of individual operating procedures employed by some district banks, but not others. We have not analyzed the appropriateness of these procedures for systemwide use but list them to illustrate that many innovative approaches are used which, if centrally evaluated and coordinated, have significant potential for improving surveillance programs throughout the Federal Reserve System:

--The requirement that annual reporting occur only on an exception basis. Benefits of such a system include reduced reporting burdens for holding companies, reduced chances of omissions in reporting, and a reduced need for Federal Reserve resources to input and review data.

--Improvements to computerized surveillance system including (1) provisions for local FDIC terminal hookup to obtain more timely bank data, (2) generation of local peer group data for more representative comparisons, (3) provisions for a statistical analysis system for easier access to and manipulation of financial data, and (4) access to specific program packages for more efficient analysis of holding company condition.

--Programmed analytical edits for the Quarterly Report of Intercompany Transactions and Balances.

--Use of an internal rating system to prioritize inspections, specifically for districts with large numbers of small holding companies.

--Use of individual ownership worksheets in districts with problems related to self-serving owner/managers.

--Routine assignment of analysts to inspection teams to perform onsite reviews of each holding company's overall financial condition and related report writeups.

--Rotation of inspector and analyst positions to provide cross training, initiate coordination between the two functions, serve as a safeguard in the event of turnover, and provide for flexible staff levels that can vary depending on the workload of either section.

--Use of preinspection packages or preinspection meetings of analysts and inspectors to exchange information that can reduce onsite efforts.

--Assignment of a group of holding companies to each analyst to allow them to develop an ongoing familiarity with assigned companies. Individuals responsible for companies within the same general location can also become sensitive to geographical conditions which may cause otherwise sound companies to be noted as potential problems.

We recognize a need for districts to have some flexibility to adjust their systems to meet local needs. Further, the scope of our work does not permit us to conclude which combination of district procedures would produce the most effective local surveillance approach. However, in view of the limited central direction provided by the Board as described below, we question whether the wide variance we observed among the districts is appropriate and believe that the Board has little assurance that each district has developed the optimum approach.

<u>Central direction for district level surveillance programs has been limited</u>

The Federal Reserve Board has provided limited direction to insure that the district banks implement a comprehensive and consistent surveillance program at the local level. Specifically, the Board has made only limited efforts to provide guidance on how the districts should implement their surveillance programs, to encourage greater coordination of surveillance activities among the districts, and to monitor and insure the adequacy of local surveillance programs. The Federal Reserve Board has provided instructions regarding its computerized surveillance program, but it has not (1) clearly defined what constitutes a comprehensive surveillance program, (2) centrally identified and described all available sources of information, or (3) established minimum standards for reviewing identified sources of information.

The Federal Reserve's Bank Holding Company Supervision Manual does not adequately address surveillance as a supervisory tool. It emphasizes inspection activities and makes only limited references to distinctions between in-house monitoring and inspection procedures.

Guidance provided by the manual may even result in a duplication of effort for districts that have separate financial analysis and inspection units. One section of the manual, for instance, directs examiners to determine the timeliness of regulatory reports as an important part of the inspection process in spite of the fact that district financial analysts perform this procedure as a routine monitoring responsibility independent of scheduled inspections.

Another section describes financial analysis as one of the most important parts of the inspection report. It provides a description of financial factors, ratios, and potential sources of review. It does not, however, discuss the analysis that is already completed through the Board's computerized surveillance program, nor does it address data available through surveillance, including exception reports and holding company performance reports generated by the Board.

The Federal Reserve Board's Operations Review Program evaluates the adequacy of the district banks' supervisory activities on the basis of periodic reviews made at each district bank. The objective of the program is to determine whether local policies and practices provide for effective supervision of member banks, bank holding companies, and subsidiaries at as low a cost as is consistent with effective supervision.

Although some of the more recent Operations Review reports address monitoring procedures to some extent, the guidelines currently used to conduct these reviews do not treat supplementary district level surveillance activities as a supervisory tool that can be used effectively to direct inspection efforts. Specifically, they do not require review teams to collect data on the timeliness and adequacy of gathered surveillance information, on the accuracy and responsiveness of financial analysis to supervisory needs, or on how surveillance data is used to streamline the inspection process.

The Board has not established formalized mechanisms to encourage the district banks to share surveillance resources, such as computer capabilities and innovative monitoring techniques. At a minimum, all district banks should be made aware of any positive innovations in field surveillance procedures. Sharing information on innovations would allow each district to consider potential improvements to its own holding company monitoring system and to benefit from the efforts of other districts.

Another area of possible improvement is the present duplication of Board and district surveillance-related efforts. Duplicative reviews of public information regarding stock price

indices, for example, are being performed by the Board and by at least three of the six district banks we visited.

The Board and the Federal Reserve Banks of Richmond and Minneapolis monitor stock price information obtained from independent contractors. The stock monitoring program of the Federal Reserve Bank of New York is based on data published in a daily newspaper published for the banking industry.

We found indications of internal coordination problems in district banks with separate financial analysis and inspection units. Such problems arise because the bank holding company inspection is a traditional and well-accepted function that is rooted in the practice of bank examination, while financial surveillance is a more contemporary function which often is not viewed as being as important as the inspection phase of the supervision process.

Indications of coordination problems between district bank personnel involved in the two functions were evident at the Federal Reserve Bank of Dallas. Although district analysts generated financial ratios and peer data comparisons, the inspectors used a separate set of financial ratios to evaluate the condition of the holding company. District management was not previously aware of this problem but assured us that efforts were being made to clarify local supervisory roles and that, once the bank's supervisory roles are more clearly defined, the coordination problems should be largely eliminated.

The Federal Reserve System has taken some positive steps to improve the surveillance program for bank holding companies. For example:

--To make surveillance a more integral part of its supervisory program, the Federal Reserve System reorganized, in April 1979, to place the surveillance section on an equal footing with the inspection section.

--More recently, the System became involved with other bank regulators in developing a uniformly accepted Bank Holding Company Performance Report format to aid in the financial evaluation of holding company condition.

--In October 1980, a surveillance conference was held in Washington, D.C., to improve communications between the districts regarding their surveillance activities.

It is too early to tell what impact these positive actions will have on the Board and district surveillance programs. The recent surveillance conference, for example, noted several of

the problems we found during our review and resulted in establishing four committees to study these problems. As of April 1981, the committees had not reported on the results of their studies.

In addition, the Board has also made limited efforts to centrally conduct and coordinate special surveillance studies that may be of value to the overall system. Such a special study, for example, might be made into the benefits of pooling data resources from all the district banks so that the Federal Reserve System could keep abreast of current economic conditions which could potentially affect the financial soundness of the banking industry. By studying the benefits of pooling data in this way, the Board could determine how to best use the surveillance system to monitor the effects of changing conditions. The Board also could research such issues as the level of resources needed to support adequate surveillance functions and various means of providing for this level of support in the Federal Reserve's budget system.

Conclusion

Surveillance can be a valuable tool for early identification of potential problem institutions and for directing the use of valuable onsite inspection resources. In this regard, the Board's computer-based financial monitoring program has been shown to be effective. However, district level monitoring activities--a potentially valuable supplement to the Board's minimum program--have not realized their optimal effectiveness because they lack central direction and coordination. Although the Federal Reserve has taken some positive steps to address this problem, improvements have been limited and more needs to be done.

