

GAO

Report to the Honorable
Charles E. Schumer
House of Representatives

November 1996

BANK OVERSIGHT STRUCTURE

U.S. and Foreign
Experience May Offer
Lessons for
Modernizing U.S.
Structure



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75 years
1921 - 1996



United States
General Accounting Office
Washington, D.C. 20548

General Government Division

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November 20, 1996

The Honorable Charles E. Schumer
House of Representatives

Dear Mr. Schumer:

Proposals to consolidate U.S. bank regulatory agencies have raised questions about how other countries structure and carry out their various bank regulation and central bank activities. You asked us to provide you with information about the structure and operations of bank oversight and central bank activities in five countries: Canada, France, Germany, Japan, and the United Kingdom, which we have done. You then asked us to draw on these reports to identify potential avenues for oversight modernization, and to identify the characteristics of the five countries' regulatory structures that might be useful to consider in any U.S. oversight modernization effort. This report responds to that request. It contains recommendations to Congress concerning characteristics that should be included in any effort to modernize the U.S. bank oversight structure.

We are sending copies of this report to the Chairman of the Board of Governors of the Federal Reserve System, the Chairman of the Federal Deposit Insurance Corporation, the Comptroller of the Currency, and the Acting Director of the Office of Thrift Supervision. We are also sending copies to Members of the House and Senate banking committees, other interested committees and subcommittees, and other interested parties.

This report was prepared under the direction of Mark J. Gillen, Assistant Director. If you have any questions, please call me on (202) 512-8678. Other major contributors are listed in appendix VIII.

Sincerely yours,

A handwritten signature in black ink that reads "James L. Bothwell". The signature is written in a cursive, flowing style.

James L. Bothwell, Director
Financial Institutions
and Markets Issues

Executive Summary

Purpose

Many proposals have been made to restructure the multiagency system for federal oversight of banking institutions in the United States. In five recent reports, GAO reviewed how banks are regulated and supervised in Canada, France, Germany, Japan, and the United Kingdom (U.K.). Although GAO found that each country's oversight structure and approach reflected a unique history, culture, and banking industry, GAO believes that certain aspects of these foreign regulatory systems may be useful for Congress to consider in any future deliberations about how to modernize bank oversight in the United States.

Several specific proposals to modernize and consolidate the U.S. bank oversight structure were debated in the 103rd Congress. To obtain insight into how banks are regulated in other major countries, Congressman Charles E. Schumer asked GAO to review the structure and operation of bank oversight in Canada, France, Germany, Japan, and the U.K., with a particular focus on the regulatory roles of the central banks in these countries. This report draws on these findings,¹ as well as previous GAO work² on the U.S. financial regulatory system, to discuss (1) aspects of the five foreign systems GAO reviewed that may be useful for Congress to consider in any future modernization efforts, (2) perceived problems with federal bank oversight in the United States, and (3) principles for modernizing the U.S. federal bank oversight structure.

Background

In many respects, the structure of the U.S. banking system is unlike those of the other major industrialized countries that GAO reviewed. For example, the United States has a dual banking system composed of almost 12,000 commercial banks and savings and loan institutions (banking institutions) that can be either state or federally chartered. As a result, all 50 states and the federal government are involved with bank oversight in the United States. In contrast, the banking industries in the five foreign countries were more concentrated, and bank oversight was generally the responsibility of the national governments. Any regional or local government involvement was typically limited to oversight of specialized financial institutions, such as credit cooperatives.

¹See Bank Regulatory Structure: The Federal Republic of Germany (GAO/GGD-94-134BR, May 9, 1991); Bank Regulatory Structure: The United Kingdom (GAO/GGD-95-38, Dec. 29, 1994); Bank Regulatory Structure: France (GAO/GGD-95-152, Aug. 31, 1995); Bank Regulatory Structure: Canada (GAO/GGD-95-223, Sept. 28, 1995); and Bank Regulatory Structure: Japan, which is currently a draft report.

²See listing of related products at the end of this report.

Differences also existed in the predominant organizational structure of banking institutions in the United States and these foreign countries. Specifically, the bank holding company structure, consisting of a parent company with one or more subsidiaries that may include banks, savings and loans, and other financial entities providing services that are deemed closely related to banking, is particular to the United States. Foreign bank organizational structures generally consisted of banks and their directly owned subsidiaries, with no parent holding companies. These organizational differences exist partly because bank activities are generally more restricted in the United States than in other countries. Each of the five foreign countries, for example, allowed banks or bank subsidiaries to conduct securities and, with the exception of Japan, insurance activities. In the United States, such activities are generally restricted to affiliates of banks within a holding company structure or prohibited entirely. Banks in some of these foreign countries were also permitted to own or affiliate with nonfinancial commercial firms, which is generally prohibited in the United States.³

Most of the five countries GAO reviewed had substantially reformed their bank oversight structures, or supervisory processes, to respond to changing conditions in their financial services sectors or to some financial crises. For example, Canada created a single federal banking supervisor in 1987 to improve bank supervision after a series of bank failures, and France revised its bank oversight structure in 1984 to address perceived regulatory inequities among financial institutions. Germany replaced its system of state bank oversight in 1961 with a federal system, involving both a single federal bank supervisor and the German central bank, to better address the increasing complexity of the banking industry. And bank oversight in the U.K. became more formal in nature, both as a result of changes in financial markets and as a consequence of three banking crises that prompted changes in British banking laws. In addition, both the U.K. and Japan are currently considering reforms to their supervisory structures and processes in the wake of recent financial institution failures.

In contrast to these foreign experiences, the bank oversight structure in the United States has evolved in a more piecemeal fashion and has not changed significantly since the 1930s. At the federal level, four agencies

³U.S. unitary thrift holding companies may be owned by or own any type of financial services or other business.

have supervisory responsibilities for different segments of the banking industry, as shown in figure 1.⁴

Figure 1: Federal Responsibilities for Bank Oversight

	Developing laws	Developing and issuing regulations	Licensing/chartering banks	Bank information reporting and analysis	Bank examinations	Enforcement authority	Deposit insurance	Failure resolution	Lender of last resort	Crisis management
Treasury ^a	●									●
OCC	●	●	●	●	●	●				●
OTS	●	●	●	●	●	●				●
Federal Reserve	●	●		●	●	●		●		●
FDIC ^b	●	●		●	●	●	●	●		●

^aOCC and OTS are within Treasury.

^bThe Board of Directors of FDIC includes the heads of OCC and OTS as well as three independent members, including the chairman and vice chairman, who are appointed by the President and confirmed by the Senate.

Source: FDIC, FRS, OCC, OTS, and Treasury.

- The Office of the Comptroller of the Currency (OCC), established in 1864, charters and supervises national banks and federal branches and agencies of foreign banks.
- The Federal Reserve System (FRS), established in 1913, supervises bank holding companies, state-chartered banks that are members of FRS, and the U.S. operations of foreign banking organizations; it also regulates foreign activities and investments of FRS member banks (both national and state chartered), and Edge Act corporations.⁵
- The Federal Deposit Insurance Corporation (FDIC), established in 1933, is the federal supervisor of federally insured, state-chartered banks that are not FRS members.
- The Office of Thrift Supervision (OTS) charters and supervises national thrifts and also supervises state-chartered thrifts and thrift holding

⁴This report does not address federal oversight of credit unions—which are also classified as depository institutions—because of their relatively small size, focus on consumer lending activities, and the fact that they have not been included in most recent reform proposals.

⁵Edge Act corporations are generally limited to international banking and certain incidental activities, and are used primarily by U.S. banks to invest indirectly in foreign banks or financial institutions.

companies. OTS assumed these functions in 1989 from the Federal Home Loan Bank Board, which was established in 1932.

Congress created the Federal Financial Institutions Examination Council (FFIEC) in 1979—comprising OCC, FDIC, FRS, OTS, and the National Credit Union Administration representatives—to promote consistency among these regulatory agencies, primarily in the area of financial examinations.

FRS and FDIC have other major responsibilities in addition to their bank oversight functions. For FRS, these include responsibility for developing and implementing monetary policy, liquidity lending, and operating and overseeing the nation's payments and clearance systems. For FDIC, these include responsibility for administering the federal deposit insurance funds, resolving failing or failed banks, and disposing of failed bank assets.

Organizationally, OCC and OTS are within the Department of the Treasury (Treasury), which has a major role in developing legislative and other policy initiatives regarding regulation of U.S. financial institutions and markets. Treasury also performs certain limited banking-related functions directly, such as approving resolutions of depository institutions whose failure could threaten the stability of the financial system.

GAO reviewed the bank oversight structures in Canada, France, Germany, Japan, and the U.K. to identify aspects that could be useful for Congress to consider if it decides to modernize the federal bank oversight structure in the United States. Although GAO did not attempt to assess the comparative effectiveness of these foreign oversight structures, GAO notes that (1) the major goals of bank oversight in these countries are similar to those in the United States; (2) the oversight structures and processes in these countries have evolved to keep pace with changing banking conditions and activities; and (3) the increasing consolidation of the U.S. banking industry and the growing importance of nontraditional banking activities for many U.S. banks are bringing it closer to its foreign counterparts.

Results in Brief

Several aspects of the bank oversight systems that GAO reviewed in Canada, France, Germany, Japan, and the U.K. may be useful for Congress to consider if it decides to modernize federal bank oversight in the United States. First, these foreign systems had less complex and more streamlined oversight structures. In all five countries, fewer national agencies were involved with bank regulation and supervision than in the United States. In all but one of these countries, both the central bank and

the ministry of finance had some role in bank oversight, and several of these countries relied on the work of the banks' external auditors to perform certain oversight functions. Second, in those countries with more than one national oversight entity, various mechanisms and procedures existed so that banking institutions were generally subject to a single set of rules, standards, or guidelines. Third, in all cases, there was one entity that was clearly responsible and accountable for consolidated oversight of banking organizations as a whole.

In contrast to these foreign systems, the bank oversight structure in the United States is relatively complex, with four different federal agencies having the same basic oversight responsibilities for those banks under their respective purview. GAO's prior work has shown that these agencies have often differed on how laws should be interpreted, implemented, and enforced; how banks should be examined; and how to respond to troubled institutions.⁶ Industry representatives and expert observers have contended that multiple examinations and reporting requirements resulting from the shared oversight responsibilities of four different regulators contribute to banks' regulatory burden, and that the federal oversight structure is inherently inefficient. Furthermore, having one agency responsible for examining all U.S. bank holding companies, with a different agency or agencies responsible for examining the holding companies' principal banks, can result in overlap and a lack of clear responsibility and accountability for consolidated oversight of the operations of U.S. banking organizations.

GAO's work on these foreign systems underscored the relevance of four basic principles that GAO believes Congress could use to help guide its decisionmaking if Congress considers modernizing the U.S. bank regulatory structure in the future. Following these principles, which GAO previously identified based on prior extensive work on the federal bank regulatory agencies, any modernized structure should provide for (1) clearly defined responsibility and accountability for consolidated and comprehensive oversight of entire banking organizations, with coordinated functional regulation and supervision of individual components; (2) independence from undue political pressure, balanced by appropriate accountability and adequate congressional oversight (3) consistent rules, consistently applied for similar activities; and (4) enhanced efficiency and reduced regulatory burden, consistent with maintaining safety and soundness.

⁶See list of related products at the end of this report.

Principal Findings

Foreign Oversight Systems

In general, the foreign oversight systems GAO reviewed had less complex structures, better defined mechanisms to coordinate policies and procedures, and clearer responsibility and accountability for consolidated oversight than that of the United States. Typically, foreign central banks, finance ministries, and sometimes a federal supervisory agency, had some role in these foreign oversight processes. Deposit insurers in these foreign countries usually had narrower roles than that of FDIC in the United States.

Bank Oversight Involved Fewer National Entities, but Generally Included Central Banks and Finance Ministries

The number of national entities involved with bank oversight in the five countries GAO reviewed ranged from one to three, with no more than two national agencies ever significantly involved in any one major aspect of bank oversight, such as chartering, regulation, supervision, or enforcement. Commercial bank chartering, for example, was the direct responsibility of only one entity in each country. In those countries where two entities were involved in oversight, the division of oversight responsibilities generally was based on whichever entity had the required expertise.

Central banks generally had significant oversight roles. While no two countries had identical oversight roles for their central banks, the central bank in each country had the ability to influence bank behavior either formally or informally and had access to information about the banking industry. In all five countries except Canada, central bank staff were directly involved in bank oversight. In large part, central bank involvement was based on the premise that traditional central bank responsibilities for monetary policy, payment systems, liquidity lending, and crisis intervention are closely interrelated with bank oversight.

Each of the five countries recognized that its national government had the ultimate responsibility for maintaining public confidence in, and the stability of, the financial system, and thus provided the ministry of finance, or its equivalent, with a role in bank oversight. In at least one country, the finance ministry had a more substantial oversight role than did the central bank, and in all five countries the finance ministries had influence over bank oversight and access to information about the financial condition of the industry. While finance ministries were generally included in bank oversight, most of these countries also incorporated unique checks and balances into their systems to guard against undue political influence.

Deposit Insurers Generally Had More Narrow Roles and Often Were Not Government Funded or Administered

While central banks and finance ministries generally had substantial roles in bank oversight, deposit insurers, with the exception of the Canada Deposit Insurance Corporation, did not. Their less substantial oversight roles may be attributable to the fact that there were no explicit guarantees of deposit insurance funds by the national governments in most of these countries and that deposit insurers were often industry administered. Thus, in most of these countries, deposit insurers were viewed primarily as a source of funds to help resolve bank failures—either by covering insured deposits or by helping to finance acquisitions of failed or failing institutions by healthy institutions. Supervisory information was generally not shared with these deposit insurers, and resolution decisions for failed or failing banks were commonly made by the primary bank oversight entities.

Mechanisms and Procedures Were Used to Help Ensure Consistent Oversight and Reduce Burden

Most of the foreign structures with multiple oversight entities incorporated mechanisms and procedures to help ensure consistent oversight and reduce regulatory burden. As a result, banking institutions that were conducting the same lines of business were generally subject to a single set of rules, standards, or guidelines. Oversight coordination mechanisms included having oversight committees or commissions with interlocking boards, shared staff, or mandates to share information. Some countries also relied on the work of the banks' external auditors, at least in part, to increase efficiency and reduce burden. Supervisors in two countries used external auditors as the primary source of monitoring information. In Germany, the use of external auditors was part of an explicit plan to minimize agency staffing and duplication of effort between examiners and auditors. In the U.K., their use was seen as the most efficient way of producing the necessary checks on banks' systems of controls and as being compatible with the Bank of England's traditional supervisory approach "based on dialogue, prudential returns, and trust," according to Bank of England staff. In part, the use of external auditors' work was also facilitated because bank oversight in these countries was focused almost exclusively on assessing the safety and soundness of banking institutions, and not on consumer protection issues.

Clear Responsibility and Accountability Existed for Consolidated Oversight

In the five countries GAO reviewed, banking organizations typically were subject to consolidated oversight, with one oversight entity clearly being legally responsible and accountable for an entire banking organization, including its subsidiaries. For example, if securities or insurance activities were permissible in bank subsidiaries, functional regulation of those subsidiaries was generally to be provided by the supervisory authority with the requisite expertise. Bank supervisors commonly relied on those

functional regulators for information but remained responsible for ascertaining the safety and soundness of the consolidated banking organization as a whole.

U.S. Bank Oversight System

In contrast to the five foreign oversight systems GAO reviewed, the U.S. bank oversight system has a more complex structure, involves less coordination and more varied policies and procedures, and lacks clear responsibility and accountability for consolidated oversight of entire banking organizations.

Four Federal Agencies Have Similar Oversight Responsibilities

In the United States, the division of oversight responsibilities among the four bank regulatory agencies is not generally based on specific areas of expertise, functions, or activities, of either the regulator or the banks for which they are responsible. Instead, it is based primarily on the type of charter—thrift or bank, national or state—and whether banks are members of FRS. Consequently, the four agencies have similar oversight responsibilities for developing and implementing regulations, taking enforcement actions, and conducting examinations and off-site monitoring, for those banking institutions that are under their respective purview.

Supervisory Information Is Used to Help Fulfill Nonoversight Duties

Officials from both FRS and FDIC told GAO that they relied on information obtained under their respective supervisory authorities to help fulfill their important, nonsupervisory duties. As GAO has stated in the past, the extent to which FRS needs supervisory authority over financial institutions to obtain the knowledge and influence necessary to carry out its other important functions is a question involving policy judgments that Congress should make.⁷ GAO believes that past experience, as well as evidence from the five foreign oversight structures GAO reviewed, supports the need for central banks, like FRS, to have direct access to supervisory information and to have some influence over banking institutions and regulatory decisionmaking.

GAO has also previously stated its support for a strong, independent deposit insurer to help protect the taxpayers' interest in insuring more than \$2.5 trillion in deposits. Prior GAO work suggested that this can be achieved by providing FDIC with (1) the capability to assess the financial condition of insured institutions by having access to examinations and being able to independently assess the quality of those examinations; (2) the ability to go into problem institutions without having to obtain

⁷Bank Regulation: Consolidation of the Regulatory Agencies (GAO/T-GGD-94-106, Mar. 4, 1994).

prior approval from another regulatory agency; and (3) backup enforcement authority over all federally insured depositories.⁸

Treasury also has several important responsibilities that require it to regularly obtain information about the financial condition of the banking industry and, at certain times, supervisory information about specific problem institutions. According to Treasury officials, Treasury's current level of involvement, through its housing of OCC and OTS and the representation of these two agencies on the FDIC board of directors, and the information it receives from other agencies as needed, is sufficient for carrying out its responsibilities.

Perceived Problems and Advantages With the U.S. Oversight System

Analysts, legislators, industry representatives, and numerous past and present agency officials have identified both weaknesses and strengths in the current federal bank oversight system. Some have broadly characterized the federal system as redundant, inconsistent, inefficient, and burdensome. Some have also raised concerns about negative effects of the oversight structure on supervisory effectiveness and believe that the multiplicity of federal regulators, despite FFIEC and other interagency coordination efforts, has resulted in inconsistent treatment in examinations, enforcement actions, and regulatory standards and decisionmaking. During the period 1990 to 1993, GAO identified significant inconsistencies in examination policies and practices among FDIC, OCC, OTS, and FRS, including differences in (1) examination scope, frequency, and documentation; (2) loan quality and loss reserve evaluations; (3) bank and thrift rating systems; and (4) examination guidance and regulations. Furthermore, divided supervisory authority, with FRS being responsible for overseeing bank holding companies and other federal regulators being responsible for the major bank subsidiaries of holding companies, obscures supervisory responsibility and accountability for banking organizations as a whole and may hinder regulators from obtaining a complete picture of an entire banking organization. Despite these weaknesses, some analysts and agency and banking institution officials credit the current structure with encouraging financial innovations and providing checks and balances to guard against arbitrary oversight decisions or actions.

Principles for Modernizing U.S. Oversight Structure

On the basis of the extensive work GAO has done in areas such as bank supervision, enforcement, failure resolution, and innovative financial activities—such as derivatives—GAO previously identified the following four fundamental principles that it believes Congress could use when

⁸GAO/T-GGD-94-106.

considering the best approach for modernizing the current regulatory structure.⁹ GAO's studies of the five foreign oversight structures reinforced the relevance of these principles. Specifically, GAO believes that any modernized bank oversight structure should provide for

- clearly defined responsibility and accountability for consolidated and comprehensive oversight of entire banking organizations, with coordinated functional regulation and supervision of individual components;
- independence from undue political pressure, balanced by appropriate accountability and adequate congressional oversight;
- consistent rules, consistently applied for similar activities; and
- enhanced efficiency and reduced regulatory burden, consistent with maintaining safety and soundness.

Recommendations

GAO's work on the five foreign oversight systems showed that there are a number of different ways to simplify bank oversight in the United States in accordance with the four principles of consolidated oversight, independence, consistency, and enhanced efficiency and reduced burden. GAO recognizes that only Congress can make the ultimate policy judgments in deciding whether, and how, to restructure the existing system. If Congress does decide to modernize the U.S. system, GAO recommends that Congress:

- **Reduce the number of federal agencies with primary responsibilities for bank oversight.** GAO believes that a logical step would be to consolidate OTS, OCC, and FDIC's primary supervisory responsibilities into a new, independent federal banking agency or commission. Congress could provide for this new agency's independence in a variety of ways, including making it organizationally independent like FDIC or FRS. This new independent agency, together with FRS, could be assigned responsibility for consolidated, comprehensive supervision of those banking organizations under its purview, with appropriate functional supervision of individual components.
- **Continue to include both FRS and Treasury in bank oversight.** To carry out its primary responsibilities effectively, FRS should have direct access to supervisory information as well as influence over supervisory decisionmaking and the banking industry. The foreign oversight structures

⁹Bank Oversight: Fundamental Principles for Modernizing the U.S. Structure (GAO/T-GGD-96-117, May 2, 1996).

GAO reviewed showed that this could be accomplished by having FRS be either a direct or indirect participant in bank oversight. For example, FRS could maintain its current direct oversight responsibilities for state chartered member banks or be given new responsibility for some segment of the banking industry, such as the largest banking organizations. Alternatively, FRS could be represented on the board of directors of a new consolidated banking agency or on FDIC's board of directors. Under this alternative, FRS' staff could help support some of the examination or other activities of a consolidated banking agency to better ensure that FRS receives first hand information about, and access to, the banking industry.

To carry out its mission effectively, Treasury also needs access to supervisory information about the condition of the banking industry as well as the safety and soundness of banking institutions that could affect the stability of the financial system. GAO's reviews of foreign regulatory structures provided several examples of how Treasury might obtain access to such information, such as having Treasury represented on the board of the new banking agency or commission and perhaps on the board of FDIC as well.

- **Continue to provide FDIC with the necessary authority to protect the deposit insurance funds.** Under any restructuring, GAO believes FDIC should still have an explicit backup supervisory authority to enable it to effectively discharge its responsibility for protecting the deposit insurance funds. Such authority should require coordination with other responsible regulators, but should also allow FDIC to go into any problem institution on its own without the prior approval of any other regulatory agency. FDIC also needs backup enforcement power, access to bank examinations, and the capability to independently assess the quality of those examinations.
- **Incorporate mechanisms to help ensure consistent oversight and reduce regulatory burden.** Reducing the number of federal bank oversight agencies from the current four should help improve the consistency of oversight and reduce regulatory burden. Should Congress decide to continue having more than one primary federal bank regulator, GAO believes that Congress should incorporate mechanisms into the oversight system to enhance cooperation and coordination between the regulators and reduce regulatory burden.

Although GAO does not recommend any particular action, such mechanisms—which could be adopted even if Congress decides not to restructure the existing system—could include

- expanding the current mandate of FFIEC to help ensure consistency in rulemaking for similar activities in addition to consistency in examinations;
- assigning specific rulemaking authority in statute to a single agency, as has been done in the past when Congress gave FRS statutory authority to issue rules for several consumer protection laws that are enforced by all of the bank regulators;
- requiring enhanced cooperation between examiners and banks' external auditors; (While GAO strongly supports requirements for annual full-scope, on-site examinations for large banks, GAO believes that examiners could take better advantage of the work already being done by external auditors to better plan and target their examinations.)
- requiring enhanced off-site monitoring to better plan and target examinations as well as to identify and raise supervisory concerns at an earlier stage.

Agency Comments

FRS, FDIC, OCC, and OTS provided written comments on a draft of this report, which are discussed in chapter 4 and reprinted in appendixes IV, V, VI, and VII. Treasury also reviewed a draft and provided oral comments of a technical nature, which GAO incorporated where appropriate.

The agencies generally believed that GAO's information and observations about the five foreign oversight systems could be useful to Congress in its consideration of a potential modernization of the bank oversight structure in the United States. Each of the agencies also provided some additional insights from its own unique oversight role and responsibilities, which GAO summarizes below and discusses further in the report where appropriate. GAO believes the agencies' perspectives will be helpful for Congress in any consideration of changes to the U.S. bank oversight structure.

FRS agreed with GAO's recommendation that it continue to be included in bank oversight. However, it felt that GAO should be specific in stating that FRS needs "active supervisory involvement in the largest U.S. banking organizations and a cross-section of other banking institutions" to carry out its key central bank functions. To clarify what was meant by this statement, a senior FRS official advised GAO that FRS' current regulatory authority gives it the access and influence FRS believes it needs. However, if the regulatory structure were changed so that there is only one federal regulator for each banking organization—both holding company and bank subsidiaries—then FRS believes that it would have to be the regulator for the largest banking organizations, as well as a cross-section of others.

FDIC provided four fundamental principles for an effective bank regulatory structure, which are generally consistent with the principles and recommendations that GAO set forth. These principles include providing FDIC with explicit backup supervisory authority, backup enforcement power, and the capability to assess the quality of bank examinations. FDIC also noted that the broader regulatory responsibilities related to the role of the deposit insurer require current and sufficient information on the ongoing financial condition and operations of financial institutions. In FDIC's judgment, periodic on-site examinations by FDIC staff remain an essential tool by which such information may be obtained.

OCC described GAO's report as comprehensive and conveying more about the foreign regulatory structures than has been available to the public. OCC agreed with GAO that the foreign structures are not readily adaptable to the United States. OCC also suggested that, given the complexity of the subject, Congress should consider further information before deciding on making any changes to the existing oversight structure in the United States. OCC agreed with GAO that the central banks in the five foreign countries had substantial oversight roles, but noted that GAO's analysis showed that central banks do not necessarily need a direct role in bank supervision in order to have direct access to supervisory information as well as influence over supervisory decisionmaking and the banking industry. OCC also stated that supervisory methods contribute to the overall effectiveness of oversight structures and that, although the five countries may not have explicit government guarantees of deposit insurance funds, they do convey some guarantee.

OTS generally concurred with GAO's recommendations and reiterated its position that consolidation will make the bank oversight system more efficient and effective.

FRS, FDIC, and OTS also commented on recent steps that have been taken to enhance regulators' cooperation and coordination and reduce regulatory burden. GAO discussed these actions in the report as appropriate.

