United States General Accounting Office

GAO

Report to the Chairwoman and the Ranking Minority Member, Subcommittee on Financial Institutions and Consumer Credit, House Committee on Banking and Financial Service

May 1997

FOREIGN BANKS

Opportunities Exist to Enhance Supervision Program as Implementation Proceeds

GAO/GGD-97-80

GAO

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

General Government Division

B-272838

May 9, 1997

The Honorable Marge Roukema
Chairwoman
The Honorable Bruce F. Vento
Ranking Minority Member
Subcommittee on Financial Institutions
and Consumer Credit
Committee on Banking and Financial Services
House of Representatives

This report responds to your request for information on the oversight of the U.S. operations of foreign banking organizations (FBO). The Foreign Bank Supervision Enhancement Act of 1991 (FBSEA) gave the Federal Reserve System (FRS) enhanced supervisory and regulatory authority over foreign banks operating in the United States.[1] Before FBSEA, each such office was examined by a federal or state supervisor and treated as a separate entity even if the FBO had multiple offices in the United States. Although FRS had overall authority for supervising the foreign banks' U.S. presence, no formal mechanism existed to enable the various agencies to share information about an FBO with offices in multiple states and to coordinate supervisory activities. In keeping with its enhanced authority, FRS has worked with other supervisory agencies to develop the Foreign Banking Organization Supervision Program (FBO Program) with the intent of improving and better coordinating supervision of FBO offices in the United States.

As agreed with your subcommittee, the objectives of this report are to (1) describe the FBO Program and (2) evaluate the banking supervisors' progress in implementing this program.

Results in Brief

The FBO Program focuses on integrating into supervisory procedures a common understanding of a given FBO in its entirety, including policies and practices in the FBO's home country as well as the overall condition of the FBO's combined U.S. operations. The program calls for coordinated development and common use of five new products. We refer to two of these as "the country reports." One country report is to provide information about the financial system and the supervisory and governmental policies in the FBO's home country, and the other is to

[1]Foreign banks may operate in the United States through bank or nonbank subsidiaries and other types of offices, including branches, agencies, and representative offices.

provide information about significant accounting policies and practices in the home country.

A third product, the Strength-of-Support Assessment (SOSA), which is to be based on the country reports and other financial data, is to provide analysis and a ranking to reflect the U.S. supervisors' judgment about the FBO's ability to provide its U.S. operations necessary financial and managerial support. SOSA reports are to be used along with other information for reaching decisions regarding the scope and frequency of exams and for other supervisory and enforcement matters.

A fourth product, the Summary of Condition and Combined Rating, is designed to provide FBO management and U.S. supervisors with an overall assessment of the FBO's U.S. operations. The last new supervisory product, an annual comprehensive examination plan, is intended to better coordinate examinations of U.S. offices of FBOs with multiple U.S. banking operations and/or significant U.S. nonbanking operations. This examination plan is to be developed from information in the SOSAs, the results of individual prior examinations, and the overall assessment of the FBO's combined U.S. operations.

In our review of the FBO Program, we found that banking supervisors had made progress in implementing the program and had begun to realize benefits from it. However, we also identified areas where improvements could be made. As of December 31, 1996, about 43 percent of the required SOSA reports and their related home country reports had been finalized.[2] Supervisors identified some broad benefits of the program—particularly increased communication and cooperation among supervisors and improved access to information about FBOs and their home countries. At the same time, comments of supervisory officials and staff indicated some skepticism about how useful the information from the SOSA reports will be in improving FBO supervision. However, they also said that the various Federal Reserve Banks are developing different formats and strategies for integrating the information into the supervisory process. In addition, we identified a number of weaknesses in SOSA and country reports that could limit the program's effectiveness. These included inconsistent, incomplete, or outdated information, as well as SOSA rankings that did not appear to be justified by information in the report.

[2]Federal Reserve Board officials told us that, as of April 7, 1997, approximately 92 percent of the SOSAs and their related home country reports were in final or draft form.

Background

As of December 31, 1996, a total of 281 FBOs based in 59 countries had banking operations in the United States that were subject to the procedural requirements of the FBO program. FBOs operate in the United States through a number of types of offices with differing powers and oversight. The most common of these types of entities are described in table 1.

Table 1: Types of Offices FBOs Operate in the United States

Type of office	Description	Supervision
Branches and agencies	Branches are legal and operational extensions of their parent foreign bank and have broad banking powers, including accepting limited uninsured deposits, lending, money market services, trade financing, and other activities related to the service of foreign and U.S. clients. Agencies have similar powers but may not accept deposits from U.S. citizens or residents.	FRS and either Office of the Controller of the Currency (OCC) if federal license or states if state license.[a]
Subsidiary bank	Separately capitalized legal entity chartered in the U.S. with shares owned or controlled by the parent foreign bank. Banking powers and legal or regulatory restrictions are the same as those of any other domestic bank.	OCC, or FDIC and state regulators, or FRS and states.
Representative office	A marketing office/liaison between the head office of the foreign bank and its customers and correspondent banks in a state or region. May engage in representational and administrative functions, but may not make any business decisions on behalf of the foreign bank.	FRS and states.
Edge Act Corporation or Agreement Corporation	Edge Act Corporations are separate subsidiaries limited to international banking activities specified in the Edge Act. Domestic activities permitted include receipt of deposits from foreign governments, financing of contracts, projects performed abroad, financing imports and exports. Agreement Corporations are limited to essentially the same powers as Edge Act Corporations by agreement with FRS.	Edge Act corporations: FRS. Agreement Corporations: FRS, states.
Commercial lending company	Specialized nondepository institution authorized under state law. May engage in borrowing and lending activities, including accepting deposits at off-shore facilities.	FRS and states.
Nonbank subsidiary	Nonbank subsidiaries of FBOs may engage in activities such as underwriting or dealing in certain securities to the same extent that U.S. bank holding companies may engage in such activities.	FRS, states, and other federal regulators, depending on activities.

[a]There are also a limited number of insured branches that are supervised in part by the Federal Deposit Insurance Corporation (FDIC).

As shown in table 2, branches and agencies are the most common types of FBO banking offices in the United States, and they account for about 51 percent of the total foreign bank assets in the United States as of December 31, 1996.

