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Report to the Congress; by Elmer B. Staats, Comptroller General.

Issue Area: Federal Regulatory Activities (3000); Accounting and Financial Reporting (2800).
Contact: Office of the Comptroller General.
Budget Function: Miscellaneous: Financial Management and Information Systems (1002); General Government: Central Fiscal Operations (803).
Organization Concerned: Federal Deposit Insurance Corp.; Federal Reserve System; Department of the Treasury; Office of the Comptroller of the Currency.
Authority: National Banking Act (12 U.S.C. 21-27). Federal Deposit Insurance Act (12 U.S.C. 1816).

Several congressional committees requested the evaluation of the effectiveness of the supervisory efforts of the three Federal agencies involved in monitoring banking operations, because of the increasing instability of banks. The study objectives were to evaluate the agencies' efforts to identify unsound conditions and violations of laws in banks, and cause bank management to take corrective actions. Examination reports and correspondence files on more than 900 banks supervised by FDIC, Office of the Comptroller of the Currency, and the Federal Reserve Boards were examined, including 30 of 42 banks that had failed, 294 of 787 problem banks, and a general sample of 600 of the banks in the United States.
Findings/Conclusions: Adverse economic conditions contributed to some bank failures, but generally embezzlement and poor management of loans were the causes. Problems were not corrected because: (1) the regulatory agencies were reluctant to use their legal authority to force the banks to change, (2) the agencies did not consult with bank boards, (3) examinations were set up on a time basis rather than a problem solving basis, and (4) recommendations were not generally made as to how to solve problems. Examiners have enforcement tools they may use, both informal and formal: (1) informally request that banks make the changes, (2) formal written agreements to confirm correction plans, (3) cease and desist orders, (4) removal of management, (5) financial assistance, (6) cancellation of deposit insurance, (7) cancellation of Federal Reserve membership, and (8) revocation of charter. Federal Reserve Board surveillance of bank holding companies is not adequate. Training of examiners is not adequate. Major improvements of bank supervision include organizational changes, closer bank surveillance, self-dealing and insider transaction monitoring, consumer protection law enforcement, new examination procedures, closer contact with bank boards, problem solving monitoring, more use of formal

powers, experiements on relying on state examinations, and better training of examiners. The agencies involved are not working as closely as they should. Recommendations: The agencies should revise their examination practices and frequencies to better identify problems. Examination reports and meetings with bank boards should follow all examinations. More aggressive policies should be developed for the use of formal actions against problem banks. Better training and screening of potential examiners should be implemented. The three agencies, either through their own initiative or legislation, should coordinate their efforts more closely. More strigent procedures for handling charter applications should be devised. (SS)

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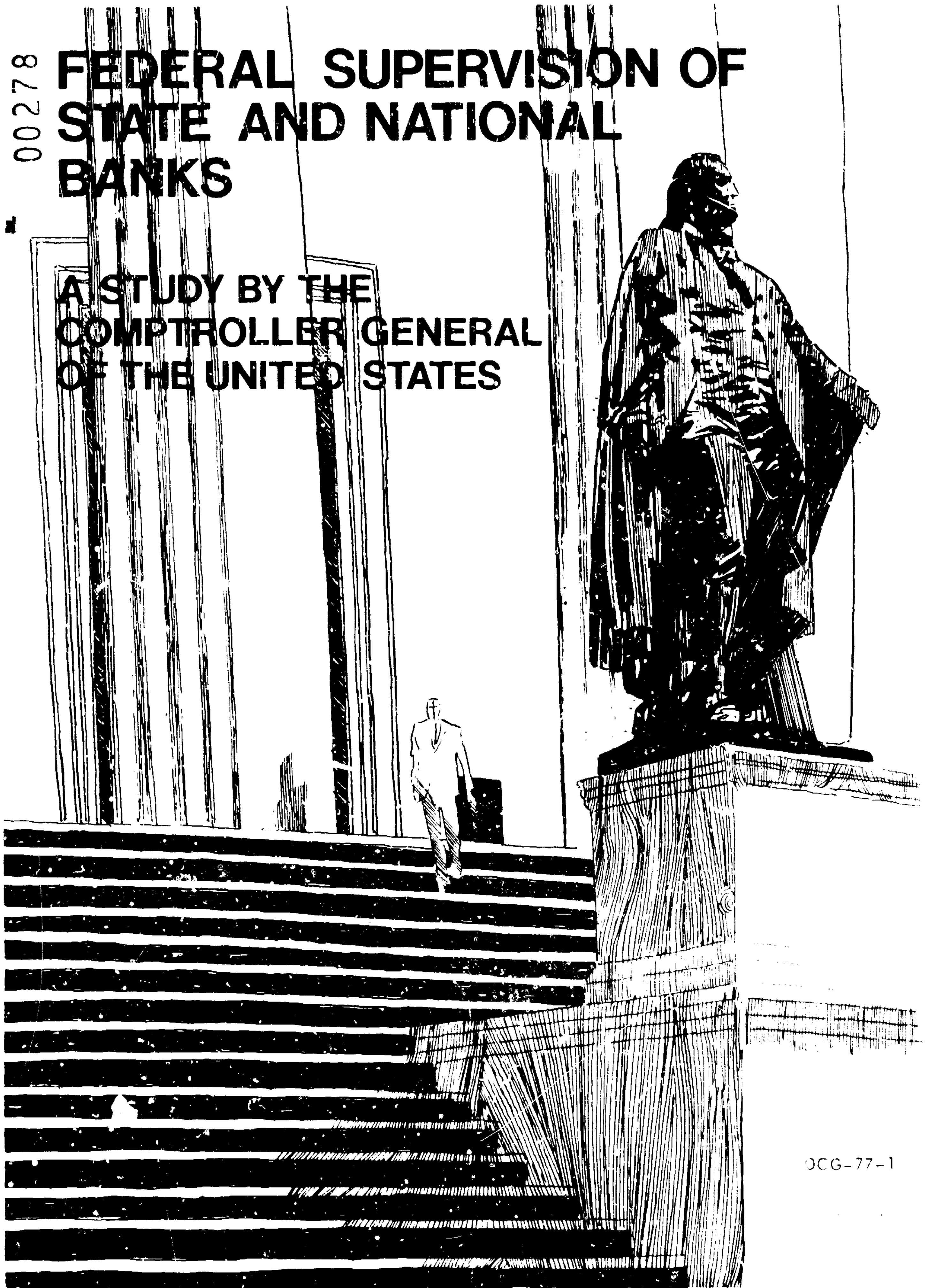
FEDERAL SUPERVISION OF STATE AND NATIONAL BANKS

A STUDY BY THE COMPTROLLER GENERAL OF THE UNITED STATES



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COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

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To the President of the Senate and the
Speaker of the House of Representatives

This report is the result of our unprecedented study of the effectiveness of State and national bank supervision by the Federal Deposit Insurance Corporation; the Federal Reserve System; and the Office of the Comptroller of the Currency, Department of the Treasury.

This study was made at the request of several congressional committees concerned over large bank failures in recent years and public disclosure that supervisory agencies' lists of "problem banks" had lengthened.

Our Office does not have legislative authority to audit the operations of the Federal Reserve System or the Comptroller of the Currency. Also, our access to the bank examination reports of the Federal Deposit Insurance Corporation has long been a matter of dispute.

In light of the heavy congressional interest in the area, the agencies allowed us to make the study. They agreed, in April 1976, to give us unlimited access to their bank examination reports and other related records, provided we would not disclose any information about specific banks, bank officers, or bank customers.

The focus of this report is on evaluating the agencies' bank examination functions and their efforts to get banks to correct problems identified. Several recommendations for improvements are made.

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The three agencies have reviewed and commented on a draft of the report. Their comments are presented, in full, as appendixes to the report. In view of the time constraints placed on us for completing and releasing the study, we have not been able to fully evaluate their comments.

In the past we have supported proposals before the Congress to give this Office continuing legislative authority to review the operations of the bank regulatory agencies and report to the Congress. With such authority, we could be more helpful to the Congress in carrying out its legislative and oversight responsibilities for bank insurance and regulation. In view of the very important part that the three agencies play in the Nation's system of money and credit, we feel that the Congress should provide for GAO audits of the agencies.

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

Comptroller General
of the United States

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ABBREVIATIONS

CSC	Civil Service Commission
EDP	Electronic data processing
FDIC	Federal Deposit Insurance Corporation
FRB	Federal Reserve bank
FRS	Federal Reserve System
GAO	General Accounting Office
NBSS	National Bank Surveillance System
OCC	Office of the Comptroller of the Currency

CHAPTER 1

INTRODUCTION

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CHAPTER 1

INTRODUCTION

PURPOSE OF THIS STUDY

The Congress is concerned with the soundness of the commercial banking system. In the past 3 years, several large U.S. banks have failed. The public has become aware that a number of major banks are on supervisory agencies' lists of problem banks 1/. The supervisory agencies' power, capability, and independence to properly supervise the banks are being questioned.

In early 1976, several congressional committees asked us to evaluate the effectiveness of the supervisory efforts of the three Federal agencies involved: Federal Deposit Insurance Corporation (FDIC); Federal Reserve System (FRS); and Office of the Comptroller of the Currency (OCC), Department of the Treasury. Specifically, the study was requested by the Chairmen of

--the House Committee on Banking, Currency and Housing;

--the Domestic Monetary Policy Subcommittee, House Committee on Banking, Currency and Housing;

--the Financial Institutions Supervision, Regulation and Insurance Subcommittee, House Committee on Banking, Currency and Housing;

--the Commerce, Consumer, and Monetary Affairs Subcommittee, House Committee on Government Operations; and

--the Senate Committee on Banking, Housing and Urban Affairs.

1/In the context of this report we use the term "problem banks" to refer to banks requiring special supervisory attention. FDIC and FRS also commonly refer to them as problem banks, but OCC considers problem banks as a portion of banks requiring special supervisory attention.

Our study was possible because the agencies granted us access to their bank examination reports and related records. We do not have statutory audit authority at FRS or OCC, and our right of access to bank examination records at FDIC has long been contested. The agencies supported our efforts and provided the cooperation essential to completing the study.

The objective of our study was to evaluate the agencies' efforts to (1) identify unsound conditions and violations of laws and regulations in banks and (2) cause bank management to take corrective actions. Our effort was directed to determining whether:

--OCC considers applications for national bank charters on a fair and consistent basis.

--Bank examinations are of sufficient scope to identify banks which are likely to run into serious managerial or financial difficulties.

--Supervisory agencies' efforts to improve their operations are satisfactory.

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

--Examiners are qualified and trained to conduct reliable bank examinations.

We reviewed examination reports and correspondence files on over 900 banks supervised by the 3 agencies. These included three sample groups:

--30 of the 42 banks which failed from 1971 to mid-1976.

--294 of 787 "problem" banks (those identified by the agencies as needing special supervision) as of December 31, 1970, and December 31, 1975.

--A general sample of 600 of the over 14,000 banks in the United States.

The scope of our study is described more fully in chapter 12.

THE BANKING INDUSTRY

About 14,700 commercial banks are chartered to do business in the United States and its possessions. Of these, about two-thirds are chartered by the 50 States and one-third by the Comptroller of the Currency.

Banks range in size from a general-store-post-office bank in the mountains of Colorado to a multibillion dollar institution with over 1,000 domestic and foreign branches. Half of the industry's assets are held by less than 200 banks.

Banking in its simplest form is a straightforward business. Funds received as deposits are invested primarily as loans to commercial and individual enterprises, and to Federal, State, and local governments. Bank profits result from investing funds at interest rates greater than the rates paid to depositors.

Banking entails risk, and these risks become greater in periods of general economic decline. To lessen the effects of possible economic declines, banks have engendered a host of strategies to reduce risks while still assuring reasonable profits. Diversifying loan and security portfolios and balancing demand and time deposits are perhaps the most basic strategies for dealing with risk.

The changing needs of consumers have also influenced the marketing strategies of banks. Today commercial banks must serve the needs of governments, multinational corporations, small businesses, farmers, and individual consumers.

Changes in the banking industry: 1971-75

During 1971-75, the commercial banking industry underwent significant change. Much of the change is reflected in the following comparative statistics for December 31, 1971 and 1975.

General Statistics

	1971	1975	Percent increase
Number of commercial banks	13,804	14,657	6
Number of large banks (assets over $100 million)	640	920	44
Number of small banks (assets under $10 million)	7,367	5,661	-23
Number of domestic branches	23,370	30,262	29
Number of bank holding companies	1,567	1,821	16
Number of multibank holding companies	177	311	76
Number of banks controlled by holding companies	2,420	3,674	52
Assets of banks controlled by holding companies (billions)	$362	$661	83
Number of foreign branches of U.S. member banks	577	762	32
Assets of foreign branches of U.S. member banks (billions)	$ 61	$176	189
Foreign loans of U.S. domestic banks (billions)	$ 27	$ 60	122

Several trends are apparent from the preceding statistical data:

--The number of banks with assets over $100 million increased 44 percent, while banks with under $10 million in assets decreased 23 percent.

--The number of banks controlled by holding companies increased 52 percent and their assets increased 83 percent.

--Assets of foreign branches of FRS member banks increased 189 percent. (Nonmember banks hold less than 1 percent of foreign branch assets.)

--Foreign loans of domestic banks and branches increased 122 percent.

The following tables describe all commercial banks, excluding their foreign operations.

Balance Sheet Data

	1971	1975	Percent increase (note a)
	(billions)		
Cash	$100	$135	35
Securities:			
Federal, State, and local government	166	222	34
Other	4	9	108
Federal funds sold	20	39	97
Loans:			
Residential real estate	57	92	62
Automobile	25	34	36
Other personal	41	59	42
Commercial and industrial	120	181	51
Banking and financial	22	42	96
Agricultural	17	26	59
Other real estate	30	53	75
All other	19	25	29
Bank premises and equipment	10	16	52
Other assets	15	42	185
Total assets	$646	$975	51
Demand deposits	$264	$326	23
Time deposits	279	467	68
Federal funds purchased	24	54	122
Other liabilities	25	49	96
Reserves for losses on loans and securities	7	9	41
Capital notes and debentures	3	5	50
Capital stock and surplus	32	43	33
Undivided profits and reserves	12	22	80
Total liabilities and capital	$646	$975	51

a/Based on amounts before rounding.

Income and Expense Data

	1971	1972	1973	1974	1975
	(billions)				
Income:					
Interest	$32	$35	$47	$61	$58
Other	5	5	6	7	9
Expenses:					
Interest	14	16	25	35	30
Compensation	8	9	10	12	13
Provision for losses	1	1	1	2	4
Other	7	7	8	10	11
Income taxes	2	2	2	2	2
Net income	$ 5	$ 5	$ 7	$ 7	$ 7

	1971	1972	1973	1974	1975
Dividends paid	$2.23	$2.20	$2.43	$2.77	$3.03

	1971	1972	1973	1974	1975
Losses charged to reserves	$1.41	$1.26	$1.55	$2.42	$3.80
Recoveries credited to reserves	-.32	-.37	-.39	-.46	-.55
Net loan and securities losses	$1.09	$0.89	$1.16	$1.96	$3.25

From our analysis of the financial data, the following observations can be made about the banking industry:

--Total assets of the commercial banking industry grew by over 50 percent. The number of banks increased only 6 percent.

--Less than 19 percent of the asset growth was financed by demand deposits (checking accounts), while 74 percent came from more costly time deposits (such as savings certificates) and borrowings. (The remaining 7 percent came from an increase in capital.)

--Loans secured by residential and other real estate increased over 66 percent.

--Other assets increased 185 percent. Included were real estate holdings resulting from foreclosures, or taken in lieu of foreclosure, which increased 380 percent, (from $0.4 billion in 1971 to $1.9 billion in 1975).

--Reserves for potential losses on loans and securities increased 41 percent, 7 percentage points less than the overall growth in loans and securities.

--Total capital increased 46 percent. Approximately half of the growth was the result of profits being retained; half, the result of new capital being added.

--Capital declined slightly in proportion to assets, from 8.36 percent in 1971 to 8.10 percent in 1975.

--The relationship of profits to assets also declined slightly (from 0.77 to 0.72 percent).

--Income and expenses for 1975 were about 82 percent greater than for 1971, due mostly to the rise in interest rates.

--Net losses from loans and securities for 1975 were approximately 200 percent greater than for 1971.

GOVERNMENT INVOLVEMENT IN BANKING--A HISTORICAL PERSPECTIVE

Government involvement in the American banking industry has consisted of recurring attempts to balance the need for healthy competition among banks with the need for a sound banking system. As history shows, these objectives are not easily reconcilable. Attempts to balance them have led to a banking system which is unique in the contemporary world; Government involvement in the Nation's 14,700 commercial banks is dispersed among 50 States and 3 Federal agencies.

The historical path to the present system followed three stages of governmental supervision: involvement initially by both Federal and State governments, then by State governments alone, and again by both levels of government.

Initial Federal and State involvement

The first bank in the United States--the Bank of Pennsylvania--was chartered in 1781 by the Continental Congress. Until 1790 there were only three commercial banks in the country--the Bank of North America (successor to Bank of Pennsylvania), which held both Federal and State charters, and two other State-chartered institutions.

In chartering the first "Bank of the United States" in 1791 and the second "Bank of the United States" in 1816, the Congress attempted to establish a "central" bank to regulate the money supply in the economy. Both banks were chartered for a specific time period and, although both banks were considered successful, their charters were not renewed for political reasons.

President Jackson's veto of its application for charter renewal in 1836 closed the second Bank of the United States and temporarily resolved two controversies--should the Federal Government charter banks, and should it regulate the money supply?

State involvement only

From the demise of the second Bank of the United States until 1863, State governments chartered banks. The Federal Government made no attempt to regulate the supply of State-bank-issued promissory notes. The Federal Government from 1836 to 1863 was out of the banking business.

With the demise of the second Bank of the United States, the era of "wild cat" banking began, under State banking laws which were often rather lax. The number of State banks grew from only 88 in 1811, to 713 in 1836, to 1,466 in 1863.

The price of increased competition was the disruptive effect of numerous bank failures. The resulting instability in the banking system led for a time to a complete ban on banking in some of the States.

During that period, entry into banking was regulated by charters granted by State legislatures. To get a charter, one needed a majority vote in the legislature.

Such "political" chartering was opposed by proponents of "free" chartering; they favored entry for anyone who could meet certain objective criteria specified by statute. The New York "Free Bank Act" of 1838 was the pioneer; it specified less subjective requirements for acquiring a bank charter. Similar free-banking laws were enacted by other States.

Reemergence of Federal involvement

The return of the Federal Government to banking supervision came in three major steps: the National Currency Act of 1863 (superseded by the National Bank Act of 1864) which created OCC; the Federal Reserve Act of 1913 which created FRS; and the Banking Act of 1933 which created FDIC.

Under the 1863 act, the Federal Government again became involved in bank chartering. The act created a new type of bank--a national bank. This bank could issue its own bank notes secured by Federal bonds. The act also created a "Comptroller of the Currency," with authority to charter and supervise national banks.

In many respects, the act extended the basic concepts of the various State free-banking acts to a national scale. National banks offer an additional avenue of entry for persons unable to secure State charters. The effect of the act was to increase competition.

While some may have intended that national banks would supplant State banks, the actual result was a dual Federal-State banking system. Attempts to force State banks to convert to national banks by taxing State bank notes reduced

the number of State banks from 1,089 in 1864 to 325 in 1870. Eventually, however, the tax caused the elimination of State bank notes, but not State banks.

The advent of deposit banking (use of checking accounts) and the realization that less stringent State laws gave State banks a competitive advantage over national banks stimulated State banking. By 1892 State banks had increased to 3,773--outnumbering national banks, which they have continued to do, although for many years after 1892 and consistently since the bank moratorium of 1933, total assets of national banks have exceeded those of State chartered banks.

With the Federal Reserve Act of 1913, the balance between competition and soundness was struck differently. Central banking powers of the Federal Government were reconstituted, but dispersed in a system of 12 Federal Reserve banks administered by a 7-member Federal Reserve Board While national banks automatically became members of the new Reserve System, State banks had to apply for membership. Supervision of State member banks by the Board presumably increased State bank soundness through reserve and other requirements.

The Banking Act of 1933 which established FDIC, increased Federal involvement in banking. Bank soundness was promoted because the Federal Government would now supervise those State banks which were not in the Reserve System and which subscribed to the Federal insurance program.

Except for 286 State banks not covered by Federal Deposit Insurance, all commercial banks were supervised by one of the three Federal agencies at the end of 1976.

The bankers' view of Federal supervision

As the historical record shows, banks in the United States have always been regulated by some level of government. At a minimum, establishing a bank has always depended on a government "blessing" in the form of a charter. The power to grant a charter carries with it the inherent power to revoke it. Further, the authority to charter establishes, ipso facto, a government interest in the soundness of the chartered entity. Protection of this interest has led, historically, to bank supervision.

Chartering, examination, and followup actions are central aspects of the State and Federal Government relationship to commercial banks.

Bankers, responding to our survey 1/, endorsed government intervention in the banking industry. Almost 90 percent indicated that "elimination of bank regulation entirely" would be, to some degree, "detrimental." Other aspects of Government intervention received similar endorsements. For example

--70 percent felt elimination of Federal chartering would be detrimental,

--72 percent felt elimination of State chartering would be detrimental, and

--88 percent felt elimination of bank examinations would be detrimental.

Approximately 80 percent of bankers responding to our questionnaire opposed any bank regulatory arrangement which did not include States. Bankers clearly favored the dual banking system over a solely Federal system.

REGULATION AND SUPERVISION OF BANKS TODAY

Government regulation is one of the strongest influences on the banking industry today. The primary regulators are the States and the three Federal agencies--FDIC, FRS, and OCC.

The Federal agencies, as well as agencies in 50 States, all have some responsibility for bank regulation (the process of interpreting banking legislation and issuing rules and regulations for the banks) and bank supervision (the process of monitoring, examining, and advising individual banks).

The Federal agencies influence the structure and operation of commercial banks by granting national bank charters, FRS membership, and FDIC insurance and by approving bank holding companies, foreign branches, and other bank structural changes.

1/Our survey of commercial bankers is described on page 12-6, and the results of the survey are summarized in appendix IV.

All banks--both State and national--are also influenced to some extent by State law. Most noteworthy are State laws which govern trust operations and branching. Twenty States permit statewide branching; 18 States permit limited forms of branch banking; and 12 States require unit banking.

Individual State laws on the formation of bank holding companies also influence the structure of the banking industry. In 8 of the 12 unit-banking States, holding companies may own more than one bank. The result is that very few States can be considered true unit-banking States. Only Illinois, Kansas, Nebraska, and Oklahoma are fairly consistent in prohibiting branches (except auxiliary teller facilities) as well as multibank holding companies.

Some of the important regulations issued and administered by the Federal agencies are in the following areas:

--Equal credit opportunity.

--Standards for security devices and procedures.

--Interest on deposits.

--Securities issuance.

--Bank holding companies.

--Interlocking relationships.

--Truth in lending.

--Fair credit reporting.

--Home mortgage disclosure.

The process of promulgating a regulation is much the same at each agency. Briefly, it entails determining the need for a regulation, drafting it, publicizing it, receiving comments on it, revising it, and issuing it. Need may be determined as the result of new legislation, or it may arise from changing circumstances or the desire to correct an abuse which has surfaced during bank examination. Regulations are proposed and issued in the Federal Register.

The agencies' responsibilities and finances

FDIC, FRS and OCC have similar supervisory responsibilities. Their structure is also similar, however, FRS is less centralized. The agencies receive no congressional appropriations, but rely essentially on the banks they supervise and their investments in U.S. Government securities for operating funds.

Federal Deposit Insurance Corporation

The Federal Deposit Insurance Corporation was created June 16 1933, under the authority contained in the Banking Act of 1933 (48 Stat. 168; 12 U.S.C. 1811). The act established FDIC, as an independent Government corporation, to insure small depositors against losses resulting from bank failures. FDIC is authorized to:

--Approve or deny a bank's application for deposit insurance currently of up to $40,000 for each private depositor and up to $100,000 for savings and time deposit accounts of Federal, State, and local governments. National banks and State banks that belong to FRS receive FDIC insurance with their charters and do not require FDIC approval.

--Approve or deny applications for structural and other changes, such as branches, mergers, and relocation of State nonmember insured banks.

--Act as receiver for closed insured banks.

--Operate special "deposit insurance national banks" for up to 2 years to provide limited banking services to communities where banks have closed.

--Purchase assets from, make deposits in, or extend loans to, insured banks which have closed or are in danger of closing.

--Administer securities registration requirements (under the Securities Exchange Act of 1934) that apply to State banks not belonging to FRS.

--Supervise State nonmember insured banks and their affiliates by surveillance, examination, and enforcement activities.

In 1975, 40 percent of FDIC's revenue came from premium assessments; the remaining 60 percent came from investments of the Deposit Insurance Fund in U.S. Government securities. Net income amounted to $592 million in 1975. The fund comprises FDIC's accumulated net income since inception. As of December 31, 1975, it amounted to $6.7 billion, or 1.18 percent of the insured deposits at 14,714 banks. In the event the fund should prove inadequate, FDIC can borrow an additional $3 billion from the U.S. Treasury.

Federal Reserve System

The Federal Reserve System was created on December 23, 1913, by the Federal Reserve Act (38 Stat. 251; 12 U.S.C. 221). The act established Federal Reserve banks, supervised by a Board of Governors to carry out monetary policy and improve the supervision of banking in the United States, as well as provide various central banking services for banks and the U.S. Government. FRS has been entrusted with many supervisory and regulatory functions:

--Approving or denying various applications, such as for branches, mergers, bank holding companies, capital stock or debenture issues, and membership in FRS.

--Determining margin requirements, i.e., the amount of credit that may be extended to purchase or hold equity securities.

--Establishing maximum interest rates that member banks may pay on savings and time deposits.

--Regulating the foreign activities of all member banks.

--Regulating the activity of bank holding companies.

--Administering securities registration requirements (under the Securities Exchange Act of 1934) that apply to State member banks.

--Establishing rules for all lenders of consumer credit to disclose interest on loans and terms of repayment ("truth in lending").

--Examining State member banks, bank holding companies and their nonbank subsidiaries, and Edge Act and agreement corporations.

FRS is financed mainly by interest on its holdings of U.S. Government securities, which it acquires in the process of creating bank reserves. After FRS operations have been financed, interest left over is returned to the Treasury. FRS does not exercise its authority to charge banks for examinations.

Office of the Comptroller of the Currency

The Office of the Comptroller of the Currency was established by the National Bank Act of 1864 (12 Stat. 665 (1863), as superceded by 13 Stat. 99 (1864)). The act provides that national banks be chartered which will operate soundly and fulfill the public need for commercial banking services.

As the administrator of the national banking system, the Comptroller:

--Approves or disapproves structural changes in the system, including applications to (1) organize new national banks, (2) establish branches of existing national banks, (3) merge or consolidate banks into national banks, and (4) relocate national bank offices.

--Determines when national banks become insolvent and appoints FDIC as the receiver for closed banks.

--Issues rules and regulations governing the corporate structure of national banks and their lending and investment practices.

--Administers securities registration requirements (under the Securities Exchange Act of 1934) that apply to national banks.

--Examines each national bank periodically to ascertain if it is being operated soundly and in accordance with Federal statutes. Each bank is required by statute to be examined twice each calendar year, except that one examination may be waived every 2 years.

About 88 percent of OCC's $59 million income in 1975 came from semiannual assessments against national banks; 7 percent from charges for special examinations and investigations; and 5 percent from investments and other sources.

The cost of Federal bank supervision

Salaries and travel account for most of the agencies' bank supervision costs. Their 1975 costs follow:

	FDIC	FRS	OCC
Number of bank examiners	1,700	700	2,000
1975 cost (millions)	$68a/	$22b/	$69

a/Includes supervision of mutual savings banks which accounts for approximately 8-10 percent of FDIC's bank supervision costs. (FDIC is the only Federal supervisor of mutual savings banks.)

b/Estimated cost of bank supervision and regulation, exclusive of occupancy and other indirect costs not allocated by the district banks. These functions account for about 3 percent of FRS total operating costs.

CHAPTER 2

ENTRY INTO THE NATIONAL BANKING SYSTEM

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CHAPTER 2

ENTRY INTO THE NATIONAL BANKING SYSTEM

OVERVIEW

The Comptroller of the Currency must approve the formation of all national banks and, thus, entry into the national banking system. This chartering responsibility is one of the Comptroller's major functions. The chartering process is intended to provide a sound national banking system without unduly restricting entry into that system. Thus, under present law, the Comptroller is vested with a great public trust. Through his decisions on chartering, he plays a vital role in structuring banking markets.

To instill the fullest public confidence in the chartering of national banks, the Comptroller needs to develop more definitive criteria and provide better documentation for his decisions to approve or disapprove applications for bank charters.

National charters may be granted to groups of organizers seeking to form new banking associations or to operating State banks seeking to convert to national banks. (See ch. 3.) OCC's goal, as stated in its recent policy statements, is to insure a healthy, competitive banking system that offers the public maximum convenience and choice and stimulates economic growth and efficiency. It is OCC's policy to charter only banks which can be economically supported and profitably operated.

From January 1, 1970, to April 30, 1976, OCC considered 865 applications for establishing new banks. As shown below, the Comptroller approved 57 percent of the applications.

Decisions on New Bank Applications

Year	Approved Number	Approved Percent	Rejected Number	Rejected Percent	Total
1970	42	48	46	52	88
1971	55	50	54	50	109
1972	84	58	60	42	144
1973	134	66	68	34	202
1974	92	57	70	43	162
1975	70	53	61	47	131
1976	13	45	16	55	29
	490	57	375	43	865

In evaluating a charter application, OCC primarily considers the proposed bank's capital structure, future earnings and management, and the convenience and needs of persons in the area to be served. State banking authorities consider similar factors.

Under OCC's application review process, five individuals independently review applications and make recommendations to the Comptroller, who decides whether to approve or reject an application.

The agency, however, has few definitive criteria for evaluating applications. The policies established on November 1, 1976, prescribe essentially general criteria. Definitive criteria were provided to measure only one factor that the agency considers--capital structure. Considerations of charter applications are highly judgmental, and OCC reviewers often had different opinions of the action that should be taken on individual applications.

Furthermore, OCC reviewers about half the time did not clearly indicate which factors they considered favorable and which unfavorable. The Comptroller himself rarely stated why he approved or disapproved a charter application. Under new policies established in November 1976, OCC will in the future furnish disapproved applicants a written statement of the reasons for disapprovals.

In ruling on the applications we reviewed, the Comptroller apparently relied on what the majority of his five reviewers recommended. The lack of definitive criteria and complete documentation for the decisionmaking process prevents us from evaluating whether OCC has considered applications fairly and consistently.

On the basis of a 1975 study conducted under its auspices, the Administrative Conference of the United States proposed that OCC state its policy objectives and decision standards so that cases could be understood and evaluated on their merits. The Conference recommended that OCC (1) fully state its objectives in approving or denying applications and (2) concretely define the standards to be applied.

The Conference said its recommendations for policies and standards did not result from any trend of public dissatisfaction, but rather from a general distrust of decisionmaking based on undefined discretion. In its March 1976 report, the Conference stated:

--The statutes governing approval of entry into banking contain sketchy or no standards defining how the agencies should exercise judgment.

--The agency has not filled this statutory void with comprehensive policy statements or meaningful rules of general applicability.

OCC has recently taken several actions to improve the processing of applications and to make charter decisions more consistent. Even with these changes, however, we believe that more definitive criteria and documentation are still needed.

THE SURVIVAL PATTERN OF NATIONAL BANKS

On the premise that banks which continue to operate for several years after chartering are evidence of the effectiveness of the chartering process, we collected data on:

--How many new national banks were chartered during the 15-year period, January 1958 through December 1972?

--How many of these banks were no longer operating as national banks on April 30, 1976?

--What happened to the banks which were no longer national banks?

indicated in the following table, most national banks chartered over this 15-year period are still operating as individual national banks.

National Banks Chartered 1958-72

Year charter granted	No. of new charters (note a)	No longer national banks: Number	No longer national banks: Percent	Conversions: Number	Conversions: Percent of total charters	Mergers: Number	Mergers: Percent of total charters	Voluntary liquidations: Number	Voluntary liquidations: Percent of total charters	Insolvencies: Number	Insolvencies: Percent of total charters
1958	18	4	22	2	11	2	11	-	-	-	-
1959	24	5	21	2	8	2	8	1	4	-	-
1960	34	5	15	3	9	1	3	1	3	-	-
1961	25	6	24	2	8	4	16	-	-	-	-
1962	67	16	24	4	6	11	16	-	-	1	1
1963	163	35	21	16	10	12	7	6	4	1	-
1964	202	61	30	20	10	28	14	12	6	1	-
1965	78	18	23	4	5	8	10	6	8	-	-
1966	23	2	9	1	4	1	4	-	-	-	-
1967	15	2	13	1	7	-	-	1	7	-	-
1968	16	2	12	-	-	1	6	-	-	1	6
1969	16	-	--	-	-	-	-	-	-	-	-
1970	40	4	10	1	2	1	2	2	5	-	-
1971	39	3	8	-	-	2	5	-	-	1	3
1972	53	9	17	1	2	7	13	1	2	-	-
Total	813	172	21	57	7	80	10	30	4	5	1

a/ The number of new charters issued in a year does not equal the number of charter applications approved in that year because of the organization period between approval and issuance of a charter.

Of the 813 new banks chartered during 1958-72, 172, or 21 percent, were no longer operating as individual national banks at the end of April 1976. However, about 76 percent of these operated for 3 or more years before ceasing to operate as national banks. Thus, of the 813 newly chartered banks, only 5 percent did not survive as national banks for at least 3 years.

Of the 172 which were no longer operating at April 30, 1976, 80 had merged with other banks, 57 had converted to a State charter, 30 were voluntarily liquidated, and 5 were declared insolvent. Thus, of the 813 banks chartered during the 15-year period, less than 1 percent ceased operations because they were declared insolvent.

The survival rate of national banks in this period is almost the same as the rate noted in a similar analysis of a sample of national and State banks chartered between 1948 and 1966.1/

Exits from the national banking system cannot always be considered a sign of weak operations or poor chartering decisions. For example, many banks converting to a State charter may still be operating as sound State banks. On the other hand, the mergers and voluntary liquidations may have occurred because of normal market changes in local banking structure or because of banks' incapability of continuing to operate. For the 14 percent that merged or were liquidated, we did not attempt to determine whether exits were actually voluntary or forced by financial difficulty.

Nevertheless, national banks' high rate of survival indicates that OCC has at least tended to charter banks that can be economically supported.

OCC'S CHARTERING CRITERIA AND PROCEDURES

The National Bank Act (12 U.S.C. 21-27) provides OCC's chartering authority and requires the Comptroller to base his charter decision on facts reported in the application and

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1/ Alhadeff, David A. and Charlotte P. "Growth and Survival Patterns of New Banks, 1948-70," Journal of Money, Banking and Credit, May 1976.

"any other facts which may come to [his] knowledge * * * whether by means of a special commission appointed by him for the purpose of inquiring into the condition of such association, or otherwise."

The act specifies the minimum number of persons needed to organize a national bank (five) and the minimum amount of initial capital required in a city of a given population. The Comptroller, however, requires substantially more capital than the legal minimum. OCC will normally not approve an application to organize a national bank with less than $1 million initial capital. The National Bank Act provides no other criteria for the Comptroller to consider in acting on charter applications. According to OCC regulations, the Comptroller may conduct investigations of applicants as he deems necessary or proper.

The Federal Deposit Insurance Act (12 U.S.C. 1816) gives OCC additional chartering guidance. Because national banks are required to have deposit insurance, before granting a charter the Comptroller must certify to FDIC that he has considered the following factors: (1) the bank's financial history and condition, (2) its capital structure, (3) its future earnings prospects, (4) the general character of its management, (5) the convenience and needs of the community it is to serve, and (6) whether its corporate powers are consistent with the purpose of the act.

OCC has assigned to its regional offices the primary responsibility for reviewing and processing charter applications. Potential applicants usually discuss their proposal with a regional administrator. After the regional office accepts an application and the information the applicant supplied to support the proposal, the applicants publish a notice of filing in a newspaper of general circulation. The regional administrator advises area banks and other bank regulatory agencies of the filing and assigns an examiner to conduct a field investigation.

The examiner visits the proposed bank site and interviews the applicants, who are called organizers. Also, the examiner usually confers with opponents to the application and local business and professional persons. With the information developed, the examiner evaluates the data furnished by the organizers and prepares a report of the investigation.

The examiner's report provides the essential information for evaluating a charter application. The examiner answers questions such as:

--Is the strength of management adequate?

--Is the proposed capital structure adequate for the estimated volume and character of operations?

--Is there a public need for the proposed bank, or do existing banks and branches serve the area reasonably well?

--Is it reasonable to expect that the available banking business will be adequate to support the proposed bank, together with existing competitive banks and branches, or will an "overbanked" situation be created?

--Are the applicant's 3-year estimates of income and expenses reasonable?

In the report the examiner summarizes his or her findings in an unstructured narrative format and recommends approval or disapproval of the application. The regional administrator also writes in narrative form his or her conclusions and makes a recommendation.

The information gathered at the regional level, plus the two staff recommendations, are forwarded to OCC headquarters. At the time of our review, the director of the Bank Organization Division and a senior economist also evaluated the application, wrote brief remarks, and recommended approval or disapproval. The deputy comptroller responsible for new charters usually wrote a memorandum setting forth his comments on capital, management, convenience and needs, and competitive factors. Finally, the Comptroller reviewed the file and approved or rejected the application, usually without written comment.

If the application was approved, the organizers were usually allowed 1 year (now 18 months) to incorporate the bank; that is, complete the sale of stock, acquire a building, and hire officers acceptable to OCC. When the bank is ready to open, the Comptroller issues a charter certificate authorizing the bank to begin business.

CHARTERING BY STATE BANKING AUTHORITIES

The 50 States also have authority to charter new banks. The States have vested their chartering authority in a State supervisor (29 States), a banking board (14), or a combination of the two (4); a commission (2); or a board of trust (1).

To gather information on State chartering criteria, policies, and procedures, we contacted all State bank supervisors in July 1976. Of the 24 State bank supervisors responding, 15 said that they investigate the same factors as OCC: the proposed bank's capital structure, its earnings prospects, the convenience and needs of its community, and the general character and the banking ability of its organizers and prospective directors. The remaining nine State supervisors who responded investigate at least three of the same factors.

The majority of the States responding also said that State statutes set forth the factors used to evaluate charter applications. Some indicated that to receive a charter, applicants must satisfy all criteria.

Unlike OCC, however, most States require, either by statute or as a matter of practice, a public hearing before they take final action on charter applications. The Comptroller conducts public hearings for national bank applications only if he considers it necessary or an opponent to the application requests it.

Of the 24 States responding, 14 also provided information on the standards used to evaluate the factors they consider. For the most part, the information provided translates into general criteria similar to that OCC uses.

ADEQUACY OF OCC'S CHARTERING CRITERIA AND PROCEDURES

To assess OCC's fairness and consistency in evaluating applications for new bank charters, we randomly selected 50 of the applications approved and 25 of the applications rejected by the Comptroller from January 1, 1974, through April 30, 1976. 1/ More than half of the 75 applications were received from applicants in 3 States--Florida (20), Texas (14), and Illinois (5). These three are "unit-banking" States which prohibit branch banking; therefore, new banking offices require new bank charters.

We could not judge OCC's fairness and consistency, because:

--OCC has few definitive criteria for its staff to use in evaluating applications.

--Considerations of charter applications are highly judgmental, and there were differences of opinion by OCC reviewers regarding the action that should be taken on individual applications.

--OCC reviewers about half the time did not clearly indicate which factors were considered favorable and which unfavorable.

--The Comptroller rarely documented the basis for his final decision on charter applications.

The professional judgment of the examiner and the other four reviewers was a key factor in considering charter applications. But the reviewers generally did not (1) document in the files the degree to which the various factors were considered or (2) clearly indicate whether they considered individual factors favorable or unfavorable. The form used by the three headquarters reviewers provided for each to state whether capital, earnings, management, and

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1/Of the 75 applications, 12 were reconsiderations, that is, applications considered and acted on by the Comptroller more than once. Reconsiderations are initiated by previously rejected applicants. The Comptroller ruled twice on 11 cases and thrice on 1 case. Therefore, our review actually included 88 charter decisions for 75 banks.

"convenience and needs" were adequate or inadequate. The reviewers did not, for the most part, provide this information. When an application reached the Comptroller for his final decision, he usually had a recommendation from each of the five reviewers. He documented the reasons for his decisions in only 7 of the 88 cases we reviewed.

Selected cases shown below illustrate the diversity of reviewers' opinions on specific applications. Throughout this report black borders have been put around case studies to distinguish them from the text of the report.

Case 1

Examiner--Recommended disapproval because of the lack of demonstrated need and the potential to damage existing banks in the area.

Regional administrator--Recommended disapproval because there was little reason to believe that the banking needs of the public were not being met fully, effectively, and on a strongly competitive basis. The prospects for the proposed bank, in this atmosphere and under the guidance of an inexperienced board of directors, would be uncertain at best.

Director, Bank Organization Division--Recommended disapproval because he thought that there was no real public need for another bank in this market.

Economist--Recommended approval because the proposed bank would probably be a marginally successful entry into a highly competitive market. However, the bank would not be a serious competitor for some time, and this new entry through the addition of competition could accentuate the problems of three local banks.

Deputy Comptroller--Recommended disapproval because even though the new bank would bring competition of a certain type to this market and provide another choice of banking for the public, the application was marginal insofar as the directorate's net worth and business representation were concerned.

The Comptroller approved the application, stating that the new bank could be justified on competitive grounds.

Case 2

Examiner--Recommended approval because even though there did not appear to be a strong need for a new bank, it was believed that applicant's loan and deposit projections were attainable and that profitable and successful operations could be achieved without providing detrimental competition to any existing banks.

Regional Administrator--Recommended approval because "* * *applicant does not contend that existing banking offices are not adequately serving the banking needs of the public." Rather the applicant intended to provide the service area with a new competitive banking unit. Further, a sampling of local public opinion indicated moderate support for the bank, and it should not have a serious adverse affect on existing banks.

Director, Bank Organization Division--Recommended disapproval because sufficient banking alternatives already provided adequate service. Also, there was no strong public support and the record showed no need.

Economist--Recommended approval because the area, while served by established banks, would probably support the proposed bank and the bank would provide modest competitive benefits.

Deputy Comptroller--Recommended disapproval because, although from the competitive standpoint it was possible this group could inject healthy competition in this market, there were a number of alternative banking offices and the convenience factor was minimal. He concluded that, on balance, a strong case was not made for this bank.

The Comptroller disapproved this application. He did not document the basis for his decision.

Case 3

Examiner--Recommended approval because it would appear that the needs of the community might be better served by a bank based on the concept of concentrating on new or growing small or medium-sized business. He commented that it would be difficult to visualize this group of organizers falling short of any goal they set for themselves.

Regional Administrator--Recommended disapproval because, although he agreed with the examiner that the proposed bank would ultimately achieve satisfactory operations, he was unable to conclude that there was a distinct unfulfilled public interest or need. Also, he thought that the banking record of about half of the proposed directorate, plus the competition in the area, suggested that the ultimate future of the bank would be a sale to a bank holding company. The application was predicated on this speculation, and it would not serve any particular public interest.

Director, Bank Organization Division--Recommended approval because (1) the proposed directorate was strong, (2) area banks were well established and had performed well, and (3) no real arm would be done to existing banks.

Economist--Recommended approval because he thought (1) there was room for another bank, (2) it would provide convenience to the public, and (3) the proposed directorate appeared strong enough to ensure success.

Deputy Comptroller--Recommended approval because he thought that the business and professional market was sufficient to provide a profit, and it would provide healthy competition in the area.

The Comptroller approved the application without comment.

Case 4

Examiner--Recommended disapproval. He stated that, although the area was experiencing economic growth and the population was increasing, relatively little development had actually begun, and the application was premature. He said also that there was no real need for a new bank at that time, as the other area banks serviced the community well.

Regional Administrator--Recommended approval because there was a reasonable public need for the bank in the future, even though he thought the application might be slightly premature. The new bank would provide healthy competition; public opinion slightly favored the need for another bank; and a fair degree of usage was indicated.

Director, Bank Organization Division--Recommended disapproval because (1) during the last year the existing local bank recorded no asset growth, (2) public reaction was mixed, and (3) no strong case had been made for added competition or service.

Economist--Recommended approval because, although the community offered a limited opportunity at that time, its proximity to the city had produced modest growth which was likely to continue. Further, there was considerable evidence that the local bank was not meeting the needs of the community. The competitive factors, convenience and needs, and holding company affiliation were favorable.

Deputy Comptroller--Recommended approval because the new bank would bring healthy competition and there appeared to be an adequate base to support this new entry.

The Comptroller approved the application without written comments.

As can be seen, the staff members based their recommendations on whatever factors they thought relevant. The application review process lacked uniformity, and differences in reviewers' opinions were left unresolved.

How did the Comptroller decide?

Judging from written comments by the five staff reviewers, approval of applications appeared to have been mainly related to the "convenience and needs" factor, broadly interpreted to include need for competition, new or better services, or service to a special clientele. Rejections included in our sample seemed to be based largely on lack of need for a new bank or on expectations of newly approved State banks opening in the community.

As previously mentioned, the Comptroller rarely documented why he approved or disapproved a charter application. He apparently relied on what the majority of his five reviewers recommended. OCC officials told us, however, that the Comptroller considers staff recommendations on charter applications as advisory because he alone has the legal power to approve or reject a charter application.

The following table shows that the Comptroller agreed with all five staff members in 44 percent of the cases we reviewed and with the majority of his staff in 91 percent of the cases.

Extent of Staff Agreement With the Comptroller's Charter Decisions

Staff recommendations against Comptroller's eventual decision	Total	Percent
None	39	44
One	28	32
Two	13	15
Three	3	4
Four	4	4
Five	1	1
	88	100

The Comptroller disagreed with his regional office staff--the examiners and regional administrators--more often than with his headquarters staff. The table below notes the frequency with which the Comptroller disagreed with the recommendations of each of the reviewers.

Staff Recommendations Compared to the Comptroller's Charter Decision

Staff member	Number of recommendations	Recommendations contrary to final decision	Percent of disagreement
Examiner	85	25	29
Regional administrator	88	21	24
Director, Bank Organization Division	85	10	12
Economist	85	16	19
Deputy comptroller	86	12	14

In some cases there was considerable disagreement among reviewers. The Comptroller, as shown above, disagreed with the examiner's recommendations in 25 cases and the regional administrator's in 21. However, only 8 of the regional administrator's cases of disagreement with the Comptroller are included in the examiner's 25. Likewise, when the Director of the Bank Organization Division, the economist, and the deputy comptroller disagreed with the Comptroller, those cases were not complete subsets of the examiner disagreements. The following tables illustrate the extent of staff disagreement on cases where the Comptroller disagreed with more than one staff member. The tables further illustrate that for the 12 applications which the Comptroller approved, he tended to agree with the majority of the reviewers more so than he did when he rejected applications.

Extent of Staff Disagreement on Approved Applications
(note a)

Case number	Examiner	Regional administrator	Director, Bank Organization Division	Economist	Deputy comptroller	Comptroller
1	Reject	Reject	Reject	Reject	Reject	Approve
2	Reject	Reject	Reject	Reject	Approve	Approve
3	Reject	Reject	Reject	Approve	Reject	Approve
4	Reject	Reject	Approve	Approve	Approve	Approve
5	Reject	Approve	Reject	Approve	Approve	Approve
6	Reject	Approve	Approve	Approve	Reject	Approve
7	Reject	Approve	Approve	Approve	Reject	Approve
8	Approve	Reject	Reject	Reject	Approve	Approve
9	Approve	Approve	Reject	Reject	Approve	Approve
10	Approve	Approve	Reject	Reject	Approve	Approve
11	Approve	Approve	Approve	Reject	Reject	Approve
12	Approve	Approve	Approve	Reject	Reject	Approve

a/ For 18 applications only 1 staff member made a recommendation contrary to the Comptroller's charter decision. The examiner accounted for 8 of them; the regional administrator, 6; the economist, 2; and the deputy comptroller, 2.

Extent of Staff Disagreement on Rejected Applications
(note a)

Case number	Examiner	Regional administrator	Director, Bank Organization Division	Economist	Deputy comptroller	Comptroller
1	Approve	Approve	Reject	Approve	Approve	Reject
2	Approve	Approve	Approve	Reject	Reject	Reject
3	Approve	Approve	Reject	Approve	Reject	Reject
4	Approve	Approve	Reject	Reject	Reject	Reject
5	Approve	Reject	Approve	Reject	Reject	Reject
6	Reject	Approve	Reject	Approve	Reject	Reject
7	Reject	Approve	Reject	Approve	Reject	Reject
8	Reject	Approve	Reject	Approve	Reject	Reject
9	Reject	Approve	Approve	Approve	Approve	Reject

a/ For 10 applications only 1 staff member made a recommendation contrary to the Comptroller's charter decision. The examiner accounted for 5 of them; the regional administrator, 2; the economist, 1; and the deputy comptroller, 2.

Haskins & Sells study noted similar weaknesses

A May 1975 Haskins & Sells report noted that OCC lacked formal guidelines for processing applications and making decisions. The report states:

> "Past practice, precedent, and policies of the present Comptroller as interpreted by key staff provide the informal guidelines on which the OCC functions. The result is considerable flexibility in the making of decisions on specific applications * * *. Policy thus tends to be formulated on an ad hoc basis and the decisionmaking process is affected by some uncertainty about the factors on which a decision will turn." (Underscoring supplied.)

The public accounting firm recommended that OCC write (1) policy statements setting forth the conditions under which applications will be received and considered and (2) decision guidelines setting forth the specific factors to be considered in the decision process. Haskins & Sells proposed that the pertinent factors be grouped into three categories: (1) major factors for which a negative finding on any one factor would ordinarily result in rejecting the application, (2) factors for which a negative finding on one or more factors would not necessarily result in rejection but which would need to be weighed in the aggregate, and (3) factors which may significantly benefit the public.

In response to the Haskins & Sells recommendations, OCC issued policy statements on November 1, 1976. The statements include decision guidelines, but no grouping of factors as recommended. OCC officials said groups of pertinent factors would not be applicable to every possible market situation and hence to every application considered. OCC's policy statements do provide, however, that when a charter application is rejected, the applicant will be furnished a written statement of the reasons for rejection.

In response to other Haskins & Sells recommendations, OCC took further actions which should help standardize the review process and provide a better documented record:

--In February 1976, OCC reorganized the headquarters division responsible for reviewing charter applications. To supplement the regional offices' evaluation of applications, staff reviewers of the newly organized Bank Organization and Structure Division are required to comment on capital, management, competition, and the market area.

--A new investigation report form was instituted in November 1976 for regional office reviewers. The comments, conclusions, and recommendations section provides space for specific comments by the examiner and regional administrator on the factors involved in arriving at their recommendations for approval or disapproval of the application.

TIME REQUIRED FOR PROCESSING APPLICATIONS

The time OCC took to process applications seems excessive. The processing time for the sampled applications is shown below.

	Months in process		
	Average	Median	Range
Approved applications	10.8	10.0	5.5 to 26.8
Rejected applications	10.2	8.8	4.0 to 25.5

OCC took an average of 10-1/2 months to initially decide on the applications. The headquarters office accounted for 5-1/2 months, and 4-1/2 of these were taken for reviews by the deputy comptroller and the Comptroller. The headquarters review time appears to be excessive, since the examiner's field investigation and any necessary public hearings are conducted by the regional office.

Of the 24 States responding to our information request on chartering, 7 said that their statutes require them to approve or reject charter applications within a certain time frame. The required time frames for the seven States are as follows:

Number of States	Months
2	2
1	3
1	5
2	6
1	12

We do not know whether the States were meeting these limits.

In response to a Haskins & Sells questionnaire, 31 percent of 180 recently chartered national banks indicated that the processing time for their applications was excessive. The accounting firm made several recommendations which should help diminish the processing time. These included revised application forms, streamlined information requirements, and a manual on procedural guidelines for processing applications. OCC implemented these recommendations on November 1, 1976.

CONCLUSIONS

The high survival rate for national banks indicates that OCC's chartering process has at least tended to charter banks that prove to be economically supported--thus contributing to a sound national banking system.

However, there is no practical way to determine whether OCC has been fair and consistent in approving or disapproving new banks because the agency lacks (1) definitive criteria for its staff to use in evaluating applications and (2) an adequately documented decisionmaking process.

The differing opinions of the staff reviewers suggest that more definitive criteria are needed to provide for uniformity in the application review process and to insure that all factors are considered and resolved either favorably or unfavorably. Although definitive criteria that would apply to every application may be difficult to develop, we believe the matter warrants further study by OCC.

The Comptroller has considerable latitude in deciding whether to approve or reject an application, and for the most part, gives no reason for ruling a particular way. While he is not legally required to make a determination on each of the factors considered, he must certify to FDIC that he has considered the six required factors. We believe reviewers' conclusions on these factors should be completely documented during the application review process.

RECOMMENDATIONS

Accordingly, we recommend that the Comptroller of the Currency (1) develop more definitive criteria for evaluating charter applications and (2) thoroughly document the decisionmaking process, including an identification by reviewers of each factor as either favorable or unfavorable.

AGENCY COMMENTS

OCC in its letter dated January 14, 1977, stated:

"The OCC is the only federal agency with the responsibility for chartering banks. It charters banks in all of the 50 states and in Puerto Rico and the Virgin Islands. The widely differing banking environments found in the U.S. make it almost impossible to develop definitive criteria which can be universally applied such as in states like Arizona, which has 6 National Banks, and in Illinois which has over 400 National Banks. The diversity of criteria therefore, is a function primarily of the differing political, social and economic environments in which the OCC must operate. The OCC's chartering criteria, of necessity, must be somewhat flexible. That is only to be expected since the OCC does not charter in one environment. Also, under the terms of the McFadden Act, the OCC's actions are often affected by applicable state law.

"The new corporate guidelines, development of which began in September 1975 and which became effective on November 1, 1976, answer many of the criticisms of the GAO. Written opinions containing reasons are now sent to applicants receiving denials.

As examples, we quote from three recent letters sent to applicants denying their charters. One letter in part, states:

> 'Based upon the population and the median income per household, it would appear difficult for many individuals in the primary service area to qualify for a loan. Furthermore, income levels are inadequate to provide a sufficient deposit base for the proposed bank to become a viable institution.'
>
> 'In another case, we quote in part: In view of the Supreme Court decision in Whitney and the Federal Reserve Board's decision in InterMountain Bank Shares, it would be an exercise in adminstrative futility for this Office to approve the present charter application...Should West Virginia change its statutes or should the statute be successfully challenged, then this Office could consider a new application in light of these changed circumstances.'
>
> 'In still another case, the denial letter to the applicants stated: The new guidelines state that a new banking office will not be approved, if its establishment would threaten the viability of a newly chartered independent bank. Such protection will typically not exceed one year. As you are aware, the new bank opened on September 27, 1976. It is the opinion of this Office that this newly chartered independent state bank is entitled to the protection set forth in the Comptroller's policy statement.'

"Every attempt is now made to document thoroughly the decision-making process. Further efforts will be made by our Office to identify each factor as favorable or unfavorable.

"Our decisions have been suject to judicial review for many years. In the long series of court cases covering our chartering process, the Comptroller's

decision on a charter application has never been finally overturned by a reviewing court. See annotations to 12 U.S.C. 21 _et seq_.

"Our Department of Research & Economic Analysis has undertaken a market study of 35 national banks chartered between 1969 and 1971. The economic study attempts to identify, statistically, those factors which can be identified with the growth or lack of growth of these new banks. The results of that study, if positive, will be incorporated into our decision-making process. We are hopeful that quantification of a sufficient number of pertinent factors applicable to a majority of cases will result."

CHAPTER 3

CONVERSIONS OF CHARTERS--CHANGES IN SUPERVISORY AGENCIES

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CHAPTER 3

CONVERSION OF CHARTERS--CHANGES IN SUPERVISORY AGENCIES

OVERVIEW

With the Comptroller of the Currency's approval, State-chartered banks are allowed to convert to national banks. By changing charters in this way, banks become subject to supervision by the Comptroller, instead of by a State authority and either by the Federal Deposit Insurance Corporation or by the Federal Reserve System.

Because such banks are already in operation and usually subject to Federal supervision, the impact on the total banking industry of whether to approve requests to change charters is not as important as initial charter decisions. From OCC's viewpoint, however, approval means entry into the national banking system; therefore, decisions to change charters are equally as important to it as initial charter decisions.

In November 1976, OCC began requiring an applicant to give reasons for wanting to convert to a national bank. It also established policy statements which say that it will ordinarily approve conversions that are consistent with maintaining a sound national banking system but that conversions should not be motivated by supervisory pressures from other bank regulators.