Contents

Executive Summary		2
Chapter 1		20
Introduction	Overview of the U.S. Banking Industry	20
	Current U.S. Oversight Structure Is Complex	25
	Goals of Bank Oversight Include Safety and Soundness, Stability, and Fairness to Consumers	28
	Agencies Have	28
	Other Major Oversight-Related Responsibilities	
	Various Federal and State Agencies Oversee Activities of Nonbank Subsidiaries of Banks and Bank Holding Companies	32
	Objectives, Scope, and Methodology	34
Chapter 2		36
Bank Oversight Structure Is Redundant	Federal Agencies Overseeing Banks and Thrifts Share Several Oversight Responsibilities	36
	FRS and FDIC Rely on Supervisory Information to Fulfill Nonoversight Duties; Treasury Obtains Information Primarily Through OCC and OTS	45
	Analysts, Regulators, and Legislators Have Identified Disadvantages and Advantages of the Oversight Structure	47
	Principles for Bank Oversight Modernization	53
Chapter 3		55
Aspects of Foreign Bank Oversight Systems May Be Useful to Consider in Efforts to Modernize U.S. Bank Oversight	Foreign Systems Had One to Three Oversight Entities	55
	Oversight Entities Were Typically Responsible and Accountable for Entire Banking Organizations, Including Subsidiaries	62
	Other Countries' Oversight Systems Generally Included Roles for Central Banks and Finance Ministries	63
	Deposit Insurers Generally Had More Narrow Roles Than That of FDIC	67
	Foreign Structures Incorporated Mechanisms and Procedures to Ensure Consistent Oversight and Efficiency	70

<hr/>			
Chapter 4		74	
	Conclusions, Recommendations, and Agency Comments	Conclusions	74
		Recommendations	78
		Agency Comments and Our Evaluation	80
<hr/>			
Appendixes	Appendix I: History of U.S. Bank and Thrift Oversight	84	
	Appendix II: External Audits of Banking Institutions	95	
	Appendix III: Description of Three Recent Bank Oversight Reform Proposals	102	
	Appendix IV: Comments From the Board of Governors of the Federal Reserve System	110	
	Appendix V: Comments From the Federal Deposit Insurance Corporation	115	
	Appendix VI: Comments From the Office of the Comptroller of the Currency	121	
	Appendix VII: Comments From the Office of Thrift Supervision	125	
	Appendix VIII: Major Contributors to This Report	128	
<hr/>			
Related GAO Products		131	
<hr/>			
Tables	Table 1.1: Assets Held by Insured Banking Institutions, as of December 31, 1995	21	
	Table 1.2: Overview of the Primary Jurisdictions of the Four Federal Banking Institution Oversight Agencies	27	
	Table 3.1: Overview of Other Countries' Bank Oversight Systems	57	
	Table III.1: Basic Structure in the Proposed Plan of the Administration	103	
	Table III.2: Alignment of Responsibilities for Federal Agencies Overseeing Banks and Thrifts Under the Leach Proposal	104	
	Table III.3: Alignment of Responsibilities for Oversight of Banks and Thrifts Under the LaWare Proposal	105	
	Table III.4: Comparison of the Number of Federal Bank Agencies in the Three Reform Proposals	106	
	<hr/>		
Figures	Figure 1: Federal Responsibilities for Bank Oversight	4	
	Figure 1.1: Simplified Structure of a Hypothetical Bank Holding Company	22	

Figure 2.1: Responsibility for U.S. Bank Oversight Functions	36
Figure 2.2: Regulation of a Hypothetical Bank Holding Company	52

Abbreviations

BIF	Bank Insurance Fund
CBO	Congressional Budget Office
CFTC	Commodity Futures Trading Commission
CPA	Certified Public Accountant
CRA	Community Reinvestment Act
FBA	Federal Bank Agency
FBC	Federal Banking Commission
FDIC	Federal Deposit Insurance Corporation
FDICIA	Federal Deposit Insurance Corporation Improvement Act of 1991
FFIEC	Federal Financial Institutions Examination Council
FHLBB	Federal Home Loan Bank Board
FHLBS	Federal Home Loan Bank System
FIRREA	Financial Institution Reform, Recovery, and Enforcement Act of 1989
FRS	Federal Reserve System
FSLIC	Federal Savings and Loan Insurance Corporation
GAAP	Generally Accepted Accounting Principles
NAIC	National Association of Insurance Commissioners
NCUA	National Credit Union Administration
OCC	Office of the Comptroller of the Currency
OTS	Office of Thrift Supervision
SAIF	Savings Association Insurance Fund
SEC	Securities and Exchange Commission
U.K.	United Kingdom

Introduction

The nearly 12,000 federally insured banks and thrifts¹ in the United States, which hold more than \$5 trillion in assets, are regulated and supervised by four federal agencies with similar and sometimes overlapping regulatory and supervisory responsibilities. Although many industry representatives, legislators, and regulators have in the past recognized the need for consolidation and modernization of federal bank oversight, major reform proposals changing the structure of bank and thrift oversight have not been adopted. This report was prepared in response to a request from Congressman Charles E. Schumer that we provide information to help evaluate efforts to modernize the U.S. system of financial industry oversight and identify potential avenues for such modernization. Much of the information in this report is based on our studies of the structures and operations of bank regulation and supervision (oversight)² activities in Canada, France, Japan, Germany, and the United Kingdom.³

Overview of the U.S. Banking Industry

This report focuses on the oversight of two major categories of depository institutions: commercial banks and thrifts. Commercial banks and thrifts originally served very different purposes and markets. Commercial banks issued debt payable on demand, which was backed by short-term commercial loans. The customers of commercial banks tended to be businesses and wealthy individuals seeking liquid deposit accounts. Savings and loan associations, however, used deposits to fund home mortgages of their members. But, because of the long terms of mortgages, members were restricted in their ability to withdraw their funds. Savings banks were initially designed to provide a range of financial services to the small saver. Their asset portfolios were generally more diversified than those of savings and loan associations to enable them to provide more flexible deposit terms. Despite the historical differences between these institutions, the powers and services of banks and thrifts have converged over time with few practical differences remaining in their authorities, except that these institutions continue to be subject to different regulatory

¹Thrifts include FDIC-insured savings and loan associations and savings banks.

²In this report, we use the term oversight to mean both regulation and supervision. Regulation includes any rulemaking activities, and supervision includes examinations and off-site monitoring of institutions and enforcement actions to ensure compliance with laws and regulations. The term regulator is used when referring to an agency or individual conducting (1) general oversight activities not specified as either supervisory or regulatory, or (2) specific regulatory activities. The term supervisor is used when referring to an agency or individual conducting supervisory activities.

³See Bank Regulatory Structure: Canada (GAO/GGD-95-223, Sept. 28, 1995); Bank Regulatory Structure: France (GAO/GGD-95-152, Aug. 31, 1995); Bank Regulatory Structure: The Federal Republic of Germany (GAO/GGD-94-134BR, May 9, 1994); Bank Regulatory Structure: The United Kingdom (GAO/GGD-95-38, Dec. 29, 1994), and Bank Regulatory Structure: Japan, which is currently a draft report.

schemes.⁴ (See app. I for more information on the history of U.S. bank and thrift oversight.)

At the end of 1995, the United States had nearly 12,000 banking institutions. In this report, we refer to commercial banks and thrifts collectively as banking institutions.⁵ These institutions held about \$5.3 trillion in loans and other assets (see table 1.1).

Table 1.1: Assets Held by Insured Banking Institutions, as of December 31, 1995

Dollars in billions			
Types of institutions	Number of institutions	Amount of assets	Percentage of total assets
Commercial banks ^a	9,941	\$4,313	81%
Thrifts ^b	2,029	1,026	19
Total	11,970	\$5,339	100%

^aCommercial banks do not include 39 insured U.S. branches of foreign banks with \$12 billion in assets.

^bThrifts include Federal Deposit Insurance Corporation (FDIC) insured savings and loans associations and savings banks.

Source: FDIC Quarterly Banking Profile, Fourth Quarter 1995.

As shown in table 1.1, the 9,941 commercial banks held 81 percent of total bank and thrift assets at the end of 1995. The 2,029 thrifts held 19 percent.

Holding Companies Are the Dominant Banking Structure in the United States

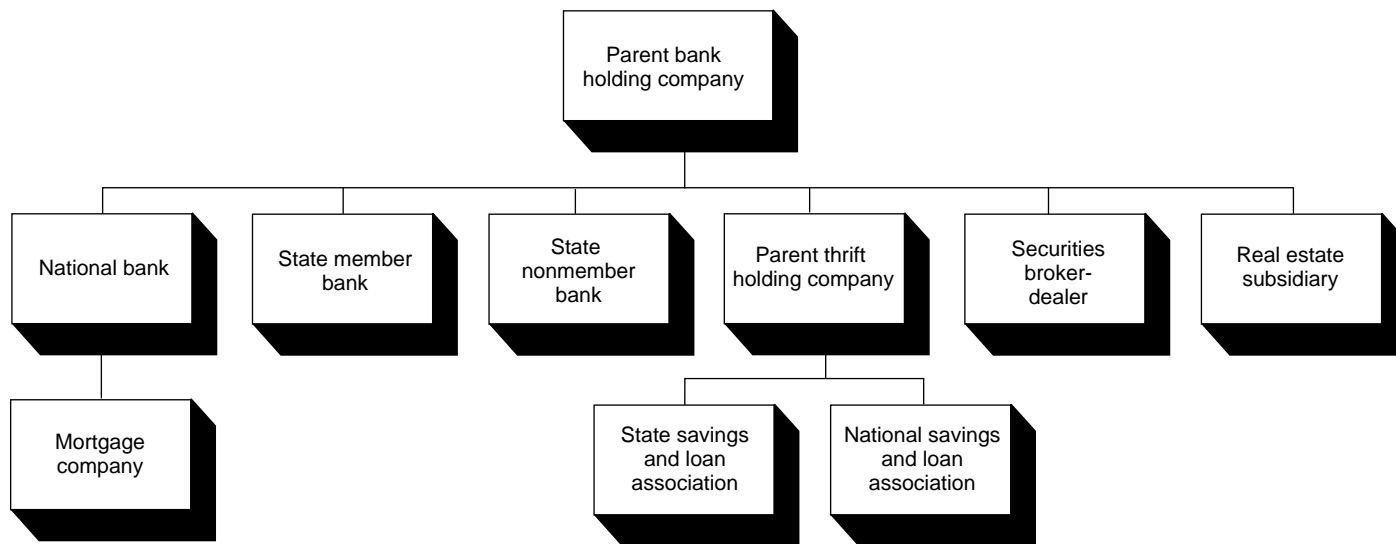
Holding companies, which are established for a variety of business, regulatory, and tax reasons, are the dominant form of banking structure in the United States. In fact, 96 percent of the assets of all U.S. commercial banks are in banks that are part of a holding company. As of December 31, 1995, about 6,122 bank holding companies and 895 thrift holding companies were operating in the United States. Of those, 4,494 bank holding companies and 833 thrift holding companies each held only 1 bank or thrift.

⁴Unlike bank holding companies, whose business is restricted to that which is “closely related to banking,” unitary thrift holding companies may be owned by or own any type of financial services or other business. Thrifts also have broader powers than banks in areas such as insurance and real estate development.

⁵For the sake of simplicity, the oversight structure for supervising and regulating banks and thrifts is referred to as the bank oversight structure and the four oversight agencies as bank oversight agencies, bank regulators, or bank supervisors.

Holding companies may consist of a parent company, banking subsidiaries, nonbanking subsidiaries, and even other holding companies—each of which may have its own banking or nonbanking subsidiaries. Figure 1.1 is a simplified illustration of a hypothetical holding company with wholly owned banking and nonbanking subsidiaries.

Figure 1.1: Simplified Structure of a Hypothetical Bank Holding Company



Source: GAO.

Parent companies own or control subsidiaries through the ownership of voting stock and generally are “shell” corporations—that is, they do not have operations of their own. Banking subsidiaries are separately chartered banks subject to the same regulation and capital requirements that apply to other banking institutions. Nonbanking subsidiaries are companies that may be engaged in a variety of businesses other than banking; however, any nonbanking activities of a bank holding company subsidiary must be closely related to the business of banking and produce

a public benefit.⁶ Thrift holding companies may be owned by or own any type of financial services or other business. Many bank holding companies have established nonbank subsidiaries engaged in consumer finance, trust services, leasing, mortgage lending, electronic data processing, insurance underwriting, management consulting services, and securities brokerage services.

Holding companies in the United States may also have multiple tiers. For example, as we mentioned above, holding companies may have subsidiary holding companies that have their own banking or nonbanking subsidiaries. Banking subsidiaries may also have their own subsidiaries. However, the activities of these bank subsidiaries are limited to those allowable for their parent institution. The largest holding companies in the United States often have very complex, multitiered structures.

Bank and thrift holding companies are particular to the U.S. financial system. In many other countries, nonbanking activities may be conducted either in a bank or in subsidiaries of a bank rather than in subsidiaries of a parent company.

U.S. Banking Industry is Consolidating and Changing Its Product Focus

The structure of the U.S. banking industry has changed substantially over the past 10 years. The industry is consolidating in response to the removal of legal barriers to geographic expansion, advancing technologies, and the globalization of wholesale banking, among other things. Between 1985 and 1995, the number of banks and thrifts in the United States fell by about 34 percent due to consolidation through mergers and also bank and thrift failures. The number of banks decreased by 4,476—from 14,417 to 9,941. The number of thrifts decreased by 1,597—from 3,626 to 2,029.⁷

Industry consolidation has been characterized by a greater concentration of deposits among the largest banking companies in the country. For example, the 10 largest bank holding companies controlled 17.4 percent of bank deposits in 1984; they increased this share to 25.6 percent in 1994. Similarly, the 10 largest thrift institutions increased their share of deposits from 12.4 percent to 17 percent. However, although nationwide

⁶Section 4 of the Bank Holding Company Act of 1956 generally prohibits bank holding companies from owning or controlling any company that is not a bank. The law, however, lists several exemptions from this rule. The most important of these authorizes the Federal Reserve Board to approve the acquisition of a nonbank affiliate where the board determines that the activities of the affiliate are “so closely related to banking . . . as to be a proper incident thereto” and would produce a public benefit. 12 U.S.C. S 1843. Under this authority, the board promulgated in its regulation Y the nonbanking activities that are or may be approved.

⁷GAO analysis of FDIC data.

concentration has been increasing over the past 10 years, increases in local market concentration have been much more modest relative to the changes at the national level.⁸ According to industry analysts, this has occurred because banking institutions not located in the same local market have merged, and constraints imposed by antitrust laws have helped to prevent increases in concentration at the local level.

The nature of the activities that banking institutions engage in has also changed drastically over the past several decades. Although traditional lending still dominates banking institutions' balance sheets, banking institutions have been moving toward more nontraditional products, such as mutual funds, securities, and derivatives and other off-balance sheet products.⁹

Banking Institutions' Share of Total Assets Held in the Financial Services Industry Has Decreased

Banking institutions, with about \$5.3 trillion in assets at the end of 1995, constitute the largest single segment of the financial services industry. However, banking institutions' share of the financial services industry shrank from about 45 percent in 1985 to about 30 percent in 1995.¹⁰ This decrease has been attributed to greater competition in the financial services industry. Consumers can now choose from a variety of providers in obtaining financial services once offered only by commercial banks and thrifts. For example, money market mutual funds, securities firms, and insurance companies all now offer interest-bearing transaction accounts. Further, although banks and thrifts were long regarded as the primary providers of consumer credit, such credit is now routinely provided by finance companies as well as by a wide variety of retail firms through credit cards and other means.

⁸Concentration refers to the market share of deposits held by certain institutions. Concentration statistics were published in an article by Dean F. Amel, "Trends in the Structure of Federally Insured Depository Institutions, 1984-94" in the January 1996 Federal Reserve Bulletin, (Vol. 82, No. 1, pp. 1-15).

⁹Off-balance sheet products represent wholesale activities and fall into two broad categories: (1) derivative products and (2) contingent liabilities. Derivative products—such as futures, forwards, options, and swaps—are financial instruments whose value depends on the value of another underlying financial product. Contingent liabilities represent agreements by a banking institution to provide funds when certain conditions are met. They have been used, in part, to replace traditional loans from banks.

¹⁰GAO analysis of FRS Flow of Funds Accounts data. Some academic studies have shown that when asset figures are adjusted to incorporate some measures of the new off-balance sheet activities banking institutions are now engaging in, the rate of decline of banking institutions' share of the industry is reduced.

Current U.S. Oversight Structure Is Complex

The federal system of oversight of banking institutions in the United States is a highly complex system. Federal responsibilities for bank authorization, regulation, and supervision are assigned to three bank regulators and one thrift regulator that have jurisdiction over specific segments of the banking industry (see table 1.2).¹¹ Although Treasury plays no formal role in bank oversight, it has some related responsibilities.

Office of the Comptroller of the Currency

The Office of the Comptroller of the Currency (OCC)¹² currently has primary responsibility for regulating and supervising national banks—that is, banks with a federal charter. OCC also has primary responsibility for regulating and supervising federal branches and agencies of foreign banks operating in the United States. As of December 31, 1995, OCC was the primary federal supervisor of 2,861 of the 11,970 banking institutions in the United States. Those banks held about 45 percent of the total U.S. banking assets in the United States.

Federal Reserve System

The Federal Reserve System (FRS)¹³ is the federal regulator and supervisor for bank holding companies and their nonbank subsidiaries, and it is the primary federal regulator for state-chartered banks that are members of FRS. It is also a federal regulator for foreign banking organizations operating in the United States.¹⁴ In addition, it regulates foreign activities and investments of FRS member banks (national and state), Edge

¹¹Each state also has its own agency to regulate and supervise the banks, thrifts, and credit unions it charters. The organization of these agencies varies from state to state.

¹²OCC, a bureau of the Treasury Department, is headed by the Comptroller of the Currency, who is appointed by the President to a 5-year term. OCC has six district offices in addition to its Washington, D.C., headquarters. At the end of 1995, OCC data show that it had 3,556 staff members, including 2,051 examiners. About 147 of OCC's examiners are part of OCC's Multinational Division, which oversees the activities of the largest banks.

¹³FRS is headed by a seven-member Board of Governors, appointed by the President to 14-year terms. One Governor is designated by the President as Chairman with a 4-year, renewable term. The major components of FRS include the Board, located in Washington, D.C.; and 12 Federal Reserve Banks, with 25 Reserve Bank branches located throughout the country. Each Federal Reserve Bank has a board of nine directors, six elected by member banks and three appointed by the Board of Governors. As of December 31, 1995, FRS data show that it had 25,288 staff members, including 1,546 examiners.

¹⁴In addition, FRS has the authority to regulate all foreign branches of U.S. banks. All national banks and state member banks must receive permission from FRS before they can open a foreign branch. Although FRS has primary regulatory authority for foreign branches of U.S. banks, it defers its examination authority to OCC concerning foreign branches of national banks because OCC is the primary federal regulator of national banks.

corporations, and holding companies.¹⁵ As of December 31, 1995, FRS had primary supervisory responsibility for 1,041 of the 11,970 banking institutions in the United States. The assets of these banks represented about 18 percent of the total U.S. banking assets. As of December 31, 1995, FRS also had responsibility for regulating 6,122 bank holding companies, 393 foreign branches, and 153 foreign agencies operating in the United States.

Federal Deposit Insurance Corporation

The Federal Deposit Insurance Corporation (FDIC)¹⁶ is the primary federal regulator and supervisor for federally insured state-chartered banks that are not members of FRS and for state savings banks whose deposits are federally insured. FDIC is also responsible for administering the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF).¹⁷ Additionally, FDIC is responsible for resolving failed banks and for the disposition of assets from failed banking institutions.¹⁸ At the end of 1995, FDIC was the primary federal regulator and supervisor for 6,632 of the 11,970 insured banking institutions. These banking institutions represented 22 percent of the total U.S. banking assets.

Office of Thrift Supervision

The Office of Thrift Supervision (OTS)¹⁹ is the primary regulator of all federally- and state-chartered thrifts whose deposits are federally insured and their holding companies. At the end of 1995, it was the primary federal

¹⁵Edge corporations are generally limited to international banking and certain incidental activities and are used primarily by U.S. banks to invest indirectly in foreign banks or financial institutions. However, Edge corporations historically have also been used to offer international banking services in U.S. markets, which interstate banking restrictions would otherwise have prohibited. With the increased opportunities for interstate banking, the significance of the latter has markedly declined.

¹⁶FDIC is an independent federal agency. It is managed by five directors, one of whom is the Comptroller of the Currency and another is the Director of the Office of Thrift Supervision—the national regulator of thrifts. Three others are appointed by the President for 6-year terms, with one appointed as Chairman and another as Vice-Chairman. FDIC's main office is in Washington, D.C., and it has eight regional supervisory offices and several other regional offices that liquidate assets from failed banks.

¹⁷BIF member institutions are predominantly commercial banks, but they also include some state and federal savings banks and certain savings and loan associations. SAIF members are predominantly savings and loan associations, but they also include some state and federal savings banks and certain commercial banks.

¹⁸As of December 31, 1995, FDIC officials said FDIC had 2,311 examiners in its Division of Supervision. It also had 476 total staff members in its Division of Compliance and Consumer Affairs, including examiners, management, and clerical staff. FDIC data show that it had 12,059 staff as of December 31, 1995.

¹⁹OTS, like OCC, is a bureau of the U.S. Department of the Treasury. The Director of OTS is appointed by the President for a 5-year term. OTS has five regional offices. As of December 31, 1995, OTS data show that it had about 1,463 staff members, including 716 examiners.

regulator of 1,436 institutions, whose assets represented 14 percent of the total assets held by banking institutions.²⁰

The Department of the Treasury

The Department of the Treasury (Treasury) is one of 14 executive departments that make up the Cabinet. It is headed by the Secretary of the Treasury²¹ and performs four basic functions, of which formulating and recommending economic, financial, tax, and fiscal policies is the one most directly related to bank oversight.²² Ultimately, Treasury is responsible for financially backing up the U.S. guarantee of the deposit insurance funds²³ and may also approve special resolution options for financial institutions whose failure “could threaten the entire financial system.”²⁴ In addition, Treasury is a principal player in the development of legislation and policies affecting the financial services industries. Treasury also shares responsibility for managing any systemic financial crises, coordinating financial market regulation, and representing the United States on international financial markets issues.

Table 1.2: Overview of the Primary Jurisdictions of the Four Federal Banking Institution Oversight Agencies

Agency	Primary jurisdiction
OCC	National banks, federal branches, and agencies of foreign banks.
FRS	State-chartered, FRS member banks. Bank holding companies and their nonbank subsidiaries. Foreign banking organizations operating in the United States.
FDIC	State-chartered, non-FRS member banks. State savings banks.
OTS	Federally and state-chartered thrifts. Thrift holding companies.

Source: GAO analysis.

²⁰As shown in table 1.1, there were 2,029 thrifts as of December 31, 1995. However, 593 of these thrifts were state savings banks supervised by FDIC.

²¹The Secretary is appointed by the President and confirmed by the U.S. Senate.

²²Treasury’s other three functions are serving as financial agent for the U.S. government, enforcing the law, and manufacturing coins and currency.

²³Subsequent to the enactment of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, all obligations issued by BIF or SAIF were backed by the full faith and credit of the United States (section 15(d) of the Federal Deposit Insurance Act).

²⁴Section 13(3)(4)(g) of the Federal Deposit Insurance Act. Such a resolution is permissible only if the Federal Reserve Board and FDIC’s Board of Directors both recommend the exception to the Secretary of the Treasury, with at least two-thirds of each board’s members voting for the recommendation.

Goals of Bank Oversight Include Safety and Soundness, Stability, and Fairness to Consumers

A primary objective of banking institution regulators is to ensure the safe and sound practices and operations of individual banking institutions through regulation, supervision, and examination.²⁵ The intent of regulators under this objective is primarily to protect depositors and taxpayers from loss, not to prevent banking institutions from failing. To help accomplish this goal, the government has chosen to protect deposits through federal deposit insurance, which provides a safety net to depositors.

Financial market stability is also considered a primary goal of banking institution regulators. Because banking institutions play an important role as financial intermediaries that borrow and lend funds, public confidence in banking institutions is critical to economic stability at local and national levels. In support of market stability, regulators seek to resolve problems of financially troubled institutions in ways that maintain confidence in banking institutions and thus prevent depositor runs that could jeopardize the stability of financial markets.

Regulators are also aware that the stability of the banking industry depends both on the ability of banking institutions to compete in an increasingly competitive environment and on maintaining competition within the industry. Regulators recognize that although their supervisory oversight should be sufficient to oversee safe and sound bank operations and practices, it should not be so onerous as to stifle the industry and impair banks' ability to remain competitive with financial institutions in other industries and in other countries. Bank regulators also seek to maintain competition by assessing compliance with antitrust laws.

Fairness in, and equal access to, banking services is also an important goal of banking institution regulators. Bank regulators seek to ensure access by assessing institutions' compliance with consumer protection laws. This goal of the banking regulators is unique to the U.S. bank regulatory structure.

Agencies Have Other Major Oversight-Related Responsibilities

While the four federal banking regulators share many oversight responsibilities, some of the principal responsibilities of FDIC and FRS fall outside direct regulation and supervision but are related to the goals of bank oversight. For FDIC these include responsibility for administration of the federal deposit insurance funds, resolution of failing and failed banks,

²⁵Regulation is the authority for rulemaking. Supervision is the responsibility for off-site monitoring and on-site examination. Examination consists of reviewing banking practices and operations.

and disposition of failed bank assets. For FRS, these include responsibility for monetary policy development and implementation, liquidity lending, and payments and settlements systems operation and oversight. In addition, all four federal regulators may play a role in the management of financial crises, depending on the nature of the crisis.

FDIC's Principal Function Is As Deposit Insurer

Although FDIC supervises a large number of banking institutions, its primary function is to insure banking institutions' deposits up to \$100,000.²⁶ FDIC administers BIF—which predominantly protects depositors of commercial banks—and SAIF—which predominantly protects depositors of thrift institutions. FDIC receives no appropriated government funding. BIF is funded wholly through premiums paid on the deposits of member institutions and with some borrowing authority from the government under prescribed conditions, such as liquidity needs of the insurance funds. SAIF is primarily funded through premiums paid on the deposits of thrift institutions and has similar borrowing authority. Both BIF and SAIF are required by statute to have a minimum reserve ratio of 1.25 percent of insured deposits. According to FDIC, as of December 31, 1995, BIF's fund balance exceeded the ratio 1.30, but SAIF was not fully capitalized.

FDIC relies on primary regulators to verify that institutions outside its direct supervisory jurisdiction are operating in a safe and sound manner. Examinations are to be done by the institution's primary regulators on all the institutions FDIC insures, and FDIC is to receive copies of all examination reports and enforcement actions. However, FDIC may also protect its interest as the deposit insurer through its backup authority. This allows FDIC to examine potentially troubled banking institutions and take enforcement actions, even when FDIC is not the institution's primary regulator.

In Conjunction With Deposit Insurance Function, FDIC Has Primary Role in Failure Resolution and Failed Bank Asset Disposition

Regardless of an institution's primary regulator, only its chartering authority—the state banking commission, OCC, or OTS—has the formal authority to declare that the banking institution is insolvent. Once the chartering authority becomes aware that one of its institutions has

²⁶All accounts owned by an individual in a single banking institution are aggregated for deposit insurance purposes and covered up to \$100,000 per depositor per insured institution. If a depositor has both checking and savings accounts in the same institution, both accounts taken together would be insured up to \$100,000. However, if an individual has a joint account with another person in the same bank, this joint account would be separately insured up to \$100,000. An individual can thus significantly increase his or her insurance coverage in a single banking institution by establishing multiple accounts with different family members. There is also no limit to the number of insured accounts an individual may have in different banking institutions.

deteriorated to the point of insolvency or imminent insolvency, it is to notify FDIC, which is responsible for arranging an orderly resolution.

FDIC is required by law to generally select the resolution alternative it determines to be the least costly to BIF and SAIF. To make this least-cost determination, FDIC must (1) consider and evaluate all possible resolution alternatives by computing and comparing their costs on a present-value basis, using realistic discount rates; and (2) select the least costly alternative on the basis of that evaluation.²⁷ If, however, the least-cost resolution would create a systemic problem—as determined by FDIC’s Board of Directors with the concurrence of the Federal Reserve Board and the Secretary of the Treasury, then, under the Federal Deposit Insurance Corporation Improvement Act (FDICIA), another resolution alternative could be selected. As of June 30, 1996, no systemic problem had been raised by FDIC in making its resolution decisions.

Typically—and particularly in the case of large, known to be troubled, institutions—active communication has taken place among the chartering authorities, primary regulators, FDIC, and FRS as liquidity provider. The interaction and coordination typically includes the sharing of examination information, strategies, and economic information, for example. This communication most commonly takes place when the primary regulator considers failure likely so that all regulatory parties can discharge their responsibilities in an orderly manner. When banks fail, FDIC is appointed receiver, directly pays insured claims to depositors or the acquiring bank, and liquidates the remaining assets and liabilities not assumed by the acquiring bank.

FRS Has Several Responsibilities

One of the principal responsibilities of FRS is conducting monetary policy. As stated in the Federal Reserve Act, FRS is “to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates.” FRS conducts monetary policy by (1) using open market operations,²⁸ the primary tool of monetary policy; (2) determining the reserve requirements that banking institutions must hold against deposits;

²⁷In selecting the least costly resolution alternative, FDIC’s process is to compare its estimated cost of liquidation—basically, the amount of insured deposits paid out minus the net realizable value of an institution’s assets—with the amounts that potential acquirers bid for the institution’s assets and deposits. FDIC’s Division of Resolutions then is to estimate the net realizable value of an institution’s assets by performing an on-site Asset Valuation Review or, when time or other constraints exist, by using a computer model based on FDIC’s historical recovery experience, to value the institution’s assets. To solicit the greatest number of bids, FDIC normally offers various marketing options to potential acquirers, such as offering the whole institution, select pools of assets, or deposits.

²⁸Open market operations involve the buying and selling of securities by FRS.

and (3) determining the discount rate charged banking institutions when they borrow from FRS. FRS is to act independently in conducting its monetary policy.

FRS also is to act as lender-of-last-resort to ensure that a temporary liquidity problem at a banking institution does not threaten the viability of the institution or the financial system. Using the discount window, FRS may lend to institutions that are experiencing liquidity problems—for example, when these institutions cannot meet deposit withdrawals.²⁹ However, when acting in this capacity, FRS requires the lending to be collateralized, and it is to be assured by the banking institution’s primary regulator that the institution is solvent. According to FRS officials, institutions generally do not approach FRS for liquidity loans unless they have no alternative. Liquidity lending may be perceived as a sign that an institution is in trouble, despite the fact that FRS is prohibited from lending to nonviable institutions.

In addition, FRS has broad responsibility in the nation’s payments and settlements systems.³⁰ It is mandated by Congress to act as an intermediary in clearing and settling interbank payments by maintaining reserve or clearing accounts for the majority of banking institutions. As a result, it settles the payment transactions by debiting and crediting the appropriate accounts of banking institutions making payments. In addition, FRS also collects checks, processes electronic fund transfers, and provides net settlement services to private clearing arrangements.

Crisis Management

Depending on the nature of the situation, federal regulators may play a role in financial system crisis management. FRS, for example, often has a significant role in crisis management in its role as a major participant in financial markets through its liquidity lending, payments and settlements, and other responsibilities. A key role of any central bank is to supply sufficient liquidity to the financial system in a crisis. For example, during the 1987 stock market crash, FRS provided liquidity support to the financial system, encouraged major banks to lend to solvent securities firms, coordinated with Treasury, and encouraged officials to keep the New York

²⁹Banks may also approach FRS to manage liquidity needs that arise from regular, seasonal swings in loans and deposits, such as those at agricultural banks.