Table 2: U.S. Operations of FBOs as of December 31, 1996

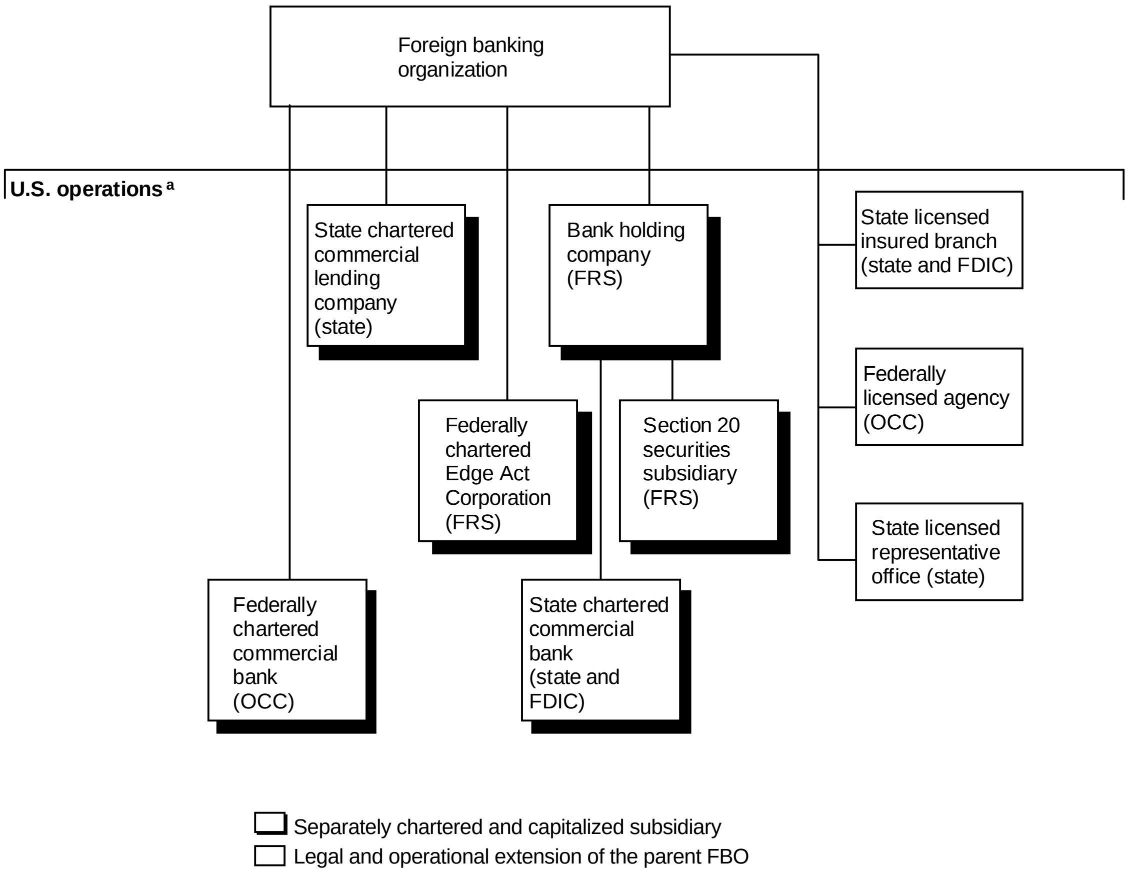
Type of office	Number of offices	Total assets (in billions)
Branches and agencies	498	**$821**
Subsidiary banks	90	**226**
Edge Act and Agreement Corporations	21	**2**
Other deposit-taking entities[a]	29	**25**
Total banking offices	638	**1,074**
U.S. nonbanking subsidiaries	672	**537**
Representative offices	138	**NA**
Total	**1,448**	**$1,611**

[a]Includes commercial lending companies, savings banks, and trust companies.

Source: Federal Reserve System.

An individual FBO may have a variety of these types of offices operating in the United States, and each individual office may be supervised by a different federal or state regulator, with FRS having overall authority. Figure 1 shows the organizational structure of the U.S. operations of a hypothetical FBO. It also shows the U.S. supervisor for each office.

Figure 1: Organizational Structure of the U.S. Operations of a Hypothetical FBO



[a]FRS has overall authority for all U.S. operations of FBOs.

Source: GAO example developed from FRS documents.

Scope and Methodology

To address the objectives of this report, we reviewed examination manuals, relevant laws, and guidance issued by the Board of Governors of FRS (Federal Reserve Board). We interviewed officials from the Federal Reserve Board and the Federal Reserve Banks of Atlanta, Chicago, New York, and San Francisco. We also interviewed state bank supervisors from

California, Florida, Illinois, and New York, and officials from FDIC, OCC, and the Institute of International Bankers—an association of foreign banking organizations with U.S. operations. The Federal Reserve Banks and state bank supervisors we interviewed are responsible for overseeing most FBO operations in the United States.

In addition to our interviews, we developed a data collection instrument (DCI) to help us systematically collect information from each of the FBO products: the country reports, SOSAs, examinations, overall assessments of U.S. offices, and the comprehensive exam plans. The type of information we collected included basic financial information on the FBO and its U.S. operations, results of past examinations of U.S. operations, and information on the supervisory and financial system of the foreign country, among other things. This DCI was designed to help us compare the content of these reports and determine the extent of use of information from SOSAs and country reports in comprehensive exam plans.

We used the DCI to review the FBO products from 18 different countries. We chose countries located in Europe, Asia, and North and South America to obtain variation in geographic location and levels of financial development. For each country, we chose two FBOs, if two existed, and reviewed their SOSAs, comprehensive exam plans, and overall U.S. assessment, if available. We chose the FBOs included in our judgmental sample to obtain variation in size, SOSA ranking, and types of offices they had operating in the United States.

We obtained written comments on a draft of this report from the Federal Reserve Board. These comments are discussed at the end of this letter and are reprinted in appendix I. We did our work in Washington, D.C.; New York; California; Illinois; and Florida in accordance with generally accepted government auditing standards from September 1996 to January 1997.

The FBO Program Was Designed to Improve and Better Coordinate Supervision of FBO Operations in the United States

The FBO Program was designed to provide the U.S. banking supervisory agencies with a collective mechanism for supervising the U.S. operations of FBOs in a highly coordinated, thorough, and efficient manner, according to the Federal Reserve Board. FRS began to implement the FBO Program in March 1995, when it issued its initial guidance on the program. Federal Reserve Board officials told us that the program was scheduled to be implemented over a 3- to 5-year period, but that they hoped to have it fully operational within 3 years.[3] The interagency program—which consists of a number of supervisory steps and assessments that each have their individual requirements regarding content, procedures, and timing—calls for the development and distribution of six supervisory products.[4]

The Six Supervisory Products Are to Provide a Wide Range of Supervisory Information

The six supervisory products of the FBO Program are to provide information about the home countries of the FBOs, the FBOs themselves, and the FBOs' operations in the United States. The six products are

- Review of Home Country Financial System,
- Review of Significant Home Country Accounting Policies and Practices,
- Strength-of-Support Assessment,
- Individual Examination Plan,
- Comprehensive Examination Plan, and
- Summary of Condition and Combined Rating.