We reviewed the 71 State-to-national conversion applications OCC acted on from January 1972 through April 1976. Sixty-four were approved, four were rejected, and three were withdrawn.

Many banks applied for conversion either to receive favorable decisions on corporate structural changes, such as branches and mergers, or to change their image or obtain the prestige of national banks. According to OCC files, few banks applied to avoid supervisory action from another banking agency.

Before deciding on the conversion applications, OCC either examined the bank itself or reviewed earlier Federal or State bank examination reports. Most banks

converting to national banks were judged by OCC or their previous supervisors as sound in every respect. Only one bank was receiving special supervisory attention when it converted.

With the approval of its State agency, a nationally chartered bank may also convert to a State charter (12 U.S.C. 214-214c). OCC has no authority over a national-to-State conversion, except to require a percentage of stockholder approval and to protect the rights of dissenting minority shareholders. From January 1972 through April 1976, 79 national banks switched to State banks. According to FRS, the major reason national banks convert their charters is to avoid maintaining assets in the non-interest-bearing reserves required for FRS membership. All national banks are required by law to be members of the Federal Reserve System; State banks are not.

CRITERIA AND PROCEDURES

The National Bank Act (12 U.S.C. 35) permits any State-chartered bank to become a national bank, if it has sufficient capital and the approval of OCC, unless conversion is prohibited by State law. The application for conversion must be authorized by owners of at least 51 percent of the bank's capital stock.

The law does not provide specific criteria for evaluating applications for charter conversions. The agency has established regulations allowing it to conduct any examination or investigation necessary, but until November 1, 1976, it had no written regulations or policy statements of criteria for approving or rejecting such conversions.

Applications include information on the bank's present and proposed capital structure and number of branches, whether it is a member of FDIC or FRS, proposed names for the converted bank, and names and addresses of bank directors. The applications are processed in generally the same way as new bank charter requests. An examiner at the regional office usually examines or visits the bank and prepares a written report recommending approval or disapproval. Reviews and recommendations are also made by the regional administrator and various OCC headquarters personnel. The Comptroller makes the final decision.

If OCC grants approval, the bank completes certain corporate documents required by statute and OCC issues a charter certificate authorizing it to commence business as a national bank on a specific date.

STATE-TO-NATIONAL CONVERSIONS

From January 1972 through April 1976, OCC considered 71 conversion applications. Of these, 64 were approved, 4 were rejected, and 3 were withdrawn. Of the 71 State banks and financial institutions applying for conversion, 23 were members of FRS, 45 were nonmember banks insured by FDIC, and 3 (a savings and loan association, a credit union, and a trust company) were not commercial banks. As shown in the table below, most of the applicants were small in terms of deposits.

Deposits (000,000 omitted)	Number of banks
Under $100	62
$100 to $500	6
$500 to $1,000	2
Over $1,000	1
	71

Many State banks convert to change supervisors

During the period covered by our review, OCC did not require applicants to disclose their reasons for wanting a national charter. Nevertheless, files for 53 of the 71 cases contained either stated or implied reasons for the requests. Reasons were given by some applicants; in other cases motives were discussed by the OCC reviewers.

Summary of Reasons for Conversions to National Banks

Reason	Number
Reasons related to supervisory agencies:	
Seeking to avoid supervisory pressure for corrective actions	4
Seeking favorable decisions on desired structural changes	22
Generally dissatisfied with former regulator	5
	31
Reasons unrelated to regulatory disagreements:	
Seeking same type of charter as affiliated banks	7
Changing image or obtaining prestige of national bank	10
Miscellaneous	5
	22
	53

For the four banks which applied for conversion to avoid supervisory action, OCC

--rejected one application, knowing the bank's problems and its desire for a structural change which probably would be rejected even if the conversion were approved,

--approved one conversion but required the bank to correct the problem identified by the previous supervisor,

--approved a second conversion, was aware of the problems identified by the previous supervisor, but took its own actions to correct the problems, and

--approved the other application but did not take the same action as the previous supervisory agencies.

In the last case, the bank obtained a more favorable decision from OCC than it had from FDIC and the State supervisory agency, which had told the bank to increase its capital. In a letter to OCC, the applicant explained its disagreement with the amount of the directed increase. After examining the bank, OCC required additional capital as a condition of approval, but less than FDIC and the State agency had asked for. Except for undercapitalization, the OCC examination disclosed that the bank was in sound condition.

For the 22 conversion applications which were related to a bank's desire for structural changes, OCC

--rejected 2 applications,

--approved 15 and later approved branches, mergers, and other structural changes, and

--approved 5 others, but either has not acted on or has not received their requests for structural changes.

Of the 15 requests for structural changes approved by OCC, 4 had been rejected by the previous supervisory agency. In the remaining 11 cases, the banks implied that structural change requests were the reasons for conversions but did not indicate whether they had actually been turned down by another agency. Since this information was readily available in the files we reviewed, OCC apparently was aware of the banks' motives for conversion. OCC investigated the merits of applications submitted by the converted banks for branches, mergers, and other structural changes. These investigations apparently satisfied OCC that the corporate structure requests should be approved.

Condition of banks applying to convert

An OCC examination or investigation was performed for 54 of the 70 conversion applications we reviewed. 1/ Fifty-one had deposits under $100 million and three had deposits over $100 million. OCC reviewed earlier bank examination reports or contacted the applicant's previous Federal or State agency for about half of the 70 banks, including the 16 which OCC did not examine firsthand. Thus, in all 70 cases, before deciding on the conversion applications, OCC either did its own examination or investigation, or reviewed previous examination reports.

Although several banks accepted for conversion had some weaknesses, most were rated by OCC or their previous agencies as sound in every respect. Two banks with weaknesses were approved because they were affiliated with bank holding companies which OCC believed would improve their condition.

A third bank had been designated a problem bank by FDIC, which was considering issuing a cease and desist order to prevent the diversion of profits through a management service contract. After examining the bank, OCC gave preliminary approval for conversion, without knowing about FDIC's proposed action. OCC believed the bank had no serious problem and had been assured by its president that the contract's objectionable provisions would be rescinded. Before OCC gave final approval for conversion, FDIC notified OCC of its proposed action, and OCC granted final approval with the understanding that the bank agree to correct problems in the management contract. Because

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1/ One applicant withdrew before any OCC evaluation.

the problems were not fully corrected after conversion, OCC entered into a formal written agreement with the bank about 7 months later to confirm the bank's planned actions to correct the problems.

Another bank with known problems was also accepted for conversion. Memos in the files indicate that OCC was aware of this bank's problems, had met with FRS before approving the application, and took its own actions to encourage the bank to correct the problems identified by that agency.

All four applicants for State-to-national charter conversions that OCC rejected from January 1972 through April 1976 were very small banks with deposits ranging from $800,000 to $3.6 million. One bank was turned down because OCC's examination revealed a poor overall condition. Two other banks had sought a relocation which OCC believed should not be approved; one of these also had not obtained the additional capital recently recommended by its State and Federal supervisors. The final application was disapproved because the bank appeared more interested in expanding through branching than in correcting operating weaknesses.

General OCC agreement on applications

OCC reviewers at the regional office and headquarters generally agreed with one another on conversion applications. The Comptroller disagreed with more than one staff member on only 1 of the 68 conversions from January 1972 through April 1976. Single recommendations were contrary to the final decision on only two other applications. Reviewers thus agreed much more often on conversions than on new charter applications.

RECENT CHANGES TO OCC'S CONVERSION PROCESS

The Haskins & Sells study addressed OCC charter conversion policies and procedures. The public accounting firm said OCC should (1) require an applicant for conversion to a national charter to give reasons for the conversion and (2) assure itself the conversion is not the result of supervisory pressure from other bank regulators because of illegalities or unsatisfactory banking practices. Several of the study's general recommendations

about OCC's handling of applications for new banks and structural changes also apply to the conversion process. These include (1) policy statements and decision guidelines, (2) better application forms, and (3) better guidelines for receiving, verifying, and reviewing applications.

OCC addressed the recommendations about conversions with a set of policy statements and revised application forms and procedures. OCC began using the policy statements and forms on November 1, 1976.

According to OCC's policy statements, it will ordinarily approve conversions which are consistent with a sound national banking system. Conversions should not be motivated by supervisory pressures from other supervisory agencies. The bank's general condition should be satisfactory and managers should have demonstrated ability to supervise a sound bank. Serious problems will normally preclude approval. Disapproved applicants will be told the reasons for rejection.

OCC's new procedures do not, however, define the method of obtaining information on the factors to be considered. Certain procedures should be part of the process; for example, contacting the applicant's current Federal and State regulatory agencies. By reviewing recent bank examination reports and talking with the appropriate regulators, OCC will have all current supervisory information and will be better able to evaluate a bank's condition and its motives for conversion. OCC officials intend to closely monitor the implementation of the new procedures and, as they gain experience in using them, make changes to insure their effectiveness.

The new conversion application now requests a bank's reasons for applying for conversion. The new procedures require an examination of the applicant unless specifically waived by a regional administrator. If the examination is waived, the region must provide a written justification to be reviewed by the Comptroller.

NATIONAL-TO-STATE CONVERSIONS

State conversion policies

Of the 24 State agencies responding to our survey, 15 provided information on their policies, criteria, or

procedures for reviewing national-to-State charter conversion applications. Several respondents stressed they have had little or no experience with bank charter conversions.

Five states indicated they use the same or similar procedures and criteria as for new bank charter applications. Nine States fully examine a bank before deciding. Of these nine, two also apply the same criteria applied to new bank charters. The remaining State explained that statutes require an investigation to assure that depositors are protected and legal requirements are satisfied. California, Michigan, and New York review OCC examinations of applicants as part of their conversion review process. Only California indicated it would waive its own examination if satisfied with a recent OCC examination.

Few States presented their policies regarding acceptance of national-to-State conversions. Michigan and Georgia stated conversion requests should not be the result of supervisory pressure and, along with Oklahoma, specifically indicated that converting banks should be in sound condition.

<u>National banks convert to withdraw from FRS</u>

National-to-State charter conversion applications are not evaluated by OCC, and the agency's files do not contain information on banks' motives for such changes. However, according to FRS, the major reason that banks have given up national charters is to avoid maintaining assets in the non-interest-bearing reserves required for FRS membership.

National banks are required by law to be members of FRS, but State banks are not. According to FRS, only 2 of the 73 national banks converting to State charters from 1972 to 1975 retained membership. Also, stockholder proxy statements available for 11 converting banks indicated that 10 gave up national charters to withdraw from FRS. The other bank converted to a State charter to prepare for a planned merger with a State bank.

Even though some national banks have converted apparently to avoid FRS reserve requirements, other factors have influenced national banks not to convert and State member banks to maintain FRS membership.

State reserve requirements for nonmember banks offset some of the disadvantages of the FRS requirements. Forty-nine States have asset reserve requirements, and over half of these States specify that the reserves are to be maintained as vault cash or non-interest-bearing demand deposits at other banks. These balances can also be used to compensate for various correspondent banking services. Only 3 States allow all the reserves to be maintained in selected interest-bearing assets, and 18 other States permit part of the reserves to be invested in certain short-term assets.

Member banks also receive advantages such as access to the FRS discount window, free shipment of coin and currency, and use of FRS safekeeping facilities. In addition, FRS membership helps banks attract interest-free demand deposits from banks that are seeking correspondent bank services.

A recent study by the Conference of State Bank Supervisors quantified the benefits and drawbacks of FRS membership, concluding that some banks profit more from membership and some from nonmembership. Apparently, most of the banks which converted from national-to-State charters had determined that they were not receiving net benefits from their membership.

CONCLUSIONS

Before OCC had policies governing conversion requests, several banks appear to have converted to national charters to avoid supervisory action by another regulatory agency. Supervision was usually consistent because OCC addressed the problems identified by the previous regulators.

Other banks converted to obtain more favorable consideration of requests for branches, mergers, or other structural changes. OCC approved many of these requests after separately considering their merits.

State banks also converted for reasons unrelated to supervisory disagreements, such as to have the same type of charter as affiliated banks or to obtain the prestige and Federal Reserve-related banking powers of national banks.

OCC's recently established policies and its requirements that State banks explain their reasons for wanting a national charter should help it make better informed

decisions about whether a bank should be allowed to change supervisors. More importantly, they should help OCC to accomplish its basic objective--maintaining a sound national banking system.

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CHAPTER 4

BANK EXAMINATIONS: 1971-75

OVERVIEW

Bank examinations have placed great emphasis on analyzing the bank's condition at the time of the examination. This approach has been reasonably effective in identifying problems in banks. However, in many cases examiners do not address the underlying causes which have existed for some time, such as the bank's basic management practices, operations, and controls. The examination approaches have also emphasized financial ratios and comparisons. The agencies had not established absolute agency-or industry-wide criteria or levels of acceptability for these ratios and comparisons. Their views of the condition of banks depended largely on individual judgment.

The Federal agencies do not examine the same banks. The Office of the Comptroller of the Currency examines national banks, the Federal Reserve banks (FRBs) examine State banks which are members of the System, the Federal Deposit Insurance Corporation examines insured State banks which are not members of FRS. State banking authorities also examine State banks.

The agencies examine banks' commercial departments, trust departments, electronic data processing operations or service bureaus, and international operations.

The National Bank Act requires that each national bank be examined twice each calendar year, but allows the Comptroller of the Currency to waive one examination for each bank in each 2-year period. During the 1974-75 cycle, OCC examined 75 percent of the national banks the required 3 times. FRS policy is to examine each State member bank at least once a year. In 1975 it examined 97.5 percent of its banks. FDIC, in practice, attempted to examine each of its banks once every 12 months. In 1975 it examined 88 percent of its banks.

In our view, the number of times a bank is examined should not be based upon a rigid frequency requirement. Rather, the agencies, using the results of the previous examination and information from reports by the bank, should schedule examinations based on an evaluation of the bank's soundness and the quality of its policies, procedures, practices, controls, audit, and management.

Under this approach, banks in poor condition would be examined more often than those in good condition. Each agency should have policies to allow it to consider such factors and exercise discretion in determining when to examine banks.

FDIC and FRS sometimes conducted their examinations at the same time as the State banking agencies. Both agencies have started very limited experimental programs to rely more on the work of State examiners instead of examining banks in those States. We believe that the agencies should expand these efforts to as many States as possible; of course, the quality of the State examinations must be considered in such programs.

The examination procedures followed by the agencies were much alike. They looked at the same things and did essentially the same types of analyses and evaluations. The major emphasis of the agencies' examinations efforts was on evaluating asset quality, adequacy of capital, and quality of management. The examiner-in-charge set the scope of each examination within general guidelines provided by agency manuals, standard report formats, and agency training and tradition.

Of the several factors which influenced the scope of an examination, the primary one was the bank's asset size. To some extent, the scope was also influenced by the condition of the bank and the quality of its internal controls and audit. However, we found no evidence that the examiners first evaluate the bank's internal controls, its internal audit, or its policies and procedures, to determine what the examination's scope should be. They did not attempt to identify areas of operational strength or weakness before beginning the detailed examination steps. Thus, the same things were usually looked at from bank to bank.

In our opinion, examiners should identify and then concentrate on weak bank operations which could cause serious problems. Also, the examiners should forego certain steps that have been done satisfactorily by the bank's internal auditors, an independent accounting firm, or State examiners.

FRS and OCC are the primary examiners of international operations because few FDIC-examined banks are internationally involved. International examinations are similar to commercial examinations, in that loan quality, controls, and management are evaluated. However, these examinations are complicated because special risks are involved in foreign loans and foreign currency trading and because the operations are conducted in foreign countries.

The different approaches used by FRS and OCC to evaluate certain loans to foreign businesses or countries may have resulted in inconsistent treatment of U.S. banks. Also, we believe that the agencies have not conducted onsite examinations of foreign branches and subsidiaries frequently enough.

While the agencies reported some violations of consumer protection laws and regulations, they acknowledged that they have not aggressively monitored consumer protection law compliance, and they have begun revising their approaches. (See ch. 7.)

According to the examiners, affiliation with a holding company caused problems for 22 of the 344 sampled banks so affiliated. 1/ With 15 of these 22, the bank examination was the first indication of such problems, although the FRBs had inspected 7 of the controlling holding companies within the previous 2 years. Had these inspections been adequate and had the other eight been inspected, the problems might have been resolved before they affected the banks.

1/ As agreed with the Board of Governors of the FRS, we confined our evaluation of holding companies to FRS actions with regard to holding companies affiliated with banks in our samples.

OBJECTIVES OF EXAMINATION

Bank examination is the agencies' primary tool for bank supervision. An examination is intended to provide the supervisory agency and the bank with an evaluation of the bank's soundness. It also discloses problems which the bank must rectify with advice and sometimes pressure from the supervisory agency.

Unlike auditors, examiners are not expected to evaluate banks' accounting practices or systems, nor do they attest to the accuracy and fairness of financial statements. However, examiners are expected to check the accuracy of the various financial reports which the banks are required to file with the agencies.

The disclosure of fraud is not a primary objective of an examination, although some examination procedures uncover defalcations in banks. Examiners, however, do evaluate the banks' systems of internal control.

EXAMINATION RESPONSIBILTIES

OCC and the State agencies have legal power to examine the banks they charter. FRS has authority to examine banks which are members of the System. FDIC has authority to examine banks which subscribe to Federal deposit insurance. State banks are also examined by their State banking supervisors. The result is a system of overlapping supervisory responsibilities. However, the three Federal agencies have agreed to allocate bank examination responsibilities. Thus, national banks are subject to only one examining agency (OCC); State banks, to two (FRS or FDIC and their State agency).

As the chart on the following page indicates, the Federal agencies have different examination workloads. FDIC examines about 60 percent of all commercial banks, but these banks account for less than 23 percent of total deposits and the majority are small or medium sized. OCC and FRS examine most of the large banks in the Nation, as well as many small and medium-sized banks; therefore, their workloads are less homogeneous.

Bank asset size	Number of banks examined by: FDIC and States	FRS and States	OCC	Total
(000,000 omitted)				
Over $1,000	11	28	78	117
$500 to $1,000	15	18	64	97
$100 to $500	259	97	468	824
Under $100	8,309	903	4,134	13,346
Total	8,594	1,046	4,744	a/14,384
Percent of total	59.7	7.3	33.0	100.0

a/An additional 273 banks had no Federal deposit insurance and, therefore, were not federally supervised.

Bank asset size	Percent of deposits of banks supervised by Federal agencies: FDIC and States	FRS and States	OCC	Total
(000,000 omitted)				
Over $1,000	1.5	12.9	32.0	46.4
$500 to $1,000	1.2	1.4	4.8	7.4
$100 to $500	5.0	2.3	10.1	17.4
Under $100	14.8	2.4	11.6	28.8
Total	22.5	19.0	58.5	100.0

TYPES OF EXAMINATION

The agencies devoted most of their resources to examining the commercial departments of banks. These departments encompass the primary operations of most banks: accepting deposits, making loans, investing in securities, etc.

The agencies have also developed examination policies, procedures, reports, and sometimes staffs for four other areas:

--Trust departments.

--International departments.

--Electronic data processing services.

--Consumer protection laws and regulations.

These areas have been given special attention because they are complex and can greatly affect a bank's overall condition.

SCHEDULING AND PLANNING OF COMMERCIAL EXAMINATIONS

All three agencies scheduled examinations at the field office or regional level. The frequency with which schedules were prepared varied. Because their banks were also examined by State examiners, FDIC and FRS coordinated their schedules with State agencies. The agencies' schedules were based on

--agency policy on examination frequency,

--bank asset size,

--the availability of examiners, and

--travel considerations.

Examination patterns

Agency officials said they tried to preserve the element of surprise in scheduling examinations so banks would not hide adverse conditions or wrongdoing. Therefore, as a matter of policy, they did not disclose examination schedules to banks or outsiders (other than State examiners) and they tried to avoid establishing predictable patterns. However, to avoid delays once the examination started, the agencies sometimes asked for information from a large bank's computer-based files just before starting an examination.

Nearly all of the bankers responding to our questionnaire said they received no advance notice of an examination. However, in some cases the agencies had established definite examination patterns. FRS examined 70, FDIC

examined 56, and OCC examined 78 of the banks in our samples in the same month of 2 or 3 consecutive years. A 1976 OCC internal review concluded that examinations of 16 banks in 8 regions were so regularly scheduled that they could easily have been predicted by the banks.

Upon entering the bank, the examiners were to take control of assets such as cash, securities, loan portfolios and collateral, etc. This procedure was intended to prevent employees from substituting assets to cover shortages or misuse of assets. Thus, the agencies considered the element of surprise to be important to the examination process, especially when they examined banks with poor internal controls or inadequate internal or external audit programs.

Conclusion

Because the agencies view surprise as an important element of an examination, they should be scheduling their examinations to avoid obvious patterns.

Recommendation

Therefore, we recommend that the Board of Directors, FDIC, the Board of Governors, FRS, and the Comptroller of the Currency establish scheduling policies and procedures which would avoid setting examination patterns.

Agency comments

FDIC in its letter dated January 17, 1977, stated:

"We believe that our recently adopted General Memorandum #1, which has been under consideration and extensively tested for several years prior to adoption, largely satisfies this recommendation. For more extensive comments on our General Memorandum, please refer to our comments on the recommendations contained on page 4-9 of the GAO Report."

FRS in its letter dated January 16, 1977, stated:

"This recommendation is based upon the premise that the agencies view surprise as an important element of an examination. The Board believes that, in many cases, there is serious doubt as to the

benefits to be gained and hence the desirability of surprise examinations. In those instances where surprise is considered important, it has been, and will continue to be, our practice to schedule examinations so that they cannot be predicted in advance."

OCC in its letter dated January 14, 1977, stated:

"Historically, the OCC has viewed surprise as an important element of an examination. However, a primary feature of our new examination approach entails the pre-examination analysis wherein the examiner will determine the adequacy of internal control and audit activity. The OCC feels the best deterrent for fraud is not periodic unannounced visits by examiners but rather the existence of sound bank policies, procedures, internal control and audit activity on a continuing basis. The element of surprise is necessary only in those cases where such factors are suspect."

<u>How often are banks examined?</u>

Although FDIC had no policy, in practice it examined most of its banks at least once every 12 months. In 1975, it did not examine 12 percent of its banks. All of those banks, unless new, had been examined in 1974.

FRS policy is to examine each State member bank at least once a year. It did not examine 2.5 percent of its banks in 1975. These banks had all joined FRS in 1975 or had been examined in 1974.

OCC is the only agency of the three subject to a statutory examination frequency requirement. The National Bank Act requires that each national bank be examined at least twice each calendar year but allows the Comptroller to waive one examination at each bank once in 2 years. According to its own reports, OCC has not examined national banks as frequently as required by the National Bank Act. During 1974-75 about 1,200 national banks were not examined the required 3 times. Some banks with poor composite ratings (see ch. 6) were examined only twice during those years although some banks with better ratings were examined three times.

OCC, since early 1975, has been using a "bobtailed" or abbreviated examination for national banks in good condition. And recently, FRS has adopted a "compacted" examination (see ch. 7) for State member banks in good condition. In November 1976, FDIC established a policy to schedule a bank examination based upon the bank's condition. (See ch. 7.)

Conclusion

Although the agencies did not examine all of their banks as frequently as their policies or the law required, they may have been examining some banks more often than necessary and others not often enough.

Using the results of previous examinations and information from reports by the banks, the agencies should base the number of times a bank is examined on an evaluation of the bank's soundness; policies, procedures, and controls; and management quality. Thus, banks in known poor condition or with major weaknesses in policies, procedures, or controls would be examined more often than banks with good policies thought to be in good condition.

Recommendations

We recommend that the Board of Directors, FDIC, and the Board of Governors, FRS, adopt flexible policies for examination frequency which would allow them to concentrate their efforts on banks with known serious problems.

We recommend that the Congress amend the National Bank Act to allow the Comptroller of the Currency to examine national banks at his/her discretion. We would be glad to assist the committees in drafting appropriate legislation.

Agency comments

FDIC stated:

"Although it was FDIC's long-standing policy to examine each bank once a year, it is inaccurate and misleading to suggest that that time-frame was the only guideline used by the FDIC in scheduling examinations, or, to state it another way, that examinations were not scheduled and conducted by the FDIC based upon

the "bank's soundness; and the quality of its policies, procedures, practices, controls, audit, and management.

"During 1975, FDIC conducted 213 follow-up examinations and a number of on-site visitations at banks presenting either financial or supervisory problems. Further, those banks which were not examined in 1975 largely consisted of banks which would not fall within the one-year time-frame guideline under General Memorandum #1. Although General Memorandum #1 was formally adopted in November 1976 and implemented on January 1, 1977, the concepts and practices embodied in it are not of recent origin. Those concepts and practices have been under consideration at FDIC since early 1974. Furthermore, the concepts and practices have been experimented with and tested in five of the FDIC's 14 Regional Offices prior to formal adoption of General Memorandum #1. We might add parenthetically that FDIC policy is to experiment on a regional basis with major policy changes before implementation for the entire Corporation.

"Accordingly, while the recently issued General Memorandum #1 expresses more definitively that scheduling of examinations is not based on time-frame priorities alone, nevertheless, we feel that the criticism of past scheduling practices expressed in the GAO recommendation is misplaced. The FDIC has followed and continues to follow a policy so aptly stated in the said General Memorandum #1, namely:

> "The first priority has been and will continue to be, effective surveillance and supervision of the institutions which present either supervisory or financial problems."

FRS said:

"The Board already has established policies that are flexible enough to allow us to concentrate our efforts on banks with known serious problems. Some years ago, the Board adopted the policy, which was reaffirmed in 1975, that all banks considered to be in a problem status be examined at a minimum

of six-month intervals. However, we will continue to schedule periodic examinations of all banks under our supervision since a bank may deteriorate with the passage of time. As pointed out in the GAO report, the Board recently approved the usage of Asset Quality and Management Performance Examinations in the case of banks thought to be relatively free of major problems. If this limited scope examination detects major changes or deterioration, a full scale examination is then commenced. These procedures give us flexibility while at the same time insuring that problems are not overlooked."

OCC said:

"We support the recommendation of legislation to permit OCC discretion in scheduling the frequency of examinations. The current method of adapting the depth of examinations to the needs of each bank, based on NBSS data and pre-examination analysis, fully complies with law. However, greater statutory discretion would enhance our effectiveness in this regard."

How are Federal examinations coordinated with State examinations?

Since the banks examined by FDIC and FRS were also examined by State banking authorities, both agencies tried to coordinate and frequently combine their examinations with those of the States. The arrangements between the Federal supervisors and State authorities were of two basic types:

- --The Federal agencies and the States conducted independent examinations.
- --The Federal agencies and the States conducted joint examinations and wrote either one or two examination reports.

The examination relationships between the Federal agencies and the States varied from State to State, from bank to bank, and sometimes from examination to examination.

In joint FDIC-State examinations which resulted in a single report, examiners shared the work. In those joint FDIC-State efforts which resulted in two reports (called concurrent examinations), the examiners also sometimes shared the workload. Similarly, FRS and State examiners sometimes shared the work during joint examinations.

The following table summarizes the predominant examination arrangements during 1975.

Predominant examination arrangements	Number of States	
	FDIC	FRS
Independent	a/ 22	15
Joint--two reports ("concurrent")	8	8
Joint--one report	13	7
Mixed	7	12
Experimental (see p. 4-13)	-	1
Total	50	b/ 43

a/Special arrangements existed for some banks in 3 States, see page 4-13.

b/In seven States, no State banks belonged to the FRS.

We asked bankers their opinions about the competence of State examiners as compared to Federal examiners. As shown below, many of the bankers believed the State examiners to be as competent as Federal examiners.

Type of bank	Percent of responding bankers who said State examiner competence, compared with that of Federal examiners, was		
	Better	The same	Worse
State nonmember	8	64	28
State member	5	61	34

FDIC and FRS were conducting experimental programs with States which could improve efficiency. In Georgia, Iowa, and Washington, FDIC was relying completely on State examinations to replace its own.

The FRB of Chicago was conducting a similar experiment in Indiana. The State examined the bank with only one Federal examiner present. The bank and the FRB received a copy of the State report. For FRS use, the FRB examiner wrote a report of examination based primarily on the work of the State examiners.

Conclusion

In our opinion, these approaches are reasonable attempts to eliminate needless duplication of work. If found acceptable, they should be expanded to enable FDIC and FRS to concentrate their efforts more on banks with serious problems. By relying more on State examinations FDIC and FRS could free their own examiners from relatively routine examinations of "good" banks to examine, reexamine, visit, or monitor banks with major problems. The Federal agencies, of course, should rely on the States' examinations only if they are of acceptable quality.

Recommendation

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

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

--use only reports of State examinations meeting those standards.

Agency comments

FDIC said:

"The FDIC has determined that the Experimental Withdrawal Program conducted in three states during the past three years will not be continued in its present form. However, agreement to examine nonproblem banks on an alternate-year basis has already been consummanted with one state and the possibility of entering into similar arrangements with other states is being explored. Furthermore, termination of the Experimental Withdrawal Program should not be construed as a decline on the part of the FDIC to cooperate to the fullest extent possible with the various states or to place less reliance on the efforts of the state supervisors. The guidelines set forth in General Memorandum #1 provide a workable framework for increased cooperation with the states. Thus, almost by definition, if the program expressed in General Memorandum #1 proves workable and if a state banking department performs in an acceptable manner, the frequency and scope of FDIC examinations in that state will be reduced."

FRS said:

"The report recognizes our current extensive efforts to eliminate unnecessary duplication by utilizing State examiners and State examination reports. If experience with our existing program in Indiana should indicate that expansion of this program is desirable, GAO's recommendations regarding standards would be appropriate. Indeed, the purpose of the existing experimental program is to develop such standards. In this connection, however, it should be recognized that written standards alone will not insure the success of any program."

Planning and preparing for examinations

The examiner-in-charge typically prepared for an examination by reviewing the previous report of examination and related workpapers. Just before entering the bank, the examiner-in-charge usually met with his/her staff and assigned specific tasks. In many districts, workload, geography, and travel difficulties precluded extensive preparation. However, some FRBs gave their examiners-in-charge a period of time, usually a week, to study the report, workpapers, and related correspondence from the previous examination.

Determining examination scope

The scope of an examination is the extent to which the examiner reviews and analyzes the bank's financial condition, operations, and management. Included in scope is the depth of the examiner's coverage; e.g., how many loans and securities were analyzed.

The areas of examination coverage were reasonably well defined and about the same at each agency. Each

--evaluated assets,

--analyzed capital structure,

--analyzed income and changes in capital,

--evaluated loan policies,

--analyzed concentrations of credit,

--analyzed "insider" loans,

--evaluated investment policies,

--reviewed the bank's premises and other real estate owned,

--analyzed borrowing,

--evaluated management,

--evaluated internal controls, and

--reviewed compliance with laws and regulations.

How thoroughly these areas were reviewed and analyzed varied, largely according to the examiner's judgment.

The standard report of examination (see ch. 6) established the basic scope of an examination. Procedural manuals, whether agencywide or local, also provided some scope guidance to the examiners. Beyond these guides, examination scope was left to the discretion of regional officials and the examiner-in-charge.

Agency officials said problems in the bank's internal controls or internal or external audit programs discovered during the previous examination could have influenced the extent to which certain records were verified or whether cash was counted.

The examiner might have expanded or reduced coverage of some areas because of the results of the previous examination. However, we found no evidence in examination reports that the examiner reviewed the bank's internal controls, policies, or procedures before setting the scope of the examination. Unless the examination was a special, limited-scope reexamination, it usually closely resembled the last examination.

Conclusion

When planning the examination and defining its scope, the examiner-in-charge should pay close attention to the bank's system of internal controls, its policies, and the audit or verification work already done by internal and external auditors. We believe that, by examining electronic data processing operations and by reviewing the system of controls and policies, the examiners could identify areas of weakness upon which to focus their commercial examinations.

The first step of the examination should be a review and evaluation of policies, procedures, controls, and audit and the scope of the remaining work should be adjusted accordingly. Thus, the examiners would not spend time reviewing areas in which problems are unlikely. Explanation for scope modifications should be included in the workpapers or the report.

New examination approaches and procedures being implemented by the agencies are described in chapter 7. OCC's new approaches and procedures should eliminate the weakness discussed above.

Recommendation

We recommend that the Board of Directors, FDIC, and the Board of Governors, FRS, establish procedures to base the scope of each examination on the examiners' evaluation of the quality of the bank's controls, policies, procedures, and audit.

Agency comments

FDIC stated:

"With respect to FDIC examinations, the findings and conclusions expressed by GAO are not accurate. The primary factor influencing the scope of the examination is not size, but the known history of strengths and weaknesses of the particular institution. Furthermore, FDIC examiners do pre-plan the scope of an examination, by studying applicable files and previous examination reports, and noting any material changes in the management or style of operations since the last examination.

"FDIC examiners have in recent years reviewed a bank's internal controls, policies and procedures prior to actual commencement of the examination in order to establish the scope of the examination within the minimum standards prescribed. With respect to smaller banks, however, such a review tends to be less formal, hence harder for GAO to detect than with larger banks. Considerable leeway in this respect is provided for in the recently adopted General Memorandum #1, and we reiterate that these procedures were considered and extensively tested in five of the FDIC's 14 Regional Offices for several years prior to formal adoption."

FRS said:

"This recommendation encompasses what we are already doing. We review the policies, procedures,

and controls in connection with all bank examinations. In most large banks, our examiners currently perform a preexamination review specifically focusing on controls, policies, and procedures. The results of such review are used to determine the amount of scrutiny given to each area. In smaller banking institutions, a review of the controls, policies and procedures in effect at the last examination is used to develop the scope of the examination."

Procedural guidelines

Each of the three agencies has a manual describing the general procedures to be followed during an examination. However, only the FDIC and OCC manuals were in use during the period covered by our review. The FRS manual was issued in 1976. Before the systemwide manual was issued, the FRBs followed their own procedures. Some had examination manuals; others formally compiled procedural memorandums. All three agencies allowed their regional officials and examiners considerable discretion in establishing examination procedures.

Beyond the manuals, procedural guidance came from agencywide and regional schools and seminars. (See ch. 10.) The reports of examination also dictated some procedures.

Documentation standards

The agencies' reports of examination (se ch. 6) were, to a great extent, the workpapers for the examination. The agencies retained certain forms for recording details about loans and securities in the files. However, there were no guides for what other material--schedules, records of interviews, etc.--should have been available or how it should have been prepared and organized.

Conclusion

More complete and organized workpaper files would

--enable the examiner-in-charge to readily determine if all the required examination steps have been followed,

--provide organized and accessible support for the preparation of the examination report,

--enable the agencies to streamline their reports (see ch. 6) by transferring information now in the reports to the workpapers,

--enable agency reviewers to determine what work was done and what information and analyses support the examiners criticisms, and

--facilitate review of the workpapers by the examiner in charge of the later examinations.

The approaches and procedures being taken by OCC (see ch. 7) should result in better documentation of bank examinations.

Recommendation

We recommend that the Board of Directors, FDIC, and the Board of Governors, FRS, develop standards for the preparation, maintenance, and use of examination workpapers.

Agency comments

FDIC stated:

"The standards for the preparation, maintenance, use and importance of examination workpapers are included in the course of study at the various schools operated by the Corporation and in our on-the-job training program. The examination workpapers do, in fact, cover a number of items other than the details relating to specific loans and securities in support of comments contained in a Report of Examination. We believe our examination workpapers will permit a determination that appropriate examination procedures have been followed, provide support for the preparation of the Report of Examination, and are utilized at the next examination."

FRS said:

"We believe that, in the vast majority of examations, the examination workpapers and line sheets prepared are adequate to meet the System's needs. The manner in which examination workpapers should be prepared and maintained is extensively covered in connection with the training of our examiners."

HOW EXAMINATIONS WERE PERFORMED

Examinations were not conducted very differently by the three agencies. Those variations which existed resulted from differences in workload and geographical dispersion of banks.

The examination team consisted of one or more examiners (one of whom was the examiner-in-charge) and one or more assistant examiners. Upon entering the banks, the examiners would take control over assets and request certain information from the banks' managers, usually through a standard questionnaire.

The actual steps followed during the examination were established at the discretion of the examiner-in-charge. He/she concentrated on evaluating loan quality, while other examiners or assistants counted cash, listed securities, and administered policy and internal control questionnaries. Sometimes the various listings and analyses were consolidated by a senior assistant examiner, but the examiner-in-charge checked his/her staff's work and drafted the report.

The time taken for an examination depended on several things: the bank's size, complexity, and condition; the number of examiners available; the skill and experience of the examiners; and the number of examinations to be conducted during a given period. Specific examination times were frequently based on the time taken for the last examination of the bank.

As shown below, the supervisory agencies generally spent more effort examining large banks than small banks.

Average Staffdays for
Independent Federal Examinations

Bank deposit size	FDIC		FRS		OCC	
	Number of examinations	Staff days	Number of examinations	Staff days	Number of examinations	Staff day
(000,000 omitted)						
Over $1,000	1	444	-	-	62	932
$500 to $1,000	1	316	1	188	32	300
$100 to $500	13	170	8	107	51	117
Under $100	99	28	36	25	55	30

SPECIFIC AREAS COVERED BY COMMERCIAL EXAMINATIONS

The agencies' examinations concentrated on several major areas, such as asset quality, deposits, capital adequacy, compliance, and management. The agencies were doing essentially the same things in considering each area.

Classification of assets

An important factor in assessing a ba s condition was the quality of its investments and its loans. Part of an examination was to judge the quality of assets. The agencies used three classifications for poor assets--namely (from bad to worst), "substandard," "doubtful," and "loss." These classifications conform to the "Uniform Agreement of 1949," signed by the Federal supervisory agencies and the National Association of State Bank Supervisors. The classifications were the examiner's judgement of the difficulty converting assets to full cash value at maturity.

The classifications were used to describe the quality of the bank's loans, investment securities, real estate other than bank premises, and other assets.

Review of loans

The examiners looked for low-quality loans, concentrations of credit, insider transactions, and loans outside of the bank's normal trading area (this practice was of special concern in small banks).

The aminers did not evaluate the quality of all the loans in a bank's portfolio. Generally, the examiner-in-charge was to review all past-due loans, all loans previously classified, and all loans of more than a specified amount. This amount varied according to the size of the bank, total loans, and the amount of classified loans found in the previous examination.

Each loan reviewed was judged on risk, collateral, character, and financial position of the borrower, and likelihood of repayment. Loan evaluation depended upon the examiner's knowledge, judgment, perception, and analytical technique.

Cutoff points and percent of loans reviewed varied from agency to agency and from region to region. We were told that FDIC examiners tried to review about 75

percent of the examined bank's loan volume. FRS examiners were to establish a cutoff point based on a percent of capital (each loan of over 1 to 2 percent was reviewed) and, we were told, usually covered 75 to 90 percent of the bank's loan dollar volume. OCC's suggested guidelines were: (1) all loans of at least 0.75 percent of gross capital were to be reviewed in banks with assets of less than $25 million and (2) all loans of at least either 0.5 percent of gross capital or $500,000, whichever was less, were to be reviewed in banks with assets of $25 million or more.

In addition to the adverse classifications, the agencies had a category for loans which required more than ordinary management attention--"other loan especially mentioned." FDIC also listed loans with which the examiner had found technical difficulties (inadequate documentation of collateral, insufficient credit information). FRS listed loans not supported by adequate credit information. OCC used two exception categories: (1) collateral exceptions and (2) loans not supported by current and satisfactory credit information.

Examiners were to check all loans and securities to identify instances where the bank depended on the ability of a single individual, entity, or industry to repay loans. The examiners were to group together all large direct and indirect loans to, and purchases of securities from, (1) individuals and their families and related interests (2) business entities and their affiliates, and (3) industries (e.g., agriculture, automobile, real estate). The examiners were to review these concentrations whether or not the loans or securities were classified or exceeded the State lending limits.

The examiners were to review and record all debts (direct and indirect) owed to the bank by its directors, officers, and employees, and their interests. Federal and State laws restrict the amounts of such loans, and the examiners were expected to comment on any loans which violated these laws. Also, examiners were to criticize any such loans which they considered large and unwarranted.

The examiners were to look for and criticize large amounts of loans to borrowers outside of the bank's normal trading area.

Evaluation of securities

The examiners were concerned about at least three factors affecting securities (stocks and bonds) the banks had purchased: current value, quality, and maturity. Examiners Examiners were usually expected to review all securities using, as guides to quality, ratings provided by various securities rating services.

The examiners were to group the bank's securites into special categories. FDIC used four; FRS used a different four; OCC used seven. The examiners were expected to compare the market values for all groups of securities to their book values. If market value was less than book value, the amount of the difference ("depreciation") would be classified substandard, doubtful, or loss depending upon the agency's standards for each group. Generally, the agencies would not classify either U.S. Government bonds or bonds which received one of the four highest ratings of one of the securities rating services.

The agencies' approach to New York City bonds shows how different classes of securities were treated by examiners. In October 1975 the agencies agreed not to classify certain New York obligations even though a rating service had lowered their rating. This was done because the agencies believed that the "unsettled condition" of the market did not reflect the true value of the securities. Ordinarily, bonds with that rating would have been classified as doubtful by the examiners. In December 1975, FRS modified its position by suggesting that New York City obligations of less than investment grade be classified as substandard. OCC similarly modified its position on New York City bonds in March 1976.

The examiners were also to see whether the bank's investment securities would be redeemed at different times to provide the bank with a steady flow of funds.

Real estate

The examiners were to review each real estate holding, other than the bank premises, to determine

--the reason the property was acquired and the plans for disposing of it,

--the book value (the cost to acquire the property) in relation to the appraised value,

--the length of time the property had been held and the reasons it had not been sold, and

--rental income and maintenance expense.

The examiners were to classify real estate as substandard, doubtful, or loss if the bank was losing money by maintaining the property or if the market value of the property w s less than its book value.

Deposits

Examiners were to analyze the bank's deposit trends both in total and by account type--checking, regular savings, or time (such as Christmas clubs or savings certificates); public or private funds; individuals, partnerships, and corporations; etc. The time spans covered differed among the agencies (FDIC looked at a 5-year span, FRS looked at 4 years, OCC looked at 3 years), as did deposit categories, but the agencies had similar objectives. The examiners were to analyze deposit trends and distribution in order to judge the bank's assets (short-versus long-term, low-versus high-interest), identify changes in its operations, and identify potential decreases in ready cash.

The examiners were to look at the sizes of deposit accounts to identify concentrations of deposits which might be withdrawn quickly, thus decreasing ready cash. To identify overreliance on public funds or an entrance into a new field of operations, the examiners were to analyze the amount of the bank's deposits which were secured by pledged assets. It was considered undesirable for a bank to have an inordinately high percentage of its assets pledged against a similarly high percentage of its deposits.

The examiners also were to analyze in detail the public funds deposited in the bank. Particular attention was given to the types of accounts, interest paid, and any special terms or conditions. The examiner also compared the current rates of interest paid to the types of accounts. The rates could have indicated the bank's competitive position.

Borrowing by banks

FDIC and OCC examiners prepared detailed listings of loans made to the banks since the previous examination;

FRS examiners summarized the bank's borrowing in the reports of examination. The examiners were interested in the same things: the amounts of borrowed funds compared to the assets and condition of the bank, frequencies and types of borrowings, borrowings which had not been approved by the bank's board of directors or which exceeded legal limits and the likelihood that the sources of loans would continue to be available. The borrowing practices were then evaluated in light of the bank's liquidity, capital, and profits.

Adequacy of capital

When analyzing the adequacy of a bank's capital, the examiners calculated a figure for "adjusted capital"--total capital minus (1) losses and estimated losses on assets and (2) half of the assets classified as doubtful. If the resulting figure was less than the amount of capital stock, the bank's capital was considered impaired. If the figure was negative, the bank could have been insolvent.

When adjusted capital exceeded capital stock, the examiner was to determine if the bank's capital structure was below an acceptable level. During the examination, the examiner would calculate various capital ratios for the bank. These would be compared to industry and/or peer group ratios. The results of such comparisons would indicate whether or not the bank required further analysis. Other factors considered in the analysis of capital were asset quality, liquidity, deposit trends and distribution, borrowings, income, and management. The bank's capital would not normally be criticized if, in the view of the examiner or reviewing agency officials, it was sufficient to support the bank's operations and protect the bank's depositors. There was no level of capital, either ratio or absolute amount, deemed minimally acceptable for all banks or any particular class of banks.

The agencies indicated that they were studying the concept of industrywide standards for adequate capital. However, these efforts have not produced standards or more definitive criteria. (Case 5 in chapter 8 illustrates this situation.) The agencies emphasized that developing industrywide capital standards is extremely difficult and might even be impossible.

Income and dividends

The examiners also were to analyze the bank's earnings and dividends to determine whether:

--Earnings were sufficient to provide capital to accommodate future growth.

--Earnings were sufficient to cover current asset losses.

--Earnings were adequate in relation to the existing dividend rate.

--The bank was sufficiently managed and operated.

--Dividends were consistent with the bank's condition.

--Dividends were legal.

The examiners were to analyze income and changes in capital using data contained in the bank's annual reports of income and other records. Specific practices for periods covered and sources of data varied among the agencies.

Liquidity

Many of the analyses performed by the examiners involved information important for determining the bank's liquidity position (its ability to fund probable and possible cash needs without liquidating assets at substantial losses). Information about such things as maturity and value of securities, types of loans, deposit concentrations, forward commitments, contingent liabilities, and deposit trends was considered by the examiner. The examiner decided (subject to the review of agency officials) whether or not the bank's liquidity was adequate based on the above information and other factors, such as the economy, management capability, access to money markets, and asset quality. The agencies also had liquidity formulas which they used as screening devices to indicate which banks warrented further analysis.

Compliance with banking laws and regulations

Examiners were instructed to inspect for violations of Federal and State laws and regulations. FDIC and FRS examiners were to cite violations of State laws in the reports of examination.

The laws and regulations enforced through the examination process varied in importance and concerned lending practices, including: specific lending limits; securities and real estate investments; dividends; activities of directors, officers, and employees; deposits and interest rates; stock registration; affiliations; consumer protection (see pp. 4-42 to 4-45); and bank security.

Management, management practices, and internal controls

Appraising a bank's management was an important part of the examination. The examiners were to consider (1) the bank's condition, (2) its policies and procedures, (3) the adequacy and quality of its earnings, (4) the relationships among individuals and management levels, and (5) provisions for management succession.

The examination was to include analyses of policies and procedures for

--loans,

--credit card and credit-check plans,

--investments,

--internal controls,

--outside involvement of the board of directors,

--insurance, and

--emergencies.

The examiners were to use a questionnaire approach in identifying and analyzing these policies and procedures. They were also to review the activities of the board of directors.

BANKERS' VIEWS ON EXAMINATION COVERAGE

We asked bankers to indicate (1) what they considered the five most important objectives of bank examinations and (2) which five objectives they thought were most important to the agencies. (See app. I, pp. I-5 and I-6.) As shown below, four objectives appear in both lists of most frequent answers, though in different order. The bankers consider the safety of depositors' funds and the quality of management more important than they thought the agencies considered it. The agencies' examination policies emphasized the importance of the evaluation of management, and each agency's rating system (see ch. 6) included a rating of management. Yet the bankers had not perceived an evaluation of management as being one of the agencies' five most important objectives.

Area of examination	Bankers' priorities	Bankers' view of agencies' priorities
Safety of depositors' funds	1	4
Asset quality	2	2
Compliance with laws and regulations	3	1
Quality of management	4	-
Adequacy of internal controls	5	5
Adequacy of capital	-	3

Less than 40 percent of the bankers believed evaluation of capital adequacy and evaluation of liquidity to be among the five most important.

The following tabulation shows that the bankers generally believed that the examiners were paying enough attention to the important aspects of examinations.

Area	Percent of bankers who felt examiners' attention was		
	Too much	Appropriate	Too little
Loan assessment	20	77	3
Compliance with banking laws and regulations	22	74	4
Management assessment	8	79	13
Internal control	12	79	9
Capital adequacy	16	81	3

INTERNATIONAL OPERATIONS EXAMINATIONS

The agencies' international examinations were similar to their commercial examinations in objective and scope. However, the special risks involved in international loans and the risks and complexities of foreign exchange transactions required specialized knowledge and procedures. Thus, the agencies used specialists in international examinations.

Domestic banks may maintain branches in foreign countries or invest in foreign banks or financial institutions. Today, foreign branches account for most of the international assets of domestic banks. Investments in foreign banks or financial institutions may be direct purchases of foreign bank stock or "Edge Act" or "agreement" corporations--domestic corporations which are chartered solely for foreign banking or financial activities. Most branches of foreign banks operating in the U.S. are not subject to FDIC, FRS, or OCC supervision. 1/

Relatively few domestic banks are engaged in major international operations. As of December 31, 1975, only 131 of the 5,790 national and State member banks had overseas branches and/or foreign subsidiaries. Foreign branches of the 20 largest banks had almost 92 percent of total foreign branch assets.

While international assets as a percentage of total assets amounted to approximately 15 percent of the banking industry as a whole, 40 to 50 percent of the assets of the largest banks were in international operations. For example, the 30 largest banks in our samples had nearly $167 billion of foreign assets at their most recent examinations. Of this amount, nearly $81 billion was in loans to foreign governments, businesses, and individuals. Also, these banks' international operations are a major source of income--up to 50 percent in some cases.

The objectives of international examinations were to determine the condition of the international departments and to assess their management. Thus, the international

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1/ See "International Banking--a Supplement to a Compendium of Papers Prepared for the FINE Study," a staff report for the House Committee on Banking, Currency and Housing, May 1976.

examiners, like commercial examiners, evaluated asset quality, internal controls, policies, and procedures.

The foreign exchange activities of banks, because of their special risk, were of major concern to the examiners. The examiners reviewed the bank's net currency positions and future commitments to identify potential large losses, evaluated the risks involved should customers not fulfill their parts of the transactions, evaluated the credit of the bank's trading partners, and evaluated the bank's system of audit and controls over foreign exchange dealings.

Evaluation of foreign credit

Foreign loans are more complicated to evaluate than domestic loans because they are often made in different currencies and to foreign governments. A special risk (called country risk) is taken with loans made in different currencies because the borrower must repay the loan in the currency borrowed. The borrower's ability to obtain the appropriate currency is affected by the political and economic stability of the borrower's country, including its

--balance of trade and of payments,

--export-import trends,

--foreign exchange reserves,

--overall debt and debt-service rates,

--gross national product growth, and

--employment and inflation rates.

FRS and OCC took different approaches to evaluating loans subject to country risk. These different approaches caused some banks' loans to be classified differently than other banks' loans to the same country or foreign business.

Within FRS, two approaches were taken. In 1976 an ad hoc committee of senior examiners in the New York FRB evaluated the country risks and assigned a general classification to loans to borrowers (including the government) within some of those countries. All loans to those countries and their businesses received the classification, unless the borrower's ability to obtain the repayment currency was independent of the country's stability or the loan was made in the local currency. A loan in a local currency was judged according to the borrower's financial condition.

At the other FRBs, foreign loans were evaluated individually. This approach led to inconsistent classifications within the FRS. For example, a loan to one country was classified by San Francisco examiners, while examiners from FPBs of New York, Philadelphia, and Richmond did not classify loans to the same country. Similarly, examiners from the FRBs of Boston, Chicago, and San Francisco criticized loans to another country, but New York examiners did not. As a result, some State member banks may have received more supervisory attention than others in different locations, even though they had similar loans subject to the same risks.

In 1974, OCC set up a committee for evaluating country risk. Each quarter senior international examiners from headquarters and the Chicago, New York, and San Francisco offices met to evaluate the risk involved in, and assign classifications to, certain loans to certain countries. The loans classified were those for which repayment was as much dependent on the borrower's ability to obtain the appropriate repayment currency as on the borrower's financial condition. The committee classified these loans by using information from major banks' research departments and Government sources available to it. The classifications arrived at by the committee were then used throughout OCC for loans to these countries.

The New York FRB and OCC thus both used "committee" systems, but with different results. In July 1976 the Reserve bank's committee and OCC's committee each developed ratings for loans to foreign countries. While the OCC committee concluded that certain loans to five countries should be classified as substandard, the New York FRB assigned the substandard classification to loans of only one of them. Neither committee classified loans to any other countries. As a result, one bank may have been subject to more supervisory attention and pressure than another even though their loans were similar.

Conclusion

Using three country risk evaluation methods has resulted in different treatment of the banks that FRS and OCC supervise. Further, the method used by the FRBs depends on individual examiners keeping abreast of economic conditions in many countries and being able to judge loans in many

countries. A team of experts who evaluate economic conditions in each country should produce more accurate and consistent results than numerous individuals who evaluate loans case by case.

Recommendation

We recommend that the Board of Governors, FRS, and the Comptroller of the Currency, using all available information, develop and use a single approach to classify loans subject to country risk.

Agency comments

FRS said:

"The evaluation of the country risk element in international loans calls for difficult analysis and judgment at the time lines of credit are established or loans extended since "country risk" involves an estimate of a country's political, economic, and social fortunes over the life of the loan as they may affect the collectability of such loans. There is serious question as to the validity of generalized characterizations of credits based on the country of residency of the borrower, particularly where the characteristics of the credit may well vary with the borrower - private or governmental - as well as the nature and extent of external resources available to support the loan. For a number of months now, the Federal Reserve has had underway a review of country risk problems in international lending as well as appropriate supervisory treatment of the problem. This review has included an on-going appraisal of the system employed by the Comptroller of the Currency. In this regard, we believe that, while there may be general agreement on the desirability of of uniform evaluation of the country risk element in individual international credits, there is a real question as to the desirability of rating individual countries. It might be noted, for instance, that the Comptroller's system focuses almost exclusively on credits to individual governments. In any event, we believe that we should strive toward uniform treatment. Of course, as with respect to many of the recommendations, the Federal Bank Examination Council proposal would accomplish this."

OCC said:

"The OCC has a well established procedure using a single approach to the classification of country credits. This procedure makes use of information from many governmental and non-governmental sources and examiners in all fourteen national bank regions.

"Copies of the minutes of our committee meetings and any resulting classifications have always been provided to members of the staff of the Board of Governors.

"The process of country risk evaluation is more precisely an art than a science. Most of the evaluation process is judgmental. However, the interagency meetings held to date have been beneficial in determining basic differences in philosophies."

Onsite versus home office examinations of foreign branches and subsidiaries

FRS and OCC conducted international examinations at the home office of the bank or the Edge Act corporation and at the foreign branch or subsidiary. The examiners usually evaluated foreign loans from information at the home office of the parent bank or corporation.

We reviewed examination reports on 18 national banks and 12 State member banks with substantial international operations. A high percentage of classified loans, inadequate controls over foreign exchange operations, and inadequate overall internal controls were the most prevalent problems found in those banks' international operations.

FRS examiners stated that two of the State member banks were experiencing some problems which were related to subsidiaries of the banks' Edge Act corporations. Both banks' Edge Act corporations had been examined by FRS before the problems were noted in the banks. However, the examiners of both had said the information available at their home offices was inadequate. The subsidiaries were not examined onsite until after the banks had begun experiencing problems.

Conclusion

We believe that these subsidiaries should have been examined onsite as soon as possible, once the home office files were found inadequate. Early onsite examinations of the subsidiaries might have disclosed their problems before parent banks were injured.

The supervisory agencies are sometimes prohibited or restricted by foreign laws from making onsite examinations of domestic banks' foreign branches and subsidiaries.

Recommendations

We recommend that the Board of Governors, FRS, and the Comptroller of the Currency implement proced' ,s to examine (where permitted by the country involved) major foreign branches and subsidiaries, including subsidiaries of Edge Act corporations, onsite--periodically and whenever adequate information about their activities is not available at the home office.

Also, we recommend that the Board of Governors, FRS, and the Comptroller of the Currency utilize each others' examiners to cut expenses when conducting examinations in foreign countries.

Agency comments

FRS said:

"The development of widespread networks of foreign branches and subsidiaries by the major banks has brought the question of the supervision of the banks' international operations to the forefront in recent years. We concur with the principle that examinations, wherever conducted, should be adequate to provide the necessary supervisory information. However, one constraint with which the Board has had to deal is, as noted in the report, that, in many cases examinations of foreign subsidiaries are not possible because of host country laws which preclude direct examinations by other governmental authorities of banks chartered in those countries regardless of the ownership. The System has not only required that banks maintain records at the head office adequate to appraise the risk and exposure of the banks

through their foreign operations, but the System has also provided for direct visitations of examiners to major foreign branches in those cases where such visitations have been legally possible.

"The Board believes that, on the whole, this system has worked well. The information available at head offices has, in general, been adequate to assure that the banks were not unduly exposed to loss or serious financial difficulties. At the same time, there has been a continual search for better and more efficient ways of satisfying the Federal Reserve's supervisory responsibilities in the international field.

