

Washington, D. C.,
December 3rd, 1914.

The Examination and Audit of Federal Reserve and Member Banks under the direction of the Federal Reserve Board.

There has been created a Division of Audit and Examination. As an outline of its duties the following is submitted for the information of all concerned:

1. EXAMINATION AND AUDIT OF FEDERAL RESERVE BANKS.

(a) Federal reserve banks.

(b) Books and accounts of Federal reserve agents.

(a) Federal Reserve Banks.

Sec. 11; Par A - Authorizes and empowers the Federal Reserve Board "To examine at its discretion the accounts, books and affairs of each Federal Reserve Bank."

Sec. 21; Par. 5 - Provides that the "Federal Reserve Board shall, at least once each year, order an examination of each Federal reserve bank, and upon joint application of ten member banks the Federal Reserve Board shall order a special examination and report of the condition of any Federal reserve bank."

The law provides for an examination of each Federal reserve bank at least once a year, but it is proposed that examinations shall be held ordinarily twice each year, covering a thorough investigation of rediscounts, collateral loans, investments and open-market transactions, particular attention being paid to compliance with the provisions of the Federal Reserve Act and regulations promulgated by the Federal Reserve Board.

Paper accepted for rediscount should be analyzed, in order to determine its eligibility under the regulations

issued. Inquiry should also be made as to the condition of member banks offering paper for rediscount. Every examination should cover a complete audit of the bank and a report made to the Federal Reserve Board as to the condition of each bank, competency of management, adequacy of records and attention given by the directors to the affairs of the reserve bank. Attention should be called to any unsafe or unsound condition, or any vicious tendency that might appear in any department of the bank.

(b) Federal Reserve Agent.

Section. 11; Par I - The Federal Reserve Board shall be authorized "to require bonds of Federal reserve agents, to make regulations for the safeguarding of all collateral, bonds, Federal reserve notes, money or property of any kind deposited in the hands of such agents, * * * and make all rules and regulations necessary to enable said board effectively to perform the same."

The records and accounts of the Federal reserve agent in each Federal reserve district shall be examined at least quarterly, and a complete report made to the Federal Reserve Board. The examination shall cover a verification of the money, Federal reserve notes and collateral in the hands of the Federal reserve agent.

2. **SPECIAL EXAMINATIONS OF MEMBER BANKS OR BANKS APPLYING FOR MEMBERSHIP.**

(A) Member Banks.

Sec. 11; Par. A - The Federal Reserve Board shall be authorized "to examine at its discretion the accounts, books and affairs of each Federal reserve bank and of each member bank."

It is expected that the exercise of this function will be confined to special examinations or investigations to be made only when deemed necessary by the Federal Reserve Board, or with the approval of the Board upon a request by any Federal reserve bank. The primary purpose of such examination should be to ascertain the condition of a member bank or of the lines of credit which are being extended by it.

The Federal Reserve Act also grants authority to the Comptroller of the Currency and to the Federal reserve banks the right to examine member banks. Therefore, in order to prevent confusion and secure co-operation and coordination with the examinations of National banks by the examiners on the staff of the Comptroller of the Currency and in order to avoid duplication in examinations a plan has been suggested, details of which are embodied in the report of a special committee on this subject appointed by the Comptroller acting with a committee of your Board to suggest a means of standardizing the salaries of National bank examiners and the method of assessing banks for the cost of such examinations. A copy of that portion of the report relating to the matter above referred to is attached to this memorandum.

(B) State Institutions Applying for Membership.

Sec. 9; Par. 2.- "The Organization Committee or the Federal Reserve Board shall establish by-laws for the general government of its conduct in acting upon applications made by the State banks and banking associations and trust companies for stock ownership

in Federal reserve banks. Such by-laws shall require applying banks * * * to submit to the examination and regulations prescribed by the Organization Committee or by the Federal Reserve Board," •

The examinations of such institutions shall be made when ordered by the Federal Reserve Board. It is recommended, however, that all such applications shall be referred to the Division of Audit and Examination, which shall communicate with the Reserve bank of the District and with the State banking authorities. In connection with this inquiry, the Division of Audit and Examination shall be authorized to call for such supplemental information as may be deemed necessary, for example, the following:

- (1) A copy of report of the last examination by State authorities;
 - (2) Loans over a stated amount;
 - (3) Real estate investments, loans secured by real estate collateral, loans secured by stock of real estate corporations, real estate mortgages with data as to maturities;
 - (4) The business, firm and corporation affiliations of officers and directors;
 - (5) A detailed statement of investments.
- (C) Special Examinations - State Banks and Trust Company Members.