³⁰The Monetary Control Act of 1980 required all depository institutions to maintain reserves in accounts at the Reserve Banks and granted them all access to FRS payment services. Recently, the Expedited Funds Availability Act of 1987 gave the Federal Reserve Board authority over private clearing arrangements. Through these actions, Congress has made it clear that it holds FRS responsible for ensuring the integrity and the efficiency of the U.S. dollar payments system.

Stock Exchange open. During the Ohio Savings and Loan crisis in 1985, FRS intervened with liquidity support until a permanent solution to the instability could be developed. Treasury is also involved in resolving major financial crises, while OCC, OTS, and FDIC have played significant roles involving large bank or thrift failures.

Various Federal and State Agencies Oversee Activities of Nonbank Subsidiaries of Banks and Bank Holding Companies

Many nonbank subsidiaries of banks and bank holding companies are engaged in securities, futures, or insurance activities. These activities are subject to the oversight of the Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC), and state insurance regulators, respectively. These regulators may provide information to the Federal Reserve about nonbank subsidiaries of bank holding companies. They may also provide information about nonbank subsidiaries of banks to the responsible primary federal regulator of the parent bank.

SEC and CFTC

The primary goals of SEC and CFTC are to maintain fair and orderly markets and public confidence in the financial markets by protecting investors against manipulation, fraud, or other irresponsible practices. The aftermath of the stock market crash of 1929 created a demand for federal oversight of securities and futures activities.³¹ The Securities Exchange Act of 1934 created SEC with powers to oversee the securities market exchanges—also called self-regulatory organizations—and to intervene if the exchanges did not carry out their responsibilities for protecting investors. The Commodity Exchange Act of 1936, as amended, governs the trading of commodity futures contracts and options. The Commodity Futures Trading Commission Act of 1974 created the current regulatory structure, consisting of industry self-regulation with government oversight by CFTC.

Securities broker-dealers must register with SEC and comply with its requirements for regulatory reporting, minimum capital, and examinations. They must also comply with requirements of the self-regulatory organizations, such as the New York Stock Exchange and the National Association of Securities Dealers. SEC is to monitor broker-dealer capital levels through periodic reporting requirements and regular examinations.

³¹The first regulation of commodity futures markets on a limited basis began in the 1920s, when falling commodity prices, farm depression, and speculative excesses on the grain exchanges led to demands for federal regulation of the grain exchanges. The Grain Futures Act of 1922 was designed to allow the federal government, through the Department of Agriculture, to license these exchanges and require the exchanges to take responsibility for preventing price manipulation by their members.

CFTC is to review exchange rules, ensure consistent enforcement, and monitor the positions of large traders. CFTC also regulates the activities of various market participants, including futures commission merchants—which must comply with CFTC’s requirements for regulatory reporting, minimum capital, and examinations. In addition, they must comply with the rules imposed by the various exchanges, such as the Chicago Mercantile Exchange and the Chicago Board of Trade as well as the National Futures Association, all of which act as self-regulatory organizations.

State Insurance Regulators

Regulation of the insurance industry and administration of insurance company receiverships and liquidations are primarily state responsibilities.³² In general, state legislatures set the rules under which insurance companies must operate. Among their other responsibilities, state insurance departments are to monitor the financial condition of insurers. States use a number of basic methods to assess the financial strength of insurance companies, including reviewing and analyzing annual financial statements, doing periodic on-site financial examinations, and monitoring key financial ratios.

State insurance departments are generally responsible for taking action in the case of a financially troubled insurance company. If the insurance company is based in another state, the insurance department can suspend or revoke its license to sell insurance in the department’s state. If a home-based company is failing, the department can put it under state supervision or, in cases of irreversible insolvency, place a company in liquidation. State insurance regulators have established a central structure to help coordinate their activities. The National Association of Insurance Commissioners (NAIC) consists of the heads of the insurance departments of 50 states, the District of Columbia, and 4 U.S. territories. NAIC’s basic purpose is to encourage uniformity and cooperation among the various states and territories as they individually regulate the insurance industry. To that end, NAIC promulgates model insurance laws and regulations for state consideration and provides a framework for multistate “zone” examinations of insurance companies.

³²In 1868, the U.S. Supreme Court upheld the constitutionality of a state statute regulating insurance agents on the grounds that the insurance business is not commerce that the federal government may regulate under the commerce clause. [Paul v. Virginia, 75 U.S. 168 (1868)] In 1944, the court abandoned the proposition that insurance is not commerce and upheld the application of federal antitrust laws to the insurance industry [United States v. South-Eastern Underwriters Assoc., et. al., 322 U.S. 533 (1944)]. In 1945, Congress reestablished the primacy of state regulation by enacting the McCarran-Ferguson Act, which strictly limited the extent to which federal law, including federal antitrust law, preempted state insurance law.

Objectives, Scope, and Methodology

Congressman Charles E. Schumer asked us to provide information to help Congress evaluate efforts to modernize the U.S. system of federal oversight of banks and thrifts. Our objectives were to (1) discuss previously reported problems with the bank oversight structure in the United States, (2) summarize those characteristics of the five countries' regulatory structures that might be useful for Congress to consider in any U.S. modernization efforts, and (3) identify potential avenues for modernizing the U.S. banking oversight structure.

This report does not address federal oversight of credit unions by the National Credit Union Administration (NCUA), which are also classified as depository institutions. Credit unions hold only a small percentage of all depository institution assets—about 5.5 percent. Also, although the legal and practical distinctions between thrifts and banks have all but disappeared in recent years, the core of credit union business remains traditional consumer lending activities. Finally, the most recent proposals to modernize oversight of financial institutions have not included oversight of credit unions within their scope.

To address the objectives of this report, we conducted interviews with senior supervisory officials from the Board of Governors of FRS, Federal Reserve Bank of New York, FDIC, OCC, OTS, and SEC. They also provided us with various documents and statistics, including bank and thrift examination manuals, guidance to examiners and banking industry officials, and statistics on the banking industry.

In addition to our interviews with U.S. supervisory officials, we met with officials representing the banking industry, including officials from the American Bankers Association, Independent Bankers Association of America, and Conference of State Bank Supervisors. We also met with officials from the accounting profession, including officials from the American Institute of Certified Public Accountants.

In conducting our work we also gathered information from many other sources. These include studies of the history of the banking industry; records from congressional hearings related to regulatory restructuring; and professional literature concerned with the industry structure, regulation, and external audits. We also reviewed relevant banking acts and regulations. This review does not constitute a formal legal opinion on the requirements of the laws.

Much of this report was based on our reports of the structures and operations of bank regulation and supervision activities in Canada, France, Japan, Germany, and the United Kingdom.³³ When preparing these reports, we interviewed regulatory and industry officials in each country and reviewed relevant banking laws, regulations, industry statistics, and other industry studies. These reports did not assess the effectiveness or efficiency of bank oversight in the countries studied.

This report also draws on extensive work that we have done over the past several years on depository institutions, the deposit insurance program, the securities and insurance industries, international competitiveness, and other aspects of the financial services system in the United States. A comprehensive list of our products addressing issues related to the financial services industry is included at the end of this report. (See Related GAO Products.)

We conducted our work from July 1995 through June 1996 in accordance with generally accepted government auditing standards. We provided a draft of this report for comment to the heads of FRS, FDIC, OCC, OTS, and Treasury. FRS, FDIC, OCC, and OTS provided written comments, which are discussed at the end of chapter 4 and reprinted in appendixes IV to VII. Treasury did not provide written comments. Each agency also provided technical comments, which we incorporated where appropriate.

³³See Bank Regulatory Structure: The Federal Republic of Germany (GAO/GGD-94-134BR, May 1991); Bank Regulatory Structure: The United Kingdom (GAO/GGD-95-38, Dec. 1994); Bank Regulatory Structure: France (GAO/GGD-95-152, Aug. 1995); Bank Regulatory Structure: Canada (GAO/GGD-95-223, Sept. 1995); and Bank Regulatory Structure: Japan, which is currently a draft report.

Bank Oversight Structure Is Redundant

All four federal oversight agencies share several supervisory and regulatory responsibilities, including developing and implementing regulations, taking enforcement actions, conducting examinations, and off-site monitoring. Chartering is the responsibility of 2 federal agencies, as well as all 50 states. This structure of shared responsibilities has been characterized by some observers as being inherently inefficient. Furthermore, our work has shown that despite good faith efforts to coordinate their policies and procedures, the four federal bank oversight agencies have often differed on important issues of bank supervision and regulation.

Federal Agencies Overseeing Banks and Thrifts Share Several Oversight Responsibilities

The division of primary oversight responsibilities among the four oversight agencies is not based on specific areas of expertise, functions, or activities, either of the regulator or the banks for which they are responsible, but based on institution type—thrift or bank, bank charter type—national or state, and FRS membership. Consequently, the four oversight agencies share responsibility for developing and implementing regulations, taking enforcement actions, and conducting examinations and off-site monitoring.

Figure 2.1: Responsibility for U.S. Bank Oversight Functions

	Developing laws	Developing and issuing regulations	Licensing/chartering	Bank information reporting and analysis	Bank examinations	Enforcement authority	Deposit insurance	Failure resolution	Lender of last resort	Crisis management
Treasury ^a	●									●
OCC	●	●	●	●	●	●				●
OTS	●	●	●	●	●	●				●
Federal Reserve	●	●		●	●	●		●		●
FDIC ^b	●	●		●	●	●	●			●

^aOCC and OTS are within Treasury.

^bThe Board of Directors of FDIC includes the heads of OCC and OTS as well as three independent members, including the chairman and vice chairman, who are appointed by the President and confirmed by the Senate.

Source: FDIC, FRS, OCC, OTS, and Treasury.

All Four Regulators Develop and Implement Regulations and Guidelines

Regulations are the primary vehicle through which regulators elaborate on what the laws mean, clarify provisions of the laws, and provide guidance on how the laws are to be implemented.¹ Regulations typically have the force of law—that is, they can be enforced through a court of law. Regulators have, in some cases, issued guidelines rather than regulations because guidelines provide them greater flexibility to change or update as experience dictates. Guidelines, however, are not directly enforceable in court.²

In most cases, each regulator is responsible for issuing its own regulations for the banking institutions under its jurisdiction. This may result in four sets of regulations implementing essentially the same provision of the law. Unless regulatory coordination in developing regulations is mandated by law, the regulators may develop regulations independently. Even if the regulators develop regulations jointly, on an interagency basis, they each still issue similar individual regulations under their own legal authority. In some instances, law designates a specific regulator to write the regulation for all banking institutions. For instance, FRS has sole rulemaking responsibility for many consumer protection laws.

All Four Regulators May Take Enforcement Actions

Each regulator has the authority to take enforcement actions against financial institutions under its jurisdiction. Regulators may initiate informal or formal enforcement actions to get bank management to correct unsafe and unsound practices or conditions identified during the banking institution examination.³ Regulators have broad discretion in deciding which, if any, regulatory action to choose, and they typically make such decisions on a case-by-case basis. Regulators have said that they prefer to work with cooperative banking institution managers to bring about necessary corrective actions as opposed to asserting formal actions. However, bank regulatory officials have also said that they may take more stringent action when the circumstances warrant it.

¹In issuing regulations, regulators must publish proposed drafts in the Federal Register to request public comments, after which they consider comments and finalize the regulations.

²Banking guidelines typically do not serve as the basis for agency enforcement actions. Noncompliance with guidelines may be cited by regulators in enforcement actions to encourage banking institution managers to take necessary actions.

³The enforcement process for regulators begins when they notify institution management and directors of financial weaknesses, operational problems, or violations of banking laws or regulations identified during an examination. Regulatory concerns are to be brought to a bank's attention through meetings with management upon completion of the examination. A report of the examination findings is also to be provided to the bank's board of directors, management, and principal ownership interests.

Under agency guidelines, the regulators are to use informal actions for banking institutions if (1) the institution's overall strength and financial condition make failure a remote possibility and (2) management has demonstrated a willingness to address supervisory concerns. Informal actions generally include

- meeting with banking institution officers or board of directors to obtain agreement on improvements needed in the safety and soundness of the institution's operations,
- requiring banks to issue resolutions to issue commitment letters to the regulators specifying corrective actions to be taken, and
- initiating memorandums of understanding between regulators and banking institution officers on actions that are to be taken.

Informal actions typically are used to advise banking institutions of noted weaknesses, supervisory concerns, and the need for corrective action. The regulators assume that banking institutions understand that if they do not comply with informal actions, regulators may take stronger enforcement actions.

Under agency guidelines, the regulators use formal enforcement actions that are authorized in banking laws when informal actions have not been successful in getting management to address supervisory concerns, management is uncooperative, or the institution's financial and operating weaknesses are serious and failure is more than a remote possibility. Formal enforcement actions generally include such actions as

- formal written agreements between regulators and bankers;
- orders to cease and desist unsafe practices or violations;
- assessments of civil money penalties; and
- orders for removal, suspension, or prohibition of individuals from banking institution operations.

In addition, OCC and OTS may revoke national banking institutions' charters and place institutions in conservatorship; FDIC may remove an institution's deposit insurance.

Each Regulator Is To Examine Banking Institutions Under its Jurisdiction

Under FDICIA, all insured banking institutions are to be examined once every 12 months by federal regulators.⁴ These examinations are to be conducted by the regulators with primary jurisdiction over the banking institutions. In addition, FDIC may conduct backup examinations of any bank, if necessary, for the purpose of protecting BIF.

The full-scope examinations⁵ required under law are usually called safety-and-soundness examinations because their primary purpose is to assess the safety and soundness of a banking institution's practices and operations. The objectives of these on-site examinations are to

- test and reach conclusions about the reliability of banking institutions' systems, controls, and reports;
- investigate changes or anomalies disclosed by off-site monitoring and analysis; and
- evaluate those aspects of the institution's operations for which portfolio managers cannot rely on the banks' own systems and controls.

CAMEL Ratings for Banks and Thrifts

Examinations have historically been extensive reviews of loan portfolios. Currently, according to officials with whom we spoke, regulators are moving toward a risk-management approach and concentrating on institutions' risk profiles⁶ and internal controls. Examiners rate five critical areas of operations—capital adequacy (C), asset quality (A), management (M), earnings (E), and liquidity (L)—to determine an overall rating (CAMEL). They use a five-point scale (with one as the best rating and five as the worst) to determine a CAMEL rating that describes the condition of the institution.

As a part of the examination process, regulators are to meet with banking institution officials after every examination.⁷ In addition, regulators are to

⁴The Federal Deposit Insurance Act allows for examinations of small well-capitalized institutions (less than \$250 million in assets) to be extended to every 18 months and allows state examinations to alternate with federal examinations for state-chartered institutions.

⁵Full-scope examinations include examining asset quality, assessing systems and internal controls, judging capital adequacy and reserves, and assessing compliance with laws and regulations.

⁶Under this approach, the examiner is to look at the bank's portfolio, balance sheet, and other activities, like derivatives, to see whether there is adequate risk management, including policies and procedures to effectively manage the risk being taken by the institution.

⁷Examiners are also encouraged to communicate with banking institution management often, and directors as needed, to discuss current significant issues about the bank. This communication can take the form of a meeting or telephone contact. Typical discussion topics may include financial performance and trends, new lines of business or other operating changes, management concerns about the bank, and other issues that could affect the bank's risk profile.

hold separate meetings with the bank’s audit committee and management after each examination to discuss the results of the examination.

Holding Company Inspections

FRS and OTS also conduct holding company inspections. Holding company inspections differ from bank examinations in that the focus of the inspection is to ascertain whether the strength of a bank holding company is being maintained and to determine the consequences of transactions between the parent company, its nonbanking subsidiaries, and the subsidiary banks. According to FRS and OTS guidelines, the major components of an inspection include

- an assessment of the financial condition of the parent company, its banking subsidiaries, and any nonbanking subsidiaries;
- a review of intercompany transactions and relationships;
- an evaluation of the current performance of the company and its management; and
- a check of the company’s compliance with applicable laws and regulations.

BOPEC Ratings for Bank Holding Companies

Examiners are to rate five critical areas of the bank holding company—bank subsidiaries (B), other nonbank subsidiaries (O), parent company (P), earnings (E), and capital adequacy (C)—to determine an overall rating referred to as BOPEC. Examiners use a five-point rating scale, similar to that used for CAMEL ratings on banks and thrifts. They also rate management separately as satisfactory, fair, or unsatisfactory.

Consumer Compliance and Community Reinvestment Act Examinations Are Done Separately From Safety and Soundness Examinations

In addition to safety and soundness examinations, regulators are to conduct examinations of banking institutions focusing on compliance with various consumer protection laws and the Community Reinvestment Act (CRA). A consumer compliance examination results in a compliance rating for an institution’s overall compliance with consumer protection laws to ensure that the provision of banking services is consistent with legal and ethical standards of fairness, corporate citizenship, and the public interest. A compliance rating is to be given to the institution based on the numerical scale ranging from 1 for top-rated institutions to 5 for the lowest-rated institutions.

Although the regulators may do a CRA compliance examination separately from a consumer compliance examination, officials from all four

regulators said that they generally do both examinations at the same time. The purpose of the CRA examination is to evaluate the institution's technical compliance with a set of specific rules and to qualitatively evaluate the institution's efforts and performance in serving the credit needs of its entire community. The CRA examination rating consists of a four-part descriptive scale including "outstanding," "satisfactory," "needs to improve," and "substantial noncompliance." Under the Financial Institution Reform, Recovery, and Enforcement Act of 1989 (FIRREA), CRA was amended to require that the regulator's examination rating and a written evaluation of each assessment factor be made publicly available—unlike the safety and soundness or compliance examination ratings, which are not made public by regulators.

Off-Site Monitoring and Analysis Supplements Examinations

In addition to on-site examinations of banking institutions, each of the regulators engages in off-site monitoring activities. These activities—which generally consist of a review and analysis of bank-submitted data, including call reports, and discussions with bank management—are to help the regulators identify trends, areas of concern, and accounting questions; monitor compliance with requirements of enforcement actions; and formulate supervisory strategies, especially plans for on-site bank examinations. According to examination guidance issued by the regulators, off-site monitoring involves review and analysis of, among other things, quarterly financial reports that banks prepare for and submit to regulators⁸ and reports and management letters prepared for banking organizations by external auditors of banks. In general, meetings are not regularly held with banking institution management as part of normal off-site monitoring activities. If off-site monitoring reveals significant changes or issues that could have an impact on the bank, then examiners may meet with management or contact management by telephone to discuss relevant issues.

Oversight agencies are focusing more on risk assessment in their off-site monitoring efforts. FDIC officials said that their off-site monitoring programs, such as quarterly reports and off-site reviews, help provide an early indication of a change in an institution's risk profile. They also said that FDIC has developed new initiatives to improve identifying and

⁸The reports for banks are called the Consolidated Reports of Condition and Income (Call Reports). The reports for bank holding companies are called the Consolidated Financial Statements for Bank Holding Companies (Y-9 reports), and similar quarterly reports on thrifts and thrift holding companies are to be submitted to OTS. The reports are to be prepared by bank management and submitted to the primary regulator on a quarterly basis. The reports consist of a balance sheet, income statement, and various supporting detailed analyses of balances and related activities.

monitoring risk. One initiative is the development of decision flowcharts that aid examiners in identifying risks in an institution as well as possible approaches to address them. Another initiative has included increasing the use of technology through the development of an automated examination package and expanding the access that examiners have to internal and external databases in order to provide relevant data to examiners prior to on-site examinations, enabling the examiner to identify specific risks areas.

External auditors' reports, originally prepared to ensure the accuracy of information provided to a banking organization's shareholders, attest to the fairness of the presentation of the institution's financial statements and, in the case of large institutions, to management's assertions about the institution's financial reporting controls and compliance with certain laws and regulations. Management letters describe important, but less significant, areas in which the banking institution's management may need to improve controls to ensure reliable financial reporting.

Supervisors generally require banking institutions that have an audit—regardless of the scope of the audit—to send the reports, including management letters and certain other correspondence, to the supervisor within a specified time period.⁹ Reviews of this information could lead examiners to focus on-site examinations on specific aspects of an institution—such as parts of an institution's internal control system—or even to eliminate some procedures from the examination plan. The purposes of external audits and safety and soundness examinations differ in important respects and are guided by different standards, methodologies, and assumptions. Even so, external auditors and examiners may review much of the same information.¹⁰ To the extent that examiners could avoid duplicating work done by external auditors,

⁹Bank and thrift regulators have either required or strongly encouraged all institutions to have annual external audits. Large banks and thrifts—with total assets in excess of \$500 million—are required to have annual independent audits; and smaller banks are generally required to have audits for the first 3 years after obtaining FDIC insurance. Some state banking regulators also require such external audits for institutions chartered in their states. Additionally, the Federal Reserve requires bank holding companies with total consolidated assets of \$150 million or more to have annual, independent financial audits; and OTS requires annual audits of holding companies whose subsidiary savings associations have aggregate assets of \$500 million or more. SEC also has a financial audit requirement for all public companies, including bank holding companies that are SEC-registrants and all banking institutions that are subject to SEC reporting requirements.

¹⁰For example, an auditor may issue an unqualified opinion on an institution after determining that its transactions and balances are reported in accordance with Generally Accepted Accounting Principles (GAAP). This does not necessarily mean, however, that the transactions reflect sound business judgment, that the associated risks were managed in a safe or sound manner, or that the asset balances could be recovered upon disposition or liquidation.

examinations could be more efficient and less burdensome for financial institutions.

Supervisors' Use of External Auditors' Work Has Been Limited by Various Factors

Supervisors' actual use of external auditors' work has varied by agency as well as by individual examiner, according to supervisory officials we interviewed. Primary factors in limiting use, according to some officials we interviewed, include skepticism among examiners about the usefulness of the work of external auditors and concerns that the findings of an external audit could be outdated by the time the financial institution is examined by its federal supervisor.

Recent Initiatives May Help Increase Supervisory Use of External Auditors' Work

OCC and FDIC recently have undertaken initiatives to improve cooperation between external auditors and examiners and potentially to identify areas in which examiners could better use the work of external auditors. One impetus for improvement efforts was a 1995 report by the Group of Thirty—"Defining the Roles of Accountants, Bankers and Regulators in the United States."¹¹ This report recommended, among other things, joint identification by the accounting profession and regulators of areas of reliance on one another's work; actions by independent audit committees to encourage interaction among regulators, external auditors, and banking institution management; routine use by examiners of audit workpapers; and a permanent board consisting of representatives from each of the federal banking agencies, SEC, the accounting profession, and the banking industry to recommend improvements in the relationship between regulators and external auditors. Regulatory officials we interviewed disagreed with some of the recommendations set out by the Group of Thirty report, and some officials said the report did not give sufficient credit to regulators' past efforts to work with external auditors. However, regulators generally agreed that this report helped provide some needed momentum for their initiatives.

In November 1995, OCC announced plans for a 1-year pilot program to promote greater cooperation between examiners and external auditors and reduce wasteful duplication and oversight burden. The program, which is to involve at least 10 large regional and multinational banks, is expected to result in nonmandatory guidelines on how and under what circumstances examiners and external auditors should work together and use each others' work. Officials said that certain process-oriented functions where external auditors and examiners are tabulating or verifying the same information—such as documenting and flow-charting

¹¹The Group of Thirty is made up of officials from accounting firms, banks, securities firms, academia, and other private sector firms.

internal controls or confirming the existence and proper valuation of bank assets—may be an area where examiners could use the work of external auditors.

FRS is also in the process of trying to establish procedures for cooperating more closely with external auditors. As of June 1996, FRS staff had prepared a draft recommendation for the FRS Board to explore opportunities to share information and analytic techniques with external auditors and to seek opportunities to benefit from the work of external auditors.

According to FDIC officials, representatives of FDIC have regular meetings with external auditors, and examiners have also recently begun reviewing selected external auditors' workpapers. Examiners we spoke with told us that information found in the workpapers can be useful because information considered immaterial for financial accounting purposes (which is therefore not discussed in the audit report) can be useful for regulatory purposes. They further found the auditors' work useful for identifying issues needing management's attention and providing indicators of management willingness or ability to address those issues. Finally, one of the most important benefits of this workpaper review, according to examiners, is that these reviews promoted expanded communication and interaction between examiners and external auditors and helped acquaint examiners and auditors with each other's techniques, policies, procedures, and objectives. FDIC officials told us they plan to issue examiner guidance to implement procedures to expand their review of internal and external audit workpapers of institutions that have substantial exposure to higher risk activities, such as trading activities. Officials also said examiners will be expected to contact an institution's auditor to solicit information that the auditor may have gained from his or her work at the institution since the last examination. Finally, they said that this guidance will require that all Division of Supervision Regional Offices institute a program whereby annual meetings are held between regulators and local accountants to informally discuss accounting, supervisory, and examination policy issues.

According to industry officials, OTS—and its predecessor the Federal Home Loan Bank Board (FHLBB)—has had a long-standing history of working with external auditors, and its examiners frequently use the work of external auditors to adjust the scope of examinations. (See app. II for additional information on the use of external auditors in bank supervision.)

Chartering of Banking Institutions Is Limited to States, OTS, and OCC

Banking institutions have a choice of three chartering authorities: (1) state banking authorities, which charter state banks and thrifts and license state branches and agencies of foreign banks; (2) OTS, which charters national thrifts; and (3) OCC, which charters national banks and licenses federal branches and agencies of foreign banks.¹² FRS and FDIC have no chartering authority. However, according to FDIC, all deposit-taking institutions are required to apply to FDIC for federal deposit insurance before they are chartered. Thus, FDIC may have a powerful influence over chartering decisions.

Although the authority to charter is limited, each regulator has responsibility for approving mergers, branching, and change-of-control applications. FRS, FDIC, and OTS share their authority to approve branching and mergers of banking institutions under their jurisdictions with state authorities, while OCC alone reviews national bank branch and merger applications.¹³ FRS is responsible for approving bank holding company mergers even though the major banking institutions in the merging holding companies may be supervised by OTS, OCC, or FDIC. Likewise, OTS approves thrift holding company mergers.

FRS and FDIC Rely on Supervisory Information to Fulfill Nonoversight Duties; Treasury Obtains Information Primarily Through OCC and OTS

As described in chapter 1, in addition to their primary bank oversight functions, FRS and FDIC have other major responsibilities that include administration of the federal deposit insurance funds; failed or failing bank resolution; and asset disposition for FDIC and, for FRS, monetary policy development and implementation, payments and settlements systems operation and oversight, and liquidity lending.

FRS and FDIC officials told us that to fulfill their duties, they rely on information obtained under their respective supervisory authorities. FRS officials said that to carry out their responsibilities effectively, they must have hands-on supervisory involvement with a broad cross-section of banks. FRS officials also said that the successful handling of financial crises often depends upon a combination of the insights and expertise gained through banking supervision and those gained from the pursuits of macroeconomic stability.

¹²Bank and thrift holding companies are not chartered but are incorporated by the state chartering authority where they are headquartered or by OTS for national thrift holding companies.

¹³For other supervisory decisions such as changes of control, the deposit-taking institution is to notify its primary regulator and meet its requirements.

Experience suggests that in times of financial stress, such as the 1987 stock market crash, FRS needs to work closely with the Department of the Treasury and others to maintain market stability. As we have pointed out in the past, the extent to which FRS needs to be a formal supervisor of financial institutions to obtain the requisite knowledge and influence for carrying out its role is an important question that involves policy judgments that only Congress can make.¹⁴ Nevertheless, past experience, as well as evidence from the five foreign oversight structures we studied (see ch. 3 for further discussion) provides support for the need for FRS to obtain direct access to supervisory information. In its comment letter, FRS stated that it needs active supervisory involvement in the largest U.S. banking organizations and a cross-section of others to carry out its key central banking functions.

FDIC officials said that their formal supervisory responsibility enables them to maintain staff that can supervise and assess risk. In their view, this gives FDIC the expertise it requires when it needs to intervene to investigate a problem institution. In addition, FDIC officials said that the agency's supervision of healthy institutions is useful because it increases their awareness of emerging and systemic issues, enabling them to be proactive in carrying out FDIC's insurance responsibilities. In its comment letter, FDIC reiterated its need for information on the ongoing health and operations of financial institutions and stated that periodic on-site examination remains one of the essential tools by which such information may be obtained.

Under FDICIA, FDIC was given backup examination and enforcement authority over all banks.¹⁵ On the basis of an examination by FDIC or the appropriate federal banking agency or "other information," FDIC may recommend that the appropriate agency take enforcement action with respect to an insured depository institution. FDIC may take action itself if the appropriate federal banking agency does not take the recommended action or provide an acceptable plan for responding to FDIC's concerns and if FDIC determines that

- the institution is in an unsafe or unsound condition,
- the institution is engaging in unsafe or unsound practices and the action will prevent it from continuing those practices, or
- the institution's conduct or threatened conduct poses a risk to the deposit insurance fund or may prejudice the interests of depositors.

¹⁴Bank Regulation: Consolidation of the Regulatory Agencies (GAO/T-GGD-94-106, Mar. 4, 1994).