"Beginning in the fall of 1976, onsite examinations were made of foreign branches of State member banks where we had previously utilized onsite inspections by State examiners or information at the head office. Moreover, a number of foreign subsidiaries were directly examined for the first time with the agreement of the host government. A full evaluation of those examinations has not yet been completed. One preliminary result of that exercise has been to provide assurance that a large portion of the material needed for proper supervision of foreign branches and subsidiaries is in the management information systems at head offices. In this connection, it should be noted that consultations are continuing with foreign bank supervisory authorities about the ways in which access to foreign subsidiaries may be broadened to accommodate onsite reviews. These consultations are part of a wider effort of international cooperation in bank supervision."

Regarding onsite examinations OCC said:

"National Banks are required by Regulations K & M to provide examiners with whatever credit and financial information the examiner deems necessary to evaluate the condition of the bank's foreign branches and subsidiaries. Those regulations require such information be transmitted to and maintained at the bank's head office. The OCC has for practical purposes defined "head office" to include any foreign or domestic office of the bank

which is readily accessible to its examiners. For example, all international credits of one large national bank are examined from two domestic offices and four foreign offices located in London, Caracas, Tokyo and Manila. All of that bank's many branches and subsidiaries located in Europe, the Middle East and Africa are examined from duplicate records in London.

"Supplemental examinations to determine the quality of the bank's operations are made onsite overseas when necessary. For purposes of performing asset and operational examinations, the OCC established in 1972 a London office permanently staffed by six examiners. In fulfilling its overseas examination obligations, the OCC in 1976 examined 141 overseas branches and subsidiaries of 25 banks located in 37 countries; 154 onsite examinations were performed by 215 National Bank Examiners."

Regarding joint overseas examinations, OCC said:

"The GAO recommendation has merit. As a bare minimum the physical support of the three agencies could be jointly provided. Further arrangements could be made so that any of the agencies could jointly commission overseas examiners. In this regard, the OCC is willing to seek a cooperative solution with our sister agencies.

"Under present statutes, however, such a sharing of examiner forces may be difficult. Section 481 of Title 12 (12 U.S.C. 481) directs the Comptroller of the Currency to appoint examiners who shall examine <u>every national bank</u>. That same section empowers the Comptroller to make a thorough examination of all the affairs of the banks under his jurisdiction including the affairs of all affiliates of National banks '<u>other than member banks</u>', in order to disclose <u>fully the relations between</u> the bank and its affiliates and the 'effect of such relations upon the affairs of such bank'. (Emphasis added.)"

ELECTRONIC DATA PROCESSING EXAMINATIONS

Over 85 percent of the country's banks use computers to process accounting and financial records. At some banks, computers support every operation. The agencies devote special attention to electronic data processing (EDP) operations (whether carried out by the banks or contracted) because

--the accuracy of management and accounting reports depends on EDP,

--the bank's ability to function might depend on the continued operation of EDP, and

--the bank could be vulnerable to large embezzlements through computer fraud.

Banks are beginning to use more advanced computer operations, such as computer audio response systems, online account changes, automatic payment and deposit procedures, and electronic funds transfer. To keep pace, the agencies will have to devote even more attention to EDP operations and increase the expertise of their staffs.

Many banks did not have enough data processing activity to justify buying a computer. To meet their data processing needs, these banks contracted with service centers, which frequently specialize in standard programs that can be used by similar customers. Examinations of such service centers were generally the same in scope as examinations of banks' in-house EDP departments.

Although each agency had an "EDP handbook," or standardized examination procedures manual, prepared by its Washington headquarters, the scope of each EDP examination was determined at the regional level. Examination procedures at the three agencies emphasized a questionnaire approach.

The time and staff allotted to an EDP examination depended on the size of the bank, its degree of automation, and the availability of qualified examiners. The average time spent on an examination varied from agency to agency and region to region.

The OCC and FDIC examination reports had various questionnaires on EDP and a comment section summarizing EDP

matters requiring management attention. The FRS examination report asked for similar information, but the questions were to be answered in narrative, rather than by "yes" or "no."

The examination reports of all three agencies contained more information than required to tell bank managers of the need for corrective action. The banks received all questionnaires answered during the examination, whether a deficiency was disclosed or not.

Conclusion

In our view the EDP examination report, like the commercial examination report, should contain the deficiencies noted by the examiner and any necessary supporting information.

OCC is developing new procedures for EDP examinations which should result in a streamlined examination report.

Recommendation

We recommend that the Board of Directors, FDIC, and the Board of Governors, FRS develop reports of examinations for EDP operations which present the problems found, corrective action needed and any necessary explanatory data in a clear and concise manner.

Agency comments

FDIC stated:

> "The summary comments page of the FDIC EDP questionnaire provides clear and concise descriptions of the results of a data center evaluation. In our judgment, a new evaluation report is not necessary at this time and our form, if effectively used, is comparable to the new one recently adopted by the OCC. However, we view our questionnaire as a constantly evolving tool which will be revised frequently in order to stay abreast of industry developments and to meet the burgeoning needs of our field personnel. See also our comments regarding EDP evaluation reports included with our general comments."

FRS said:

"The Board wishes to note that it believes its present EDP examination report adequately presents the major problems found and corrective action needed. Furthermore, the System has already undertaken a review of EDP examination procedures to determine whether there are possible improvements, particularly in the review of internal controls, and, in connection with that review, is preparing a revised examination report."

TRUST DEPARTMENT EXAMINATIONS

Banks operate trust departments to control or manage customers' money or property at their request. The agencies have developed special trust examination techniques to focus on two issues:

--Is the trust department complying with laws and with individual trust agreements?

--Is the trust department managed so the bank does not incur any major liabilities?

We reviewed (1) the agencies' trust examination policies and procedures and (2) examination reports on 30 trust departments. We learned that:

--The agencies' policies and procedures were similar.

--Their examination reports differed only in format.

--They used different trust department rating systems, all of which emphasized the examiner's judgment.

COMPLIANCE WITH CONSUMER PROTECTION LAWS

The Congress has enacted several laws to protect consumers. Certain of these laws affect banks' lending practices, efforts to attract depositors, and billing discrepancies. The agencies are responsible for enforcing these provisions.

How violations are discovered

The agencies learn of violations through consumer complaints and bank examinations. Each agency defines the handling of consumer complaints as a major function of its consumer affairs effort. Both FDIC and OCC keep computerized records of consumer complaints and their disposition. FRS records consumer complaints on a card filing system, and each FRB handles complaints in its district. Each agency processes hundreds of complaints and inquiries each year.

Until recently, all three agencies reviewed consumer credit as part of their regular commercial examinations. FDIC adopted separate compliance reports and consumer credit reviews in September 1974. In the most recent examinations of banks in our general sample, FDIC examiners cited violations of consumer credit and truth-in-lending regulations more often than did FRS and OCC examiners.

Law or regulation	Percent of banks in which violations were found by		
	FDIC	FRS	OCC
Credit discrimination (regulation B)	3	1	-
Truth-in-lending (regulation Z)	29	17	14

Unaggressive examinations

Consumer advocates have frequently complained that bank regulators have been deficient in their enforcement of truth-in-lending provisions (regulation Z) and other regulations. Although consumer credit compliance was being reviewed, agency officials acknowledged that examinations in this area had not been penetrating. Both consumer protection organizations and the agencies agreed that the consumer credit regulations are complex and, therefore, difficult to comply with or enforce. Officials of each agency stated that most complaints are technical problems resulting from a lack of understanding of the regulations by both banker and consumer.

In addition, some agency representatives pointed out the potential conflict between a bank's objective of financial soundness and strict compliance with consumer credit laws. For example, the financial soundness of a bank may depend upon its lending selectivity. This selectivity could violate consumer credit laws if the criteria used discriminate illegally. Also, consumer credit violations disclosed by examiners may stimulate consumer lawsuits which force banks to pay large settlements.

Since September 1974, FDIC has used consumer credit compliance reports which contained questions concerning consumer credit practices. The current report consists of four pages entitled "Truth-in-Lending--Fair Credit Billing," "Fair Credit Reporting Act," "Advertising of Interest or Dividends on Deposits," and "Equal Credit Opportunity." Each question required a yes or no response, and each page allowed space for comments.

FRS was reviewing consumer credit laws as part of the regular commercial examination. Several general questions in the regular report of examination referred to consumer credit laws; however, there was no evidence of the type or extent of testing done for consumer credit compliance.

The OCC review of consumer credit laws was also included in the regular commercial examination. A truth-in-lending disclosure checklist of 22 items for review was used; however, forms were not provided for other consumer credit laws.

The forms used by the agencies for reporting on banks' consumer credit compliance:

--Did not require specific enough information as to the extent of noncompliance in cases of possible or probable violation.

--Did not ask about lawsuits, other civil claims, or pending prosecution.

--Left the real questions of compliance up to the individual examiner.

Discovery of violations depended on the examiner's familiarity with the regulations and persistence in asking

questions. However, compliance training for examiners has been limited and inconsistent. Examiner training in consumer credit regulations, according to agency officials, has varied from 2 hours at OCC to 10 hours at FDIC and FRS. Officials at all three agencies acknowledge that training has not emphasized examining for consumer credit law compliance other than with regulation Z.

Action on violations

The agencies investigated each complaint. If they found it valid, they notified the complainant and the offending bank. The agencies did not publicly disclose the violation. When a violation was discovered during an examination, the agency informed bank managers in meetings and in the examination report. The agencies have statutory authority to issue cease and desist orders (see ch. 8) for persistent violations of consumer protection laws and regulations.

Conclusions

The agencies were not devoting enough attention to monitoring banks' compliance with consumer protection laws and regulations. Their procedures were not sufficiently comprehensive or detailed. Thus, they relied heavily upon the individual examiners to find violations; yet examiner training was insufficient. The agencies have started new programs to improve their approaches, including more comprehensive procedures, specialized training, and specialized examination staffs. (See ch. 7.)

BANK AFFILIATION WITH HOLDING COMPANIES

Bank holding companies are those which own or control one or more banks. They are a major element in the American banking system, owning or controlling one-fourth of all commercial banks in America which control two-thirds of all assets and deposits.

A holding company may be a source of financial and managerial strength to its affiliated bank or banks, or it may be a source of weakness. In 1956 the Congress passed the Bank Holding Company Act to control the concentration of financial resources, and preserve effective competiton. FRS was assigned responsibility for supervising and regulating bank holding companies.

Some holding companies caused problems for subsidiary banks

The agencies' examiners were expected to review banks' relationships with their affiliates, including holding companies, and to criticize any relationship which could cause or was causing problems for the banks. Examiners said that 72 of the 344 banks in our samples which were affiliated with holding companies had problems resulting from that affiliation. According to the examination reports for 50 of these banks, holding company management was not the primary cause of the problems. However, for the remaining 22 banks, 20 holding companies' actions were causing the problems.

According to the examination reports for these 22 banks, problems were caused by inept and ineffective holding company management--particularly overexpansion, unsound operations of nonbank subsidiaries, and real estate loans which were unpaid. Holding company actions which harmed subsidiary banks were

--transferring loans between subsidiaries and charging excessive management fees and dividends to

(1) offset weaknesses in nonbank subsidiaries, particularly mortgage subsidiaries with weak real estate loan portfolios (nine holding companies), or

(2) repay loans for either expansion or additional subsidiary bank capital (seven companies);

--excessive investment in bank quarters (one company);

--insisting that a bank make real estate loans which were subsequently classified as risky (one company);

--self-dealing and engaging in various unsound banking practices (one company); and

--fraud (one company).

Unsound holding companies' expansion applications approved

Through December 1975, FRS approved applications by 15 of the 20 detrimental holding companies to acquire

additional banking and nonbanking subsidiaries. Such acquisition contributed to problems in two subsidiary banks. In 1972, FRS approved six of seven applications for purchases by one holding company with inadequate capital. Serious problems in the company's lead bank were noted 2 years later. According to examiners, by the end of 1975 the holding company and its banks were in hazardous capital positions.

Another holding company's applications to acquire additional subsidiary banks were approved by FRS, despite serious asset problems in one of its subsidiaries. Recently the holding company went bankrupt and its lead bank failed. (See case on p. 4-41.)

FRS surveillance and inspection policies

Bank holding companies are supervised by FRBs, with the Division of Bank Supervision and Regulation providing general policy guidance and oversight from FRS headquarters.

In 1972, FRS developed a surveillance system to identify and monitor actual and potential problems by gathering and analyzing information. The system consists of

--reviews of examination reports on holding-company-affiliated banks, whether national, State member, or State nonmember,

--reviews of holding companies' registration statements, annual reports, applications, and other financial information, and

--visits to holding companies to review records and operations.

The aim of these activities is to insure that bank holding companies are operated in a manner that does not jeopardize subsidiary banks.

Review of financial data

Reserve bank surveillance activity focuses on analyzing information on each holding company and its banking and nonbanking subsidiaries.

All bank holding companies are required to report annually, and the larger companies must also file quarterly and annual supplementary data. Annual reports are due not later than 3 months after the end of a holding company's fiscal year, but the Reserve Board will grant an extension. FRB personnel are supposed to study these reports in depth and appraise the holding companies' conditions in detail. Reserve bank staff also review registration statements; applications and related memorandums; bank examination reports by FRS, OCC, FDIC, and State bank supervisors; Securities and Exchange Commission annual (10K) reports; and all correspondence. Also, FRB officers frequently contact holding company managers, who yield useful information.

According to FRS officials, they monitor those holding company activities that are most likely to place a bank in a difficult financial position, such as loans and other extensions of credit; capital adequacy, including debt equity, liquidity, and cash flow; nonbank subsidiary earnings; and intracompany transactions, including dividends and management fees. They are specifically concerned with those holding companies, subsidiaries, and affiliates which engage in leveraging activities, such as mortgage banking, consumer financing, and leasing.

Reserve Board officials believe that the information presently gathered, both oral and written, allows early identification and monitoring of problems that otherwise would come to FRS' attention only after they affected the banks. We found only one instance where the review of financial data disclosed a problem before it was found by a bank exmination.

Cnsite inspection

FRS inspection guidelines state that the frequency and scope of holding company inspections should depend not only on the holding company's size and complexity but also on information gained from other sources, such as registration statements, annual reports, and particularly examination reports on the company's subsidiary banks.

According to responsible officials, of the 12 Reserve banks:

--9 have no written guidelines detailing the scope of inspections;

--5 do not evaluate nonbank subsidiaries' assets;

--3 perform limited evaluations of nonbank subsidiaries;

--4 do not meet with holding company boards of directors to discuss findings;

--2 do not submit inspection reports to holding company managers or directors; and

--7 restrict supervisory activities, including inspections, due to budgetary restraints which preclude hiring additional personnel.

Time spent on inspections

The average time for an inspection by each Reserve bank ranged from about 4 staff-days to about 150 staff-days. Some of the variance can be attributed to differences in the average size of holding companies supervised by each FRB.

Many of the FRBs did not begin formal holding company inspection programs until 1974. FRBs had made 527 inspections through December 1975, as follows:

Year	Number of inspections	Percent of all holding companies
1971	13	1
1972	69	5
1973	89	6
1974	128	8
1975	228	13

Three FRBs made approximately 55 percent of these inspections. Six others together accounted for only about 20 percent. One of these made only six inspections in this 5-year period.

Holding company inspections did not discover weaknesses

FRS did not detect weaknesses in 15 of the 20 holding companies until after they had damaged subsidiary banks. Problem in the 20 holding companies were first identified by

--examinations of subsidiary banks of 15 companies,

--the review of financial data of 1 company,

--2 simultaneous bank examinations and holding company inspections, and

--inspection of 2 holding companies.

Nine of the 20 holding companies had not been inspected before problems appeared in their banking subsidiaries. Seven holding companies had been inspected before problems were found in the banks, but these inspections did not discover the potential for problems. Four of the seven had last been inspected 1 to 2 years before the problems were identified in the banks. In one case the inspection was confined to a review of the holding company's financial data. The remaining two inspections occurred less than 3 months before the bank examinations that identified the problems. The following case illustrates how FRS inspections failed to disclose problems.

> The bank became a subsidiary of a multibank holding company in the late 1960's. The holding company operated several banks and had other subsidiaries engaged in real estate, data processing, mortgage banking, life insurance, factoring, and loan servicing. The principal nonbank subsidiary was a mortgage corporation.
>
> The bank failed because of numerous deteriorating real estate loans associated with the mortgage company. The bank participated heavily in these loans, which were arranged by officials who controlled both the holding company and the bank. In fact, some decisions regarding the bank's operations were made by personnel who worked, not for the bank, but for the holding company.
>
> FRS inspected the holding company 4 years after it acquired the bank, but no problems were noted. In bank examination reports issued 1 month before and 7 months after the holding company inspection OCC examiners criticized loan participations purchased by the bank from the mortgage subsidiary. However, on both occasions, the examiners considered the bank's financial condition and management good, and the bank received the highest composite rating possible (a "1" rating).

Noting that the condition of the holding company and its subsidiaries was "generally satisfactory," FRS issued application approval orders the year following its inspection, authorizing the holding company to acquire other banks. A later FRS memorandum noted, "At the time of each of these Orders there was apparently no evidence available that problems were developing in [the] mortgage subsidiary."

Thirteen months after the inspection, FRS conducted a special investigation of the holding company and its mortgage subsidiary. The investigation had been prompted by a large increase in short term borrowings by the holding company. The resulting report noted substantial asset problems in the mortgage subsidiary which were causing a highly leveraged position for the holding company. The report stated,

> "of primary concern to the Reserve Bank is the increasing dependency of [the holding company] on [the bank] for financial support to meet the demand of the mortgage corporation and the resulting financial strain placed on [the bank] by such demands."

The report was provided to the OCC regional administrator.

The OCC examination of the bank 2 months after the FRS investigation disclosed that mortgage loans had severely deteriorated. The examiners considered the condition of the bank and its management poor, and assigned the lowest composite rating possible, a "4."

The bank never recovered.

Reserve Board oversight of FRBs' holding company surveillance and inspection activities

The Division of Bank Supervision and Regulation received data from the FRBs on specific holding companies, and Division personnel were in frequent contact with FRB employees. However, Division employees did not completely monitor FRB supervisory activities. For instance, they had no system, such as status reports, to keep track of the number of holding companies inspected and to insure that all holding companies with closely monitored subsidiary banks or leveraging nonbanking subsidiaries had been inspected.

Interagency coordination

The agencies exchanged information on holding company matters at both headquarters and regional levels. FDIC and OCC provided the FRBs with copies of their examination reports on banks affiliated with holding companies. The FRBs gave their holding company inspection reports to FDIC and OCC.

A March 1975 bulletin requires OCC regional offices to promptly notify, in writing, the appropriate FRB whenever their examination reveals an unsatisfactory or deteriorating condition in a bank affiliated with a holding company. FRB officials said they usually received oral but not written notices from OCC of significant bank problems.

FDIC examiners can inspect parent holding companies of State nonmember banks. Such inspections, however, are not often made.

Holding companies are also inspected by OCC personnel, who are authorized to review the operations and condition of organizations connected with national banks. OCC examiners can inspect parent holding companies and nonbank affiliates in conjunction with bank examinations when they need to consider the interaction which occurs. However, an OCC official said such inspections are rare.

The agencies did not normally conduct simultaneous holding company inspections and bank examinations, even when the main subsidiary of the holding company was a national or State nonmember bank.

Conclusions

For the cases we reviewed, the FRS holding company surveillance by financial analysis and limited onsite inspection did not discover problems in the holding companies or their nonbanking subsidiaries before those problems affected the affiliated banks. FRS should be attempting to identify and correct holding company problems before the banks are affected. And we believe that more frequent indepth inspections of holding companies would enable FRS to do so.

Because it has provided no systematic procedural guidelines or standard inspection report and does not evaluate holding company inspection units, the Reserve board cannot be sure that holding companies are effectively and consistently supervised.

We consider the exchange of information among the agencies especially important to the supervision of bank holding companies. The problems encountered by holding companies and their nonbank subsidiaries could threaten the soundness of affiliated banks and vice versa; thus, the appropriate supervisory agency should be aware of any problems. We believe that the channels of communication should be as formal as possible and that information should be exchanged regularly. Also, we see some merit in the possibilities of simultaneously inspecting holding companies and examining their subsidiaries--which would require greater interagency coordination and cooperation than now exists. (See ch. 11.)

Recommendation

We recommend that the Board of Governors, FRS, implement a system of supervision which is based on onsite inspections of holding companies and their major nonbanking subsidiaries. We also recommend that the Board strengthen its oversight of Reserve banks' holding company supervision by establishing

--a systemwide manual of inspection procedures,

--a standard inspection report, and

--periodic onsite evaluations of Reserve bank supervisory activities.

Agency comments

FRS said:

"The System has for some time conducted on-site inspections of selected holding companies. Partly as a result of these inspections and problems which came to its attention, the Board in late 1974 requested and was granted legislative authority to impose the same supervisory remedies on holding companies that were applicable to banks under the Financial Institutions Supervisory Act of 1966. In early 1976, the Board directed that this inspection

program be significantly expanded with initial efforts directed toward holding companies requiring special supervisory attention.

"In addition, in 1975 the Board commenced work on a computer based monitoring system in order to identify those holding companies which might require special attention. This program is partially operational at the present time and is expected to be fully operable within the next few months.

"A manual of inspection procedures is currently under development. However, completion of such a manual has of necessity awaited experience gained from the direct on-site inspections which have been carried out. We believe that the recommendations relating to a standardized inspection report as well as periodic on-site evaluations of Reserve Banks supervisory activities warrant further consideration. We might note that the initial steps to set up such periodic evaluations already have been commenced by the Board.

"While we see no difficulty with the thrust of the recommendations, the Board is concerned that the method used in the GAO report may lead to unwarranted fears as to the general health of bank holding companies. The sample chosen was one in which problem banks were at least six time more likely to occur than in the industry as a whole. A sample biased toward problem banks is naturally biased toward problem holding companies."

CHAPTER 5

BANK PROBLEMS IDENTIFIED BY EXAMINATIONS

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CHAPTER 5

BANK PROBLEMS IDENTIFIED BY EXAMINATIONS

OVERVIEW

Examiners found problems in nearly all of the banks in our samples including those not on the agencies' problem lists. The most frequently found problems were similar among the banks in our general and problem samples. The degree of severity for problems related to loan concentrations, liquidity, loan policy, and capital adequacy differed dramatically between problem banks and banks in general. Also, banks with liquidity, loan collateral, management or insider loan problems--whether severe or not--in addition to more common problems were likely to be problem banks.

Banks of different sizes had different problems. Large banks were more often criticized for problems related to the character of their business (classified loans, excessive real estate holdings) whereas smaller banks were most often criticized for problems related to procedures and operations (inadequate credit files, poor collection procedures).

For banks in general and, to a lesser degree, for problem banks, FDIC examiners cited problems more often than FRS or OCC examiners.

Surprisingly, far fewer banks were cited for ineffective management than were criticized for the related problems of inadequate internal routines and controls and violations of laws and regulations:

--Four percent of the banks in general were cited for ineffective management; 55 percent, for violations of laws and regulations though some of these are of a technical nature and did not impair the soundness of the banks; and 44 percent, for inadequate rountines and controls.

--Sixteen percent of the problem banks were cited for ineffective management; 81 percent, for violations of laws and regulations; and 55 percent, for inadequate routines and controls.

The agencies rarely criticized a bank's loan policies until loan problems developed. For example, if a bank's managers had not adequately diversified the bank's risks, examiners did not criticize the inadequate diversification policy until those lines of credit actually became classified. Insider and out-of-territory lending were not frequently mentioned problems for banks in our samples.

WHAT PROBLEMS DID EXAMINATIONS DISCLOSE?

Examiners found some type of problem in virtually all banks in our samples. The types and severity of problems varied from bank to bank and among various groups of banks. In the most recent reports of examination for the 600 banks in our general sample, examiners cited the problems listed below for at least 10 percent of the banks.

	Percent of sample banks
Classified loans	70
Violations of laws and regulations	55
Inadequate routines and controls	44
Overdue loans	35
Inadequate credit files	32
Inadequate capital	21
Concentration of credit	21
Loan collection procedures	15
Classified assets	14
Inadequate loan policy	12
Excessive real estate holdings	12

Over half of the frequently cited problems involved the banks' loan quality and credit procedures. Examiners stated that 61 percent of the problems with overdue loans and 49 percent of the problems with classified loans were severe. They also stated that no more than 25 percent of the other problems were severe in the cases in which they were cited.

WHAT TYPES OF PROBLEMS CAUSE THE AGENCIES TO PUT BANKS ON THE PROBLEM LIST?

As shown by the following chart, the problems found in 10 percent or more of the problem banks closely resembled those cited for banks in general.

	Percent of sample banks (note a)
Classified loans	96
Violations of laws and regulations	81
Overdue loans	65
Inadequate credit files	57
Inadequate routines and controls	55
Inadequate capital	53
Inadequate loan policy	53
Loan collection procedures	40
Liquidity	40
Concentration of credit	31
Classified assets	28
Inadequate collateral documentation	27
Excessive real estate holdings	20
Management effectiveness	16
Insider loans	11

a/Based on information in second earliest reports of examination for those banks selected from lists of problem banks as of December 31, 1975.

These problems were cited for a larger portion of the problem banks than the banks in general. Seven problems were cited for over 50 percent of the problem banks; whereas, two problems were cited for more than half the general sample. Therefore, the number of problems found in a bank is related to whether it receives special supervisory attention.

To a lesser extent, the type of problems found in problem banks were different than those of banks in general. In addition to the problems cited above, inadequate liquidity, inadequate collateral documentation, ineffective management, and excessive insider loans were criticized in at least 10 percent of the problem banks. No problems were cited in at least 10 percent of general sample banks which were not also cited for problem sample banks.

Using the examiners' descriptions of the problems in the examination reports, we ranked the apparent severity of the problems. Except for violations of laws and regulations, internal routines and controls, real estate holdings, and collateral for loans, the examiners clearly cited problem

banks' problems as being severe more often than those of banks in general. As shown below, the difference in severity for certain problems between banks in general and problem banks is quite dramatic.

	Percent of banks with problem described as severe	
	Banks in general (note a)	Problem banks (note b)
Concentration of credit	20	70
Loan collection procedures	25	51
Classified assets	25	58
Inadequate loan policy	23	61
Liquidity	16	61
Inadequate capital	22	57

a/ Based on information in the most recent reports of examination for banks in our general sample.

b/ Based on information in the second earliest reports of examination for those banks selected from lists of problem banks as of December 31, 1975.

Banks with severe problems in these areas were more likely to be considered problem banks than banks cited for other problems, such as violations of laws and regulations.

DO EXAMINERS FIND THE SAME PROBLEMS IN LARGE AND SMALL BANKS?

Problems varied among banks of different sizes. As shown below, problems related to the nature of the bank's business, such as classified loans, classified assets, and inadequate capital were more often cited for large banks than small. The problems most often cited for small banks were generally related to policies and procedures.

	Deposits (000,000 omitted)			
	Over $1000	$500 to $1000	$100 to $500	Under $100
	Percent of general sample banks			
Nature of business:				
Classified loans	93	77	73	59
Inadequate capital	31	19	21	18
Classified assets	22	22	14	9
Excessive real estate holdings	18	19	15	7
Concentration of credit	17	23	17	23
Overdue loans	30	46	34	34
Policies and procedures:				
Inadequate loan policy	10	13	10	14
Violations of laws and regulations	46	52	55	59
Inadequate routines and controls	28	35	41	54
Loan collection procedures	7	14	14	18
Inadequate credit files	9	20	27	47

DO THE AGENCIES GENERALLY IDENTIFY THE SAME TYPES OF PROBLEM?

As shown below, FDIC examiners reported more problems to the banks than FRS examiners, who reported more than OCC examiners.

	Percent of general sample banks with problem		
	FDIC	FRS	OCC
Classified loans	82	68	60
Violations of laws and regulations	70	49	46
Inadequate routines and controls	65	47	20
Overdue loans	39	39	27
Inadequate credit files	47	30	20
Inadequate capital	24	25	14
Concentration of credit	37	17	8
Loan collection procedures	20	13	11
Classified assets	18	13	11
Inadequate loan policy	21	8	8
Excessive real estate holdings	18	10	10

Some of the disparity between FDIC and the other two is no doubt due to the fact that the problems most frequently cited are most often found in small banks, which are mainly examined by FDIC. But FDIC examiners also cited more often the problems found usually in larger banks--classified loans and classified assets. The only exception to this is inadequate capital--FRS examiners cite this problem slightly more often.

The agencies often found problems which they disclosed only in a report "confidential section" not given to the banks. OCC examiners generally discussed problems more often in the confidential sections than the examiner's comments sections. This could explain the disparity between OCC and the other agencies. However, a bank does not benefit from a discussion of its problems in a report section it does not see. (See ch. 6.)

The agencies identified problems in problem banks with the same order of frequency, but the differences among agencies were smaller.

OCC cited some problems relatively more frequently, like liquidity or inadequate credit files.

	Percent of problem sample banks with problem		
	FDIC	FRS	OCC
Classified loans	98	98	92
Violations of laws and regulations	91	68	80
Overdue loans	76	53	64
Inadequate credit files	54	63	56
Inadequate routines and controls	67	60	38
Inadequate capital	61	60	38
Inadequate loan policy	80	48	28
Loan collection procedures	54	40	24
Liquidity	37	30	50
Concentration of credit	46	15	26
Classified assets	37	28	18
Inadequate collateral documentation	41	18	20
Excessive real estate holdings	31	18	10
Management effectiveness	26	10	10
Insider loans	22	5	4

DO EXAMINERS CRITICIZE THE CAUSES OF PROBLEM?

While the examiners frequently cited banks for problems in two areas of management--internal controls and compliance with laws and regulations--they did not often criticize management effectiveness. As shown below, management was most often criticized in problem banks with less than $500 million in deposits, even though 51 percent of larger banks in the general and problem samples were also criticized for violations and 32 percent were criticized for inadequate internal routines and controls.

	Percent of sampled banks with management problems					
	Banks in general			Problem banks		
Bank deposit size	FDIC	FRS	OCC	FDIC	FRS	OCC
(000,000 omitted)						
Over $1,000	-	9	5	a/	-	-
$500 to $1,000	-	-	6	-	-	-
$100 to $500	5	2	4	23	11	25
Under $100	4	3	5	28	14	11

a/ No bank in our sample of problem banks at FDIC had deposits of over $1 billion.

As we noted in our study of failed banks (see ch. 9) poor management policies caused the problems that led to the failures. These problems included concentration of credit, inadequate credit information, and poor loan collection procedures. As shown on the previous page, similar problems were found by examiners in problem banks. But the examiners often did not criticize a banks' policies until the problems had already developed. For example, inadequate loan policies were not cited by examiners unless the banks had classified loan problems, as shown by data for banks cited for either problem in our general and problem samples combined:

Agency	Bank deposit size	Number of banks	Percent of banks cited for: Only loan policy problem	Both policy and quality problem	Only loan quality problem
	(000,000 omitted)				
FDIC	Over $1,000	3	-	-	100
	$500 to $1,000	18	-	22	78
	$100 to $500	53	-	40	60
	Under $100	146	2	38	60
FRS	Over $1,000	28	-	11	89
	$500 to $1,000	18	-	17	83
	$100 to $500	73	-	16	84
	Under $100	57	2	28	70
OCC	Over $1,000	63	-	16	84
	$500 to $1,000	29	4	10	86
	$100 to $500	34	-	9	91
	Under $100	44	5	25	70

ARE INSIDER AND OUT-OF-TERRITORY LOANS SIGNIFICANT PROBLEMS IN BANKS?

Two kinds of bank problems--insider loans and out-of-territory loans--are of particular concern because they are commonly found in banks that failed. (See ch. 9.) An insider loan may be described as direct or indirect credit to a bank officer, director, major shareholder, or his interests. These loans are not necessarily improper or detrimental to a bank, but they may be if abused. Out-of-territory loans are those made to borrowers outside a bank's normal trade area. This is a greater problem for small banks because they cannot properly service loans to such borrowers.

The examiners criticized the banks for excessive "insider lending" in 3 percent of our general sample and 11 percent of our problem sample.

Loans were considered to be "out of territory" when the borrower was located outside of the bank's normal trading area. Many banks, especially medium-sized or small ones, were unable to maintain adequate contact with borrowers outside of their trading areas--which could make collection difficult. Also, such loans could have been riskier than most, since borrowers with good credit could have obtained the loans from banks in their own localities. When out-of-territory lending was cited as a problem, it was usually for banks with deposits under $100 million.

WHAT VIOLATIONS OF LAWS AND REGULATIONS ARE FOUND BY EXAMINERS?

Banking laws and regulations are an essential element of the regulatory system. They protect depositors, customers, investors, creditors, and the public by establishing the boundaries of banking activities. Violations of laws and regulations reflect management's capability.

Some laws and regulations are complex, and violating some technical provisions of them does not affect the soundness of a bank. Other types of violations, such as exceeding a bank's legal lending limit could result in losses to the bank.

The laws and regulations enforced through examinations pertained to lending practices; investments in securities and real estate; dividends; activities of directors, officers, and employees; deposits and interest rates; stock registration; affiliations; and bank security.

The examiners cited violations as a problem for 60 percent of the banks in our samples. Reports most frequently mentioned the violations of the laws and regulations listed below.

Area of violation	Percent of banks in which violations were cited by					
	FDIC		FRS		OCC	
	G	P	G	P	G	P
	(General (G) and Problem (P) samples)					
Extensions of credit:						
Excessive	29	54	6	23	16	72
To insiders	16	28	6	10	11	18
To affiliates	8	22	7	10	10	28
Collateral:						
Loans	18	39	4	10	4	10
Securities	16	26	3	5	3	4
Securities acquired	7	7	5	5	5	4
Real estate acquired other than premises	3	4	1	-	13	4
Amount of borrowings	-	2	1	-	1	2
State laws:						
Lending	4	6	20	23	-	-
Others	27	26	9	13	1	2
Interest rate ceiling	3	4	15	23	4	20
Reporting requirements	-	-	1	3	1	-
Bank premises	1	2	8	8	2	8
Interlocking directorate	-	-	1	3	1	-
Dividends	-	-	2	5	1	-
International operations	2	2	2	3	-	-
External crimes	25	7	8	-	1	-
Consumer credit (regulation B)	3	4	1	-	-	-
Truth in lending (regulation Z)	29	24	17	23	14	16

Note: National banks and State-chartered banks are not subject to all of the same laws and regulations.

For all three agencies, more problem banks were cited for violations of laws or noncompliance with regulations than were general sample banks. However, the more prevalent violations were nearly the same for general and problem sample banks in FDIC and OCC. For example, 4 of the 5 laws and regulations cited for 10 percent or more of the general sample national banks were also cited for 10 percent or more of the problem national banks. Only 3 laws or regulations were violated by 10 percent or more of the general sample State member banks--8 laws and regulations were cited for 10 percent or more of the problem sample banks.

WHAT PROBLEMS DO HOLDING COMPANIES CAUSE IN BANKS?

Our sample of commercial banks included 344 that were affiliated with 279 holding companies. Bank examiners noted that 72 of these banks had problems resulting from their affiliation. We reviewed the examination reports on these banks. In 50 cases, holding company management was not the primary cause of the problems but neither was it a source of strength. Twenty holding companies had either caused serious problems or had contributed to existing problems in the remaining 22 banks. (See ch. 4.)

Bank problems caused by their holding companies are shown below:

Type of Problem	Banks affected Number	Percent
Impaired bank liquidity because of excess management fees or dividends paid to holding company	14	64
High volume of low-quality loans made at insistence of holding companies	10	45
Bank profit decrease	7	32
Improper control by holding company over operations or services of the bank	7	32
Overall negative effect on the bank	7	32
Violations of laws and regulations	6	27
Excessive purchase of assets at insistence of holding companies	4	18

WHAT PROBLEMS WERE FOUND IN BANKS' INTERNATIONAL OPERATIONS?

We reviewed examination reports for 18 national banks and 12 State member banks which had substantial international operations. The examiners cited the following problems related to international operations:

	Banks with problem	
	Number	Percent
Loans:		
High percentage of classified international loans	9	30
Poor credit files	3	10
Large concentrations	3	10
Poor loan analysis	1	3
Inadequate information on affiliate investments	1	3
Inadequate information on branch credit	1	3
Foreign exchange operations:		
Poor internal controls	5	17
Lack or violation of net open position	2	7
Lack of customer exposure limits	2	7
Lack of well-defined policies	1	3
Management:		
Poor overall internal controls	6	20
Violations of laws and regulations	4	13

Also, in the latest reports of examination, these banks were reported as having a total of $80.5 billion in loans to foreign governments, businesses, and individuals. The examiners had classified 3.7 percent of these loans as substandard, 0.4 percent as doubtful, and 0.1 percent as loss. Seven percent were "specially mentioned."

CHAPTER 6

REPORTING PRACTICES: 1971-75

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CHAPTER 6

REPORTING PRACTICES: 1971-75

OVERVIEW

The success of the supervisory process depends heavily on how examination results are disclosed to those responsible for correcting problems--the bank's board of directors. While the agencies' examiners discussed the results of their work with bank managers during and after the examination, the agencies generally did not meet with boards of directors. Examiners or agency officials met with the boards of directors of less than 10 percent (FDIC 1 percent; FRS 9 percent; OCC 6 percent) of the general sample banks after examinations conducted in 1974 or 1975. Even when the banks had major problems, the examiners met with the boards of directors in only about half of the cases. After the second most recent examination we reviewed, FDIC representatives met with the boards of directors of 30 percent of the banks in our sample of problem banks; FRS representatives with 53 percent; and OCC representatives with 54 percent. We believe that the agencies should always discuss the results of their examinations with the boards of directors or the directors' audit or examining committees.

The agencies rated each bank after each examination. Although the rating systems used were mechanically different, they considered the same basic factors and were subjective. Generally, these ratings were not disclosed to the banks and were important only as internal shorthand ways of referring to the condition of individual banks.

The agencies prepared reports of examination which were sent to the examined banks' boards of directors and to agency headquarters. The reports were organized differently but contained the same basic information. The problems noted during the examination were presented in a summary section which was given to the bank. Detailed schedules, analyses, and listing contained in the "body" of the report were also given to the bank. This section

--supported the examiner's criticisms and conclusions,

--documented some of their work, and

--communicated some of the bank's financial data to agency officials.

The examination reports also had a "confidential" section which bank personnel did not see. Here, the examiner expressed his or her opinions on the bank's financial condition and management quality. This section was a major medium for communications between the examiner and agency management about a specific bank.

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

--Many problems and criticisms were stated in the confidential sections but not disclosed in the sections given to the banks. For example, in three consecutive reports of examination for one bank, the examiner criticized the bank's capital position in the confidential sections only.

--Much of the information reported originated from the banks and was included to document the examiners' work rather than to inform the banks. The reports provided the banks with their own balance sheets, income and expense data, deposit trends, and real estate holdings.

--The examiners generally did not recommend how the banks could correct the problems. For 63 percent of the problems noted in banks in our problem samples, the examiners did not recommend corrective actions. In some instances, the required corrective action would have been obvious to the bank.

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

DISCUSSION OF EXAMINATION RESULTS WITH BANK MANAGEMENT

During and after the examination, the examiners were expected to discuss their findings with bank managers; loan classifications, in particular, were to be discussed in detail. In a few instances, the banks were given preliminary written report results. The FRB of Philadelphia examiners, for example, gave large banks in their district a "minireport," containing examiner's comments and loan write-ups, when the examiner left the bank.

Although specific duties, responsibilities, and liabilities vary from State to State, generally bank directors are required to be fully aware of the bank's policies, operations, and condition. They are supposed to apply ordinary care and prudence in administering the bank's affairs, and they may be liable for any resulting losses if they do not. Thus, the results of an examination should be important to the board of directors, and the supervisory agencies should be doing their utmost to communicate the examination results to the directors.

Another indication of the board of directors' ultimate responsibility for the bank is that about half of the States require some form of directors' audit or examination. While the actual work might be done by an independent accounting firm, many boards have established audit or examining committees to insure that their examining responsibility is met.

The agencies routinely send copies of examination reports to the banks' boards of directors, but they did not require their examiners or regional officials to meet with each banks' board of directors after each examination. As shown by the following chart, the agencies rarely met with the boards of directors of banks in general and very often did not meet with those of banks with major problems. (Cases 1, 2, 3, 4, and 5 in ch. 8 illustrate the agencies' practices with regard to meeting with directors.)

Agency	Percent of banks in which agencies met with directors	
	Banks in general (note a)	Problem banks (note b)
FDIC	1	30
FRS	9	53
OCC	6	54

a/ Based on actions taken after the earliest reports of examination.

b/ Based on actions taken after the second most recent examination for sample of problem banks as of December 31, 1975.

Both FDIC and FRS have a general policy of meeting with boards of directors of all problem banks. Officials of one FRB, however, had a policy of meeting with the board of directors of each examined bank and believed that this practice reduced the incidence of serious problems. In January 1976, OCC instituted a policy of meeting with the board of directors of every national bank each year.

Conclusion

One factor common to many bank failures was the lack of oversight exercised by the banks' boards of directors. (See ch. 9.) The agencies can at least insure that the directors have the information needed for exercising the proper degree of oversight by informing them of the results of each examination.

We believe that the report of examination should not be the only method by which examination results are disclosed to the bank. The agencies should also meet with the banks' boards of directors or audit or examining committees after each examination irrespective of the nature of their findings to

--emphasize to the bank the importance of the examination and the agency's concern for its well-being.

--insure that the boards, which are ultimately responsible for the bank's operations, are fully aware of the examination results.

--discuss findings,

--establish closer working relationships with the boards, and

--enhance the stature of the examiners.

Perhaps, it would be appropriate to provide the examiners with some instruction on how to conduct the meetings.

Recommendation

Therefore, we recommend that the Board of Directors, FDIC, and the Board of Governors, FRS require their examiners to meet with the bank's board of directors or audit or examining committee after each examination.

Agency comments

FDIC said:

"FDIC conducted approximately 7,900 examinations in 1975. Senior officials from the various Regional Offices met with bank management on approximately 1,750 occasions, representing 22% of all examinations. Throughout 1975, there was an average of 224 banks under our supervision which were formally designated as financial problems. FDIC policy is to meet with bank directors at least where problem situations exist.

"FDIC staff has in the past year been considering the question of how often meetings with bank directors should be held. In consideration of this subject, the responsibilities of bank directors, the Corporation's responsibility to bank directors, and our past and present practices in holding board meetings were weighed.

"In a broad sense, the board of directors of a bank is responsible for the formulation of sound policies and objectives of a bank, the effective supervision of its affairs, and promotion of its welfare. In discharging these responsibilities, a director's duty is to exercise due care or be

exposed to a charge of negligent performance of his duty. To insure that bank directors are aware of the contents of examination reports the Corporation requires that a receipt accompanying each report be signed by the bank's executive officer stating that the report "...was duly considered by the directors...and a record of the action taken thereon by the Board has been entered in the minutes." Moreover, at each examination, the examiner is charged with the responsibility of determining that the bank's board minutes reflect a thorough consideration of examination reports and correspondence received from supervisory authorities since the last examination.

"To enable bank managements to begin work on problem areas prior to receipt of the completed examination report, a list of adversely classified assets and other major criticisms is provided to the executive officer at the completion of each examination and most of the FDIC Regional Offices have implemented deadlines for receipt of completed examination reports in the Regional Office--usually 10 calendar days after the close of the examination.

"The FDIC Manual of Examination Policies states, with respect to examiners holding meetings with directors (Section Q, page 3, paragraph I.E.):

> "Except in instances where authority has been delegated by the Regional Director, the Examiner should consult with the Regional Office before calling a board meeting. Ordinarily, meetings with the board of directors should be held at the conclusion of all examinations of problem banks. A meeting of the board may also be required when experience and instinct tells the Examiner a likelihood exists that the bank will be added to the problem list or will be earmarked for other special supervision. Additionally, where there is a substantial volume of classified assets, low capital or other areas of important criticism, a board meeting may be desirable. This is particularly true when the trend has been unfavorable and previous admonitions have gone unheeded."

"In keeping with this policy, it is in fact the practice in most regions for the examiner to hold a meeting with bank directors if problems of consequence are found at the examination, or if significant adverse trends are noted since the last examination. In virtually all instances involving problem banks, a representative from the Regional Office will meet with the directors, and in most cases an invitation is extended to the state authority to participate in the meeting.

"The FDIC is cognizant of the benefits flowing from more frequent meetings with the boards of directors of banks under our direct supervision and anticipates holding such meetings with increased frequency in the future. We are also actively reviewing the posture of the FDIC in this regard with a view of improving upon the timeliness and conduct of such meetings."

FRS stated:

"The System has for many years been concerned that the board of directors be particularly aware of the results of an examination. Thus, the System has historically required that the examination report be considered and discussed at a meeting of the board of directors. To insure that this is done, directors are required to sign a statement attached to the report that it has been so read and considered. Further, examiners are instructed to review the minutes of board of director meetings to insure that the spirit of these requirements has been fully carried out.

"With respect to meetings, the Board in 1975 directed that an earlier existing policy for most of the System be expanded to all Reserve Banks. This policy requires that Reserve Bank staff meet with the board of directors of all so-called problem banks. The Board believes that such meetings are important where significant problems are revealed."

BANK RATINGS

The supervisory agencies developed systems to rate banks on financial condition and management quality. The ratings were used only by the agencies as a shorthand for describing a bank's condition and were generally not disclosed to the banks. A rating was an indicator of the need for supervisory attention, but not the sole determinant of whether or not a bank was designated to receive special supervision. (See ch. 8.)

At FDIC the examiners-in-charge rated banks. At FRBs, ratings were assigned by the examiners-in-charge or the review examiners, the chief examiners or the vice presidents, depending on the FRB. At OCC, the regional administrators assigned the ratings.

The ratings were based upon information developed during the examinations and were combinations of specific ratios and judgment.

The agencies used different systems to rate banks, but they considered the same basic factors: asset quality, capital adequacy, and management quality. FDIC also considered the adequacy of the bank's earnings.

The FDIC rating included the ratios of

--adjusted capital and reserves to adjusted gross assets,

--net capital and reserves to adjusted gross assets, and

--net earnings to average gross assets.

The FDIC rating also included the examiner's judgment of the bank's management as good, satisfactory, fair, unsatisfactory, or poor.

The rating system used by all FRBs had four elements:

--a rating of capital position (1, I, 2, 3 or 4),

--a rating of asset quality (A, B, C or D),

--a rating for management (S, F, or P), and

--a composite rating (1, 2, 3 or 4) of those three factors.

Although the rating system employed several ratios and some thresholds, judgment was again a major component.

OCC's rating system included an overall rating of the bank, ranging from "1" to "4"--"1" being the best. In addition, the bank was rated for capital position, quality of assets, and management. The best rating indicated that the bank was sound in every respect. A "2" rating was given to banks with "relatively moderate to moderately severe" asset weaknesses, which had insufficient capital, unsatisfactory management, or a combination of problems and weaknesses. A "3" rating was given to banks with "an immoderate volume of asset weaknesses" which, when combined with other factors, could have developed into "a situation urgently requiring aid either from the shareholders or otherwise." A "4" rating was given to banks whose failure, if aid was not provided, appeared "probable." The ratings for capital position and asset quality were based on specific ratios coupled with the regional administrator's judgment. Management ratings were based on the judgment of the regional administrator rather than on established criteria.

The following chart summarizes the composite ratings received by the banks in our general sample as a result of their most recent examinations.

Agency (note a)	Percent of banks receiving rating of			
	1	2	3	4
FRS	52	37	10	1
OCC	46	34	19	1

a/ As explained on page 6-8, FDIC does not develop an overall rating for a bank. However, FDIC uses a problem designation system which designates banks as "other problem," "serious problem," and "serious problem potential payoff." (See ch. 8.) Five percent of the FDIC banks in our general sample were designated as one of these.

While about half of the banks received a rating of "1", our analysis of ratings for these banks after previous examinations shows a decrease in "1" rated banks and increases in "2", "3", and "4" rated banks.

THE REPORT OF EXAMINATION

The report of examination had three distinct parts:

1. The "examiner's comments" or "summary."

2. The "body."

3. The "confidential" section.

The examiner's comments section presented the examination's results and was the primary written communication from the examiner to the bank. The examiner cited problems and sometimes suggested actions to resolve them.

However, in the second earliest reports on our sample of December 31, 1975, problem banks, the agencies' examiners recommended corrective steps for an average of only 34 percent of the problems they found. FDIC recommended actions for 37 percent; FRS for 23 percent; and OCC for 39 percent. In some instances, the required corrective action would have been obvious to the bank.

The body, which was the bulk of the examination report, presented the facts and analyses on which the examiner's comments were based. Tables, questionnaires, lists, and some narrative comments were included. This section served a number of functions:

--It detailed the results of some examiner analyses.

--It documented some of the steps followed by the examiner.

--It supplied some financial information to the supervising agency.

Although the body section was given to the bank, it contained information such as the balance sheet and income and expense data which the bank had furnished to the examiners.

The confidential section was not provided to the examined bank. In addition to some factual material, this section contained the examiner's more explicit comments and opinions on the bank's condition, management, ownership, earnings, growth potential, and progress toward resolving problems. It was intended as an internal communication from the examiner to agency management.

The confidential sections of reports we reviewed contained criticisms which were not noted elsewhere in the reports. The examiners were more critical of bank management here than they were in the comments section as shown by the following table, based upon information in the second earliest reports of examination for our sample of problem banks as of December 31, 1975.

	Percent of reports in which problems were noted in					
	Confidential section			Examiner's comments section		
Problem or criticism	FDIC	FRS	OCC	FDIC	FRS	OCC
Inadequate or incompetent management	63	45	60	26	10	10
Inadequate capital	43	63	68	61	60	38
Insufficient liquidity	19	35	54	37	30	50
Earnings	11	25	26	17	18	8

The following cases illustrate the types of problems discussed in the confidential section which were not disclosed to the banks. (See also cases 2 and 4 in ch. 8.)

Case 1

For three consecutive examinations, the FDIC examiner-in-charge criticized the effectiveness of the bank's management and indicated a severe problem with management domination in the confidential section but not in the examiner's comments section. The examiner-in-charge criticized the management's responsiveness to problems in only the confidential section in the most recent report of examination.

Case 2

The FRB examiner-in-charge criticized the bank's unsatisfactory capital ratios in the confidential sections of two consecutive reports and indicated that the bank's capital was inadequate in the confidential section of the following report. Also, in one year the examiner-in-charge criticized excessive amounts of real estate holdings and a lack of top management in the confidential section. None of these criticisms were pointed out in the examiners comments sections of the reports given to the bank.

Case 3

The OCC examiner-in-charge criticized the bank's loan policies in the confidential sections of three consecutive reports of examination but not in the examiner's comments section. Also in the second and third reports, the confidential sections contained criticism of costs and expenses, internal routines and controls, and borrowing frequency which were not disclosed in the examiner's comments sections of the report given to the bank.

Conclusion

The report of examination was not serving its primary function as effectively as possible. We believe that the report of examination should present clearly and concisely the results of the examination, the agency's recommendations for corrective action, and any information necessary to support the examiner's conclusions. It need not go to great length to provide information which the bank already has.

If the agency needs additional information for review or statistical purposes, the report sent to headquarters should be accompanied by a detailed, structured set of workpapers and standard data collection forms. (See ch. 4.) Thus, the bank would not be burdened by a report containing superfluous information, and the agencies would be better able to review the examiners' work.

OCC is implementing new examination procedures which will result in a revised report of examination and standard workpapers. (See ch. 7.)

Recommendation

We recommend that the Board of Directors, FDIC, and the Board of Governors, FRS, develop and use reports of examination which provide the banks with the results of the examination and any necessary supporting information.

Agency comments

FDIC said:

"FDIC conducted an intensive study in 1965 to assess the impact of its examination report on banks. As a result in 1969, a new examination report format was put into use. We believe this report format, and the guidelines under which it is used, provides a clear, concise picture of problem areas to bank managements. Various FDIC staff members have attended familiarization sessions on the OCC's new examination report format. The OCC has tested this new format in only ten banks and the impression of the FDIC staff members is that the report format is somewhat cumbersome, especially in problem situations.

"There appears to be some misunderstanding with respect to the purpose and thrust of the confidential (supervisory) section of the report of examination. The purpose and thrust of the confidential section are to allow the examiner to comment on matters uncovered during the course of the examination which may not lend themselves to complete substantiation, but which may serve to alert his superiors that further investigatory or supervisory efforts may be necessary. For obvious reasons, such material is not, and should not, be provided to the management of the bank. However, a thorough study of the role and use of the confidential

section was started some months ago and, when completed, will probably result in significant changes in its thrust, format and content, or in its elimination."

FRS said:

"We believe the bank examination report presently provides the banks with the results of an examination and necessary supporting information. We also believe it should provide the System with the information it needs to carry out its supervisory functions. The present examination report adequately carries out these needs. It should not be forgotten that the System also uses other methods of communicating its views to its member banks, such as correspondence, informal meetings, and consultations on applications. Of course, the System is continually exploring methods of improving communications."

REPORT PROCESSING

The examiners-in-charge were responsible for drafting and signing the reports of examination. Where and when they drafted the report varied among and within the agencies.

Regional report review

In all three agencies the reports of examination were reviewed in the regional offices before they were finalized and sent to the banks and the agencies' headquarters. In general, the reports drafted by the examiners-in-charge were reviewed for arithmetic accuracy, grammar, logic, support for statements, and internal consistency. Reviewer positions were filled by senior field examiners either permanently or on a rotating basis.

FDIC stated that about 30 days elapsed from the drafting of an examination report to its transmittal to the bank and receipt by Corporation headquarters. The FRBs attempted to send the reports to the banks within 30 days of completing the examination. OCC attempted to send reports to the banks within 20 days of completing the examination.

Headquarters review

Each agency headquarters received a copy of each report of examination. FDIC headquarters staff reviewed the reports, designated certain banks for special attention, and monitored the supervisory actions taken by the field offices. At FRS, the headquarters staff reviewed each report but paid special attention to those banks with composite ratings of 3 or 4 or those rated 2 which, in the reviewer's judgment, required intensive monitoring. The FRS reviewers would suggest supervisory action only in those cases where they believed the FRB's action was inappropriate. OCC headquarters staff primarily reviewed the reports to insure that banks requiring increased supervision were identified, and to validate the follow-up activity of the regional offices.

INTERAGENCY REPORT EXCHANGE

Each agency could request any report of another agency. In addition, FRS provided FDIC with all reports on banks composite-rated 3 or 4, and OCC provided FRS with all reports and FDIC with all reports on problem banks.

State exchange arrangements varied from region to region but FDIC and FRS generally provided their reports of examination to the State banking agencies.

CHAPTER 7

EFFORTS TO IMPROVE BANK EXAMINATION

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CHAPTER 7

EFFORTS TO IMPROVE BANK EXAMINATION

OVERVIEW

The Federal Deposit Insurance Corporation and the Federal Reserve System recently revised their examination approaches to give greater priority to examining the weakest banks and less emphasis to examining relatively trouble-free banks. To assist in identifying banks that may have problems, the agencies are expanding their systems to analyze banks' performance by using financial data that agencies periodically obtain from the banks.

The Office of the Comptroller of the Currency initiated development of a new examination approach in the fall of 1975 which also focuses more on banks with problems and less on trouble-free banks; however, its changes are much more extensive than those being made by FDIC and FRS. OCC has developed examination procedures emphasizing early identification of weaknesses in management policies and procedures. If OCC can influence the banks to rectify these weaknesses promptly, many of the problems now occurring can be corrected before they seriously threaten the soundness of the banks. This concept, in our opinion, offers significant benefits over the traditional examination approach which has been used by the three regulatory agencies.

At the time of our study, the process had only recently been developed and field tested at 10 banks. Neither we nor the agency could fully evaluate the practical problems that may be encountered in implementing the new procedures, such as the resources needed and the applicability of the process to all types of banks. Undoubtedly, many practical problems will be encountered and futher refinement of the process will be necessary. We believe, however, that these problems can be worked out as OCC gains additional experience. The basic concept of the process seems logical and, we believe, should be pursued jointly by the three supervisory agencies.

OCC'S NEW EXAMINATION APPROACH

In May 1974, Comptroller of the Currency, James E. Smith, commissioned the public accounting firm of Haskins & Sells to comprehensively review and evaluate OCC operations--the first major outside study of the Office since its establishment in 1863. On May 30, 1975, the firm reported to the

Comptroller numerous recommendations for modifying or extending existing activities. Regarding bank examinations, Haskins & Sells recommended that OCC

--monitor the financial reports of national banks,

--require national banks to report financial data more promptly and in accordance with uniform principles of accounting and reporting, and

--modify the examination procedures.

Monitoring systems

To monitor national banks, Haskins & Sells recommended a system which they called the National Bank Surveillance System (NBSS). The system consists of four basic elements:

--A data-collection system.

--A computer-based monitoring system to detect unusual or significantly changed circumstances within a bank and within the national banking system.