THE FEDERAL RESERVE SHOULD RELY ON EXAMINERS TO PERFORM CERTAIN NECESSARY PROCEDURES DURING SUBSIDIARY BANK EXAMINATIONS

A well-developed surveillance system can provide much of the information needed to monitor a company's condition. Other information, however, will have to be obtained through onsite analysis, especially for companies with greater risk. The Federal Reserve should be able to satisfy its remaining information needs for many companies by requesting the Federal regulator of the subsidiary bank(s) to perform those necessary procedures as part of scheduled subsidiary bank examinations.

Of the 2,480 bank holding companies supervised by the Federal Reserve, 1,725 companies, or nearby 70 percent, control only one bank and do not engage in nonbank activities. The Federal Reserve now performs onsite inspections at these companies. The type of inspection procedures employed by the Federal Reserve are the same type that bank examiners are trained and qualified to perform at banks and that could be performed by the bank examiners for the Federal Reserve when they are onsite performing the subsidiary bank examinations. For these 1,725 companies the location of the holding company and the bank is generally the same. Thus, if the bank examiners were to perform the onsite inspection of the holding company while they are at the bank, it eliminates the need for the Federal Reserve to send its inspectors to the holding company. This concept would reduce unproductive time spent in traveling to and from the holding company as well as direct travel costs. We did not, however, attempt to estimate what precise saving would be involved if this concept were adopted.

Onsite procedures may include an assessment of management competence, an evaluation of asset quality, and other procedures depending on the type of company. Assessing management competence is important since the ability of management bears importantly on every aspect of holding company operations. Consequently, the evaluation of management is included as a major factor in the evaluation of each of the five principal elements used in rating a company, as well as in the assignment of an overall rating.

Although the assessment of management requires an onsite presence, the frequency of onsite assessments can vary with the type of holding company. In a small one-bank holding company, management at the parent level is often the same as bank management. If an initial onsite assessment is made, and there is not a change in holding company or bank management, objective measurements of financial performance in the surveillance system could serve as an adequate continuing check on management performance and could extend the period between site visits. Two district banks which supervise a large number of small one-bank companies use this approach to conserve limited resources.

An asset quality evaluation is required where the company extends credit on its own or through nonbank subsidiaries. Evaluation of asset quality is an important element to be taken into consideration when performing a financial analysis of a company because of the severe impact that poor quality assets can have on the organization's overall condition. Regulators may need to go onsite to the company or its nonbank subsidiaries to review the records or documentation supporting the making of a loan and its payment and to classify suspect loans. The amount of classified loans figures into several key ratios used by the regulators to assess financial condition.

Other onsite procedures may be required to obtain information necessary to assess a company's condition, but each set of procedures will address only certain risk characteristics and, therefore, should not be required in all situations. For example, where a company controls nonbank subsidiaries, a review of these activities should be made. Procedures could include determining the permissibility of activities and verifying that transactions between these subsidiaries and other affiliates are appropriate. In a one-bank company without nonbank subsidiaries, the only intercompany transactions possible are between the parent company and the bank, and these transactions are reviewed during the bank examination.

Examiners are qualified to perform inspections of low risk companies

With guidance and direction by the Federal Reserve, bank examiners are qualified to perform holding company inspection procedures. The three onsite procedures most commonly necessary for an adequate holding company analysis are the assessment of management competence, review of asset quality, and review of nonbank activities. Examiners already perform these procedures during the course of bank examinations.

Bank examiners regularly evaluate management as an essential part of their bank examinations. Both OCC and FDIC examination manuals detail the importance of evaluating bank management and provide appropriate examination procedures. Management in many holding companies and subsidiary banks is the same. As discussed in chapter 2, many companies are single-subsidiary companies operating in the corporate form for tax advantages. A similar situation is often found in larger companies as well, where management is often centrally located in the larger subsidiary bank. Researchers' studies conclude that most holding companies try to manage their organizations as integrated entities. 1/

Bank examiners regularly evaluate the quality of assets held by nonbank subsidiaries of the banks they are examining. Since the types of nonbanking activities operated directly by banks are largely the same as those operated by holding companies, the fundamental approach for judging asset quality is similar. With additional guidance from the Federal Reserve, bank examiners should be able to perform capably in this area.

With few exceptions, the nonbank activities permissible for banks and bank holding companies are similar. The examination manuals for all three Federal bank regulators recite the importance of reviewing nonbank subsidiaries of a bank and prescribe instructions for such reviews. In addition, examiner training

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1/See our report to the Congress "Federal Supervision of Bank Holding Companies Needs Better, More Formalized Coordination," (GGD-80-20, Feb. 12, 1980).

courses at these agencies include instruction on how to review nonbank activities. The Federal Reserve's integrated training program for bank examiners and holding company inspectors demonstrates that a fundamental knowledge is needed for both.

Involving the other Federal bank regulators in performing limited inspection procedures is a workable idea generally accepted by those bank regulators. When approached with our suggestion, FDIC and OCC expressed a willingness to perform limited inspection procedures on behalf of the Federal Reserve. Some duplication is occurring between the Federal Reserve's holding company inspection and the other Federal regulators' subsidiary bank examinations. Officials at both agencies told us that, to some extent at least, they are currently performing procedures during subsidiary bank examinations which address the holding company. When we recounted a list of onsite procedures for low-risk companies, FDIC officials said that to the best of their knowledge, FDIC examiners routinely perform those procedures. OCC officials we talked with were more certain that the procedures we listed were currently part of an affiliated national bank examination.

Savings can be achieved if bank examiners perform holding company inspection tasks

Expanding the scope of scheduled bank examinations to include holding company inspection procedures would be less costly than the Federal Reserve conducting a separate holding company inspection. Currently, each bank is examined every 12 to 18 months. In addition, the holding company is inspected at least once every 3 years. In many companies the location of visit is the same. Where this situation exists, having inspection procedures performed during a scheduled bank examination will eliminate a site visit by the Federal Reserve without additional travel burden to the other regulatory agency. This would result in a savings of travel costs and time lost in travel status for about two inspectors for each company examined. We believe supervising most of the 1,725 one-bank holding companies without nonbank subsidiaries in this fashion would relieve part of the burden on several district banks and thus allow those district banks to provide increased supervisory attention to more risky companies.

Legal authority exists for bank examiners to perform holding company inspection tasks

There is legal authority for the Federal Reserve to request other bank regulators to perform inspection procedures. FDIC and OCC can, at the request of the Federal Reserve or at their own initiative, enter certain holding companies in the exercise of their own regulatory authorities. Both FDIC and OCC have authority

to examine the affairs of holding companies which constitute "affiliates" of State or national banks which are subject to their examinations.

Any FDIC or OCC examinations of holding companies as "affiliates" of banks subject to their examination authority would have to be related to scheduled examinations of the affiliated banks. However, FDIC and OCC have broad power to examine the affairs of a covered holding company to the extent relevant to the relationship between the holding company and affiliated bank.