¹⁵Under FIRREA, FDIC was given similar backup enforcement authority for thrifts.

We are on record as favoring a strong, independent deposit insurance function to protect the taxpayers' interest in insuring more than \$2.5 trillion in deposits.¹⁶ Previous work we have done suggests that a strong deposit insurance function can be ensured by providing FDIC with (1) the ability to go into any problem institution on its own, without having to obtain prior approval from another regulatory agency; (2) the capability to assess the quality of bank and thrift examinations, generally; and (3) backup enforcement authority.¹⁷

As described in chapter 1, Treasury also has several responsibilities related to bank oversight, including being the final decisionmaker in approving an exception to FDIC's least-cost rule and a principal participant in the development of financial institution legislation and policies. These responsibilities require that Treasury regularly obtain information about the financial and banking industries, and, at certain times, institution-specific information. According to Treasury officials, Treasury's current level of involvement, through its housing of OCC and OTS and their involvement on the FDIC Board of Directors, and the information it receives from the other agencies, like FDIC and FRS, as needed, is sufficient for it to carry out these responsibilities. For example, according to Treasury, officials at OCC and OTS meet regularly with senior Treasury officials to discuss general policy issues and market conditions. In addition, the Secretary of the Treasury meets regularly with the FRS Chairman, and other senior Treasury officials meet regularly with members of the FRS Board. Furthermore, Treasury officials are in frequent contact with FDIC officials about issues relevant to both organizations.

Analysts, Regulators, and Legislators Have Identified Disadvantages and Advantages of the Oversight Structure

Analysts, legislators, banking institution officials, and numerous past and present regulatory agency officials have identified weaknesses and strengths in the structure of the federal bank oversight system. Some representatives of these groups have broadly characterized the federal system as redundant, inconsistent, and inefficient. Some banking institution officials have also raised concerns about negative effects of the structure on supervisory effectiveness. At the same time, some agency and institution officials have credited the current structure with encouraging financial innovations and providing checks and balances to guard against arbitrary oversight decisions or actions.

¹⁶GAO/T-GGD-94-106.

¹⁷GAO/T-GGD-94-106.

Bank Oversight Structure Has Contributed to Inefficiencies and Could Cloud Accountability to Congress, According to Regulators and Industry Officials and Analysts

A principal concern associated with four regulators essentially conducting the same oversight functions for various segments of the industry is that the system is inefficient in numerous respects. For example, each agency has its own internal support and administrative functions, such as facilities, data processing, and training to support the basic regulatory and supervisory tasks it shares with three other agencies.

Concerns about inefficiency have also been raised by banking industry officials and analysts because a number of federal regulatory agencies may oversee the banking and nonbanking subsidiaries in a bank holding company. Inefficiencies could result to the extent that the regulator responsible for supervision of the holding company itself, FRS, might duplicate work done by the primary regulator of the holding company subsidiaries—that is, OTS, OCC, or FDIC.¹⁸

According to SEC officials, another area of potential inefficiency is the lack of uniform regulations of bank securities activities. For example, banking institutions that are not part of a holding company are exempted from SEC filing requirements, such as registering their securities offerings and making periodic filings with SEC. This means that there is a duplication of expertise that both SEC and the federal banking institutions' regulators must develop and maintain to oversee securities offerings and related activities.

Overlapping authority and responsibility for examination of subsidiaries could also have the effect of clouding accountability to Congress in cases of weaknesses in oversight of such subsidiaries. According to testimony by the Comptroller of the Currency in 1994, "it is never entirely clear which agency is responsible for problems created by a faulty, or overly burdensome, or late regulation."¹⁹

Regulators have also raised concerns about FDIC's backup examination authority. The backup authority remains open to interpretation and, according to regulatory officials, gives FDIC the authority to examine banking institutions regardless of the examination coverage or conclusions of the primary regulator. Regulatory officials said that they were concerned about FDIC's backup authority because of the possible

¹⁸As the primary supervisor of bank holding companies, FRS collects and reviews information on nonbank subsidiaries. If FRS determines, on the basis of its own information or information of other regulatory and supervisory agencies, that the nonbank subsidiary needs an on-site inspection, FRS examiners may inspect the nonbank subsidiary. In addition, OCC can examine nonbank subsidiaries of national banks and FDIC can examine those of state-chartered nonmember banks.

¹⁹Testimony of Eugene A. Ludwig, Comptroller of the Currency, Mar. 2, 1994.

duplication of effort and the resulting regulatory burden on the affected banks. FDIC's Board of Directors has worked with FDIC officials in efforts to establish a policy statement clarifying how this authority will be applied in order to avoid inefficiency or undue burden while allowing FDIC to safeguard deposit insurance funds.

Multiplicity of Regulators Creates Inconsistencies

Regulators, banking officials, and analysts alike assert that the multiplicity of regulators has resulted in inconsistent treatment of banking institutions in examinations, enforcement actions, and regulatory decisions, despite interagency efforts at coordination. For example, in previous studies,²⁰ we have identified significant inconsistencies in examination policies and practices among FDIC, OCC, OTS, and FRS, including differences in examination scope, frequency, documentation, loan quality and loss reserve evaluations, bank and thrift rating systems, and examination guidance and regulations. To address some of these problems, the federal agencies have operated under a joint policy statement since June 1993 designed to improve coordination and minimize duplication in bank examination and bank holding company inspections. According to OTS, the oversight agencies have adopted a common examination rating system and have improved coordination of examinations, and some conduct joint examinations when feasible.

Some of the differences among banking institution regulators result from differences in the way they interpret and apply regulations. Banking officials told us that the agencies sometimes apply different rules to similar situations and sometimes apply the same rules differently. A 1993 Congressional Budget Office (CBO)²¹ study cited frequent disagreements between OCC and FRS on the interpretation of laws governing the permissible activities of national banks. These disagreements resulted in a failed attempt by FRS to prevent one national bank from conducting OCC-approved activities in a bank subsidiary.²² The CBO study also detailed historical differences between the two agencies in other areas, such as merger approvals.

²⁰GAO/T-GGD-94-106. Bank and Thrift Regulation: Improvements Needed in Examination Quality and Regulatory Structure (GAO/AFMD-93-15, Feb. 16, 1993).

²¹Congressional Budget Office Staff Memorandum Options for Reorganizing Federal Banking Agencies, September 1993.

²²The Federal Reserve Board argued that it had jurisdiction over the bank subsidiary since it was responsible for the holding company as a whole.

In addition to interpreting regulations differently, the regulatory agencies sometimes enforced them differently as well. For example, we observed that regulatory agencies have given different priority to enforcing consumer protection and community lending legislation.²³ Similarly, in our examination of regulatory impediments to small business lending we also found that the agencies had given conflicting advice to their institutions about the procedures for taking real estate as collateral to support traditional small business working capital and equipment loans.²⁴

Inconsistency among the regulators in examinations as well as in interpreting, implementing, and enforcing regulations may encourage institutions to choose one charter over another to take advantage of these differences. For example, a merger of banking institutions with differing charters may be purposefully structured to place the application decision with the agency deemed most likely to approve the merger and expand permissible activities. According to some former agency officials, a regulatory agency's desire to maintain or increase the number of institutions under its jurisdiction could inhibit the agency from taking the most appropriate enforcement action against an institution because that action could prompt a charter switch.

Although the statutory mandates that define responsibilities of federal regulators help produce a common understanding of the principal goals of bank regulation, bank regulators may prioritize these goals differently, according to the mission of the particular regulatory agency, among other factors. As a result, a banking organization overseen by more than one of the regulators can have different, and sometimes conflicting, priorities placed on its institutions.

Various functions within an agency may also differ in the priority they assign oversight goals. For instance, safety-and-soundness examiners from one agency focus on the goals of safety and soundness and the stability of the system and may emphasize high credit standards that could conflict with community development and investment goals. Other examiners from the same agency focus on consumer protection and community reinvestment performance of banking institutions. According to industry officials, the two types of examiners may have different priorities when assessing banking institution activities, even though each represents the same regulatory agency. As a result, industry officials have said that they

²³GAO/T-GGD-94-106.

²⁴Bank Regulation: Regulatory Impediments to Small Business Lending Should Be Removed (GAO/GGD-93-121, Sept. 7, 1993).

are sometimes confused about how consistently the goals are applied to individual institutions as well as across the industry.

Regulatory Coordination Is Not Always Efficient

Coordination among regulators to ensure consistent regulation and supervisory policies has been encouraged by Congress in FIRREA and FDICIA and, according to agency officials, has taken place through the Federal Financial Institutions Examination Council (FFIEC),²⁵ various interagency committees or subcommittees, interagency task forces or study groups, or through agency officials working together. Many joint policies and regulations have been developed in this way. Currently, for example, according to several of the oversight agencies, the federal agencies are working to develop consistent regulations and guidelines that implement common statutory or supervisory policies, pursuant to Section 303 of the Riegle Community Development and Regulatory Improvement Act. How they are to coordinate and the degree to which coordination takes place is to be decided on a case-by-case basis.

Although acknowledging the need for agency coordination, bank oversight officials have said that efforts to develop uniform policies and procedures—regardless of the coordination means used—can take months, involve scores of people, and still fail to result in uniformity. Further, they said the coordination process has often caused long delays in decisions on important policy issues. Implementation of FDICIA is such a case. Numerous staff from each of the regulatory agencies were involved over an extended period. However, despite this effort, the agencies missed the statutory deadline for the noncapital tripwire provision authorizing closure of banking institutions even when they still have positive capital levels (section 132 of the act) by several months.²⁶ In addition, banking institution officials have stated that efforts to coordinate have usually led to what too often becomes the “least common denominator” agreement rather than more explicit uniform regulatory guidance.

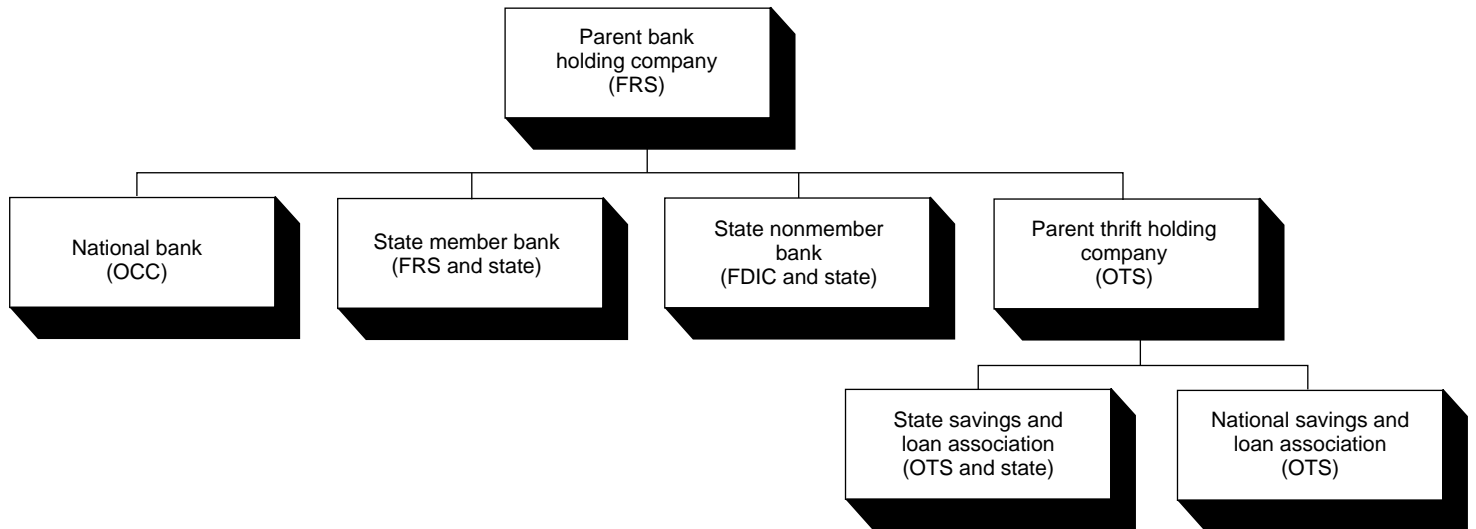
²⁵FFIEC was created by Congress in 1979 to promote consistency in the examination and supervision of financial institutions. The Council is composed of the Comptroller of the Currency, one FRS Governor, the OTS Director, the FDIC Chairman, and the Chairman of the NCUA board. FFIEC was principally designed to address duplication in examination procedures and has had some success in this area. For example, with the passage of FIRREA, FDICIA, and the Riegle Community Development and Regulatory Improvement Act of 1994, regulators have worked more actively on an interagency basis to develop examination policies and procedures and to coordinate examinations, much of which was done through FFIEC.

²⁶GAO/T-GGD-94-106.

Current Structure May Hamper Effectiveness of Oversight

Certain aspects of the U.S. banking oversight structure may also negatively affect regulatory effectiveness. According to FRS testimony, as of April 30, 1996, about 60 percent of the nation's bank and thrift organizations were supervised by at least two different federal banking agencies.²⁷ Some holding companies may be subject to oversight by three or all four of the federal oversight entities (see fig. 2.2).

Figure 2.2: Regulation of a Hypothetical Bank Holding Company



Source: GAO.

The overlapping authority in bank holding company supervision has sometimes been a problem, according to regulatory officials, because each regulator examines only a segment of the holding company and so must rely upon other regulators for information about the remaining segments. Banking officials have said this not only results in a fragmented approach to supervising and examining institutions but also ignores how the banking organization operates and hinders regulators from obtaining a complete picture of what is going on in the organization. According to these officials, the regulatory structure may result in potential blind spots

²⁷Statement by Edward W. Kelley, Jr., Member, Board of Governors of the Federal Reserve System before the Committee on Banking and Financial Services, U.S. House of Representatives, Apr. 30, 1996.

in supervisory oversight and, therefore, may not be the most effective way to guard against risk to banking institutions or the banking system as a whole. Work that we have done supports these assessments.²⁸

Multiagency System Has Been Credited With Encouraging Financial Innovations and Providing Checks and Balances to Ensure Banks Are Treated Fairly

Although banking officials have acknowledged weaknesses in the structure of the U.S. bank oversight system, they have also found strengths. For example, some regulatory officials believe that regulatory monopolies or single regulators run the risk of being inflexible and myopic; are slow to respond to changes in the marketplace; and, in the long term, are averse to risktaking and innovation by banking institutions. These officials have stated that having multiple federal regulators in the U.S. system has resulted in the diversity, inventiveness, and flexibility in the banking system that is important for responding to changes in market share and in technology. These officials consider the present system to be flexible enough to allow market-driven changes and innovations. The same officials have said that the present system of multiple regulators—with the ability of banking institutions to change charters—provides checks and balances against arbitrary actions and rigid and inflexible policies that could stifle healthy growth in the banking industry.

Principles for Bank Oversight Modernization

On the basis of the extensive work we have done in areas such as bank supervision, enforcement, failure resolution, and innovative financial activities—such as derivatives—we have previously identified four fundamental principles that we believe Congress could use when considering the best approach for modernizing the current regulatory structure.²⁹ We believe that the federal bank oversight structure should include

- consolidated and comprehensive oversight of companies owning federally insured banks and thrifts, with coordinated functional regulation and supervision of individual components;
- independence from undue political pressure, balanced by appropriate accountability and adequate congressional oversight;

²⁸See, for example, *Bank Supervision: OCC's Supervision of the Bank of New England Was Not Timely or Forceful* (GAO/GGD-91-128, Sept. 16, 1991).

²⁹*Bank Oversight: Fundamental Principles for Modernizing the U.S. Structure* (GAO/T-GGD-96-117, May 2, 1992).

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- consistent rules, consistently applied for similar activities; and
 - enhanced efficiency and as low a regulatory burden as possible consistent with maintaining safety and soundness.

Aspects of Foreign Bank Oversight Systems May Be Useful to Consider in Efforts to Modernize U.S. Bank Oversight

Aspects of bank oversight systems in Canada, France, Germany, Japan, and the United Kingdom (U.K.) may be useful to consider when addressing bank oversight modernization. All of the foreign systems had fewer total entities overseeing banking institutions than did the U.S. system of bank oversight—ranging from one (U.K.) to three (France).¹ No more than two oversight entities in the foreign countries were responsible for any single major oversight activity—chartering,² regulation, supervision, or enforcement. In all five countries we studied, banking organizations typically were subject to consolidated oversight, with one oversight entity being legally responsible and accountable for the entire banking organization, including its banking and nonbanking subsidiaries. The oversight systems in the countries we reviewed generally included roles for both central banks and finance ministries. This reflects a close relationship of traditional central bank responsibilities with oversight of commercial banks as well as the national government’s ultimate responsibility to maintain public confidence and stability in the financial system. At the same time, most of the foreign countries incorporated checks and balances to guard against undue political influence and to ensure sound supervisory decisionmaking. The other countries’ deposit insurers had narrower roles than that of FDIC and often were not government entities. Finally, foreign systems incorporated a variety of mechanisms and procedures to ensure consistent oversight and improve efficiency.

Foreign Systems Had One to Three Oversight Entities

Compared to the U.S. bank oversight structure, with four federal agencies performing many of the same oversight functions, the other countries’ structures looked less complex (see table 3.1 for a brief overview of the other countries’ oversight systems). The total number of bank oversight entities in each of the countries we studied ranged from one (U.K.) to three (France). At one end of the spectrum was the Bank of England, which performed all bank oversight functions. At the other end, in France, were the three independent decisionmaking committees—chartering, regulating, and supervising—all of which were supported by central bank staff. The foreign systems also had fewer oversight entities engaged in chartering, regulation, supervision, and enforcement activities compared to the U.S. system. Although all four U.S. agencies issue rules, conduct examinations, and take enforcement actions—OCC and OTS are the only federal chartering authorities in the United States—the foreign systems

¹The discussion in this report is limited to national-level oversight entities, unless otherwise noted.

²Chartering is sometimes also referred to as authorization in some countries.

Chapter 3
Aspects of Foreign Bank Oversight Systems
May Be Useful to Consider in Efforts to
Modernize U.S. Bank Oversight

had authorized no more than two agencies to perform each of those functions.

**Chapter 3
Aspects of Foreign Bank Oversight Systems
May Be Useful to Consider in Efforts to
Modernize U.S. Bank Oversight**

Table 3.1: Overview of Other Countries' Bank Oversight Systems

Country	Overview of system characteristics
Canada	The system is dominated by a federal supervisor whose top official is appointed by the cabinet and reports directly to the Minister of Finance, a member of the government's cabinet. A federal deposit insurer plays a secondary role in bank oversight. Canada's central bank, the Bank of Canada, whose primary function is monetary policy, maintains a data reporting system on the financial system and individual institutions. It also sits on two oversight coordination committees with the supervisor and insurer and on the insurance Board of Directors with the supervisor and Department of Finance representatives.
France	Three separate, independent committees are responsible for bank regulation, supervision, and authorization; each is supported primarily by staff of the central bank, the Bank of France. A general purpose of the three-committee system is to prevent an overconcentration of power by any individual or institution in government oversight of banking. The Bank of France and the French Ministry of Economic Affairs are the key members of all three committees, which also include a representative of the banking industry.
Germany	The system consists of both public and private participants—with two federal agencies (a supervisor and the central bank, the Bundesbank) sharing certain responsibilities with external auditors and private banking associations. De jure, the primary German bank regulatory and supervisory authority, is the federal bank supervisor, which reports to the Ministry of Finance and is held accountable for its actions to the German parliament. However, the supervisor and the central bank work closely together and are generally considered partners in the formulation of regulatory and supervisory policies. In addition, the central bank has the most active role in day-to-day supervision.
Japan	The system involves two primary parties—the Ministry of Finance and the Bank of Japan, Japan's central bank. The Ministry of Finance has sole formal authorization to charter banks and issue and enforce governmental bank regulations and is principally responsible for collecting reports and financial statements from banks. Japan's central bank derives its authority principally from the contractual agreements it makes with financial institutions. It may also issue guidance to banks to ensure the safety and soundness of the financial system. Both the Ministry of Finance and the Bank of Japan conduct—generally on an alternating basis—examinations of banks.
U.K.	The system is dominated by its central bank, the Bank of England, which is the primary regulator and sole supervisor of authorized banks in the United Kingdom. The central bank is formally governed by its 16-member Court of Directors but is managed by the Governor of the Bank, his deputy, and four executive directors responsible for monetary and financial stability. The Bank is subordinate to Her Majesty's Treasury and accountable to Parliament but has been accorded a high degree of independence in bank regulation and supervision.

(Table notes on next page)

Chapter 3
Aspects of Foreign Bank Oversight Systems
May Be Useful to Consider in Efforts to
Modernize U.S. Bank Oversight

Source: The Canadian Office of the Superintendent of Financial Institutions, French Banking Commission, German Bank Supervisory Office, Japanese Ministry of Finance, and the Bank of England.

Other Countries Had One Entity to Charter Banking Institutions

In each of the countries we studied, chartering of commercial banking institutions was the responsibility of only one entity.³ This differs markedly from the U.S. system, in which banking institutions may be chartered by state banking commissions, OTS, or OCC.⁴ As in the United States, the chartering entities in the other countries assessed applications on the basis of several factors.⁵ The most universal of the factors considered were the adequacy of capital resources and the expertise and character of financial institution management.

In the United States, as noted in chapter 1, a banking institution's federal oversight agency is largely determined by the institution's charter, and under most circumstances an institution may switch its charter in order to come under the jurisdiction of an agency it may favor. Such switching of regulators is not a possibility in the countries we studied.

In Most Other Countries, Regulations Were Issued by One Entity

In contrast to the U.S. system, in which each of the four banking institution oversight entities is generally authorized to issue its own regulations or regulatory guidelines, responsibility for issuing regulations in the countries we studied was usually limited to one entity.⁶ In France, this responsibility was assigned to the Bank Regulatory Committee; in Germany, to the Federal Bank Supervisory Office (FBSO); in Japan, to the Ministry of Finance; and in the U.K., to the Bank of England. In Canada, however, the bank supervisor and the deposit insurer were both authorized to issue regulations or standards. The insurer had the authority to issue standards pertaining to its operations and functions and those of its members. To guard against monolithic decisionmaking, the regulatory processes in all five countries were designed to include the views of other

³In some countries, other kinds of banking institutions, such as trusts, were chartered at the local level.

⁴U.S. chartering authority is further complicated by FDIC's responsibility to approve federal deposit insurance for institutions at the time of chartering. In effect, this gives FDIC veto power over chartering decisions.

⁵The Banking Acts of 1933 and 1935 require U.S. federal banking agencies to consider capital adequacy, earnings prospects, managerial character, and community needs before chartering a bank.

⁶Many regulations in European Union member countries—including France, Germany, and the U.K.—are written in response to European Union directives that are to be transposed into national law by the member countries. Any regulations to implement such laws are the responsibility of the member countries' national oversight agencies.

agencies involved in bank, securities and insurance oversight, and those of the regulated industry.

The single-regulator approach in four of the foreign countries we studied and the coordination of regulation between the federal regulator and the deposit insurer in Canada meant that in all five countries, all banking institutions conducting the same lines of business were subject to the same safety and soundness standards, including rules related to permissible activities. This contrasts with the four regulator system in the United States, as discussed in chapter 2.

**Supervisory
Responsibilities Were
Shared by No More Than
Two Entities, and Only One
Had Formal Enforcement
Authority**

In the countries we studied, major supervisory activities were never shared by more than two entities. For purposes of our analysis, we defined these activities as (1) monitoring banks' financial condition and operations through on-site examinations or inspections, (2) monitoring through the collection and analysis of data in reports filed by banks and through meetings with bank officials and others, and (3) enforcing laws and regulations through formal or informal actions. In Canada, both the bank supervisor and the deposit insurer performed supervisory duties. In France, the supervisory duties were performed by the committee called the Banking Commission; in Germany, by the federal bank supervisor and the central bank; in Japan, by the Ministry of Finance and the Bank of Japan;⁷ and in the U.K., by the Bank of England.

In four of the five countries we studied, the responsibility for taking formal enforcement actions was limited to one supervisor.⁸ For instance, in the U.K., the Bank of England was solely responsible for formal enforcement actions. In Germany, the federal supervisor was responsible for enforcement actions; in France, the Banking Commission; and, in Japan, the Ministry of Finance in Japan. Canada's deposit insurer could take specific, narrowly defined enforcement actions to protect the deposit insurance fund, such as levying a premium surcharge on individual members or terminating an insured institution's deposit insurance.

⁷The Bank of Japan derives its authority for such duties mostly from bilateral contracts with individual banks.

⁸Formal actions can include revoking a bank's authorization; removing bank managers or directors; or imposing conditions on the bank, such as limiting deposit taking to current depositors, restricting the bank's scope of business, prohibiting the bank from entering into certain transactions, and requiring the bank to cease and desist particular practices or activities.

Most Foreign Bank Supervisors
Said They Conducted On-Site
Examinations Less Frequently
Than Did U.S. Supervisors

Most of the other countries' bank supervisors said they conducted on-site examinations less frequently than U.S. bank supervisors, and they said that the examinations conducted were often narrower in scope than U.S. examinations. In France, on-site examinations were conducted on average less frequently than every 4 years, depending on the institutions being examined. In Japan, examinations were conducted approximately every 1 to 3 years. Canada's frequency of on-site examinations, like that of U.S. supervisors', was to be once a year. Supervisors in Germany and the U.K. said they relied on information collected for them by external auditors rather than conducting their own regularly scheduled on-site examinations.⁹

In the three countries that conducted regular on-site examinations, the examinations were to primarily assess the safety and soundness of bank operations and verify the accuracy of data submitted for off-site monitoring purposes. Special purpose examinations, in Canada and elsewhere, were also to be conducted across the industry to determine how specific issues—such as corporate governance—were being handled across the banking system.

Supervisors in Other Countries
Relied Extensively on
Information Provided in
Periodic Reports and Meetings

In monitoring the financial conditions and operations of banks, most of the supervisory entities in other countries said they generally relied more extensively than supervisors in the United States on off-site information, primarily information in periodic reports submitted by banking institutions. Reporting by banks included information on assets, liabilities, and income, as is the case in the United States, as well as more detailed information. In France, for example, the Banking Commission had implemented a new reporting system for credit institutions for the purpose of collecting and analyzing information for prudential, monetary, and balance of payments purposes. The system was intended to provide an early warning of potential problems in individual banks or in the banking system as a whole.¹⁰ Indicators of potential safety and soundness problems were typically to be discussed with bank officials, whether in meetings or correspondence, and could trigger an on-site examination. Banks in several of the countries were also required to submit information on their major credit exposures, which the regulators could analyze for

⁹The only routine examinations conducted by the central bank in Germany were foreign exchange examinations.

¹⁰The reporting could include several hundred pages of information on balance sheets, profit and loss statements, solvency, liquidity, concentration risk, large exposures, exchange rate positions, and other areas. Appendixes include information on risks associated with activities, such as market making, trading, and derivatives. The database allowed the Commission to conduct peer group comparisons, analyze individual banks' break-even points, and forecast trends in the industry.

excessive growth or concentrations that might indicate safety and soundness problems for either the individual bank or the banking system.

Other important sources of information included meetings with bank management. For example, supervisors said they often met with management to follow up on information collected through their off-site monitoring. Such meetings could include questions about potential informational discrepancies and any business implications, or they could provide an opportunity for discussions about the institution's operations. In three countries (Canada, Germany, and the U.K.), work performed by banks' external auditors also contributed significantly to supervisory information (see discussion below on the contribution of external auditors to bank supervision).

As discussed in chapter 2, U.S. federal bank supervisors also monitor the condition of banks using information contained in periodic reports and discussions with bank management. However, U.S. regulators do not collect some of the information that is used for risk assessment purposes overseas, such as the reporting of large credit exposures.

Other Countries Used Informal Enforcement Actions More Than Formal Actions

As has often been true in the United States, supervisors in each of the countries we reviewed said they preferred to rely principally on informal enforcement actions, such as warnings or persuasion and encouragement. Informal actions generally were regarded by supervisors as easier and faster to put into effect and sufficiently flexible to ensure that the institutions took timely corrective actions. Supervisors also told us that banking institutions understood that if they did not comply with informal actions and recommendations, formal actions were sure to follow.

While authorization to take formal actions in most of the foreign countries was limited to the primary supervisor, informal actions sometimes could be taken by more than one oversight entity. In Germany, for example, the central bank could suggest to banks remedies for perceived shortcomings and recommend enforcement actions to the federal supervisor. In Japan, the Bank of Japan also could recommend informal enforcement actions, such as suggested remedies to perceived problems. In Canada, the deposit insurer could recommend enforcement actions to the supervisor as well as take some limited enforcement actions on its own if the insurance fund was considered at risk.

The financial services industries in the five countries have, over time, experienced serious failures, control problems, or other financial difficulties that have resulted in significant changes or at least the consideration of such changes to bank oversight structures. These changes include a strengthened on-site examination capability and an increased formality in the supervisory process and use of enforcement actions in several countries.