--An evaluation by experienced personnel of the impact of such changes on bank soundness.

--A review procedure that would provide administrative controls over all proposed OCC remedial actions.

To implement the recommendation, in September 1975 OCC established a small staff of experienced OCC examiners and Haskins & Sells employees. Information for the NBSS data base was derived from reports of condition (balance sheet data) and reports of income which national banks are required to periodically submit to OCC. FDIC also processes the same data from all banks. (See ch. 11.)

The staff, in implementing the system, generally followed the concepts set out in Haskins & Sells' report, and by mid-1976, a limited system, with a 5-year data base, began operation with data reported for March 31, 1976. By October 1976, the system was fully operational, although OCC plans to add additional data to the system, including data from its examination reports.

NBSS supplements the new examination procedures by detecting, each quarter, financial changes in national banks.

Data produced from the system is to be used to identify those banks which need priority examination and to provide statistical data in a usable form to assist the examiners in evaluating the bank's financial condition.

One computer program provides a statistical profile, or performance report, of each national bank in comparison with a profile of its peers. Another computer program quarterly summarizes key performance data, and ranks those banks which are to receive priority review. For those banks ranked by the computer as being in greatest need of review, trained specialists analyze the bank performance reports, looking for high or low percentile rankings and for short term and long term trends. The performance reports contain ratios of financial data for current and past periods for each bank, as well as for its peers. Certain key ratios provide, in OCC's opinion, the best general measures of unusual or changed circumstances in a bank that require further investigation. For example, one ratio monitors changes in the composition of the loan portfolio. This ratio is used as an indicator of changed management emphasis on types of loans made.

An NBSS specialist who detects unusual or significantly changed circumstances within a bank, is to report them to the regional administrator, who may direct any investigations considered necessary--ranging from a telephone call to the bank to a full, priority examination--to analyze the impact of the change on the bank's soundness.

In planning bank examinations, the examiner also uses the bank performance report to develop an overview of financial conditions and results of bank operations and to to identify potential problem areas so staff and procedures can be selected.

NBSS also includes an action control system to monitor the problems identified to see that they are resolved. Banks designated for priority review are placed quarterly in the action control system. Banks cannot be removed from the system until all problems are resolved. For those banks that remain in the system, reports will be made every 2 weeks showing the progress or the lack of progress in resolving their problems.

According to OCC officials, the system will be expanded to also monitor the actions taken by banks in response to deficiencies disclosed in examination reports. During the

period of our review, OCC should have been more aggressive in requiring banks to correct problems noted during examinations. (See ch. 8.) In this regard, the use of the action control system to monitor the progress that banks make in correcting their problems would be a useful tool to the agency.

Commercial examination procedures

During the fall of 1975, OCC formed a task force to revise its commercial examination procedures. The task force developed more sophisticated, formal, and uniform procedures for examining banks, incorporating (1) the recommendations of Haskins & Sells, (2) the informal practices of many examiners in the past, and (3) other changes considered necessary. In the spring of 1976 these procedures were field-tested in two banks. The procedures were revised as a result of the field test, and during July 1976, 4 examiners from each of the 14 OCC regional offices were instructed on the revised procedures. These examiners then conducted pilot examinations of eight banks. Beginning in September 1976, additional bank examinations commenced under the new approach. The four trained examiners from each region began in mid-1976 to gradually train other examiners. OCC expects all its examiners to be using the new procedures by mid-1977.

The new procedures provide for three types of examinations:

General examinations which are broad in scope and are to be performed once every 2 years at all banks.

Specialized examinations which are limited in scope and are to be performed at all banks twice in each 2-year period.

Special supervisory examinations which are made only at those banks with severe problems necessitating close supervision.

The limited testing of the new procedures indicates that the general examinations, at least the initial examination at each bank, will be very time consuming in relation to the traditional examination. During the 1976-77 cycle, OCC may not have sufficient staff to make a general examination plus two specialized examinations of all national banks, in addition to the special supervisory examinations of banks requiring close supervision.

During 1975, OCC made 6,000 regular commercial examinations and 860 special examinations. The average time required to complete the examination of the test banks was about three times the amount required to examine the banks under the traditional method. OCC has not estimated the resources required by the new procedures. Officials said that, while some problems will be encountered in meeting their 1976-77 examination goals, the required examinations for the 1978-79 cycle can be met with their existing staff.

They also said that the time required to make the general examination under the new procedures will decrease as the examiners become more familiar with the procedures. Officials pointed out that the second general examination of a bank will consist largely of updating the workpapers of the initial examination and will not require as much staff time. They also stated that the two specialized examinations to be made in each 2-year cycle will not require as much staff time as the current traditional examination.

The new general examination consists of two separate phases--the preexamination analysis and review, and the detailed examination.

Preexamination analysis and review

The preexamination analysis and review ordinarily is to be performed by the examiner-in-charge and one or two assistants, depending on the size and complexity of the bank, and is expected to take from 1/2 day to 2 weeks to complete. Where possible, the review is to be performed at the bank several weeks in advance of the examination date.

The principal purpose of the preexamination analysis and review is to determine the scope and objectives of the general examination. In other words, OCC expects to identify areas where deficiencies exist and where it should put the most emphasis. This analysis and review is also intended to

--familiarize the examiner with the bank's operations,

--determine staff requirements for the detailed examination,

--identify potential problems in applying the examination procedures,

--coordinate work schedules with bank management, and

--decide which affiliated companies to examine and how broadly to cover them.

This phase of the examination process consists of obtaining basic data about the bank's policies, procedures, controls, and internal and external audit activities. The data is evaluated and the scope of the general examination is defined, including the extent of examination and verification procedures to be performed during the detailed examination. If the examiners find that the conclusions reached during the preexamination analysis and review phases were incorrect they may revise the scope during the general examination.

The work performed during the preexamination analysis and review includes

--reviewing prior examination reports and applicable working papers,

--analyzing bank financial data as shown on the NBSS report, including any comments or analysis by NBSS specialists,

--completing an internal control questionnaire,

--reviewing the bank's audit functions,

--completing an examination planning and control questionnaire, and

--reviewing minutes of board of directors and committee meetings.

This phase of the work is intended to tailor the work programs for the general examination to the bank being examined and at the same time to provide for consistent examinations whose scope is dictated by the bank's condition and not by the examiner's judgment alone.

Detailed examination

The basic task of the detailed examination is to complete the work programs, with any adjustments that become necessary during the course of the examination; to reach a conclusion on the overall condition of the bank, present and prospective; and to develop recommendations for correcting deficiencies.

In our view, the most important facet of the new examination procedures is that they will center more on the underlying causes of problems rather than on the results of operations. Poor results are visible in bad loans, concentrations of credits, excessive insider loans, risky investments, inadequate capital, inadequate liquidity, violations of laws, etc. The traditional examination has focused on identifying these types of problems. (See ch. 4.)

The agencies have previously made little use of a formal or structured approach to examining those elements of bank activities that cause problems. The extent of examination of bank policies, practices, procedures and controls was largely left to the discretion of the examiner, and according to agency officials, time restrictions often caused examination efforts in these areas to be minimal or superficial. While the new procedures still provide for examining the end results of operations, they place much more emphasis on identifying conditions which, if not corrected, could lead to poor results.

OCC has developed a comprehensive handbook, a standard internal control questionnaire, and sets of examination and verification procedures for specific asset and liability accounts and for particular banking and examining activities.

According to OCC officials, many examiners had developed their own informal examination procedures, which differed from examiner to examiner and from bank to bank. To a large extent, the new examination procedures represent a composite of these informal procedures.

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

In essence, OCC will be looking at how well banks are managing themselves from day to day. Where weaknesses are found in bank management, OCC will be recommending changes in bank policies, practices, controls, and audit to a much greater extent than previously. While the objective of the new procedures is to identify weaknesses in bank management which could lead to such problems as bad or risky loans and investments, and liquidity and capital deficiencies, it can

also help to reduce fraud--sometimes a cause of bank failure. (See ch. 9.) Although fraud detection is not one of the primary objectives of the new procedures, early correction of weaknesses in policies, procedures, controls, and audit activities may reduce the opportunity for fraud or allow it to be discovered before the bank's condition is seriously impaired.

The contrast between the old and new approaches can be seen by comparing the examination reports of the 10 banks that were examined using the new procedures with prior reports for the same banks that were prepared under the old approach. Numerous weaknesses in managerial practices and controls were discussed in the new reports which apparently had existed for a long time but had not been identified in the prior reports. The following examples, in our opinion, illustrate the contrast in the examination approaches.

Case 1

The new report on one of the test banks depicted the condition of the bank as unsatisfactory because of the amount of classified assets. The report attributed this condition to poor, unwritten, or nonexistent lending policies. The report stated that

> "* * * the bulk of criticized items have orgination [sic] dates in the 1972 to 1974 period and many reflected weaknesses at inception, particularly with respect to financial support, establishment of valid repayment sources, documentation and collateral, and these deficiencies have become especially pronounced during this period of economic strain. Those granted in the 1975-forward period which are listed in this report often exhibit the same deficiencies which can be traced primarily to the absence of a sound lending policy, thus allowing for the continuing extension of credit without defined and approved guidelines."

The report pointed out that a lending policy was being drafted by the bank and suggested that the bank establish an internal loan review department.

The three prior examination reports on this bank, prepared under the traditional approach, criticized the volume of classified assets but did not criticize the bank's lending policies or controls. In the confidential section of

two prior reports the examiner concluded that the lending policies were reasonably sound and conservative. The confidential section of the other report did not express any opinion on the bank's loan policy.

Since the report is the product of the examination procedures used, one can understand why the traditional reports were not critical of the bank's lending policies and controls. The traditional approach is to examine a large portion of the loans as of a certain date and to appraise and classify them according to the degree of risk involved. (See ch. 4.)

In addition, the Comptroller's old handbook of examination procedures required the examiner to analyze the bank's lending and collection policies and practices; however, the examiner had almost complete discretion in deciding the specific procedures to be used and the workpapers to be prepared.

Under the new approach, loans are still examined in detail, appraised, and classified. Increased emphasis, however, is placed on evaluating whether the bank's policies, procedures, practices, internal controls, and internal and external audit are adequate to assure compliance with laws, regulations, and sound banking principles.

To provide a basis for these evaluations, the examiner completes an internal control questionnaire and a prescribed schedule of detailed examination and verification procedures.

Case 2

One of the test banks had no problems requiring attention, according to a January 26, 1976, report conducted under the traditional approach. In a report prepared June 30, 1976, using the new approach, the examiner concluded that the bank's overall condition was good, but he pointed out numerous deficiencies in internal audit and controls and a lack of written policies on accounting procedures and concentration of credit.

The January report analyzed the bank's audit department and the scope of its audits and found them adequate. The analysis of the audit department and internal audit scope was limited to a one-page, question and answer worksheet. The new procedures provide for a more indepth review and evaluation. In addition to a nine-page questionnaire, it includes numerous examination procedures, such as reviewing the internal audit reports and related workpapers.

The same auditor was still employed by the bank in June, but OCC was very critical of the audit department. The June report concluded:

> "The internal audit function is considered ineffective. The audit program, scope of audits and documentation thereof are generally considered to be unacceptable. * * *
>
> "The internal audit staff lacks * * * experience and professional ckground to audit a bank the size and complexity of your bank. * * *"

The January report did not criticize any bank activity or recommend improvements. The confidential section of the report, which did not go to the bank, considered internal controls and audit procedures adequate. Since the bank had no changes in management or substantial growth in resources, the numerous recommendations in the June report appear attributable to the broadened scope of the new examination procedures, rather than to a deterioration in bank operations.

Revised examination report

The examination report itself has been revised to communicate information more effectively both to OCC management and to the banks.

The traditional examination report contains numerous pages of data, taken from the bank's records, that is readily available to bank management. Many of the critical comments are contained in the confidential section, which the bank does not receive. (See ch. 6.)

The new report contains four major sections:

--Letter to the board of directors.

--Comment section.

--Appendix.

--Confidential section.

The letter to the board is to set forth the scope of the examination and the examiners' evaluation of the condition of the bank--either positive or negative. Where problems exist, the letter is to describe the probable causes of the problems and recommend corrective actions.

The comment section is several pages of narrative in which the examiner discusses the problems found and evaluates such areas of bank activity as loan portfolio management, investments and broker-dealer activities, earnings, capital adequacy, and asset-liability management.

Much of the appendix contains schedules supporting the narrative in the comment section, such as a writeup of classified loans and a list of credit data and collateral exceptions.

The confidential section of the report, which is not furnished to the bank, is to relate matters requiring the prompt attention of OCC senior staff, such as

--suspected violations of law uncovered during the course of the examination,

--actions of senior bank officers which may require such official sanctions by OCC, as the threat of cease-and-desist orders or officers' removal, and

--subjective comments which have not been proven by the examiner but which nevertheless constitute areas of concern.

The examination report also contains a form requiring the signature of each board member attesting that he or she has personally reviewed the content of the report.

Specialized and special supervisory examinations

OCC decided that, with its new more extensive examinations and with NBSS to identify changing situations in banks, completely examining a bank three times every 2 years is unnecessary. Therefore, during each 2-year cycle it will normally examine each national bank completely once and perform two specialized examinations. For those banks which

are well managed, the specialized examinations will be directed primarily at following up on changes that are disclosed by OCC's surveillance system. For those banks which show substantial weaknesses during the general examinations, the specialized examinations will be directed largely at following up on the actions taken to correct these weaknesses as well as any changes detected by NBSS. In determining the scope of specialized examinations, the examiners are to consider the bank's changes in policy, procedures, or management and any plans that could significantly affect future operations.

OCC has established minimum procedures to be used during specialized examinations. The examiners may add procedures after considering such matters as

--the results of the most recent general examination,

--the risk ascribable to the policies and practices employed by the bank,

--internal controls,

--the capability of managers and directors,

--the nature of and risk ascribed to transactions with and investments in related organizations,

--the internal audit function,

--the scope and results of the most recent examination by external auditors,

--the anticipated impact of local and national economic factors, and

--adverse changes in risk assets, earnings, or liquidity, or other matters coming to the examiners' attention as a result of performing the minimum procedures.

Other special supervisory examinations are to be performed when a bank's condition necessitates an examination or supervisory visit more than twice in one calendar year. These examinations have no minimum scope requirements. Rather, they are to consist of procedures selected to fit the circumstances in each case.

These specialized examinations will be scheduled primarily in response to NBSS identification of a bank with severe changes in its quarterly financial reports.

Evaluation of large shared loans

In 1975, OCC began a program of conducting special examinations at certain banks which participate with other banks in loans to large corporations. The purpose of the program is to provide uniform treatment of the same loan among participating banks. A loan qualifies for the program (and is termed a shared national credit) if it totals $20 million or more and two or more banks participate.

A team of OCC bank examiners reviews a shared national credit at the lead bank (or the national bank with the largest dollar share when the lead bank is State-chartered) and votes whether or not the loan will be classified (i.e., criticized). The shared national credit evaluation is then incorporated into regular examination reports of all national banks which participate in the loan.

In 1975, OCC reviewed 521 shared national credits at 14 lead national banks. The loans totaled $48 billion--9 percent of the dollar value of all outstanding loans in the commercial banking system. In 1976, under the shared national credit program, OCC reviewed 704 loans at 16 lead banks. These loans amounted to $63 billion, or 13 percent of the value of all commercial bank loans.

Many of the participating banks are State-chartered. FDIC and FRS received limited data on OCC's 1975 shared national credit evaluations and its 1976 consolidated report. FDIC and FRS, however, did not use the OCC's evaluations when their examiners reviewed the loans at the State-chartered participating banks. On December 21, 1976, FDIC headquarters advised its regional directors that their examiners should begin utilizing the OCC's shared national credit classifications when they examine a participating State nonmember bank unless some change has occurred since OCC's classification which would warrant a different classification.

We traced 183 State bank participations in 53 loans evaluated by OCC's shared national credit program, to compare the evaluations of FRS and FDIC examiners to those of OCC's team. In over half the cases for which the examination dates were comparable, the FRS or FDIC evaluation of the loan differed from the OCC uniform rating.

Loan evaluations were inconsistent at both FDIC- and FRS-supervised banks. At each of the 12 State member banks we reviewed and at both of the State nonmember insured banks which had participated in more than one shared national credit, at least one loan evaluation differed. In general, many more State members than nonmembers participate in shared national credits. Of the 183 participations we traced, only 19 were to State nonmember insured banks.

Revised trust examination procedures

OCC has also made extensive changes to its trust examination process, as the Haskins & Sells study recommended.

The new approach includes preprinted forms which are to be completed for each trust department examined. These forms provide for more uniform examinations but still permit the examiner-in-charge some leeway for dealing with a particular bank's situation. The examiners may reduce their verification work if they find they can rely on the work done by the bank's internal and external auditors.

In March, April, and May 1976, the new procedures were field tested in six banks: two in California, one in Iowa, one in Kansas, and two in Pennsylvania. Full implementation began October 1, 1976.

Revised EDP examination procedures

Traditionally, examinations of electronic data processing operations have been regionally administered with little or no national coordination. They consisted of interviews with bank personnel supplemented by limited reviews of corroborating documents. The EDP reports contained questionnaires requiring in some cases the examiners' overall assessment of some EDP-related activity. There were no agencywide work plans or guidance to assist the examiners in these assessments. A headquarters official concluded that examinations were not being conducted uniformly and in many instances were of poor quality. The Haskins & Sells report made several recommendations for improving OCC's EDP examinations.

By November 1976, OCC was completing improvements in numerous EDP related areas such as:

--Upgrading EDP examiners' expertise.

--Developing a detailed examination handbook.

--Developing a comprehensive work program.

--Expanding the EDP field staff.

--Revising the EDP examination report.

--Increasing headquarters direction of EDP examinations.

The new OCC handbook and work program should improve and standardize examinations.

In the traditional EDP examination report, questionnaires were filled out on various EDP activities whether or not a deficiency was disclosed. (See ch. 4.) The revised report eliminates the questionnaires and consists of narrative comments on

--the scope of the examination,

--any exceptions and deficiencies noted, and

--specific recommendations for improvement.

CHANGES IN FRS'S EXAMINATION APPROACH

During 1975 the Federal Reserve Board's Committee on Bank Regulation and Supervision undertook a number of studies and projects to update and improve examination policies and procedures.

Revised examination procedures

In March 1976, the Board adopted a limited-scope examination of historically sound banks, referred to as an asset-management examination. These examinations are to be alternated with regular examinations. Use of the new procedure, however, is left to the discretion of the Reserve banks.

This examination is designed to increase efficiency by shifting some examination resources from banks that are prudently operated and relatively trouble-free to those banks that are in more critical need of attention.

The asset-management examination is intended to be integrated with a surveillance program which, according to FRB, need not be formal, but which should be sufficient to highlight unusual shifts in a bank's position. The

surveillance results may influence whether an asset-management examination or a regular examination will be made. If substantial changes in senior management, ownership, or local or general economic conditions have occurred or harmful trends are developing, a regular examination may be warranted. This is, however, a subjective decision left to the discretion of the Reserve bank.

Techniques employed in this type of an examination may differ from those employed in regular examinations. The principle thrust of the examination is to

--analyze assets (The examiner uses discretion in deciding how many to examine.),

--identify and analyze changes in overall financial condition and the caliber of management since the previous examination, and

--ascertain that policies and procedures are being followed that will insure compliance with relevant laws and regulations.

Monitoring systems

The Board has developed three major computer programs that perform screening and monitoring functions on a variety of data files for banks and bank holding companies. The main computer program generates a list of banks or bank holding companies by specifying any set of financial ratios for a peer group, which have actual or potential financial problems, and monitors the progress of such companies over time. The data sources for the main computer program are the periodic reports of condition and income for banks and the bank holding company annual report and quarterly financial report (now under development).

The consolidated bank holding companies shareholders' report program uses published financial data to produce a comparative ratio analysis of the 300 largest bank holding companies. The program produces six reports including comparative percentage breakdowns of each holding company's financial statements, year-to-year percentage changes in various financial items and ratios, and rankings of bank holding companies within peer groups by 24 financial ratios. The data sources for this program are the annual and quarterly reports to shareholders published by large bank holding companies.

The weekly bank monitoring program screens four weekly reporting series which allow analysts and examiners to follow weekly and monthly changes of key balance sheet items of large banks and to derive monthly net income of reporting banks.

The main computer program and the shareholders' program became operational during September 1976, and the weekly monitoring program will be operational during January 1977.

Additionally, FRS developed in 1975 a report that identifies transactions that take place between the nonbank portion of the holding company and the bank portion. Major transactions are to be reported 10 days after they occur; other transactions are to be reported quarterly. Information from the report is computer processed at the Reserve bank and sent to the Board. The report is reviewed at the Reserve bank and the computer printout summary of the report is reviewed at the Board to identify any large, unusual, or improper transactions. A memorandum is prepared quarterly for the Board that summarizes major transactions and balances.

In order to set up the surveillance system for bank holding companies, the Board began developing in 1974 a computer supplement to the bank holding company annual report. In 1975 the Board developed the intercompany transactions and balances report that identifies major transactions between the bank and nonbank portion of the holding company During 1976 the Board revised the bank holding company annual report to add new information to aid monitoring, and reformat the report to aid computer processing of the information. The Board is now in the process of developing a quarterly financial report for bank holding companies which is intended to enhance the monitoring of the financial condition of these companies.

In addition to its computer programs, the Board monitors banks and bank holding companies through manual systems. For example, the Board monitors on a daily basis stock market prices and earnings reports that appear in the financial press. Formalized relationships have been set up with stock surveillance groups of the major stock exchanges which alert the Board when a stock price breaks a price or volume parameter. Monitoring of earnings releases enables the Board to obtain information before it would otherwise be available to the Board.

In September 1976 the conference of presidents of the Federal Reserve Banks completed plans for a minimum monitoring system to be developed by each Reserve bank in addition to any other monitoring the bank considers necessary. Meanwhile, several Reserve banks have developed their own monitoring systems. The Board's surveillance group is to work closely with the Reserve banks in developing a minimum surveillance system so that the systems are compatible. According to FRS the Reserve Banks' systems are directed more to the district level and the Board's system is directed towards monitoring large peer groups of banks and bank holding companies that cross district boundaries.

The Boston Federal Reserve bank began developing a monitoring system about 4 years ago. The system started to monitor banks about 2 years ago; the portion dealing with bank holding companies is still under development. The system's purposes include monitoring individual banks as well as the banking industry, providing a basis for scheduling examinations, and preparing an examiner for an examination.

Data for the system comes from reports of condition and income, weekly reports from certain banks, holding company reports, and internally generated information. Banks and holding companies are ranked in relation to each other, and the most extreme cases can be designated for additional review.

The Kansas City Federal Reserve bank monitors the liquidity position of 36 large banks in its district to identify banks whose liability management activities may pose a threat to their financial stability. The Reserve bank's staff developed several ratios which relate a bank's confidence-sensitive money (such as Federal funds and $100,000-or-larger certificates of deposit) to that bank's ability to refund this money to lenders on short notice. Such funds are not backed by Federal deposit insurance and can be highly volatile. The Reserve bank uses rankings rather than absolute criteria, and examines trends over time. Data for this system comes from weekly reports filed by certain large banks and from internally generated data on borrowing from the Reserve bank. The Reserve bank began developing the system in late 1974 and put it into operation in early 1975.

Of the 36 banks tracked, 33 are national banks monitored largely for comparative purposes (although adverse

trends are brought to the attention of the OCC regional administrator), and 3 are State member banks, over which the Reserve bank has supervisory authority.

The Kansas City Federal Reserve bank is also developing a comprehensive bank monitoring system, which it expects to begin operating in early 1977.

The San Francisco Federal Reserve bank is developing a financial monitoring system to track the condition of banks and bank holding companies in that district. In addition to monitoring, the system is expected to be useful in scheduling examinations, preparing examiners to begin an examination, and providing data for research, as well as in other areas.

The system will use data from call and income reports, weekly data on certain large banks, quarterly data on bank holding companies, and examination data. The information will be analyzed on two levels: (1) all institutions will be compared quarterly with approximately 18 relative or absolute ratios relating to liquidity, leverage, capital adequacy, profitability, and operating efficiency, and those comparing unfavorably will be noted and (2) institutions so noted will be subjected to detailed individual analysis. The system is designed to give users flexibility in changing the ratios used without reprogramming.

The Reserve bank decided in mid-1975 to begin developing such a system and entered into a $76,000 contract for its design. The system is expected to be operational in early 1977 and is expected to have yearly operating costs of about $23,000.

CHANGES IN FDIC'S EXAMINATION APPROACH

On November 2, 1976, the Director, Division of Bank Supervision, announced a new examination policy to become effective January 1, 1977. The principal policy changes relate to examination frequency and scope. FDIC is also planning to make greater use of financial data that banks prepare for it each quarter.

Frequency of examination

The new policy is to conduct, at least once every 12 months, a full-scope examination of each State nonmember insured bank having supervisory or financial problems. Additional examinations or visitations of such banks will be

made as considered necessary by the regional directors. Banks not having supervisory or financial problems are to be examined at least once every 18-month period, with no more than 24 months between examinations.

As stated in chapter 4, during the period of our review FDIC did not have a policy on examination frequency. In practice, however, it examined most of its banks once each year.

Scope of examination

The scope of examination, as well as the report, may be modified for banks with assets of less than $100 million that have been operating for 3 full years and meet certain prescribed standards with respect to management, capital, earnings, fidelity coverage, controls, and audit.

FDIC's new policy statement provides:

> "* * * Full use should be made of the bank's EDP and management reports, and sampling should be utilized wherever possible, and proof and verification procedures may be eliminated or substantially limited unless circumstances indicate additional effort is needed in these areas. Additionally, the volume of loans subjected to analysis may be reduced, and less important branches need not be examined. Emphasis at these modified examinations should be placed on management policies and performance; the evaluation of asset quality, alignment and liquidity; capital adequacy; and, compliance with applicable laws and regulations.
>
> Where adverse trends or other justifications appear, appropriate revisions in the conduct of the examination should be made and report schedules added."

For banks with assets over $100 million which do not have supervisory or financial problems, some curtailment is permitted in the scope and reports of examination under certain conditions.

Monitoring systems

FDIC has in operation and under development several systems to monitor bank performance for adverse trends and

identify banks which may have potential problems. Banks so identified may be scheduled for priority examination or other followup. These systems are based on data reported periodically by banks on reports of condition and income.

These systems were designed to utilize different methodologies and are, to some extent, competing. FDIC plans to evaluate all of these systems over the next year or two to determine which provide the most useful results. Thereafter, FDIC plans to integrate the most effective systems into a coordinated bank monitoring system.

Three systems are currently in operation.

--Financial Trend Analysis. From this system a user can obtain a printout showing which banks in certain geographical areas meet certain levels for all or some of 83 variables.

--JAWS (Just A Warning System). This system identifies banks whose financial ratios do not meet predetermined levels in 13 critical areas. Headquarters staff set a critical threshold for each ratio, but these can be changed for individual regional offices.

--Early Warning System. Based on statistical analyses to identify the most critical differences between problem and non-problem banks, seven variables were selected and various weights, or importance, were assigned to each. This sytem produces a score for each bank which is designed to indicate the severity of its potential problems.

Two other systems are under development:

--Monitoring System. On the basis of 11 variables, this sytem compares one bank against other banks of comparable size, and identifies those banks which are furthest above or below the group average.

--Regression Model. Based on balance sheet data, this system generates a model bank with an asset structure similar to the bank under study, and compares income and expense data of the bank under study with projected data for the model to evaluate operating efficiency.

Revised trust examination procedures

Changes in FDIC's trust examination process include (1) a revised report format, more extensively covering corporate activities and collective investment funds, and (2) preprinted checklists, similar to the questionnaire and checklists established by OCC but not as extensive.

Of the three agencies, FDIC was the only one that did not have specialized positions for trust examiners. FDIC has now established 14 trust specialist positions which are being filled.

NEW APPROACHES TO CONSUMER CREDIT COMPLIANCE EXAMINATIONS

The agencies have planned expanded efforts in consumer credit regulation, following the enactment in 1975 of increased legislative requirements.

In testimony before the U.S. Senate Committee on Banking, Housing and Urban Affairs, the State Bank Commissioner of Connecticut described a test based on a sample of 15 FDIC examination reports. With only 2 exceptions, all 15 reported compliance. In contrast, 15 State reports revealed 961 offenses, including $35,180 in overcharges.

FDIC, which has been using separate consumer credit compliance reports nationally since September 1974, plans to adopt standard statistical sampling techniques and to install a specialist within each region, but not to change its examination or reporting procedures.

FRS, which plans to perform separate consumer credit compliance examinations, found that the techniques needed to examine bank policies and practices in the consumer credit area are quite different from those used for determining the safety and soundness of banks. The Federal Reserve Board has developed new supplemental manuals for consumer credit examinations. Additionally, several Federal Reserve banks are developing their own procedural checklists for the other consumer credit regulations. FRS is also developing a separate report of examination and procedures for consumer credit compliance examinations. A committee of the Board of Governors has been formed to study various approaches to uniform enforcement of consumer credit laws.

OCC conducted a test project during 1975 and 1976 in one regional office. It found that consumer credit protection laws were violated more frequently than was previously thought. OCC officials, acknowledging that the national banks have received only cursory reviews for compliance with consumer credit laws, have begun a special crash program in September 1976, with the target of examining all national banks within 12 months. Key elements of the new examination effort include

--a revamped and greatly expanded examination questionnaire which will enable the examiner to probe the policies, procedures, and practices of national banks,

--expanded programs to train assistant examiners in the new consumer-oriented examination procedures,

--coordinated followup procedures which will require the regional officer to secure early correction of banks' deficient practices,

--the help of the Comptroller's Enforcement and Compliance Division in getting banks to correct deficiencies, and

--the use of standard statistical sampling techniques to provide examiners with a simplified yet accurate testing approach.

All three agencies, as part of their increased efforts in consumer credit regulation, have begun intensive examiner training schools. Beginning in September 1976, the three agencies started training experienced bank examiners to look for consumer credit and fair housing violations. They expect to eventually train all bank examiners in procedures for consumer credit compliance examination. A separate staff of compliance examiners will be developed to work independently of other examiners or, in the case of FRS, to work concurrently with the commercial examiners.

CONCLUSIONS

We support FDIC's and FRS's objective of giving greater emphasis in the examination process to the weaker banks and less emphasis to the relatively trouble-free banks. In our view, however, the new approaches adopted by FDIC and FRS will not provide the degree of assurance that OCC's new approach will provide that examiners will systematically and

indepth examine banks' policies, practices, procedures, controls, and audit to identify weaknesses in bank management which could lead to serious problems.

OCC's revised commercial examination procedures should provide the agency with more meaningful information regarding the banks it supervises and result in more complete and consistent examinations. More importantly, the new approach should result in early detection of situations which could cause banks difficulty. Examiners could thus help banks avoid problems rather than point out problems after they have occurred.

To derive the full benefit of this approach OCC must act more aggressively than in the past to influence banks to remedy defects in operations disclosed by its new examinations. (See ch. 8.) While the new procedures do provide better documentation for deficiencies noted and more effective communication between OCC and bank directors and senior management, the new procedures will not guarantee that weaknesses noted will be corrected. We believe that a computerized system for monitoring the actions taken to correct deficiencies, such as the NBSS action control system, is a step in this direction.

The new OCC procedures for examining trust departments and EDP operations, in our view, would assure more uniform and indepth examinations than do the traditional approaches and could be used by all three agencies.

More experience is needed with the new examination processes before many practical aspects of the processes can be fully assessed. However, we believe that the concepts are logical and offer benefits which could also apply to FDIC and FRS. Because of the importance of the changes, we believe that OCC should invite FDIC and FRS to jointly compare its new processes with the traditional processes, as well as the modifications being made by the other two agencies, both in terms of benefits derived and resources consumed. Such an assessment would provide a sounder foundation for fully implementing the new processes at OCC, as well as at FDIC and FRS. It could help resolve such issues as:

--Costs and staffing implications of new processes.

--Applicability of new processes to banks of all sizes.

--Whether the agency already has sufficient data about certain well-managed banks to waive some of the detailed review of policies, procedures, etc. at these banks.

In our view, the responsibility to analyze all large shared national credits should be centralized in one group composed of examiners from all three agencies. This group could produce classifications of these loans at the lead banks which would be accepted by all three agencies when they examine the participating banks--both national and State banks. The three agencies operate under a uniform agreement for classifying loans; thus examiners from the three agencies should not encounter insurmountable difficulties in arriving at uniform classifications.

By different routes, the agencies are striving to find the most meaningful system for monitoring banks and the most effective approach to examine banks for compliance with consumer protection laws. We believe they would benefit from jointly evaluating the various systems and approaches being developed. Each agency could modify its approach to incorporate strengths that other approaches may offer.

RECOMMENDATIONS

We recommend that the Comptroller of the Currency invite FDIC and FRS to jointly evaluate its new examination approach. We further recommend that, in the event of a favorable assessment of the new process, the Board of Directors, FDIC, and the Board of Governors, FRS, revise their examination processes to incorporate the concepts of OCC's approach.

We recommend that the Board of Directors, FDIC, the Board of Governors, FRS, and the Comptroller of the Currency jointly staff a group to analyze shared national credits at State and national lead banks under Federal supervision and that the three agencies use the uniform classification of these loans when they examine the participating banks.

We recommend that the Board of Directors, FDIC, the Board of Governors, FRS, and the Comptroller of the Currency work together to refine their monitoring systems and their approaches to examining for compliance with consumer credit laws.

AGENCY COMMENTS

With respect to our recommendation relating to OCC's new examination approach,

FDIC stated:

"In light of the limited testing that has been conducted (10 banks) of the OCC's new process, we believe it is premature to consider that process a success either for large or small banks. Representatives of the OCC admitted that, while the new procedures are workable in banks with assets between $50 million and $1 billion, they do not appear feasible for banks with assets of less than $25 million. We therefore question the logic and wisdom of GAO's recommendation that FDIC adopt such process, either for the large or small banks under our direct supervision, especially when it is recalled that 91% of the banks we directly supervise have assets of less than $50 million and 77% less than $25 million. Since the number of large banks directly supervised by the FDIC has and continues to increase, our examination process is necessarily designed to handle small, medium and large-sized banks. However, we shall follow closely OCC's experience with the new examination process as it undergoes further testing, and we remain receptive to further revision in our own examination approach which will be beneficial to and improve our supervisory capabilities.

"In our judgment, the discussion of changes in FDIC's examination approach does not reflect sufficiently the impact and significance of those changes, especially with respect to our review of the management policies and internal controls of a bank under examination. We believe that the changes made by the FDIC represent, at the present time, the most logical, beneficial, and prudent improvements in the examination process. We have blended the proven techniques and practices with a new approach which we feel should enable FDIC to focus more directly on, and devote more time and effort to, problem and near-problem situations, and concomitantly less on healthy banks. We refer to excerpts from our General Memorandum #1, included with our general comments."

FRS stated:

"The Comptroller's new procedures are based in large part on the Haskins & Sells report. At the time that report was prepared, the Comptroller furnished it to the other banking institutions in the belief that some of the recommendations might be jointly applicable. A task force at the Federal Reserve reviewed the report shortly after its issuance and concluded that, in most instances, the System had already implemented those recommendations involved which would have been applicable to the System. Subsequent to that time, the development of new examination procedures at the Comptroller's office has been substantially completed. Recently, senior members of the Board's staff attended a briefing by the Comptroller's office on these new examination procedures and the report form to be used by that agency. The Board believes that the Comptroller has been most cooperative in sharing his new systems with us and fully intends to use whatever benefits may be derived from the Comptroller's efforts in this area in our on-going review of our examination procedures."

OCC stated:

"On November 23, 1976, OCC staff members made a presentation to approximately 20 FRS and FDIC staff members on the revised examination procedures. Copies of our draft Handbook of Examination Procedures were furnished. Their review and evaluation on an ongoing basis is welcomed. The Acting Comptroller has proposed to the Interagency Coordinating Committee that a permanent staff group be set up for this purpose."

With respect to our recommendation relating to joint evaluation of shared national credits,

FDIC stated:

"Although--as the GAO report points out--of the 183 participations in shared national credits traced by GAO only 19 were to state nonmember insured banks, the FDIC is now a participant in the Shared National Credits Program."

FRS stated:

"A joint approach to shared national credits is clearly desirable. In fact, in June 1976 the Board and the Office of the Comptroller of the Currency entered into a preliminary agreement which provides for a sharing by each agency of examiners' classifications of a national credit."

OCC stated:

"In 1974, meetings were held with representatives of the OCC, FRS and FDIC present to discuss the possibilities of using a uniform program for the review of selected large shared loans. Both the FRS and the FDIC found merit in the program but they believed sufficient pitfalls existed to delay their participation in the program. Also, in March of 1974 this Office met with representatives of the Conference of State Bank Supervisors to discuss the proposed program. They indicated interest and agreed to work out arrangements with various bank supervisors.

"In 1975, the Office of the Comptroller of the Currency conducted uniform reviews of shared national credits in applicable National Banks. The loan write-ups generated by these reviews were made available to both the FRS and the FDIC. In March, 1975 FRS expressed their continued interest in the program and hoped they could participate if the "pitfalls" could be overcome. In November, 1975 FRS revealed they were instituting a test review program involving state member banks paralleling our methods and procedures. In July, 1975 FDIC again expressed interest and a meeting was held in September, 1975 with representatives of the FDIC. This Office indicated FDIC involvement would be welcomed in whatever way they deemed appropriate.

"During May, 1976 the second uniform review was conducted and again the data generated was made available to the FRS and FDIC.

"In July, 1976 the Comptroller of the Currency and the Vice Chairman of the Federal Reserve

Board met to discuss the approaches of the two agencies to shared national credits. It was agreed that the OCC should continue to provide FRS with the information developed under its program and to explore at a staff level whether uniform procedures could be developed between the two agencies which would be acceptable to all of the Federal Reserve Banks. It is our understanding that the New York Federal Reserve Bank is conducting a pilot project involving shared credits which may assist in resolving some of the anticipated problems associated with a combining of the approaches of the two agencies."

With respect to our recommendation relating to monitoring systems,

OCC stated:

"The OCC has met on several occasions with officials of the other two Federal supervisory agencies to present its NBSS system. Those orientations were given both orally and with complete submission of all relevant documents. Further, we have offered the other supervisory agencies computer programs and technical knowledge to implement the programs."

FDIC and FRS did not respond to this recommendation.

With respect to our recommendation relating to consumer credit compliance examinations,

FDIC stated:

"We are, of course, in favor of the three federal bank regulatory agencies sharing and working together in the important area of consumer credit compliance. However, in many instances healthy competition in the area of consumer credit compliance as well as in other areas of banking supervision between the three federal bank regulatory agencies can lead to a better system of supervision then complete uniformity. Thus, the development of an independent approach by one or more of the agencies may lead to a better end result."

FRS stated:

"The second portion of this recommendation deals with the desirability of uniform refinement of consumer credit enforcement and compliance policies. In the report, the GAO states that some agencies believe there is a possible "conflict between a bank's objective of financial soundness and strict compliance with consumer credit laws." The Board does not agree with this statement. On the contrary, we believe that stringent enforcement of consumer laws and regulations will achieve compliance and thereby reduce the likelihood that banks will incur substantial liability as a result of consumer suits.

"The Federal Reserve has had the major responsibility for drafting regulations to implement the explosion of legislation that has taken place in this area over the past two years. In this connection, the Board's Division of Consumer Affairs has worked very closely with the other agencies. It has formed a Federal Reserve task force to develop approaches to the enforcement of newly enacted consumer credit laws. A cadre of examination specialists who will concentrate on inspection and compliance is being trained. Two schools on consumer regulations were conducted in 1976 and four have been planned for 1977.

"Additionally, examination manuals that deal with the full array of consumer regulations have recently been prepared. A new examination report form dealing exclusively with this area has been prepared and is expected to be in use in the near future."

OCC stated:

"With reference to consumer credit compliance examinations the draft report does not fully recognize that our new program is already operational. Over 6% of our field staff is currently allocated to the consumer area. We

have conducted three two week schools which trained over 140 examiners in the new procedures; a second series of three schools is scheduled for March and April, and a third series will take place in the Fall. The schools stress examination techniques and feature heavy reliance on case studies to give experience in examining for compliance. The procedures are tailored to spot problems most likely to result in harm to consumers. We make use of sophisticated advanced financial calculators, specially programmed for banking applications, and sampling techniques designed to increase our effectiveness.

Eleven percent of the country's 4,700 national banks have been examined under the new procedures. Preliminary analysis of these reports indicates that our expanded efforts in this area are both justified and effective.

"The draft report also does not reflect the extent to which other agencies have cooperated in developing our new program. The Federal Reserve Board and H.U.D. aided in reviewing our procedures. Speakers from the Federal Reserve Board, H.U.D. and the Justice Department participated in our schools. Observers from the Federal Reserve Board, FDIC, N.C.U.A. and H.U.D. attended the schools to assess the new procedures. As a result many of our examination procedures and teaching materials have been adopted by these four agencies. This experience has reinforced our awareness of the benefits of such cooperative efforts."

CHAPTER 8

EFFECTIVENESS OF AGENCIES IN RESOLVING PROBLEMS

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CHAPTER 8

EFFECTIVENESS OF AGENCIES IN RESOLVING PROBLEMS

OVERVIEW

Our analysis of enforcement actions taken by the supervisory agencies for almost 900 banks included in our samples showed that informal actions were used most of the time and that formal actions were seldom used.

The agencies dealt with problem and nonproblem banks in basically the same way. Even though the same types of problems existed from one examination to another, the agencies did not always change or intensify the type of enforcement actions used to get the problems corrected. The supervisory agencies should have used their formal enforcement powers more often.

Examiners find some type of problem in virtually all banks; however, some banks have more serious problems and require more supervisory attention than others. The agencies cannot correct the banks' problems themselves but they can use many enforcement tools to get banks to correct their problems. These tools include both informal and formal enforcement actions.

Informal enforcement actions are nothing more than an agency's attempts to persuade bank management to take corrective action. Formal enforcement actions are used as a last resort for getting problems corrected. Some of the formal enforcement actions do not help correct problems or save banks, but result in closing the bank to protect depositors.

After an examination, the agencies evaluate the effect that the problems identified during the examination can have on the bank's soundness. If the problems are serious, the bank is designated for special supervisory attention. Such banks are sometimes referred to as "problem banks."

Because the agencies use different criteria to identify problem banks, they often do not agree on which banks require special supervision. Of the 4,744 national banks operating on December 31, 1975, OCC considered 85 as requiring special supervision; FRS 267; and FDIC 52.

Among the 1,046 State member banks, FRS identified 65 problem banks and FDIC identified 17. Because the agencies' interest in and responsibility for dealing with the banks overlap, and because their interest should intensify as serious problems are identified, we believe they should work towards a common definition of banks requiring close supervisory attention.

To assess the supervisory agencies' effectiveness in getting banks to resolve their problems once they have been designated for special supervisory attention, we analyzed the agencies' "problem list" for the 5-year period ending December 31, 1975. During that period 718 State nonmember banks, 128 State member banks, and 686 national banks had at some time been in the agencies' problem bank category. Of those banks, 414 (58 percent) of the State nonmember banks, 38 (30 percent) of the State member banks, and 392 (57 percent) of the national banks were returned to nonproblem status by December 31, 1975. Although most returned to nonproblem status within 2 years, 19 percent were problem banks from 2 to 5 years, and 5 percent were problem banks for over 5 years.

The supervisory agencies' success in getting bank problems corrected depends heavily on cooperation from bank management in changing the practices and policies which caused the problems. Those banks which are receptive to the agencies' identification of problems and suggestions for solutions stand a better chance of correcting their problems sooner. Informal enforcement action works for these banks.

What concerns us are those banks which are problem banks for long periods of time, for example the 201 banks that were problem banks for over 2 years during 1971-75. We believe that the supervisory agencies should have used formal enforcement actions more frequently when dealing with these banks. During the entire 5-year period, the agencies made limited use of written agreements and cease and desist orders, probably their most effective tools. The use of written agreements was FDIC 3, FRS 8, and OCC 48, and the use of cease and desist orders was FDIC 38, FRS 5, and OCC 13. During 1976, each agency increased its use of cease and desist orders. FDIC used 29, FRS used 4, and OCC used 7. Also, OCC increased its use of written agreements in 1976, when it used such action 23 times.

The supervisory agencies have requested additional statutory authority to remove a bank official whose acts

stem from either personal dishonesty or gross negligence and to assess civil penalties against banks and individual officials for specific violations. Our study of failed and problem banks showed that the authority to remove individuals or to apply penalties could have been helpful in dealing with the officials of these banks. We believe that the authority to remove individuals or to apply civil penalties could be useful to the agencies and we would support such legislation.

HOW THE AGENCIES DEAL WITH PROBLEMS

Once the supervisory agencies have identified problems and communicated them to the bank, they have at their disposal a number of enforcement tools which they can use to get bank management to correct its problems. These tools include both informal and formal actions.

For purposes of analyzing agency files, we identified 10 kinds of informal enforcement actions and 7 kinds of formal actions.

Informal enforcement actions

Informal enforcement actions, sometimes referred to as moral suasion, are simply the supervisory agencies' efforts to persuade bank managers to correct a problem.

Discussion at time of examination

The examiner-in-charge discusses problem situations with the bank's executive officers as problems are discovered or at the close of the examination. The purpose of such meetings is to direct managers' attention to the problems found and to possible resolutions. If the problems are serious, regional or district officials may attend the discussions. If the bank is State chartered, State officials may also attend. The supervisory agencies may also discuss the deficiencies with the bank's board of directors. (See below.)

Request for formal response to reported deficiencies

The supervisory agencies frequently request that banks respond formally to criticisms in examination reports. Such a request is made in the transmittal letter to the bank. The agency, after reviewing the bank's response, may conclude that the bank is correcting or has corrected its problems. The agency would then followup no further until the next scheduled examination. On the other hand, if the agency is not satisfied that the problem is being dealt with, it can take other followup actions.

Request for periodic progress reports

The supervisory agencies often ask banks to report periodically on progress in correcting deficiencies (e.g., the status of classified assets). Such a request also is made in the transmittal letter accompanying the bank examination report. After reviewing progress reports, the agency may decide the bank is correcting its problems and may request no further progress reports. On the other hand, the agency may decide that more frequent progress reports are required or that some other type of enforcement action is needed.

Request for meeting with bank's board of directors

The supervisory agencies can request a meeting with the bank's board of directors to discuss examination results and the bank's condition.

Since January 1976, OCC's policy is to meet with each board of directors annually, usually at the time of the examination. FDIC and FRS do not routinely meet with the bank's boards of directors. (See ch. 6.)

Written communications

One method of informal followup, other than the transmittal letter, is a letter from the supervisory agency to the bank. Depending on the seriousness of the problems, the letter may be signed by the examiner-in-charge, a regional or district official, or a headquarters official. If a State agency is involved, a State official may sign the letter. The agencies can use written communications to make followup requests for formal responses to examination report deficiencies and progress reports.

Bank visits

The supervisory agencies can visit banks to followup on problems. Such a visit may be to meet with directors, executive officers, or other individuals in the bank.

Special examinations

OCC and FRS use special examinations to monitor certain bank problems. Such examinations are limited in scope. For example, the agency might visit the bank and review its

classified loans if the examiner cited them as a serious problem during the last examination or if the agency notes from the bank's progress reports that classified loans are not improving.

FDIC does not generally conduct special examinations but prefers to increase examination frequency of problem banks. The frequencies of examinations for the 1970 and 1975 problem bank samples were as follows:

	Months between examinations		
	FDIC	FRS	OCC
12/31/70 sample	6.5	8.0	5.3
12/31/75 sample	6.7	8.1	5.8

The three agencies may also place examiners in banks for long periods to monitor certain problem situations.

Branch application rejections

The supervisory agencies may reject a bank's application for a new branch as a way of inducing management to correct its problems. These actions can be effective in improving the condition of banks suffering from managerial neglect. FRS also may reject a bank holding company's application for banking and nonbanking subsidiaries to influence management to correct problems.

Public disclosure

The supervisory agencies can disclose or threaten to disclose a bank's problems publicly to force bank management to correct its problems. However, public disclosure of problems requires advance notice to the bank and could have undesirable effects, such as causing depositors to withdraw their funds from the bank.

Threat of legal action

One of the more effective informal actions that the supervisory agencies can use is the threat of taking legal or formal action if the bank does not correct its problems within a given period of time.

Formal enforcement actions

Formal enforcement actions are used by the supervisory agencies as a last resort to get bank managers to correct their problems. Some formal actions do not help correct problems, but result in closing the bank to protect depositors.

Written agreements

The supervisory agencies use formal written agreements, sometimes referred to as voluntary agreements or letter agreements, to confirm a bank's plans to correct problems. The agency and the bank both sign the agreement. A violated agreement can be the basis for issuing a cease and desist order against the bank.

The agencies' use of written agreements for the period 1971 through 1976 was as follows:

Year	FDIC	FRS (note a)	OCC	Total
1971	1	1	3	5
1972	1	-	4	5
1973	1	3	6	10
1974	-	2	17	19
1975	-	2	18	20
1976	-	1	23	24
	3	9	71	83

a/Does not include 12 agreements against bank holding companies.

Cease and desist orders

The supervisory agencies, under authority of the Financial Institutions Supervisory Act of 1966 (12 U.S.C. 1818(b)), can issue cease and desist orders against banks to get problems corrected. First, a notice of charges is served upon a bank

--which has engaged or is engaging in unsafe or unsound practices,

--which has violated or is violating a law, a rule, a regulation, or a written agreement with the agencies, or any condition imposed in writing by the agencies in connection with the granting of any application or other request, or

--which is about to do either.

The notice of charges presents a statement of facts constituting the alleged violations or unsound practices and establishes a time and place for a hearing to determine whether a cease and desist order should be issued.

If bank representatives do not appear at the hearing or if the hearing confirms the violation or the unsafe or unsound practices, the agencies may issue the cease and desist order. A bank can consent to the cease and desist order, thereby obviating a hearing. Once the order becomes effective, it remains in effect until it is stayed, modified, terminated, or set aside by the agency or a reviewing court.

The agencies' use of cease and desist orders for the period 1971 through 1976 was as follows:

Year	FDIC	FRS (note a)	OCC	Total
1971	7	1	-	8
1972	10	3	2	15
1973	9	-	4	13
1974	4	-	2	6
1975	8	1	5	14
1976	29	4	7	40
	67	9	20	96

a/Does not include 12 orders against bank holding companies.

Removal of management

Also under the Financial Institutions Supervisory Act of 1966 (12 U.S.C. 1818(e)), FDIC and FRS may order the removal of a director or officer of a State bank which they supervise and OCC may recommend that FRS remove one from a national bank when

--the director or officer has violated a law, a rule, a regulation, or a final cease and desist order; has participated in any unsafe or unsound banking practice, or has committed or engaged in any act, omission, or practice which constitutes a breach of his fiduciary duty; and

--as a result, the bank has suffered or will probably suffer substantial financial loss or other damage, or the interests of its depositors could be seriously prejudiced; and

--the violation, practice, or breach involved personal dishonesty on the part of the director or officer.

The agency must first serve the director or officer with a written notice of its intention to remove him/her from office. The notice of intention states the grounds for removal and establishes a time and a place for a hearing. As with a cease and desist order, the agency can remove the director or officer if he fails to appear at the hearing or if the charges specified in the notice of intention are substantiated. The removal order, too, remains in effect until stayed, modified, terminated, or set aside by the agency or a reviewing court.

In addition, the agencies have the authority (12 U.S.C. 1818(g)(1)) to suspend any bank director or officer indicted for a felony involving dishonesty or breach of trust. The statute provides that such a suspension can be enforced by written notice and remains in effect until the charges are disposed of or the suspension is terminated by the agency. In _Feinberg_ v. _Federal Deposit Insurance Company_, 420 F. Supp. 109 (D.D.C. 1976), a three-judge district court declared the statute to be "constitutionally infirm" insofar as it permits the issuance of a notice and order of suspension without affording the individual an immediate post-suspension hearing, preceded by notice of such a right, and an opportunity to be represented by counsel, to make written submissions, and to make oral argument. FDIC officials said they are working with the other agencies to prepare and issue regulations in an effort to comply with the due process requirements.

During the period 1971 through 1976, the agencies took action to remove or suspend management as follows:

Year	FDIC (note a)	FRS (note a)	OCC (note a)	Total
1971	-	-	-	-
1972	3	1	3	7
1973	3	-	8	11
1974	4	-	3	7
1975	6	2	9	17
1976	3	1	3	7
	19	4	26	49

a/Includes 15 FDIC, 2 FRS, and 25 OCC suspensions.

Financial assistance

FDIC has the authority (12 U.S.C. 1823(c)(e)) to provide funds to insured banks in danger of closing which are essential for providing banking services to the community or to assist a merger, or sale of assets and assumption of liabilities of a failing or failed bank into or by another insured bank. In providing financial assistance, FDIC can require that bank managers correct their problems.

Such assistance may include

--making deposits in the troubled bank,

--purchasing assets of the failing or failed bank,

--granting a loan secured by the assets of the failing or failed bank, or

--guaranteeing another insured bank against loss in assuming the assets and liabilities of the troubled bank.

FRS has the authority (12 U.S.C. 347(a)) to extend credit to member banks

--to increase their available funds because of developments such as a sudden withdrawal of deposits or seasonal requirements for credit which cannot reasonably be supplied from the banks' own resources or

--to assist them in meeting unusual situations which may result from national, regional, or local difficulties.

Cancellation of deposit insurance

FDIC has the authority (12 U.S.C. 1818(a)) to terminate a bank's deposit insurance if

--its officers or directors are engaging in unsafe or unsound banking practices,

--it is in an unsafe or unsound condition, or

--it has violated an applicable law, rule, or regulation, or order; a condition imposed in writing; or a written agreement with FDIC.

When FDIC initiates proceedings to terminate insurance, it may give that bank a maximum of 120 days to correct its problems. If the bank corrects all or some of its problems within the time period allowed, FDIC may drop the termination proceedings altogether or take other action, for example a cease and desist order. If the bank does not correct its problems, FDIC's Board of Directors can terminate its insurance.

During the period 1971 through 1976, FDIC initiated termination proceedings as follows:

Year	Number of proceedings
1971	5
1972	5
1973	1
1974	3
1975	5
1976	8
	27

Only 1 of the 27 proceedings, in 1976, resulted in termination of deposit insurance. Before 1971, FDIC terminated the insurance of 13 banks. Canceling a bank's deposit insurance does not solve its problems.

Cancellation of FRS membership

FRS has the authority (12 U.S.C. 327) to cancel a bank's membership in the Federal Reserve. As far as we could determine, FRS has used this authority only once as a corrective tool. As with terminating deposit insurance, this action does not solve a bank's problems.

Revocation of charter

OCC has the authority (12 U.S.C. 93,481) to revoke national bank charters and States have the authority to revoke State bank charters, although this too solves no problems. In the last 2 decades, as far as we could determine, OCC has not revoked a bank's charter for not correcting its problems.

FREQUENCY OF ENFORCEMENT ACTIONS TAKEN BY AGENCIES

The table below shows the percentage of sampled banks for which the supervisory agencies took various informal and formal enforcement actions.

Our tabulations are based on agency actions documented in examination reports and correspondence files. In interpreting the tabulations, the reader should recognize that the agencies would hardly ever need to use all types of actions with any one bank. We are not suggesting that the figures should be 100 percent, even for problem banks.

The tabulations show how differently the agencies treated problem banks from banks in the general sample. They also show differences between actions toward banks considered problems in 1970 and actions toward banks considered problems in 1975.

	General sample banks (note a)			Dec. 1970 problem sample banks (note b)			Dec. 1975 problem sample banks (note b)		
	FDIC	FRS	OCC	FDIC	FRS	OCC	FDIC	FRS	OCC
Number of banks	161	192	201	53	37	54	54	40	50
Informal actions:	(percent of sampled banks)								
Request for formal response to reported deficiencies	30	61	43	17	57	35	44	65	34
Request for periodic progress reports	6	5	12	32	46	56	41	48	62
Request for meetings with bank's board of directors	1	9	6	36	57	50	30	53	54
Written communications	22	35	30	34	27	43	54	50	58
Bank visits	1	2	4	2	11	33	6	10	18
Special examinations	-	2	3	2	3	19	-	18	32
Branch application rejections	-	-	1	-	-	-	4	-	4
Public disclosure	-	-	-	-	-	-	-	-	-
Threat of legal action	-	-	-	2	-	-	4	-	-
Formal actions:									
Written agreements	-	-	-	1	-	-	-	-	6
Cease and desist orders	1	-	-	2	-	-	4	-	2
Removal of management	-	-	-	-	-	-	-	3	-
Financial assistance	-	-	-	-	-	-	-	-	-
Cancellation of deposit insurance	-	-	-	-	-	-	-	-	-
Revocation of charter	-	-	-	-	-	-	-	-	-

a/ Since earliest report of examination.

b/ Since second most recent report of examination.