We refer to the first two products, which focus on a country's financial system and accounting policies and practices, as "the country reports." The contents of the six supervisory products are summarized in table 3.

[3]For the initial implementation phase of the FBO program, Federal Reserve Board officials said they decided to apply the FBO program only to FBOs with a direct banking presence in the United States through branches or agencies, Edge or Agreement Corporations, commercial lending companies, or subsidiary banks. Once the program becomes fully operational, FRS will consider incorporating foreign banks with a representative office presence only.

[4]These products include the five new products discussed earlier and the individual exam plan, which the regulators have routinely used in the past.

Table 3: Supervisory Products of FRS' FBO Program

Product	Summary of contents
Review of Home Country Financial System	For each country with bank representation in the United States, the assigned supervisor (usually a Federal Reserve Bank) is to describe the financial system structure, process of supervision and regulation, treatment of problem or failed institutions, and, if warranted by existing issues, current condition and operating performance of the financial system.
Review of Significant Home Country Accounting Policies and Practices	For each country with bank representation in the United States, the assigned supervisor (usually a Federal Reserve Bank) is to highlight accounting policies and practices that differ significantly from U.S. standards, including asset valuation, income and expense items, consolidation rules, off- vs. on-balance sheet items, tax considerations, and disclosure rules.
Strength-of-Support Assessment (SOSA)	For each FBO, the assigned supervisor (usually a Federal Reserve Bank) is to assess internal and external resources to give U.S. operations necessary (1) financial and (2) managerial support. Financial support assessment—summarized by A-E rankings—is to be based on available information on the financial and operational condition of the FBO in the context of the home country reports. Managerial support assessment requires placement of an asterisk (*) beside the letter assessment if actual or potential managerial or operational control risks are apparent.
Individual Exam Plan	For each FBO office in the United States, U.S. federal or state supervisors are to develop examination plans for individual offices based primarily on the findings and scope of previous examinations, the results of any off-site surveillance, the latest assessment of the combined U.S. operations of the FBO and the role of the office in the context of the FBO's overall U.S. business activities, and the evaluation of the FBO and the assigned SOSA.
Comprehensive Examination Plan	For all U.S. operations of an FBO except for commercial banks, the assigned Federal Reserve Bank is to prepare comprehensive examination plans that describe the overall scope and frequency for the next series of examinations.
Summary of Condition and Combined Rating	For all FBOs with multiple U.S. operations, an assigned Federal Reserve Bank is to prepare a summary in the form of a letter to the FBO's head office management that highlights areas of overall strength and any systemic weaknesses in the FBO's U.S. operations. A rating of the FBO's combined U.S. operations, based on a 1-5 scale, is to be included.

The Federal Reserve has assigned responsibility for preparing the FBO products to the various Reserve Banks that have offices of foreign banks in their districts.[5] Responsibility for the products is generally assigned according to the location of the FBO offices in the United States. Given the preponderance of FBO offices in New York, the Federal Reserve Bank of New York was preparing the majority of products. Draft country and SOSA reports are to be circulated to other relevant U.S. supervisors for comment. Final versions of the reports are also to be provided to the relevant U.S. supervisors.[6] Based on FRS guidance issued in August 1996, SOSA rankings are to be considered final only when they have been formally reviewed and approved by a committee headed by officials of the Federal Reserve Board's international supervision function.

The Country Reports and the SOSA Are Intended to Improve U.S. Supervision of FBO Operations in the United States

One of the principal goals of the SOSA is to identify FBOs that may pose risks to their U.S. operations or to U.S. financial markets due to financial, operational, or other concerns at the FBO as a whole. As table 3 shows, the SOSA utilizes a two-component assessment ranking system for financial and managerial support. Financial support is summarized by A to E rankings, with A representing the lowest level of supervisory concern and E the highest. An asterisk is to be placed beside the letter assessment on an as-needed basis to identify whether there are any factors that raise questions about the ability of the FBO to maintain adequate internal controls and compliance procedures at its U.S. offices, irrespective of the overall financial condition of the FBO. The SOSA—which is supported by the two country reports—is to provide information to the U.S. bank supervisory agencies that they can take into account in reaching decisions regarding the scope and frequency of examinations and whether other supervisory initiatives may be appropriate.[7] The SOSA assessment serves to categorize all FBOs with U.S. banking operations by levels of supervisory concern, highlighting those whose U.S. operations are thought to warrant higher levels of supervisory attention.

An FBO's SOSA, along with other information, is to be taken into consideration in setting the examination plan for the FBO's U.S. operations. For example, the U.S. operations of FBOs whose assessments are marked

[5]OCC also has responsibility for preparing products for nine FBOs in six countries that operate in the United States only under a national charter or license.

[6]For example, copies of draft and final country reports are to be provided to each state supervisor responsible for a banking office of an FBO from the country, each Federal Reserve Bank in which an FBO from that country has a banking presence in the district, OCC if an FBO from the country has a federally licensed office, FDIC if an FBO from the country has an insured office, and the Federal Reserve Board.

[7]Any particular changes that need to be made to the supervisory strategy for the U.S. operations of an FBO that arise from the SOSA analysis are to be presented in a separate supervisory implications section of the SOSA. The SOSA is expected to include the specific implications for any examination plan of a SOSA ranking of C or lower or when an asterisk is included in the ranking.

by an asterisk, denoting potential internal controls or compliance risks, may receive examinations in which supervisors investigate those risks.

The FBO's SOSA analysis and ranking are to be considered in implementing supervisory follow-up action for the U.S. operations, although specific SOSA rankings are not linked to mandatory supervisory actions. According to procedural guidance for the program, an assessment of C or lower is expected to imply a level of concern that would subject the FBO's U.S. offices to at least periodic monitoring of their net due to/due from positions.[8] Any additional supervisory step, such as imposing an asset pledge or asset maintenance requirement,[9] is to be implemented largely based on the condition and nature of the U.S. operations. If an FBO is accorded an assessment of D or lower, this is generally expected to indicate a higher level of supervisory concern, with some presumption of asset maintenance regardless of the condition of the FBO's U.S. operations.[10]

As part of the FBO Program, FRS is to maintain a database containing information on the financial system and on significant accounting policies and practices of each country with bank representation in the United States. The information in the database is to be provided by FRS and other supervisory agencies, and FRS is to make the information available to all of the supervisory agencies.