Sec. 21; Par. 1.- The Federal Reserve Board "may authorize examination by the State authorities to be accepted in the case of State banks and trust companies and may at any time direct the holding of a special examination of State banks or trust companies that are stockholders in any Federal Reserve Bank."

The intent of the law seems to be to accept the examination made by State authorities wherever it can be

done without discrimination. It should therefore be a function of this Division to investigate the examining methods of State authorities in order to ascertain whether or not the standard of examinations is such as to be acceptable to the Federal Reserve Board.

It will be necessary to request State authorities to furnish the Federal reserve banks information as to the condition of each State institution that is a member of the Federal Reserve System. Whenever a special examination is necessary by either the Federal Reserve Board or a Federal reserve bank it is usually desirable that such examination should be made in connection with an examination made by State authorities.

3. SPECIAL INVESTIGATIONS.

Special investigations will be held only when deemed advisable or order by the Reserve Board, either when warranted by general business or other conditions. Applications for the establishment of domestic or foreign branches, or of member banks to exercise trust company powers shall be investigated by this Division.

4. CREDIT BUREAUS.

The establishment of credit bureaus in Federal reserve banks, and of a central credit bureau at Washington is so closely related to examinations, that it is desirable that the Division of Audit and Examination

shall be responsible for the development of the system. The purpose of the credit bureau is to collect and record data concerning member banks and the standing of individuals, firms and corporations discounting at and borrowing from these banks, or selling paper to them. Furthermore, it is very desirable that credit bureaus be established in each Federal reserve bank, under the joint supervision of the Federal Reserve Agent and the Governor of the Bank, in order that material may be there collected, recorded and indexed for the benefit of the board of directors or Executive Committee passing upon the paper offered for rediscount, and open for inspection by examiners of the Federal Reserve Board.

Under the accounting system which has been adopted reports of various loans made are reported daily to the Washington office. It is proposed a few months hence to require a further weekly report giving the aggregate liability of the makers or payers of the paper rediscounted. This data will then be analyzed at the Washington office and recommendations made which will assist the credit bureaus of the different districts. It will be necessary to establish a system of co-operation and interchange of information between the district credit bureaus and also establish co-operation between National bank examiners and the Federal reserve banks in each district. This subject is more fully covered in the

report of the committee of examiners to the Comptroller and the Federal Reserve Board, to which reference is now made.

5. REPORTS AND STATEMENTS.

Various detailed and periodical reports are forwarded to the Federal Reserve Board by the reserve banks. Information as to rediscounts and loans is received daily and the figures recorded on the records of the Division of Reports and Statistics. Loan reports will require careful analysis. The work of the Division of Reports and Statistics and that of the Division of Audit and Examination are so closely related that it is essential that close cooperation shall exist between the two.

6. AUDIT.

The Board will determine later whether it will include under the Division of Audit and Examination a Department for audit of bills for its own purchase of material, or disbursements.

Staff of the Division of Audit and Examination.

The Board does not contemplate making general examinations until January, 1915. The number of men who will be required on this work will depend entirely upon the extent of the special examinations and investigations demanded, and it is expected to draw upon the staff of the Comptroller of the Currency for assistance in these examinations.

For the routine work of examination, three to four Federal reserve examiners and say two assistant examiners will be necessary. An auditing clerk will be required to pass upon the bills for disbursement; a report clerk to analyze the reports made by the Federal reserve banks and record loan data on the Credit Bureau records will be needed. At least one stenographer will be required for the use of the Division.

Submitted to the Board
On Behalf of the Committee on
Audit and Examination.

Adopted by the Federal Reserve Board
December 18, 1914.

EXAMINATION OF MEMBER BANKS.

1. Section 11, Par. 4. The Federal Reserve Board shall be authorized;
 (a) "To examine at its discretion the accounts, books, and affairs of each Federal Reserve Bank and of each member bank."
11. Section 21, Par. 1. provides that "The Comptroller of the Currency, with the approval of the Secretary of the Treasury, shall appoint examiners who shall examine every member bank at least twice in each calendar year and oftener if considered necessary. The Federal Reserve Board may authorize examination by State authorities to be accepted in case of State Banks and Trust Companies."
111. Section 21, Par. 3. provides that "In addition to the examination made and conducted by the Comptroller of the Currency, every Federal Reserve Bank may, with the approval of the Federal Reserve Agent or the Federal Reserve Board provide for special examination of member banks within its district. * * * Such examinations shall be so conducted as to inform the Federal Reserve Bank of the condition of its member banks and of the lines of credit which are being extended by them."