As the above table shows, the frequently used enforcement actions were requests for formal responses to reported deficiencies, requests for periodic progress reports, requests for board of directors meetings, and written communications. For the most part the above actions were used more frequently on problem banks than on general banks.

Compared with their treatment of 1970 problem banks, in 1975 the agencies requested more formal responses and periodic progress reports and used more written communications. FDIC's increase was the largest.

As far as the remaining enforcement actions, including formal actions, are concerned, their use was limited.

Results of enforcement actions

We reviewed a sample of 149 banks which were on the supervisory agencies' problem lists at December 31, 1970, to determine how effective the agencies were in getting bank management to correct problems. We used the 1970 sample of problem banks because the agencies had had 5 years to get the banks to correct their problems. As of December 31, 1975, the status of the 149 banks was as follows:

	FDIC		FRS		OCC	
	Number	Percent	Number	Percent	Number	Percent
Removed from problem bank list (105)	44	80	15	38	46	84
Converted to a national or State charter (5)	-	-	1	3	4	7
Withdrawn from FRS membership (7)	-	-	7	18	-	-
Merged with another bank (7)	-	-	6	15	1	2
Failed (4)	2	4	1	3	1	2
Remained on problem list (21)	9	16	9	23	3	5
Total	55	100	39	100	55	100

For the 105 banks which had been taken off the problem lists we determined the length of time spent in problem status:

Years	FDIC		FRS		OCC	
	Number	Percent	Number	Percent	Number	Percent
Under 1	6	14	1	7	12	26
1 to 2	13	30	1	7	18	39
2 to 3	9	20	2	13	5	11
3 to 4	7	16	4	26	2	4
4 to 5	4	9	1	7	3	7
5 to 10	5	11	6	40	6	13
Total	44	100	15	100	46	100

The supervisory agencies used primarily informal enforcement actions against the 149 banks. OCC and FDIC had the greatest degree of success using informal action, returning 84 and 80 percent respectively of the problem banks to nonproblem status, while FRS was successful with only 38 percent of its problem banks.

OCC had the greatest success in getting problems resolved quickly. About 65 percent of its banks which returned to nonproblem status did so within 2 years. Only 44 percent of the FDIC banks and 14 percent of the FRS banks which returned to nonproblem status did so within 2 years.

What types of problems can formal actions be used to correct?

We analyzed the use of certain formal enforcement actions to determine what types of problems they were intended to correct and whether our sample of problem banks exhibited these same types of problems. During 1971-75 the agencies used cease and desist orders 56 times and written agreements 57 times to obtain corrective action on problems in banks. The agencies used these two actions to correct many of the same types of problems identified in our sample of problem banks. The following table shows the percentage of cease and desist orders and written agreements that were used to deal with specific problems. The reader should note that each formal action usually addresses more than one type of problem.

Problem	Cease and desist orders	Written agreements
Capital adequacy	54	14
Violations of laws and regulations	52	65
Loans--collections, policies, and procedures	45	39
Loans--condition and classified	43	42
Management--effectiveness	41	35
Management--self-serving	29	40
Liquidity/borrowings	20	-
Internal controls/ operating policies	20	26
Loans--concentrated, excessive, and out of territory	16	12
Loans--extension of credit	-	19

As the above table shows, the agencies used cease and desist orders and written agreements to correct many different types of problems. A high percentage of problem banks exhibited these same types of problems. For example, 92 percent of the problem banks which we reviewed had classified loan problems; 81 percent had loan collection, policy and procedures problems; and 78 percent had violated laws and regulations. Yet each of these two formal actions was taken against less than 4 percent of the banks on the problem list during the 5-year period. We believe the agencies could have used cease and desist orders and written agreements more than they did to correct the problems noted in our sample of problem banks.

What happened when formal actions were used?

The supervisory agencies used cease and desist orders and suspension of managers 18 times against 17 banks in our problem sample. As of November 30, 1976, eight of these banks were classified as nonproblems by the agencies. The following tables show a chronology of events for the banks which were returned to nonproblem status and for the banks which were still problems as of November 30, 1976.

Banks Returned to Nonproblem Status

Bank	Date designated problem	Months before formal action taken	Type and date of formal action	Months before problems resolved	Date designated nonproblem	Total time on problem list
1	12/74	5	Suspension (5/75)	12	5/76	17
2	2/74	16	Cease and desist order (6/75)	13	7/76	29
3	4/69	37	Cease and desist order (5/72)	4	9/72	41
4	5/69	31	Cease and desist order (12/71)	12	12/72	43
5	9/75	-	Suspension (9/75)	13	10/76	13
6	2/67	45	Cease and desist order (11/70)	43	6/74	88
7	11/67	59	Cease and desist order (10/72)	22	8/74	81
8	5/70	20	Cease and desist order (1/72)	29	6/74	49
Average months		27		18		45

Banks in Problem Status at November 30, 1976

Bank	Date designated problem	Months before formal action taken	Type and date of formal action	Months since action	Number of months in problem status
1	3/55	196	Cease and desist order (7/71)	64	260
2	8/75	7	Cease and desist order (3/76)	8	15
3	5/68	27	Cease and desist order (8/70)	75	102
4	9/73	30	Cease and desist order (3/76)	8	38
5	2/66	76	Cease and desist order (6/72)	53	129
		90 a/	Suspension (8/73)	39	129
6	6/71	39	Cease and desist order (9/74)	26	65
7	1/75	9	Cease and desist order (10/75)	13	22
8	4/73	37	Cease and desist order (5/76)	6	43
9	6/65	95	Suspension (5/73)	42	137
Average months		57		33	90

a/ Data for this action not included in the averages.

Conclusions

The supervisory agencies can use a variety of informal and formal enforcement tools to get bank management to correct problems. The agencies rely on informal tools much more heavily than on formal tools.

The agencies were somewhat successful in getting bank management to correct the problems of the banks in our 1970 problem sample. Primarily through informal enforcement actions, 70 percent of the banks had reached nonproblem status as of December 31, 1975. What concerns us is the banks that were in problem status for over 2 years and the remaining banks which the agencies had been unable to return to nonproblem status as of December 31, 1975. We believe that there is a need for the agencies to use stronger formal actions against these banks.

The agencies could have used their formal enforcement powers more than they did to correct problems that we identified in a sample of problem banks. On the average, when the agencies did use formal action, the sooner the action was taken the faster the problems got corrected.

We recognize that every problem situation has to be evaluated on a case by case basis and that formal enforcement action would not always be applicable. However, we believe that the agencies should use formal enforcement action as much and as soon as possible to get problems corrected, especially when the problems exist over long periods of time.

Recommendation

We recommend that the Board of Directors, FDIC, the Board of Governors, FRS, and the Comptroller of the Currency establish more aggressive policies for using formal actions. Written guidelines should be developed to identify the types and magnitude of problems that formal actions could appropriately correct.

Agency comments

FDIC stated:

"Congress granted cease and desist powers in 1966 with the enactment of Section 8(b) of the Federal Deposit Insurance Act. For several years thereafter, there was some reluctance to utilize Section 8(b) powers due mainly to a general misunderstanding of its purpose and usefulness. Prior to enactment of Section 8(b), the FDIC's only experience with formal administrative corrective measures was the termination of insurance proceedings, a severe form of action which could result in the removal of the deposit insurance coverage of a bank. Because of its severity, the Section 8(a) proceeding was used judiciously and only after all other means for accomplishing correction were exhausted. Apparently, albeit erroneously, that same rationale was largely applied to Section 8(b) proceedings. In addition, there was to a lesser extent an unwillingness to try something new. Commencing in 1970, a program to educate FDIC personnel as to the usefulness of Section 8(b) action was begun. The FDIC first used its cease and desist authority in 1971 and between 1971 and 1975 issued 38 cease and desist orders and three formal written agreements. In contrast, in a recent renewed effort to foster the use and to test the effectiveness of cease and desist powers, in calendar year 1976 alone FDIC issued 24 such orders and five emergency orders. In addition, at year-end 1976, 18 more cease and desist actions were in various stages of process.

"While cease and desist action is in most cases effective as a corrective measure, there are some instances where it may be of little or no use and could perhaps be counterproductive. For example, the recently experienced worst economic period since the great depression caused severe problems to the banking industry, many of which did not lend themselves to correction through use of the cease and desist powers. In short, it is not a panacea for the removal of all problems experienced by the banking community.

"The recommendation for adoption of criteria for use in formal actions, contained in the last sentence of the recommendation, is troublesome. We would recommend against adopting formal criteria for use of Section 8, because the statutory criteria are adequate. The facts and circumstances of bank problems seem so varied, and the remedial actions can differ so much according to the problem, it would be inhibiting to have to work within the confines of additional written criteria. The adoption of such criteria could give the banks additional bases for contesting Section 8 actions."

FRS stated:

"In this section the report notes that each problem situation has to be evaluated on a case-by-case basis and formal action would not always be appropriate. The report goes on to recommend that more aggressive policies be used for formal actions and that written guidelines be developed to identify the types and magnitude of problems that formal actions could appropriately correct. In this regard, we note that the report confirms that all of the agencies have already markedly expanded their formal enforcement activities. On November 3, 1975, the Board issued a policy statement emphasizing its intention to take formal action where appropriate in connection with violations of the Bank Holding Company Act.

"Further, we do not believe that adequate weight has been given in the report to existing hindrances to formal action under the Financial Institutions Supervisory Act of 1966. The chapter does, however, support the Board's existing recommendations for changes to the Financial Institutions Supervisory Act which would enable the supervisory authorities to remove bank officers for gross negligence and to assess civil penalties for violations of laws and regulations. These legislative recommendations were made in response to procedural and substantive problems inherent in making effective use of the present formal procedures set forth in the Financial Institutions Supervisory Act. In this regard, the Board's letter of September 5, 1975, to the banking committees of both Houses of Congress

setting forth the legislative proposals made it clear that there were a number of situations in which the existing formal regulatory remedies would have little or no value in preventing or ameliorating problem bank situations. We believe that those recommendations, embodied in H.R. 9743 and S. 2304, would help to substantially reduce the incidence of problem banking situations. Further, the Board has continued to review areas in which it appears that changes may be of substantial aid. The Board intends to submit further legislative proposals to this end in the very near future. In this regard, Chairman Proxmire has introduced legislation in the 95th Congress which encompasses the earlier recommendations.

"The Board is further concerned that the discussion in this chapter of the manner in which the agencies are handling problem bank situations may not present an accurate view in all respects. The major shortcoming in this regard stems from the fact that the different agencies utilize problem bank lists for varying purposes. Furthermore, even between agencies with similar goals, different judgments may occur as to the severity of an institution's problems and the length of time monitoring is required. Meaningful comparison between agencies' enforcement activities in this area is therefore impossible. We would, however, note that the report's conclusions relating to the agencies' effectiveness in returning institutions to nonproblem status are not supported by the tables since the percentages used excluded institutions withdrawing from membership and merging. Presumably, the approving agency found in the case of the mergers, as required by the Bank Merger Act, that the financial and managerial condition of the resulting bank was satisfactory and, in the case of withdrawals from membership, supervisory pressure may well have contributed to such withdrawals. Further, as noted in the table, withdrawals and mergers are disproportionately high in the sample for the Federal Reserve."

OCC stated:

"We believe that in supervising the vast majority of national banks, our most effective remedy continues to be the examination process and the meetings held

as part of that process between the board of directors of the bank and OCC personnel. Since December 23, 1975, the OCC has required meetings with boards of directors of each national bank at least once every calendar year and, in certain cases, following every examination. We believe that the increased use of such meetings together with our new examination procedures and early warning system will make our first-line, informal supervisory techniques even more effective.

"As the GAO report elsewhere notes, our informal supervisory techniques even without the improvements noted above, have proven effective in rehabilitation of most of the so-called problem bank situations. For example, over the period reviewed by GAO informal procedures utilized by OCC were successful 84% of the time. Nonetheless, we agree that increased use of formal agreements and cease and desist orders under the Financial Institutions Supervisory Act may accelerate correction of problems in the more recalcitrant institutions.

"OCC use of such formal agreements and orders has increased tenfold from 1970 to 1975. The OCC has originated slightly more than half of the combined total (179) formal agreements and cease and desist orders issued by all three agencies during the last five years. The OCC, however, supervises fewer than half the number of banks supervised by the other two agencies combined. When compared to the number of banks supervised, the OCC over the past five years has used the formal enforcement tools of Financial Institutions Supervisory Act about two and one half times as often as the other two agencies.

"It should also be noted that the three banking agencies jointly requested Congress in 1975 to refine and increase the agencies' formal enforcement powers. Congress failed to pass the necessary legislation.

"The OCC has developed as part of its National Bank Surveillance System a severity anomaly ranking system which identifies every three months the national banks most likely to require special supervisory attention. A computerized action control system is designed to assure that the OCC responds promptly and appropriately to these situations. The criteria built into these systems identifies more systematically and promptly those cases in which formal enforcement action is appropriate."

CASE STUDIES--HOW AGENCIES DEALT WITH BANKS TO RESOLVE PROBLEMS

The following six case studies illustrate how the supervisory agencies dealt with specific banks. These cases are reasonably typical of the agencies' efforts. The reader should look for the problems which the examiner identified, the enforcement actions which the agencies took to get the problems corrected, any differences in enforcement action for problem and nonproblem banks, and evidence of the existence of the same problems at subsequent examinations. The reader should also look to see whether the agencies intensified or varied their use of followup actions when the same problems appeared from one examination to another.

Case 1--FDIC Problem Bank

January 1974 examination

The first examination report which we reviewed cited the following problems and recommendations:

(1) Inadequate capital--the board of directors should adopt their proposed $3.5 million capital enhancement program.

(2) Classified loans totaling $1.4 million, compared to adjusted capital and reserves of $5.1 million.

(3) Overdue loans had increased substantially and were 4.4 percent of gross loans--collection and renewal policies need to be reviewed.

(4) Concentrations of credit total $10.3 million, violating the sound principles of diversification.

(5) Violation of various laws--early correction is warranted.

FDIC rated management "satisfactory" and classified the bank "nonproblem."

The examiner-in-charge discussed the above problems with the bank's officers at the close of the examination.

March 1974

The transmittal letter forwarding the examination report to the bank discussed asset problems, requested a response to the reported problems, and requested plans for corrective action.

September 1974

The examiner visited the bank to review loans made to an individual.

January 1975

The examiner visited the bank a second time to review several loans including the above-mentioned loans. He noted a discrepancy between the bank's records and the amount due for one of the loans.

April 1975 examination

The next examination report cited the following problems and recommendations:

(1) A capital to asset ratio of 5.6 percent--the board of directors should formulate a plan to raise from $3 to $5 million additional capital.

(2) Classified loans totaling $21 million compared to adjusted capital and reserves of $8 million--the bank should put a moratorium on all future real estate construction loans and initiate a comprehensive loan policy.

(3) Overdue loans amounting to 27 percent of the loan portfolio.

(4) Non-interest earning loans totaling $8 million.

(5) Violations of laws and regulations.

FDIC rated management "unsatisfactory" and classified the bank as a "serious problem."

At the close of the examination, the examiner-in-charge, an assistant regional director, a headquarters official, and the chief examiner from the State banking agency met with the bank's board of directors to discuss these problems.

July 1975

The transmittal letter to the bank expressed concern about the deterioration in the loan portfolio and the potential for a liquidity problem. The regional director requested (1) a plan of action to correct the problems noted and (2) progress reports.

Members of the board of directors met at the FDIC regional office to discuss the April examination. They failed to present specific plans to correct problems. The assistant regional director prepared a letter of understanding which required the board to meet and submit progress reports twice monthly. The letter of understanding was later signed by the board members.

August 1975

The bank sent a progress report to FDIC.

September 1975 examination

The following problems and recommendations were cited:

(1) Inadequate capital and earnings as a result of loan losses--the infusion of capital is necessary.

(2) Classified loans totaling $18.7 million, over twice the amount of adjusted capital and reserves.

(3) Twenty-three percent of total loans are overdue.

(4) Concentrations of credit totaling $8.4 million.

(5) Improperly recorded interest income accruals.

(6) Excessive cash dividends.

FDIC again rated management "unsatisfactory" and classified the bank as a "serious problem."

The examiner-in-charge discussed the above problems with the bank's board of directors at the close of the examination.

November 1975

The bank sent a progress report to FDIC.

December 1975

The transmittal letter to the bank discussed the above problems, requested a meeting with the bank and State banking officials, and requested that progress reports be continued.

January 1976

Two meetings were held with bank and State banking officials to discuss the bank's request to make further dividend payments. The request was denied.

March 1976

The bank sent a progress report to FDIC.

April 1976 examination

The fourth examination was conducted in April 1976; however, FDIC was unable to locate the examination report for our study. In a memorandum to the files, the regional director had cited the following problems:

--Rapid growth has caused a serious capital deficiency. The capital assets ratio is a low 5.4 percent and classified assets are 193 percent of the capital structure.

--Overdue and classified loans are excessive, representing 22.9 and 22.2 percent respectively, of total loans.

--Concentration of credit among real estate speculators, developers and builders has resulted in a grossly unsatisfactory asset condition.

--Loans were hastily made without written lending policies. Lending deficiencies include a lack of equity in collateral, no repayment programs, undercapitalized and inexperienced borrowers, and poorly documented loans.

--Liquidity is a serious problem.

--The president is considered liberal and unimpressive. Lack of directorate involvement is one of the primary reasons for the bank's current condition.

--The parent holding company is regarded as a serious problem by FRS.

FDIC rated management "unsatisfactory" and classified the bank as a "serious problem."

May 1976

A meeting was held with bank officials to discuss their proposed plan to raise capital.

July 1976

A meeting was held with bank directors, parent company directors, and the State banking commissioner to discuss proposals to raise $3 million in capital.

September 1976

The Director, Division of Bank Supervision, requested approval to seek the bank's consent to a cease and desist order. The bank's attorney wrote FDIC that a cease and desist order would be "counter productive" and that additional time was needed to complete the capitalization program.

A meeting was held with bank officers and State banking officials to discuss cease and desist proceedings against the bank. Afterwards, the bank agreed to comply with the cease and desist order. The order was issued to stop "hazardous lending and lax collection practices."

The bank sent a progress report to FDIC.

October 1976

The bank wrote to FDIC and said it was complying with the consent cease and desist order.

Our comments

This bank has had the same basic problems since the January 1974 examination. FDIC used informal enforcement actions for 32 months without success. In September 1976, FDIC took formal action.

This case illustrates that the agencies do not always discuss the results of the examination with the banks' boards of directors. (See ch. 6.) FDIC officials did not meet with the bank's directors until 15 months after continuing problems were found. The examiners did not criticize the bank's loan policies until the amount of classified loans had increased substantially. (See ch. 5.)

Case 2--FRS Problem Bank

July 1974 examination

The first examination report which we reviewed cited problems and recommendations as follows:

(1) Overdue loans of 5.2 percent of total loans.

(2) Classified assets totaled $125,000, with adjusted capital totaling $1.7 million.

(3) The bank should review its current lending procedures.

(4) Credit files should be updated.

In the confidential section of the report, the examiner-in-charge noted that the general condition of the bank was satisfactory. He noted also that capital ratios were well below generally acceptable levels and that earnings showed a moderate decline from the previous year.

At the conclusion of the examination, the examiner-in-charge met with two of the bank's executive officers to discuss the above matters.

FRS rated management "satisfactory" and classified the bank as a "nonproblem."

August 1974

The Federal Reserve Bank, in its transmittal letter to the bank, cited the various criticisms noted in the examination report and recommended that the bank increase capital by $1 million.

May 1975

The bank responded to the above recommendation and informed the FRB of its intention to raise $1.3 million of additional capital.

June 1975 examination

In the report, the examiner-in-charge said that the bank's condition had deteriorated since the last examination. He cited the following problems:

--Overdue loans of 3.4 percent of total loans.

--Classified assets totaling $1.7 million, with adjusted capital only $1.4 million.

--Inadequate capital.

--Violations of laws.

The examiner-in-charge mentioned that the bank's plans to increase capital might well prove inadequate in the future.

In the confidential section of the report, the examiner-in-charge said two former executive officers were primarily responsible for the "swift deterioration of the quality of the bank's assets." He noted that the bulk of the classified loans were of "poor quality at inception or rapidly proved to be." He stated, "it was not known why the two officers, whose previous records had not been the subject of criticism, quite obviously embarked on a program of lending liberalism." One officer had resigned and the other had become inactive.

According to the examiner-in-charge, the present officers had yet to demonstrate the ability to deal with the many problems presented. In addition, he said that earnings

were below the average of other banks of similar size in that State.

At the conclusion of the examination, the examiner-in-charge met with the bank's active officers and available board members to discuss the bank's asset problems.

FRS rated management "fair" and classified the bank as a "problem."

August 1975

The FRB's transmittal letter to the bank emphasized the need for strict adherence to the bank's recently strengthened lending procedures. It requested monthly status reports and a meeting with senior managers.

September 1975

FRB officials met with the bank's board of directors to discuss the loan situation. They noted minor improvement in the bank's loan portfolio.

February 1976 examination

In the report, the examiner noted a more favorable condition but cited the following problems:

--Classified assets totaling $1.4 million, with adjusted capital of $2.8 million.

--Violations of laws.

--Heavy loan losses.

--Poor earnings.

In the confidential section of the report, the examiner-in-charge noted that the general condition of the bank was "unsatisfactory" and that earnings were poor as a result of heavy loan losses.

An internal FRB memorandum referring to the February 1976 examination stated, "Management may be improved but it is apparently unimpressive and believed to lack adequate depth to administer the improved policies."

The FRS met with the board of directors at the close of the examination to discuss the bank's problems.

FRS rated management "fair" and classified the bank as a "nonproblem."

April 1976

The transmittal letter indicated that further effort was needed to reduce classified loans and again requested monthly status reports. The letter also mentioned that capital ratios were low despite the addition of capital.

As of April 1976, the bank had sent nine progress reports to the FRB.

August 1976

Between April and August, the bank sent five more progress reports to the FRB.

Our comments

After the February 1976 examination, FRS removed the bank from problem status, even though classified assets had decreased only $300,000 since the last examination. The ratio of classified assets to adjusted capital was more favorable because over $1 million of capital had been added.

This case demonstrates that the examiners often make important observations about the bank's condition without including them in the portion of the report sent to the bank. (See ch. 6.) In the confidential section of the first examination report, the examiner noted that the bank's capital ratios were below acceptable levels. Although the transmittal letter commented on the capital deficiency, such comments were not included in the portion of the examination report going to the bank until the second examination report--11 months later. Also, the agency did not attempt to discuss the problems with the bank's directors until after the second examination.

The same problems have been in evidence for almost 2 years yet FRS has had little success in using informal enforcement action to get the problems corrected.

Case 3--OCC Problem Bank

July 1974 examination

The first examination report which we reviewed disclosed the following problems:

--Violations of laws.

--Increasing classified assets.

--Inadequate credit files.

--Low liquidity.

--Internal control deficiencies.

Following the examination, OCC classified the bank as a "nonproblem" and rated management "satisfactory."

September 1974

Regional officials wrote to the bank expressing concern with the sharp increase in classified assets and the violations of laws cited in the report. OCC requested the bank to submit progress reports.

The president of the bank and officials of its holding company visited the OCC regional counsel to discuss a group of loans criticized in the July report. As a result of the meeting, the examiner-in-charge visited the bank's mortgage loan department and found that classified loans had increased since the July examination.

Because of problems disclosed in the July examination and the visit, the bank's president and three officials of the mortgage loan department resigned under pressure from the bank's board of directors.

November 1974 and January 1975

The bank submitted a progress report to the regional office.

February 1975 examination

The report cited:

--Violations of laws.

--Increasing classified assets.

--Inadequate credit files.

--Low liquidity.

--Overdue loans.

OCC classified the bank as a "problem" and rated management as "fair."

April 1975

At the close of the examination, the examiner-in-charge and the deputy regional administrator met with the bank's board of directors to discuss the deficiencies.

May 1975

The regional administrator sent the bank's board of directors a letter reemphasizing the bank's violations of laws, classified assets, poor credit information, and low liquidity. He requested monthly progress reports to the region and to headquarters.

July 1975

The bank submitted a progress report.

August 1975

Regional officials noted that liquidity had dropped below acceptable levels and they held a meeting with bank officials to discuss plans for improving liquidity.

The bank submitted another progress report.

September 1975 examination

The report cited:

--Violations of laws.

--Classified assets are decreasing but still are considered high.

--Low liquidity.

--High volume of overdue loans.

OCC classified the bank as a "problem" and rated management "fair."

The bank submitted another progress report.

October 1975

The bank submitted a progress report.

November 1975

The regional administrator wrote to the bank's board of directors, citing violations of laws, classified assets, overdue loans, and low liquidity. He also asked that progress reports be continued.

December 1975, January and February 1976

The bank submitted progress reports.

March 1976

The bank's president and an official of the parent holding company visited the regional office to discuss problems experienced by the bank.

The bank submitted progress reports.

April 1976 examination

The report cited:

--Violations of laws.

--Classified assets are decreasing but are still high.

--Inadequate credit files.

--Overdue loans.

OCC classified the bank as a "problem" and rated management "fair."

The bank submitted a progress report.

June 1976

The regional administrator's transmittal letter to the bank's board of directors referred to the problems cited in the report and mentioned pending litigation. He again requested that progress reports be continued.

July 1976

The deputy regional administrat[illegible] with the bank's board of directors.

The bank submitted a progress report.

August 1976

The bank submitted another progress report.

Our comment

For 2 years OCC has used mostly the same types of informal enforcement actions to get the bank to correct its problems, yet many of the problems continued.

This case also shows that although the agencies find problems, they sometimes do not address the basic causes. (See ch. 5.) For four consecutive examinations, the examiners cited several problems with loans and yet, the probable causes--poor loan policies and procedures--were not cited as problems. The agency did not meet with the bank's board of directors until after the bank was designated as a problem, even though similar problems were found 10 months earlier. (See ch. 6.)

Case 4--FDIC Nonproblem Bank

April 1973 examination

The first examination report which we reviewed cited problems and recommendations as follows:

(1) Increase in classified loans due to weak lending policies, collection practices, and credit analyses--certain classified loans should be written off.

(2) Adjusted capital below State and national averages for comparable banks--capital should be increased.

(3) Internal control weaknesses--management's attention is needed.

In the confidential section of the report, the examiner stated:

--The bank's lending policies were liberal.

--Management was unwilling to accept his recommendations.

--The loan function was totally decentralized and working space was too limited.

--The president was too preoccupied with expansion plans.

Following the examination, FDIC rated management as "fair" and classified the bank as a "nonproblem."

August 1973

The State supervisory agency wrote to the bank and recommended an increase in capital and better control and supervision of lending and collection policies. The bank responded to the State that it had increased its capital as recommended.

September 1973

The bank wrote to FDIC regarding the deficiencies mentioned in the examination report.

March 1974 examination

The report cited the following problems and recommendations:

(1) Excessive classified assets; primarily loans.

(2) Weak credit supervision, loan portfolio management, and collection efforts--corrective action required.

(3) Adjusted capital well below State and national averages of comparable banks, despite the recent injection of capital.

(4) Internal control deficiencies.

(5) Violation of State banking laws.

Again in the confidential section of the report, the examiner stated that the president was more concerned with expansion than with daily banking activities.

Following the examination, FDIC rated management as "fair" and classified the bank as "nonproblem."

August 1974

FDIC wrote to the bank asking for its actions or plans to increase capital and reduce the volume of classified and delinquent loans.

September 1974

The bank reported to FDIC on its planned actions.

May 1975

The bank submitted, for FDIC's approval, a proposed circular for issuing capital notes.

June 1975

FDIC approved the circular.

July 1975 examination

The report cited problems and recommendations as follows:

(1) A 98 percent increase in classified assets, primarily loans, due mainly to ineffective supervision and collection of loans.

(2) Losses in real estate and securities--bank managers should obtain additional capital.

The examiner noted other deficiencies similar to those of the two previous examinations and said the bank was having problems issuing its capital notes.

Again, the examiner remarked in the confidential section that the bank's president devoted 100 percent of his time promoting his "bank's image" for growth, through mergers and branching. The examiner stated that the bank's financial condition was less than average as the quality of its assets continued to depreciate.

Following the examination, FDIC rated management "fair" and classified the bank as "nonproblem."

October 1975

FDIC's transmittal letter requested that the bank report action taken or planned to correct all cited problems.

December 1975

The bank responded to the reported deficiencies and action taken on them.

Our comment

The bank has had the same problems for 2-1/2 years, yet FDIC has not varied or increased its followup activity. It could have used more informal enforcement action or considered using formal action to correct these problems.

The agencies rarely met with the boards of directors of banks unless the banks were considered to be problems. (See ch. 6.) In this case, despite an apparently unresponsive management, FDIC representatives did not meet with the bank's directors during 2-1/2 years. The examiners were highly critical of management in the confidential sections of the reports but not in the portions of the reports the bank received.

Case 5--FRS Nonproblem Bank

October 1973 examination

The first examination report which we reviewed cited two problems:

--Substantial decline in net income.

--Substantial decline in net income.

--Low capital position.

FRS rated management as "satisfactory" and classified the bank as "nonproblem."

March 1974

FRS wrote to the bank and requested its formal response to and its action taken on the examination deficiencies.

April 1974

The bank informed FRS of the action it had taken to correct the examination deficiencies.

June 1974 examination

The report cited four problems:

(1) Capital continues to be somewhat low.

(2) Increasing classified and specially mentioned loans.

(3) Violations of law.

(4) Serious internal control deficiencies--it is imperative that immediate corrective action be taken.

FRS rated management as "fair" and classified the bank as a "nonproblem."

November 1974

FRS wrote to the bank requesting that it formally state what actions it would take to correct the examination deficiencies.

December 1974

The bank informed FRS of its efforts to strengthen internal controls and gave its assurance that the other deficiencies would be corrected.

May 1975 examination

The report cited four problems:

--Capital funds continue to be low.

--Classified loans have again increased.

--More violations of law were committed.

--Internal control weaknesses still existed.

In the confidential section of the examination report, the examiner stated that the bank's general condition was satisfactory; however, he noted that the capital structure, the classified assets including loans, and the violations of law were unsatisfactory.

The examiner discussed the examination deficiencies with the bank's managers at the close of the examination.

FRS rated management as "satisfactory" and classified the bank as "nonproblem."

September 1975

FRS sent the examination report to the bank and requested response to its criticisms.

October 1975

The bank responded that it was acting to correct the deficiencies.

Our comment

Even though the same problem has existed for 2 years, FRS has not increased its use of informal enforcement action or considered using formal action.

Although the reports of examination indicated that the bank was not solving its problems, the FRS did not discuss the examinations with the bank's board of directors. (See ch. 6.)

Case 6--OCC Nonproblem Bank

August 1973 examination

The first examination report which we reviewed cited the following problems and recommendations.

(1) Inadequate capital--the bank should secure additional capital.

(2) Poor liquidity--liquidity should be improved.

In the confidential section of the examination report, the examiner recommended that OCC headquarters formally request that the bank secure additional capital.

OCC rated management as "satisfactory" and classified the bank as "nonproblem."

September 1973

The regional administrator wrote to the bank's board of directors expressing concern over the capital position and suggesting that the board (1) study ways to correct the problem and (2) advise him of the results.

November 1973

The bank responded to OCC, agreeing that capital should be strengthened and providing a plan for improvement.

After reviewing the bank's financial report, the regional administrator wrote to request its plans for improving its liquidity position.

The regional administrator wrote to the bank stating that OCC would not pursue the capital adequacy matter until the next examination.

December 1973

The bank responded to OCC that it was aware of its liquidity situation and was making every effort to keep it within a satisfactory range.

July 1974 examination

The report cited the following problems and recommendations:

(1) Inadequate capital--capital should be increased.

(2) Poor liquidity--liquidity position should be improved.

(3) Internal control deficiencies.

For the second time the examiner recommended that OCC headquarters request that the bank increase its capital.

OCC rated management as "satisfactory" and classified the bank as "nonproblem."

October 1974

The regional administrator wrote to the bank and suggested that the bank adopt a program to increase capital and inform him of its plans.

November 1974

After reviewing the bank's financial report, the regional administrator wrote to the bank about its low liquidity position and requested plans for improving liquidity.

December 1974

Bank officials agreed with the need to increase capital. They said the increase could not come from external sources due to market conditions and presented a plan for increasing capital from internal sources.

The regional administrator wrote to the bank stating that OCC would not pursue the capital adequacy matter until the next examination.

July 1975 examination

The report cited the following problems and recommendations:

(1) Inadequate capital--capital should be increased.

(2) Poor liquidity--liquidity should be improved.

The examiner, for the third time, mentioned that the bank would increase its capital if OCC headquarters would make the recommendation.

OCC rated management as "satisfactory" and classified the bank as "nonproblem."

September 1975

The regional administrator wrote to the bank about the problems noted and the need for a program to add more capital. He requested a formal response from the board of directors.

October 1975

The bank's president responded that the bank was making every effort to correct its problems. The regional administrator decided not to pursue the capital adequacy matter until the next examination.

Our comment

Even though the same problems have existed for over 2 years, OCC has not altered or intensified its use of followup activity. In addition, coordination is apparently lacking between the regional office and headquarters in getting the bank to take corrective action. OCC could have increased its use of informal enforcement actions or considered using formal actions to correct these problems.

The agencies do not have definitive criteria for assessing the adequacy of a bank's capital. (See ch. 4.) In this case, the examiner and regional administrator seemingly did not agree on the seriousness of the bank's capital problem. Judging by actions it took, OCC's position on the bank's capital was at best confusing.

Conclusions

The supervisory agencies dealt with the above "problem" and "nonproblem" banks in basically the same way and had little success in getting them to correct their problems. Even though the same types of problems existed from one examination to another, the agencies frequently did not vary or intensify their use of enforcement action to get the problems corrected. We believe the agencies could have made more use of their formal enforcement powers to correct some of the problems, because formal powers had been used in the past to correct some of these same types of problems.

Problem banks presumably present a greater risk of financial loss than do nonproblem banks. We believe, therefore, that in order to fulfill their responsibility to maintain soundness in the banking system and to protect depositors, supervisory agencies should followup on problem banks more aggressively than they do on nonproblem banks. If the supervisory agencies find that certain followup actions are not working, they should try something else or at least intensify their actions in order to get the problems corrected.

HOW THE AGENCIES DECIDE WHICH BANKS REQUIRE SPECIAL SUPERVISORY ATTENTION

After every examination, the supervisory agencies evaluate the effects of the problems identified on the soundness of the bank. If agency officials judge the bank's problems as serious enough to affect its soundness, they designate it as a problem bank or one requiring special supervisory attention.

A bank's rating is not always the determining factor in deciding whether it is a problem bank. Not all banks

with poor ratings are designated as problem banks, nor are problem banks only those with poor ratings. The supervisory agencies say they consider a bank's overall condidition--capital adequacy, asset quality, earnings, liquidity, quality of management--and do not always rely on any specific rating factor in determining whether a bank is a problem bank.

The regional offices and district banks have primary responsibility for monitoring problem situations in banks, whether or not they are designated problem banks. If the bank is designated as a problem bank, the supervisory agencies' headquarters also become involved in the monitoring process.

FDIC problem classifications

FDIC classifies banks according to the severity of their problems so its Board of Directors can assess the degree and dollar volume of potential threat to the insurance fund. The classifications follow:

--Serious problem, potential payoff: FDIC has no specific guidelines for placing a bank in this category. It is reserved for serious problem banks (see below) which are in advanced deterioration that could result in failure and which present a 50-percent chance of requiring FDIC financial assistance in the near future.

--Serious problem: a bank that threatens to involve FDIC in a financial outlay unless drastic changes occur. These banks are usually those in which the nature, prevalence, and trends of weaknesses are such that correction is urgently needed. Their net capital and reserves position (the second element of the FDIC rating) is likely to be substantially negative. In addition, management (the fourth element of the FDIC rating) is usually rated unsatisfactory or poor.

--Other problem: a bank that has major weaknesses but a lesser degree of vulnerability and that requires more than ordinary concern and aggressive supervision. These banks' net capital and reserves position is generally low or negative. Banks also can be placed in this category because of excessive loan delinquencies, a rapid rate of asset deterioration, significant violations of laws or regulations,

an unusually low adjusted capital position (the first element of the FDIC rating), an undesirable liquidity posture, pronounced management deficiencies, or other adverse factors. Usually, management is rated unsatisfactory, with a rating of fair or satisfactory the exception.

FRS problem classifications

FRS classifies banks which have composite ratings of "3" or "4" as problem banks. However, a bank which is rated "2" can also be designated as a problem bank if FRS judges that its problems could ultimately affect its soundness. The composite rating is one of the four elements of the FRS rating. A bank rated "3" requires special supervision and a bank rated "4" usually requires prompt and extensive attention to restore it to a satisfactory condition.

OCC problem classifications

Since 1970, OCC criteria for problem banks have varied. Until late 1974, problem banks were those banks whose classified assets totaled 40 percent or more of the bank's gross capital. An OCC official said problem banks were probably those with an overall rating of "3" or "4".

In November 1974, OCC initiated the "Victor program." Initially, the Victor program included all banks with a composite rating of "3" or "4" and any other banks which OCC believed warranted special attention. In December 1974, OCC changed the criteria for including banks in the Victor program. Examiners were required to include banks when they judged that any condition existed which could lead to insolvency or when criticized assets were 65 percent or more of adjusted capital.

In late 1975, OCC began a "special projects/bank review program." The special projects group supervises banks with total resources of $100 million or more and the bank review group supervises banks with total resources below $100 million. The criteria for selecting banks for the program are as follows:

--Banks are designated by the regional administrators according to their judgment of the quality of assets, adequacy of earnings, quality of management, capital adequacy, and other factors.

--Banks having criticized assets totaling 65 percent or more of adjusted capital, as well as other deficiencies, are reviewed by the regional administors for possible inclusion.

--All other banks with assets exceeding $100 million and criticized assets that total 65 percent or more of adjusted capital are reviewed by the special projects group for possible inclusion.

--Still other banks are designated by banking operations, special projects, and the National Bank Surveillance System group using the above criteria.

--All banks operating under a formal written agreement or a cease and desist order are included.

OCC classifies banks included in the program as follows:

--Critical: a bank which exhibits a combination of weaknesses and adverse financial trends which endanger its liquidity and solvency. The probability of failure is high for such banks and they require the most intense supervision and monitoring.

--Serious: a bank whose weaknesses and financial trends are not so severe as to immediately threaten the liquidity and solvency of the institution. The potential for failure is present but is not pronounced. Such banks require continuous monitoring, supervision, and attention.

--Special levels of supervision: a bank that may be experiencing a combination of adverse factors to the same or lesser degree than those banks in the serious category. However, banks in this category possess certain characteristics more favorable than banks in the critical and serious categories. They are less vulnerable; their strength ard financial capacity is such as to make a failure a remote possibility. OCC maintains that these banks are not problem banks but require more than ordinary supervisory concern and monitoring.

Different cri' ia--different problem banks

As shown above, each supervisory agency uses its own criteria to identify problem banks and the bank's rating is not always the determining factor.

OCC included 255 of the 4,744 national banks in the "special projects/bank review program" as of December 31, 1975. Of that number 85 were problem banks which required more than ordinary supervisory concern and monitoring. OCC said that while the remaining 170 banks were monitored under the program, they did not receive the same degree of monitoring as did the 85 banks or were monitored for reasons other than the fact that they were problem banks.

Of the 85 banks, 22 had composite ratings of "1" or "2," 46 had composite ratings of "3," and 17 had composite ratings of "4." Since all national banks are members of FRS, it also is interested in the condition of those banks. FRS does not maintain a list of problem national banks, but it would have so classified 267 national banks--those which OCC rated as composite "3" or "4." The banks so classified would have included 63 banks identified by OCC. All national banks are also insured by FDIC, so it, too, is interested in their condition. FDIC, using its criteria, classified 52 national banks as problem banks, including 32 of those identified by OCC.

Of the 1,046 State member banks as of December 31, 1975, FRS classified 65 as problem banks. Since all State member banks are insured by FDIC, it is concerned about the condition of those banks. FDIC classified only 17 of these State member banks as problem banks. FDIC's rating of national and State member banks, however, is based on financial risk to the insurance fund. The difference in the number of designated problem banks could also be partially due to a difference in judgment by the ag encies in identifying problems in areas such as capital, liquidity, and management.

We believe there should be some consistency among the supervisory agencies in determining whether or not a bank is a problem bank. OCC included 22 national banks as problem banks which FRS did not include and 53 national banks as problem banks which FDIC did not include. On the other hand, FRS included 204 other national banks as problem banks but OCC did not include them and FDIC included 20

national banks not included by OCC. The same holds true for FRS and FDIC. FRS included 48 State member banks as problem banks which FDIC did not include.

Conclusions

Because the supervisory agencies are responsible for maintaining soundness in the banking system and for protecting depositors, they should agree on which banks are problem banks needing extra attention. The use of different criteria to identify problem banks results in some differences in the agencies' problem bank lists. As a result, some banks may be receiving more attention than they need and some less. The reader would have had difficulty concluding which of our case studies were problem banks and which were not, if we had not labeled them as such. We believe that uniform criteria are necessary to assure that the agencies are identifying and monitoring the right problem banks.

Recommendation

We recommend that the Board of Directors, FDIC, the Board of Governors, FRS, and the Comptroller of the Currency develop uniform criteria for identifying problem banks.

Agency comments

FDIC stated:

"We believe our general comments clarify the posture of the three federal bank regulatory agencies with respect to problem banks, including those which pose supervisory problems as well as those which present inordinate financial risk to the FDIC. Moreover, we do not believe there is confusion or wide disagreement among the bank regulatory agencies as to which banks should be accorded close surveillance and supervision by the respective agencies and that, except in a failing bank, and to a limited extent in a bank holding company situation, there is virtually no overlap of regulatory jurisdiction at the federal level. Furthermore, the need to develop common criteria for problem banks is not obvious and indeed may not be appropriate.

"It is, we believe appropriate and useful for the FDIC as an insurer to view what constitutes a problem bank from a somewhat different perspective than the other two federal bank regulatory agencies. In addition, the extent to which the three federal bank regulatory agencies use somewhat different approaches to the issue of banks in need of increased and intensified supervision could foster a greater degree of innovation in this area of supervisory endeavor and could serve as a check and balance in the promotion of the widest coverage of such banks. Finally, the objectives and detached review process conducted by FDIC of all types of examinations, in order to assess the degree of financial exposure to the insurance fund, provides an overall review of all banks without imposing across-the-board guidelines which may not be suitable for the three agencies on individual basis."

FRS stated:

"As previously noted in earlier responses, the rating systems are utilized for different purposes within different agencies. However, we believe there is certainly room for much common ground in this area. The legislative proposals for a Federal Bank Examination Council referred to earlier would aid in this development, though judgmental evaluation of any common critieria will likely lead to some diversity."

OCC stated:

"The term 'problem bank' is banking agency jargon for many different fact patterns. To an outsider, it appears reasonable and logical to expect a uniform definition of the term. The agency staff person recognizes the difficulty of reducing all the variables to a single definition. At the same time, he has little difficulty in communicating with colleagues in other banking agencies on particular bank situations.

"OCC's approach is to computerize to the greatest extent possible the many variables which characterize a bank's condition and management from time to time. This results in a capability to rank all banks in relation to their peers. The final selection of banks

needing special supervision can only be done subjectively by trained personnel using all the tools available and the results of our revised examinations. The dividing line on the spectrum between 'problem' and 'non-problem' status is hard to define but OCC is more than willing to consult and cooperate with the other agencies in seeking such dividing lines."

DYNAMICS OF THE PROBLEM BANK LIST: 1971-75

In the early 1970's problem banks were decreasing, however, by the end of 1975, they had increased substantially. At the same time, more banks with deposits of over $100 million began appearing on the supervisory agencies' problem lists. This is illustrated by the following schedule:

	Problem Lists					
	FDIC (note a)		FRS		OCC	
Date	Total no. of banks	Large banks	Total no. of banks	Large banks	Total no. of banks	Large banks
12/31/70	190	-	39	4	123	9
12/31/71	183	2	48	6	119	10
12/31/72	145	3	36	6	73	5
12/31/73	124	1	29	5	109	7
12/31/74	144	4	38	7	187	33
12/31/75	275	14	65	18	267	58
9/30/76	288	16	65	19	219	48

a/FDIC includes national and State member banks on their problem lists, in addition to State nonmember banks--for which they have supervisory responsibility. However, these figures represent only the State nonmember banks on FDIC's problem list.

We analyzed the number of problem banks at the supervisory agencies for the 5-year period ended December 31, 1975. OCC's criteria varied during the period, and it could not identify for us all banks which had been considered problem banks. An OCC official said that until December 1974, problem banks were mostly those with composite ratings of "3" or "4." Therefore, we are showing those national banks with composite ratings of "3" or "4" as OCC problem banks.

	FDIC		FRS		OCC	
Number of problem banks at 12/31/70	190		39		123	
Number added from 1/1/71 thru 12/31/75	528		89		563	
Total number of problem banks during the 5-year period	718	(100%)	128	(100%)	686	(100%)
Number returned to non-problem status during the period	414	(58%)	38	(30%)	392	(57%)
Number merged with another bank	14	(2%)	9	(7%)	8	(1%)
Number closed	15	(2%)	2	(1%)	11	(2%)
Number converted to a national/State charter	-		1	(1%)	8	(1%)
Number that withdrew from FRS membership	-		13	(10%)	-	
Number removed from list	443	(62%)	63	(49%)	419	(61%)
Number of problem banks at 12/31/75	275	(38%)	65	(51%)	267	(39%)
Total number of banks at 12/31/75	8,594		1,046		4,747	
Percentage of problem banks among total banks supervised at 12/31/75	3.2		6.2		5.6	

The following analysis shows, for the 844 banks returned to nonproblem status, the length of time they were classified as problem banks.

Years	Total		FDIC		FRS		OCC	
	Number	Percent	Number	Percent	Number	Percent	Number	Percent
Under 1	395	47	149	36	12	32	234	60
1 to 2	248	29	136	33	8	21	104	26
2 to 3	88	11	59	14	6	16	23	6
3 to 4	45	5	26	6	4	10	15	4
4 to 5	21	3	14	3	2	5	5	1
5 to 10	45	5	28	7	6	16	11	3
10 or more	2	-	2	1	-	-	-	-
	844	100	414	100	38	100	392	100

Of the 844 problem banks that returned to nonproblem status, 76 percent were problem banks for 2 years or less. Nineteen percent were problem banks from 2 to 5 years; 5 percent, from 5 to 10 years; and 2 banks, for over 10 years.

In addition, 15 banks were on the problem list during the entire 5-year period of our study. As of December 31, 1975, these banks had been problem banks for an average of 9.2 years. Of these, one State nonmember bank had been on the problem list for 20 years; one State member bank, for 26 years; and one national bank, for 10 years.

Conclusions

The supervisory agencies' success in getting bank problems corrected depends largely on how willing and cooperative bank managers are to change those practices and policies which caused the problems. Those banks which are receptive to the agencies' identification of problems and suggestions for solving them stand a better chance of correcting their problems sooner. Therefore, movement off the problem list results from the banks' as well as the agencies' actions.

Most banks (55 percent) were returned to nonproblem status during the 5-year period--most of them (76 percent) within 2 years. Informal enforcement action worked for these banks. The banks remaining on the list (40 percent) probably had come on the problem list near the end of the 5-year period, too late to have already had their problems corrected. The problem list as of December 31, 1975, included only 4 percent of all banks in the system.

What concerns us are those banks which were problem banks for long periods of time; e.g., those that were problem banks for over 2 years. We believe that the agencies have to use more formal enforcement actions when dealing with them.

We also question whether banks which have been on the agencies' problem lists for extended periods of time are really problem banks. Obviously some banks were able to remain in existence even though they were on the agencies' problem lists for a long time.

ENFORCEMENT ACTIONS AGAINST BANK HOLDING COMPANIES

FRS deals with bank holding company problems the same way the three agencies deal with problem banks. When FRBs identify holding company problems, they use informal enforcement methods. Formal methods can be used when informal ones fail.

We reviewed 20 holding companies and found that FRBs used the following types of enforcement actions from January 1, 1973, through September 30, 1976, to induce holding company management to correct its problems:

Enforcement action	Number of actions
Informal:	
Phone calls and letters	13
Visits	11
Special inspections or examinations	9
Requests for progress reports	8
Analytical checks	4
Threat of cease and desist orders	2
Disapproval of expansion applications	6
Formal:	
Cease and desist order (note a)	1

a/Cease and desist order authority was not given to FRS until October 1974.

As the above table shows, FRBs primarily used informal enforcement actions when they dealt with bank holding companies.

DO THE SUPERVISORY AGENCIES HAVE APPROPRIATE POWERS?

Earlier in this chapter we discussed the formal powers available to the supervisory agencies. Closing a bank or canceling its insurance does not save it or solve its problems, although the threat of these actions can influence managers to take corrective action. Short of these procedures, the agencies' formal powers that can be actually used to influence a bank are removing officers and issuing cease and desist orders.

Officials at all three agencies said removing bank officers is now too cumbersome to be useful. The agencies must prove that the officers have committed acts of personal dishonesty, and they say such proof is difficult. In addition, OCC cannot proceed directly against a bank officer. It must present its evidence to FRS and rely on that agency to take action. Consequently, the agencies do not use their removal power as frequently as they would like to.

Agency officials said further that cease and desist orders are not always a deterrent to bank mismanagement, since they require a bank to stop performing an act or to take affirmative action to correct the conditions resulting from any such violation or practice.

Another problem pointed out by the agencies is that available legal measures do not get at the individuals causing banks problems. This is because the measures are aimed at banks, not bank officials, except for the unwieldy removal procedure.

The supervisory agencies requested additional statutory authority in a bill (S. 2304) which was considered in the second session of the 94th Congress. Among other provisions, the bill would authorize the three agencies to initiate removal proceedings against a bank official whose acts stem from either personal dishonesty or gross negligence. The bill would have also authorized civil penalties against banks and officials who violate sections 22 and 23A of the Federal Reserve Act, or regulations pursuant to them. These sections deal with (1) purchases of securities from directors, (2) interest on deposits of directors, officers, and employees, (3) loans to executive officers, and (4) loans to affiliates.

The agencies made only limited studies of the need for specific legal powers. In response to the failure of Franklin National Bank, FRS formed a task force to develop requests for more statutory tools, but made no quantitative analyses of bank problems. The agencies used their supervisory experience to decide what measures could aid them in dealing with banks. Agency officials do not expect to use the requested powers very often, but they feel that the extended authority would be useful when needed.

In our study of 30 banks that failed, we found that the examiners often stated that the failures were caused by bank managers who followed self-serving loan practices or who were incompetent. Also, among our sample of problem banks on December 31, 1975, management effectiveness was cited as a problem in 57 percent of the banks at the time the banks were put on the problem list. Therefore, the ability to apply penalties or to remove individuals could have been helpful in dealing with these bank officials.

As for the types of violations mentioned in section 22 and 23A of the Federal Reserve Act, we found that the percentages of banks in our samples that had these violations cited after the most recent reports of examination were as follows:

Violation	Universal	Sample Problem	Failed
	(percent)		
Purchase of securities	5	4	4
Interest on deposits	6	8	4
Loans tc insiders	10	10	22
Loans to affiliates	8	10	4

While relatively few banks committed these violations the authority to levy penalties could be a deterrent.

Conclusions

Although in the past the supervisory agencies have not used their legal powers often enough, additional powers could enhance their ability to deal with bank problems. Specifically, the authority to remove bank officers for gross negligence and to levy civil penalties for certain violations could be useful. Therefore, we would support legislation which would authorize the agencies to remove bank officials for gross negligence and to assess civil penalties for violations of laws and regulations.

We would also support legislation to allow OCC to present evidence and argument at removal proceedings conducted by FRS.

CHAPTER 9

AN ANALYSIS OF BANKS THAT HAVE FAILED IN THE LAST 5 YEARS

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CHAPTER 9

AN ANALYSIS OF BANKS THAT HAVE FAILED IN THE LAST 5 YEARS

OVERVIEW

For the first time since the massive bank failures of the 1930s, the public is concerned about the health of the banking system. One direct result of those earlier failures was the creation of the Federal Deposit Insurance Corporation in 1933, to protect depositors and prevent mass withdrawals. Since 1933, banks have continued to fail, but until 1966 these failures involved relatively small banks. (The largest had deposits of $48.8 million.)

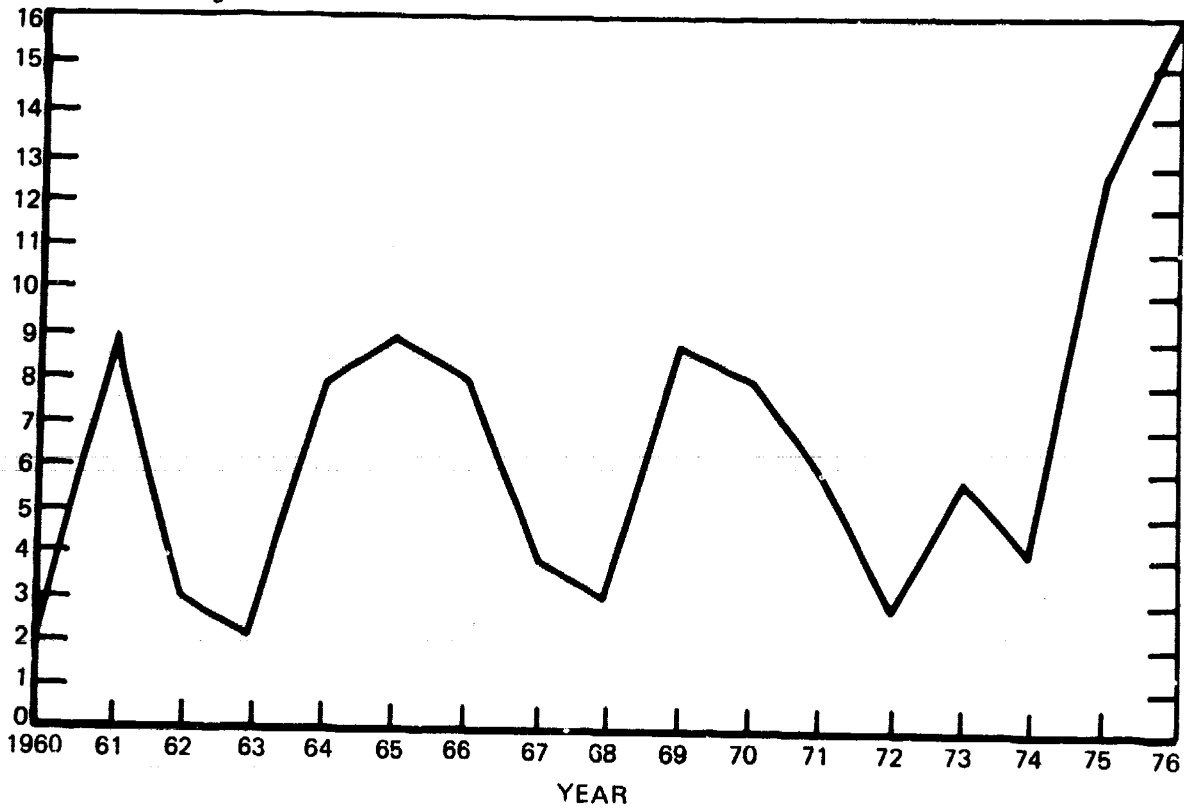
However, several larger banks have failed since 1965. The Public Bank of Detroit, with deposits of $93 million, closed in 1966. In 1971 it was Sharpstown State Bank of Houston with $66.8 million in deposits; in 1973, U.S. National Bank of San Diego with $932 million; in 1974, Franklin National Bank of New York with $1.4 billion; in 1975, American City Bank and Trust of Milwaukee with $99.5 million; and in 1976, Hamilton National Bank of Chattanooga with $341 million.

The graphs on the following page show the number of failures and the total deposits of banks that closed between January 1960 and December 1976. Although the number of failures is still small, the total of failed banks' deposits has risen dramatically.