The Comprehensive Examination Plan and the Overall Assessment Are to Help Coordinate Agencies' Efforts in Supervising FBOs

The comprehensive examination plan and the overall assessment of an FBO's U.S. operations—that is, the Summary of Condition and the Combined Rating—are designed to help coordinate agencies' efforts in supervising FBO offices in the United States. To ensure coordination of supervisory efforts and avoid duplication, the FBO Program calls for U.S. banking supervisory agencies to increase interagency communications regarding their examination plans, examination results, and any proposed

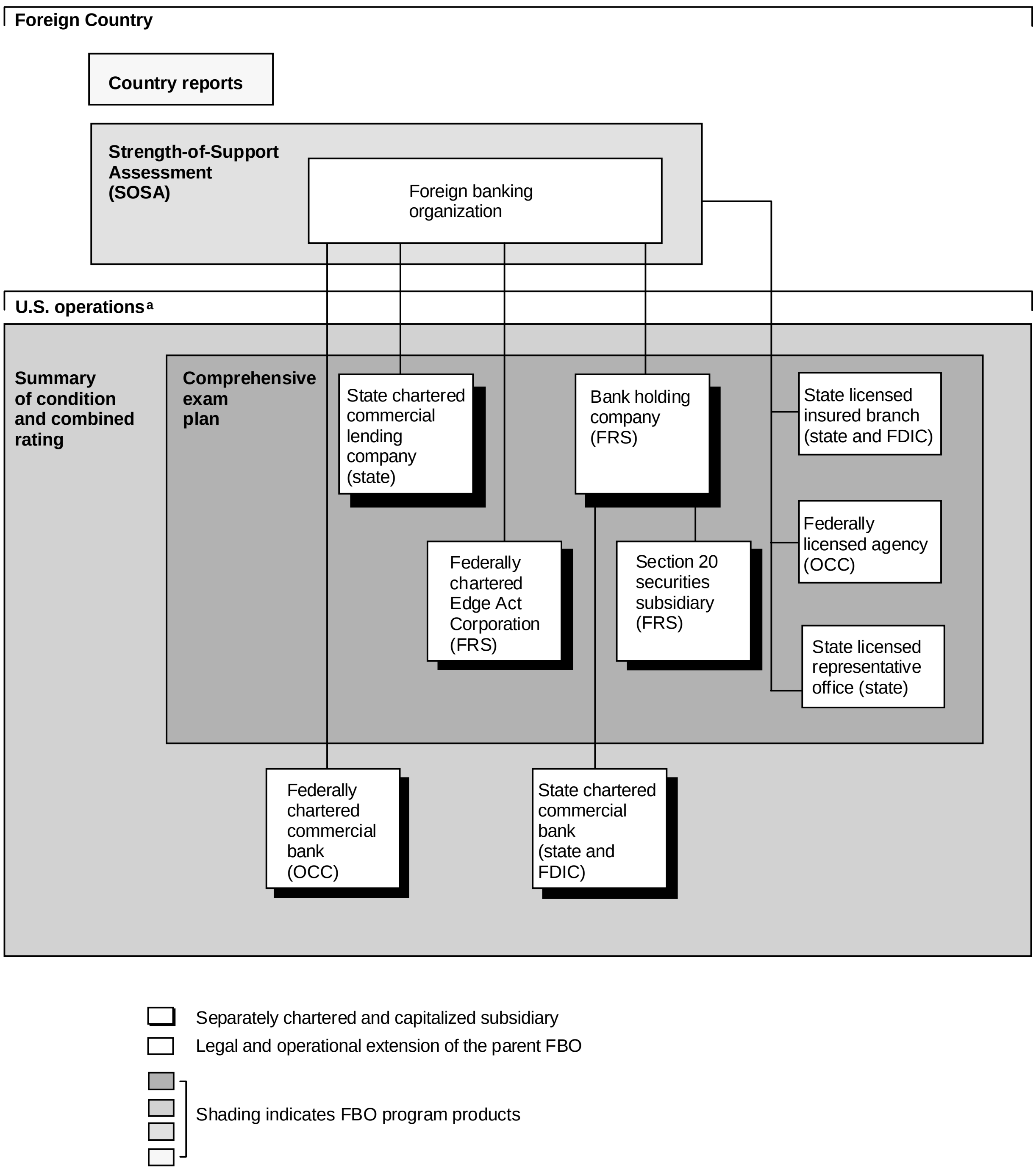
[8]Net due to and from positions refer to the flow of funds between an office of the parent foreign bank and the parent bank or other offices of the bank. For example, if the U.S. offices are in a net due from position with the parent foreign bank, then once all the transactions between the U.S. offices and the parent foreign bank are netted, the parent bank owes funds to the U.S. offices.

[9]Asset pledges, also called capital equivalency deposits, are required cash deposits or eligible securities deposits at an approved depository bank. Asset maintenance requirements are to ensure that a branch or agency maintains "eligible" assets in excess of third party liabilities for protecting creditors. Eligible assets usually include assets for which there is a reasonable expectation of liquidation on a timely basis.

[10]An assessment of A or B is generally expected to imply little if any concern relating to the ability of the FBO to meet its obligations. If an FBO does raise liquidity or solvency concerns, the FBO should not be accorded an assessment of A or B, according to the guidance.

supervisory follow-up actions. Also, to fulfill its responsibilities for the overall U.S. operations of individual FBOS, FRS is to prepare annually an overall assessment of the combined U.S. operations of each FBO, based largely on input from and discussions with the examining agencies. As noted in figure 2, the comprehensive examination plan is to cover all U.S. operations of an FBO with the exception of commercial banks, which are to be treated as domestic institutions for the purpose of examination planning during the initial implementation of the FBO Program.

Figure 2: Coverage of FBOs and Their U.S. Offices by the FBO Products



[a]FRS has overall authority for all U.S. operations of FBOs.

Source: GAO example developed from FRS documents.

The FBO Program is to provide for the coordination of examination schedules through the development of an annual comprehensive examination plan for each FBO with banking offices licensed by more than one supervisory agency and/or with significant U.S. nonbanking activities.[11] Other U.S. supervisors of FBO offices in the United States are to provide responsible Federal Reserve Banks with a copy of their preliminary examination schedules. FRS is to use these, in conjunction with the preliminary examination schedules of the Reserve Banks, to derive a draft comprehensive examination schedule for all U.S. operations of individual FBOs. This draft schedule, to be provided to all the supervisory agencies, is designed to permit each agency to coordinate its own schedule with those of other agencies. FRS is to provide the final comprehensive examination schedule to all the supervisory agencies. Likewise, the various supervisors are to provide individual examination plans to be used by FRS in drafting a comprehensive examination plan.