Federal Reserve districts are split on the use of bank examiners

Several Federal Reserve district banks favor involving the other Federal bank regulatory agencies in performing inspection procedures while others argue against this. District banks favoring the proposal believe it would result in more timely and effective supervision of bank holding companies. They feel by having the other Federal agencies inspect small companies while onsite for subsidiary bank examinations, considerable duplication of effort could be avoided, resulting in a savings of travel and manpower costs. District banks opposed to having other agencies inspect small bank holding companies feel it would be a step toward, and would perhaps hasten, the emergence of the other agencies becoming primarily responsible for the supervision of bank holding companies--a development the Board should continue to resist. As discussed above, we believe the other regulators are qualified to perform necessary review functions for many companies.

Conclusions

In certain situations the Federal Reserve will need information about a company which must be developed through onsite procedures. Potential savings are available by requesting Federal bank examiners to perform these procedures for many companies during their scheduled bank examinations. Examiners have the essential qualifications and experience to perform certain necessary inspections of low-risk companies, and FDIC and OCC have legal authority to enter the holding company during a bank examination.

CHAPTER 4

OVERALL CONCLUSIONS, RECOMMENDATIONS,

AND AGENCY COMMENTS

The number of bank holding companies has grown significantly in recent years. This trend is likely to continue and to place increasing performance and budgetary demands upon the Federal Reserve System's holding company supervision program. The Federal Reserve has made several meaningful improvements to its supervision program in the last 3 years, but we believe certain continuing weaknesses must be corrected if the agency is to effectively meet the increasing demands on its supervision resources.

The Federal Reserve's past inspection policy strongly emphasized routine onsite inspection of holding companies at stated intervals. The policy did not provide needed flexibility to vary the frequency of inspections to reflect a company's risk characteristics or financial condition. Although we were told that the latest policy revision was intended to provide the needed flexibility, this is not clear. On the basis of our observations at the district banks, we are not convinced that district bank officials will feel free to alter the suggested inspection frequency schedule to inspect holding companies where there is a greater perceived need.

The risk to the safety and soundness of subsidiary banks can be greatly increased when a holding company also controls nonbanking subsidiaries which extend credit. Some Federal Reserve district banks do not have sufficient, uniform information and expertise to adequately assess nonbanking subsidiaries' potential risk and to judge how much surveillance and inspection effort is needed. Further, the Federal Reserve Board staff does not have an adequate means for evaluating district banks' reviews of holding companies' nonbanking subsidiaries.

The Federal Reserve's surveillance system can be an effective tool for identifying potential problem companies and for directing the use of onsite inspection resources. The Board has developed a centralized computer-based financial monitoring program. However, district level monitoring activities--a potentially valuable supplement to the Board's minimum program--have not realized their optimal effectiveness because they lack central direction and coordination. The Board has taken some steps to address this problem, but improvements have been limited and more needs to be done.

The Federal Reserve's policy and its inspection manual encourage full-scope inspections in most situations. Conversely,

we believe that once it has been decided that an inspection is needed, holding company inspectors should be encouraged to limit their work to those procedures that address areas of perceived risk. The areas of perceived risk should relate directly to those factors that, through surveillance or other management determination, caused the company to be selected for onsite review.

There will always be instances when the Federal Reserve needs information which can only be developed through onsite procedures. We believe that Federal bank examiners have the legal authority and the qualifications and experience to perform necessary holding company inspection procedures. For many companies--primarily those which do not engage in nonbank activities and where the location of the holding company and the bank is the same--economies can be achieved if the Federal Reserve satisfied its bank holding company information needs by having bank examiners obtain needed information during the course of their bank examinations.

RECOMMENDATIONS

We recommend that the Chairman, Board of Governors of the Federal Reserve System:

--Clarify inspection frequency guidelines to encourage district banks to inspect holding companies whenever there is a perceived need regardless of inspection schedules. In assessing perceived need, the district banks should place greater reliance on surveillance and give more emphasis to companies which have nonbank subsidiaries that extend credit.

--Increase expertise in nonbank industries and improve training and control mechanisms to ensure that the risk of holding companies' nonbanking operations is uniformly and adequately considered in the surveillance and onsite inspection processes.

--Reassess reporting requirements to improve the information available on the activities of holding companies' nonbank subsidiaries, including peer group data for comparative financial analysis. This reassessment should attempt to minimize any increased reporting burden by concentrating on collecting only that data required for effective holding company supervision.

--Establish procedures for evaluating district bank surveillance activities. Such evaluations should prompt establishment of more definitive guidelines and criteria for district bank surveillance activities and should

assure that the most appropriate practices, from a programmatic and economic standpoint, are adopted.

--Revise the inspection manual to limit onsite inspection tasks to those which are needed in each circumstance.

--Develop the concept under which the Federal Reserve would request the Federal bank examiners from each agency to perform needed holding company tasks in the course of their bank examinations. We recognize that this concept will not be appropriate in all cases and its use will depend upon timing, examiner capability and availability, and the economics of each situation. We anticipate that this concept will be most appropriate for holding companies that do not conduct nonbanking activities and where the holding company and subsidiary bank management are essentially the same.

AGENCY COMMENTS AND OUR EVALUATION

The Federal Reserve stated that it is reviewing its policies and procedures in each of the areas we note as in need of improvement, and it has under consideration or has already taken certain steps to modify and strengthen its supervision program.

The Board agrees with us that problem situations should receive priority and that scheduled inspections of such companies should be performed when needed rather than adhere to a rigid frequency formula. The Board believes, however, that its recently adopted inspection policy provides appropriate flexibility to district banks to determine inspection frequency. It intends to encourage the exercise of this flexibility through such internal mechanisms as the operations reviews of district bank inspection activities. The Board also stated that it believes periodic onsite inspections are warranted, especially of large companies with a high degree of leverage and/or significant nonbank subsidiaries.

During our audit work we noted that district bank officials have been reluctant to forego scheduled inspections to permit inspecting companies with potential problems. After reviewing and commenting on our draft report, the Federal Reserve's Division of Supervision and Regulation issued a letter to district bank officials in charge of holding company inspections clarifying, by example, the flexibility district banks are permitted to exercise. We believe that the recently issued letter should clarify the Board's scheduling policy.

We believe Board staff are committed to implementing a flexible policy and will encourage the exercise of this flexibility through its operations reviews of district bank inspection

activities. We found that it was the operations review program, at least in part, from which district bank officials perceived the pressure to rigidly adhere to inspection frequency requirements. Operations review participants should not only encourage flexibility but should also specifically assess district bank judgment and timeliness in responding to surveillance information and scheduling of inspections for companies with potential problems. Because of the recentness of the policy clarification, we were unable to gauge the impact it will have on scheduling decisions made by district bank officials.

In reference to the Federal Reserve comment that periodic inspections for some companies are warranted, we have never stated that periodic onsite inspections are not warranted if they relate to a perceived risk. Rather, our position is that scheduled inspections should specifically address risk factors and not be routinely performed solely to satisfy established frequency requirements. The effective use of limited inspection resources mandates that only necessary tasks be performed during scheduled inspections.

The Federal Reserve disagreed with our conclusion that some district banks do not always have sufficient expertise to evaluate nonbank activities and that it lacks adequate means for evaluating district efforts in this area. It noted that inspection policy requires periodic onsite reviews of nonbank subsidiaries unless necessary records can be obtained from the parent company. A written statement of the scope of the parent company and nonbank subsidiary reviews is to be included in the inspection report. The Federal Reserve noted that its training curriculum now provides instructions in all aspects of bank and holding company activities.