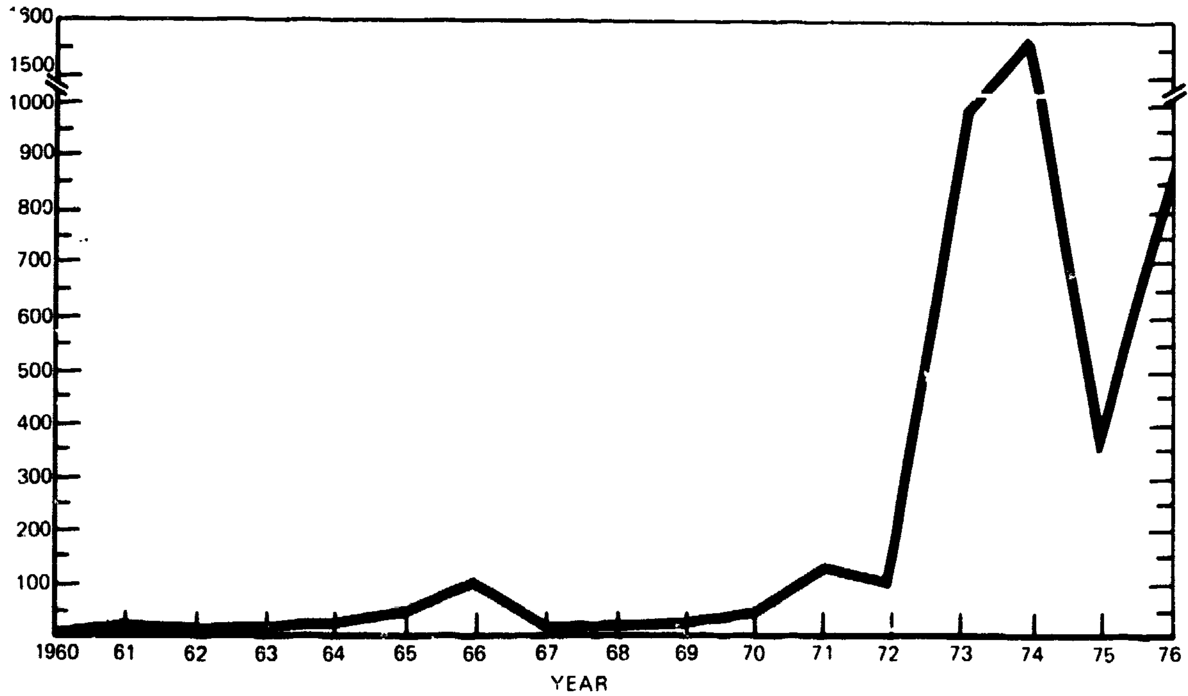
Placing the figures in perspective, the largest number of failures in any year shown was 16 during 1976. This represents about 0.1 percent of the total number of banks. At the end of 1975 the three supervisory agencies listed a total of 607 different banks needing special attention; and the number of failures during 1976 was only 2.6 percent of that figure.

FDIC studies of 92 bank failures from 1960 through September 1976 indicate self-serving and improper loans caused 57.6 percent of the failures; defalcations, such as embezzlement and fraud, 27.2 percent; and other management weaknesses, 15.2 percent.

NUMBER OF BANKS CLOSED 1960–1976



TOTAL DEPOSITS OF CLOSED BANKS 1960–1976



We selected for detailed review 30 of the 42 banks that were closed between January 1971 and June 30, 1976. Of these 30 banks, 19 were supervised by FDIC, 9 by OCC, and 2 by FRS. An additional 27 banks merged with others to avert probable failure.

Adverse economic conditions in the early 1970s contributed to some of the bank failures. However, the primary cause of each failure was the practices followed by the bank's managers. These practices left the banks more vulnerable to economic fluctations.

Among the 30 cases we reviewed, 14 banks' problems were related to self-serving loan policies, which had been pointed out by examiners well before the banks failed. Illegal acts such as embezzlements caused eight of the failures and in seven of those cases examiners had criticized the banks for poor internal controls. Examiners actually discovered illegal acts at three of those banks. The remaining eight failures were caused by general loan mismanagement.

According to FDIC, one factor common to banks that failed was the lack of supervision by the banks' boards of directors. The directors did not fulfill their responsibilities to set and enforce bank policies.

Faced with incompetent or dishonest managers and with boards of directors that often did not become involved enough in bank operations, bank supervisors used informal persuasive techniques in vain. Managers of banks that eventually failed did not respond to the supervisory agencies methods and did not correct their problems.

Short of closing a bank the regulators have formal legal methods available to them, such as terminating insurance and issuing cease and desist orders. (See ch. 8.) However, the supervisory agencies used their legal powers in only 8 of the 30 cases we studied, and only after the banks' problems had become critical. Notwithstanding their recent requests for additional powers, we believe the agencies should have used the ones they have sooner and more often.

WHAT IS A FAILED BANK?

For purposes of our report, a failed bank is one which closes due to financial or other problems. A bank can voluntarily liquidate, or, if the Comptroller of the Currency becomes satisfied that a national bank is insolvent, he may appoint a receiver. Although State laws vary, State chartering authorities can similarly close State banks. Our charts on page 9-2 include banks both voluntarily and involuntarily closed.

Some banks in imminent danger of failing are merged with or are purchased by other banks. Each supervisory agency can approve such mergers or purchases on an emergency basis. OCC approved 14 such mergers during the period covered by our study, FDIC approved 10 and FRS 3. If a purchaser cannot be found and the bank is considered vital to a community, the regulators may give direct financial aid to keep it open.

WHAT HAPPENS WHEN A BANK FAILS?

When a national bank closes, FDIC is appointed receiver with power to liquidate assets of the closed bank, enforce the liability of the stockholders and directors of the bank, and wind up the bank's affairs. Usually FDIC is appointed receiver for insured State banks that fail.

How does FDIC handle closings?

FDIC can choose from three basic methods of handling closings, depending on the potential cost to the Corporation and the needs of the community.

Deposit assumption

FDIC can assist a sound bank to absorb a failed bank, when such action will reduce risk or avert a threatened loss to the Corporation. It can do this by purchasing assets of the failed bank, granting a loan to the assuming bank evidenced by a capital note, or indemnifying the assuming bank against actual or potential losses.

Often, the transaction works as follows:

(1) FDIC, as receiver of a failed bank, solicits bids to assume deposit liabilities of the bank.

(2) The winning bidder, which could be a newly chartered bank, assumes the failed bank's deposits and perhaps other specified liabilities. The assuming bank may also purchase assets of the failed bank from the receiver.

(3) If liabilities assumed exceed the assets purchased and the premium paid, the failed bank's receiver pays the assuming bank the difference in cash with funds from FDIC for for its purchase of the remaining assets of the failed bank.

Twenty of the thirty banks we studied were handled as deposit assumptions. For example, the newly chartered First Tennessee National Bank was the winning bidder for the deposit liabilities of the defunct Hamilton National Bank of Chattanooga. First Tennessee took over $385 million in deposits and other liabilities. It paid a premium of over $16 million, and accepted about $314 million in assets. To complete the transaction, FDIC as receiver paid over $54 million. FDIC also purchased a capital note of $24 million.

Statutory payoff (straight receivership)

FDIC pays insured depositors out of the insurance fund. It acts as receiver for the failed bank. The 30 cases we reviewed included 8 statutory payoffs. One such case was the Elm Creek State Bank of Nebraska. This bank had total deposits of about $2.9 million, including those of 23 uninsured depositors. All insured depositors were paid, and even the uninsured depositors had received 95 percent of their money at the time we made our study.

Deposit insurance national bank

If FDIC finds that it is advisable and in the interest of the depositors of the closed bank, OCC may charter a Deposit Insurance National Bank (DINB). For a period of up to 2 years the DINB services deposits and may, if its charter allows, extend loans. The manager of the bank is appointed by FDIC and is under its direction. FDIC may make a public offering of the DINB, but if a buyer cannot be found within 2 years FDIC must wind up the affairs of the DINB.

DINB's were established in 2 of the 30 cases we studied. One was the Swope Parkway National Bank of Kansas City, Missouri. The DINB assumed all insured deposits up to $40,000 and also assumed cash and "due from banks" accounts, along with certain investments. As assets are liquidated, uninsured deposits and other creditors are being paid off. The stockholders have lost their investments, but they have the first chance at buying into the DINB. Insured deposits were about $4.9 million, and FDIC has established a loss reserve of $1.5 million for this case.

What are the effects of a bank failure?

The financial effects of a bank closing vary according to the method used to handle it.

A deposit assumption may offer the least inconvenience to the bank's former customers. Banking services often re-remain uninterrupted for members of the community. No deposits are lost, and at least some borrowers may continue to have creidit available from the assuming bank. Generally, FDIC acquires the unassumed loans and continues to collect them. Most creditors other than depositors must await the outcome of FDIC liquidation proceedings before they know what their losses are. They are left to any legal remedies they might have against the receivership. The bank's stockholders can lose their investments but may recoup something as a result of liquidation by FDIC.

In a statutory payoff, only insured depositors are paid off quickly. Uninsured depositors, other creditors, and stockholders must await the outcome of liquidation. Bank customers, of course, must try to find services from another bank.

The full financial impact of a closing is not calculable until the liquidation process is completed. This process may take several years after the closing, so we could not determine the full effects of each failure we studied. However, according to FDIC, for banks that failed since 1934, over 99 percent of all depositors--insured and uninsured--have been paid in full or have had their funds made available to them, as in a deposit assumption.

FDIC's costs include the amount it pays to depositors in a payoff, or the amount it pays to facilitate an assumption; the interest income lost on the money it pays out; and the expenses of acting as receiver for the failed bank. FDIC may recover money from the liquidated assets of the bank; proceeds from fidelity bonds; and proceeds from directors' liability.

When a bank fails, FDIC estimates the potential losses on liquidating the assets it assumes. As the bank's assets are liquidated, the reserve established for the losses is adjusted semiannually. As of June 30, 1976, FDIC had approved the following reserves for banks that failed during the period we studied:

FDIC Reserves for Losses on Closed Banks

Name of bank	Reserve
	(000 omitted)
Payoffs:	
Sharpstown State Bank Houston, Tex.	$1,050
Farmers State Bank of Carlock, Ill.	300
First National Bank of Cripple Creek, Colo.	140
Surety Bank & Trust Co. Wakefield, Mass.	4,100
Swope Parkway National Bank Kansas City, Mo. 1/	1,500
Franklin Bank Houston, Tex.	3,025
Peoples Bank of the Virgin Islands 1/	2,350
Mt. Zion Deposit Bank Mt. Zion, Ky.	100
Coronado National Bank Denver, Col.	200
Citizens State Bank Carrizo Springs, Tex.	300

1/ Deposit Insurance National Bank

Name of bank	Reserve
	(000 omitted)
Deposit assumptions:	
Skyline National Bank Denver, Col.	$ 130
U.S. National Bank San Diego, Cal.	150,000
First National Bank of Eldora, Iowa	85
American Bank & Trust Orangeburg, S. C.	2,700
Tri-City Bank Warren, Mich.	2,100
Northern Ohio Bank Cleveland, Ohio	5,725
Algoma Bank Algoma, Wisc.	825
Bank of Chidester Chidester, Ark.	620
State Bank of Clearing Chicago, Ill.	8,700
Astro Bank Houston, Tex.	440
American City Bank & Trust Co., N.A. Milwaukee, Wis.	13,530
Peoples Bank Wilcox, Ariz.	125
Bank of Bloomfield, N. J.	600
Bank of Woodmoor Monument, Col.	330
South Texas Bank Houston, Tex.	950
Northeast Bank of Houston, Tex.	680
First State Bank of Hudson County Jersey City, N. J.	570

Not all the banks that failed during the period we studied are on the preceding list, because FDIC did not project losses for them. For example, FDIC does not anticipate losses on Franklin National Bank, so no reserve was established.

FDIC derives most of its income from assessments (similar to insurance premiums) paid by insured banks and from investments in U.S. Government securities. From the total assessments due each year FDIC subtracts its expenses, insurance losses, and net increases in loss reserves. Two-thirds of the remainder is credited back to insured banks to offset forthcoming assessments. Therefore, the more banks that fail and the larger their assets, the less is credited back to the banks still operating. In this way, all insured banks bear the costs of failures --the concept of risk-spreading through insurance.

FDIC officials said failures, especially of small banks, have usually had little impact on the communities involved. Of concern to many is the effect of large bank failures on the public's confidence in our banking system. Although it is apparent that the economy can tolerate the number of failures that have occurred in recent years, we cannot determine at what point an intolerable situation would develop. For example, if the number of large bank failures were to increase, the economy could be seriously affected.

WHY DID BANKS FAIL?

From 1934 to the early 1960s, illegal acts--such as fraud and embezzlement--were the major cause of bank failures. Some failures also resulted from extremely bad management.

The Chairman of FDIC 1/ has pointed out that in the late 1960s some banks began expanding their activities into riskier areas, such as real estate, direct lease financing, and foreign operations. These banks were primarily concerned with rapid growth and high profits, and they adopted more liberal lending policies. With the relatively stable growth and moderately stable prices of that period, no noticeable harm was caused by these new banking philosophies.

1/Robert E. Barnett, in a speech before the 92nd annual convention of the Texas Bankers Association, El Paso, (May 3, 1976).

But the early 1970s provided a tougher economic climate. Bankers faced not only a major recession but also tight credit and high borrowing costs. These economic conditions contributed to the increase in bank failures.

However, our study of examination records of failed banks revealed that the failures were primarily caused by the policies used by the banks' managers. Examiners in 17 of the 30 cases we studied had criticized the banks' managers for following self-serving loan practices. In 26 cases examiners considered managers incompetent. In 17 cases examiners had warned that the banks were overconcentrating their loan risks in a single industry or to a single borrower. And in 27 of 30 cases we reviewed, examiners stated that the banks' loan records were inadequate.

In other words, management practices were unusually risky even under good economic conditions, since poor loans were often made. Therefore, the banks were more vulnerable to economic fluctuations.

A recent FDIC study of 92 bank failures between January 1960 and September 1976 showed that 57.6 percent were caused by improper loans to officers, directors, or owners, or by loans to out-of-territory borrowers; 27.2 percent resulted from embezzlement or manipulation of funds; and 15.2 percent were due to general loan management weaknesses. Compared with an earlier FDIC study through 1974, this one showed proportionately more failures caused by poor loan management and fewer caused by embezzlement.

The 30 banks we reviewed that failed from January 1971 to June 1976 followed a slightly different pattern. Fourteen of the banks (46.7 percent) failed because the management made improper or self-serving loans. Eight of the cases (26.7 percent) involved general loan management weaknesses. Eight other cases involved embezzlement or other crimes. The differences in our statistics reflect an increase in mismanagement as a cause of failure, because our study covered the most recent cases.

Typical of the cases of self-serving or improper loans is the following one, which we shall call State Bank. State Bank opened in the 1960s and shared ownership with

three other banks. In the first examination we studied, examiners criticized the self-serving tendencies of the bank's management. The examiners stated the bank's directors had borrowed one-fourth of all the money loaned by the bank, over twice the bank's adjusted capital and reserves. Subsequent examinations divulged problems such as loans secured by affiliated banks' stock, affiliated banks financing each other, an overconcentration of large speculative advances to real estate developers, and unsecured credits to heavily indebted borrowers.

When it closed State Bank had assets classified as "loss" that exceeded its total capital and reserves. Another bank owned by the same group failed a year later.

A bank which we shall call Capital Bank illustrates failures caused by the mismanagement of loans in general.

Capital Bank was closed in the 1970s. Some years earlier the State's capital city experienced a boom in the real estate market, and developers started many new housing projects. Some of these projects were aided by a Federal program promoting low-income housing.

The bank's directors, according to Federal examiners, were eager for the bank to grow. They approved large loans to several developers, thereby overextending the bank in the real estate area. Examiners believed that many of these loans were made on the assumption that the real estate market would continue to expand and that the bank's officers paid too little attention to the creditworthiness of the borrowers. Some of the construction projects did not have sufficient funds to complete them.

The Federal Government announced plans to phase out its low income housing subsidy, and the real estate market in general also suffered a decline. Loans made by Capital Bank became overdue, with some borrowers unable to meet their interest payments. Capital Bank made new loans to some of these borrowers so they could make the overdue payments on the previous loans. The bank accepted insufficient collateral for these new loans, according to examiners.

Rumors of the bank's financial troubles caused many depositors to withdraw their funds, severely affecting the bank's liquidity. In spite of a loan from FDIC and a line of credit at another bank, Capital Bank had to close.

The crimes that lead to failures are exemplified by a bank we shall call Country Bank.

Country, the only bank in a small town, suffered from a variety of problems. Its management had been rated unsatisfactory by the examiners over most of the last 5 years of its existence. Examiners had been criticizing the bank for classified loans, overdue payments, poor internal controls, and violations of regulations. During that time a new owner took over as president.

As Country Bank was apparently beginning to improve, its principal correspondent bank informed the State banking commission that Country Bank had been exposed to a massive check kiting scheme. Federal and State examiners determined that the scheme involved a substantial sum to one of the bank's customers and that the same customer had other unsecured credit at the bank.

A kiting scheme is one in which a depositor with accounts in two or more banks draws on nonexistent funds by taking advantage of the time required for checks to clear in order to obtain unauthorized credit. This scheme can function only if depositors are allowed to draw against checks which have not yet cleared--a commonly extended courtesy.

In this case the customer maintained checking accounts at Country Bank and at several other banks. He wrote checks on his Country Bank account and made deposits to that account using checks of a corporation with an account at one of the other banks. The cashier at Country told examiners these checks were mailed to the bank at various times so that enough would be on hand to keep the account in the black. Once the other banks involved cut off the kite, Country Bank was unable to recover from its losses.

A bank's board of directors is responsible for setting policies and overseeing bank operations. According to FDIC, one factor common to many banks that failed was that their boards of directors did not carry out their responsibilities properly. Examiners had criticized the lack of director involvement in 20 of the 30 cases we reviewed.

HOW EARLY DID THE AGENCIES IDENTIFY THE CAUSES OF FAILURES?

The examiners identified the underlying problems which led to most bank failures. In 21 of the 30 cases we reviewed, the agencies identified the banks' problems at least 2 years before they closed. Moreover, the examiners usually commented to bank managers on the problems in reports or meetings.

Supervisors readily identified continued self-serving tendencies and poor loan policies. The problems were usually cited in examination reports for several years before banks failed. For example, OCC examiners criticized credit practices of the Swope Parkway National Bank almost 4 years before it closed. Although managers were replaced, losses from the original loans so depleted the bank that it never recovered.

Even among the eight banks we studied which failed because of frauds, examiners had noted problems with internal controls in seven long before they were forced to close.

One example is a bank we shall call National Bank. In the 5 years we studied, examiners had made 9 examinations and 22 visits, and a public accounting firm had audited the bank.

In one report examiners disclosed that the salaries of both the bank's vice president and its cashier were "dangerously low"; however, both men indicated they had "outside resources or assistance." The bank had a history of problems, including poor internal controls. But the examiners stated they waived normal control requirements since the bank had only a few employees.

Following the discovery of a shortage by an employee of an affiliated bank, the vice president and

cashier were found dead in what was termed a mutual self-destruction pact. Subsequently, the authorities found substantial shortages and determined that irregularities had existed for at least 3 years. According to examiners the two employees had kept two sets of records to hide the misapplications of funds from examiners. Unfortunately for the bank, its bonding insurance had been canceled earlier, and it could not recover from the loss.

HOW DID THE AGENCIES TRY TO RESOLVE THE BANKS' PROBLEMS?

Supervisory agencies could use both informal and formal action when dealing with banks having problems. (See ch. 8.) First they attempted to influence bank managers and owners with informal techniques. For example, in some of the cases we reviewed, the supervisory agencies made periodic visits to the banks in addition to regular examinations. Some of the banks were required to report periodically on progress in solving their problems. In one case we studied, OCC even placed examiners in the bank full time to monitor its progress.

A bank which we shall call Town Bank will help illustrate agency actions.

Town Bank served a rural community and was not highly rated when it was purchased by a new owner. After the bank was closed it was alleged several persons used illegal means to finance highly speculative real estate ventures. This line of credit comprised almost half of Town Bank's loan portfolio when it closed.

Examiners had cited the concentrated loans and self-serving tendencies in one of their examinations. Some months later the bank was sold again, but examiners felt the new owner was inexperienced. Both Federal and State banking authorities stepped up their activity. Federal regional officials met with bank officials, and they conducted a special examination. Town Bank also agreed to submit progress reports on its efforts to solve its problems. Federal authorities considered issuing a cease and

desist order or terminating the bank's insurance, but the State Commissioner of banking recommended against it, reasoning that the offending individual had gone and the offensive acts had ceased. In addition, the Commissioner felt that such an action would discourage efforts to resell the bank.

The bank requested that FDIC grant it a loan to stay open. FDIC declined, suggesting the bank was not really essential to the community, and began proceedings to terminate Town Bank's deposit insurance. A hearing had been scheduled when the bank finally closed. In the last few months both Federal and State authorities had tried to help arrange a merger between Town Bank and another bank, but their efforts proved futile.

Agency field personnel preferred to use informal enforcement techniques and usually found them effective. Regional officials stated they can even influence a bank's directors to force an undesirable officer to resign. For example, one bank we reviewed changed managers at the insistence of OCC, but the bank still failed.

When informal measures fail to elicit corrective action, formal legal authority is available to the supervisory agencies:

--FDIC may terminate a bank's insurance.

--FRS may expel member banks.

--Any of the agencies may remove offending managers (OCC must rely on FRS for action).

--Any of the three agencies may issue a cease and desist order.

In 7 of the 30 cases we reviewed, the agencies threatened to either close the banks or terminate deposit insurance. FDIC actually began to terminate the insurance of four banks we reviewed. The agency removed an officer of one bank. However, he owned a controlling interest in the bank and so remained influential.

Since 1966 the Federal regulators have had the power to issue cease and desist orders. Proceedings were

initiated in only 4 of the 30 cases we reviewed. Two were begun 18 months or more after the problems had first been identified. None of the proceedings went to the hearing stage because all the banks involved consented to the orders.

In addition to the actions discussed above, FDIC and FRS can each render financial assistance to banks in trouble. Under section 13(c) of the Federal Deposit Insurance Act (12 U.S.C. 1823(c)), FDIC may make loans, purchase assets, or make deposits to prevent the closing of an insured bank which is essential to its community.

Under section 13(e) of the Federal Deposit Insurance Act (12 U.S.C. 1823(e)), to facilitate a merger, the FDIC may make loans to the acquiring bank, purchase assets, or guarantee any other insured bank against losses on purchasing assets. Such actions were taken to avert a closing for the first time in 1975, when FDIC loaned $10 million to assist the merger of the failing Palmer First National Bank and Trust Company.

The Federal Reserve can also make credit available to banks in trouble. FRS loaned Franklin National almost $2 billion to keep it operating until a permanent solution could be found to its problems. None was found and Franklin ultimately closed.

CONCLUSIONS

Most bank failures we studied were caused by bad management practices that were readily identified by the supervisory agencies' examiners. Although economic conditions worsened the banks' problems, the primary causes of the failures were the management decisions that left the banks inordinately vulnerable.

The difficulty confronting the agencies in most of the cases we studied was not in identifying the problems but in influencing the banks to solve them. Although agency personnel said informal persuasive techniques are usually sufficient to convince a bank's managers to solve its problems, persuasion obviously did not work with the banks that failed. This was usually because the bank officials followed self-serving loan practices and were incompetent, as stated in examination reports and correspondence. In addition, the banks' boards of directors did not meet their responsibilities.

Faced with this situation, the agencies could have turned to their legal powers. However, we noted a tendency by each supervisory agency to delay formal action until a bank's problems had become so severe as to be difficult at best to correct. The regulators kept waiting for the banks to take action they had promised, and we found bank managers would break those promises several times before the agencies began legal steps.

Judging the appropriate time to take formal measures against a bank's management is difficult. Nevertheless, in the cases of failed banks we studied, supervisory agencies did not use their cease and desist authority as effectively as they might have.

Since 1975, the agencies have begun to initiate more cease and desist orders. Issuing cease and desist orders early, when a bank's problems are still manageable, should increase the supervisory agencies' effectiveness.

CHAPTER 10

EXAMINER CAPABILITY AND INDEPENDENCE

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CHAPTER 10

EXAMINER CAPABILITY AND INDEPENDENCE

OVERVIEW

The quality of bank supervision depends largely on the competence and objectivity of the bank examiners.

In responding to our questionnaire mailed to 1,678 banks, commercial bank officials generally reported favorably on the competency of examiners. Senior examiners' understanding of the specialized examination areas of trust and international was rated adequate or more than adequate by 89 percent of the bankers while 11 percent thought it was borderline or less. Toward examinations of electronic data processing, however, bankers were less favorable. Here, approximately 25 percent thought senior examiners' understanding was borderline or inadequate. Opinions concerning each of the three agencies were similar.

An examiner's competence, or examining skill, is his/her ability to analyze a commercial bank's operations and judge its soundness. Competence is based on knowledge of banking practices and of the supervisory agency's policies and regulations. Examiners may acquire this knowledge from colleges, from employment with banks, and from training and experience provided by the agency. Agency training and experience are probably the most important elements to help the examiner understand and evaluate banking practices.

The agencies are not legally subject to Civil Service Commission (CSC) rules and regulations governing Federal personnel practices; however, FDIC follows them in recruiting, compensating, and promoting examiners. OCC uses CSC's General Schedule in paying its examiners. For the most part, Federal Reserve district banks set their own personnel policies.

Although the agencies' personnel policies are similar in many respects, there are important differences. FDIC and OCC are more centralized than FRS; therefore, they have more uniform policies and practices. Each Federal Reserve district bank has primary responsibility for recruiting, training, evaluating, and paying examiners, and, as might be expected, policies and practices vary considerably.

Most of the examiners hired by the three agencies have undergraduate degrees in business-related subjects, and some have worked in banks or as bank examiners. During 1971-75, FDIC, FRS, and OCC hired 912, 594, and 1,147 examiners, respectively, from the following sources:

	FDIC	FRS	OCC
	(percent)		
College	81	58	71
Commercial Banks	2	12	12
Other a/	17	30	17

a/ Private sector, Federal agencies, intra-agency transfers, reemployed military.

The agencies operate internal schools which instruct examiners in various aspects of bank examination, such as commercial banking, trusts, international banking, and electronic data processing. Bank examiners we questioned generally rated the internal courses as useful or very useful; however, many thought they needed additional training, particularly in law, EDP, and accounting.

In the specialized areas of EDP and international banking operations, FRS has not provided much training in recent years. Its EDP school was not held in 1975 or 1976 though plans have been formulated for a school in 1977. Its international school was held once in 1972, 1974 and 1976. FRS officials note however, that the New York Federal Reserve Bank provides continuing training in international topics.

FDIC offers three EDP schools which are available to examiners at various stages of their careers. It does not have an international school; officials said that the banks supervised by FDIC tend to be small and are therefore unlikely to be engaged in international banking. FDIC uses OCC's schools or instructors to provide international training when needed for its examiners. OCC annually operates one EDP and three international schools for its examiners.

In 1975, the three agencies spent the following amounts for internal and external training of their examiners, including tuition, books, fees, space rental, and students' and instructors' subsistence and travel:

	Training expenditures	Examining staff	Average expenditure per examiner
FDIC	$946,450	1,712	$552
FRS	321,836	709	453
OCC	636,000	1,968	323

All three agencies periodically evaluate the job performance of their bank examiners. FDIC and OCC require employees to complete a formal evaluation process before they can take charge of bank examinations. The process emphasizes the skills needed to analyze a bank's management, assets, and soundness. FRS does not have such a process.

All three agencies have policies to guard against actual or potential conflicts of interest among their examiners. The policies generally prohibit examiners from owning stock in banks or bank holding companies, from having loans or credit cards with banks that they may be asked to examine, and from examining banks where their relatives work.

Each agency requires examiners to file statements of financial and personal interests when they are hired but only FRS requires annual updates. We have been requested by the Chairman, Subcommittee on Commerce, Consumer and Monetary Affairs of the House Committee on Government Operations to examine, in a separate study, the financial disclosure practices of the three agencies.

RECRUITMENT POLICIES AND PRACTICES

Sources of bank examiners

The three bank supervisory agencies generally hire college graduates with bachelor's degrees in business-related subjects such as finance, accounting, and economics; however, they also consider applicants without degrees who have worked in banks. Most of the positions are filled at the entry level, although the agencies hire some individuals at higher levels who have prior work experience, usually with banks or with other Federal or State bank supervision agencies.

Methods of filling examiner positions vary among the three agencies. OCC regional offices typically recruit at local colleges and universities. In addition, they accept walk-in applicants and referrals from bankers and OCC employees. FDIC regional offices fill positions from CSC job registers. Individual Federal Reserve district banks fill their positions by various methods: recruiting at colleges, accepting referrals from employees and bankers, contacting employment bureaus, advertising in newspapers, etc.

Standards for beginning examiners

Minimum qualification requirements for examiners hired by the three agencies are generally an undergraduate degree in a business-related major or at least 3 years work in banking or bank examining. In addition, FDIC requires mo applicants to pass CSC's Professional Administrative Career Examination 1/ and OCC requires its applicants to pass a general abilities test. Each Federal Reserve district bank sets its own qualification requirements for examiner positions. Some require an undergraduate degree as a minimum while others accept bank experience in lieu of the degree. Of the 325 examiners interviewed at the 3 agencies, 301 had college degrees.

1/Those with experience who apply for higher than entry-level positions must pass CSC's mid of senior-level examination.

DEVELOPMENT OF CAREER EXAMINERS

The three agencies' bank supervision duties are carried out primarily by their field examining staffs. Examining teams are composed of assistant examiners and those who have reached the full examiner level. Typically, assistants are apprentices who begin with the more mechanical tasks, such as cash verification, and progress to more analytical ones, such as loan evaluation. Those who have reached the full examiner level are considered capable of conducting the overall examination and preparing the examination report. Typically, it takes 4 to 5 years for an individual to progress from entry level to full examiner.

Types of training

Bank examiners are trained by three methods. The primary one is on-the-job training. New examiners are generally considered to be in training for 1 or more years while more experienced examiners help them learn examining skills through assignments with increasing responsibility and progressively more complex tasks.

The second type of training is through formal schools and seminars operated at agency headquarters or at regional offices and Federal Reserve district banks. There examiners receive training in the commercial, trust, international, and EDP areas of bank operations. Examiners at each agency learn fundamentals at commercial bank examining schools during their first 6 months of employment. The agencies also operate more advanced schools in the commercial area to prepare assistant examiners to take charge of bank examinations. These schools emphasize the more analytical and evaluative aspects of examination--judging asset quality, management effectiveness, and bank policies and preparing examination reports.

Each agency also offers basic and advanced courses for examiners who will be specializing in trust examining or who will be examining commercial banks with small trust departments.

In the international banking area, OCC operates three schools for individuals who will be examining banks with international departments or overseas branches or subsidiaries. FDIC does not have an international school because, according to officials, the banks it supervises are typically

small ones which do not have international operations. FDIC uses OCC schools or instructors to provide training in international examining for individuals who may need it. FRS holds an international school every 2 to 2-1/2 years.

FDIC and OCC each offer introductory and more advanced schools in examining the computerized aspects of bank operations. FRS used to have a 3-week basic EDP school, designed to cover EDP examinations and provide guidelines for preparing an examination report. This course was not held in 1975 or 1976 though plans have been formulated for a course in 1977.

Examiners in the three agencies may also receive job-related training from external sources. According to agency officials, examiners are encouraged to enroll in correspondence courses offered by such firms as Dun and Bradstreet, Inc., or by such industry groups as the American Institute of Banking. Some examiners also enroll in industry-sponsored banking schools such as the Stonier Graduate School of Banking at Rutgers University and the National Trust School at Northwestern University.

Conclusion

Generally, the agencies operate examiner training schools in the same areas of bank operations. Since their schools cover generally the same topics, the agencies could (1) realize economies by consolidating their schools and (2) assure high quality instruction by exchanging information and standardizing curriculums.

Recommendation

We recommend that where feasible the Board of Directors, FDIC, the Board of Governors, FRS, and the Comptroller of the Currency combine their examiner schools and standardize their curriculums.

Agency comments

FDIC stated:

"Although we find the comments and recommendations contained in the report on examiner training provocative,

on balance we believe they did not afford sufficient treatment or depth to the various examiner training and educational programs offered by the FDIC.

"We are especially dismayed by the fact that the GAO study largely ignores the operation of the FDIC Division of Bank Supervision (DBS) Training Center. The FDIC Training Center is undoubtedly the best bank examiner training program in the country. Nevertheless, because of our burgeoning training needs, the FDIC is considering constructing its own, larger facility with resident dormitory quarters. The FDIC has approached the FRS and the OCC to join with the Corporation in a cooperative training facility. Both the FRS and the OCC have evidenced interest in this project and discussions on a cooperative training effort are going forward. A brief summary of the operation of the FDIC DBS Training Center is included with our general comments."

FRS stated:

"The examiner schools were a combined effort of the three agencies when they were established in 1952 by the Federal Reserve. However, in 1962 the Office of the Comptroller of the Currency withdrew from the program, believing it preferable to operate its own school. In the early 1970's the number of FDIC students necessitated some sessions held for FDIC examiners only and, when the FDIC enrollment needs continued at this high level, it was decided that the only practical course of action for the FDIC and the Federal Reserve System was to establish separate schools.

The Board believes that a joint effort in this area would be appropriate and desirable. This is among the reasons the Board supports the concept of a Federal Bank Examination Council. Short of this proposal, the Board will explore with other agencies the feasibility of conducting joint schools."

OCC stated:

"The OCC recognizes that a common training effort and a combined examiners' school would be highly desirable both in terms of expense and coordination of examination policy. Our Office stands ready to cooperate fully with all such efforts. Indeed, our Office is in receipt of a letter from Chairman Barnett of the FDIC

asking our cooperation and financial support for a combined training facility to be constructed at a Rosslyn, Virginia site. This matter is receiving serious attention.

The practical difficulty is that our Office has implemented the Haskins and Sells Report which has created fundamental changes in our examination process. These changes are so basic to our examination process that it would be difficult to coordinate a curriculum. A combined examiners' school is viable only if the other agencies modernize their techniques in line with those being implemented at the OCC. It would be possible, however, to offer jointly courses in more generalized subjects such as Economics and Accounting."

Adequacy of training

We asked 325 examiners' opinions on the usefulness of their agencies' training schools in increasing their banking skills and helping them meet requirements of their work. Most answered that the training they received was useful; however, they said that more training would be helpful in certain areas. The areas most often cited were law, accounting, EDP, management, fiscal management, corporate taxation, and foreign exchange transactions.

The responses of commercial bank officials to our questionnaire also support the need for additional training, especially in EDP.

--In response to a question about examiners' knowledge of banking, approximately 92 percent of the bankers thought it was adequate or more than adequate.

--We also asked the bankers to rate the competence of examiners-in-charge in 11 analytical and evaluative areas, such as loans, internal controls, and bank liquidity. In each of these areas, although approximately 85 percent or more rated the examiners' competence as adequate or more than adequate, up to 15 percent rated it as borderline or inadequate.

--Regarding the specialized examination areas of trust, international, and EDP, the bankers' opinions about

> the competence of examiners-in-charge were mixed. In the trust and international areas, approximately 89 percent of the bankers thought examiners' understanding adequate or more than adequate while 11 percent thought it borderline or inadequate. The bankers' opinions were less favorable on EDP examining. Here, approximately 25 percent thought examiners' understanding borderline or inadequate. This pattern of bankers' opinions was consistent among the agencies.

OCC is improving its training for bank examiners, as recommended public accounting firm of Haskins & Sells. Beginning in January 1977, OCC headquarters will implement an agencywide personnel development program consisting of a continuing education segment and a career development segment.

The education segment will consist of at least 80 hours of formal, technical education annually in the first several years of an examiner's career. This training is intended to assure that the examiners learn needed skills at appropriate points in their careers. Training programs for the first, second, and fifth years of the examiner's career have so far been developed.

The career development segment will provide management oriented and technical training later in the examiner's career.

OCC officials also believe that its on-the-job training of examiners will be improved by the agency's adoption of a new handbook of examination procedures, which describes the various areas of banking operations and provides instructions on the examining functions to be performed for each. An official said that these procedures will provide new employees with guidance about the examiner's role and understanding of sound banking practices.

Improvement needed in FRS training

Federal Reserve examiner training also needs improvement, according to the findings of a 1975 FRS study of examiner recruiting, training, development, and compensation done for the Conference of Reserve Bank Presidents.

Half of the district Reserve Banks considered examiner training inadequate, while most had reservations about adequacy or expressed the need for expansion, generally or in specialized areas. The study stated that to cope with current problems and new developments, examiners would need additional specialized skills in the areas of EDP, international banking, bank holding company operations, and consumer protection.

The Board has offered little or no training in these areas in recent years. It has not offered its introductory EDP school at all in 1975 or 1976 (plans have been formulated for a school in 1977). It only held its introductory international school once in 1972, 1974, and 1976. Officials note however, that the New York Federal Reserve Bank provides continuing training in international topics. At the time of the study, FRS offered no courses in bank holding company examinations and only a few hours on examining for compliance with various laws affecting consumer credit.

The FRS study recommended that the Conference of Reserve Bank Presidents urge the Board of Governors to reevaluate its examiner training program and insure that examiners learn to deal effectively with current banking practices and developments. The study specifically recommended

--a school for examiners who inspect bank holding companies,

--a refresher program for full examiners, and

--a reappraisal of district Reserve Bank budget and planning policies which have limited examiner training programs.

In January 1976, the Board appointed a committee on education to study training needs. A result of this study has been the establishment of an FRS school for bank holding company examiners, the first session of which was held in October 1976. Further, the Federal Reserve Board's Division of Consumer Affairs has designed a school for examiners who check on commercial banks' compliance with the various consumer protection laws. This school began in September 1976. Officials said these schools will be held regularly to build up a cadre of examiners knowledgeable in these examining areas. The FRS education committee is also considering establishing a new EDP school and a seminar for higher level examiners to inform them of new developments in banking and other subjects of interest.

According to the Board's staff, it has long been aware of the need for a complete review of the curriculums for the the examiner schools but the pressure of the work has not permitted this. Similarly, the Board staff has recognized a longstanding need for teaching experienced examiners about new developments in banking. The officials responsible for the Board's schools are in its Division of Banking Supervision and Regulation, where they have other duties. In the small portion of time they can devote to training, they cannot do the planning needed to revise current schools.

Conclusions

FDIC's training program seems to be providing its examiners with most of the skills needed to assure high-quality supervision of banks. OCC has recognized problems with its program and has acted to improve it. Although the Federal Reserve Board has improved its program as a result of a recent FRS study, we do not believe that training can receive enough attention as a part-time responsibility of the Board's Division of Banking Supervision and Regulation.

Additional training in subjects such as EDP, law, and accounting would be useful for examiners in the three agencies.

Recommendations

We recommend that the Board of Governors, FRS, (1) establish a full-time training office to operate its examiner training program and (2) carry out the revision of examiner school curriculums which it has recognized as needed for sometime.

We also recommend that the Board of Directors, FDIC, the Board of Governors, FRS, and the Comptroller of the Currency increase their training in EDP, law, and accounting, as desired by their examiners.

Agency comments

FDIC stated:

"We plan to give further attention to this apparent need. It is worth pointing out in passing, however,

that, at least with respect to EDP training, in addition to the regular basic EDP courses (Course in Examining a Computerized Bank (CECB) I and II), and advanced eight-week technical EDP school, known as Field Examiner Advanced Automation Training (FEAAT), is presently offered to examiners who have a desire to become highly proficient technically in EDP matters."

FRS stated:

"One individual currently administers the various Federal Reserve examination schools held in Washington. In addition, one full time staff member is assigned to handle preparatory and procedural aspects such as registration, printing and distribution of instructional materials and day-to-day dealings with instructors and students. Other responsibilities for the different schools have been assigned to various members of the Board's staff who are experts in each field of training. For instance, the curriculum for the newly established Holding Company School was devised by members of the Federal Reserve staff expert in matters relating to holding companies and the new Consumer Regulations School is handled by individuals who have been actively involved in implementing the recent consumer legislation. The Board believes that this system has met its needs.

If the report's recommendation for a joint school is adopted, this would reduce the need to consider a separate office at the Board. However, if such arrangements cannot be worked out, the Board will consider establishing such an office.

We might note that the portion of this recommendation relating to a revision of examination curricula had been started prior to the report. At the direction of the System Education Committee, the curricula for the schools for assistant examiners and examiners were updated and revised in the spring and summer of 1976 and the curriculum for the EDP school was revised in the fall. The Holding Company and the Consumer Regulation School have been recently established and therefore have new curricula.

With respect to that portion of the recommendation relating to additional training in specific areas, the Board has a previously scheduled session of the EDP school set for 1977 which will use a recently

updated curriculum. The laws relating to consumer affairs are extensively covered in schools developed by the Office of Consumer Affairs now conducted in Washington as part of the overall examination program. The Board will study the question whether additional training in the areas of law and accounting should be provided to examiners."

OCC stated:

"As part of our acknowledged need for specialized training, and consistent with the advice of our consultants, the Training Division of the Personnel Management Department has identified a multitude of different specialized courses which selected examiners will take; they include 7 different commerical examination schools, 3 trust examination schools, an EDP school, an International school and a consumer examination school. That program has now been implemented and is in full operation. The schools are programmed for examiners at different stages of their professional development. Among the many courses that will be offered by skilled personnel, both from within the OCC and, where necessary, from outside, are ones in EDP, Law and Accounting. Among the other areas that will be covered in that curriculum development will be specialized work in Economics , Bank Marketing, Finance, Auditing and similar topics."

PERFORMANCE EVALUATION

Each agency has procedures to evaluate the performance of its examiners. Generally, examiners are rated annually on the promptness, quality, and quantity of their work; their ability to plan, organize, and lead; their interest, attitude, and interpersonal relations; and their judgment. Newer examiners are rated more frequently. Assistant examiners in FDIC, for example, are evaluated every 6 months. Agency officials said supervisors discuss performance appraisals with examiners. They also said they emphasize these performance evaluations when considering individuals for annual salary increases and for promotion.

Qualifying for examiner-in-charge

The examiner-in-charge is the key member of the bank examination team, the agencies' front line of bank supervision. This individual's duties require the ability to analyze and appraise factors affecting a bank's condition, such as quality of assets, degree of liquidity, competency of management, and adequacy of internal controls. The judgment of the examiner-in-charge is important in determining the scope, depth, and results of the examination. The examiner-in-charge also deals with bank managers and prepares and signs the examination report. FDIC examiners-in-charge and those at some Federal Reserve banks are responsible for rating banks according to their agencies' procedures.

Examiners-in-charge are individuals who the agency believes have acquired the experience and skill needed to conduct bank examinations. These individuals may advance to the higher examining positions and to management positions.

One way the agencies determine if an assistant examiner is skillful enough to conduct bank examinations is through job performance ratings. FDIC and OCC also have formal evaluation processes, lasting 3 to 4 days, which are administered by one or more full examiners. In these processes candidates

--answer oral and written questions on banking terms, regulations, and examination procedures,

--analyze and evaluate bank loans from an actual examination, and

--prepare the confidential section of an examination report, based on analysis of bank operational data from an actual report.

Generally, an assistant examiner must pass the performance evaluation to be promoted to full examiner status.

Federal Reserve district banks do not use such a formal evaluation process. Assistant examiners are advanced to full examiner status when their performance has demonstrated that they are ready.

Conclusion

We believe that formally evaluating examiners, as FDIC and OCC do, is a sound practice for assuring that examiners have received the necessary training and experience to make the appropriate decisions and judgments in the bank examination process.

Recommendation

We recommend that the Board of Governors, FRS also establish a formal evaluation process to measure the competence of persons seeking advancement to examiner status.

Agency comments

FRS stated:

"We note that this recommendation is not based upon a conclusion that the examiners of any one agency are more or less competent than those of another agency. Standardized tests are merely one way of arriving at a formal evaluation, and we would not want to rely on them exclusively. However, there is something to be said in favor of formal tests as a supplementary evaluation device, and the Board intends to investigate their feasibility."

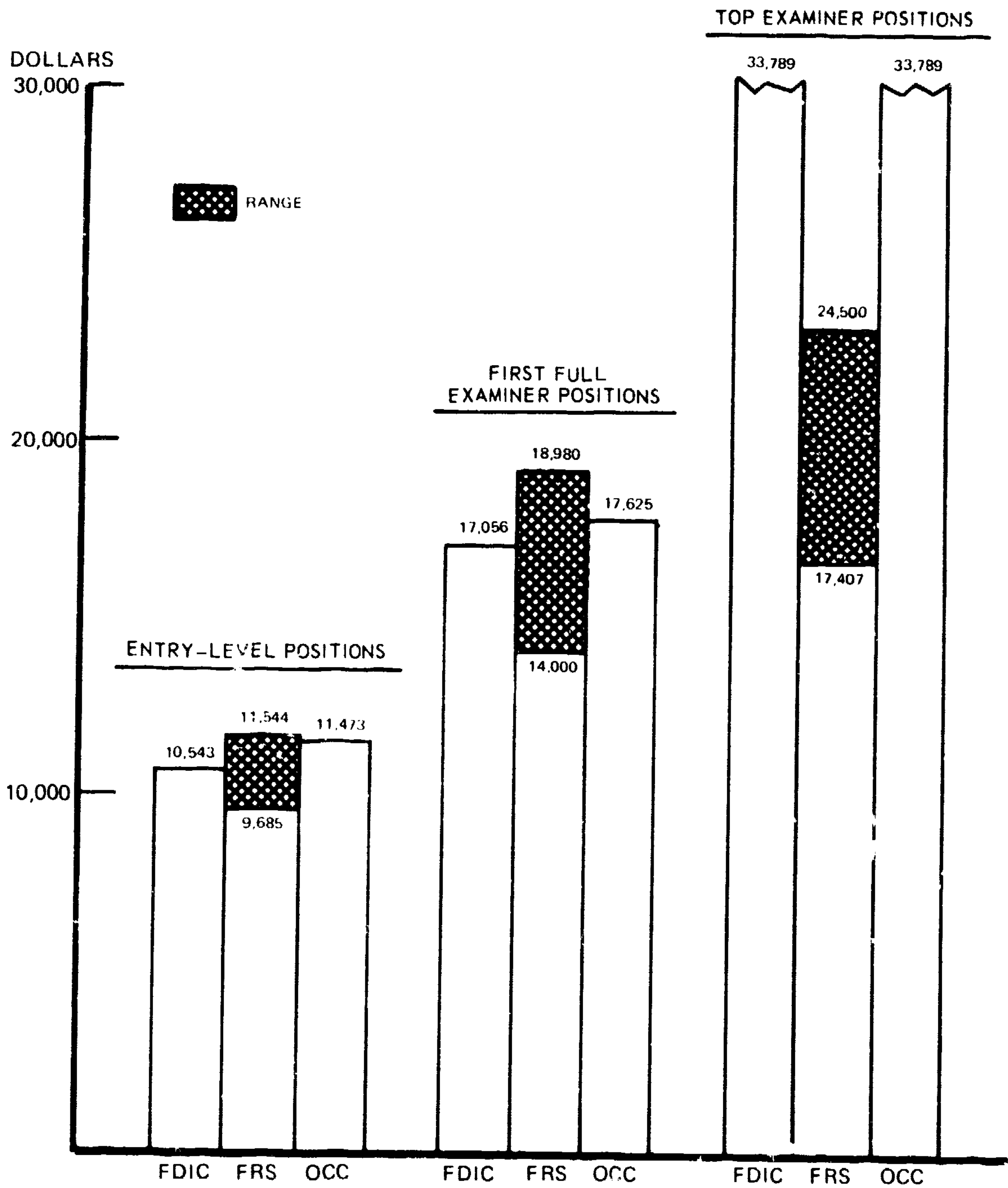
ADVANCEMENT AND COMPENSATION OF EXAMINERS

Bank examiners are hired and employed at FDIC and OCC regional offices and at district Reserve Banks. Generally, examiners are not recruited and assigned to headquarters for active examining work. Individuals hired without prior banking or bank examining experience start as assistant examiner trainees at salaries ranging from $9,685 to $11,544, depending on the agency or Federal Reserve district bank. Each of the 12 district Reserve Banks sets its own salaries, titles, and grades. The agencies report no difficulty in attracting qualified applicants at their starting salaries.

The career path fr : a bank examiner is typically through two or three levels as assistant examiner to the first full examiner position in 4 to 5 years, at which point his/her salary would be $17,056 at FDIC, $17,625 at OCC, and from $14,000 to $18,980 at the various Federal Reserve district banks. Thereafter, individuals may advance to the higher ex iner positions depending on their job performance.

At FDIC and OCC, qualified individuals may reach the top examiner positions with a salary of $33,789, in 10 to 12 years after reaching the first full examiner position. Time required to reach the top examiner positions is approximately 8 years in the Federal Reserve banks; however beginning salaries for these position are lower than the other two agencies, ranging from $17,407 to $24,500.

The following chart compares the agencies' starting salaries for entry-level positions, for the first full examiner positions, and for top examiner positions.


TOP EXAMINER POSITIONS
DOLLARS
30,000
33,789
33,789
RANGE
24,500
FIRST FULL
EXAMINER POSITIONS
20,000
18,980
17,625
17,056
17,407
ENTRY-LEVEL POSITIONS
14,000
11,544
11,473
10,543
10,000
9,685
FDIC
FRS
OCC
FDIC
FRS
OCC
FDIC
FRS
OCC

FDIC and OCC use a career ladder procedure to advance their examiners from the entry level to the second full examiner position (GS-12). Individuals are generally promoted annually if they perform satisfactorily. FDIC uses a formal competitive promotion system for advancement to higher positions. This system requires advertisement of vacancies, within a regional office for GS-13 examiner positions and throughout the agency for GS-14 and GS-15 positions. OCC has a less formal competitive promotion procedure which does not advertise vacancies agencywide. Federal Reserve banks do not use career ladder or competitive promotion procedures. Instead, employees are promoted when their job performance demonstrates they are ready to assume the duties of the next position.

In response to recommendations of the 1975 Haskins & Sells study, OCC has developed a new compensation and benefits program intended to encourage high performance. It includes:

--Comprehensive position descriptions listing specific qualifications.

--Results-oriented performance appraisals intended to strengthen the concept of basing salary increases on merit instead of on time-in-grade.

--A new salary administration procedure to replace the GS system currently used. An annual salary survey will be taken to establish compensation levels and ranges competitive with positions of comparable responsibility in other government agencies and in the private sector.

OCC hopes to have the program in operation by early 1977.

ASSURING EXAMINER OBJECTIVITY

A bank examination could be biased by an examiner's financial or personal interests in the bank or his/her over-familiarity with bank managers. Each agency therefore restricts its examiners' outside financial and personal interests, and limits the number of consecutive examinations at a bank by the same examiner-in-charge.

Restrictions on examiners' outside activities

Various laws and agency policies restrict the outside financial activities and personal relationships of bank examiners. They may not engage in any outside employment, or accept any fees, gifts, or payments of expenses, which could cause actual or apparent conflicts of interest.

The agencies generally prohibit the ownership by examiners and their immediate families of stock in banks, their affiliates, and bank holding companies. At FDIC, the prohibition applies to banks insured by the agency. Federal Reserve Board policy forbids ownership of stock in any bank, affiliate, or holding company. OCC prohibits its examiners from investing in national banks.

Bank examiners are prohibited from accepting a loan or gratuity from any bank which they examine or have authority to examine. This prohibition applies also to credit cards of banks or their affiliates.

Each FDIC and OCC regional office and Federal Reserve district bank sets its own restrictions on assigning examiners to banks where their relatives work. In general, examiners are not allowed to examine banks that employ close relatives.

Financial disclosure requirements

At the three agencies, employees in certain sensitive positions must file statements listing any outside work, stock holdings, and indebtedness. Each agency requires its examiners to file these statements when they are hired and FRS requires examiners to file annual updated statements.

In this study, we did not review the agencies' implementation of their policies regarding outside financial and personal interests; however, we have been requested to do this as a separate study by the Chairman, Subcommittee on Commerce, Consumer, and Monetary Affairs of the House Committee on Government Operations. We expect to complete that study in mid-1977.

Rotation of examiners

The agencies have policies intended to maintain an "arm's length" relationship between examiners-in-charge and bank officials by limiting the number of consecutive examinations an examiner may make at the same bank. OCC has a general

policy that examiners-in-charge may not make more than five consecutive examinations at one bank. Each FDIC regional office and each Federal Reserve district bank sets its own policy. Four offices and district Reserve Banks where we inquired limited consecutive examinations to two or three.

We reviewed the last three examination reports on 200 banks supervised by each of the agencies and found that the above policies are generally followed.

Examiner turnover

During 1973-75, the turnover rate of examiners in each of the agencies was approximately 10 percent. Most examiners who leave the three agencies do so either to take jobs with commercial banks, other private firms or organizations, or other government agencies or to continue their education. Most departures occur during the first 5 years of employment. Examiners who left during 1973-75 numbered 506 at FDIC, 218 at FRS, and 603 at OCC.

Examiners who left for commercial banks accounted for 29, 37, and 41 percent of total departures at FDIC, FRS, and OCC, respectively. We checked at the agencies to determine how many full examiners--i.e., those who can be in charge of examinations--were hired by banks which they had examined shortly before resigning.

At FDIC during 1974 and 1975, 19 full examiners went to work for banks which they had examined during the year preceding resignation. Eleven of these had assisted on the examination and eight had functioned as examiner-in-charge. At two Federal Reserve district banks that we checked, no full examiners left during these 2 years to join banks which they had examined. During 1974 and 1975, 24 full examiners left OCC to go to work for banks which they had examined in the 3 years preceding their resignation. Of these, 15 had assisted in and 9 had been in charge of the examinations.

The three agencies recognize that many of their examiners leave to go with commercial banks. They consider this to be beneficial because former examiners are a source of qualified bank managers who understand the importance of

sound banking practices and the regulatory function of the agencies. Agency officials do not believe that the objectivity of examinations is lessened by examiners going to work for banks they examine.

Conclusion

Since few examiners left to work for banks they examined, we see no threat to their objectivity as long as the agencies continue rotating examiners-in-charge among banks examined and reviewing examination reports at regional offices and district banks.

CHAPTER 11

POTENTIAL FOR BETTER INTERAGENCY COOPERATION

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CHAPTER 11

POTENTIAL FOR BETTER INTERAGENCY COOPERATION

OVERVIEW

The legislation establishing the three agencies created several overlaps in authority. The area with the greatest potential for duplication of effort is bank examination. FDIC has statutory authority to examine all insured banks (including national banks and State-chartered FRS members); FRS has statutory authority to examine all member banks (including national banks and State-chartered member banks that are insured by FDIC); and OCC has statutory authority to examine all national banks. (See ch. 4.)

The three agencies have other inter-related responsibilities:

- --OCC is responsible for closing national banks which have become insolvent and FDIC is responsible for liquidating these banks.
- --FRS has primary responsibility for inspecting bank holding companies, but FDIC may examine a nonmember insured State bank subsidiary and its parent holding company, and OCC may examine a national bank subsidiary and its parent holding company.
- --All banks are required, under the Securities Exchange Act of 1934, as amended (15 U.S.C. 78a _et seq._), to report to FRS on extensions of credit for the purchase of stock. If any bank fails to furnish such information, FRS may inspect such bank in order to obtain the information.

In addition to legislative overlaps, the three agencies conduct many similar activities, and they coordinate their activities to varying degrees. The three agencies have operated under a uniform agreement--signed in 1938 and amended in 1949--for classifying bank assets and for appraising certain securities during bank examinations. According to a former FRB Governor, the first interagency coordination committee began in 1952 and functioned until about 1960.

Formal mechanism for coordination was resumed in 1964, when President Johnson expressed concern about the lack

of coordination among the Federal bank regulatory agencies and instructed the Secretary of the Treasury to establish procedures to insure that they act in concert and resolve their differences. The Secretary established a procedure for the exchange of information among the bank regulatory agencies.

The 1964 procedure was revised in 1965 to establish a Coordinating Committee on Bank Regulation composed of the Chairman of the FRS Board of Governors or a designated Governor, the Comptroller of the Currency, the Chairman of FDIC, and the Chairman of the Federal Home Loan Bank Board. The Committee meets at the call of any member, but not less than quarterly. Under the procedure, the Committee chairman is to report to the Secretary of the Treasury any instance where the Committee cannot agree on conflicting rules, regulations, or policies.

We were told that eight meetings were held during 1975 and six meetings were held from January 1, 1976, to October 31, 1976. We were advised that the Committee does not maintain minutes of its meetings.

We were furnished an agenda for all but two of the Coordinating Committee meetings. Approaches and techniques of bank examination were apparently discussed on several occasions in connection with changes in call and other reports, fair lending in housing, and classification of certain bonds. Most of the topics, however, related to various types of accounts a bank might offer, such as individual retirement accounts, corporate savings accounts, telephone transfers to and from savings accounts, overdraft protection for checking accounts, and experiments with deposit rate ceilings in New England. According to a Treasury official, no conflict among the Committee members has ever been reported to the Secretary of the Treasury.

Coordination also occurs through meetings and discussions with senior management at the three agencies. In addition, the Comptroller of the Currency is by law a member of the FDIC Board of Directors and thus is directly involved with that agency.

Effective cooperation between the three Federal bank regulatory agencies is important to:

--avoid duplication of effort,

--afford equal treatment to all classes of banks, and

--maximize economy and efficiency of operations.