According to FRS officials, FBOs that operate in the United States through multiple offices often will have all offices examined using the same "as of" financial statement date; this will provide the supervisory agencies with increased information on the interrelationship among the various offices and can enhance the examination of individual offices and the FBO's overall operations. The U.S. supervisory agencies have committed to advising other agencies' supervising offices of the same FBO of any critical examination findings prior to the exit meeting with FBO officials for that examination.

The overall assessment of an FBO's combined U.S. operations is intended to provide the FBO and the U.S. supervisory agencies with a view of the overall condition of the FBO's U.S. operations and help put into context the strengths and weaknesses of individual offices. The assessment is to be prepared by FRS for all U.S. offices supervised by more than one agency. The assessment is to address all risk factors, including (1) all elements of the ROCA rating system,[12] (2) the quality of risk management oversight

[11]For FBOs that conduct all or substantially all of their U.S. operations through offices licensed or chartered by one banking supervisory agency, the timing of the annual examination is to be established by the licensing authority.

[12]The ROCA rating system is the system used to rate U.S. branches and agencies of FBOs and is an assessment of Risk management, Operational controls, Compliance, and Asset quality.

employed by all levels of management in the FBO's U.S. operations, and (3) the examinations of all offices of the FBO conducted during the year.

The system for rating the FBO's combined U.S. operations is to result in the assignment of a single-component rating between 1 and 5, with 1 being the highest. The rating system contains language describing the level of supervisory concern and required supervisory attention. See table 4 for a description of the ratings.

Table 4: Definitions of Ratings of the Combined U.S. Operations of FBOs

Numerical rating	Definition
1	The overall operations are fundamentally sound in every respect. They cause no supervisory concern and require only normal supervisory attention.
2	The combined U.S. operations operate in a basically sound manner, but may have modest weaknesses that can be corrected by management in the normal course of business. They do not require more than normal supervisory attention.
3	Overall U.S. operations are weak in risk management, operational controls, and compliance, or have numerous asset quality problems that, in combination with the condition of the FBO, cause supervisory concern. U.S. and/or head office management may not be taking the necessary corrective actions to address any weaknesses. This rating may also be assigned when either risk management, operational controls, or compliance is individually viewed as unsatisfactory. Generally, these operations raise supervisory concern and require more than normal supervision to address their weaknesses.
4	The combined U.S. operations have a significant volume of serious weaknesses. Serious problems or unsafe and unsound banking practices or operations exist, which have not been satisfactorily addressed or resolved by U.S. or head office management. These operations require close supervisory attention and surveillance monitoring and a definitive plan for corrective action by head office management.
5	The combined U.S. operations have so many weaknesses or unsafe and unsound conditions that they require urgent restructuring by head office management.

Source: Federal Reserve Board guidance (SR95-22) issued March 31, 1995.

This composite assessment is intended to apprise the various U.S. supervisory authorities of the overall condition of the U.S. offices of individual FBOs. These agencies can then factor this information and that in the Summary of Condition into their supervision of the U.S. offices under their jurisdiction.

The FBO Program Has Achieved Some Benefits, but Has Weaknesses That Could Limit Its Effectiveness

Banking supervisors have made progress in implementing the FBO Program. They have developed and distributed procedural requirements and guidance. As of December 31, 1996, about 43 percent of the SOSA reports and their related home country reports had been finalized, and supervisors were just beginning to use the information in these reports in developing comprehensive examination plans. Supervisors identified some broad benefits of the program—particularly increased communication and cooperation among supervisors and improved access to information about FBOs and their home countries. At the same time, supervisors told us that determining how to use this information to improve their supervision was clearly the biggest challenge they face as they move forward. In addition, we identified a number of weaknesses in SOSA and country reports that could limit the program's effectiveness. These included inconsistent, incomplete, or outdated information, as well as SOSA rankings that did not appear to be justified by data in the report.

Supervisors Have Made Progress in Implementing the FBO Program

In late March 1995, the Federal Reserve Board distributed to the Reserve Banks initial guidance for implementing the FBO Supervision Program. Additional guidance was issued as implementation progressed from March 1995 to August 1996. As of December 31, 1996, SOSA reports and accompanying home country reports were completed for 120 (about 43 percent) of the 281 FBOs subject to the requirements of the program.[13] We found only limited use of country and SOSA report information in the comprehensive examination plans that we reviewed. However, at the time of our review, supervisors had just begun to incorporate SOSA and country report information into the supervisory process.

Supervisors Identified Benefits of the Program

Although the FBO Program has not been fully implemented, FRS staff and other banking supervisors told us of a number of benefits of the program—most importantly, improved communication and cooperation among supervisors and bank management, both domestic and foreign, and improved access to information about FBOs and their home countries.

[13]FRS is responsible for preparing 272 of the 281 SOSA and accompanying home country reports. FRS officials told us that, as of April 7, 1997, approximately 92 percent of the SOSAs and their related home country report were in final or draft form. OCC is responsible for 9 SOSAs, and an official from OCC told us they had not completed any of these reports or the accompanying country reports as of December 31, 1996.

Improved Communication and Cooperation Among Supervisors and Bank Management

Regulators reported many instances of increased coordination and cooperation among federal and state supervisors. Supervisory officials told us that implementing the FBO Program has, in some cases, required supervisors from different agencies to coordinate with each other—whereas before the program, they said coordination was more ad hoc. For example, because an FBO may have subsidiaries or offices in several locations across the United States, the development of a coordinated examination strategy for a given FBO has required supervisors to work cooperatively, sharing information about the subsidiaries or offices they individually supervise. This is important because problems identified at a particular office could manifest themselves at other offices of an FBO. This improved coordination and communication is intended to result in improved supervision of the U.S. operations of FBOs.

FRS officials also said preparing home country reports and SOSAs had helped them develop valuable relationships with foreign regulators and foreign central banks. These officials said such preparation has helped them supervise the U.S. operations of foreign banks. They also said the relationships they have developed with foreign regulators have helped them obtain better information on how U.S. banks are doing abroad.

Finally, officials at a Federal Reserve Bank told us that providing foreign bank management with a summary of the condition of the FBO's U.S. operations and a combined rating has helped them communicate more effectively with foreign bank officials and has resulted in quicker and better compliance by the foreign banks. These summaries are to be sent directly to the foreign bank's head office and are to highlight the issues that need the most attention.