As stated in our report, we reviewed a sample of inspection reports to determine if the scope section clearly described the extent of nonbank subsidiary review. In most cases it did not. Inspectors must provide more descriptive information if Board staff intend to assess adequacy of coverage in this manner. We believe improved monitoring of this important area is needed because district banks do not have sufficient, uniform information and expertise to adequately assess the nonbank risk. The Federal Reserve should note that officials at several district banks expressed a need for acquiring individuals with expertise in various nonbank industries to (1) provide training for inspectors, (2) assist in analysis of subsidiaries, and (3) project trends which bear close attention.

The Federal Reserve and GAO agree that offsite financial analysis of surveillance information can eliminate collecting and analyzing essentially similar data during onsite inspections. We reviewed a draft of the new section on surveillance to be

included in the holding company inspection manual. The draft encourages the expanded use of surveillance information that we advocate, including the use of ongoing monitoring to assist in scheduling inspections and directing limited inspection resources toward companies with declining financial conditions.

The Federal Reserve disagreed, however, that additional information is needed for surveillance purposes. We share the Board's concern that new requirements could increase the reporting burden on some companies, but we agree with OCC that better information can only enhance the effectiveness of holding company supervision while reducing the overall regulatory burden. OCC strongly endorsed our recommendation that the Federal Reserve reassess reporting requirements with a view toward improving the information available on the activities of holding companies' subsidiaries. The increased reporting burden can be minimized if present reporting requirements are reviewed and unnecessary information originally required for research purposes is eliminated. On a broader basis, increased effectiveness of surveillance could permit inspectors to extend the time between inspections without increasing the risk that the condition of the holding companies will deteriorate.

During our review we noted that one district bank was computerizing financial information on small one-bank holding companies. The Board stated that it will do this on a systemwide basis and develop an abbreviated performance report. We are not sure to what extent this report will satisfy the need for additional information on small companies expressed by FDIC in its comments. We are hopeful that the Federal Reserve will ask the other Federal regulators to provide input on information needed to supervise banks held by small one-bank holding companies.

The Federal Reserve disagreed with our recommendation that they establish more definitive guidelines and evaluation procedures for district level surveillance activities. Existing surveillance guidelines require uniformity and compliance with the Board-level computerized surveillance system but allow the districts great flexibility to respond to changing conditions and evolving banking structures. We acknowledge that some flexibility is essential but question the wide variety of approaches observed at the district banks. We noted specific instances where one district bank had developed a procedure which would have enhanced the surveillance efforts of other districts. District level surveillance activities will not realize their optimal effectiveness without central direction and coordination.

The Federal Reserve did not comment specifically on the merits of our recommendation that it consider requesting the Federal bank examiners from each agency to perform, where appropriate, inspection tasks in the course of scheduled bank examinations. The Federal Reserve states only that it plans to review its inspection policy for small companies and will consider a number of alternatives for gathering information on companies that have no nonbank activities or subsidiaries.

We requested the FDIC and OCC to comment on our draft report, specifically on our recommendation that they perform inspection tasks for some holding companies at the Federal Reserve's request. Although FDIC felt our recommendation would probably achieve some savings in the overall cost of regulation, both FDIC and OCC stated that our report did not address the divided supervision of holding company systems which they saw as the more fundamental problem.

FDIC stated that it is able and would be willing to perform holding company inspections at the request of the Federal Reserve provided that a system can be developed which would provide the Federal Reserve with its information needs in a manner that would be cost effective for FDIC. In their opinion, current examiner training provides the expertise necessary to examine and evaluate holding company systems. FDIC's main concern is that a system not be created that would require a separate report for the holding company that is largely duplicative of the examination report of the bank. FDIC believes that some savings in the overall cost of regulation would probably be achieved by implementing our recommendation. OCC was not responsive to our request for comments on this recommendation. Instead, it cited the strengthened interagency coordination of examinations and holding company inspections which has enhanced supervision of the holding company systems.

Both OCC and FDIC believe that our recommendation to obtain holding company information for some companies during bank examinations does not go far enough in addressing what they see as the more fundamental problem--divided supervision of holding company systems. Both agencies reiterate long-standing positions that favor the lead bank supervisor concept. Under this concept the Federal regulator responsible for supervising the only bank in a one-bank company or the largest (lead) bank in a multibank company would assume supervisory responsibility for the holding company and all its subsidiaries.

Specifically, OCC states that a unified supervisory perspective on, and authority over, the entire holding company system is needed. OCC believes that the possibilities for regulatory confusion and duplication are real and present concerns. It further adds that, inevitably, the current supervisory approach will be

at times conflicting and uncoordinated. FDIC suggests that experience since 1970 demonstrates the need to supervise the holding company system as a single economic entity and makes reference to major bank failures involving holding companies.

In a report to the Congress 1/ we stated that the existing regulatory structure inhibits effective supervision and has led to problems in dealing with holding company banks in trouble. We reviewed cases, including examples provided by all three Federal regulators, in which one or more of the Federal bank regulators took a formal action against a bank holding company or bank subsidiary for unsafe, unsound practices. We concluded that the potential exists for serious holding company and bank problems to remain unsolved because of inadequate agency coordination.

The lead bank supervisory approach is a logical alternative for limiting potential uncoordinated action and duplication in supervising holding company systems. Such a solution, however, would require a major legislative restructuring of current supervisory responsibilities. Although OCC and FDIC refer in broad generalities to the problems, either potential or real, inherent in the current Federal structure, few specific examples have been offered. We did not find any current cases of banks which failed or which were threatened with failure because of poor coordination. In our evaluation, the evidence supporting legislative restructuring is not persuasive.

Since the Congress had recently created the Federal Financial Institutions Examination Council (Council) to promote interagency cooperation, we concluded that the appropriate solution was for the Council to develop procedures requiring greater coordination in gathering information and taking supervisory action. The Council adopted a policy which requires the Federal regulators to coordinate inspection of the holding company and examination of the subsidiary bank(s) when (1) the holding company has consolidated assets in excess of $10 billion or (2) where the holding company or its lead bank exhibits problems.

Although it is too early to fully assess the effectiveness of the Council's procedures, we are encouraged by OCC's statement that coordination of bank examinations and holding company inspections, along with the exchange of examination results, has enhanced the supervision of holding company systems. Unless

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1/"Federal Supervision of Bank Holding Companies Needs Better, More Formal Coordination," (GGD-80-20, Feb. 12, 1980).

strong new evidence of harm to financial institutions can be demonstrated, the agencies should commit themselves to enthusiastically supporting the coordinated approach.

OCC noted that it initiated testing of a multibank holding company examination concept which is expected to result in less frequent onsite examinations or greatly reduced examination time at bank subsidiaries of multibank holding companies. This program is still in the testing phase and we have not had an opportunity to review it in detail. We believe, however, that the approach raises significant problems which need to be addressed during the testing period and resolved before the program is adopted.

Although OCC's examinations of holding companies grow out of its concerns over the subsidiary national banks, the areas examined by OCC are remarkably similar to the areas included in the Federal Reserve's inspections of holding companies. At the conclusion of the OCC examination, a letter is sent to the board of directors of the holding company addressing such areas as the company's overall financial condition, assets, earnings, capital, liquidity, fund management, internal auditing, and litigation. These areas are addressed by the Federal Reserve in its inspection of the holding company.