Oversight Entities Were Typically Responsible and Accountable for Entire Banking Organizations, Including Subsidiaries

In the five countries we studied, banking organizations typically were subject to consolidated oversight, with an oversight entity responsible and accountable for an entire banking organization, including banking and nonbanking subsidiaries. For instance, if a bank had nonbank subsidiaries regulated by securities or insurance regulators, bank regulators nonetheless were responsible for supervisory oversight of the bank as a whole.¹¹ The bank regulators would generally rely on the nonbank regulators' expertise in overseeing the bank's subsidiaries. For example, in France, the Banking Commission was responsible for the supervision of the parent bank and the consolidated entity, even though securities or insurance activities in bank subsidiaries were the responsibility of other regulators in those areas.

In Canada, the federal supervisor was responsible for all federally incorporated financial institutions, such as banks, insurance companies, and trust companies. Securities subsidiaries of banks were the responsibility of provincial securities regulators who shared information with the bank regulator for purposes of consolidated oversight.

Regulators in the U.K. also operated under the consolidated oversight approach. For a bank that owned nonbank subsidiaries, the Bank of England remained the lead regulator and had responsibility for the entity as a whole. However, it relied on the expertise of securities and insurance supervisors to provide information on subsidiaries conducting such activities. If the major top-level entity was a securities firm that owned a bank, then the securities regulator was the lead regulator of the entire entity and would rely on the bank regulator for information about the bank.

¹¹The United States is unique in its bank holding company structure. None of the countries we studied had multiple bank subsidiaries in a single company, as can be the case in the United States. Further, those nonbanking activities that were not permitted in the bank itself were conducted in bank subsidiaries, not holding company subsidiaries.

If banks conducted securities or other activities within the bank department rather than in a nonbank subsidiary, then the bank regulator retained supervisory responsibility. In Germany, for example, where universal banks were able to conduct an array of activities from deposits to securities activities within the banking institutions, the federal supervisor was responsible for all bank and nonbank activities conducted within a bank.

Other Countries’ Oversight Systems Generally Included Roles for Central Banks and Finance Ministries

The oversight systems in the countries we reviewed generally included roles for both central banks and finance ministries, reflecting the close relationship of traditional central bank responsibilities with oversight of commercial banks as well as the national government’s ultimate responsibility to maintain public confidence and stability in the financial system.

Central Banks Usually Played Significant Roles in Supervision and Regulatory Decisionmaking

Central banks generally played significant roles in supervision and regulatory decisionmaking in the countries we studied, largely based on the premise that central bank responsibilities for monetary policy and other functions, such as crisis intervention, oversight of clearance and settlements systems, and liquidity lending, are interrelated with bank oversight. Although no two countries had identical structures for including central banks in bank oversight, they each accorded their central banks roles that ensured access to, and certain influence over, the banking industry. The central bank’s role was most direct in the U.K., where the Bank of England had sole responsibility for the authorization, regulation, and supervision of banks.

Canada had a far less direct role for its central bank in supervision and regulation. Even so, the Bank of Canada influenced supervisory and regulatory decisionmaking as a member of (1) the deposit insurance board; (2) the Financial Institutions Supervisory Committee, an organization established to enhance communication among participants in financial institution regulation and supervision; and (3) the Senior Advisory Committee, which was to meet to discuss major policy changes or legislative proposals affecting bank oversight.¹² However, it had no direct authority over supervisory or regulatory decisionmaking.

¹²The committees’ other members are the bank supervisor, the Deputy Minister of Finance, and the chairman of the deposit insurer.

In France, Germany, and Japan the central bank was one of two principal oversight agencies, but the countries had different structures for involving the central banks in bank oversight. In Germany, the primary supervisor, not the central bank, was authorized to issue banking regulations and, with few exceptions, issue or revoke bank licenses and take enforcement actions against banks. However, a sharp contrast existed between the legally assigned responsibilities of the central bank and its de facto sharing of oversight responsibilities with the federal bank supervisor. The central bank and the federal bank supervisor worked closely together and were considered partners in the formulation of regulatory and supervisory policies. The supervisor was to consult the central bank about all regulations; the central bank was substantively involved in the development of most of the regulations and could veto some. It also had the most active role in day-to-day bank supervision of banks and was very influential in determining the enforcement actions to be taken by the federal bank supervisor. The influence of the central bank in bank oversight arises from its detailed knowledge about banks in Germany, certain legal requirements that it be consulted before supervisory or regulatory action was taken, and the general perception that its nonoversight responsibilities were closely linked with bank oversight.

The central bank of France was also very involved in bank oversight, but the structural basis for its involvement differed significantly from that in Germany. The decisionmaking responsibilities for supervision and regulation of banking institutions in France were divided among three different but interrelated oversight committees: one for chartering, one for regulation, and one for supervision. The Bank of France was a member of each of these committees. Its influence over bank oversight stemmed from its chairmanship of two of the three oversight committees—the committee for chartering and the committee for supervision (the Banking Commission); the fact that it staffed all three oversight committees and the examination teams; its authority in financial crises; and its importance in and influence over French financial markets.

The Japanese central bank also had some oversight responsibilities derived principally from the contractual agreements it made with financial institutions that opened accounts with the Bank of Japan—including all commercial banks. As a result, it examined these banks on a rotational basis with the Ministry of Finance and also met regularly with bank management. Although only the Ministry had the legal authority to take formal enforcement actions, the central bank provided guidance that banks usually interpreted as binding.

Finance Ministries
Included in Oversight
Structures, Although Roles
Varied

In all of the countries we reviewed finance ministries were included in oversight structures, although their roles varied. In some countries, the bank supervisors reported to the finance ministries and the finance ministries had final approval authority for regulations or enforcement actions. In other cases, the finance ministry acted as the principal supervisor or a representative of the finance ministry participated as a member of a decisionmaking committee. In most countries, the finance ministries received industrywide information to assist in discharging fiscal policy and other responsibilities. They often did not receive bank-specific information unless the regulator believed an institution to be a potential threat to system stability. In such situations, the finance ministry was to be apprised for crisis management and information purposes, as were the central bank and deposit insurer in order to ensure each could effectively carry out its respective responsibilities.

In Canada and Germany, the principal bank supervisor reported to the Minister of Finance. The oversight entities that reported to the finance ministries said that on day-to-day issues they had a significant amount of independence—the government was generally informed only of key regulatory or supervisory decisions. However, the agreement of the finance ministry was usually necessary for these decisions to be carried out.

In France, the Ministry of Economic Affairs was represented on each of the three independent oversight committees and chaired one of them. According to oversight and banking officials with whom we spoke, its influence over bank oversight was derived primarily from its chairmanship of the bank regulatory committee and its membership on the chartering and oversight committees, as well as from its position of power in the French cabinet, including its powers of final approval with regard to bank regulations.

In Japan, the Minister of Finance was the formal supervisor of banking institutions. It was solely responsible for chartering banking institutions, taking formal enforcement actions, and developing and issuing regulations. In addition, it also examined banks and conducted off-site monitoring.

In the U.K., the Bank of England reports to the Chancellor of the Exchequer, who heads the Treasury. The Treasury has no formal role in banking supervision, although it would expect to be consulted on any major regulatory or supervisory decision. The Chancellor does have the

power to issue directions to the Bank of England after consultation with the Governor of the Bank, ensuring that the government would have the final say in the event of a disagreement. Historically, the Bank of England has been accorded a high degree of independence in bank regulation and supervision.

Foreign Systems Had
Checks and Balances to
Guard Against Undue
Political Influence and
Ensure Sound
Decisionmaking

Other countries' systems of bank oversight incorporated various checks to guard against undue political influence in bank oversight and to ensure sound decisionmaking. These checks included shared responsibilities and decisionmaking and the involvement of banking institutions in the development of bank oversight policies and other decisionmaking.

According to Canadian officials, a degree of overlapping authority of the federal supervisor and the deposit insurer (whose governing board is to include four directors from the private sector) plays a useful role in ensuring integrity in bank oversight. For example, the independent assessments of the deposit insurer could provide a constructive second look at the bank supervisor's oversight practices. Similarly, the interactions of the supervisor with banking institutions could help the insurer assess risks of particular banking practices. Finally, the federal supervisor is required to consult extensively with banking industry representatives in developing regulations and guidelines. In Canada, the large size and small number of banks enabled banks to be influential players in the financial system, according to supervisory and central bank staff. The large banks believed they had a special responsibility for helping to ensure the stability of the financial system, as well as a self-interest in that stability. We were told by management of some of the major banks that they often related concerns and offered comments about other banks or financial institutions to the federal supervisor or the central bank.¹³

In France, a rationale for the committee oversight structure—with the Bank of France and the Ministry of Economic Affairs participating jointly on the committees—was to ensure that no single individual or agency could dominate or dictate oversight decisionmaking, according to Bank of France officials. In addition, the committee structure ensures that the interests of banks are represented. Each of the three bank oversight committees includes four members, including representatives of the banking industry, drawn from outside the Bank of France and the Ministry of Economic Affairs.

¹³However, the banks have no express legal responsibility for informing regulators about specific problems with individual banks.

In Germany, the decisionmaking power of the politically accountable federal bank supervisor was checked by the participation in bank oversight of the very independent central bank. Without the central bank's accord, very few, if any, important supervisory or regulatory actions would be taken. The central bank's express approval was legally required for certain regulations, such as those affecting liquidity and capital requirements, to take effect. In addition, the federal supervisor was required by law to consult with banking associations when changes to banking law or regulations were being considered and before banking licenses were issued.

In Japan, the Ministry of Finance typically developed policy by consensus, according to Ministry officials—a process that usually involved the input of many parties, such as the central bank, other government agencies, industry groups, and governmental policy councils. In addition, the Japanese central bank's participation in bank oversight could provide a second opinion on some oversight issues.

In the U.K., the Banking Act of 1987 formally established an independent body, known as the Board of Banking Supervision, to bring independent commercial banking experience to bear on banking supervisory decisions at the highest level. In addition to three exofficio members from the Bank of England, the Board's members are to include six independent members who are to advise the exofficio members on policymaking and enforcement issues. If the Bank decides not to accept the advice of the independent members of the Board, then the exofficio members are to give written notice of that fact to the Chancellor of the Exchequer.

Deposit Insurers Generally Had More Narrow Roles Than That of FDIC

Deposit insurers in the countries we studied generally had more narrow roles than that of FDIC. This less substantial oversight role may be attributable to the fact that national governments provided no explicit guarantees of deposit insurance and that deposit insurers were often industry administered.

Deposit Insurers Viewed Primarily as Sources of Funds and Were Not Explicitly Guaranteed by National Governments

The foreign deposit insurers we studied did not have a role in bank oversight as substantial as FDIC's. As discussed in chapter 1, FDIC is the administrator of federal deposit insurance, the primary federal regulator and supervisor for state-chartered banks that are not members of FRS, and the entity with primary responsibility for determining the least costly resolution of failed banks. In most countries, by contrast, deposit insurers

were viewed primarily as a source of funds to help resolve bank failures—either by covering insured deposits or by helping to finance acquisitions of failed or failing institutions by healthy institutions.¹⁴ Supervisory information was generally not shared with these deposit insurers, and resolution decisions for failed or failing banks were commonly made by the primary bank oversight entities with the insurer frequently involved only when its funds were needed to help finance resolutions.

The broader role of FDIC as compared to deposit insurers in other countries may be attributable in part to the fact that deposit insurance is federally guaranteed in the United States. For example, FDIC’s involvement in bank resolutions—particularly its responsibility to determine the least costly of resolution methods—helps protect the interests of both the industry and potentially of taxpayers when a bank fails. None of the governments of the other countries we studied provided such an explicit guarantee.¹⁵ Four of the five deposit protection programs—Germany is the exception—also provide less coverage than does the U.S. system.¹⁶

Banking Industries
Generally Had Important
Roles in Administration of
Deposit Protection
Systems

In Germany and France, deposit protection systems were administered by banking associations, with no direct government involvement. The German commercial banking association administered Germany’s deposit protection plan for commercial banks. The association obtained independent information about its members through external audits conducted by an accounting firm affiliate. It also could play a significant role in resolving troubled institutions. It had the power to intervene and attempt to resolve a member bank’s difficulties and could be pressured by the central bank or bank supervisor to do so.¹⁷ Thus, the German banking

¹⁴In every country we studied, as in the United States, deposit insurance (or protection) funds were obtained from the insured or protected banks in the form of deposit-based premiums or other types of assessment.

¹⁵In Canada, the deposit insurer is a crown corporation with semiofficial government status. As a result, even though the government provides no explicit guarantee of the deposit insurance fund, it is expected, by both depositors and the government itself, that the government would provide funding when necessary to protect the integrity of the fund.

¹⁶Coverage in France is about \$68,000; in Canada it is approximately \$42,000; in the U.K., 75 percent of approximately \$30,000; and in Japan, about \$95,000. Deposits in commercial banks in Germany are covered up to 30 percent of liable capital—defined as the paid-up endowment capital and the reserves plus up to 25 percent of tier 2 capital. This means that a depositor in one of Germany’s largest banks could be protected for almost \$1 billion.

¹⁷The central bank and the bank supervisor are to work together to resolve potential bank failures that could have systemwide ramifications. In the past, for example, the central bank has played influential roles in persuading creditor banks to forgive some of their debts and to delay repayment of other debts, thereby giving institutions an opportunity to dissolve in an orderly fashion.

industry generally resolved its own problems. In France, the deposit protection system—a loss-sharing agreement among member banks—was administered by the French Bank Association. The French Bank Association itself played a relatively minor role in resolving bank problems. Instead, the Banking Commission was responsible for resolving troubled institutions.¹⁸

In the U.K. and Japan, the responsibility for the administration of deposit insurance was shared by government and the banking industry. Deposit insurers were independent bodies whose boards of directors were headed by government officials and included members from the banking industries. In these countries, the government, not the banking associations, resolved banking institutions' problems.¹⁹

Canada's oversight system was most similar to that of the United States. The Canadian deposit insurer did not act as a primary supervisor for any banking institutions; however, like FDIC, it had examination and rulemaking authority—although its powers were more limited than those of FDIC's. It could take limited enforcement action and was represented on two of Canada's oversight-related committees. The Canadian deposit insurer generally relied on the primary banking supervisor for examination information it needed to safeguard insurance funds. Until a financially troubled institution was declared insolvent and was placed in liquidation, the bank supervisor had the lead role in resolving that institution. However, the supervisor was to continuously inform the deposit insurer of the institution's status. The deposit insurer could order a special examination to determine its exposure and possible resolution options if the institution failed. In the case of a failure, the deposit insurer was responsible for developing resolution alternatives and for implementing the chosen resolution plan.

¹⁸Once it became clear that an institution could not be rescued, the Banking Commission was responsible for withdrawing an institution's authorization, appointing an acting manager, and, in most cases, helping the institution develop a self-liquidation plan.

¹⁹In Japan, the Ministry of Finance and the Bank of Japan are to work together to assist troubled financial institutions. The Ministry of Finance usually is to take the lead by establishing policy and providing directions for a resolution, and the Bank of Japan usually finances loans as necessary. In the U.K., the Bank of England was the driving force in determining if, when, and how a bank would be closed or acquired by a merger partner, even though the courts officially had the responsibility for deciding whether a troubled institution should be placed into administration, receivership, or liquidation.

Foreign Structures Incorporated Mechanisms and Procedures to Ensure Consistent Oversight and Efficiency

Most of the foreign structures with multiple oversight entities incorporated mechanisms and procedures that could ensure consistent and efficient oversight. Some countries relied on the work of external auditors, at least in part, for purposes of efficiency. Unlike in the United States, bank oversight in these countries generally did not include consumer protection or social policy issues.

Foreign Oversight Entities Often Shared Staff, Information, and Committee Assignments

Coordination mechanisms designed to ensure consistency and efficiency in oversight in the countries we studied included oversight committees or commissions with interlocking boards, shared staff, and mandates or mechanisms to share information and avoid duplication of effort.

In Canada, the federal bank supervisor, central bank, and finance ministry each had a seat on the deposit insurer's board of directors and participated with the deposit insurer on various advisory committees. Also, the Canadian deposit insurer, which had backup supervisory authority to request or undertake special examinations of high-risk institutions, was required to rely for much of its information on the primary supervisor, whose examiners conducted all routine bank examinations and engaged in other data collection activities.

In France, central bank employees staffed all three committees charged with oversight responsibilities for chartering, rulemaking, and supervision. In addition, the central bank and the Ministry of Economic Affairs were represented on each of the three oversight committees.

In Germany, the central bank and the federal bank supervisor used the same data collection instruments. They were also legally required to share information that could be significant in the performance of their duties.

Three of the Foreign Countries' Supervisors Used External Auditors' Work to Enhance Efficiency

Bank supervisors in three of the five countries whose systems we reviewed used the work of the banks' external auditors as an important source of supervisory information. In the most striking contrast with the United States' system, supervisors in Germany and the U.K. used external auditors as the primary source of monitoring information. In Canada, as in the United States, the primary supervisor conducted examinations; information from the banks' external auditors was to be used to supplement and guide these examinations. Supervisors in all three

countries recognized that auditors' objectives for reviewing a bank's activities could differ from those of a supervisor, and they also recognized that a degree of conflict could exist between the external auditors' responsibilities to report to both their bank clients and to the bank supervisory authorities. However, they generally believed that their authority over auditors' engagements was sufficient to ensure that the external auditors properly discharged their responsibilities and openly communicated with both their bank clients and the oversight authorities.

In both Germany and the U.K., supervisors' use of external auditors' work was adopted at least in part for purposes of efficiency. In Germany, the use was part of an explicit plan to minimize agency staffing and duplication of effort between examiners and auditors. In the U.K., the use was seen as the most efficient way of introducing the necessary checks on systems controls and as a method compatible with the Bank of England's traditional approach of supervising banks "based on dialogue, prudential returns, and trust," according to Bank of England officials.

Canada, Germany, and the U.K. differed from the United States in three other important ways:

- All banking institutions in the three foreign countries were required to have external audits. As discussed in chapter 2, large U.S. banks are required by U.S. oversight agencies to have external audits, and others are encouraged to do so.
- Bank supervisors in the three foreign countries had more control than U.S. bank supervisors over the work performed by external auditors. In Germany and the U.K., external audits were conducted using specific guidelines developed by the bank regulators, and the scope of individual audits could be expanded by all three regulators, or special audits ordered, to address issues of regulatory concern. By contrast, U.S. supervisors have more limited authority over the scope of external audits.²⁰
- External auditors in the three foreign countries had affirmative obligations to report findings of concern to supervisors. In Canada, external auditors are required to report simultaneously to the institution's CEO and the bank supervisor anything discovered that might affect the viability of the

²⁰Under FDICIA, the banking agencies in the United States have some authority to set standards for external auditors. For example, external auditors have been directed by FDIC to provide information on large banks' compliance with safety and soundness regulations related to loans to insiders and dividend restrictions. The primary standards that certified public accountants follow in auditing U.S. financial institutions are promulgated by the American Institute of Certified Public Accountants.

financial institution. In Germany, external auditors are required by law to immediately report to the bank supervisor information that might result in qualification of the report or a finding of a significant problem. In the U.K., external auditors are required to report to the central bank any breaches in the minimum authorization criteria as well as expectations of a qualified or adverse report. In the United States, however, external auditors are required merely to notify the appropriate banking agency if they withdraw from an engagement.²¹ External auditors are required to withdraw from an audit engagement if identified problems are not resolved or if bank management refuses to accept their audit report.

Further detail about the role of external audits in U.S. bank supervision is provided in appendix II.

Supervisors in Other Countries Generally Did Not Focus on Consumer Protection or Social Policy Issues

Bank oversight in the countries we studied, was focused almost exclusively on ensuring the safety and soundness of banking institutions and the stability of financial markets and generally did not include consumer protection or social policy issues. The national governments of the countries we studied used other mechanisms to address these issues or to promote these goals.

Consumer protection and antidiscrimination concerns were addressed in many of the other countries by industry associations and government entities other than bank regulators and supervisors. In addition, some of the policy mechanisms used to encourage credit and other services in low- and moderate-income areas in these countries included the chartering of specialized financial institutions and direct government subsidies for programs to benefit such areas. In Canada, for example, the banking industry developed voluntary guidelines related to consumer and small business lending, partly to prevent the need for legislated solutions to perceived problems. Similarly, the banking industries in France and the U.K. also developed industry guidelines on issues such as consumer protection. Bank supervisors in Canada and the U.K. were not responsible for enforcing compliance with these guidelines and best practices, but the bank supervisor in France did have such responsibility. In addition, bank supervisors in the countries we studied were not expressly responsible for assessing compliance with other consumer protection laws, like those involving discrimination or antitrust; but they were responsible, in some countries, for advising their Justice Department equivalents of potential

²¹A recent amendment to the Securities Exchange Act requires independent public accountants to report to SEC certain illegal acts they detect if the audited company does not take appropriate remedial action.

Chapter 3
Aspects of Foreign Bank Oversight Systems
May Be Useful to Consider in Efforts to
Modernize U.S. Bank Oversight

violations identified in carrying out their bank oversight duties. Officials in these countries suggested that concern and attention to various consumer issues were increasing, but they did not anticipate bank regulators would assume any new responsibilities in this area.

Conclusions, Recommendations, and Agency Comments

Conclusions

The division of responsibilities among the four federal bank oversight agencies in the United States—FDIC, FRS, OCC, and OTS—is not based on specific areas of expertise, functions or activities, either of the regulator or the banks for which they are responsible, but based on institution type—bank or thrift, bank charter type—national or state, and whether banks are members of the FRS. Consequently, the four oversight agencies share responsibility for developing and implementing regulations, taking enforcement actions, and conducting examinations and off-site monitoring.

Analysts, legislators, banking institution officials, and numerous past and present agency officials have identified weaknesses and strengths in this oversight structure. Some representatives of these groups have broadly characterized the federal system as redundant, inconsistent, and inefficient. Some banking institution officials have also raised concerns about negative effects of the structure on supervisory effectiveness. Some regulators, banking institutions, and analysts alike have asserted that the multiplicity of regulators has resulted in inconsistent treatment of banking institutions in examinations, enforcement actions, and regulatory decisions, despite interagency efforts at coordination. We have cited significant inconsistencies in examination policies and practices among FDIC, OCC, OTS, and FRS, including differences in examination scope, frequency, documentation, loan quality and loss reserve evaluations, bank and thrift rating systems, and examination guidance and regulations. At the same time, some agency and institution officials have credited the current structure with encouraging financial innovations and providing checks and balances to guard against arbitrary oversight decisions or actions.

As a result of concerns about the current oversight structure, many proposals have been made to restructure the multiagency system of bank regulation and supervision. These proposals have not been implemented, partly as a result of assertions by FRS and FDIC officials that they rely on information obtained under their respective supervisory authorities to fulfill their nonoversight duties: monetary policy development and implementation, liquidity lending, and operation and oversight of the nation's payment and clearance systems for FRS; administration of the deposit insurance funds, resolution of failing or failed banks, and disposition of failed bank assets for FDIC. As we have pointed out in the past, the extent to which FRS needs to be a formal supervisor of financial institutions to obtain the requisite knowledge and influence for carrying out its role is an important question that involves policy judgments that

only Congress and the President can make.¹ Nevertheless, past experience, as well as evidence from the five foreign oversight structures we studied (see below for further discussion) provides support for the need for FRS to obtain direct access to supervisory information. We have also favored a strong, independent deposit insurance function to protect the taxpayers' interest in insuring more than \$2.5 trillion in deposits.² Nonetheless, previous work we have done suggests that a strong deposit insurance function can be ensured by providing FDIC with (1) the ability to go into any problem institution on its own, without having to obtain prior approval from another regulatory agency; (2) the capability to assess the quality of bank and thrift examinations, generally; and (3) backup enforcement authority.³

Treasury also has several responsibilities related to bank oversight, including being the final decisionmaker in approving an exception to FDIC's least-cost rule. In addition, Treasury plays a major role in developing legislative and other policy initiatives with regard to financial institutions. Such responsibilities require that Treasury regularly obtain information about the financial and banking industries and, at certain times, institution-specific information. According to Treasury officials, Treasury's current level of involvement, through its housing of OCC and OTS and their involvement on the FDIC Board of Directors, and the information it receives from the other agencies as needed, is sufficient for it to carry out these responsibilities.

On the basis of the work we have done in areas such as bank supervision, enforcement, failure resolution, and innovative financial activities—such as derivatives—we have previously identified four fundamental principles that we believe Congress could use when considering the best approach for modernizing the current regulatory structure. We believe that the federal bank oversight structure should include: (1) clearly defined responsibility for consolidated and comprehensive oversight of entire banking organizations, with coordinated functional regulation and supervision of individual components; (2) independence from undue political pressure, balanced by appropriate accountability and adequate congressional oversight; (3) consistent rules, consistently applied for similar activities; and (4) enhanced efficiency and reduced regulatory burden, consistent with maintaining safety and soundness.

¹Bank Regulation: Consolidation of the Regulatory Agencies (GAO/T-GGD-94-106, Mar. 4, 1994).

²GAO/T-GGD-94-106.

³GAO/T-GGD-94-106.

In five recent reports, we reviewed the structure and operations of bank regulation and supervision activities in Canada, France, Germany, Japan, and the U.K. Each of the oversight structures of these five countries reflects a unique history, culture, and banking industry, and, as a result, no two of the five oversight structures are identical. Also, all of the countries we reviewed had more concentrated banking industries than does the United States, and all but Japan had authorized their banks to conduct broad securities and insurance activities in some manner. Nevertheless, certain aspects of these structures may be useful to consider in future efforts to modernize banking oversight in the United States, even though no structure as a whole likely would be appropriate to adopt in the United States.

In the five countries we studied, banking organizations typically were subject to consolidated oversight, with an oversight entity being legally responsible and accountable for the entire banking organization, including its subsidiaries. If securities, insurance, or other nontraditional banking activities were permissible in bank subsidiaries, functional regulation of those subsidiaries was generally to be provided by the supervisory authority with the requisite expertise. Bank supervisors generally relied on those functional regulators for information but remained responsible for ascertaining the safety and soundness of the consolidated banking organization as a whole.

The number of national bank oversight entities in the countries we studied was fewer than in the United States, ranging from one in the U.K. to three in France. Furthermore, in all five countries no more than two national agencies were ever significantly involved in any one major aspect of bank oversight, such as chartering, regulation, supervision, or enforcement. Commercial bank chartering, for example, was the direct responsibility of only one entity in each country. In those countries where two entities were involved in the same aspect of oversight, the division of oversight responsibilities generally was based on whichever entity had the required expertise.

The central banks in the countries we studied generally had significant roles in supervisory and regulatory decisionmaking; that is, with the exception of the Canadian central bank, their staffs were directly involved in aspects of bank oversight, and all central banks had the ability to formally or informally influence bank behavior. In large part, central bank involvement was based on the premise that traditional central bank responsibilities for monetary policy, payment systems, liquidity lending,

and crisis intervention are closely interrelated with oversight of commercial banks. While no two countries had identical oversight roles for their central banks, each country had an oversight structure that ensured that its central bank had access to information about, and certain influence over, the banking industry.

In each of the five countries, the national government recognized that it had the ultimate responsibility to maintain public confidence and stability in the financial system. Thus, each of the bank oversight structures that we reviewed also provided the Ministry of Finance, or its equivalent, with some degree of influence over bank oversight and access to information. Although each country included its finance ministry in some capacity in its oversight structure, most also recognized the need to guard against undue political influence by incorporating checks and balances unique to each country.

While central banks and finance ministries generally had substantial roles in bank oversight, deposit insurers, with the exception of the Canada Deposit Insurance Corporation, did not. Their less substantial oversight role may be attributable to the fact that national governments provided no explicit guarantees of deposit insurance and that deposit insurers were often industry-administered. Thus, in most of these countries, deposit insurers were viewed primarily as a source of funds to help resolve bank failures—either by covering insured deposits or by helping to finance acquisitions of failed or failing institutions by healthy institutions. Supervisory information was generally not shared with these deposit insurers, and resolution decisions for failed or failing banks were commonly made by the primary bank oversight entities.

Most of the foreign structures with multiple oversight entities incorporated mechanisms and procedures that could ensure consistent and efficient oversight. As a result, banking institutions that were conducting the same lines of business were generally subject to a single set of rules, standards, or guidelines. Coordination mechanisms included having oversight committees or commissions with interlocking boards, shared staff, or mandates to share information. Some countries relied on the work of external auditors, at least in part, for purposes of efficiency. Bank oversight in these countries generally did not include consumer protection or social policy issues.

There are many practical problems associated with creating a new agency or consolidating existing functions. Although such issues were beyond the

scope of this report, it remains important that transition and implementation issues be thoroughly considered in deliberations about any modernization of bank oversight.