Improved Access to Information About FBOs and Their Home Countries

Several supervisors stated that the program has been beneficial in centralizing information about an FBO and its home country. For example, staff at one Federal Reserve Bank said the FBO Program helps examiners by providing a single contact for information about an FBO. The SOSAs and country reports also have provided a benchmark of information on FBOs and home countries—so that all supervisors would have access to the same information about a particular FBO or country. At another Reserve Bank, staff said the reports have also provided a ready and complete source of information for U.S. officials in their meetings with foreign banks and officials from other countries.

Staff at another Federal Reserve Bank stated that the FBO Program has given "more form" to their system of supervision. For example, this

Reserve Bank has been monitoring the FBOs' conditions in a particular country since 1992. However, the staff were not sure whether other supervisors were doing similar monitoring, and state supervisors told us they did not have adequate resources for such monitoring. Reserve Bank officials said the FBO program reduced the likelihood that problems would fall through the cracks in the supervisory system.

According to supervisory officials, the new program's products and information have also helped supervisors get information about FBOs and countries that is not commonly known. FRS has had long-standing relationships with most of the central banks and bank regulators of the major industrialized nations. Particularly for the G-10 countries,[14] officials told us that information sharing has occurred in the past, and that their accounting standards and practices are generally similar to those in the United States. FRS officials said such is not the case for other countries, however, particularly many of the countries with developing financial and supervisory systems that have banking presences in the United States. For this reason, some supervisory officials said that the development of SOSAs and home country reports—including reports on accounting and auditing standards and practices—have been particularly useful.

Weaknesses Exist That Could Limit the Effectiveness of the FBO Program

An important goal of the FBO Program is to enhance supervision by integrating the information in SOSAs and country reports into the supervisory and enforcement processes. Officials told us that this phase of the program was just starting at the time of our review. However, based on our review of completed SOSA and country reports and our interviews with supervisory officials and staff, we identified a number of concerns and weaknesses that could limit the program's effectiveness in improving supervisory and enforcement processes in oversight of U.S. operations of FBOs.

Supervisors Expressed Concerns About Use of SOSAs in Exam Planning and Enforcement

While supervisors and supervisory staff recognized a variety of benefits of the FBO Program, as discussed earlier, they also expressed concern about the usefulness of information in the SOSA and country reports and about how this information could be integrated into the examination planning process. Further, they expressed concerns about how to use this information to help them make enforcement decisions.

[14]The G-10 countries include the United States and the following foreign countries: Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, and the United Kingdom.

Regarding examination planning, some examiners told us that the SOSAs were useful mainly for general background information, while others said the information was not particularly useful. Officials from one Federal Reserve Bank told us they had been experimenting with a new comprehensive examination plan format that incorporated more information from the SOSA and country reports, such as key strengths and weaknesses related to the FBO's lines of business. Officials from another Reserve Bank said they were in the process of developing a strategy for integrating the information from SOSA and country reports into the exam planning process. They said they were also in the process of considering how the SOSAs could be improved to make them more useful. They said some possible improvements might include making the reports shorter and more user friendly for examiners; updating the reports just before the beginning of an exam cycle; and focusing the reports more on risk—for example, analyzing the impact the FBO's overall business strategy might have on its U.S. operations.

Many supervisors told us that determining how to use information from the SOSA and country reports to improve their oversight was clearly the biggest challenge they face as they move forward. In order to help meet this challenge, Federal Reserve Board officials told us they commenced development of an FBO training seminar in late 1996 that will emphasize that the FBO Program is a process directed towards ensuring an appropriate supervisory strategy for the U.S. operations of each FBO. Among other things, they said the seminar will place emphasis on creating a greater linkage between the SOSAs and the comprehensive examination planning process.

With regard to enforcement decisionmaking, some supervisors told us that they would like to be able to use the SOSAs to some extent to adjust their supervisory requirements, such as capital equivalency deposits. In order to do this, SOSAs must be accurate, consistent, and up-to-date. However, officials told us that they have concerns about whether this will be possible in the future because of the difficulties involved in obtaining consistent information from FBOs and home country regulators.

Information in an FBO's SOSA and Country Reports Was Sometimes Inconsistent

As we reviewed the 36 SOSAs, we found some examples of inconsistent information in individual country reports as well as examples of inconsistency in information between SOSAs and their associated country reports, as illustrated by the following:

- A discussion of financial disclosure practices in a certain country report mentioned that nonperforming loan (NPL) ratios[15] provide a limited indication of the country's problem loan situation because public disclosure of substandard loans was not required. In addition, the report said the monetary authority's manipulation of accounting practices to ease pressure on bank performance undermines reported financial figures and renders year-to-year analysis difficult. Yet, the final SOSA report for an FBO in that country stated that capital was adequate—with ratios slightly exceeding Bank for International Settlements (BIS)[16] minimum standards—without providing a clear, explicit qualification of the statement.
- One country report pointed out that external auditors had not yet developed the status or the degree of independence they had in the United States. The report said that qualified audit reports were virtually unheard of in this country and warned that the lack of independence may potentially hinder the reliability of audited financial statements. However, a SOSA for one of the FBOs in the country said that the financial statements were deemed reliable due to an unqualified opinion rendered by an audit firm.
- Another report on home country supervision stated that banking supervision is considered relatively strong. Yet, the same report noted that reporting of certain key data—such as NPLs, hidden reserves, off balance sheet items, and risk-based capital ratios—was not a supervisory requirement in that country.

Information in the SOSA and Country Reports Was Sometimes Incomplete

Based on our review of Federal Reserve Board guidance[17] and discussions with staff at the Federal Reserve Board, Reserve Banks, OCC, and select state banking departments, we developed a basic list of information that most supervisors would expect in the SOSAs.[18] We then reviewed 36 SOSAs and their corresponding country reports to determine whether this information was provided. In reviewing SOSA and country reports, we expected some variation in the types of information provided because of

[15]Nonperforming loans are loans that are not performing according to the original terms of the borrower's loan agreement. In the United States, loans 90 days or more past due are generally considered to be nonperforming.

[16]BIS is an organization of central banks that is based in Basle, Switzerland. It is the principal forum for consultation, cooperation, and information exchange among central bankers.

[17]Federal Reserve Board guidance describes general categories that must be addressed, but does not prescribe a list of specific required information.

[18]Examples of the types of information we looked for in SOSAs include key activities of the FBO; the operating structure of the FBO; whether the FBO meets the BIS capital standards; financial information on the FBO's earnings, asset quality, and liquidity; the likelihood of home country support; the level of disclosure; and external audit coverage.

differences in (1) the availability of information and the financial and supervisory systems in various countries and (2) the weight that supervisors would place on different types of information.