In a May 20, 1980, letter to the Senior Deputy Comptroller for Bank Supervision we expressed interest in the procedures being written by OCC and what areas they addressed that were not already adequately being performed by Federal Reserve inspectors. In response to our letter OCC did not clearly state why it is entering areas being assessed by the Federal Reserve.

A task force of the Federal Financial Institutions Examination Council has under consideration a project to review OCC's test program. While the extent of the Council's involvement in the test program is not clear at this time, there are important issues concerning this program which need to be addressed. First, if it is determined that the OCC multibank holding company examination concept is the most effective method for supervising banks, a uniform policy should be adopted under which all Federal regulators would use and benefit from this approach. Second, if the concept is desirable for supervising banks, a decision is needed on how to integrate the multibank holding company examination concept with the Federal Reserve's bank holding company inspections. Specifically, there is a need to determine how to eliminate

--any duplication between the Federal Reserve's bank holding company inspections and OCC's examinations, and

--separate reporting to holding companies by different Federal regulators on their assessment of the same areas with the possibility of conflicting comments on areas where corrective action is needed.

In determining how to integrate the examinations, consideration should be given to whether it is appropriate for each agency to perform work at holding companies which control subsidiary banks they supervise, as OCC now is doing, or if the Federal Reserve should expand its inspection procedures, if necessary, to obtain the information needed by the subsidiary bank regulators.

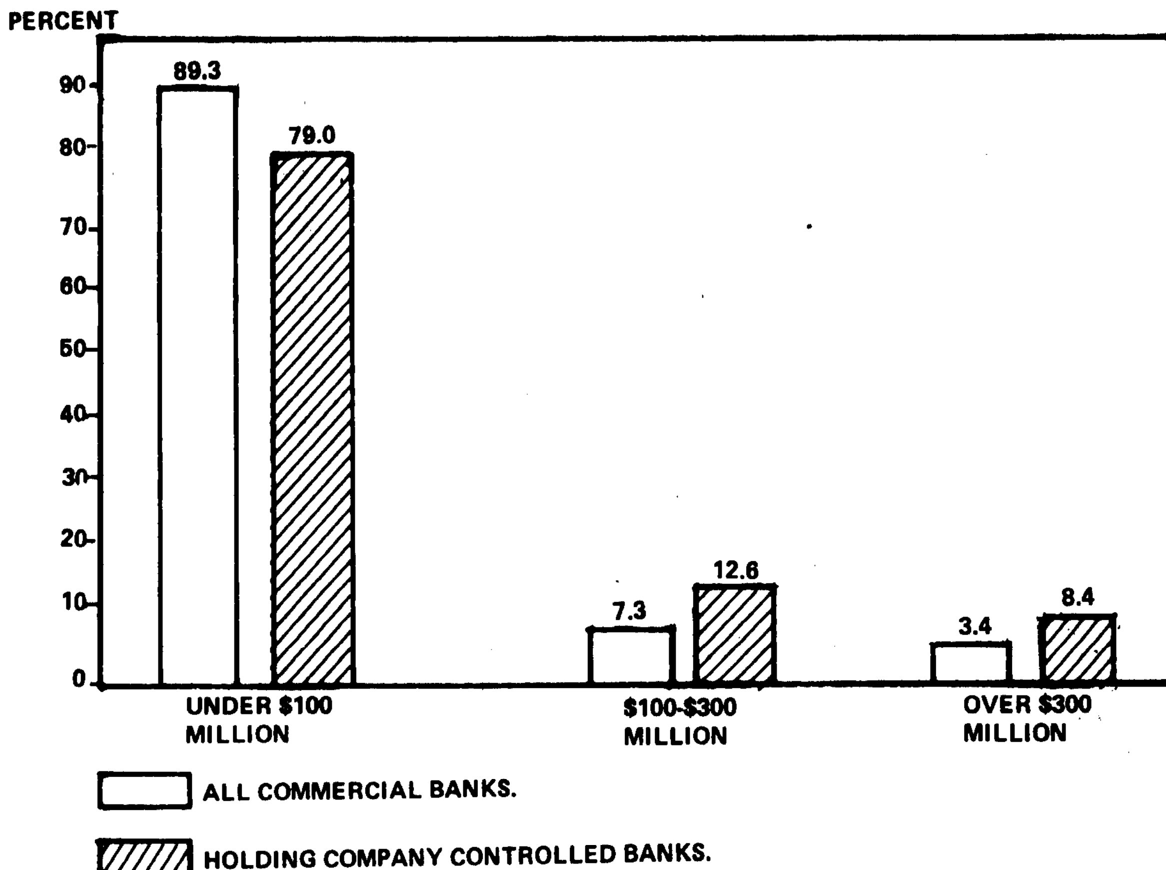
A DESCRIPTION OF THE BANK HOLDING

COMPANY INDUSTRY

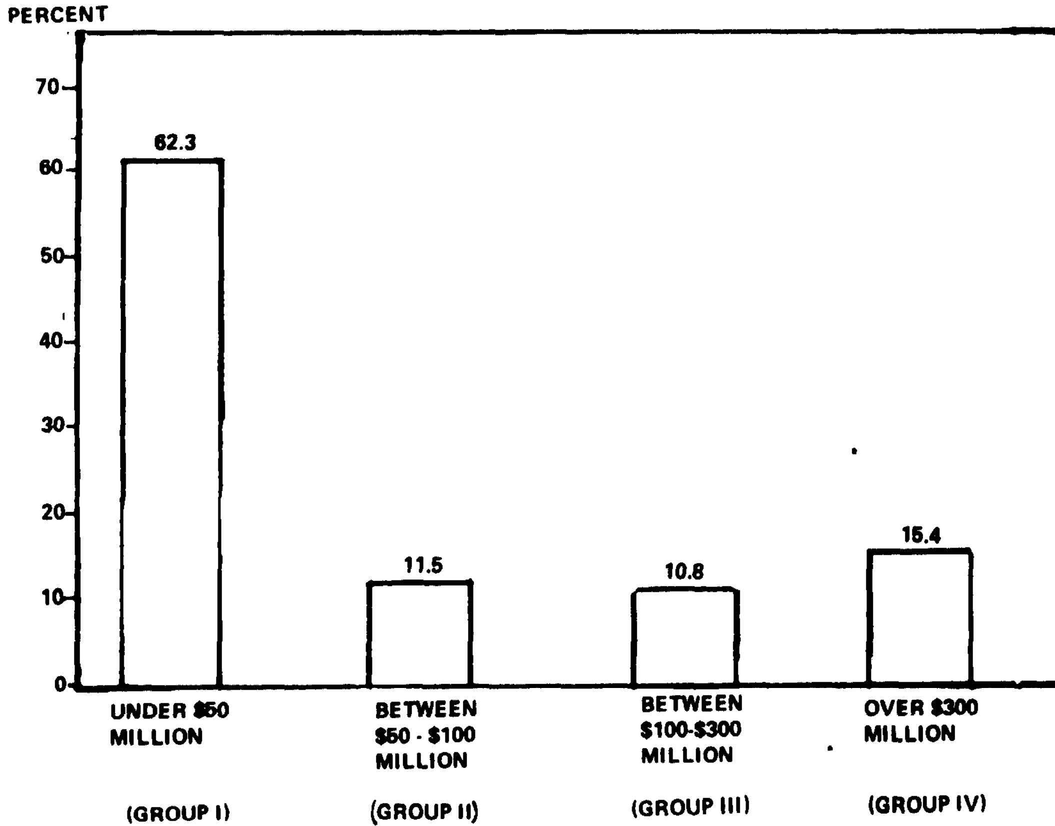
The charts and accompanying narrative in this appendix are based on information provided to us by the Federal Reserve. The Federal Reserve accumulates its data primarily from reports it requires bank holding companies to file. As discussed in chapter 1, there are accuracy and other problems with the data, which Board staff worked with us to overcome. Although we believe this presentation of data is both fair and reasonable, we discourage the use of this data for any purpose other than to describe the approximate composition of the bank holding company industry.