Recommendations

GAO's work on the five foreign oversight systems showed that there are a number of different ways to simplify bank oversight in the United States in accordance with the four principles of consolidated oversight, independence, consistency, and enhanced efficiency and reduced burden. GAO recognizes that only Congress can make the ultimate policy judgments in deciding whether, and how, to restructure the existing system. If Congress does decide to modernize the U.S. system, GAO recommends that Congress:

- **Reduce the number of federal agencies with primary responsibilities for bank oversight.** GAO believes that a logical step would be to consolidate OTS, OCC, and FDIC's primary supervisory responsibilities into a new, independent federal banking agency or commission. Congress could provide for this new agency's independence in a variety of ways, including making it organizationally independent like FDIC or FRS. This new independent agency, together with FRS, could be assigned responsibility for consolidated, comprehensive supervision of those banking organizations under its purview, with appropriate functional supervision of individual components.
- **Continue to include both FRS and Treasury in bank oversight.** To carry out its primary responsibilities effectively, FRS should have direct access to supervisory information as well as influence over supervisory decisionmaking and the banking industry. The foreign oversight structures GAO viewed showed that this could be accomplished by having FRS be either a direct or indirect participant in bank oversight. For example, FRS could maintain its current direct oversight responsibilities for state chartered member banks or be given new responsibility for some segment of the banking industry, such as the largest banking organizations. Alternatively, FRS could be represented on the board of directors of a new consolidated banking agency or on FDIC's board of directors. Under this alternative, FRS' staff could help support some of the examination or other activities of a consolidated banking agency to better ensure that FRS receives first hand information about, and access to, the banking industry.

To carry out its mission effectively, Treasury also needs access to supervisory information about the condition of the banking industry as

well as the safety and soundness of banking institutions that could affect the stability of the financial system. GAO's reviews of foreign regulatory structures provided several examples of how Treasury might obtain access to such information, such as having Treasury represented on the board of the new banking agency or commission and perhaps on the board of FDIC as well.

- **Continue to provide FDIC with the necessary authority to protect the deposit insurance funds.** Under any restructuring, GAO believes FDIC should still have an explicit backup supervisory authority to enable it to effectively discharge its responsibility for protecting the deposit insurance funds. Such authority should require coordination with other responsible regulators, but should also allow FDIC to go into any problem institution on its own without the prior approval of any other regulatory agency. FDIC also needs backup enforcement power, access to bank examinations, and the capability to independently assess the quality of those examinations.
- **Incorporate mechanisms to help ensure consistent oversight and reduce regulatory burden.** Reducing the number of federal bank oversight agencies from the current four should help improve the consistency of oversight and reduce regulatory burden. Should Congress decide to continue having more than one primary federal bank regulator, GAO believes that Congress should incorporate mechanisms into the oversight system to enhance cooperation and coordination between the regulators and reduce regulatory burden.

Although GAO does not recommend any particular action, such mechanisms—which could be adopted even if Congress decides not to restructure the existing system—could include

- expanding the current mandate of FFIEC to help ensure consistency in rulemaking for similar activities in addition to consistency in examinations;
- assigning specific rulemaking authority in statute to a single agency, as has been done in the past when Congress gave FRS statutory authority to issue rules for several consumer protection laws that are enforced by all of the bank regulators;
- requiring enhanced cooperation between examiners and banks' external auditors; (While GAO strongly supports requirements for annual full-scope, on-site examinations for large banks, GAO believes that examiners could take better advantage of the work already being done by external auditors to better plan and target their examinations.)

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- requiring enhanced off-site monitoring to better plan and target examinations as well as to identify and raise supervisory concerns at an earlier stage.

Agency Comments and Our Evaluation

FRS, FDIC, OCC, and OTS provided written comments on a draft of this report, which are described below and reprinted in appendixes IV through VII. Treasury also reviewed a draft and provided oral technical comments, which we incorporated where appropriate.

FRS agreed that it is useful to consider the experience of other countries in making policy determinations. It also agreed that there are different ways to accommodate the policy goal of modernizing the U.S. supervisory structure. FRS reiterated its opinion that the purpose of bank supervision is to enhance the capability of the banking system to contribute to long-term national economic growth and stability. FRS agreed with our description of the direct involvement of central bank staff in bank oversight in the countries we studied and our recommendation that FRS continue to be included in bank oversight. However, it felt that we should be more specific in stating that FRS needs “active supervisory involvement in the largest U.S. banking organizations and a cross-section of other banking institutions” to carry out its key central banking functions. To clarify what was meant by this statement, a senior FRS official advised us that FRS’ present regulatory authority gives it the access and influence it needs. But if the regulatory structure were changed so that there is only one federal regulator for each banking organization—holding company and all bank subsidiaries—then FRS feels that it would have to be the regulator for the largest banking organizations and a cross-section of others in order to carry out its key central banking functions.

We agree that FRS needs to have direct access to supervisory information as well as the ability to influence supervisory decisionmaking and the banking industry if the oversight structure is changed. However, in our studies of foreign oversight structures we found that direct central bank involvement in bank oversight, and access to and influence over the banking industry, could be accomplished in several ways. These could include giving the central bank a formal role as bank supervisor, participating on oversight boards with staff involvement in examination and other areas of supervision, and serving in informal yet influential roles that included participation in oversight by central bank staff.

FRS also noted that 88 percent of U.S. banks are part of banking organizations that are actively supervised by no more than two oversight agencies. The portion of activities supervised by the third or fourth agency in holding companies where more than two agencies are involved in oversight is generally small. We acknowledge that most U.S. banks are supervised by no more than two federal banking supervisory agencies. Nevertheless, as the table provided by FRS shows (see app. IV), more than 50 percent of bank assets are held in companies that are supervised by three or four of these agencies. Furthermore, it is the larger, more complex banking institutions—whose failure could pose the greatest danger to the financial system—that are likely to be subject to oversight by more than two agencies, with the potential attendant oversight problems described in our report. In addition, the percentage of assets supervised by additional agencies—which may be relatively small—does not indicate their importance or potential risk to the banking organization.

FDIC provided four fundamental principles for an effective bank regulatory structure, which are generally consistent with the principles and recommendations that we advocate. These principles include providing FDIC with an explicit backup supervisory authority, backup enforcement power, and the capability to assess the quality of bank and thrift examinations. We also support providing FDIC with such backup authority. FDIC also noted that the broader regulatory responsibilities related to the role of the deposit insurer require current and sufficient information on the ongoing health and operations of financial institutions. In FDIC's judgment, periodic on-site examination remains one of the essential tools by which such information may be obtained.

FDIC commented on the mechanisms we described that Congress might consider to enhance regulators' cooperation and coordination and reduce regulatory burden, noting that the current processes for coordinating regulation allow for the consideration of the unique regulatory perspectives of each agency. We agree that the present practice of cooperation, coordination, and communication among the agencies in rulemaking allows the unique viewpoints of each of the oversight agencies to be considered. The assignment of rulemaking authority to a single agency would not preclude incorporating other viewpoints, as evidenced by the current rulemaking process with regard to some consumer protection regulations, where a single agency has been assigned such authority. We believe assigning rulemaking authority for safety and soundness regulations could be one way to attain a more efficient regulatory process.

OCC described our report as comprehensive and conveying more about the foreign regulatory structures than has been available to the public, albeit not exhaustive. OCC agreed with us that the foreign structures are not readily adaptable to the United States and described some of its observations about the differences among the five countries' regulatory structures. Consequently, OCC suggested that Congress consider our suggestions very carefully in making any changes to the oversight structure in the United States. We agree that Congress should be cautious in any consideration it gives to changing the regulatory structure.

OTS generally concurred with our principal recommendations and restated its position that consolidation will make the bank oversight system more efficient and effective. It added that reducing the number of federal oversight agencies should be done in a way that preserves a strong and stable regulatory environment and protects agency employees. We agree that the consolidation of any oversight agencies should be done in a way that preserves a strong and stable regulatory environment that is effective, efficient, and responsive to the needs and risks of the supervised institutions.

FRS, FDIC, and OTS also noted several regulatory actions and other initiatives underway that are designed to improve coordination—including joint or coordinated examinations—and reduce regulatory and supervisory redundancy and overlap. We believe such efforts are important to the consistency and efficiency of the regulatory structure and have incorporated this information into our report where appropriate.

The comment letters from FRS, FDIC, and OTS attest to the unique perspectives of each of the oversight agencies, which we believe provide valuable insights to Congress. As we describe in our report, there is a range of ways to address our recommendations and to capture these perspectives in any congressional consideration of changing the current U.S. bank oversight structure. Therefore, we have incorporated the agencies' insights in the report where appropriate. In addition, we have included descriptions of the interagency efforts discussed in the agencies' responses to improve coordination and cooperation and reduce regulatory burden.

History of U.S. Bank and Thrift Oversight

The U.S. bank oversight structure was subject to significant change from its early years through 1933. After 1933, the four-agency structure of bank oversight was to change little. Instead, changes in the bank and thrift industries were addressed principally through additions to and revisions of banking law.

Historical Development of U.S. Bank and Thrift Oversight

The role of the U.S. federal government in the banking industry and the structure of federal oversight of banking institutions has been significantly shaped by congressional efforts to promote public confidence in the nation's financial system—often following financial crises. The federal government has sought over time to address difficulties related to paper currency, the financing of government operations, the money supply, inflation, and unsafe and unsound practices of banking institutions that can lead to financial system disruptions. The federal agencies that oversee banking institutions today were created piecemeal, largely in response to these difficulties.

Pre-1863: Beginning of the U.S. Banking Industry

During the late 1700s, the first commercial banks were chartered by special acts of some state legislatures.¹ At that time, limited and varied governmental oversight was provided by the states.² Sporadic state efforts to prescribe rules for state banks were often ineffective. Bankers in some jurisdictions refused to provide any information about the conditions of their banks, contending that running a bank was a private affair. The federal government first became involved in bank oversight in 1791, when Congress created the Bank of the United States. The U.S. government was the major stockholder, owning one-fifth of the bank's \$10 million in capital. The bank earned most of its income by operating as a commercial bank, but it also assumed some of the functions of a central bank. For example, it was to provide a first-rate convertible currency, serve as a lender to the Department of the Treasury, and act as a fiscal agent for the

¹The first bank chartered in the United States was the Bank of Pennsylvania, formed in 1781 under a resolution by the Continental Congress. It was replaced in 1784 by the Bank of North America, which was chartered by both the federal government and the state government of Pennsylvania. In 1784, two other states chartered banks. These were the only commercial banks in existence until 1790. However, by 1811, there were 88 state-chartered banks in the country.

²It was a common procedure at the time for state legislatures to grant all corporate charters. Eventually, states passed laws permitting incorporation of other companies without a special legislative act, although charters were still required for banks. As the requests for bank charters increased, state legislatures became flooded with requests for charters and a movement toward "free" banking began. "Free" banking meant that anyone could start a bank if they complied with certain procedural steps prescribed in statute. By the 1850s, about one-half of the states had free banking laws that provided for readily available charters but also required bond-secured note issues and other constraints.

federal government. The federal government's oversight of the bank was limited. The bank was required to furnish statements of condition to the Secretary of the Treasury, but the Secretary did not make the reports public, nor did he make them available to Congress unless a Member asked for specific information.

The Bank of the United States was not rechartered in 1811. However, problems financing the War of 1812 and a deterioration of paper currency in the United States led to renewed support for a federal bank. Consequently, Congress chartered a second Bank of the United States in 1816. The U.S. government was again a major stockholder in this bank, owning one-fifth of the bank's \$35 million in capital. The bank was required to furnish statements of condition to the Secretary of the Treasury, and Congress reserved the right to inspect the bank's records.

This bank played a greater role in central banking than had the first Bank of the United States. It acted as a lender-of-last-resort to commercial banks, while also acting as a commercial bank itself, and took actions to offset swings in economic activity. Its notes circulated without a discount, and it had branches in many areas of the country. State bankers and agrarian interests opposed the bank because they believed it unduly restricted the money supply. For this reason, among others, the bank's charter was not renewed in 1836.

During the first half of the 19th century, particularly after the public recognized that the second Bank of the United States would not be rechartered, state banks increased in number. At the same time, bank note problems and bank failures increased. In response to the increasing bank note problems and failures, states gradually began to assume more oversight responsibilities. Some states required statements of financial condition reports, either on a regular or as-requested basis. Most states requiring reports were stockholders in the banks and therefore entitled to statements of condition. Some states also issued regulations limiting the total face value of notes that a bank could issue to some multiple of the bank's capital. Other states' regulations required minimum denominations for notes. Some states that were bank stockholders also began to examine banks. Another development that contributed to more vigilant bank oversight was the development in the mid-1800s of state self-insurance systems to protect depositors.³ Stricter state government oversight helped to limit the liability of participants in the insurance system.

³The first of these insurance systems was established by the New York legislature in 1829, with five other states following. These insurance systems generally required each bank in the insurance system to contribute annually into an insurance fund up to a certain maximum percentage of its capital.

By 1860, more than 1,500 state-chartered banks operated in the United States. These banks had, on average, 6 denominations of notes; more than 9,000 different kinds of paper bills were therefore in circulation. Some of these bills were traded at face value, some were traded at discounts, and some might have been worthless because they were counterfeit or had been issued by banks that had failed. Judging the authenticity of notes and determining their discount rates became complicated and expensive for businesses and households. It was decided that a uniform national currency was needed to solve these problems.

1863-1929: Creation of the Office of the Comptroller of the Currency and the Federal Reserve System

The National Currency Act of 1863 and the National Bank Act of 1864, which recodified and strengthened the 1863 act, provided for a national currency and a national banking system. These acts authorized national charters for commercial banks and allowed these banks to issue notes in standardized denominations that were collateralized by Treasury bonds.⁴ To discourage state-chartered banks from issuing competing notes, the acts required notes issued by state-chartered banks to be taxed. This effectively discouraged state banks from issuing notes and ultimately left only national bank notes in circulation.

The National Bank Act also created OCC and gave it responsibility for chartering, regulating, supervising, and examining all national banks. This was the beginning of federal government oversight of commercial banks—with the exception of the very limited oversight by the Department of the Treasury of the first and second Banks of the United States. Since the National Bank Act was essentially a currency measure, the aim of bank supervision was, through examinations, to make sure that banks would be able to redeem their notes when presented. Over time, the scope and quality of national bank oversight broadened and improved.

Between 1864 and the early 1900s, financial panics and bank runs continued to occur, even though supervision increased. The banking system was not always successful in meeting the demand for currency. Banks supported only a fraction of their demand deposits with cash reserves, and the banking system as a whole had no outside source of liquid reserves. Disruptions in the monetary system and lending activities caused by financial panics eventually curtailed commercial activity. Industry observers expressed the belief that such downturns were likely to

⁴National bank notes were gradually replaced with Federal Reserve notes following the creation of FRS in 1913. By 1935, the last national bank notes were withdrawn from circulation.

continue until the public gained enough confidence to return funds to the banking system and banks were again willing to expand their lending.

To help correct for these financial panics and curtailments in commercial activity, Congress established FRS in 1913. Among other things, the primary function of FRS was to provide an outside source of reserves for the banking system.⁵ Banks that were members of FRS could borrow from FRS reserves to obtain funds needed to meet a temporary cash drain or a rapid increase in the demand for credit. This helped correct for the fixed supply of currency and thereby decreased financial panics. All national banks were required to become members of FRS, and state banks were given the option to join.

The organization of FRS represented a compromise among diverse and, at times, conflicting forces. The urban business community favored a highly centralized organization, independent of the federal government and dedicated to stabilizing the purchasing power of the dollar. Rural agricultural interests favored a decentralized, government-owned system oriented toward providing credit on liberal terms. The compromise achieved decentralization through the establishment of 12 regional or district banks. These banks were owned by the member commercial banks, which also elected the majority of the directors. A degree of centralization was achieved by the creation of a Board of Governors in Washington, D.C., whose members were appointed by the President and confirmed by the Senate and shared the responsibility for determining and executing FRS policies with the regional banks. The Board was also given a significant degree of independence by providing its members with 14-year terms and FRS with independent sources of operating revenue.⁶

The Federal Reserve Act gave both OCC and FRS authority to regulate and supervise all national and state-chartered member banks. The act provided that OCC was to examine each member bank at least twice a year. But it also authorized the Federal Reserve Board to examine member banks at its discretion, and another provision gave further authority to the 12 Federal Reserve Banks to make special examinations of member banks.

⁵The Federal Reserve Act also gave FRS the authority to hold a portion of its member banks' deposits in reserve and to make open-market purchases and sales of government securities.

⁶FRS generates income from a variety of sources, including interest on U.S. government securities it has acquired through open-market operations; interest on loans to depository institutions; and fees received for services provided to depository institutions, such as check clearing, funds transfers, and automated clearinghouse operations. FRS revenues in excess of expenses are turned over to the U.S. Treasury. For additional information see Federal Reserve System: Current and Future Challenges Require Systemwide Attention (GAO/GGD-96-128, June 17, 1996).

Thus, OCC, the board, and the Federal Reserve Banks could each look into the affairs of member banks. In addition, state authorities maintained their supervisory authority of state-chartered banks within their jurisdictions and examined those banks at their discretion. The federal and state banking chartering and corresponding supervisory authorities are often referred to as the dual banking system.

After the enactment of the Federal Reserve Act, conflicts arose between FRS and OCC over the Federal Reserve's right to the examination reports of national banks. Conflicts also arose about the Federal Reserve's participation in examinations and OCC supervision of state member banks. State member banks objected to the expense of OCC examinations and were also unwilling to subject themselves to OCC's more rigorous examination procedures. FRS officials argued that OCC examination was deterring state-chartered banks from joining FRS, and, in June 1917, the Federal Reserve Act was amended to exempt state banks from OCC examination. Since that time, OCC has supervised and examined national banks and provided their examination reports to FRS, and FRS has supervised state member banks. At the time, state-chartered nonmember banks were supervised only by the states.

During the 1920s, no major shifts in responsibility relative to bank supervision occurred. Although many small, particularly rural, banks failed or merged with other banks, high business profits during that time spurred many banks to increase their commercial lending and securities activities. Additionally, many large banks began expanding their branch networks to the extent allowable by law.

1930s: Financial Crisis and Reform

During the 1930s, the most dramatic financial decline in U.S. history occurred. In the 3 years after the stock market crash of 1929, many banks failed. In 1933, President Roosevelt ordered all banks closed from March 6 to March 13, and banks opened again only after state and federal regulators had examined their condition and issued a license to reopen. Many banks never reopened. By the end of 1933, over 4,000 banks were closed or absorbed by other banks. This left about 14,500 banks—less than half the number of banks that had existed in 1921, when the number of banks had peaked at about 30,000.

After this financial crisis, many reform measures were proposed to help the banking system avoid another such calamity. The banking acts of 1933 and 1935 required many reforms. One of the most important was the

creation of federal deposit insurance and the administrator of the insurance, FDIC.⁷ All FRS member banks, which included all national banks, were required to be insured, and nonmember banks were given the option to be insured, on approval of FDIC. By the end of 1935, a few months after the permanent plan of federal deposit insurance was introduced, more than 90 percent of all U.S. commercial banks were insured. Once the insurance system was established and began to prove itself, bank panics and the loss of public confidence became much less of a threat to the banking system.

These banking acts gave FDIC the authority to examine all insured banks. The acts also required that insured banks ultimately become members of FRS, and membership implied that FRS would have oversight responsibility. But legislative pressures of nonmember banks led to the removal of the membership requirement in 1939. To avoid regulatory duplication, OCC, FRS, and FDIC agreed to a formal division of responsibility for the bank examination function that still exists today: OCC would be responsible for national banks, FRS for state-member banks, and FDIC for state-nonmember banks.

The stock market crash of 1929 was also the impetus for the 1932 creation of a Federal Home Loan Bank System (FHLBS) as a regulatory and support structure for the savings and loan associations. FHLBB was empowered to charter and regulate federal savings and loan associations. Previously, all savings and loan associations were chartered by the states. Savings and loan associations were initially organized in the mid-1800s by groups who wanted to buy their own homes but did not have enough savings to finance the purchase. At that time, neither commercial banks nor life insurance companies lent money for residential mortgages. The members of the groups pooled their savings and lent them back to a few members to finance their home purchases. As loans were repaid, funds could be lent to other members of the group.

The purposes of FHLBS were in some ways parallel to those of FRS. The primary objectives of FHLBS were to (1) provide secondary liquidity to mortgage lending institutions that had temporary cash flow problems,

⁷The banking acts of 1933 and 1935 also (1) prohibited banks from paying interest on demand deposits; (2) provided for limitations on the interest banks could pay on time deposits; (3) prohibited investment banks from receiving deposits; (4) restricted banks to a limited range of investment banking activities, including a prohibition on bank underwriting of corporate securities; (5) required federal banking agencies to consider capital adequacy, earnings prospects, managerial character, and community needs before chartering a bank; (6) gave the Federal Reserve Board the authority to change the reserve requirements for member banks; and (7) allowed national banks to form branch offices to the same extent as state banks.

(2) transfer loanable funds from areas where there was excess saving and little demand for loans to areas where the demand for loans was higher than the funds available, and (3) attempt to stabilize the residential construction and financing industries. Federal deposit insurance for savings and loan associations was created in 1934 when the Federal Savings and Loan Insurance Corporation (FSLIC) was established under FHLBB. Although FHLBB purposes were similar to those of FRS relative to money supply and similar to those of FDIC relative to deposit insurance, FHLBB structure included both functions; the bank regulatory structure had FDIC as a separate independent insurer.

The Late 1980s: The Thrift Crisis and Changes in Thrift Oversight and Deposit Insurance

From 1980 through 1990, 1,020 thrifts failed at a cost of about \$100 billion to the federal deposit insurance funds.⁸ Despite a doubling of premiums and a special \$10.8 billion recapitalization program, sharply mounting thrift losses in the 1980s bankrupted FSLIC. Observers have recognized many factors as contributing causes of the thrift failures, including increasing competition from nondepository institutions, such as money-market funds and mortgage banks, as well as periods of inflation, recession, and fluctuating interest rates. The high interest rates and increased competition for deposits created a mismatch between the interest revenues from the fixed-rate mortgages that constituted the bulk of the thrift industry's assets and the cost of borrowing funds in the marketplace. Increased powers granted to thrifts in a period during which FHLBB supervision was scaled back has also been cited as a contributing cause of problems in the industry.

The Financial Institution Reform, Recovery, and Enforcement Act of 1989 (FIRREA)⁹ was enacted primarily in response to the immediate problems surrounding FSLIC's bankruptcy and troubles in the thrift industry. Among other actions mandated by FIRREA, a new regulator was created for the thrift industry—OTS, a bureau of the Department of the Treasury. A new insurance fund, the Savings Association Insurance Fund (SAIF), was also established to replace the bankrupt FSLIC. SAIF was to be administered by FDIC.

⁸For more specific information on the costs of resolving the thrift crisis, see Financial Audit: Resolution Trust Corporation's 1995 and 1994 Financial Statements (July 2, 1996, GAO/AIMD-96-123).

⁹FIRREA, P.L. 101-73, became effective on Aug. 9, 1989.

Major Banking Legislation

Congress has passed many laws over the last 70 years that affect the banking industry. These laws address many issues, including the types of activities banking institutions and their holding companies may engage in, how these institutions may expand their operations, how consumers are to be protected and served, and how agency oversight is to be exercised. Some of these laws are described below.

Separation of Commercial and Investment Banking

A significant development in financial regulation during the 1930s was the separation of the commercial and investment banking industries. After the stock market crash of 1929, Congress examined the mixing of the commercial and investment banking industries that occurred during the 1920s. Congressional hearings revealed alleged conflicts of interest and fraud in some banking institutions' securities activities. Changes legislated in the resulting Banking Act of 1933 forced the separation of the banking and securities businesses. These changes, found in sections 16, 20, 21, and 32 of the Banking Act of 1933, are known as the Glass-Steagall Act.¹⁰

Bank Holding Companies

The Bank Holding Company Act of 1956, as amended, restricts bank holding companies' activities to the management and control of banks consistent with the public interest. Among other things, the act requires that bank holding companies register with the Board of Governors of FRS and gives FRS regulatory and supervisory authority over those corporations. The act provides that bank holding companies may not own or control nonbanking companies or engage in nonbanking activities unless the Board determines that the activities are closely related to banking and expected to produce net benefits to the public if performed by a bank holding company. As mentioned earlier, existing nonbank subsidiaries of bank holding companies include businesses engaged in consumer finance, trust services, leasing, mortgage, electronic data processing, securities underwriting and brokerage, management consulting services, and futures trading.

¹⁰Section 16 of the Glass-Steagall Act limits the securities activities of national banks essentially to brokerage services. Section 20 prohibits member banks from affiliating with organizations engaged principally in securities activities, although with FRS approval a bank holding company may engage in limited securities activities through a subsidiary—called a section 20 subsidiary. Section 21 makes it a crime for any person engaged in the securities business to engage at the same time in the business of receiving deposits, except that it permits state-chartered banks or trust companies, if authorized by state law, to engage in the securities business to the extent permitted national banks in section 16. Section 32 prohibits interlocking directorates between member banks and persons engaged primarily in the securities business, with waiver discretion granted to the Federal Reserve Board.

Interstate Branching and Banking

Until Congress enacted the Interstate Banking and Branching Efficiency Act of 1994 (Interstate Banking Act), the degree of inter- and intrastate branching and banking allowable was largely determined by state laws.¹¹ Under the McFadden Act of 1927 and the Banking Act of 1933, state laws determined how banks, including national banks, could branch within each state. The McFadden Act also prohibited interstate branching for all banks except state-chartered, nonmember banks. State laws governed the ability of these banks to branch interstate, but few states took advantage of this provision to permit interstate branching. However, as of June 1, 1997, the Interstate Banking Act will allow interstate branching through consolidation of existing banks or branches. The act gives states the ability to “opt-out,” or choose not to allow branching, before June 1, 1997. They can also “opt-in,” or authorize branching earlier. De novo branching—branching other than by merger with an existing bank—must be specifically authorized by individual states.

Until 1995, section 3(d) of the Bank Holding Company Act of 1956, commonly known as the Douglas Amendment, prohibited bank holding companies from acquiring a bank in another state unless the state the bank holding company wanted to enter specifically permitted such entry. However, as of September 29, 1995, the Interstate Banking Act allows nationwide interstate banking through the bank holding company, so long as certain safety and soundness and community reinvestment conditions are met and specified concentration levels are not exceeded.

Antitrust

The primary purpose of antitrust laws is to prevent anticompetitive behavior and preserve and promote competition. The Sherman Act and the Clayton Act are the linchpins of federal antitrust enforcement. In general, they—and several state antitrust statutes that mirror their provisions—prohibit mergers that would result in or tend to create a monopoly or may substantially lessen competition. The Department of Justice is charged by these acts to enforce the antitrust statutes in all industries, including banking.

Until the Bank Merger Act of 1960 was enacted, it was not clear whether federal bank regulators had the authority to deny bank mergers that were anticompetitive. The Bank Merger Act clarified this uncertainty by mandating that bank regulators with responsibility over the surviving bank consider the competitive effects of bank mergers. Congress further

¹¹Branches are bank offices and are regulated as integral parts of the bank. As a result, they do not have separate capital requirements, and transfers of assets and liabilities among branches and between branches and the headquarters bank are not restricted.

strengthened bank merger enforcement efforts by amending both the Bank Merger Act and the Bank Holding Company Act in 1966 and by passing the Change in Bank Control Act in 1978. These amendments and the Change in Bank Control Act introduced the principles of the Sherman and Clayton antitrust acts into the banking laws. As a result, federal bank regulators and the Department of Justice generally enforce similar antitrust statutes when addressing the competitive concerns arising from bank mergers.

Consumer Protection

Since the late 1960s, over 20 laws have been passed to provide various consumer protections. These laws were created to deal with all aspects of consumer banking services and transactions and can generally be grouped into three categories: civil rights laws, disclosure laws, and safeguards against specific abuses. The banking civil rights laws are aimed at eliminating the consideration of factors unrelated to creditworthiness when banks make judgments about whether to extend credit. These civil rights laws are directed at both intentional acts of discrimination and practices that have the effect of discrimination. With respect to banking activities, the term “civil rights laws” generally includes the Equal Credit Opportunity Act of 1974, the Fair Housing Act of 1968, and the Home Mortgage Disclosure Act of 1975. Additionally, the Community Reinvestment Act of 1977, although not a civil rights law, is intended to encourage depository institutions to help meet the credit needs of their communities, including low- and moderate-income neighborhoods.

The second category of consumer protection laws—disclosure laws—is generally intended to provide consumers with adequate information to make better financial choices. These laws include, among others, the Truth in Lending Act of 1968, the Real Estate Settlement Procedures Act of 1974, and the Truth in Savings Act of 1991.

Finally, the third category of consumer protection laws can generally be labeled as laws designed to provide specific safeguards against specific abuses, such as the inappropriate use of or access to credit information. These laws include, among others, the Fair Credit Reporting Act of 1970 and the Right to Financial Privacy Act of 1978.