Although we expected some variation in the information provided, we found that nearly all of the SOSAs failed to provide all of the information on our basic list. Moreover, many seemed incomplete in ways that would reduce the reliability of the reports for supervisory use. For example, some of the SOSAs lacked information central to the purpose of the reports, such as statements of the likelihood of home country support.

Important details that we found lacking in some SOSA and country reports were those to clarify

- the date of the financial data;
- whether the data were consolidated and, if so, at what level;
- the date the reports were written and finalized;
- whether the risk-based capital standards referred to the BIS standards, and if not, how the capital ratios related to the BIS standards.

Our findings were consistent with statements of some supervisory officials we interviewed who expressed concern about the usefulness of the reports to supervisors. For example, an official from one banking supervisor told us reports lacked important detail. The same official also said that the reports lacked candor and did not always address controversial issues.

A staff member of a federal supervisor also told us that relevant information for planning examinations of some U.S. operations of FBOs could be almost wholly lacking in the SOSA report. This staff member told us that the country reports and SOSAs for the banks he supervised were useless in preparing examination plans because the country and SOSA reports focused on credit and asset quality, while the primary business of the banks in this country is trading in financial products.

Information in the SOSA and Country Reports Was Sometimes Outdated

Some SOSAs and country reports contained outdated information on the FBO's financial condition or the economic or political condition of the FBO's home country. In our review, we found that a number of products completed in 1996 relied on December 1994 or March 1995 data. In addition, some products presented discussions of outdated political or economic conditions. In discussing these products and their usefulness, we found that supervisory officials we interviewed often agreed that outdated information is a problem. Also, staff at a Federal Reserve Bank identified as a problem the time lag between when the information was being analyzed and receipt of the finished product.

To help correct this problem, the Federal Reserve Board is in the process of pilot testing a program, called FBO Desktop, with the Federal Reserve Bank of San Francisco. This program is designed to put all of the FBO Program products on-line. The goal of the program is to make it more efficient to share information and review FBO products.[19] An official from the Federal Reserve Board told us the pilot was nearly completed, as of March 1997, and would be rolled out soon to the other Federal Reserve Banks and then to the other state and federal supervisors. However, Federal Reserve Board officials pointed out that, even though this system is expected to help improve timeliness, timeliness will continue to be impaired to some degree due to the fact that FBOs are required to file full financial statements with FRS only on an annual basis, English translations of such filings are often not available until mid-year, and disclosure problems may continue to exist.

Some SOSA Rankings Did Not Appear to Be Supported by Information Provided in the Report

During our review of SOSA reports, we found some cases where the SOSA rankings did not appear to be justified by the information in the SOSA reports. For example, the program guidance states that an "A" SOSA ranking would indicate an FBO with a financial profile that is regarded as strong, with superior risk-based capital ratios, and that is comprehensively supervised, among other things. Yet, several FBOs that received "A" SOSA rankings were based in countries in which (1) banks were not required to disclose asset quality in reports to supervisors and (2) the reports said that the efficacy of supervision was questionable and that the supervisory system lacked an effective early warning system to identify financially weak institutions.

Many of the supervisors we interviewed told us that they expect that the assignment of all SOSA rankings will eventually be consistent with the criteria in program guidance. However, they said achieving this level of consistency may be difficult because of the differences in financial and supervisory systems and types of information available among countries.

Conclusions

Banking supervisors have made progress in implementing the FBO Program. Supervisors have identified a number of benefits of the

[19]Federal Reserve Board officials said that data security procedures will be established so that certain documents can only be reviewed on a "need to know" basis.

program—most importantly, improved communication and cooperation among supervisors and improved access to information about FBOs and their home countries. At the same time, supervisors have just begun to use the information in SOSA and country reports to improve supervision and enforcement, and some supervisors indicated some skepticism about how useful the information from SOSA and country reports will be in improving FBO oversight. The various Federal Reserve Banks are developing different formats and strategies for integrating the information into the supervisory process. In addition, we identified a number of weaknesses in SOSA and country reports that could limit the program's effectiveness, including inconsistent, incomplete, or outdated information, as well as SOSA rankings that did not appear to be justified by information in the report.

SOSA rankings that are unsupported or inconsistent with the ranking system criteria and report information that is inconsistent, incomplete, and out-of-date are obstacles to achieving a principal goal of the SOSA—to identify FBOs that may pose risks to their U.S. operations or to U.S. financial markets. Supervisory use of unreliable SOSA rankings could lead to inefficient levels and types of monitoring and to unequal treatment of FBOs' U.S. operations in enforcement actions, as well as potentially leading to ineffective oversight. The identified weaknesses could also cause supervisors to doubt the credibility of SOSA rankings and reports and thus limit supervisory use of the information resources the FBO supervision program is designed to provide.

Recommendations

As FRS continues its implementation of the FBO Program, we recommend that the Board of Governors of the Federal Reserve System

- identify best practices for using the information in the SOSA and country reports to improve supervision and enforcement, and disseminate these best practices to all Federal Reserve Banks; and
- monitor the report process to help ensure that SOSA and country reports are consistent, complete, and timely, and that the SOSA rankings are consistent with the ranking system criteria.

Agency Comments and Our Evaluation

The Federal Reserve Board provided written comments on a draft of this report, and these comments and our responses are reprinted in appendix I. It also provided technical comments, which we incorporated where appropriate.

The Federal Reserve Board generally agreed with the conclusions reached regarding the need for certain improvements in the content and use of the SOSA reports. In a subsequent conversation, a senior Federal Reserve Board official stated that the Federal Reserve Board had no objection to the recommendations. In its written comments, the Federal Reserve Board also noted that its work going forward will be largely concentrated on refining certain areas of the FBO Program to enhance its overall effectiveness, particularly in the areas of integration of the SOSA into examination planning and ensuring that appropriate linkages are established between all products in the program to promote the program's objectives. The Federal Reserve Board noted four steps that are being taken to help achieve this program improvement, which we have incorporated into the report.

The Federal Reserve Board also observed that our efforts were directed principally toward a review of the SOSAs and emphasized that the SOSA is one of several tools in the FBO Program designed to assist bank supervisors in meeting the objectives of the program. While we did review a judgmental sample of finalized SOSAs and discuss the weaknesses we found, our efforts were not principally directed toward this review. The report describes each of the products of the FBO program and their interrelationships, and it discusses the benefits of all parts of the program realized to date.

We are sending copies of this report to the Chairmen and Ranking Minority Members of the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Banking and Financial Services, the Chairman of the Federal Reserve Board, the Chairman of the Federal Deposit Insurance Corporation, the Comptroller of the Currency, and other interested parties. We will also make copies available to others on request.