The agencies have to a large extent--through formal and informal coordination efforts--avoided duplication of effort and provided equal treatment of all classes of banks. The current framework for coordinating the activities of the three regulatory agencies provides a forum for exchanging information about possible conflicting rules, regulations, or policies, but it does not provide a mechanism for the three agencies to combine their forces in improving the bank supervisory process or in resolving problems common to the three agencies.

We identified several areas where, in our opinion, the agencies could benefit by working together, sharing experiences about innovations in bank supervision, and undertaking activities jointly or on a reciprocal basis.

PROBLEMS IN INTERAGENCY COOPERATION

In some areas similar activities were being carried out differently by the three agencies and, as a result, from an overall Federal viewpoint, did not provide for efficient operation. In some cases these differences resulted in treating different classes of banks unequally under similar conditions.

The following examples, which are generally discussed in other sections of this report in greater detail, illustrate areas where greater cooperation could benefit the agencies. The Coordinating Committee apparently did not consider any of these areas during 1975 or 1976.

New approaches to bank examination

While all three agencies have recently made changes in their examination approaches, OCC's changes are the most extensive. OCC's new examination approach, which places more emphasis on bank policies, procedures, practices, controls, and audit, resulted primarily from several recommendations in Haskins & Sells' May 1975 report. The new examination procedures were developed during the fall of 1975 and spring of 1976 and were field tested in mid-1976. (See ch. 7.)

OCC made a large investment in a major step in bank supervision. Yet there is no formal mechanism for sharing the results among the agencies. Not until November 1976 did OCC present its new approach in detail to FDIC and FRS.

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

Examinations for compliance with consumer protection laws

The agencies have recognized that their past approaches for examining banks' compliance with consumer protection laws needed improvement, and all three are modifying their examination approaches. We believe, however, that they should work together more closely in refining their approach to consumer credit compliance examinations. (See ch. 7.)

Development of monitoring systems

Each of the three agency headquarters and several Federal Reserve Banks, generally independently of each other, have developed or are developing monitoring systems to identify banks that may require close supervision. (See ch. 7.) A cooperative effort among the agencies might have reduced the developmental effort and--through "cross fertilization" of concepts--speeded development. The agencies are still working on these systems, and the need for coordination continues.

Examiner training

The three agencies have generally provided formal training to its bank examiners through their own operated schools and seminars. Much of the training in the past has covered the same topics at each agency. (See ch. 10.) While we recognize that OCC is implementing new examination approaches that are conceptually different than those of the other two agencies and thus, some of their current training needs may be somewhat different, we are also suggesting (see ch. 7) that the agencies jointly evaluate the OCC's new approaches and determine whether they should be adopted by all three agencies.

We believe, therefore, where feasible, that the three agencies should combine their examiner schools and standardize their curriculums. (See ch. 10.)

Qualifying for examiner-in-charge

FDIC and OCC use a formal evaluation process in addition to performance evaluation for determining whether an assistant examiner is skillful enough to be in charge of a bank examination. At FRS assistant examiners are advanced to full examiner status on the basis of their performance. (See ch. 10.)

We believe that, in addition to performance evaluation, a formal evaluation process is desirable to measure the competence of assistant examiners to assume the responsibilities of a full examiner. The agencies should work together to develop a uniform approach to the formal evaluation process.

Joint evaluation of foreign loans

FRS and OCC independently evaluate the soundness of loans to foreign governments and businesses. Loans to the same foreign borrower were rated differently by the various Reserve Banks and by OCC. (See ch. 4.) This practice results in duplication of effort and inconsistent treatment of credit to foreign borrowers. The Federal agencies should coordinate their efforts to avoid these problems.

Joint examination of foreign branches

The foreign branches and subsidiaries of U.S. banks should be examined, but such examinations are costly because of the travel involved. (See ch. 4.) OCC's London office employs six examiners who are in charge of examining branches and subsidiaries in Europe. In addition, FRS maintains staffs of international examiners in New York, Chicago, and San Francisco, and OCC maintain staffs in all their regions who make onsite examinations of foreign branches and subsidiaries.

OCC and FRS should consider coordinating their examinations of foreign branches and subsidiaries so that examiners visiting a foreign city could examine branches of both State and national banks.

Data processing

An interagency agreement assigns responsibility for processing data on all national and State member banks to FRS and responsibility for processing data on State nonmember banks to FDIC. FDIC subjects all of this data to edit-checks. However, according to an OCC official, the interagency system for processing data was inadequate because among other reasons, banks were not meeting established reporting deadlines, and FDIC was taking approximately 4 months to keypunch and computer-edit the data. Therefore, in connection with implementation of the National Bank Surveillance System (see ch. 7), OCC began in December 1975 to process and edit data on national banks shown in reports of condition and reports of income, even though--pursuant to the interagency agreement--FRS already processes this data, FDIC edits it, and OCC responds to errors noted by FDIC. A coordinated effort would avoid this duplication.

Supervision of bank holding companies

FRS has primary responsibility for supervising and regulating bank holding companies. Banks under the control of these holding companies may be either State member, nonmember insured, or national banks, and may therefore be examined by FRS, FDIC, or OCC. However, procedures for coordinating efforts among the three agencies on holding companies and their subsidiary banks are not fully effective. (See ch. 4.)

Because bank holding companies and their subsidiary banks may substantially affect one another, the three agencies should establish better procedures for coordinating their supervisory responsibilities.

Joint evaluation of shared loans to large corporations

Some loans, especially those made to large corporations, involve several participating banks, which may be either national or State-chartered. Even though only one extension of credit is involved, the three agencies reviewed the loan differently and, in some cases, evaluate it differently. (See ch. 7.)

OCC recently initiated a program to review these loans at a single location, thus assuring consistent treatment of the loans at all participating national banks. This evaluation is then incorporated into regular examinations of all national banks which have participated in the loan.

Both FRS and FDIC had been in contact with OCC about the uniform review of shared national credits. However, at the time of our review neither had used OCC's uniform evaluations in examining participating banks. As a result, loans which had been reviewed at the lead bank by OCC were also reviewed at individual participating State banks by other Federal agencies; and the same loans in some cases received different classifications from the three Federal supervisory agencies. On December 21, 1976, FDIC headquarters advised its regional staffs to use the OCC classifications when they examine the State participating banks.

Full and prompt coordination among the three agencies on the review of shared loans would allow more efficient use of supervisory staff and fair and consistent treatment of involved banks.

Criteria for identifying problem banks

The three regulatory agencies do not have common criteria for determining which banks are designated as problem banks. (See ch. 8.) Since FDIC, FRS, and OCC all have an interest in the condition of national banks, and FDIC and FRS both have an interest in the condition of State-chartered member banks, we believe that the three agencies should work together to develop uniform criteria for identifying problem banks.

CONCLUSIONS

While the agencies have to a large extent been reasonably effective in minimizing problems from the overlap of Federal supervisory jurisdiction over commercial banks, no mechanism exists to insure that the agencies act in concert to operate effectively and efficiently. There are several alternatives under which this could be achieved. One would be to establish a permanent interagency working level group. This group could monitor the agencies' operations to identify areas where interagency cooperation would be beneficial and to make appropriate recommendations to the agency heads.

RECOMMENDATION

We recommend that either (1) the Board of Directors, FDIC; the Board of Governors, FRS; and the Comptroller of the Currency jointly establish a more effective mechanism to combine their forces in undertaking significant initiatives to improve the bank supervisory process or in attacking and resolving common problems, or (2) the Congress enact legislation to establish a mechanism for more effective coordination. We would be glad to assist the committees in drafting appropriate legislation.

AGENCY COMMENTS

FDIC stated:

"We recognize the merit of resolving common problems of the three agencies through closer coordination and cooperation. Indeed, there is at the present time a substantial exchange of information between the agencies' headquarters as well as at the field levels. However, if there is any merit

to the concept of separate federal supervisory agencies, and to a dual banking system with State and federal supervision of banks, the benefit would seem to be the opportunity to try different approaches and to have a diversity of examination and supervisory procedures. The possibility of useful innovation and improvement in the bank examination and supervisory processes is greater if there are several agencies trying different approaches than if every change in examination methodology required approval of all the agencies. Nevertheless, the possibility of establishing a particular vehicle for the agencies to resolve common problems and take joint efforts in new initiatives will receive serious consideration."

FRS stated:

"The Board is pleased that this portion of the report supports it previous conclusions and initiatives in this area and favors the legislative approach.

"In December, 1975, Governor Holland testified before the Senate Committee on Banking, Housing and Urban Affairs and in that testimony made reference to the concept of a joint Bank Examination Council which at that time had received substantial support within the Board. In that regard, he stated:

> Such a Council would be focused on the areas that we believe are most in need of improvement; that is, efficient and uniform modernization of bank examination and vigorous and consistent follow-up procedures when bank weaknesses are revealed. Such a Council could be established administratively or by statute. Its statutory authorization would undoubtedly give more impetus to the establishment of such a Council, and would also provide it with clear-cut authority to take definitive action within its statutorily defined areas of administration.

The Federal Bank Examination Council should have authority to establish standards and procedures for bank surveillance, examination and follow-up, applicable to all the Federal banking agencies, and it should review significant problem cases when and as they develop. All three Federal banking agencies should be represented on the Council.

"Subsequently, at our suggestion, Senator Stevenson introduced the Federal Bank Examination Council Act (S. 3494). Such a Council would establish mandatory uniform standards and procedures for Federal examination of banks and uniform reporting systems and conduct joint schools for examiners. The Board believes that a proposal along these lines could accomplish most of the objectives set out in the report's recommendations in the examination area."

OCC stated:

"The OCC has always stood for the strongest possible working relationships between federal supervisory authorities. At the December, 1976 meeting of the Interagency Coordinating Committee, Mr. Robert Bloom, Acting Comptroller of the Currency, asked that the committee take up at its next meeting the subject of strengthening coordination of examination procedures. It will be proposed that a permanent staff group be set up for this purpose. We anticipate modification and refinement of our newly implemented examination approach on an ongoing basis. Review and evaluation of such changes as they affect problems common to the three agencies would be most useful."

CHAPTER 12

SCOPE AND APPROACH OF GAO STUDY

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CHAPTER 12

SCOPE AND APPROACH OF GAO STUDY

During 1976 we evaluated the way FDIC, FRS, and OCC supervised the Nation's commercial banks.

Since we do not have audit authority at FRS or OCC and our access to bank examination files of FDIC has long been contested, we had to negotiate an agreement with each supervisory agency to review its records. Although the agreements contain some differences, the scope and approach of our study remained the same at all three agencies.

Key provisions of the agreements which affected our scope and approach follow:

--The agencies allowed full access on their premises to bank examination reports, correspondence files, and other records. In return, we agreed not to publicly disclose any information about specific banks or their officers, affiliates, and customers. We also agreed not to evaluate the accuracy of the examiners' factual findings by independently examining the banks involved.

--We further agreed to consider the agencies' supervisory practices, procedures, and policies that existed from 1971 through 1975 and some of their planned changes.

The FRS agreement barred us from evaluating certain regulatory functions, such as the policies and procedures for implementing the Bank Holding Company Act of 1956, as amended, and the consumer protection statutes. FRS monetary policy functions and certain FRS operations, such as check clearing and electronic funds transfer, were also excluded from review.

Our access to information on bank holding companies was limited to those whose subsidiary banks had holding-company-related problems and were included in our samples of banks selected for review.

We reviewed legislation, rules and regulations, and administrative and operating policies and procedures. We interviewed numerous agency officials, bank examiners, and employees at various organizational levels, and we visited 6 FDIC and 9 OCC regional offices and 12 Federal Reserve district banks to discuss the bank supervisory process and review examination reports, workpapers, and other records.

In our study, we considered

--current practices and planned changes in the agencies' bank supervision policies and procedures,

--bank examination policies and procedures, as described in manuals and explained by examiners and officials, and

--status reports on supervisory activities to the agencies' headquarters from the regional offices or district banks.

CHARTERING OF NATIONAL BANKS

Our work entailed analyzing 75 of the 322 bank charter applications acted on by OCC from January 1974 through April 1976 and all 71 charter conversion applications acted on from January 1972 through April 1976. In addition, we determined how many national banks chartered from January 1958 through December 1972 were still operating as national banks by April 30, 1976.

We reviewed criteria and procedures for considering national bank charter applications. We surveyed State banking authorities to compare their chartering processes with OCC's. We also reviewed several files on applications for FDIC insurance and FRS membership.

BANK SUPERVISION AND EXAMINATION PRACTICES

We discussed the bank supervisory process with examiners and agency officials; reviewed examination reports, supervisory files, and other supporting documents; and analyzed and summarized the data collected on more than 900 banks of all sizes and locations.

We drew samples representing

--banks which failed during a 5-year period,

--banks that had been designated as having problems serious enough to require more than normal supervision by the agencies, and

--banks from the total universe of about 14,400 which are supervised by the three Federal agencies.

Failed banks

Our study included 30 insured banks closed by their chartering authorities between January 1971 and June 1976. In that period, 40 insured and 2 uninsured banks had failed. We analyzed examination reports and related files covering the last 5 years of each bank's existence. We also considered studies and congressional hearings on failures of two banks--Franklin National Bank and U.S. National Bank of San Diego.

Problem banks

We selected two statistical samples of problem banks--149 banks at December 31, 1970, and 145 banks at December 31, 1975. For each bank selected we noted the problems identified by the examiner and the agency's efforts to obtain corrective action. For each bank in the 1970 sample, we reviewed the most recent examination report before December 31, 1970, and reports on subsequent examinations until the bank returned to nonproblem status. For each bank in the 1975 sample, we reviewed the examination report before the one which designated the bank as a problem and subsequent examination reports up to June 30, 1976.

Banks in general

Using statistical sampling techniques, we selected a total of 600 banks supervised by the 3 agencies. For each of the banks selected, we identified the problems noted by the examiners and the recorded followup actions taken by the Federal and State agencies and we summarized financial and operational data using supervisory files and the three latest reports of examination.

The following table summarizes our samples of banks.

Supervisory agency	Total	Number reviewed
FDIC:		
Failed banks	29	19
Problem banks:		
At 12/31/70	190	55
At 12/31/75	275	55
Banks in general	8,594	199
FRS:		
Failed banks	2	2
Problem banks:		
At 12/31/70	39	39
At 12/31/75	65	40
Banks in general	1,046	200
OCC:		
Failed banks	9	9
Problem banks:		
At 12/31/70	123	55
At 12/31/75	85	50
Banks in general	4,744	201
Total:		
Failed banks	40	30
Problem banks:		
At 12/31/70	352	149
At 12/31/75	425	145
Banks in general	14,384	600

Note: In some cases the agencies could not locate from storage facilities all the records we requested. This neither seriously limited our scope nor affected the reliability of our samples. Regarding banks in general, we reviewed the latest three reports of examinations when available. A recently chartered bank might have been examined only once by the appropriate agency.

From our samples of banks, we found 20 bank holding companies whose bank subsidiaries were identified as having major problems caused by their affiliation. For these 20 companies, we reviewed available files of registration statements, applications, memorandums, reports of inspection, annual financial reports, and related FRS analysis and correspondence. We also reviewed the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1841 et seq.), FRS policies and procedures for supervising holding companies, and pertinent literature.

Our study of international bank examinations included a review of the last 3 reports of international examination for 30 large banks. We discussed the process of evaluating loans to foreign countries with officials of the Export-Import Bank, as well as with FRS and OCC.

For trust departments we reviewed and analyzed reports of trust examination and related files on 33 banks. We summarized data on violations and deficiencies reported by examiners.

Our study of electronic data processing examinations included collecting and analyzing data from the 3 latest reports of EDP examination on 38 banks' data processing centers or outside servicers. We considered examination frequency and duration, the type of EDP system, applications, operations, internal audit and control, deficiencies reported by examiners, and remedial action by the agencies.

We reviewed the efforts of the three bank supervisory agencies to detect violations of consumer credit laws and regulations. Considered were the examiners' training for evaluating compliance, compliance examination procedures, the reporting of violations, and the agencies' use of sampling techniques. We also evaluated the agencies' plans to expand compliance examination efforts.

We studied the agencies' bank monitoring systems, particularly their use of regularly reported data to identify certain trends within individual banks. We spoke with representatives of the Federal Home Loan Bank Board and other groups involved with bank supervision about using monitoring systems to identify serious problems in financial institutions.

We reviewed FDIC, FRS, and OCC policies and procedures concerning recruitment, career development, and objectivity of bank examiners, to ascertain how they affect the quality of bank supervision. Using a questionnaire, we obtained the views of 325 examiners at the 3 agencies.

SURVEY OF COMMERCIAL BANKERS

Part of our study was a survey of commercial bankers' views on Federal supervision of banks. We mailed a questionnaire to 1,678 commercial banks, of which 1,501, or 89.5 percent, responded. We selected our samples so as to include banks of varying deposit size. Each agency provided a list of banks receiving special supervisory attention, from which we selected other samples. The following table summarizes the number of banks surveyed.

Supervisory agency and deposits	Banks	
	Total	Number surveyed
(000,000 omitted)		
FDIC:		
$100 or more	216	108
$10 to $100	4,105	216
Less than $10	3,993	210
Special attention	280	131
	8,594	665
FRS:		
$100 or more	112	54
$10 to $100	606	151
Less than $10	263	131
Special attention	65	33
	1,046	369
OCC:		
$100 or more	510	251
$10 to $100	3,105	205
Less than $10	1,047	149
Special attention	85	39
	4,747	644
Total	14,387	1,678

Each bank's response to the questionnaire was correlated with bank information routinely collected by the three agencies--deposit size, supervisory status, location, and rating. The responses are integrated throughout the report and summarized in appendix IV.

Comptroller of the Currency
Administrator of National Banks

Washington, D.C. 20219

January 14, 1977

Honorable Elmer B. Staats
Comptroller General of the
United States
General Accounting Office
441 G Street, N. W.
Washington, D. C. 20548

Dear Mr. Staats:

Enclosed find original and one copy of our comments on the recommendations advanced in the draft General Accounting Office Report entitled "Study of Federal Supervision of our Nation's Banks".

I understand that in accordance with the usual procedures our comments will be included in toto in the final report.

Sincerely,

Robert Bloom
Acting Comptroller of the Currency

Enclosures

Note: Page references have been changed to conform to the final report.

PREAMBLE

Bank Examination and the Office of the Comptroller of the Currency

The Office of the Comptroller of the Currency (OCC) commends the General Accounting Office (GAO) for the objective and workmanlike quality of GAO's report and for the positive attitude shown by the GAO staff which prepared the report.

The GAO report correctly states that one important goal of bank regulation is maintaining the soundness of the banking system; achievement of that goal requires minimizing the number of bank failures. We agree with that goal, and suggest that the banking agencies record over the last forty years has been a good one. For example, 1974 witnessed a severe economic recession and the two largest bank failures in the history of the United States -- yet no depositors in these banks lost money and confidence in the banking system was maintained. The average annual bank failure rate since 1937 has been 0.08 percent -- a remarkably low failure rate for any human endeavor.

But it is the other goal of supervision which is not stressed in the GAO report. The ultimate measure of how well a bank supervisory agency operates is how well the banking system operates. The OCC believes that one of its major functions is to preserve a competitive, responsive and innovative system. Bank supervision's role is to ensure that the banking system is able to provide the widest possible array of banking services to both the depositor and the borrower.

Thus, the bank supervisory agency has two contradictory goals: monitoring soundness and sponsoring the competitive, innovative response. It is this dual role which presents the basic paradox for the bank supervisory agency. An intensely competitive industry can never be completely safe.

Striking the balance between these two goals is the basic problem of the bank supervisory agency. According to a former Comptroller of the Currency:

> One regulatory approach is to identify a problem in one area and remedy across the board, taking no notice of the different characteristics, or idiosyncracies of the components of the whole. That approach is acceptable if the object is to produce a "fail-safe" banking system. Believe me, I can screw down the National Banking System with enough regulations to prevent bank failure. But, under that regime, the banking industry would be financing the capital needs of the country and its citizens at about 60% of capacity, and that is not in the public interest. Equally important, it is contrary to the economic principles of our nation. Instead, I would advocate that we free up the system to manage itself, loosen the bonds and take the quite limited risks that some unit will slip through the supervisory net and founder.

A well known critic of bank supervision, economist George J. Benston, has addressed the question of the costs of bank regulation -- both the direct cost of running the agencies and the indirect costs of limiting competition by the banking industry -- and has suggested that the best solution is improved supervisory techniques. Specifically he recommended:

1. A primary responsibility of the supervisory agencies is to determine the most effective method of examining banks.

2. Supervisory agencies should be able to use bank reporting as a guide to self-examination by the banks and as a preliminary examination tool.

3. Models should be developed that predict possible problems.

4. Banks that are likely to get into trouble should be examined more frequently and in greater depth.

That list, although not complete, is similar to the revisions of examination procedures proposed by the consulting firm of Haskins & Sells and implemented by the Office of the Comptroller of the Currency. Examination of the larger banks has moved from a detailed examination of the bank's assets to an in-depth evaluation of the bank's management, auditing, and control systems. Instead of concentrating on the bank's loan customers, the OCC has moved to an evaluation of the bank itself. During 1976, the OCC began to use bank financial reports as a preliminary examination tool, identifying potential difficulties at individual banks.

GAO reviewed these and other new procedures being adopted by the OCC, and concluded:

> As discussed in Chapter 4, we believe that the traditional examinations of the three agencies have concentrated too much on the review of loans and not enough on bank policies, procedures, practices, controls, and audit. The changes made by FDIC and FRS will not substantially remedy this defect. In our view the new procedures being implemented by the OCC offer the best opportunity for improvement. The OCC's revised commercial examination procedures should provide the agency with more meaningful information regarding the banks it supervises and result in more complete and consistent examinations. More importantly, the new approach should result in early detection of situations which could lead to deterioration in some aspect of banking operations. This approach could help avoid bank problems after they have occurred.

Thus the OCC is not attempting to improve bank supervision through arbitrary regulations which might limit bank services to the public. Instead the OCC is attempting to foster procedures in each bank through which that bank can better manage itself.

The GAO report -- while endorsing the new OCC procedures -- makes the implied criticism of the OCC for not developing its new programs in conjunction with the two other agencies. As pointed out in the OCC responses to the GAO recommendations, the OCC has attempted to share its new ideas with the other two agencies. The

OCC also endorses the GAO recommendation of more formalized communication among the agencies concerning new examination techniques. The OCC takes issue, however, with the apparent GAO assumption that the best way to generate new ideas is through an interagency committee (or, as some have proposed, through a giant monolith combining the three agencies). A primary virtue of three agencies, each with somewhat differing statutory responsibilities, is the ability of a single agency to experiment with a new idea or procedure. It is doubtful that the new OCC examining techniques endorsed by GAO could have been developed otherwise. A unified approach is important and appropriate after a new idea has been proved successful, not when it is being first developed.

In summary, the purpose of the OCC is to operate so that economic progress and change is not inhibited while simultaneously, preventing unsound banking practices. It is that fine line of promoting innovative response while supervising the banking system that makes bank supervision so difficult. The banking system has just come through its first major economic crisis since the world wide depression of the 1930s. There were some casualties. But, in fact, the threatened financial crisis did not develop, and the banking system seems to be stronger today than it was before. New procedures have been developed by the banking system and the continuing dynamic future of American banking is assured. For the first time we are assured that, just as the industry has changed, the tactics and techniques of a major bank supervisor, the Office of the Comptroller of the Currency, has changed in a similar, positive, fashion.

Recommendation (2-21)

Accordingly, we recommend that the Comptroller of the Currency (1) develop more definitive criteria for evaluating charter applications and (2) thoroughly document the decision-making process, including an identification by reviewers of each factor as favorable or unfavorable.

OCC Response:

The OCC is the only federal agency with the responsibility for chartering banks. It charters banks in all of the 50 states and in Puerto Rico and the Virgin Islands. The widely differing banking environments found in the U.S. make it almost impossible to develop definitive criteria which can be universally applied such as in states like Arizona, which has 6 National Banks, and in Illinois which has over 400 National Banks. The diversity of criteria therefore, is a function primarily of the differing political, social and economic environments in which the OCC must operate. The OCC's chartering criteria, of necessity, must be somewhat flexible. That is only to be expected since the OCC does not charter in one environment. Also, under the terms of the McFadden Act, the OCC's actions are often affected by applicable state law.

The new corporate guidelines, development of which began in September, 1975, and which became effective on November 1, 1976 answer many of the criticisms of the GAO. Written opinions containing reasons are now sent to applicants receiving denials. As examples, we quote from three recent letters sent to applicants denying their charters. One letter in part, states:

> Based upon the population and the median income per household, it would appear difficult for many individuals in the primary service area to qualify for a loan. Furthermore, income levels are inadequate to provide a sufficient deposit base for the proposed bank to become a viable institution.
>
> In another case, we quote in part: In view of the Supreme Court decision in Whitney and the Federal Reserve Board's decision in InterMountain Bank Shares, it would be an exercise in administrative futility for this Office to approve the present charter application...Should West Virginia change its statutes or should the statute be successfully challenged, then this Office could consider a new application in light of these changed circumstances.
>
> In still another case, the denial letter to the applicants stated: The new guidelines state that a new banking office will not be approved, if its establishment would threaten the viability of a newly chartered independent bank. Such protection will typically not exceed one year. As you are aware, the new bank opened on September 27, 1976. It is the opinion of this Office that this newly chartered independent state bank is entitled to the protection set forth in the Comptroller's policy statement.

Recommendation (2-21) Continued

Every attempt is now made to document thoroughly the decision-making process. Further efforts will be made by our Office to identify each factor as favorable or unfavorable.

Our decisions have been subject to judicial review for many years. In the long series of court cases covering our chartering process, the Comptroller's decision on a charter application has never been finally overturned by a reviewing court. See annotations to 12 U.S.C. 21 *et seq*.

Our Department of Research & Economic Analysis has undertaken a market study of 35 national banks chartered between 1969 and 1971. The economic study attempts to identify, statistically, those factors which can be identified with the growth or lack of growth of these new banks. The results of that study, if positive, will be incorporated into our decision-making process. We are hopeful that quantification of a sufficient number of pertinent factors applicable to a majority of cases will result.

Recommendation (4-7)

Therefore, we recommend that the Board of Directors, FDIC, the Board of Governors, FRS, and the Comptroller of the Currency establish scheduling policies and procedures which would avoid the setting of examination patterns.

OCC Response:

Historically, the OCC has viewed surprise as an important element of an examination. However, a primary feature of our new examination approach entails the pre-examination analysis wherein the examiner will determine the adequacy of internal control and audit activity. The OCC feels the best deterrent for fraud is not periodic unannounced visits by examiners but rather the existence of sound bank policies, procedures, internal control and audit activity on a continuing basis. The element of surprise is necessary only in those cases where such factors are suspect.

Recommendation (4-9)

We recommend that the Board of Directors, FDIC, and the Board of Governors, FRS, adopt flexible policies for examination frequency which would allow them to concentrate their efforts on banks with significant problems.

We recommend that the Congress amend the National Bank Act to allow the Comptroller of the Currency to examine National Banks at his/her discretion.

OCC Response:

We support the recommendation of legislation to permit OCC discretion in scheduling the frequency of examinations. The current method of adapting the depth of examinations to the needs of each bank, based on NBSS data and pre-examination analysis, fully complies with law. However, greater statutory discretion would enhance our effectiveness in this regard.

Recommendation (4-33)

We recommend that the Board of Governors, FRS, and the Comptroller of the Currency develop and use a single approach to the classification of loans subject to country risk.

OCC Response:

The OCC has a well established procedure using a single approach to the classification of country credits. This procedure makes use of information from many governmental and non-governmental sources and examiners in all fourteen national bank regions.

Copies of the minutes of our committee meetings and any resulting classifications have always been provided to members of the staff of the Board of Governors.

The process of country risk evaluation is more precisely an art than a science. Most of the evaluation process is judgemental. However, the interagency meetings held to date have been beneficial in determining basic differences in philosophies.

Recommendations (4-35)

We recommend that the Board of Governors, FRS, and the Comptroller of the Currency implement procedures whereby major foreign branches and subsidiaries, including subsidiaries of Edge Act corporations, are examined periodically and whenever adequate information about their activities is not available at the home office.

Also, we recommend that the Board of Governors, FRS, and the Comptroller of the Currency exchange each other's examiners' to cut expenses when conducting examinations in foreign countries.

OCC Response:

a) Overseas Examination

National Banks are required by Regulations K & M to provide examiners with whatever credit and financial information the examiner deems necessary to evaluate the condition of the bank's foreign branches and subsidiaries. Those regulations require such information be transmitted to and maintained at the bank's head office. The OCC has for practical purposes defined "head office" to include any foreign or domestic office of the bank which is readily accessible to its examiners. For example, all international credits of one large national bank are examined from two domestic offices and four foreign offices located in London, Caracas, Tokyo and Manila. All of that bank's many branches and subsidiaries located in Europe the Middle East and Africa are examined from duplicate records in London.

Recommendations (4-35) Continued

Supplemental examinations to determine the quality of the bank's operations are made on-site overseas when necessary. For purposes of performing asset and operational examinations, the OCC established in 1972 a London office permanently staffed by six examiners. In fulfilling its overseas examination obligations, the OCC in 1976 examined 141 overseas branches and subsidiaries of 25 banks located in 37 countries; 154 on-site examinations were performed by 215 National Bank Examiners.

b) Joint Examinations

The GAO recommendation has merit. As a bare minimum the physical support of the three agencies could be jointly provided. Further arrangements could be made so that any of the agencies could jointly commission overseas examiners. In this regard, the OCC is willing to seek a cooperative solution with our sister agencies.

Under present statutes, however, such a sharing of examiner forces may be difficult. Section 481 of Title 12 (12 U.S.C. 481) directs the Comptroller of the Currency to appoint examiners who shall examine every national bank. That same section empowers the Comptroller to make a thorough examination of all the affairs of the banks under his jurisdiction including the affairs of all affiliates of National banks "other than member banks", in order to disclose fully the relations between the bank and its affiliates and the "effect of such relations upon the affairs of such bank". (Emphasis added.)

Recommendation (7-25)

We recommend that the Comptroller of the Currency invite FDIC and FRS to jointly review and evaluate its new examination approach. Further, we recommend that, in the event of a favorable assessment of the new process, the Board of Directors, FDIC, and the Board of Governors, FRS, revise their examination processes to incorporate the features of OCC's new examination approach.

OCC Response:

Examination Approach

On November 23, 1976 OCC staff members made a presentation to approximately 20 FRS and FDIC staff members on the revised examination procedures. Copies of our draft Handbook of Examination Procedures were furnished. Their review and evaluation on an ongoing basis is welcomed. The Acting Comptroller has proposed to the Interagency Coordinating Committee that a permanent staff group be set up for this purpose.

Recommendation (7-25)

Additionally, we recommend that the Board of Directors, FDIC, the Board of Governors, FRS, and the Comptroller of the Currency jointly staff a group to analyze shared national credits at State and National lead banks under Federal supervision and that the three agencies use the uniform classification of these loans when they examine the participating banks.

OCC Response:

Shared National Credits

In 1974, meetings were held with representatives of the OCC, FRS and FDIC present to discuss the possibilities of using a uniform program for the review of selected large shared loans. Both the FRS and the FDIC found merit in the program but they believed sufficient pitfalls existed to delay their participation in the program. Also, in March of 1974 this Office met with representatives of the Conference of State Bank Supervisors to discuss the proposed program. They indicated interest and agreed to work out arrangements with various bank supervisors.

In 1975, the Office of the Comptroller of the Currency conducted uniform reviews of shared national credits in applicable National Banks. The loan write-ups generated by these reviews were made available to both the FRS and the FDIC. In March, 1975 FRS expressed their continued interest in the program and hoped they could participate if the "pitfalls" could be overcome. In November, 1975 FRS revealed they were instituting a test review program involving state member banks paralleling our methods and procedures. In July, 1975 FDIC again expressed interest and a meeting was held in September, 1975 with representatives of the FDIC. This Office indicated FDIC involvement would be welcomed in whatever way they deemed appropriate.

During May, 1976 the second uniform review was conducted and again the data generated was made available to the FRS and FDIC.

In July, 1976 the Comptroller of the Currency and the Vice Chairman of the Federal Reserve Board met to discuss the approaches of the two agencies to shared national credits. It was agreed that the OCC should continue to provide FRS with the information developed under its program and to explore at a staff level whether uniform procedures could be developed between the two agencies which would be acceptable to all of the Federal Reserve Banks. It is our understanding that the New York Federal Reserve Bank is conducting a pilot project involving shared credits which may assist in resolving some of the anticipated problems associated with a combining of the approaches of the two agencies.

Recommendation (7-25)

We also recommend that the Board of Directors, FDIC, the Board of Governors, FRS, and the Comptroller of the Currency work together in refining their monitoring systems and their approach to consumer credit compliance examinations.

OCC Response:

Monitoring

The OCC has met on several occasions with officials of the other two federal supervisory agencies to present its NBSS system. Those orientations were given both orally and with complete submission of all relevant documents. Further, we have offered the other supervisory agencies computer programs and technical knowledge to implement the programs.

Consumer Credit Compliance

With reference to consumer credit compliance examinations the draft report does not fully recognize that our new program is already operational. Over 6% of our field staff is currently allocated to the consumer area. We have conducted three two week schools which trained over 140 examiners in the new procedures; a second series of three schools is scheduled for March and April, and a third series will take place in the Fall. The schools stress examination techniques and feature heavy reliance on case studies to give experience in examining for compliance. The procedures are tailored to spot problems most likely to result in harm to consumers. We make use of sophisticated advanced financial calculators, specially programmed for banking applications, and sampling techniques designed to increased our effectiveness.

Eleven percent of the country's 4,700 national banks have been examined under the new procedures. Preliminary analysis of these reports indicates that our expanded efforts in this area are both justified and effective.

The draft report also does not reflect the extent to which other agencies have cooperated in developing our new program. The Federal Reserve Board and H.U.D. aided in reviewing our procedures. Speakers from the Federal Reserve Board, H.U.D. and the Justice Department participated in our schools. Observers from the Federal Reserve Board, FDIC, N.C.U.A. and H.U.D. attended the schools to assess the new procedures. As a result many of our examination procedures and teaching materials have been adopted by these four agencies. This experience has reinforced our awareness of the benefits of such cooperative efforts.

Recommendation (8-~~20~~ 18)

a). We recommend that the Board of Directors, FDIC, the Board of Governors, FRS and the Comptroller of the Currency establish more aggressive policies for using formal actions.

OCC Response:

We believe that in supervising the vast majority of national banks, our most effective remedy continues to be the examination process and the meetings held as part of that process between the board of directors of the bank and OCC personnel. Since December 23, 1975, the OCC has required meetings with boards of directors of each national bank at least once every calendar year and, in certain cases, following every examination. We believe that the increased use of such meetings together with our new examination procedures and early warning system will make our first-line, informal supervisory techniques even more effective.

Recommendation (8-20) Continued

As the GAO report elsewhere notes, our informal supervisory techniques even without the improvements noted above, have proven effective in rehabilitation of most of the so-called problem bank situations. For example, over the period reviewed by GAO informal procedures utilized by OCC were successful 84% of the time. Nonetheless, we agree that increased use of formal agreements and cease and desist orders under the Financial Institutions Supervisory Act may accelerate correction of problems in the more recalcitrant institutions.

OCC use of such formal agreements and orders has increased tenfold from 1970 to 1975. The OCC has originated slightly more than half of the combined total (179) formal agreements and cease and desist orders issued by all three agencies during the last five years. The OCC, however, supervises fewer than half the number of banks supervised by the other two agencies combined. When compared to the number of banks supervised, the OCC over the past five years has used the formal enforcement tools of Financial Institutions Supervisory Act about two and one half times as often as the other two agencies.

It should also be noted that the three banking agencies jointly requested Congress in 1975 to refine and increase the agencies' formal enforcement powers. Congress failed to pass the necessary legislation.

b). Written criteria should be developed to identify the types and magnitude of problems that formal actions appropriately could correct.

OCC Response:

The OCC has developed as part of its National Bank Surveillance System a severity anomaly ranking system which identifies every three months the national banks most likely to require special supervisory attention. A computerized action control system is designed to assure that the OCC responds promptly and appropriately to these situations. The criteria built into these systems identifies more systematically and promptly those cases in which formal enforcement action is appropriate.

Recommendation (8-49)

We recommend that the Board of Directors, FDIC, the Board of Governors, FRS, and the Comptroller of the Currency develop uniform criteria for identifying problem banks.

OCC Response:

The term "problem bank" is banking agency jargon for many different fact patterns. To an outsider, it appears reasonable and logical to expect a uniform definition of the term. The agency staff person recognizes the difficulty of reducing all the variables to a single definition. At the same time, he has little difficulty in communicating with colleagues in other banking agencies on particular bank situations.

OCC's approach is to computerize to the greatest extent possible the many variables which characterize a bank's condition and management from time to time. This results in a capability to rank all banks in relation to their peers. The final selection of banks needing special supervision can only be done subjectively by trained personnel using all the tools available and the results of our revised examinations. The dividing line on the spectrum between "problem" and "non-problem" status is hard to define but OCC is more than willing to consult and cooperate with the other agencies in seeking such dividing lines.

Recommendation (10-6)

We recommend that where feasible the Comptroller of the Currency, Board of Directors, FDIC, and Board of Governors, FRS, combine their examiner schools and standardize their curricula.

OCC Response:

The OCC recognizes that a common training effort and a combined examiners' school would be highly desirable both in terms of expense and coordination of examination policy. Our Office stands ready to cooperate fully with all such efforts. Indeed, our Office is in receipt of a letter from Chairman Barnett of the FDIC asking our cooperation and financial support for a combined training facility to be constructed at a Rosslyn, Virginia site. This matter is receiving serious attention.

The practical difficulty is that our Office has implemented the Haskins and Sells Report which has created fundamental changes in our examination process. These changes are so basic to our examination process that it would be difficult to coordinate a curriculum. A combined examiners' school is viable only if the other agencies modernize their techniques in line with those being implemented at the OCC. It would be possible, however, to offer jointly courses in more generalized subjects such as Economics and Accounting.

Recommendation (10-11)

We recommend that the Board of Governors, FRS (1) establish a full-time training office to operate its examiner training program and (2) carry out the revision of examiner school curricula which it has recognized as needed for some time.

We also recommend that the Comptroller of the Currency, Board of Directors, FDIC, and Board of Governors, FRS, increase their training in EDP, Law and Accounting as desired by their examiners.

OCC Response:

As part of our acknowledged need for specialized training, and consistent with the advice of our consultants, the Training Division of the Personnel Management Department has identified a multitude of different specialized courses which selected examiners will take; they include 7 different commercial examination schools, 3 trust examination schools, an EDP school, and International school and a consumer examination school. That program has now been implemented and is in full operation. The schools are programmed for examiners at different stages of their professional development. Among the many courses that will be offered by skilled personnel, both from within the OCC and, where necessary, from outside, are ones in EDP, Law and Accounting. Among the other areas that will be covered in that curriculum development will be specialized work in Economics, Bank Marketing, Finance, Auditing and similar topics.

APPENDIX I

Recommendation (11-8)

We recommend that the Board of Directors, FDIC, the Board of Governors, FRS, and the Comptroller of the Currency either (1) jointly establish a more effective mechanism for the three agencies to combine their forces in undertaking significant new initiatives to improve the bank supervisory process or in attacking and resolving problems common to the three agencies, or (2) the Congress enact legislation to establish a mechanism for more effective coordination.

OCC Response:

The OCC has always stood for the strongest possible working relationships between federal supervisory authorities. At the December, 1976 meeting of the Interagency Coordinating Committee, Mr. Robert Bloom, Acting Comptroller of the Currency, asked that the committee take up at its next meeting the subject of strengthening coordination of examination procedures. It will be proposed that a permanent staff group be set up for this purpose. We anticipate modification and refinement of our newly implemented examination approach on an ongoing basis. Review and evaluation of such changes as they affect problems common to the three agencies would be most useful.

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

January 16, 1977

The Honorable Elmer B. Staats
Comptroller General of the United States
Washington, D. C. 20548

Dear Mr. Staats:

We appreciate the opportunity to review the General Accounting Office's draft report on the "Study of Federal Supervision of our Nation's Banks."

The data contained in the report reflect favorably on the Federal Reserve's supervisory performance with respect to both banks and bank holding companies. However, the report does suggest a number of refinements in examination procedures and urges more uniformity of standards among the Federal bank regulatory agencies. In most instances, the Federal Reserve had already taken steps to accomplish the objectives of the recommendations.

The Board's specific comments concerning individual recommendations and its general comments concerning the GAO report are enclosed. It is our understanding that our responses to specific recommendations will appear verbatim in the report immediately following the applicable recommendation and that our general comments entitled "Statement by the Board of Governors of the Federal Reserve System" will appear in the Highlight Section of the final report.

Sincerely yours,

Arthur F. Burns

Enclosures

STATEMENT BY
THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
ON THE GAO REPORT

The agreement between the General Accounting Office and the three bank regulatory agencies, pursuant to which the special GAO review of the bank supervisory process was commenced in May, 1976, provided that each of the agencies involved would have an opportunity to comment on the conclusions and recommendations set forth in that report. In addition to its specific comments on individual recommendations which are set forth throughout the main body of the report, the Board also believes that some introductory comments are appropriate.

--The report confirms the basic health and soundness of the banking system. The number of banks requiring special supervisory attention is a small percentage of the total number and the percentage which have in fact failed is much smaller still.

--The report confirms the basic soundness of the current system of supervision. Refinements, rather than basic revisions in the current system, are recommended. In most instances, the Federal Reserve Board had already taken steps to implement such refinements and we believe the same to be true of the other agencies.

--The report confirms the necessity for the legislative improvements in the bank supervisory and regulatory area which the Board recommended to Congress as early as September, 1975, as well as the Board's proposals for a Federal Bank Examination Council.

The bulk of the GAO review focuses on banking institutions which have required special supervisory attention and the responses of the various agencies to this requirement. Despite this limitation, the report establishes that, at any one time, the percentage of banking

institutions in the country which for various reasons can be considered to require special supervisory attention is extremely small, in the neighborhood of 5 per cent. The data in the report show that between 1970 and 1975, encompassing an exceptionally difficult economic period for the country, only 42 of the approximately 14,000 commercial banks in the country failed. Most of those institutions were relatively small and aggregate losses to depositors were minimal.

Also relevant to an evaluation of the supervisory process is the conclusion of the report that the group of banks identified as requiring special supervisory attention is fluid. The composition of the problem lists changes with some frequency as the regulatory agencies identify problems and the banks respond to the need for corrective action.

The recommendations made throughout the report indicate that no need was found for any basic revisions in the country's present system of bank regulation. Rather, the report identifies a number of areas which GAO believes need further attention by the agencies. As noted in our specific comments on the recommendations, in most instances the Federal Reserve and the other regulatory agencies had already taken actions in harmony with the basic thrust of the recommendations. For example, the Board was already focusing more of its supervisory resources on institutions with known problems and less on those thought to be in good condition.

The majority of the recommendations in the area of bank examination and supervision relate to a desire for greater uniformity in supervisory

treatment among the agencies. These recommendations support the Board's conclusions and initiatives in this area. In December, 1975, Governor Holland testified before the Senate Committee on Banking, Housing and Urban Affairs and in that testimony made reference to the concept of a joint bank examination council which at that time had received substantial support within the Board. In that regard, he stated:

> Such a Council would be focused on the areas that we believe are most in need of improvement; that is, efficient and uniform modernization of bank examination and vigorous and consistent follow-up procedures when bank weaknesses are revealed. Such a Council could be established administratively or by statute. Its statutory authorization would undoubtedly give more impetus to the establishment of such a Council, and would also provide it with more clear-cut authority to take definitive action within its statutorily defined areas of administration.
>
> The Federal Bank Examination Council should have authority to establish standards and procedures for bank surveillance, examination and follow-up, applicable to all the Federal banking agencies, and it should review significant problem cases when and as they develop. All three Federal banking agencies should be represented on the Council.

Subsequently, at the Board's request, Senator Stevenson introduced the Federal Bank Examination Council Act (S. 3494). Such a council would establish mandatory uniform standards and procedures for Federal examination of banks as well as uniform reporting systems and conduct joint schools for examiners. The Board strongly supports such legislation and believes a proposal along those lines could accomplish most of the objectives set out in the report's recommendations in the examination area.

The report focuses extensively on the method by which the agencies deal with problem bank situations and makes a number of recommendations for improvements in this area which will be discussed later. Further, in a number of instances the report specifically supports enactment of various legislative proposals made by the Board on behalf of the regulatory agencies. As Chairman Burns stated in a letter of September 5, 1975 proposing such legislation, "All of these recommendations arise from the agencies concern over 'problem bank' situations and are designed to help prevent or correct such situations." H.R. 9743 and S. 2304, which embodied these recommendations, would have provided civil penalties for violations of various provisions of Federal law by banks and bankers; imposed new restrictions on a bank's transactions with insiders; and placed the agencies in a position to make more effective use of the Financial Institutions Supervisory Act of 1966. The Board believes that the report provides strong support for this legislation. In this regard, we note that Senator Proxmire has just introduced a bill in the 95th Congress which encompasses these recommendations.

The GAO report stated that "Examiners found problems in nearly all of the banks in our samples, including those not on the agencies' problem lists . . . ." The tables contained in the review of this element of bank supervision showed that examiners applied strict standards; e.g., in 70 per cent of the banks the examiners criticized the volume of classified loans; violations of law and regulations, whether merely technical or substantive, were identified in 55 per cent of the banks;

inadequate routines and controls were noted in 44 per cent of the banks. We agree with the GAO and believe the report readily confirms that bank examiners are effective in identifying problem areas in commercial banks.

We believe that the study also demonstrates that the supervisory agencies are effective in resolving significant problems once they have been identified by the examiners. We are not convinced that analysis of the dynamics of so-called "problem lists" -- one of the techniques employed by the GAO -- is a proper basis for measuring supervisory effectiveness. Thus, we are somewhat concerned with the report's focus on the length of time an institution remains subject to special supervisory attention as being an indication of whether or not the supervisory process is, in fact, working. We believe that substantial weight should also be given to the percentage of banks which fail as an indication of whether or not the process works. During the period examined by the GAO, only two State member banks failed, and they were relatively small.

However, we believe that even the focus of the report on the dynamics of the list of institutions subject to special supervisory attention demonstrates the effectiveness of the present system. The report shows that the composition of the lists changes with some frequency as problems are identified by the regulators and resolved by the institutions in conjunction with the regulators. During the period examined by the GAO, 1,180 banks were added to these lists and 897 were removed. Furthermore, as set forth in more detail in our specific responses to individual recommendations, we believe the data gathered in chapter 8

demonstrate that the performance of the three agencies is roughly the same and, in fact, good for all three agencies.

In addition to the recommendations for greater uniformity in examination and follow-up among the agencies, the report makes a number of recommendations relating to examination techniques and training. As more specifically set forth in our responses to the particular recommendations, the Board has taken, or is in the process of taking, effective action compatible with the major thrust of most of the recommendations. For instance, a major portion of the recommendations deal with the desire that the agencies focus more of their resources on institutions with known problems. In this regard, the Board requires all problem banks to be examined at a minimum of six-month intervals. Further, the Board has recently adopted limited scope Asset Quality and Management Performance Examinations to be used on banks thought to be in relatively good condition. The Board believes that these procedures give us the needed flexibility while at the same time minimizing the likelihood that problems will be overlooked.

In the area of training, the Board has, among other things, recently revised curricula for its various examiner schools and has instituted new schools in the areas of consumer regulations and bank holding company analysis.

The Board would also like to comment on the broad purposes of the bank examination process lest the sum of the report's recommendations be misconstrued. We believe that bank examination and supervision should

be directed at securing compliance with banking laws and regulations and determining that a bank is operated soundly so as to assure, to the greatest extent possible, safety and soundness of depositors' funds and continued banking services to the community. A system of bank regulation which goes beyond these goals imposes certain social costs and dangers. It is not the job of the supervisors to determine whether specific loans should or should not be extended or whether a bank's resources should be used in a particular manner unless such decisions contravene law or affect the safety and soundness of the bank. Rather, private initiative should be encouraged to the greatest extent possible.

Finally, the report also comments on the Board's supervision of bank holding companies. The data in the report confirm that, as in the case of banks, the percentage of problem institutions is relatively small. Even utilizing a sample biased toward problem institutions, there were limited instances in which bank holding companies were found to have caused problems in the subsidiary banks. Out of the sample of 344 which were affiliated with bank holding companies, there were 22 banks in which the report stated that the problem was caused by the parent holding company. This constitutes 6.5 per cent of the sample banks affiliated with bank holding companies. However, the Board's examination of the parent bank holding company in each of these instances demonstrates that, in fact, the actions of only five holding companies could be said to have caused any serious problem in the subsidiary banks. In addition, the Board believes that it is taking effective supervisory

action in those cases where holding companies are causing problems for the subsidiary banks. In October, 1974, the Board's request for cease-and-desist authority over bank holding companies was granted. Since that time, the Board has significantly expanded its supervisory efforts with respect to bank holding companies, concentrating primarily on those exhibiting problems. With respect to formal actions, in the 26 months the Board has had the authority, it has issued 12 cease-and-desist orders and 12 written agreements against holding companies.

In concluding our general statement, we wish to note once again that our banking system has weathered an extremely difficult period successfully. The bank supervisory process of this country, which by no means is perfect, has materially contributed to this achievement.

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The Board's further responses to individual recommendations may be found throughout the body of the main report as follows:

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-- Combined examiner schools ----------------- 10- 6

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-- Evaluation of examiners ------------------- 10-15

-- Uniformity in the supervisory process ----- 11- 8

Recommendation

Therefore, we recommend that the Board of Directors, FDIC, the Board of Governors, FRS, and the Comptroller of the Currency establish scheduling policies and procedures which would avoid setting examination patterns.

Comments

This recommendation is based upon the premise that the agencies view surprise as an important element of an examination. The Board believes that, in many cases, there is serious doubt as to the benefits to be gained and hence the desirability of surprise examinations. In those instances where surprise is considered important, it has been, and will continue to be, our practice to schedule examinations so that they cannot be predicted in advance.

Recommendation

We recommend that the Board of Directors, FDIC, and the Board of Governors, FRS adopt flexible policies for examination frequency which would allow them to concentrate their efforts on banks with known serious problems.

We recommend that the Congress amend the National Bank Act to allow the Comptroller of the Currency to examine national banks at his/her discretion. We would be glad to assist the committees in drafting appropriate legislation.

Comments

The Board already has established policies that are flexible enough to allow us to concentrate our efforts on banks with known serious problems. Some years ago, the Board adopted the policy, which was reaffirmed in 1975, that all banks considered to be in a problem status be examined at a minimum of six-month intervals. However, we will continue to schedule periodic examinations of all banks under our supervision since a bank may deteriorate with the passage of time. As pointed out in the GAO

report, the Board recently approved the usage of Asset Quality and Management Peformance Examinations in the case of banks thought to be relatively free of major problems. If this limited scope examination detects major changes or deterioration, a full scale examination is then commenced. These procedures give us flexibility while at the same time insuring that problems are not overlooked.

Recommendation

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

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

--use only reports of State examinations meeting those standards.

Comments

The report recognizes our current extensive efforts to eliminate unnecessary duplication by utilizing State examiners and State examination reports. If experience with our existing program in Indiana should indicate that expansion of this program is desirable, GAO's recommendations regarding standards would be appropriate. Indeed, the purpose of the existing experimental program is to develop such standards. In this connection, however, it should be recognized that written standards alone will not insure the success of any program.

Recommendation

We recommend that the Board of Directors, FDIC and the Board of Governors, FRS, establish procedures to base the scope of each examination on the examiners' evaluation of the quality of the bank's controls, policies, procedures, and audit.

Comments

This recommendation encompasses what we are already doing. We review the policies, procedures, and controls in connection with all bank examinations. In most large banks, our examiners currently perform a preexamination review specifically focusing on controls, policies, and procedures. The results of such review are used to determine the amount of scrutiny given to each area. In smaller banking institutions, a review of the controls, policies and procedures in effect at the last examination is used to develop the scope of the examination.

Recommendation

We recommend that the Board of Directors, FDIC, and the Board of Governors, FRS, develop standards for the preparation, maintenance, and use of examination workpapers.

Comments

We believe that, in the vast majority of examinations, the examination workpapers and line sheets prepared are adequate to meet the System's needs. The manner in which examination workpapers should be prepared and maintained is extensively covered in connection with the training of our examiners.

Recommendation

We recommend that the Board of Governors, FRS, and the Comptroller of the Currency, using all available information, develop and use a single approach to classify loans subject to country risk.

Comments

The evaluation of the country risk element in international loans calls for difficult analysis and judgment at the time lines of credit are established or loans extended since "country risk" involves

an estimate of a country's political, economic, and social fortunes over the life of the loan as they may affect the collectability of such loans. There is serious question as to the validity of generalized characterizations of credits based on the country of residency of the borrower, particularly where the characteristics of the credit may well vary with the borrower - private or governmental - as well as the nature and extent of external resources available to support the loan. For a number of months now, the Federal Reserve has had underway a review of country risk problems in international lending as well as appropriate supervisory treatment of the problem. This review has included an on-going appraisal of the system employed by the Comptroller of the Currency. In this regard, we believe that, while there may be general agreement on the desirability of uniform evaluation of the country risk element in individual international credits, there is a real question as to the desirability of rating individual countries. It might be noted, for instance, that the Comptroller's system focuses almost exclusively on credits to individual governments. In any event, we believe that we should strive toward uniform treatment. Of course, as with respect to many of the recommendations, the Federal Bank Examination Council proposal would accomplish this.

Recommendation

We recommend that the Board of Governors, FRS, and the Comptroller of the Currency implement procedures to examine (where permitted by the country involved) major foreign branches and subsidiaries, including subsidiaries of Edge Act corporations, periodically and whenever adequate information about their activities is not available at the home office.

Also, we recommend that the Board of Governors, FRS, and the Comptroller of the Currency utilize each others examiners to cut expenses when conducting examinations in foreign countries.

Comments

The development of widespread networks of foreign branches and subsidiaries by the major banks has brought the question of the supervision of the banks' international operations to the forefront in recent years. We concur with the principle that examinations, wherever conducted, should be adequate to provide the necessary supervisory information. However, one constraint with which the Board has had to deal is, as noted in the report, that, in many cases examinations of foreign subsidiaries are not possible because of host country laws which preclude direct examinations by other governmental authorities of banks chartered in those countries regardless of the ownership. The System has not only required that banks maintain records at the head office adequate to appraise the risk and exposure of the banks through their foreign operations, but the System has also provided for direct visitations of examiners to major foreign branches in those cases where such visitations have been legally possible.

The Board believes that, on the whole, this system has worked well. The information available at head offices has, in general, been adequate to assure that the banks were not unduly exposed to loss or serious financial difficulties. At the same time, there has been a continual search for better and more efficient ways of satisfying the Federal Reserve's supervisory responsibilities in the international field.

Beginning in the fall of 1976, on-site examinations were made of foreign branches of State member banks where we had previously utilized on-site inspections by State examiners or information at the head office. Moreover, a number of foreign subsidiaries were directly examined for the first time with the agreement of the host government. A full evaluation of those examinations has not yet been completed. One preliminary result of that exercise has been to provide assurance that a large portion of the material needed for proper supervision of foreign branches and subsidiaries is in the management information systems at head offices. In this connection, it should be noted that consultations are continuing with foreign bank superisory authorities about the ways in which access to foreign subsidiaries may be broadened to accommodate on-site reviews. These consultations are part of a wider effort of international cooperation in bank supervision.

Recommendation

We recommend that the Board of Directors, FDIC, and the Board of Governors, FRS develop reports of examination for EDP operations which present the problems found, corrective action needed and any necessary explanatory data in a clear and concise manner.

Comments

The Board wishes to note that it believes its present EDP examination report adequately presents the major problems found and corrective action needed. Furthermore, the System has already undertaken a review of EDP examination procedures to determine whether there are possible improvements, particularly in the review of internal controls, and, in connection with that review, is preparing a revised examination report.

Recommendation

We recommend that the Board of Governors, FRS implement a system of supervision which is based on onsite inspections of holding companies and their major nonbanking subsidiaries. We also recommend that the Board strengthen its oversight of holding company supervision by establishing

--a systemwide manual of inspection procedures,

--a standard inspection report, and

--periodic onsite evaluations of Reserve bank supervisory activities.

Comments

The System has for some time conducted on-site inspections of selected holding companies. Partly as a result of these inspections and problems which came to its attention, the Board in late 1974 requested and was granted legislative authority to impose the same supervisory remedies on holding companies that were applicable to banks under the Financial Institutions Supervisory Act of 1966. In early 1976, the Board directed that this inspection program be significantly expanded with initial efforts directed toward holding companies requiring special supervisory attention.