The law requires that two examinations of every member bank shall be made in each calendar year by examiners appointed by the Comptroller of the Currency. An exception is made, however, in State Banks and Trust Companies where the Federal Reserve Board has authorized the acceptance of examinations by State authorities. It will be seen further that the Federal Reserve Act gives to the Federal Reserve Board the power to examine each member bank, and also that each Federal Reserve Bank has the power to examine its member banks.

At present many banks supplement Federal or State examination by independent examinations by clearing house examiners, public accountants or directors. State institutions are examined by State bank examiners and under the laws of some States compulsory examinations by directors are also required.

If advantage is taken of the right to examine member banks, by all of the authorities upon whom the power is conferred, it will place member banks under continuous examination, at a tremendous expense, cause duplication and confusion, and defeat the purpose which the law is intended to serve. The law contemplates not an increase in examinations but rather an increase in the effectiveness of examinations in both city and country districts.

SUGGESTIONS AS TO EXAMINATIONS - MEMBER BANKS.

(a) National Bank Examinations.

It is plainly the intent of the law that all regular examinations of member banks shall be made by national bank examiners. The Act permits the Federal Reserve Board to accept examinations by State authorities as to State banks and trust companies admitted to the Federal Reserve System.

The primary purposes of all examinations are to ascertain that the institutions are solvent, that business is being conducted in accordance with the law, and to correct unsafe and unsound tendencies.

(b) Federal Reserve Bank Examinations.

The primary purpose of such examinations is to "inform the Federal Reserve bank of the condition of its member banks and of the lines of credit which are being extended by them".

In order to determine the line of rediscount which may be safely and wisely extended, the Federal reserve bank in each district will be interested in obtaining detailed information concerning each member bank, as to financial condition, character of management, competency of officers and directors, care exercised in granting and checking credits, customs in extending accomodation to directors and officers, or to corporations which they may own, control or be interested in, and relations with large borrowers.

The necessary information could be obtained by the national bank examiners in connection with the regular examination. If the plan of co-operation is approved, it is suggested that the Federal Reserve Agent be furnished with -

1. Record of loans over a stated amount as shown at each examination in order that the data may be recorded on the Credit Bureau records and made available for future reference.
2. Such other information as may be desired by the Federal Reserve bank.
3. Copies of the reports of examinations of member banks, upon request made to the Supervising National Bank Examiner of the district. These copies to be later returned to the Supervising Examiner.

Under the proposed plan of co-operation between the Federal reserve banks and the National Bank Examination system information will be obtained by the examiners for the use of each Federal reserve bank. On the other hand, the records will be available to the examiners for use at subsequent examinations. Each bank will have a record of the business, firm and corporation affiliations of directors and officers of each member bank; credit information concerning member banks and the standing of borrowers, and record of failures and bankruptcies. The loan lists, after being recorded on Credit Bureau records will be returned for use at following examinations.

If a special examination by an examiner appointed by a Federal reserve bank, is thought to be necessary, it should be made, whenever possible, in connection with the regular examination made by national or State examiners, but under no circumstances without the approval of the Federal Reserve Board.

(c) Federal Reserve Board - examination of member banks.

The exercise of this function should be confined to special examinations or investigations, to be made when and as deemed necessary by the Federal Reserve Board, or with the approval of the Board upon a request made by any Federal reserve bank. It will frequently be desirable to have the examination made by national bank examiners acting under assignment or instructions from the Comptroller of the Currency in cooperation with the Federal Reserve Board.

EXPENSES OF EXAMINATION.

Federal Reserve Board Examinations.

Section 10 of the Federal Reserve Act provided that "The Federal Reserve Board shall have power to levy semi-annually upon the Federal reserve banks, in proportion to their capital stock and surplus, an assessment sufficient to pay its estimated expenses and the salaries of its members and employees".

It is apparent that the expenses of examinations made by direction of the Federal Reserve Board must be provided for in the semi-annual assessment above referred to. In connection with the preliminary examination of State institutions seeking admission, it may be possible to charge the institutions investigated the actual expenses incurred.

December 3, 1914.