Industry Deregulation

Legislation enacted in the late 1970s and early 1980s was aimed at creating a more open competitive banking environment and a more equal treatment of different types of financial institutions. For example, the Depository Institutions Deregulation and Monetary Control Act of 1980 provided for,

among other things, the phase-out of interest rate ceilings on time and savings deposits. It also broadened the investment and lending powers of savings and loan associations and savings banks. The Garn-St Germain Depository Institutions Act of 1982, among other things, effectively eliminated the deposit interest rate ceilings, permitted savings and loan associations to hold assets—up to certain specified percentages—in certain types of commercial and consumer loans, and eliminated statutorily imposed loan-to-value ratios for savings and loan associations.

Banking Problems

Much of the legislation in the late 1980s and 1990s has focused on dealing with troubled institutions and strengthening the regulatory framework. This legislation included FIRREA, mentioned earlier, which provided \$50 billion in funding for resolving failing thrifts and established more stringent capital and regulatory standards. The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) is another law that was enacted to deal with banking problems of the 1980s. FDICIA instituted changes intended to improve the supervision of banks; enhance safety and soundness; reduce the cost of resolving failing or failed banks; and provide additional resources to the Bank Insurance Fund, among other things.

External Audits of Banking Institutions

This appendix supplements the chapter 2 discussion of U.S. examiners' cooperation with external auditors and the use of external auditors' work. In the United States, examiners' cooperation with external auditors and use of the work and expertise of external auditors has generally been more limited than in the countries we studied, and any cooperation or reliance that takes place has varied significantly across agencies as well as among individual examiners and auditors. Improving cooperation between external auditors and examiners can be a challenge, primarily because of the different roles auditors and examiners play. Yet, some of the regulatory agencies have recently initiated programs to improve cooperation and identify possible areas where examiners could use the work of external auditors. Such programs have the potential to improve examinations, enhance the efficiency of examinations, and reduce regulatory burden on banking institutions.

Requirements for External Audits

As we mentioned in chapter 2, banks and thrifts in the United States are either required or strongly encouraged to have annual external audits of their financial statements. Large banks—with total assets in excess of \$500 million—are required to have annual independent audits of their financial condition. Smaller banks are generally required to have such external audits for the first 3 years after obtaining FDIC insurance. Others are strongly encouraged to have such annual external audits. OTS also requires large thrifts to have annual external financial audits, encourages all thrifts to have such annual audits, and has the explicit authority to require financial audits of any thrifts it has determined present safety and soundness concerns. Some state banking regulators also require such external audits for institutions chartered in their states. Additionally, the Federal Reserve requires bank holding companies with total consolidated assets of \$150 million or more to have annual, independent financial audits; and OTS requires annual audits of holding companies whose subsidiary savings associations have aggregate assets of \$500 million or more.¹ SEC also has a financial audit requirement for all public companies, including bank holding companies that are SEC-registrants and all banking institutions that are subject to SEC reporting requirements. In practice, regulators told us that most banking institutions have annual independent financial audits.

¹OTS selected the \$500 million asset threshold to achieve comparability with the approach used by FDIC for banks. Setting a lower-asset threshold, as the Federal Reserve has, in effect requires certain insured subsidiary institutions to obtain an audit that otherwise would not have been required by FDIC.

The scope of banking institutions' external audit requirements varies by the size of the institution and the type of activities it engages in. Small institutions are encouraged to have an external audit that is designed to test and evaluate the high-risk areas of an institution's business. Such external audits are to be performed by an independent auditor who may or may not be a certified public accountant (CPA).²

For large banking institutions, the requirements for the scope of audits are more specific. Large institutions—those with total assets in excess of \$500 million—are required, among other things, to annually engage an independent public accountant to

- audit and report on the institution's annual financial statements in accordance with generally accepted auditing standards;
- examine, attest to, and report separately on the assertions of management concerning the institution's internal control structure and the procedures for financial reporting; and
- determine compliance by the institution with designated laws and regulations.³

Unlike other countries we studied, external auditors in the United States are not required to immediately report problems they identify to the banking agencies. However, external auditors do have the responsibility to withdraw from an audit engagement if identified problems are not resolved or if bank management refuses to accept their audit report. Auditors must also notify the banking agencies if they withdraw from an engagement, which serves as a flag to the supervisors to look into the reasons for the withdrawal. Additionally, a recent amendment to the Securities Exchange Act requires independent public accountants to report to SEC certain illegal acts they detect if the audited firm does not take appropriate remedial action and inform SEC of the auditors' report.

²Independence has traditionally been defined as the ability to act with integrity and objectivity. Banking regulators may test the independence of the CPA through reviews of loan listings, contracts, stockholder listings, or other measures.

³The regulations implementing FDICIA require external auditors to follow a detailed set of procedures to test compliance with safety and soundness regulations related to specific areas (i.e., loans to insiders and dividend restrictions).

U.S. Examiners' Past Cooperation With and Use of External Auditors Has Been Limited

U.S. examiners' cooperation with external auditors and use of the work of external auditors has generally been more limited than in most of the countries we studied. Banking supervisors in the United States are required by examination guidelines to use audit reports—and sometimes audit workpapers—to help plan examinations and identify potential safety and soundness problems. The banking regulators generally require that any institution that has an external audit, regardless of the scope of the audit, provide them with copies of any audit reports or management letters. Institutions are required to submit their audit reports, including management letters and certain other correspondence, to the examiners within 15 days of receipt of the report. When these audit reports are provided, examination guidelines require staff at each agency to review them to determine whether there are any issues that need to be followed up on immediately or during the next examination.⁴ Generally, audit reports are to be used to assist in the financial analysis of institutions, to identify areas of supervisory concern or accounting complexity, and to detect trends and information not otherwise revealed through regulators' off-site monitoring.

Examiners also are to review auditor's reports, management letters, and other information, including correspondence and memorandums between the bank and its auditor for areas of particular concern when planning examinations. As a result of these preexamination reviews, regulatory officials said examiners may decide to place greater emphasis during the examination on specific areas—such as reviewing more thoroughly certain aspects of an institution's internal control system or ensuring problems identified by the auditors have been addressed. Some regulatory officials also said examiners may be able to use external auditors' work to eliminate certain examination procedures from their examinations—such as verifications or confirmations of the existence and valuation of institution assets like loans, derivative transactions, and accounts receivable. External auditors perform these verifications or confirmations routinely as a part of their financial statement audits; but such verifications have rarely been done by examiners because they are costly and time consuming.

Beyond these examination procedures, regulatory officials said they generally do not use the work of external auditors to reduce the scope of their examinations, although the extent to which officials at each agency

⁴Specifically, examiners look for (1) information pertaining to the scope of the audit; (2) the type of opinion issued by the CPA on the financial statement audit; (3) findings, recommendations, and conclusions stated in the report, paying particular attention to any unusual transactions or noted weaknesses or issues in the report or footnotes; and (4) compliance with required reporting standards.

said they would consider altering the scope of their examinations varied. Officials at FDIC, for example, told us that examiners do not have the authority to rely exclusively on the work of external auditors. However, officials at OTS, which has had a longstanding history of working with external auditors, said there are a broad range of areas where auditors' work can be used to adjust the scope of their examinations.

In July 1992, the federal bank and thrift oversight agencies issued a joint policy statement that promotes coordination and cooperation between examiners and external auditors. In the statement, federal bank and thrift regulators encourage auditors to attend examination exit conferences or other meetings between examiners and bank management at which examination findings relevant to the scope of the audit are discussed. The statement also says that auditors may request meetings with the federal bank and thrift regulators. Furthermore, this statement provided guidelines concerning information that institutions should give to their external auditors, such as condition and examination reports, correspondence received from the regulators, any supervisory "memorandum of understanding" or other written agreement, or any other enforcement action.

Greater Cooperation and Reliance Could Improve Examinations, Enhance Efficiency, and Reduce Regulatory Burden

Improving cooperation between external auditors and examiners and identifying areas where examiners could use the work of external auditors has the potential to improve examinations, enhance the efficiency of examinations, and reduce regulatory burden on banking institutions, according to many of the regulatory officials we interviewed. For example, external auditors' work may help examiners identify those high-risk areas in a banking institution in which examiners should focus their review and may consequently improve the quality of examinations. Increasing use of external auditors' work may also help examiners determine areas in which sufficient work was performed by the external auditor, thereby allowing the examiners to limit their work in the area. Examiners could then focus their efforts on other areas or other institutions, thereby improving the efficiency of examinations. Banking institutions could also benefit from such cooperation if it resulted in a more narrow scope of examination or if information requests by auditors or examiners were reduced by coordinating requests and sharing information.

Numerous Barriers to Cooperation and Reliance Exist

Regulatory officials said that the extent of coordination with external auditors varies significantly, has been sporadic, and past efforts to achieve improved coordination have often achieved lackluster results, even after the issuance of the 1992 guidelines. In most cases, the degree of cooperation seemed to depend on the attitude of the banking clients toward auditor/examiner coordination and on the willingness of examiners and auditors to work together. For example, some auditors are not interested in attending examination exit conferences, according to regulatory officials, while auditors said that examiners do not always inform them of such conferences. Regulatory officials also said that they get few requests by auditors to meet with examiners or to review examiner workpapers, reflecting a statement by one audit industry executive that examiner workpapers would be of little use to auditors because of the differing missions of auditors and examiners.

Improving cooperation between external auditors and examiners can be a challenge, primarily because of these differing missions. External auditors are generally engaged by a banking institution to attest to the fairness of the presentation of the institutions' financial statements and, in the case of large institutions, to managements' assertions about the institutions' financial reporting controls and compliance with laws and regulations. Banking institutions' examiners, however, conduct periodic on-site examinations to address broader regulatory and supervisory issues, such as the safety and soundness of institutions operations and activities as well as compliance with all banking laws and regulations, not just insiders lending and dividend requirements. Although external auditors have responsibility for assessing an institution as a going concern, they are primarily concerned with the accuracy of the information provided to the institution's shareholders about their investments at a particular point in time. Examiners, however, have a responsibility to protect depositors, taxpayers, and the financial system, and are consequently concerned about the future viability of the institution.

In performing their functions, external auditors and examiners may review much of the same information. However, both audit and exam officials told us they are expected to apply different standards in preparing their separate reports. Officials said that different methodologies, assumptions, and the passage of time between audits and regulatory examinations can lead to different results and different assessments of the financial health of a banking institution. For example, an auditor may issue an unqualified opinion on an institution after determining that its transactions and balances are reported in accordance with generally accepted accounting

principles (GAAP). This does not necessarily mean, however, that the transactions reflect sound business judgment, that the associated risks were managed in a safe or sound manner, or that the asset balances could be recovered upon disposition or liquidation. These are all issues that examiners must consider in safety and soundness examinations. Different results between external audits and examinations might also occur if the audits and examinations are based on different periods. All banks must operate on a calendar year basis (i.e., having fiscal years ending December 31). Audits are performed in close proximity to the end of an institution's fiscal year, whereas examinations are scheduled year-round and based on the financial condition as of the end of a specific month or quarter.⁵ Examiners told us that the differences in "as-of" dates makes it difficult for them to use the work of external auditors, because the auditors' work may not be in close proximity to the period they examined and the institutions' activities and conditions may have changed significantly since the audit.

Such different assessments between examiners and auditors have often led them to be skeptical about the purpose of each others' work and the assumptions and methodologies used. Regulatory and accounting industry officials both told us that this skepticism often resulted from a lack of understanding and education about each others' work. Officials also said this lack of understanding, along with problems in the banking industry and regulators' professional liability lawsuits against accounting firms, have contributed to the failure of past efforts to improve cooperation between auditors and examiners. They said these various circumstances remain a significant barrier today.

Recent Initiatives May Identify Specific Areas of Overlap and Help Improve Cooperation Between Examiners and External Auditors

As we discussed in chapter 2, some of the regulatory agencies have recently initiated programs to improve cooperation between external auditors and examiners and potentially to identify areas where examiners could better use the work of external auditors. Although, as we discussed above, past efforts to promote cooperation between examiners and external auditors were often unsuccessful, both regulatory officials and officials from the accounting industry said they were more optimistic about recent initiatives to promote cooperation. Regulatory officials said current initiatives are more likely to be successful because the condition of the industry is better than it was when past efforts were made. Also, they said the current focus on reducing regulatory burden will help new

⁵Thriffs are not required to have calendar year-ends for their fiscal years; therefore, auditors and examiners can more easily coordinate their respective assessments to a period in closer proximity to one another.

Appendix II
External Audits of Banking Institutions

efforts. Furthermore, since the enactment of FDICIA, regulators have had additional information and leverage—including the auditors’ attestations and authority to review external auditors workpapers—that could help these efforts be more successful.

Description of Three Recent Bank Oversight Reform Proposals

Three plans to reform the federal system of oversight of depository institutions that have been proposed in the past 3 years include a proposal put forward by the U.S. Department of Treasury (the administration's proposal),¹ a proposal of Representative James A. Leach (the Leach proposal),² and an informal proposal of a former member of the Federal Reserve Board (the LaWare proposal).³ Each proposal sought to reduce the number of agencies with rulemaking and supervisory authority over banking organizations and reduce possible overlap and duplication in regulation and supervision. None would change the current system of regulating credit unions.⁴

The Administration's Proposal

Of the three proposals, the administration's would result in the most comprehensive change. It would realign the federal banking agencies by core policy functions—that is, the bank supervision and regulation function, central bank function, and deposit insurance function. Generally, this proposal would combine most regulatory and supervisory duties of OCC, FRS, FDIC, and OTS into a new independent agency, the Federal Banking Commission (FBC). Under this proposal, FDIC would continue to be responsible for administering federal deposit insurance, and FRS would retain central bank responsibilities for monetary policy, liquidity lending, and the payments system. Although FDIC and FRS would lose most bank supervisory rulemaking powers, each would be allowed access to all information of FBC as well as limited secondary or backup enforcement authority.⁵ In addition, FRS would be authorized to examine a cross-section of large and small banking organizations jointly with FBC. FDIC would continue to oversee activities of state banks and thrifts that could pose risks to the insurance funds and maintain responsibility for resolving failures of banking organizations at the least cost to those funds.

The governing board of the commission would consist of

¹This proposal was outlined in the statement of the Honorable Lloyd Bentsen, Secretary of the Treasury, before the Committee on Banking, Housing, and Urban Affairs of the U.S. Senate (Mar. 1, 1994).

²H.R. 1227: The Bank Regulatory Consolidation and Reform Act of 1993 (Mar. 4, 1993).

³This proposal was outlined in the statement of Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System before the Committee on Banking, Housing, and Urban Affairs of the U.S. Senate (Mar. 2, 1994).

⁴The Leach proposal leaves the regulation of credit unions with the National Credit Union Administration but calls for regulations comparable to those imposed on banks and thrifts.

⁵The Federal Reserve would receive backup enforcement authority to correct safety and soundness problems at the nation's 20 largest banking organizations, and FDIC would also retain backup enforcement authority over all insured institutions.

**Appendix III
Description of Three Recent Bank Oversight
Reform Proposals**

- a chairperson appointed by the President and confirmed by the Senate, serving a 4-year term (both as a member and as chairperson) expiring on the last day of March following a Presidential election;
- The Secretary of the Treasury (or the Secretary’s designee);
- a member of the Federal Reserve Board, designated by the Federal Reserve; and
- two members appointed by the President and confirmed by the Senate, serving staggered 5-year terms.

Table III.1: Basic Structure in the Proposed Plan of the Administration

Agency	Responsibilities
FBC	Supervises, regulates, and examines all federally insured banks and thrifts and their holding companies, U.S. banks’ foreign operations, and foreign banks’ U.S. operations.
FRS	Examines a cross-section of large and small banking organizations jointly with FBC.
FDIC	Oversees activities of troubled state banks and thrifts; has backup enforcement authority over all insured institutions.

Source: GAO analysis.

The Leach Proposal

The Leach proposal would consolidate OCC and OTS in an independent Federal Bank Agency (FBA) and align responsibilities among the new and the other existing agencies. This would reduce the multiplicity of regulators to which a single banking organization could be subject, while avoiding the concentration of regulatory power of a single federal agency. The role of FFIEC would be strengthened whereby it would see to the uniformity of examination, regulation, and supervision among the three agencies.

According to an analysis performed by the Congressional Research Service, the Leach proposal would put FRS in charge of more than 40 percent of banking organization assets, with the rest divided between the FBA and the reorganized FDIC.⁶ Thus, each of the three agencies would be important regulators.

The proposed realignment of responsibilities is shown in table III.2.

⁶CRS Report for Congress: Bank Regulatory Agency Consolidation Proposals: A Structural Analysis (Mar. 18, 1994).

**Appendix III
Description of Three Recent Bank Oversight
Reform Proposals**

**Table III.2: Alignment of
Responsibilities for Federal Agencies
Overseeing Banks and Thrifts Under
the Leach Proposal**

Agency	Responsibilities
FBA	Federally chartered banks and savings institutions, unless otherwise regulated. Bank holding companies and affiliates whose lead bank is federally chartered, except for those with assets over \$25 billion. ^a Savings and loan holding companies and affiliates whose principal depository institution subsidiary is a federal savings association, regardless of asset size.
FDIC	State banks and their holding companies except for those with assets over \$25 billion and state-chartered savings institutions and their holding companies, regardless of asset size.
FRS	Bank holding companies with assets over \$25 billion. ^a

^aInternational banking regulation is split among the three agencies; see text of H.R. 1277 for details.

Source: Congressional Research Service, March 1994.

The FBA would be led by an Administrator assisted by two deputy administrators, one of whom would be specific for savings institutions. The Administrator would be appointed for a 5-year term. All three administrators would be appointed by the President with the advice and consent of the Senate.

The LaWare Proposal

The LaWare proposal was outlined in testimony to the Congress but never presented as a formal legislative proposal, according to Federal Reserve Board officials. It called for a division of responsibilities defined by charter class, and, as in the other plans, a merging of OCC and OTS responsibilities. As outlined in table III.3, the two primary agencies under the proposal are an independent Federal Banking Commission (FBC)—whose structure the LaWare proposal did not address—and FRS. FRS would supervise all independent state banks and all depository institutions in any holding company whose lead institution was a state-chartered bank. FBC would supervise all independent national banks and thrifts and all depository institutions in any banking organization whose lead institution is a national bank or thrift. As with domestic bank holding companies, all U.S. banks, branches and agencies of foreign banks would be supervised and regulated according to the charter class of the largest depository institution. FDIC would not examine financially healthy institutions, but would be authorized to join in examination of problem banking institutions. Based on estimates of assets of commercial banks and thrifts

**Appendix III
Description of Three Recent Bank Oversight
Reform Proposals**

performed by the Congressional Research Service, the LaWare proposal would have nominally put FBC in charge of somewhat more commercial bank assets than FRS.

Table III.3: Alignment of Responsibilities for Oversight of Banks and Thrifts Under the LaWare Proposal

Agency	Supervisory Responsibilities^a
FBC	All independent national banks and thrifts and all depository institutions in any banking organization whose lead depository institution is a national bank or thrift.
FRS	All independent state banks and all depository institutions in any banking organization whose lead depository institution is a state-chartered bank.

^aThe supervisor would examine, take enforcement actions, establish operational rules, and act on applications for all the depository institutions under its jurisdiction, regardless of the banks' charter class.

Source: GAO analysis.

The LaWare proposal included two options for the regulation of bank holding companies. The first option would retain FRS jurisdiction over all holding companies and their nonbank affiliates.⁷ The second option would divide the jurisdiction of virtually all holding companies between FRS and FBC on the basis of charter class of the lead bank. However, for systemic risk reasons, jurisdiction over those holding companies and nonbank affiliates of banking organizations that meet certain criteria—such as size and payments and foreign activity—would be retained by FRS, even if the lead bank of the organization had a national charter.⁸

A variant of the second option that the proposal discussed was to retain FRS authority over permissible activities of all holding companies, with all other authority being exercised by the regulator of the lead bank, except for the 25 or 30 large organizations with lead national banks.⁹

The Congressional Research Service estimated regulatory power in terms of assets of institutions supervised under each of these options. Under the second holding company option, the balance of regulatory power could

⁷The first option would result in two regulators for about 1,650 banking organizations, because the lead bank has a national charter, of which 92 percent would be subject to very light FRS supervision because the latter entities have no nonbank activities.

⁸Under this approach, only about 25 to 30 organizations with lead national banks would have two supervisors, depending on the criteria established. All other organizations would have only one supervisor/regulator for the entire organization.

⁹According to the proposal, this variant of the second option would retain some of the benefits of the first option.

well go to FRS, although less so than under the first option, according to the estimates.

Under both of the holding company options, FRS would retain supervision and regulation of (1) all foreign banks that operate a bank, branch, agency, or commercial lending affiliate in the United States and (2) all U.S. nonbanking operations of these foreign banks. As with domestic bank holding companies, all U.S. banks, branches and agencies of foreign banks would be supervised and regulated according to the charter of the largest depository operations.

The Number of Federal Agencies Proposed Differed

Although each of the proposals would have reduced the number of federal agencies authorized to perform various oversight functions, the extent of the proposed reductions differed. The variances in the number of proposed agencies reflect differences of view regarding, among other things, the number of federal agencies best suited to meet society’s goals for a financial system.

Table III.4: Comparison of the Number of Federal Bank Agencies in the Three Reform Proposals

	Number of agencies with examination and enforcement authority	Number of agencies with rulemaking authority
Current system	4	4
Three reform proposals		
Administration’s proposal	3	1
Leach proposal	3	3
LaWare proposal	2	2

Source: GAO analysis.

Federal Reserve Board officials have opposed the creation of a single federal bank agency as adverse to three principles that the Federal Reserve Board believes to be basic to any bank regulatory structure:

- To avoid the risks associated with the undue concentration of regulatory power, there should be at least two federal regulators, one of which should have macroeconomic responsibilities, because a single regulator without such responsibilities would have a tendency to inhibit prudent risk-taking by banks, thus limiting economic growth.
- The dual banking system—in which banks can be chartered by either the states or the federal government—should be preserved because choice of

both charter and federal regulator facilitates the diversity of approach that has made the U.S. banking system the most innovative in the world.

- As the nation’s central bank, FRS should continue to have direct, hands-on involvement in supervision and regulation of a broad cross-section of banking organizations in order to carry out its core central bank responsibilities to insure the stability of the financial system, manage the payment system, act as a lender of last resort, and formulate and implement a sound monetary policy.

The Secretary of the Treasury, however, has said that

- regulatory power is not restrained by creating additional agencies to perform duplicate functions; rather, an agency acts responsibly because it is subject to congressional oversight, the courts, the press, and market pressures—particularly from the nonbank financial services sector and foreign bank regulators.
- nothing in the administration’s proposal would prevent an institution from seeking a state, rather than a Federal, charter. Moreover, the Secretary of the Treasury has said, arguments that preservation of the dual banking system requires a choice between two or more federal regulators are really arguments for retaining the ability for institutions to arbitrage federal supervision. With regard to innovation, the Secretary of the Treasury said competition among bank agencies is not needed to promote financial product innovation, which is initiated in the marketplace—particularly by nonbank financial service providers, foreign banks, and state banking industries—and not by bank regulatory agencies.
- under the administration’s proposal, FRS would have ample bank supervisory powers to perform its central bank functions, full authority to manage the payments system and operate the discount window, and abundant bank supervisory powers to guard against systemic risk.

The Proposals Differed in Checks and Balances

The proposals differed in their provision of checks and balances to ensure that banks are treated fairly. FRS officials recognized risks associated with “undue concentration of regulatory power,” such as an increased likelihood of sudden changes in policy that would add uncertainties and instability to the banking system or actions that might inhibit prudent risk-taking by banks, thus limiting economic growth. Both the LaWare and the Leach proposals provide for multiple federal oversight agencies to avoid concentration of regulatory power. Because the administration’s proposal would put banking regulation in the hands of one agency, the administration’s proposal would create the greatest concentration of

regulatory power, compared with the other proposals. However, the Secretary of the Treasury has said that congressional oversight, the courts, the press, and market pressures serve to ensure that agencies act responsibly. Other mechanisms that would help ensure responsible actions by the proposed single regulator, according to the Secretary of the Treasury, are the composition of the FBC Board—with five members, including a representative of FRS—and a requirement that there be a political mix on the FBC Board.¹⁰

The Proposals Differed in the Means Used to Balance Independence and Accountability

The three proposals differed in mechanisms related to the goal of balancing the need for independence in regulatory action with accountability to the electorate. The administration’s proposal would establish FBC as an independent agency whose board would include a representative of the Treasury Department. According to the Secretary of the Treasury, the 5-member board would be of a manageable size that would allow individual board members to be held accountable for their decisions. In the Leach proposal, the executive branch would continue to have a major regulatory agency housed in one of its departments, but FBA would have to coordinate with the independent FRS and FDIC. The LaWare proposal—which, as mentioned earlier, was outlined in congressional testimony but never presented as a formal legislative proposal—did not discuss details about the independence of the new Federal Banking Commission or the composition or manner of determination of its leadership. However, FRS is independent in its policymaking, and the members of the Board of Governors are appointed by the President and confirmed by the Senate.

The Proposals Differed In the Supervisory/ Rulemaking Role Given to the Central Bank

The proposals also differed in the roles that they assigned to FRS. Two of the three proposals—the Leach proposal and the LaWare proposal—gave FRS a primary supervisory and rulemaking role for the institutions under FRS jurisdiction. The administration’s proposal provided FRS with representation on the FBC board and opportunities to participate in various bank examinations and backup enforcement authority.

The Chairman of the Federal Reserve Board has said that FRS must continue to have hands-on involvement in supervision and regulation to effectively carry out its macroeconomic responsibilities. Removing FRS

¹⁰The three appointed members of the commission would include the chairperson (specifically appointed and confirmed as such), and two other appointed members. According to testimony presented by the Secretary of the Treasury on March 1, 1994, “One of these two members must be from another political party.”

from supervision and regulation would greatly reduce its ability to forestall financial crises and to manage a crisis once it occurs, according to the Chairman. FRS has also said that a central bank brings a unique and invaluable perspective to regulation and it is far better situated than a narrowly focused regulatory agency to see how bank regulation and supervision relate to the strength of the payment system, the stability of financial markets, and the health of the economy.

The Secretary of the Treasury has said that the contention that sound monetary policy rests on FRS's continued direct supervision of banks is not credible because FRS already relies on other federal banking agencies for much of the information it obtains. The Secretary also said that potential conflicts exist between monetary policy and supervisory functions of FRS. According to the Secretary of the Treasury, the administration's plan would satisfy the needs articulated by FRS for a significant supervisory role and, at the same time, dramatically reduce the duplication and eliminate the inconsistency inherent in the current supervisory system.

The Proposals Differed in the Supervisory Role of the Deposit Insurer

Under two of the three proposals (the administration's proposal and the LaWare proposal) FDIC's supervisory role would be substantially reduced. Under the administration's proposal, FDIC would be relieved of its role as a primary supervisor. However, FDIC would be able to conduct its own special examinations of insured institutions where necessary to protect the deposit insurance fund and take "backup" enforcement action to stop unsafe practices if FBC does not do so. It also would retain its responsibility as deposit insurer for overseeing activities of state banks and thrifts that could pose risks to the insurance funds and resolving bank and thrift failures at the least cost to the insurance funds. Under the Leach proposal, FDIC was one of three supervisory and regulatory agencies. Under the LaWare proposal, FDIC would be removed from examining financially healthy institutions but authorized to join in examination of problem institutions.

Comments From the Board of Governors of the Federal Reserve System

Note: GAO comments supplementing those in the report text appear at the end of this appendix.



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

ALAN GREENSPAN
CHAIRMAN

August 21, 1996

Mr. James L. Bothwell
Director
Financial Institutions and
Markets Issues
United States General
Accounting Office
Washington, D.C. 20548

Re: Bank Oversight: U.S. and Foreign
Experience May Offer Lessons for
Modernizing U.S. Structure

Dear Mr. Bothwell:

As requested, we have reviewed the recently completed draft report on the organization of banking supervision in other countries and on the views of the GAO regarding possible methods of altering the U.S. banking supervisory system. We agree that it is useful to consider the experience of other countries in making policy determinations. We also concur with the recognition given in the report to the unique features of the U.S. financial system and the need for a supervisory structure that acknowledges these features. Also, as the GAO notes, within the context of the U.S. system, there are different ways to accommodate the policy goal of modernizing the U.S. supervisory structure.

The Federal Reserve continues to support the fundamental principle that the purpose of bank supervision is to enhance the capability of the banking system to contribute effectively to the nation's long-term economic growth and stability. The enhancement of long-term economic growth through sound monetary policy is the primary goal of the Federal Reserve.

The draft report details the key role of central banks in supervision of the banking systems in four of the five countries reviewed (France, Germany, Japan and the United Kingdom). In each of these countries, the central bank and its staff are involved, directly and substantially,

Appendix IV
Comments From the Board of Governors of
the Federal Reserve System

Mr. James L. Bothwell
Page Two

in hands-on, day-to-day banking supervision and regulation. This type of involvement not only brings central bank experience to the banking supervision system, but also provides the central bank with the feedback from the banking system that is an essential ingredient in determining an effective monetary policy, acting as lender of last resort, and effectively dealing with systemic disruptions. We presume this is the type of role envisaged by the GAO for the central bank when it recommends that the Federal Reserve should continue to have a role in banking supervision; however, we feel this point needs to be stated more clearly in your report. Anything less than active supervisory involvement in the largest U.S. banking organizations and a cross section of other banking institutions would impair the ability of the Federal Reserve to carry out its key central banking functions.