Bank holding company subsidiary banks

Bank holding company subsidiary banks represent a cross section of the banking industry ranging in total assets from $1.9 million to $106 billion. The following chart shows that most bank holding company subsidiary banks are small, as are most U.S. banks in general; but the percentage of holding company controlled banks that are large is greater than the percentage of large banks in the banking industry.



In what follows we divided holding companies into four groups, according to asset size, for purposes of description and discuss other categories within each group. These categories include: whether a company is rural or urban, whether a company controls one bank or more than one, whether a company has nonbanking subsidiaries, and where companies are geographically located.



Group I companies with less than $50 million in consolidated assets generally control only one bank, have no nonbank subsidiaries, and are located in rural areas. Over 89 percent of these companies control only one subsidiary--the bank. Of the 1,546 companies in this group, 98 percent control one bank, and 91 percent operate without nonbank subsidiaries.

Holding companies in this group are being formed at a rapid rate. Over 300 small companies were formed in the first 9 months of 1980. Most small companies are "tax shells," that is, they were formed by the owners of the controlled bank to attain advantageous tax treatment. These companies are inactive parents and control no subsidiaries other than the bank.

These small companies are predominately located in the midwest. The Kansas City Federal Reserve Bank is responsible for supervising 650 of these companies, the Chicago Federal Reserve Bank 338, and the Minneapolis Federal Reserve Bank 262.

Group II companies with consolidated assets of $50 to $100 million are similar in structure to companies with assets less than $50 million. These companies constitute 11.5 percent of all holding companies and are primarily located in the Kansas City, Chicago, and Dallas Federal Reserve Districts. Of the 284 companies in this category, 89.4 percent controlled only one bank, and 72.5 percent had no nonbank subsidiaries.

Group III companies, those with consolidated assets of $100 to $300 million, vary in structure and are located throughout the United States. Supervision of the 268 companies in this category is evenly distributed among most of the Federal Reserve banks with the exception of Chicago, which supervises 81 companies. About 70 percent of the 268 companies control only one bank, and 55.6 percent operate with no nonbank subsidiaries.

Group IV companies with consolidated assets of $300 million or more are quite diverse. This group contains only 382 companies, 15 percent of all holding companies, but it accounts for almost 80 percent of all holding company controlled assets. About half of the companies control more than one bank, and 77.7 percent have nonbank subsidiaries. The largest number of these companies are located in the Chicago, New York, and Atlanta Federal Reserve Districts.

Extent of nonbank activities

Most bank holding companies are not extensively involved in nonbank activities. Although some companies have hundreds of nonbank subsidiaries, including such activities as insurance, mortgage lending, leasing, and personal finance companies, 75 percent of all holding companies do not directly engage in nonbank activities. Most small companies engaged in nonbank activities have only a few nonbank subsidiaries, often only an insurance subsidiary. However, larger companies control more subsidiaries engaged in a wide variety of permissible activities. About 47 percent of the companies controlling nonbank subsidiaries have consolidated assets of $300 million or more.

Companies generally control only one bank

As of December 1979, only 340 holding companies (14 percent) controlled more than 1 bank, but some controlled as many as 80. Companies with more than one bank are generally larger, however, with 47 percent of these multibank companies

having consolidated assets of $300 million or more. Nearly half of the multibank companies are located in the Atlanta, Chicago, and Kansas City Federal Reserve Districts. About 80.6 percent of the one bank companies operate without nonbank subsidiaries, but 63.8 percent of the multibank holding companies have nonbank subsidiaries.

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

ADDRESS OFFICIAL CORRESPONDENCE
TO THE BOARD

June 12, 1981

Mr. William J. Anderson
Director
General Government Division
United States General Accounting
Office
Washington, D.C. 20548

Dear Mr. Anderson:

The Board appreciates the opportunity to respond to the draft GAO report entitled "The Federal Reserve Can Improve Bank Holding Company Inspections." The report discusses the Federal Reserve's supervision of bank holding companies through its inspection and surveillance activities and points out that the Federal Reserve has initiated a number of steps within the last several years to improve its supervisory program. Principal among these steps are the adoption of a standardized inspection report format, the development of a holding company supervision and inspection manual, the establishment of a computerized surveillance program, the implementation of a uniform rating system, the promulgation of a set of supervisory policies dealing with transactions between bank subsidiaries and their holding companies, and the revision of the training curriculum for Federal Reserve supervisory personnel. Moreover, recently the Federal Reserve adopted a new, more flexible policy for scheduling holding company inspections that explicitly relates the required inspection frequency to principal indices of risk such as financial condition, amount of leverage and the existence of nonbank subsidiaries. The purpose of all of these actions is to improve the Federal Reserve's ability to identify and respond to the risk associated with nonbank and holding company activities and to monitor the effect of holding company actions on banking subsidiaries. Another important objective that underpins many of these steps is the need to make maximum efficient use of resources in the supervision of bank holding companies.

In addition to noting these improvements, the GAO report raises a number of other issues relating to inspection frequency, the scope of the review of nonbank subsidaries, reporting requirements and the adequacy of data on nonbank subsidiaries, the role of financial surveillance in the supervision process and the conduct of inspections of small, "shell" holding companies. The Federal Reserve is reviewing its policies and procedures in each of these areas and has under consideration or has already taken certain steps to modify and strengthen its supervision program.

The GAO report recommends that inspection frequency guidelines be clarified to ensure that inspections are based on preceived need, rather than on a required periodic inspection frequency criterion. The GAO also endorses placing greater reliance upon surveillance results in determining frequency. As already noted, the recently adopted inspection policy gives additional flexibility to Reserve Banks to determine inspection frequency and ties scheduling to financial condition,

Mr. William J. Anderson - 2 -

leverage, and size and condition of nonbank activities. The determination with respect to condition and leverage are in part a function of the results of ongoing computerized surveillance and monitoring activities which have been formally incorporated in the frequency policy. The Board agrees with the GAO that problem situations should receive priority and that scheduled inspections of such companies should not adhere to a rigid frequency formula at the expense of timely inspection. In this spirit, the new frequency policy calls for the inspection of troubled companies as often as necessary, regardless of size. However, the Board does believe that periodic on-site safety and soundness inspections, especially of large companies with leverage and/or nonbank subsidiaries, are warranted and therefore has incorporated such a requirement in its frequency policy.