Major contributors to this report are listed in appendix II. Please contact me at (202)512-8678 if you or your staff have any questions.

Thomas J. McCool
Associate Director, Financial Institutions
and Markets Issues

Contents

Abbreviations

BIS	Bank for International Settlements
DCI	Data Collection Instrument
FRS	Federal Reserve System
FBO	Foreign Banking Organization
FBSEA	Foreign Bank Supervision Enhancement Act of 1991
FDIC	Federal Deposit Insurance Corporation
NPL	Nonperforming loan
OCC	Office of the Comptroller of the Currency
SOSA	Strength-of-Support Assessment

Comments From the Federal Reserve Board

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

DIVISION OF BANKING
SUPERVISION AND REGULATION

April 30, 1997

Mr. Thomas J. McCool
Associate Director
Financial Institutions and Markets Issues
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. McCool:

This is in response to the GAO's draft report on the Foreign Banking Organization Supervision Program ("FBO Program"). Many of the draft report's conclusions and recommendations relate to the Strength of Support Assessment ("SOSA") and its overall function and use, to date, in the FBO Program. We agree generally with the conclusions reached regarding the need for certain improvements in the content and use of the SOSA reports. In addition to our comments below, we have provided comments of a more technical nature on individual pages of the draft report.

While the GAO's efforts were directed principally toward a review of the SOSAs, it is appropriate at this point to emphasize that the SOSA is one of several tools in the FBO Program designed to assist bank supervisors in meeting the objectives of the program. In summary, the program objectives are to enable U.S. supervisory authorities to have a complete assessment of the U.S. operations of each FBO, to maintain an appropriate supervisory strategy for such operations, and to coordinate the supervisory process on an interagency basis.

The value of a SOSA is to provide bank supervisors with a measure regarding the ability of an FBO to support its U.S. operations, both financially and managerially. Toward that end, the SOSA is intended to provide a general framework for evaluating and assimilating significant financial and managerial information related to individual FBOs. Factors to be considered include a review of the FBO's financial condition and prospects, the system of supervision in the FBO's home country, the record of how the home country deals with problems in the banking system, likely sources of support for the FBO, and any transfer risk concerns. Also to be identified are any factors that raise questions about the ability of the FBO to maintain adequate internal controls and compliance procedures at its U.S. offices.

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The Reserve Bank responsible for the SOSA analysis is expected to exercise discretion in deciding what information is provided in the analysis based on the individual circumstances of the FBO. Under present guidance, the SOSA is expected to address the following at a minimum: 1) executive summary, 2) overview of the FBO, 3) financial factors, 4) prospects, 5) home country support, 6) other assessment factors, and 7) supervisory implications of the assessment. Other than these general categories, there is no prescribed list of required information. Given that the initial SOSAs have already or are in the process of being completed, annual updates are expected to primarily address any material changes to the financial condition or operating environment of the FBO, or other specific issues deemed significant. Therefore, future SOSA reviews are likely to vary even more in terms of form and content.

See comment 1.

See comment 2.

As noted in the report, the Federal Reserve began implementation of the FBO Program on March 31, 1995, when it issued its initial guidance on the program. The program was intended to be implemented over a three to five year period, and we believe we will be able to meet this schedule. The GAO review was conducted as of the end of approximately the first year and a half of the program's existence.

Additional progress has been made in implementation of the FBO Program since completion of the GAO's review of program documentation. Many of the initial more time-consuming elements of the program (i.e., the development of the various products and related review and distribution processes) are well underway.[1] Because the program involved substantial cross-agency coordination and the creation of new analytical products, some implementation problems were to be expected. Our work going forward largely will be to concentrate on refining certain areas of the program to enhance its overall effectiveness, particularly in the areas of integration of the SOSA into examination planning, ensuring that appropriate linkages are established between all products in the program to promote the program's objectives, and ensuring a more risk-focused examination process.

To that end, the following steps have been/are being taken:

See comment 3.

o In late 1996, System staff commenced development of an FBO Program training seminar for examiners and in-house international supervision staff. While course segments will cover the various individual products generated under the FBO Program, emphasis will be placed on the

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[1] As of April 7, 1997, approximately 92 percent of SOSA reports had either been completed or were in draft form.

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FBO Program as a *process* directed towards ensuring an appropriate supervisory strategy for the U.S. operations of each FBO, rather than the generation of discrete analytical products. Among other things, the seminar will place emphasis on creating a greater linkage between the SOSA review and the comprehensive examination planning process.

See comment 4.

o The Reserve Banks have been directed by Board staff to ensure that any changes that need to be made to the supervisory strategy for the U.S. operations of the FBO that arise from the SOSA analysis are presented in a separate supervisory implications section of the SOSA report. The SOSA is expected to include the specific implications for any examination plan of a SOSA ranking of C or lower or when an asterisk is included in the ranking.

See comment 5.

o Procedures have been developed in order to ensure that SOSA rankings are considered final only when they have been formally reviewed and approved by a committee headed by officials of the Board's international supervision function. This initiative is intended to ensure the consistency and completeness of SOSA analyses and the assignment of a ranking that is supported by the analysis.

See comment 6.

o As noted in the draft report, an automated system (the FBO Desktop) is being developed to more efficiently share information and to review FBO program products. The system is expected to help improve the timeliness of information. Timeliness of information will likely continue to be impaired to some degree, however, due to the fact that FBOs are required to file full financial statements with the Federal Reserve only on a annual basis, English translations of such filings are often not available until mid-year, and disclosure/transparency problems may continue to exist. However, SOSAs are designed to arrive at an intermediate term view of the organization rather than to focus on short term changes.

We appreciate the opportunity to provide comments on the draft report.

Sincerely,

Richard Spillenkothen
Director

The following are GAO's comments on the Federal Reserve Board's April 28, 1997, letter.

GAO Comments

1. We added a footnote on page 19 that states that there is no prescribed list of required information for SOSAs.

2. As we stated on page 19, we expect some variation in the information provided in SOSA reports and as these reports are updated annually for any material changes, we expect this variation will continue. However, this variation is not necessarily a problem provided that important information—such as the likelihood of home country support or other details necessary for accurate analysis—is included in the SOSA reports.

3. We added a description of FRS' training seminar on page 18.

4. We added information on the supervisory implications section of the SOSA report in footnote 7 on page 9.

5. We added information on the procedures to review SOSAs on page 9. However, for the case of inconsistency between the country report and final SOSA we described on page 19, the SOSA had been approved through these new procedures, and this problem had not been corrected.

6. We added information on the likelihood that some problems with the timeliness of information will continue on page 21.

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