We also would like to bring your attention to the fact that, although there are four federal banking supervisory agencies in the United States, most U.S. banks (88%) are part of banking organizations actively supervised by no more than two of these agencies¹. You have noted that in France, Germany and Japan, banking organizations also are subject to supervision by two separate federal agencies. There are, of course, some institutions, including a small number of large, complex U.S. banking organizations, that are subject to supervision by more than two federal banking supervisory agencies; however, it should be noted that the portion of activities supervised by the third or fourth agency is generally small (see the enclosed table).

Finally, we would like to emphasize that numerous steps have been taken over the years to promote consistency and strengthen coordination among the banking agencies. The Federal Financial Institutions Examination Council (FFIEC) has played a constructive role in fostering uniformity and consistency with respect to a number of supervisory policies and procedures. For example, the FFIEC has been responsible for coordinating uniform data collection from financial institutions, the analysis of which is critical to the ongoing supervisory process at all the banking supervisory agencies. Since June 1993, the federal agencies have operated under a joint policy statement designed to improve coordination and minimize duplication in the examination of depository institutions and the inspection of their holding company

¹ There is also the residual supervisory authority of the Federal Deposit Insurance Corporation for all federally insured banking organizations, which the GAO recommends retaining under any supervisory structure.

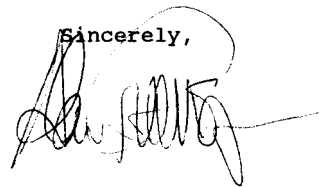
**Appendix IV
Comments From the Board of Governors of
the Federal Reserve System**

Mr. James L. Bothwell
Page Three

See comment 1.

affiliates. More recently, pursuant to Section 303 of the Riegle Community Development Banking Act, the federal agencies are working to make uniform those regulations and guidelines that implement common statutory or supervisory policies.

Sincerely,

A handwritten signature in black ink, appearing to be "Alan J. Folsom", written over the word "Sincerely,".

Enclosure

**Appendix IV
Comments From the Board of Governors of
the Federal Reserve System**

**NUMBER OF FEDERAL REGULATORS
FOR DEPOSITORY INSTITUTIONS
(BANKS, THRIFTS AND MUTUAL SAVINGS BANKS)**

	One Regulator	Two Regulators	Three Regulators	Four Regulators
Total # of Institutions	9,132	1,441	955	451
Total Assets (\$ billion)	1,747	831	2,013	736
% Assets Supervised By Primary Regulator	100.0	93.0	85.3	82.1
% Assets Supervised by 2nd Regulator	-	7.0	12.5	13.7
% Assets Supervised by 3rd Regulator	-	-	2.2	3.9
% Assets Supervised by 4th Regulator	-	-	-	0.3

NOTE: Data are as of December 31, 1995. The data do not include the Federal Reserve when its only capacity is supervising a shell bank holding company because of the de minimis nature of such a supervisory role. Similarly, the FDIC is not included as a regulator if its only role is as the residual supervisor because of its insurance responsibilities.

**Appendix IV
Comments From the Board of Governors of
the Federal Reserve System**

The following are GAO's comments on the Board of Governors of the Federal Reserve System's letter dated August 21, 1996.

GAO Comments

1. FRS described steps that the oversight agencies have taken to promote consistency and strengthen coordination among the agencies. We have added additional information on recent agency efforts to make uniform regulations and guidelines to our discussion of interagency coordination activities on pages 49 and 51 of our report.

Comments From the Federal Deposit Insurance Corporation

Note: GAO comments supplementing those in the report text appear at the end of this appendix.



FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, DC 20429

OFFICE OF THE CHAIRMAN

September 4, 1996

Mr. James L. Bothwell
Director, Financial Institutions and Markets Issues
United States General Accounting Office
Washington, D.C. 20548

RE: "Bank Oversight: U.S. and Foreign Experience May Offer Lessons for Modernizing
U.S. Structure"

Dear Mr. Bothwell:

Thank you for the opportunity to respond to your draft report to Representative Charles E. Schumer on the above subject. Your analysis of the oversight structure of banking institutions in certain other industrialized nations is useful information to the Congress for its deliberations on the appropriate regulatory structure for this country.

There are many forces for change affecting the financial institutions industry today. These include such matters as Congressional consideration of expanded powers and possible unification of the bank and thrift charters, as well as fundamental changes in the marketplace such as interstate banking, consolidation, and the proliferation of various types of electronic banking. Our recent testimony before Congress stated that we believe that the benefits and costs of a major realignment of the bank and thrift regulatory structure should be evaluated following Congressional deliberations on reform of the laws governing the banking and thrift industries. Our testimony also stated that when restructuring proposals are presented, they should be examined in the context of four fundamental principles. First, the regulatory structure should work to ensure the stability of the financial system, and the safety and soundness of individual financial institutions and the deposit insurance system. This means, among other things, that the FDIC must have the necessary authority to protect the deposit insurance funds, through explicit backup supervisory authority, backup enforcement power, and the capability to assess the quality of bank and thrift examinations generally. Second, the regulatory structure should encourage, not stifle, innovation and competition. Third, it is critical that the regulatory structure remain independent. Finally, the broader regulatory responsibilities to the financial system, of deposit insurance and monetary policy, require current and sufficient information on the ongoing health and operations of financial institutions. In our judgment, the periodic on-site examination remains one of the essential tools by which such information may be obtained.

Notwithstanding certain similarities between the goals and objectives of bank oversight between the United States and the five countries included in your study, there are important

**Appendix V
Comments From the Federal Deposit
Insurance Corporation**

fundamental differences in the banking industries among those nations and ours. Probably the most striking, of course, is the dual banking system. You correctly note that such a tradition is absent in the oversight structures of the countries you analyzed, and that this represents one of the unique features of our system. We continue to believe that the dual banking system, which has deep roots in our country's history, is a strength of our system that has fostered innovation and encouraged competition among banking organizations. The differing perspectives of federal and state regulators has led to greater scrutiny of the costs and benefits of regulatory actions, thereby providing a system of checks and balances. Other differences between our system and the others examined by the GAO include the common use of bank holding company structures in this country and the use here of the federal bank regulatory system to enforce certain consumer protection statutes. These fundamental differences make the analysis of the potential application of regulatory structures from the foreign systems to ours more problematic. A fully comprehensive determination of this issue would require an assessment of the effectiveness of bank oversight in the countries included in your review as well as other major countries, but you indicate that such an assessment of effectiveness was not performed.

Your report offers four possible mechanisms to improve consistency of bank oversight and reduce regulatory burden. We have the following comments on those mechanisms.

Expand the current mandate of the FFIEC to ensure consistency in rule-making for similar activities as well as consistency in examinations - The FFIEC has proven to be a useful mechanism for developing more uniform examination principles, standards, and report forms by the federal financial institution regulatory agencies. State bank regulators are also given a voice in this process through the FFIEC's state liaison committee. There is, in addition, a substantial body of work accomplished outside the formal structure of the FFIEC through regular interagency meetings and *ad hoc* task forces and working groups. These less formal cooperative efforts have a long history among the federal banking regulators. Examples of this coordination and uniformity in regulatory initiatives include efforts addressing risk-based capital standards, revision of the Community Reinvestment Act regulations and examination procedures, and development of a uniform form for the reporting of suspicious criminal activity. Under the auspices of the FFIEC and other interagency mechanisms, it has become a standard practice that regulations that apply to all banks and thrifts are developed by the agencies on a joint basis or are adopted only after significant interagency analysis and coordination.

Assign specific rule-making authority in statute to a single agency - It is our judgment that the present practice of informal cooperation, coordination and communication among the agencies has the important benefit of ensuring that each agency has a full opportunity to set forth its views and unique regulatory perspectives during the rule-making process. The FDIC, for example, brings the perspective of the deposit insurer and the primary regulator of more than 6,000 smaller state-chartered institutions, while the OCC brings the perspective of the charterer and regulator of federally chartered institutions which are generally much larger. The Federal Reserve brings the systemic perspective of a central bank and of the agency responsible for monetary policy as well as the regulator of banks that are members of the Federal Reserve System and of entities that own

See comment 1.

**Appendix V
Comments From the Federal Deposit
Insurance Corporation**

banks. The OTS brings the perspective of a federal charterer and regulator of thrift institutions. We believe this cooperative approach strikes a reasonable balance between consistency in regulations on the one hand while, on the other, ensuring that each agency's experiences and the characteristics of its constituent institutions are taken into account for the benefit of all participants in the system.

See comment 2.

Require enhanced cooperation between examiners and banks' external auditors - For a number of years, the FDIC has been working to improve communications and coordination between examiners and external auditors. These efforts have included a 1992 interagency policy statement that addressed, among other things, coordination between external auditors and regulatory agencies on the scheduling of examinations and audits. In addition, our examiners have been instructed beginning in 1993 that audit and other reports submitted in accordance with Part 363 of our Rules and Regulations¹ should be reviewed (i) for information that raises concern about the safety and soundness of an institution and (ii) to help establish the appropriate timing and scope of the examination. Examiners have also previously been directed to emphasize the review of auditor work papers for institutions that have exhibited internal control problems, significant derivative activities, or a history of unusual accounting practices.

See comment 3.

More recently, I testified before Congress on the subject of Daiwa Bank and the supervision of foreign banks operating in the United States. Our testimony stated we will expand our review of internal and external audit work papers with regard to institutions having substantial exposure to higher risk activities, such as trading activities. Examiner guidance will implement this and related procedures. Specifically, in addition to addressing the matter of auditor work paper review for higher risk activities, our examiners will be expected to contact an institution's auditor to solicit information that the accountant may have gained from his or her work at the institution since the last examination concerning the institution's operations and current condition. This guidance will also remind examiners that, for those banks subject to Part 363, they should evaluate the sufficiency of documentation supporting management's review of the institution's internal controls. Finally, this new guidance will require that all Division of Supervision Regional Offices institute a program involving annual meetings between regulators and local accountants to discuss informally accounting, supervisory, and examination policy issues. Some of our Regions have been participating in these informal gatherings and they have been found to be quite worthwhile.

It is important to note that all these steps to enhance examiner-auditor communications provide benefits to both the insured institution and the FDIC. They lessen the burden on the institution because they enable examiners to focus on areas where an institution has a higher risk

¹ Part 363 implements certain provisions of the Federal Deposit Insurance Corporation Improvement Act and applies to institutions with \$500 million or more in assets. Among other things, it requires that such banks have an annual opinion audit performed by an independent public accountant, as well as certain reports by management and an attestation by the accountant about the bank's internal control structure and procedures for financial reporting.

**Appendix V
Comments From the Federal Deposit
Insurance Corporation**

profile and where examiners can devote a substantial share of their resources. For these reasons, we believe we are addressing the substance of this recommendation.

See comment 4.

Require enhanced off-site monitoring to better plan and target examinations and identify and raise supervisory concerns at an earlier stage - Our offsite monitoring programs are intended to supplement and guide the onsite examination process by providing an early indication that an institution's risk profile may be changing. From banks' quarterly Reports of Condition and Income data, we can identify institutions that are experiencing rapid loan growth or are reporting unusual levels or trends in the volume of nonaccrual or delinquent loans, investment activities, off-balance sheet transactions, earnings structure, funding strategies and capital levels. Based on the information in this data base, a component and composite rating is assigned that looks at all the CAMEL factors except management. Those CAEL ratings are then used for planning and examination targeting decisions. Recent enhancements to the system include reports on credit card institutions and agricultural banks. To monitor larger institutions, including those for which the FDIC is not the primary federal regulator, we conduct quarterly offsite reviews of all institutions with \$1 billion or more in total assets. These quarterly reviews involve analysis of all available public and regulatory data, as well as information that may be provided directly by the institution or its auditors.

We believe that interstate banking, and assuring compliance with the requirements of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, call for certain changes in reporting by financial institutions of loan and other data to the regulatory agencies. That is, in the past it was generally valid to assume that the bulk of deposits and loans reported in a bank's quarterly Reports of Condition were generated from within the state of the reporting institution. As the banking industry consolidates, however, there is less and less correlation between the state where the reporting institution is located and the geographic area where the deposits and loans actually originate. That geographic information is relevant for off-site monitoring and other supervisory purposes. We are therefore working with our sister agencies on ways of resolving this issue, but amending the Call Report may be the only way to assure complete and accurate information.

Let me mention two other initiatives that are directly related to the matter of improved targeting and planning of our examinations while at the same time reducing regulatory burden on insured institutions. Both initiatives are designed to enhance our traditional examination and supervisory processes and to assist us in identifying, measuring, and monitoring risk. The first is the development of a graduated approach to risk assessment in examinations through the development of decision flow charts for use by examiners for each major risk area, including credit risk, interest rate risk, and operational risk. We believe these decision flow charts will aid examiners at critical points in their inquiry and decision making process by helping to identify the types of risk that may exist in a particular institution and by providing examiners with possible approaches to addressing them. We believe the charts are a tool that will lead to more analytical and more fact-based decision making, and that the scope and focus of our examinations will

**Appendix V
Comments From the Federal Deposit
Insurance Corporation**

become more a flow of risk assessments and evaluations of the changing risks institutions face rather than a static evaluation at a particular point in time.

The second initiative has two main components. One is the expansion of examiner access to internal and external databases so that pre-examination planning and offsite analysis can be expanded. The other involves increasing our use of technology to improve the efficiency of examinations through the development of an automated examination package. As one aspect of this latter effort, we recently implemented a program of automated loan line sheet preparation in our safety and soundness examinations. This program automates a good portion of the process of obtaining basic loan information on borrowers. Beyond the automated loan line sheet, the automated examination package will include the use of technology to help analyze liquidity risk, interest rate risk, and other risks against which bank operations can be assessed. These initiatives will materially expand the amount of timely and relevant data available to the examiner prior to the on-site examination, thus enabling the examiner better to identify the specific risk areas that should be addressed during the examination. When fully implemented, these measures will substantially increase the amount of examination work that can be performed off site rather than in the institution. Not only does this lessen the disruption to the normal daily operations of banking organizations, it also leads to an on-site examination that is more efficient, more tightly focused, and more rigorous.

We share the GAO's interest in the analysis of measures that will ensure an effective and efficient regulatory structure. Your review of the bank oversight systems in a few foreign countries is an additional important contribution to this process. We believe that although this is not an advantageous time to implement fundamental changes to the financial institutions regulatory structure, the four principles outlined above provide a reasonable and sound basis for evaluating such proposals. We stand ready to work with the Congress as it considers such measures.

Sincerely,



Ricki Helfer
Chairman

The following are GAO's comments on the Federal Deposit Insurance Corporation's letter dated September 4, 1996.

GAO Comments

1. We agree with FDIC's comments that coordination occurs among the oversight agencies outside of the scope of FFIEC, and we described such coordination mechanisms on page 51 of our report. Nevertheless, as noted in our discussion of the agencies' coordination, there remains the opportunity for some inconsistency among regulators in examinations as well as in interpreting, implementing, and enforcing regulations, which could potentially be reduced with an expanded role for FFIEC.
2. We previously described FDIC's efforts to improve communications and coordination between examiners and external auditors in appendix II. We also discussed examiners use of audit reports on page 97. Finally, we discussed FDIC's current requirement that examiners review selected workpapers on page 44 of our report.
3. We have incorporated the information provided by FDIC on planned efforts by FDIC to further improve cooperation with external auditors into our discussion of FDIC's initiatives on page 44 of our report.
4. We have included a summary of the information on off-site monitoring provided by FDIC on page 41 of our report.

Comments From the Office of the Comptroller of the Currency

Note: GAO comments supplementing those in the report text appear at the end of this appendix.



Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

September 17, 1996

Mr. James L. Bothwell
Director, Financial Institutions and Markets Issues
General Government Division
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Bothwell:

We have reviewed your draft audit report titled Bank Oversight Structure: U.S. and Foreign Experience May Offer Lessons for Modernizing U.S. Structure. The report was prepared in response to Congressional requests for information about the structure and operation of bank oversight and central bank activities in Canada, France, Germany, Japan, and the United Kingdom. The report summarizes characteristics of the foreign regulatory structures; discusses problems with the oversight structure in the U.S.; and identifies potential avenues for modernizing the U.S. structure. GAO recommends that the Congress consider reducing the number of federal agencies with primary responsibility for oversight while continuing a role for the Federal Reserve (FRS) as the central bank and the Department of Treasury as the ministry of finance.

The report is comprehensive and probably conveys more about the structure of bank regulatory agencies in the selected countries than has been written before for the public. We agree that the regulatory structure in any of the five foreign countries may not be readily adaptable to the U.S., nor would one of the foreign structures necessarily be superior. Some of the conclusions drawn by the GAO must be read carefully to fully understand and appreciate them, because the subject of the analysis is highly complex. For example, we believe that the GAO analysis shows that central banks do not necessarily need a direct role in bank supervision. We would emphasize, what to some might be only a subtle point, that access to supervisory information is more important than being a supervisor in order to permit central banks a substantial role in oversight. We are also disappointed that the analysis does not adequately convey the differences among countries in the practice of on-site examination. Therefore, although this study represents a substantial undertaking and clearly conveys an enormous amount of detail, the Congress should consider further information before deciding on any changes to the oversight structure in the U.S.

Regulatory Structure

The GAO concludes that central banks in the studied countries have substantial oversight roles. This is true, depending on the definition of oversight. We agree that the central bank in each of the countries is part of the oversight structure, but as the GAO points out, the role and organizational

**Appendix VI
Comments From the Office of the
Comptroller of the Currency**

relationship with bank supervision varies. Although the central bank in each of the countries is part of the oversight structure, the role and organizational relationship with bank supervision varies. OCC analysis of bank supervision in the G-10 countries concludes that each country has developed its own way for the national government to oversee regulation and supervision of particular classes of financial institutions and the oversight structure of the government agencies involved is peculiar to the regulatory/supervisory approach taken. For example, Canada's central bank is quite independent of other oversight entities and is not directly involved in bank supervision. But formal structures are in place in Canada for sharing supervisory information among the Office of the Superintendent of Financial Institutions, the Department of Finance, the Bank of Canada and the Canada Deposit Insurance Corporation. The role of France's central bank in supervision results from the bank and bank supervisor having common employees, making them at once both separate and the same. Although possibly difficult for Americans to understand, this arrangement is one way to address the conflict of interest between central banking and bank supervisory functions while at the same time attempt to benefit from keeping the central bank highly informed about supervisory matters. In a complicated arrangement, responsibility for safety and soundness is shared by the Bank of Japan and the Ministry of Finance. In Germany, supervisory functions are shared, similar to the system in the U.S. In the United Kingdom, there is no separate supervisory agency--the Bank of England is responsible for central banking and bank supervision, and the Governor of the Bank of England chairs the independent Deposit Protection Board. Of the G-7 countries, two conduct bank supervision exclusively through the central bank, four share bank supervision between the central bank and a bank supervisory agency, and one conducts bank supervision exclusively through a bank supervisory agency. Of the four other countries that comprise the G-10, three have bank supervisory agencies and one conducts bank supervision exclusively through the central bank. Clearly, the delineation of central banking and bank supervisory functions is different among different countries.

Features of Bank Supervision

Oversight structure cannot be considered alone. The supervisory methods used contribute to the overall effectiveness of the structure. The approach to supervision is significantly different in each of the six countries studied. The key to bank supervision in Canada used to be the parliamentary chartering of widely-held banks which enabled effective use of moral suasion. Structural changes, and granting of exceptions to wide-ownership resulted in institutional and regulatory failure. As a result, Canada devised a more rigorous supervisory structure with greater reliance on hands-on supervision. Germany relies on its requirement for credit institutions to have two licensed managers and strict corporate governance. Japan and France, and to a lesser extent Germany, rely on voluminous reporting requirements that would be considered burdensome and intrusive by bankers in the U.S. The U.S. relies on examinations, which are vastly different from those in other countries that perform them.

Deposit Guarantee

GAO states that the governments in the countries studied provide no explicit guarantees of deposit insurance. While the studied countries do not have a guarantee as we do in the U.S., all of the countries have a formal arrangement for conveying some guarantee. The formal system may be government sponsored, an industry arrangement, or some combination. Moreover, the European

See comment 1.

**Appendix VI
Comments From the Office of the
Comptroller of the Currency**

See comment 2.

Union's Second Directive requires members to have a formalized system to effect at least a minimum guarantee.

Financial Institutions

The focus of the report is limited to the oversight structure as it affects banks. However, GAO's use of the term "bank" is not consistent. For example, the report treats savings and loans and savings banks in the U.S. as banks. However, it does not treat similar institutions in the other countries as banks -- trust and mortgage loan companies in Canada, building and loan societies in the U.K., and municipal savings banks in Germany.

There are also other providers of financial services that are common among the countries, such as credit unions. All of these entities should be included in considering changes to the oversight structure .

Thank you for the opportunity to review and comment on the report. Technical comments were provided to your evaluators separately.

Sincerely,



Judith A. Walter
Senior Deputy Comptroller for Administration

The following are GAO's comments on the Office of the Comptroller of the Currency's letter dated September 17, 1996.

GAO Comments

1. We agree with OCC that supervisory methods contribute to the overall effectiveness of oversight structures and that the approach to supervision is significantly different in each of the countries we studied. Although Canada, France, Japan, and the U.K. all conduct on-site examinations to some degree, the scope of their examinations differs from that in the United States. Generally, the examinations done in the United States are more transaction oriented. However, in Germany, the U.K., and to a lesser degree in Canada, the work of external auditors provides a significant amount of supervisory information that is generally received through examinations in the United States. Additional detail on supervisory practices in the five countries we studied can be found in the individual country reports.¹

2. OCC observed that our report is limited to the oversight structure as it affects "banks" in the United States, which we have defined on pages 20 to 21 to include commercial banks and thrifts. OCC also observed that we do not treat similar institutions in other countries as banks. Such institutions were included in our discussions of the oversight structures in Canada, France, Germany, and Japan. We did not include the supervision of building societies—institutions that lend predominantly for house purchases—in our discussion of the oversight structure in the U.K. because (1) we considered these institutions to be significantly different from banks in their activities and (2) building societies held a relatively small percentage of depository institution assets.

OCC also observed that other providers of financial services such as credit unions should be included in any consideration of changes to the oversight structure. We agree that credit unions are classified as depository institutions. However, as we noted on pages 4 and 34 of our report, because credit unions hold only a small percentage of all depository institution assets—about 5.5 percent—and the services they provide are somewhat unique, we did not include them in our definition of "banks" for the purposes of this report.

¹See Bank Regulatory Structure: The Federal Republic of Germany (GAO/GGD-94-134BR, May 9, 1991); Bank Regulatory Structure: The United Kingdom (GAO/GGD-95-38, Dec. 29, 1994); Bank Regulatory Structure: France (GAO/GGD-95-152, Aug. 31, 1995); Bank Regulatory Structure: Canada (GAO/GGD-95-223, Sept. 28, 1995); and Bank Regulatory Structure: Japan, which is currently a draft report.

Comments From the Office of Thrift Supervision

Note: GAO comments supplementing those in the report text appear at the end of this appendix.



Office of Thrift Supervision
Department of the Treasury

1700 G Street, N.W., Washington, D.C. 20552 • (202) 906-6853

John F. Downey
Executive Director, Supervision

August 26, 1996

Mr. James L. Bothwell
Director, Financial Institutions
and Markets Issues
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Bothwell:

We have reviewed the draft report entitled "Bank Oversight Structure: U.S. and Foreign Experience May Offer Lessons for Modernizing U.S. Structure". We appreciate the opportunity to review the draft document and have the following comments:

Recommendation 1: Reduce the number of federal agencies with primary responsibilities for bank oversight. We concur with the GAO's recommendation to reduce the number of federal agencies with primary responsibility for bank oversight. As Acting Director Jonathan L. Fiechter has stated in testimony before Congress, the OTS supports federal banking agency consolidation. We feel that consolidation will make our regulatory system more efficient and effective. The GAO report, however, does not specifically address the manner of this consolidation. If it is determined that the functions of the OTS should be merged into one or more of the other federal regulatory agencies, it is important that this process be carried out in a way that preserves a strong and stable regulatory environment that is effective, efficient and responsive to the needs and risks posed by the supervised institutions. There are a number of significant issues that would need to be addressed prior to any merger of the regulatory agencies, including employee protections.

Recommendation 2: Continue to include both FRS and the Department of the Treasury in oversight. We concur.

Recommendation 3: Continue to provide FDIC with necessary authority to protect the deposit insurance funds. We concur.

Appendix VII
Comments From the Office of Thrift
Supervision

Mr. James L. Bothwell

-2-

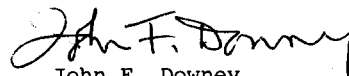
Congress should incorporate mechanisms to help ensure consistent oversight and reduce regulatory burden. The OTS, as well as other federal banking agencies, is sensitive to the need to reduce unnecessary regulatory burden. The agencies have undertaken various interagency initiatives to achieve greater uniformity and consistency in their rules and practices. Many of these initiatives were developed under the coordination of the Federal Financial Institutions Examination Council (FFIEC), which was established in 1979 to promote consistency in federal examinations and federal banking agency supervision. For instance, the OTS and FDIC routinely conduct joint rather than separate safety and soundness examinations of troubled thrift institutions. Similarly, the OTS and FRB coordinate their oversight of joint bank/thrift holding companies. The four federal banking agencies have also adopted a common examination rating system. This reduces overlap and redundancy when multiple examinations are conducted, preserves valuable agency resources and, most important, reduces examination burdens imposed on insured depository institutions. The federal banking agencies have also collaborated on the development of many regulatory initiatives, such as real estate appraisals, safety and soundness standards, risk-based capital standards, and the development of uniform practice and procedure rules. The banking agencies are also currently working, again through the FFIEC, to develop consistent interagency regulations and policies.

See comment 1.

See comment 2.

Thank you for providing the opportunity to comment on this draft document. I hope these comments are of assistance to you and your staff.

Sincerely,



John F. Downey
Executive Director, Supervision

The following are GAO's comments on the Office of Thrift Supervision's letter dated August 26, 1996.

GAO Comments

1. OTS provided examples of efforts by oversight agencies to promote consistency in federal examinations and federal banking agency supervision. We have added information on the conduct of joint examinations and additional coordination of examinations on page 49 of our report.
2. OTS noted that the federal banking agencies have collaborated on many initiatives to enhance consistency among the oversight agencies. We have added information on such efforts on page 51 of our report.

Major Contributors to This Report

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Appendix VIII
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Appendix VIII
Major Contributors to This Report

Related GAO Products

Bank Regulatory Structure: Canada (GAO/GGD-95-223, Sept. 28, 1995).

Bank Regulatory Structure: France (GAO/GGD-95-152, Aug. 31, 1995).

Bank Regulatory Structure: The United Kingdom (GAO/GGD-95-38, Dec. 29, 1994).

Bank Regulatory Structure: The Federal Republic of Germany (GAO/GGD-94-134BR, May 9, 1994).

Financial Derivatives: Actions Needed to Protect the Financial System (GAO/GGD-94-133, May 18, 1994).

Financial Regulation: Modernization of the Financial Services Regulatory System (GAO/T-GGD-95-121, Mar. 15, 1995). Bank Regulation: Consolidation of the Regulatory Agencies (GAO/T-GGD-94-106, Mar. 4, 1994).

Bank and Thrift Regulation: FDICIA Safety and Soundness Reforms Need to Be Maintained (GAO/T-AIMD-93-5, Sept. 23, 1993).

Bank Regulation: Regulatory Impediments to Small Business Lending Should Be Removed (GAO/GGD-93-121, Sept. 7, 1993).

Bank Examination Quality: OCC Examinations Do Not Fully Assess Bank Safety and Soundness (GAO/AFMD-93-14, Feb. 16, 1993).

Bank and Thrift Regulation: Improvements Needed in Examination Quality and Regulatory Structure (GAO/AFMD-93-15, Feb. 16, 1993).

Bank Examination Quality: FDIC Examinations Do Not Fully Assess Bank Safety and Soundness (GAO/AFMD-93-12, Feb. 16, 1993).

Bank Examination Quality: FRB Examinations and Inspections Do Not Fully Assess Bank Safety and Soundness (GAO/AFMD-93-13, Feb. 16, 1993).

Thrift Examination Quality: OTS Examinations Do Not Fully Assess Thrift Safety and Soundness (GAO/AFMD-93-11, Feb. 16, 1993).

Banks and Thrifts: Safety and Soundness Reforms Need to Be Maintained (GAO/T-GGD-93-3, Jan. 27, 1993).

Related GAO Products

Bank Supervision: OCC's Supervision of the Bank of New England Was Not Timely or Forceful (GAO/GGD-91-128, Sept. 16, 1991).

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