The Board believes the new policy provides appropriate flexibility and will encourage the exercise of this flexibility through such internal mechanisms as the operations reviews of Reserve Bank inspection activities. With respect to small one-bank holding companies, Board staff is planning to computerize the financial data already being collected and to develop an abbreviated performance report. This will improve our ongoing surveillance of small companies while obviating the need to increase reporting burden. Depending upon the outcome of this effort, the Board staff will review the periodic inspection requirement for small, nonleveraged companies with the possibility of providing even greater discretion to Reserve Banks in setting inspection schedules.

The GAO report raises questions concerning the Federal Reserve's ability to monitor the scope of the review of nonbank activities, the level of examiner expertise in analyzing nonbank subsidiaries and the adequacy of information on holding companies' nonbank subsidiaries. The on-site review of nonbank credit-related assets is an essential part of the Federal Reserve's inspection program. During an inspection, each significant subsidiary is analyzed, its risk assets are evaluated and classified and the results are included in the inspection report. Periodic on-site reviews of nonbank subsidiaries are required unless the parent has sufficient records to obviate the need to expend time and resources travelling to the subsidiary. The risk associated with significant subsidiaries is evaluated, and examiners are instructed to provide a written statement describing the scope of their holding company and nonbank reviews. The Board believes that the on-site inspection should be limited to certain necessary functions, and that existing sources of reported data should be utilized where appropriate in lieu of collecting essentially similar data during the inspection. The System's inspection manual has been expanded to prescribe the conduct of preliminary off-premise financial analysis of surveillance and monitoring results and holding company performance reports. These steps should make better use of existing data sources and improve the allocation of Federal Reserve examiners' time. Examiners are instructed in the preliminary analysis to isolate those areas requiring greater on-site review and to focus their attention during the inspection on asset quality, nonbank activities, management, supervisory report accuracy, and compliance with applicable laws and regulations. Together the financial analysis and the on-site review of assets and management give a comprehensive and accurate indication of the condition of the holding company and its nonbank subsidiaries.

With respect to the issue of examiner training, the Federal Reserve believes that it has sufficient expertise to assess the risk of bank holding companies' nonbanking operations. Many of the permissible credit-related

activities in Regulation Y have long been conducted or financed by banks and, therefore, reviewed by System personnel during the bank examination. Nonetheless, the Board recognizes that the changing financial environment has resulted in more complex financial institutions and practices and, to this end, has upgraded its training curriculum to provide improved instruction in all aspects of bank and holding company activities.

In addition to the extensive information on nonbank subsidiaries collected during the inspection, the System also receives valuable data in the annual reports filed by holding companies. While much of this information was originally required for research and statistical purposes, its does supplement the supervisory data compiled during the inspection. Moreover, recent modifications to computer programs have improved the use of these data for supervisory purposes. While additional information for supervisory purposes would be helpful, the Board believes the nonbank data gathered during the inspection and the annual report of holding companies obviates the need to place additional reporting burden on holding companies. The Board is, however, committed to improving its use of existing data, as in the above noted case of small companies, to support and strengthen its supervision program.

The GAO recommends that the Federal Reserve establish definitive guidelines and evaluation procedures for Reserve Bank surveillance activities. While pointing out that the System's surveillance program is a valuable supervisory tool and that minimum guidelines and procedures have been promulgated throughout the System, the GAO questions the degree of discretion and flexibility exercised by Reserve Banks in carrying out their surveillance activities.

The Board believes the System's present guidelines are sufficient to ensure that financial deficiencies are detected and followed-up in a timely manner. In accordance with the GAO's observations concerning inspections, the Board feels that flexibility is also necessary in conducting surveillance activities in order to allow Reserve Banks to respond to changing conditions and evolving banking structures within their respective Districts. The existing surveillance guidelines provide a proper balance between Systemwide uniformity and regional innovation, and encourage the exploitation of surveillance economies in the supervisory and inspection processes. The Board believes that uniformity and compliance with surveillance procedures are essential and, to this end, an important part of the Reserve Bank operations reviews are now devoted to evaluating surveillance and monitoring activities. Moreover, Board staff is continually reviewing surveillance procedures and, as the GAO points out, the Federal Reserve has recently taken a number of steps to foster innovation and better communication within the System.

The GAO report recommends that the Federal Reserve explore the concept of requesting bank examiners from other Federal agencies to perform certain inspection-related tasks for small, shell holding companies. The Federal Reserve has cooperated in a number of actions to integrate more effectively holding company and subsidiary bank supervision, including the program to coordinate bank and holding company examinations in large and problem institutions. Implementation of this program will result in coordinated or concurrent holding company-bank examinations for organizations representing approximately 50 percent of the aggregate assets of U.S. banking institutions. Moreover, the Federal Reserve is also working with the other Federal agencies to

Mr. William J. Anderson - 4 -

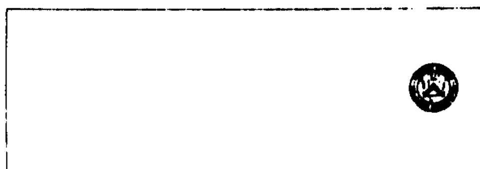
coordinate bank and parent company examination efforts in certain large, centralized multibank holding companies. These efforts are intended to limit supervisory overlap and inconsistencies, encourage efficiencies and minimize burden on bank management.

In conjunction with these on-going programs, the Federal Reserve, as already noted, plans to review its inspection policy for small companies, including the required frequency and timing of on-site inspections. The goal of this review will be to further incorporate surveillance results together with the possibility of greater discretion in the setting of inspection priorities. In the context of this review, the Federal Reserve will consider a number of alternatives for gathering information on holding companies that have no nonbank activities or subsidiaries.

The Board would like to thank the GAO for the professional manner in which the study was conducted.

Very truly yours,

James McAfee
Assistant Secretary of the Board



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

OFFICE OF DIRECTOR - DIVISION OF BANK SUPERVISION

June 12, 1981

Mr. William J. Anderson
Director
General Government Division
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Anderson:

We appreciate the opportunity of commenting on your draft report entitled "The Federal Reserve System Can Improve Bank Holding Company Inspections." As you have requested, comments will be directed primarily toward the recommendation that the Federal Reserve request Federal bank examiners to perform the inspection of many bank holding companies in the course of their scheduled bank examinations.

As stated in the draft report, GAO recommends that the Federal Reserve explore the concept of requesting Federal bank examiners from each agency to perform needed holding company tasks in the course of bank examinations. GAO feels that this concept will not be appropriate in all cases and its use will depend upon timing, examiner capability and availability, and the economics of the situation. GAO anticipates that this concept will be most appropriate for holding companies that do not conduct nonbanking activities and where the holding company and subsidiary bank management are essentially the same.

With respect to the precise recommendation, the FDIC is able and would be willing to perform holding company inspections at the request of the Federal Reserve provided that a system can be developed which would provide the Federal Reserve with its informational needs in a manner that would be cost effective for the Corporation. As noted in the report, most of the companies which GAO contemplates FDIC would inspect are shell corporations whose management is largely identical with that of the bank. Consequently, the volume of information necessary over and above that contained in the bank's examination report would probably not be extensive in most instances. Our main concern

here is that a system not be created that would require a separate report for the holding company that is largely duplicative of the examination report of the bank.

While the procedure recommended by GAO would probably achieve some savings in the overall cost of regulation, it does not, in our view, go far enough in addressing the more fundamental problem, which is the divided supervision of holding company systems. Under the system being recommended FDIC would perform an inspection of a one-bank holding company along with its examination of the bank. Any problems existing in either entity would undoubtedly be discussed with management by the examiner; however, subsequent supervisory requests or actions emanating from the examination would continue to come through FDIC with respect to the bank and through FRS with respect to the holding company. We believe this division of supervisory responsibility will retain many of the weaknesses which exist in the present system.

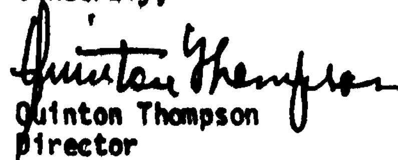
Chairman Sprague of FDIC has testified before Congress on several occasions that the major shortcoming of our current regulatory system is the divided supervision of holding company entities. Experience since enactment of the 1970 amendments to the Bank Holding Company Act -- including some major bank failures involving holding companies -- have demonstrated convincingly that a holding company is a single economic unit and should be supervised as such. In view of this, the Corporation has recommended a system whereby the supervisor of the lead bank be assigned the supervision of the holding company itself and its nonbank affiliates and that the lead supervisor be authorized to coordinate the examination of the other bank affiliates by their respective supervisors. Under this arrangement, the entire holding company would be examined and monitored as a unit; but each bank component would continue to be examined by its primary regulator. The Federal Reserve would retain its present role of determining permissible activities for holding companies and their nonbank affiliates.

In recognition of the single entity concept of holding company operations, the FDIC began offering, in 1978, a course in analysis of banks and bank holding company systems. Close to 50 percent of our commissioned examiners, including all of our more senior examiners throughout the country, have already received this training. The holding company segment of the course, to which about half of the one-week session is devoted, equips the examiner to perform an analysis of a holding company system through use of various data which is available from income and condition reports, reports filed with SEC, and FRS inspection reports. This training, together with existing bank examination skills, provides our examiners with the expertise to examine and evaluate holding company systems to the extent we are called upon to do so.

The GAO report offers several comments and recommendations concerning holding company reporting requirements and the surveillance systems based thereon. We

would like to offer comment on one other aspect of this which the GAO has not specifically mentioned. Under current reporting requirements holding companies with under $50 million in consolidated assets provide parent company information in a form which does not lend itself to computerization. This effectively precludes incorporation of this data into a computerized surveillance system. The major problem encountered in small holding companies has been the high debt load which they frequently carry and the impact of the related cash flow requirements on the bank. This type of problem could be effectively monitored through a computerized surveillance system if the data were available. Consequently, we believe such companies should be required to file their data on the existing Y-9 or some similar form so that it could be used for surveillance purposes.

Sincerely,



Quinton Thompson
Director

Comptroller of the Currency
Administrator of National Banks

Washington, D. C. 20219

June 15, 1981

Mr. William J. Anderson
Director
General Government Division
United States General Accounting Office
441 G Street, N.W.
Washington, D. C. 20548

Dear Mr. Anderson:

We have reviewed your May 15, 1981 draft of a proposed GAO report entitled, "The Federal Reserve System Can Improve Bank Holding Company Inspections." Although recommendations in the report have not been addressed specifically to OCC, we appreciate GAO's invitation to comment on the draft.

The increase in holding company organizations signifies the industry's zeal to offer a wide range of products, to increase service to consumers, to achieve economies of scale, and to use this corporate structure's financial flexibility as a source of strength to both bank and non-bank subsidiaries. Recent rapid growth and development of holding company systems evidence the repositioning now occurring in the financial services industry. It should be noted that bankers continue to pursue changes in state law to permit multibank holding companies.

Recognizing the growing significance of holding companies, the OCC has taken positive action to develop appropriate examination techniques to improve the effectiveness of supervision of national bank subsidiaries. The OCC initiated testing of a multibank holding company examination concept in 1980. This concept is based on the premise that many holding company systems develop central objectives, budgets, policies, plans, procedures, internal controls, and accounting and reporting systems for their subsidiary banks. Also, some multibank systems provide audit services, internal loan review, uniform investment portfolio, asset/liability management and funding strategies. Performance is often monitored through the use of sophisticated management information systems.

The OCC anticipates that significant efficiencies can be realized through implementation of the new multibank holding company examination process. We expect the process to result in less frequent on-site examinations or greatly reduced examination time at bank subsidiaries of multibank holding companies. The economies to be realized, of course, will depend on the extent to which holding companies provide policy direction, monitor subsidiaries' performance, and audit reports received through comprehensive and reliable management information systems. In the testing phase of our new multibank holding company examinations, we found the concept was well-received by senior management of both the holding companies and their lead national banks but, more importantly, contributed to more effective supervision of all of the national bank subsidiaries.

In view of the OCC's new multibank holding company examination procedures, we strongly endorse GAO's recommendation that the Federal Reserve Board reassess reporting requirements with a view toward improving the information available on the activities of holding companies' subsidiaries. Improved and expanded information can only enhance the effectiveness of holding company supervision while reducing the overall regulatory burden.

Regarding GAO's recommendation that the Federal Reserve request Federal bank examiners from other agencies to obtain information needed for the Federal Reserve's supervisory purposes, it should be noted that cooperation among the agencies has strengthened considerably during recent years. Coordination of examinations and inspections of holding companies among the agencies, along with the exchange of examination results, has enhanced the supervision of the holding company system. We expect a continuation of efforts to support this expanding cooperation while the agencies seek innovative and creative methods to improve further their examination processes in an efficient and effective manner while taking into account the attendant regulatory burden.

On balance, the OCC feels that GAO's report does not go to the heart of the matter. What is lacking is a unified supervisory perspective on, and authority over, the whole corporate entity. Over two-thirds of the multibank holding companies contain at least one bank which is nationally chartered and at least one bank which is state chartered. Indeed, it is not uncommon for a holding company system to include national banks, state member banks, and state nonmember banks - sometimes in several states.

The possibilities for regulatory confusion and duplication are real and present concerns. It is not sensible for a multiplicity of regulators to have safety and soundness jurisdiction over various segments of an integrated business enterprise. Inevitably, this approach will be at times conflicting and uncoordinated. Both the FDIC and the OCC are on record as favoring resolution of this serious flaw in the present regulatory structure.

In an earlier draft report on bank holding companies, GAO suggested a possible solution:

> "Changing the holding company supervisory structure by giving holding company supervisory authority to the lead bank supervisor may, in the long run, be the best solution. This approach would eliminate the need for interagency coordination for one bank and some multibank holding companies. In other multibank holding companies, the Federal agency most familiar with the key segment of the holding company would supervise the entire organization."

GAO, however, did not recommend the necessary enabling legislation in its earlier report. We submit that the current draft report will not be the final GAO review of this important topic. Indeed, the problems inherent in the present regulatory structure assuredly will be revisited by GAO in the future - unless and until enabling legislation rationalizes the system.

Again, we appreciate the opportunity to comment on your draft and would be willing to elaborate on our comments with you or your staff.

Sincerely,

Charles E. Lord
Acting Comptroller of the Currency

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