In addition, in 1975 the Board commenced work on a computer based monitoring system in order to identify those holding companies which might require special attention. This program is partially operational at the present time and is expected to be fully operable within the next few months.

A manual of inspection procedures is currently under development. However, completion of such a manual has of necessity awaited experience

gained from the direct on-site inspections which have been carried out. We believe that the recommendations relating to a standardized inspection report as well as periodic on-site evaluations of Reserve Banks supervisory activities warrant further consideration. We might note that the initial steps to set up such periodic evaluations already have been commenced by the Board.

While we see no difficulty with the thrust of the recommendations, the Board is concerned that the method used in the GAO report may lead to unwarranted fears as to the general health of bank holding companies. The sample chosen was one in which problem banks were at least six times more likely to occur than in the industry as a whole. A sample biased toward problem banks is naturally biased toward problem holding companies.

Under the heading "Unsound Holding Companies' Expansion Applications Approved" the report states that the Board approved applications by 15 of 20 "detrimental holding companies" to acquire additional banking and nonbanking subsidiaries. Our review of these companies indicates that the problems of over two-thirds of these companies were problems centered in the banking subsidiaries as opposed to problems in either the parent holding company or a nonbanking subsidiary. As such, these problems would be most effectively handled by the primary examining authority of the bank involved. Furthermore, the majority of the applications involving these institutions which are referred to were acted on in the early 1970's, long before any of the institutions had experienced difficulty or had been identified as requiring special supervisory attention.

In fact, only three applications were approved at a time when any of the institutions involved was considered to be in a problem condition. Two of these applications consisted of corporate reorganizations having no financial impact on the institution whatsoever. The third application involved permission to engage in a nonleveraged, potentially profitable, operation which was considered to be a positive factor to improve the condition of the company involved.

The Board regards its policy, adopted in June 1974, of curbing bank holding company expansion into nonbanking activities, particularly with respect to bank holding companies with financial problems, as being an effective supervisory tool. In fact, the Board has acted to deny a significant percentage of applications on financial and managerial grounds since this policy was introduced, and many more have been withdrawn by applicants after discussions with staff. The Board believes it has applied this policy responsibly and it remains in effect.

Recommendation

Therefore, we recommend that the Board of Directors, FDIC, and the Board of Governors, FRS require their examiners to meet with the bank's board of directors or audit or examining committee after each examination.

Comments

The System has for many years been concerned that the board of directors be particularly aware of the results of an examination. Thus, the System has historically required that the examination report be considered and discussed at a meeting of the board of directors. To insure that this is done, directors are required to sign a statement

attached to the report that it has been so read and considered. Further, examiners are instructed to review the minutes of board of director meetings to insure that the spirit of these requirements has been fully carried out.

With respect to meetings, the Board in 1975 directed that an earlier existing policy for most of the System be expanded to all Reserve Banks. This policy requires that Reserve Bank staff meet with the board of directors of all so-called problem banks. The Board believes that such meetings are important where significant problems are revealed.

Recommendation

We recommend that the Board of Directors, FDIC, and the Board of Governors, FRS, develop and use reports of examination which provide the banks with the results of the examination and any necessary supporting information.

Comments

We believe the bank examination report presently provides the banks with the results of an examination and necessary supporting information. We also believe it should provide the System with the information it needs to carry out its supervisory functions. The present examination report adequately carries out these needs. It should not be forgotten that the System also uses other methods of communicating its views to its member banks, such as correspondence, informal meetings, and consultations on applications. Of course, the System is continually exploring methods of improving communications.

Recommendation

We recommend that the Comptroller of the Currency invite FDIC and FRS to jointly evaluate its new examination approach. We further recommend that, in the event of a favorable assessment of the new process, the Board of Directors, FDIC, and the Board of Governors, FRS revise their examination processes to incorporate the concepts of OCC's approaches.

Comments

The Comptroller's new procedures are based in large part on the Haskins and Sells report. At the time that report was prepared, the Comptroller furnished it to the other banking institutions in the belief that some of the recommendations might be jointly applicable. A task force at the Federal Reserve reviewed the report shortly after its issuance and concluded that, in most instances, the System had already implemented those recommendations involved which would have been applicable to the System. Subsequent to that time, the development of new examination procedures at the Comptroller's office has been substantially completed. Recently, senior members of the Board's staff attended a briefing by the Comptroller's office on these new examination procedures and the report form to be used by that agency. The Board believes that the Comptroller has been most cooperative in sharing his new systems with us and fully intends to use whatever benefits may be derived from the Comptroller's efforts in this area in our on-going review of our examination procedures.

Recommendation

We recommend that the Board of Directors, FDIC, the Board of Governors, FRS, and the Comptroller of the Currency jointly staff a group to analyze shared national credits at State and national lead banks under Federal supervision and that the three agencies use the uniform classification of these loans when they examine the participating banks.

We recommend that the Board of Directors, FDIC, the Board of Governors, FRS, and the Comptroller of the Currency work together to refine their monitoring systems and their approaches to examining for compliance with consumer credit laws.

Comments

A joint approach to shared national credits is clearly desirable. In fact, in June 1976 the Board and the Office of the Comptroller of the Currency entered into a preliminary agreement which provides for a sharing by each agency of examiners' classifications of a national credit.

The second portion of this recommendation deals with the desirability of uniform refinement of consumer credit enforcement and compliance policies. In the report, the GAO states that some agencies believe there is a possible "conflict between a bank's objective of financial soundness and strict compliance with consumer credit laws." The Board does not agree with this statement. On the contrary, we believe that stringent enforcement of consumer laws and regulations will achieve compliance and thereby reduce the likelihood that banks will incur substantial liability as a result of consumer suits.

The Federal Reserve has had the major responsibility for drafting regulations to implement the explosion of legislation that has taken place in this area over the past two years. In this connection, the

Board's Division of Consumer Affairs has worked very closely with the other agencies. It has formed a Federal Reserve task force to develop approaches to the enforcement of newly enacted consumer credit laws. A cadre of examination specialists who will concentrate on inspection and compliance is being trained. Two schools on consumer regulations were conducted in 1976 and four have been planned for 1977.

Additionally, examination manuals that deal with the full array of consumer regulations have recently been prepared. A new examination report form dealing exclusively with this area has been prepared and is expected to be in use in the near future.

Recommendation

We recommend that the Board of Directors, FDIC, the Board of Governors, FRS, and the Comptroller of the Currency establish more aggressive policies for using formal actions. Written guidelines should be developed to identify the types and magnitude of problems that formal actions could appropriately correct.

Comments

In this section, the report notes that each problem situation has to be evaluated on a case-by-case basis and formal action would not always be appropriate. The report goes on to recommend that more aggressive policies be used for formal actions and that written guidelines be developed to identify the types and magnitude of problems that formal actions could appropriately correct. In this regard, we note that the report confirms that all of the agencies have already markedly expanded their formal enforcement activities. On November 3, 1975 the Board issued a policy statement emphasizing its intention to take formal action where appropriate in connection with violations of the Bank Holding Company Act.

Further, we do not believe that adequate weight has been given in the report to existing hindrances to formal action under the Financial Institutions Supervisory Act of 1966. This chapter does, however, support the Board's existing recommendations for changes to the Financial Institutions Supervisory Act which would enable the supervisory authorities to remove bank officers for gross negligence and to assess civil penalties for violations of laws and regulations. These legislative recommendations were made in response to procedural and substantive problems inherent in making effective use of the present formal procedures set forth in the Financial Institutions Supervisory Act. In this regard, the Board's letter of September 5, 1975, to the banking committees of both Houses of Congress setting forth the legislative proposals made it clear that there were a number of situations in which the existing formal regulatory remedies would have little or no value in preventing or ameliorating problem bank situations. We believe that those recommendations, embodied in H.R. 9743 and S. 2304, would help to substantially reduce the incidence of problem banking situations. Further, the Board has continued to review areas in which it appears that changes may be of substantial aid. The Board intends to submit further legislative proposals to this end in the very near future. In this regard, Chairman Proxmire has introduced legislation in the 95th Congress which encompasses the earlier recommendations.

The Board is further concerned that the discussion in this chapter of the manner in which the agencies are handling problem bank situations may not present an accurate view in all respects. The major

shortcoming in this regard stems from the fact that the different agencies utilize problem bank lists for varying purposes. Furthermore, even between agencies with similar goals, different judgments may occur as to the severity of an institution's problems and the length of time monitoring is required. Meaningful comparison between agencies' enforcement activities in this area is therefore impossible. We would, however, note that the report's conclusions relating to the agencies' effectiveness in returning institutions to nonproblem status are not supported by the tables since the percentages used excluded institutions withdrawing from membership and merging. Presumably, the approving agency found in the case of the mergers, as required by the Bank Merger Act, that the financial and managerial condition of the resulting bank was satisfactory and, in the case of withdrawals from membership, supervisory pressure may well have contributed to such withdrawals. Further, as noted in the table, withdrawals and mergers are disproportionately high in the sample for the Federal Reserve.

Recommendation

We recommend that the Board of Directors, FDIC, the Board of Governors, FRS, and the Comptroller of the Currency develop uniform criteria for identifying problem banks.

Comments

As previously noted in earlier responses, the rating systems are utilized for different purposes within different agencies. However, we believe there is certainly room for much common ground in this area. The legislative proposals for a Federal Bank Examination Council referred to earlier would aid in this development, though judgmental evaluation of any common criteria will likely lead to some diversity.

Recommendation

We recommend that where feasible the Comptroller of the Currency, the Board of Directors, FDIC, and the Board of Governors, FRS, combine their examiner schools and standardize their curriculums.

Comments

The examiner schools were a combined effort of the three agencies when they were established in 1952 by the Federal Reserve. However, in 1962 the Office of the Comptroller of the Currency withdrew from the program, believing it preferable to operate its own school. In the early 1970's the number of FDIC students necessitated some sessions held for FDIC examiners only and, when the FDIC enrollment needs continued at this high level, it was decided that the only practical course of action for the FDIC and the Federal Reserve System was to establish separate schools.

The Board believes that a joint effort in this area would be appropriate and desirable. This is among the reasons the Board supports the concept of a Federal Bank Examination Council. Short of this proposal, the Board will explore with other agencies the feasibility of conducting joint schools.

Recommendation

We recommend that the Board of Governors, FRS, (1) establish a full-time training office to operate its examiner training program and (2) carry out the revision of examiner school curriculums which it has recognized as needed for sometime.

We also recommend that the Comptroller of the Currency, the Board of Directors, FDIC, and the Board of Governors, FRS, increase their training in EDP, law, and accounting, as desired by their examiners.

Comments

One individual currently administers the various Federal Reserve examination schools held in Washington. In addition, one full time staff member is assigned to handle preparatory and procedural aspects such as registration, printing and distribution of instructional materials and day-to-day dealings with instructors and students. Other responsibilities for the different schools have been assigned to various members of the Board's staff who are experts in each field of training. For instance, the curriculum for the newly established Holding Company School was devised by members of the Federal Reserve staff expert in matters relating to holding companies and the new Consumer Regulations School is handled by individuals who have been actively involved in implementing the recent consumer legislation. The Board believes that this system has met its needs.

If the report's recommendation for a joint school is adopted, this would reduce the need to consider a separate office at the Board. However, if such arrangements cannot be worked out, the Board will consider establishing such an office.

We might note that the portion of this recommendation relating to a revision of examination curricula had been started prior to the report. At the direction of the System Education Committee, the curricula for the schools for assistant examiners and examiners were updated and revised in the spring and summer of 1976 and the curriculum for the EDP school was revised in the fall. The Holding Company School and the Consumer Regulation School have been recently established and therefore have new curricula.

With respect to that portion of the recommendation relating to additional training in specific areas, the Board has a previously scheduled session of the EDP school set for 1977 which will use a recently updated curriculum. The laws relating to consumer affairs are extensively covered in schools developed by the Office of Consumer Affairs now conducted in Washington as part of the overall examination program. The Board will study the question whether additional training in the areas of law and accounting should be provided to examiners.

Recommendation

We recommend that the Board of Governors, FRS also establish formal evaluation process to measure the competence of persons seeking advancement to examiner status.

Comments

We note that this recommendation is not based upon a conclusion that the examiners of any one agency are more or less competent than those of another agency. Standardized tests are merely one way of arriving at a formal evaluation, and we would not want to rely on them exclusively.

However, there is something to be said in favor of formal tests as a supplementary evaluation device, and the Board intends to investigate their feasibility.

Recommendation

We recommend that either (1) the Board of Directors, FDIC, the Board of Governors, FRS, and the Comptroller of the Currency jointly establish a more effective mechanism to combine their forces in undertaking significant initiatives to improve the bank supervisory process or in attacking and resolving common problems, or (2) the Congress enact legislation to establish a mechanism for more effective coordination. We would be glad to assist the committees in drafting appropriate legislation.

Comments

The Board is pleased that this portion of the report supports its previous conclusions and initiatives in this area and favors the legislative approach.

In December, 1975, Governor Holland testified before the Senate Committee on Banking, Housing and Urban Affairs and in that testimony made reference to the concept of a joint Bank Examination Council which at that time had received substantial support within the Board. In that regard, he stated:

> Such a Council would be focused on the areas that we believe are most in need of improvement; that is, efficient and uniform modernization of bank examination and vigorous and consistent follow-up procedures when bank weaknesses are revealed. Such a Council could be established administratively or by statute. Its statutory authorization would undoubtedly give more impetus to the establishment of such a Council, and would also provide it with more clear-cut authority to take definitive action within its statutorily defined areas of administration.

> The Federal Bank Examination Council should have authority to establish standards and procedures for bank surveillance, examination and follow-up, applicable to all the Federal banking agencies, and it should review significant problem cases when and as they develop. All three Federal banking agencies should be represented on the Council.

Subsequently, at our suggestion, Senator Stevenson introduced the Federal Bank Examination Council Act (S. 3494). Such a Council would establish mandatory uniform standards and procedures for Federal examination of banks and uniform reporting systems and conduct joint schools for examiners. The Board believes that a proposal along these lines could accomplish most of the objectives set out in the report's recommendations in the examination area.

FEDERAL DEPOSIT INSURANCE CORPORATION, Washington D.C. 20429

OFFICE OF THE CHAIRMAN

January 17, 1977

Honorable Elmer B. Staats
Comptroller General of the United States
Washington, D.C. 20548

Dear Mr. Staats:

I appreciate the opportunity to comment on the draft of your report to Congress on federal supervision of the commercial banks in this country.

In general, I believe that the General Accounting Office has done a workmanlike job with an extremely difficult task, made more difficult by a relatively tight time frame. We feel that your comments as an impartial professional observer should be studied carefully by us in an atmosphere of cooperativeness and receptiveness. In that vein, I would like to comment on a few points in the draft.

1. The day-to-day relationship which the FDIC has with state banking supervisors is extremely important in our supervisory effort. Unlike the Comptroller of the Currency, we supervise banks who are operating under 50 state laws as well as the Federal Deposit Insurance Act. Those banks are chartered by 50 different state supervisory authorities and the manner of supervising those banks at the federal level differs as a result from state to state.

2. It is important to realize that the FDIC is the sole federal regulator for the entire mutual savings bank industry, a $100 billion industry. While I appreciate that your report is directed only to commercial banks, I believe it is essential to take into account its activities with respect to the mutual savings bank industry in order to understand the supervisory effort of the FDIC.

3. Your report emphasizes the need for flexibility in examination techniques. We wholeheartedly concur and as a result of a continuing study going back a number of years, we amended in early November of 1976 our basic memorandum which governs our examination policy. This amended General Memorandum No. 1 is quite consistent with the thrust of your report and I am sorry that you did not include it and a full discussion of it in your report. We like to think that the philosophy outlined in this memorandum, which we have tested during the past few years by experimenting in different

Honorable Elmer B. Staats
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regions, is the best philosophy for the FDIC to pursue in the examination of nonmember banks. Since it is so central to our operations, and since it is a relatively new statement of a flexible examination policy, I would personally have liked to have seen your in-depth comments about it.

4. We believe, as your report recommends, that more formal actions should be taken in the supervisory process by federal regulators. We have attempted to pursue that policy, particularly since late spring and early summer of 1976, and have requested from the Congress additional supervisory powers.

5. The report notes the large number of violations of the law during a typical examination. I was pleased to note that you point out that some of the laws and regulations are complex and that some of the violations were of a technical nature that would in no way affect the soundness of a bank. Rightfully, you also point out that other types of violations, such as a loan in excess of a bank's legal lending limit, could result in losses to a bank. In our experience, the major portion of violations of laws set forth in reports of examination do not affect the safety and soundness of a bank. All violations of laws or regulations are a matter of concern, of course, but it is the particular responsibility of the bank regulator to consider each violation in terms of whether it was intentional or willful, the consequences flowing therefrom, the likelihood of continued violations, and other similar matters, and to then take the appropriate corrective action.

6. Finally, the report implicitly argues that Corporation examiners should be criticizing loan policies before bad loans are made. I certainly agree that a closer review of loan policies is important, and criticism of such policies in advance of their implementation be made where the policies will obviously lead to an unsafe and unsound condition for the bank or to violations of law. Most written loan policies will be stated in such a way, however, that a reasonable examiner will find it extremely difficult to find something significant in them to criticize. I suspect that the written policies themselves are not the problem but rather the implementation of those policies. I certainly see no expertise in our Corporation for drafting standard written policies that banks we supervise should pursue. The FDIC was not created to manage banks, nor do I believe that it is your intention to have your report suggest that. Nevertheless, it does suggest it, and I do feel obliged to make these comments about that implication.

APPENDIX III

Honorable Elmer B. Staats
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Finally, the FDIC Division of Bank Supervision has prepared extensive detailed comments concerning recommendations and comments made in your report which I enclose for your consideration. Please excuse the length and the detail of those comments; I believe they reflect, however, the thoughtfulness with which we have reviewed your report.

Thank you for permitting us the opportunity to comment on the draft of your report.

Very truly yours,

Robert E. Barnett
Chairman

Enclosure

FEDERAL DEPOSIT INSURANCE CORPORATION

DIVISION OF BANK SUPERVISION

Staff General Comments and Agency Recommendations

Note: Page references have been changed to conform to the final report.

CHAPTER 4

The GAO report indicates that the agencies have not established criteria or levels of acceptability with respect to financial ratios and comparisons used in the examination process. FDIC uses financial ratios as general guidelines for initial screening purposes. In banking and in finance, ratios are only indicators, and as such need to be individually assessed. The key element in banking, as in a number of other industries, aside from management, is the quality and turnover rate of the inventory. In banking, of course, inventory is principally made up of loans and securities. Since no two banks have identical inventories, it logically follows that where the relevant ratios for two banks are identical or in the same range, further analysis is required before a meaningful evaluation of a bank's condition can properly be made.

The examination is designed to and does enable the FDIC to ascertain the overall condition of the bank, the quality of its management, and the extent of compliance with applicable laws and regulations. Moreover, the examination report, including the examiner's recommendations, is thoroughly reviewed and analyzed at the appropriate Regional Office. During these reviews, the reviewer also considers the Statements of Condition and Reports of Income and Dividends filed by the bank; the bank's complete correspondence file, showing its history and the attitudes and abilities of the bank's management; reports of loans to the bank's

officers at other banks, reports of loans against the bank's stock at other banks, and any supervisory programs which are in effect; and, computerized monitoring systems which subject the bank to a number of financial checks. The major purpose of this review is to determine the extent and type of supervision which may be needed, not just "...for arithmetic accuracy, grammar, logic, support for statements, and internal consistency," as the GAO report states.

After review of the examination report as well as other relevant data at the Regional level, another review process is conducted at the Washington level for each bank. Corrective and follow-up programs are initiated at the conclusion of the examination, and in addition to possible on-site visitations or follow-up examinations, the bank's "vital signs" are monitored via an automated monitoring system fed by data from call reports, Reports of Income and Dividends, and examination data.

The GAO report also states that examinations have not given enough emphasis "to the bank's basic management practices, operations, and controls." Both from a policy standpoint and the practical application of that policy, the FDIC has been and is in the forefront of stressing the need to review, analyze and evaluate the policies and controls of a bank under examination. Thus, the following quotations from the Manual of Examination Policies typify our basic approach to this phase of the examination process:

"The Examiner's evaluation of the loan portfolio involves much more than merely appraising the individual loans therein. Present management and administration of the overall loan account, including the establishment of sound lending and collection policies are of vital importance if the bank is to be continuously operated in an acceptable manner." (Section H, page 3, paragraph III.)

"Management of a bank's securities portfolio is facilitated by the adoption of a definite investment policy. *** Details of the investment policy, expressed in writing, should establish standards for selection that thoroughly consider: (a) Quality, (b) Maturity, (c) Diversification, (d) Marketability, and (e) Income." (Section G, page 1, paragraph I.)

"Sound portfolio management dictates that procedures be established and adhered to relative to the execution of purchases and sales, review of portfolio and maintenance of credit information." (Section G, page 3, paragraph III.)

"An important part of the Examiner's duties is the appraisal of the bank's internal controls to determine their adequacy for assuring both the necessary degrees of accuracy in recorded information and reasonable protection of the bank's assets." (Section P, page 7, paragraph III. A.)

In addition, the essential thrust of the examination is premised on the concept that the entire posture of the bank rests on its management practices, operations and controls and these areas of concern are carefully reviewed and evaluated in the course of an examination and at other key points in the supervisory process. For example, the examination report, which, by necessity, must be limited to essentials, includes 13 schedules dedicated to the practices, operations and controls of the bank's management out of a total of approximately 30 schedules in the report.

The GAO report states, in part:

"While the agencies reported some violations of consumer protection laws and regulations, they acknowledged that they have not aggressively monitored consumer protection law compliance, and they have begun revising their approaches. (See Ch. 7.)"

While we do not argue with the implication of the above statement, the FDIC has expended considerable resources in the area of consumer protection. It is estimated that about 10% of our supervisory effort is taken up with examining for compliance with consumer laws and other matters not related to safety and soundness. We recognize, however, that additional efforts will be necessary to enforce the many recently enacted consumer laws and regulations. Some of the major activities of the Corporation in the area of consumer protection are: (1) adoption of a separate compliance report for reporting examinations for compliance with consumer laws, which has significantly increased the volume of violations cited over the former method used; (2) establishment of the Office of Bank Customer Affairs which serves as a focal point within FDIC for protecting the legitimate interests of bank customers; (3) expanded training for examiners and assistant examiners in consumer laws and regulations, including an orientation in consumer laws for assistant examiners, a week of training for senior assistant examiners, and case problems and additional training for commissioned examiners; and (4) providing information and education to bankers and to a lesser extent to consumers (e.g., FDIC has under active consideration issuance of a series of pamphlets to consumers covering consumer laws and banking and FDIC's role in that area).

In 1972, the FDIC considered issuing regulations and held hearings on regulatory proposals dealing with the subject of discrimination in granting home loans. However, for a number of reasons, including that there was a paucity of data needed to write effective regulations, final regulations were not issued. However, a major undertaking conducted jointly by the FDIC and the OCC has been undertaken to develop a program to insure that the banks under their jurisdiction are complying with federal laws prohibiting discrimination in the granting of home loans. During the test phase, approximately 300 banks will use a specially designed form in connection with their home mortgage lending activity. The FDIC expects that the new systems of data retention and analysis will provide a reliable indication of where discriminatory lending is taking place and serve as an adjunct to the examination and complaint mechanisms already used by the Corporation.

The GAO report implies that the FDIC has the authority to examine routinely all insured banks, including member and national banks. In point of fact, the legislative history of the Federal Deposit Insurance Act of 1950 quite clearly indicates that the intent of Congress was to circumscribe the FDIC's examination of member and national banks in the following manner (H.R. Rep. No. 3049, 81st Cong., 2d Sess. 3 and 4):

"In providing direct authority to the Corporation to make a special examination of any national bank, District bank, or State member bank, the conferees were firmly of the opinion that such authority is not to be utilized by the Corporation to embark upon a program of regular

> periodic examinations of such banks, which would only result in a needless duplication of effort. Such special examination authority is to be utilized by the Corporation only in a case where, in the judgment of the Board of Directors, after a review of the Federal Reserve or Comptroller of the Currency examination reports, there are indications that the bank may be a problem case, or that it is in a condition likely to result in loss to the depositors or to the Corporation."

Unless otherwise directed by Congress, the FDIC feels constrained to exercise its examination authority in accordance with the above statement of Congressional intent. In addition, the further implication in the GAO report of overlapping examination authority having to be parceled out through voluntary agreement between the three agencies is not, at least with respect to the FDIC, completely accurate.

The GAO report lists four criteria for scheduling examinations. We simply note in passing that the list of criteria for scheduling examinations fails to mention the primary criteria employed by FDIC, namely the overall condition, compliance posture, and needs of the bank about to be examined.

The following comments are directed to the statements in the GAO report relating to Electronic Data Processing (EDP) matters:

The FDIC has recognized the need to devote additional attention to EDP operations and to expand EDP expertise within our examiner and supervisory staffs. Efforts are continuing to develop more EDP field examiners and provide an interim career path position for a select cadre of our commercial examiner force. While our commercial examination effort addresses all aspects of bank

EDP, including the developments in electronic funds transfer, we also recognize the need for the development of EDP expertise in trust operations and will be devoting attention to that area during 1977. We are planning to provide EDP review examiner positions for each of the 14 Regional Offices, as appropriate, to accommodate EDP examination needs.

The Corporation offers an introductory course in EDP for assistant examiners, entitled Course in Examining a Computerized Bank-I (CECB-I), which is designed to prepare them to evaluate EDP input/output controls and reconcile the automated applications to the general ledger control accounts. Approximately 150 FDIC assistant examiners are processed through this school each year. In addition, a Course in Examining a Computerized Bank II (CECB-II) is offered for senior assistant and commissioned examiners to train them in basic automation concepts and computerized examination techniques. Approximately 125 examiners complete this course each year. Finally, an eight-week advanced course entitled Field Examiner Advanced Automation Training (FEAAT) was commenced in 1974 to provide in-depth technical training in EDP matters. Through 1976, 59 examiners have completed this course and two sessions have been scheduled for 1977 for approximately 28 more examiners. Accordingly, all of the FDIC's EDP training needs are provided in-house.

The FDIC has developed and implemented an instalment loan retrieval package for the use of examiners in conducting examinations. This package not only eliminates menial data-gathering

efforts and saves considerable manhours, but it has improved the quality of examinations, uncovering some practices which may have gone undetected heretofore. Further, during 1976 three other deposit EDP capabilities were added to the examiners' software package and a mortgage loan capability will be implemented early in 1977. Other applications of EDP for use in conducting examinations are in various developmental stages and software will be considered for trust examinations during 1977.

EDP techniques and capabilities are also being used within the Washington Office to seek and project solutions to problem and failing bank situations.

While it is true that many banks do not have enough data processing activity to justify purchasing an in-house computer and satisfy their data processing needs through contract servicers, a number of small banks have acquired so-called mini-computers and perform their own data processing on-premises. The evaluation (examination) of contract servicers presents no unusual problems for our trained EDP examiners and the evaluation procedures employed parallel those used for bank-operated data centers. However, the evaluation of mini-computer operations presents unusual control considerations and our experience in this area has not matured. We are continuing in our efforts to develop a sound examination approach in this area.

The Division of Bank Supervision Manual of Examination Policies, Appendix C, provides guidance for the preparation of EDP

checklists, questionnaires, summary comments and report of examination treatment for banks with their own computers. Memorandums to Regional Directors, EDP examiner conferences, and EDP seminars provide communication and input for the redesign of examination practices and training courses. Each Region adopts its own EDP examination program and some variance does occur, depending on the EDP sophistication found in the banks supervised. The provisions for the interim EDP examiner career path and EDP review examiner positions for each of the Regions during 1977 should result in improved examination efforts as the circumstances and need dictate.

The average number of man-days per EDP evaluation in 1975 was 3.9 and year-to-date 1976 is 4.1. Our experience indicates that Regional Offices with the more sophisticated banks tend to devote more manpower to EDP evaluations and to develop more expertise in EDP matters than Regional Offices with less sophisticated banks. Further, it seems, within certain limits, the more knowledgeable the EDP examiner, the more time expended in conducting evaluations.

The FDIC furnishes the results of data center evaluations to the bank's management or to the independent data servicer of a state nonmember insured bank. Where a data center evaluation is conducted as part of a bank examination, the findings of the evaluation are incorporated into the report of examination. Where the data center evaluation is conducted independently of a bank examination, the findings are transmitted under separate cover. These evaluations findings may consist of the EDP examiner's

summary comments with or without the questionnaire. Where the questionnaire is included, appropriate explanation is provided to ensure that the reader understands that a negative response to a particular question does not necessarily constitute an unsatisfactory finding with respect to that part of the EDP operation covered by that section of the questionnaire. Our experience indicates that many data center managements have requested the entire questionnaire for their review and we feel that it serves as a useful educational tool for management. However, the questionnaire is viewed by the FDIC as a formal workpaper. The results of an evaluation of servicer data centers are available to serviced state nonmember insured banks on request or at the option of the Regional Director without any request. They are also available to any other federally insured serviced institution upon request. All data center evaluation reports developed by the FDIC are considered to be confidential and the property of the FDIC and appropriate statements to that effect accompany each such report released.

The creation of EDP review examiner positions at the Regional Office level should provide the capacity to communicate more effectively with all data centers and help to achieve more uniform correction of operational deficiencies.

Recommendation (page 4-7)

Therefore, we recommend that the Board of Directors, FDIC, the Board of Governors, FRS, and the Comptroller of the Currency establish scheduling policies and procedures which would avoid setting examination patterns.

FDIC Response

We believe that our recently adopted General Memorandum #1, which has been under consideration and extensively tested for several years prior to adoption, largely satisfies this recommendation. For more extensive comments on our General Memorandum, please refer to our comments on the recommendations contained on page 4-9 of the GAO Report.

Recommendations (page 4-9)

We recommend that the Board of Governors, FDIC and the Board of Governors, FRS adopt flexible policies for examination frequency which would allow them to concentrate their efforts on banks with known serious problems.

We recommend that the Congress amend the National Bank Act to allow the Comptroller of the Currency to examine national banks at his/her discretion. We would be glad to assist the committees in drafting appropriate legislation.

FDIC Response

Although it was FDIC's long-standing policy to examine each bank once a year, it is inaccurate and misleading to suggest that that time-frame was the only guideline used by the FDIC in scheduling examinations, or, to state it another way, that examinations were not scheduled and conducted by the FDIC based upon the "bank's soundness; and the quality of its policies, procedures, practices, controls, audit, and management."

During 1975, FDIC conducted 213 follow-up examinations and a number of on-site visitations at banks presenting either financial or supervisory problems. Further, those banks which were not examined in 1975 largely consisted of banks which would not fall within the one-year time-frame guideline under General Memorandum #1. Although General Memorandum #1 was formally adopted in November 1976 and implemented on January 1, 1977, the concepts and practices embodied in it are not of recent origin. Those concepts and practices have been under consideration at FDIC since

early 1974. Furthermore, the concepts and practices have been experimented with and tested in five of the FDIC's 14 Regional Offices prior to formal adoption of General Memorandum #1. We might add parenthetically that FDIC policy is to experiment on a regional basis with major policy changes before implementation for the entire Corporation.

Accordingly, while the recently issued General Memorandum #1 expresses more definitively that scheduling of examinations is not based on time-frame priorities alone, nevertheless, we feel that the criticism of past scheduling practices expressed in the GAO recommendation is misplaced. The FDIC has followed and continues to follow a policy so aptly stated in the said General Memorandum #1, namely:

> "The first priority has been and will continue to be, effective surveillance and supervision of the institutions which present either supervisory or financial problems."

Recommendations (page 4-13)

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

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

--use only reports of State examinations meeting those standards.

FDIC Response

The FDIC has determined that the Experimental Withdrawal Program conducted in three states during the past three years will not be continued in its present form. However, agreement to examine nonproblem banks on an alternate-year basis has already been consummated with one state and the possibility of entering into similar arrangements with other states is being explored. Furthermore, termination of the Experimental Withdrawal Program should not be construed as a decline on the part of the FDIC to cooperate to the fullest extent possible with the various states or to place less reliance on the efforts of the state supervisors. The guidelines set forth in General Memorandum #1 provide a workable framework for increased cooperation with the states. Thus, almost by definition, if the program expressed in General Memorandum #1 proves workable and if a state banking department performs in an acceptable manner, the frequency and scope of FDIC examinations in that state will be reduced.

Recommendation (page 4-17 ~~13 and 4-14~~)

We recommend that the Board of Directors, FDIC and the Board of Governors, FRS, establish procedures to base the scope of each examination on the examiners' evaluation of the quality of the bank's controls, policies, procedures, and audit.

FDIC Response

With respect to FDIC examinations, the findings and conclusions expressed by GAO are not accurate. The primary factor influencing the scope of the examination is not size, but the known history of strengths and weaknesses of the particular institution. Furthermore, FDIC examiners do pre-plan the scope of an examination, by studying applicable files and previous examination reports, and noting any material changes in the management or style of operations since the last examination.

FDIC examiners have in recent years reviewed a bank's internal controls, policies and procedures prior to actual commencement of the examination in order to establish the scope of the examination within the minimum standards prescribed. With respect to smaller banks, however, such a review tends to be less formal, hence harder for GAO to detect than with larger banks. Considerable leeway in this respect is provided for in the recently adopted General Memorandum #1, and we reiterate that these procedures were considered and extensively tested in five of the FDIC's 14 Regional Offices for several years prior to formal adoption.

Recommendation (page 4-19)

We recommend that the Board of Directors, FDIC, and the Board of Governors, FRS, develop standards for the preparation, maintenance, and use of examination workpapers.

FDIC Response

The standards for the preparation, maintenance, use and importance of examination workpapers are included in the course of study at the various schools operated by the Corporation and in our on-the-job training program. The examination workpapers do, in fact, cover a number of items other than the details relating to specific loans and securities in support of comments contained in a Report of Examination. We believe our examination workpapers will permit a determination that appropriate examination procedures have been followed, provide support for the preparation of the Report of Examination, and are utilized at the next examination.

Recommendation (page 4-39)

We recommend that the Board of Directors, FDIC and the Board of Governors, FRS develop reports of examination for EDP operations which present the problems found, corrective action needed and any necessary explanatory data in a clear and concise manner.

FDIC Response

The summary comments page of the FDIC EDP questionnaire provides clear and concise descriptions of the results of a data center evaluation. In our judgment, a new evaluation report is not necessary at this time and our form, if effectively used, is comparable to the new one recently adopted by the OCC. However, we view our questionnaire as a constantly evolving tool which will be revised frequently in order to stay abreast of industry developments and to meet the burgeoning needs of our field personnel. See also our comments regarding EDP evaluation reports included with our general comments.

CHAPTER 5

GAO stated, in relevant part, that:

"The relationship between the frequency with which banks were cited for problems with internal routines and controls and violations of laws and regulations--both of which are related to management effectiveness--and the frequency of criticism of management effectiveness was not what would have been expected."

* * *

"While the examiners frequently cited banks for having problems in two areas indicative of management effectiveness--internal controls and violations of laws and regulations--they did not often criticize management effectiveness. As shown below, management effectiveness was most often criticized in problem banks with less than $500 million in deposits even though 30 to 50 percent of larger banks in the general and problem samples were also criticized for violations of laws and regulations and poor internal routines and controls."

* * *

"Violations of laws and regulations reflect on management's capability."

Generally, the size and character of the operation engaged in by a bank defines the scope and requirements of sound internal controls for that particular bank. Clearly, the internal controls deemed appropriate for a large, sophisticated operation are, in most cases, not appropriate for a smaller, less complicated one. Management is charged with the responsibility of deciding the internal controls best suited for its bank in order to provide adequate protection for its assets and a meaningful flow of information to senior management. Recognizing the practicalities of the situation, FDIC closely monitors the various internal controls

employed by banks under our direct supervision and our examiner personnel may comment on apparent weaknesses observed. However, if the particular system has worked with reasonable effectiveness for a given bank, is within the general bounds of prudence, and does not constitute an unsafe or unsound practice, corrective measures are not aggressively pursued, notwithstanding the critical comment in the examination report.

Banking is a highly controlled industry and, thus, is subject to a plethora of laws and regulations on both the federal and state levels. It is, therefore, not unexpected that banks will on occasion be found to have violated, intentionally or unintentionally, a particular statute or regulation. It is the job of the bank regulator to consider each violation in terms of whether it was intentional or willful, the consequences flowing therefrom, the likelihood of continued violations, and management's history of compliance and attitude toward taking appropriate corrective measures. Accordingly, if the violation is unintentional or merely technical in nature and not recurring, criticism of management effectiveness would not seem warranted. If otherwise, of course, criticism of management is probably appropriate. In short, in this area as well as all areas of its supervisory responsibility, the FDIC attempts to follow a rule of reason. Overreaction to technical, unintentional violations of law or regulations could, in our judgment impact adversely on the entire enforcement posture of the Corporation.

GAO stated that:

"The agencies rarely criticized a bank's loan policies until loan problems developed. For example, if a bank's managers had not adequately diversified the bank's risks, examiners did not criticize the inadequate diversification policy until those lines of credit actually became classified."

* * *

"For example, inadequate loan policies were not cited by examiners until the banks had large amounts of classified loans, as shown by data for banks in our general and problem samples combined."

The FDIC, of course, encourages banks under our direct supervision to adopt sound written loan policies. Furthermore, in virtually every formal enforcement action, FDIC routinely requires the offending bank to provide written loan policies acceptable to the Corporation and the appropriate state authority. However, oversight of a bank's written loan policies does not, and is not intended to, extend to writing the loan policies for the bank or specifically prescribing how, when and to whom the credit facilities of the bank are to be used. We view such action by the FDIC as objectionable on two grounds: (1) as encroaching on management's prerogatives, and (2) perhaps constituting a form of credit allocation. Our task is to review the policies to determine that they are within the bounds of safe and sound banking practices. However, it may be somewhat naive to assume that a review of the written loan policies of a bank will, in most cases, reveal imprudence. Typically, it is the implementation of such policies which generates criticism.

It is not accurate to suggest that the failure to diversify risk is only criticized when "those lines of credit became classified." It is both FDIC policy and practice to comment on a failure to diversify (concentration of credit) without regard as to whether or not the assets involved have been adversely classified. The Division of Bank Supervision Manual of Examination Policies states in relevant part:

> "...the inclusion of a concentration of credit in a report implies criticism of a bank's policies amenable or susceptible to management control." (Section H, page 6, paragraph IV. C.)

GAO note: Omitted comments pertain to material in the draft report but omitted from the final report.

CHAPTER 6

The thrust of Chapter 6 may be summarized as follows: examiners seldom meet with bank directors, the examination reports do not convey the bank's problems in a clear and concise manner to the directors, and the material in the confidential section should be furnished to the banks. The recommendations are that the FDIC and the FRS require examiners to meet with the directors or audit or examining committee after each examination and that the FDIC and FRS develop and use reports of examination "which provide the banks with the results of the examination and any necessary supporting information." As we view it, the implication is that FDIC and the FRS redesign the report of examination along the lines of the OCC's new format.

We believe that the statements and recommendations stem from a misconception, or perhaps a misunderstanding, of the policies and practices of the FDIC in the matters covered in Chapter 6. The following responses to the GAO recommendations represent a brief summary of the FDIC's policies and practices, and efforts to improve those policies and practices, regarding the supervisory areas dealt with in Chapter 6.

Recommendation (page 6-5)

Therefore, we recommend that the Board of Directors, FDIC, and the Board of Governors, FRS require their examiners to meet with the bank's board of directors or audit or examining committee after each examination.

FDIC Response

FDIC conducted approximately 7,900 examinations in 1975. Senior officials from the various Regional Offices met with bank management on approximately 1,750 occasions, representing 22% of all examinations. Throughout 1975, there was an average of 224 banks under our supervision which were formally designated as financial problems. FDIC policy is to meet with bank directors at least where problem situations exist.

FDIC staff has in the past year been reconsidering the question of how often meetings with bank directors should be held. In consideration of this subject, the responsibilities of bank directors, the Corporation's responsibility to bank directors, and our past and present practices in holding board meetings were weighed.

In a broad sense, the board of directors of a bank is responsible for the formulation of sound policies and objectives of a bank, the effective supervision of its affairs, and promotion of its welfare. In discharging these responsibilities, a director's duty is to exercise due care or be exposed to a charge of negligent performance of his duty.

To insure that bank directors are aware of the contents of examination reports, the Corporation requires that a receipt accompanying each report be signed by the bank's executive officer stating that the report "...was duly considered by the directors...and a record of the action taken thereon by the Board has been entered in the minutes." Moreover, at each examination, the examiner is charged with the responsibility of determining that the bank's board minutes reflect a thorough consideration of examination reports and correspondence received from supervisory authorities since the last examination.

To enable bank managements to begin work on problem areas prior to receipt of the completed examination report, a list of adversely classified assets and other major criticisms is provided to the executive officer at the completion of each examination and most of the FDIC Regional Offices have implemented deadlines for receipt of completed examination reports in the Regional Office--usually 10 calendar days after the close of the examination.

The FDIC Manual of Examination Policies states, with respect to examiners holding meetings with directors (Section Q, page 3, paragraph I.E.)

> "Except in instances where authority has been delegated by the Regional Director, the Examiner should consult with the Regional Office before calling a board meeting. Ordinarily, meetings with the board of directors should be held at the conclusion of all examinations of problem banks. A meeting of the board may also be required when experience and instinct tells the Examiner a likelihood exists that the bank will be added to the problem list or will be earmarked for other special supervision. Additionally, where there is a substantial volume of classified assets, low capital or other areas of important criticism, a board meeting may be desirable. This is particularly true when the trend has been unfavorable and previous admonitions have gone unheeded."

In keeping with this policy, it is in fact the practice in most regions for the examiner to hold a meeting with bank directors if problems of consequence are found at the examination, or if significant adverse trends are noted since the last examination. In virtually all instances involving problem banks, a representative from the Regional Office will meet with the directors, and in most cases an invitation is extended to the state authority to participate in the meeting.

The FDIC is cognizant of the benefits flowing from more frequent meetings with the boards of directors of banks under our direct supervision and anticipates holding such meetings with increased frequency in the future. We are also actively reviewing the posture of the FDIC in this regard with a view of improving upon the timeliness and conduct of such meetings.

Recommendation (page 6-13)

We recommend that the Board of Directors, FDIC, and the Board of Governors, FRS, develop and use reports of examination which provide the banks with the results of the examination and any necessary supporting information.

FDIC Response

FDIC conducted an intensive study in 1965 to assess the impact of its examination report on banks. As a result in 1969, a new examination report format was put into use. We believe this report format, and the guidelines under which it is used, provides a clear, concise picture of problem areas to bank managements. Various FDIC staff members have attended familiarization sessions on the OCC's new examination report format. The OCC has tested his new format in only ten banks and the impression of the FDIC staff members is that the report format is somewhat cumbersome, especially in problem situations.

There appears to be some misunderstanding with respect to the purpose and thrust of the confidential (supervisory) section of the report of examination. The purpose and thrust of the confidential section are to allow the examiner to comment on matters uncovered during the course of the examination which may not lend themselves to complete substantiation, but which may serve to alert his superiors that further investigatory or supervisory efforts may be necessary. For obvious reasons, such material is not, and should not, be provided to the management of

the bank. However, a thorough study of the role and use of the confidential section was started some months ago and, when completed, will probably result in significant changes in its thrust, format and content, or in its elimination.

CHAPTER 7

As is indicated in the FDIC comments to the recommendations made by GAO in this chapter, we view the impact of the changes in the FDIC examination process set forth in General Memorandum #1 as significant and vital to an understanding of the Corporation's examination philosophy and practices. We believe the entire General Memorandum should be included in the GAO report. However, in the absence of that we offer the following excerpts from General Memorandum #1, with emphasis added:

> "The first priority has been, and will continue to be, effective surveillance and supervision of those institutions which present either supervisory or financial problems."

* * *

> "Emphasis at these modified examinations should be placed *on management policies and performance*; the evaluation of asset quality, alignment and liquidity; capital adequancy; and, compliance with applicable laws and regulations."

> "In those banks with assets of $100 million or more, all report schedules which are presently in use and are applicable to the given bank will continue to be included in the examination report. Where the fixed asset investment is moderate in relation to capital, there are no statutory violations with respect to fixed assets, and absent other problems of significance, fixed asset schedules may be omitted from these examination reports. Further, examiners are instructed to *assess the quality of management systems and reports as well as audit and control functions, and where it is permissible to do so without compromising the integrity of the examinations, utilize the output of those systems*. Cash counts and proof and verification procedures may be omitted in those banks where it is appropriate to do so, and branch offices which do not have a significant volume of important assets need not be examined, however, in the latter instance, conditions at these offices should be reviewed with management prior to the conclusion of the examination."

"If believed desirable in the opinion of the Regional Director, simultaneous examinations may be arranged of all closely related banks or subsidiaries of bank holding companies, requiring coordination with other bank regulatory agencies. The type of examination employed in each bank at simultaneous examinations will be at the discretion of the Regional Director unless precluded by the guidelines for modified examinations."

* * *

"It is expected that the Corporation's automated bank examination programs and monitoring systems will be used wherever possible in an effort to provide increased efficiency and conserve manpower. This use should include the scheduling of examinations as well as their conduct. Further, sampling techniques should be used wherever possible."

"It is expected that visitations will be frequently used as an investigatory and supervisory tool for those banks which show adverse trends, either at examinations or through a monitoring system, and to gauge compliance with provisions of cease and desist orders. Further, visitations subsequent to management or ownership changes should be used to assess the attitudes and abilities of the new management/ownership if the principals are not already known to the Regional Office."

"In addition to the required periodic examinations, it will be the policy to conduct a visitation at each new bank quarterly during the first two years of operation (visitations need not be held during the quarter in which an examination, either by the Corporation or the state authority, is conducted). The purpose of these visitations is to gain some measure of the performance of management and the direction in which the bank is headed. At the discretion of the Regional Director, findings of the visitation may be reported in either memorandum form or examination report format."

The GAO comments on the status of monitoring systems in the Office of the Comptroller of the Currency and in the Federal Deposit Insurance Corporation set forth in chapter 7 of the report have served a useful purpose in that they focus on an aspect of bank supervision which has grown in importance in the recent past few years and may be of even greater importance in the future. Some clarification is needed of the fundamentals

of analysis of bank reports, of the various systems which have been developed to facilitate such analysis for supervisory purposes, and of a framework for evaluation of the efficiency of the programs. For purposes of illustration, the following comments are based upon a comparison of the National Bank Surveillance System (NBSS) and the systems in use at FDIC.

a) An essential element of any monitoring system is a data collection system. The quarterly Reports of Condition and the quarterly, in the case of large banks, and semi-annual, in the case of smaller banks, Reports of Income comprise the primary data base for both the NBSS and the FDIC systems. Data from reports of examination are important supplements to the data base; at the present time FDIC probably relies more heavily than the NBSS on this source of information. Obviously, a monitoring system that depends on regular financial reports submitted by banks is only as good as the information in the reports. The information items must be meaningful; they must be accurate; and they must be available on a timely basis. Given that the OCC and the FDIC use the same format of the Reports of Condition and Income, their divergence appears to be in the areas of accuracy and timeliness.

The OCC has put into effect an editing system which requires less stringent tests for mathematical accuracy and internal consistency in the national bank reports than that used by the FDIC in processing reports for all insured banks. FDIC

has worked from another angle. The Corporation has begun to levy fines on banks that get their reports in late. All three federal bank regulatory agencies have cooperated in an effort to upgrade the quality of the bank reports so that less correction and revision are required; clearly much more needs to be done. While this process is moving forward, both the OCC and the FDIC have had to modify their analytical systems in order to utilize bank reports that are sufficiently accurate for monitoring purposes.

b) Another essential of a monitoring system is a computer based program that compiles individual bank ratios of balance sheet and income and expense items and compares the ratios of each bank with the same ratios for comparable banks. Most monitoring systems use a technique known as "outlier analysis," flagging banks if its ratios deviate substantially from the average of ratios for comparable banks. The presumption is that such analysis can provide clues as to banks with financial problems, current or prospective.

In a banking system as diverse as that in the U.S., differences in operations among banks can be expected to be substantial. A very large money market bank's ratios may appear to be unusual or atypical of averages based upon ratios for all the banks, large and small. When its ratios are compared with those of banks of comparable size, doing a comparable business, i.e., ratios of its "peers," such a bank may not be atypical or an outlier.

Neither the OCC nor the FDIC could afford to wait for the completion of definitive studies on how to sort banks into peer groups. Such work is continuing on a theoretical level as well as on an empirical level. Currently, however, the OCC has established peer groups on the basis of bank asset size.

At FDIC, the effort has been made to allow the Regional Director to specify the banks within his region that are "peers." For analytical purposes of the Washington Office staff, peer groups have been defined primarily on the basis of asset size of bank within Region or state.

With the large number of items in the Reports of Condition and Income and the frequency with which such reports are filed, the number of ratios that can be constructed for a particular period or as measures of change between periods is extremely large. Selection of the key indicator or indicators has consumed a considerable amount of time at FDIC. One approach, the Early Warning System (EWS), examined literally hundreds of ratios to determine which were the best discriminators between known problem banks and control groups of banks with no known serious problems. The result was a winnowing down to 7 ratios, 2 based upon income and expense items and 5 based upon balance sheet items. EWS is run annually to produce a list of banks whose seven ratios indicate the similarity to banks with known problems. A second approach (JAWS) selected 6 ratios (plus an additional 2 for large banks)

which have proven to be indicators of basic changes in a bank's operations. These indicators have been incorporated into on-line system available in the Regional Offices which flags banks with ratios atypical of peer group averages, and displays five important ratios based upon the latest report of examination of each of these banks.

The OCC system includes certain ratios which have been designated as "key indicators," i.e., that provide the best general measures of unusual or changed circumstances in a bank. The process is sequential in that analysis of banks with atypical values for key indicators is extended to additional financial ratios that round out the picture of a bank's condition in the critical area.

c) A third essential element of a monitoring system is the development of a method for evaluating its effectiveness or results. The crux of the monitoring systems is the review of the output of the computer based systems by trained financial analysts and the FDIC has been using experienced examiners in this important function who have flagged "watch lists" of banks which should be examined earlier or more often than other banks. In the final analysis, however, no monitoring system has yet been developed which is 100% efficient in signaling banks with unusual problems. Thus, some flagged banks turn out, on further analysis, to be perfectly sound while some banks with serious problems are not flagged. Presently, the most any system does is suggest that a bank examination should be scheduled and the aspect or aspects of a bank's operation which requires special scrutiny.

d) The fourth or final element of a monitoring system is implementation. At the present time, the monitoring exercise leads up to an examination of banks singled out by the financial analysts. Optimally, the examiner receives a profile of the bank to be examined and a blueprint of the areas to be focused on with the most care.

The GAO report states, in essence, that the FDIC has recently established trust examiner specialist positions. Although the FDIC historically was the only one of the three federal bank regulatory agencies that did not designate trust examiner specialists as such, some FDIC bank examiners devoted a major portion of their examining time to trust work. However, it is correct that the FDIC has now established 14 trust examiner specialist positions and is in the process of filling these positions.

Recommendations (page 7-25)

We recommend that the Comptroller of the Currency invite FDIC and FRS to jointly evaluate its new examination approach. We further recommend that, in the event of a favorable assessment of the new process, the Board of Directors, FDIC, and the Board of Governors, FRS revise their examination processes to incorporate the concepts of OCC's approaches.

FDIC Response

In light of the limited testing that has been conducted (10 banks) of the OCC's new process, we believe it is premature to consider that process a success either for large or small banks. Representatives of the OCC admitted that, while the new procedures are workable in banks with assets between $50 million and $1 billion, they do not appear feasible for banks with assets of less than $25 million. We therefore question the logic and wisdom of GAO's recommendation that FDIC adopt such process, either for the large or small banks under our direct supervision, especially when it is recalled that 91% of the banks we directly supervise have assets of less than $50 million and 77% less than $25 million. Since the number of large banks directly supervised by the FDIC has and continues to increase, our examination process is necessarily designed to handle small, medium and large-sized banks. However, we shall follow closely OCC's experience with the new examination process as it undergoes further testing, and we remain receptive to further revision in our own examination approach which will be beneficial to and improve our supervisory capabilities.

In our judgment, the discussion of changes in FDIC's examination approach does not reflect sufficiently the impact and significance of those changes, especially with respect to our review of the management policies and internal controls of a bank under examination. We believe that the changes made by the FDIC represent, at the present time, the most logical, beneficial, and prudent improvements in the examination process. We have blended the proven techniques and practices with a new approach which we feel should enable FDIC to focus more directly on, and devote more time and effort to, problem and near-problem situations, and concomitantly less on healthy banks. We refer to excerpts from our General Memorandum #1, included with our general comments.

Recommendations (page 7-25)

We recommend that the Board of Directors, FDIC, the Board of Governors, FRS, and the Comptroller of the Currency jointly staff a group to analyze shared national credits at State and national lead banks under Federal supervision and that the three agencies use the uniform classification of these loans when they examine the participating banks.

We recommend that the Board of Directors, FDIC, the Board of Governors, FRS, and the Comptroller of the Currency work together to refine their monitoring systems and their approaches to examining for compliance with consumer credit laws.

FDIC Response

Although--as the GAO report points out--of the 183 participations in shared national credits traced by GAO only 19 were to state nonmember insured banks, the FDIC is now a participant in the Shared National Credits Program.

We are, of course, in favor of the three federal bank regulatory agencies sharing and working together in the important area of consumer credit compliance. However, in many instances healthy competition in the area of consumer credit compliance as well as in other areas of banking supervision between the three federal bank regulatory agencies can lead to a better system of supervision than complete uniformity. Thus, the development of an independent approach by one or more of the agencies may lead to a better end result.

CHAPTER 8

Our comments here cover the general theme of the chapter, namely the supervisory and enforcement practices of the three agencies and their "problem bank" criteria. We feel discussion of these vital subjects is desirable in order to place them in their proper perspective.

The FDIC serves the dual roles of bank supervisor and insurer. Accordingly, the FDIC "problem bank" definitions are based on those banks which pose the greatest degree of financial risk to the Corporation, with fine tuning of the designations into various gradations of risk. The three problem bank categories used are analagous to the three adverse classifications of Substandard, Doubtful, and Loss which the federal bank regulatory agencies utilize to designate assets of greater than normal risk.

There are no simple mechanical formulae that can be universally applied to determine whether or not an operating bank warrants FDIC problem bank status. Indeed, we believe a problem bank designation should only be imposed on a case-by-case basis after a comprehensive, in-depth analysis of the entire bank. Among the more important elements requiring analysis and evaluation are asset quality and liquidity, the margin of capital protection, the degree of stability or volatility in the bank's liability structure, the character and ability of its management, the bank's earnings performance, and its adherence to applicable laws and regulations. These elements are closely interrelated and, depending on the circumstances, each element may be

weighted differently. Accordingly, the FDIC disseminates general criteria--not specific guidelines--for the designation of problem banks to our Regional Directors in order to encourage independent judgment and provide some flexibility to meet the new areas of regulatory concern as they arise. The Washington Office of the Division of Bank Supervision then applies more standardized analysis and evaluation to the recommendations of our Regional Directors before determining whether to add a particular bank to or delete it from our list of problem banks. The listing themselves are not subject to approval by the Corporation's Board of Directors, although the Board regularly receives extensive information about all problem banks and may be directly involved in the imposition and enforcement of a corrective program with respect to particular banks.

FDIC also reviews examination reports of the FRS and the OCC, assesses the risk exposure which the banks examined by those agencies pose to the deposit insurance fund, and, where appropriate, designates state member and national banks as Other Problem, Serious Problem or Serious Problem-Potential Payoff. Although FDIC does not directly supervise these banks, we do follow closely the supervisory efforts of the other agencies, largely because of our financial stake in the outcome.

It should be noted that, with respect to banks under the direct supervision of the FDIC, an inferior financial condition is not the sole cause for more intense supervisory activity. Causes for concern

may be reflected in violations of laws or regulations, marginal management and policies, or a subpar financial condition which had not yet reached a level presenting an undue risk to the FDIC fund, and thus, does not warrant a formal prolbem designation. For example, the various Regional Offices maintain informal listings of banks which pose supervisory--but not financial--problems, and the Washington Office uses a computerized screening device which serves as an additional test for uncovering financial as well as non-financial supervisory problems.

The fundamental approach of FDIC to banks exhibiting supervisory problems or trends in that direction is to exercise preventive measures, that is to take necessary and appropriate measures early enough to keep the bank from deteriorating to a level requiring the assignment of a formal problem designation. As the GAO report points out, informal methods are generally relied upon, and experience indicates that these methods have largely been successful. One of the more useful methods of informal supervision which FDIC frequently employs has been effectively overlooked or ignored in your report. The method we refer to involves the use of the so-called "Letter Agreement." The Letter Agreement is used by our Regional Directors following an examination to confirm with bank directors a program which the Regional Director feels will, if adhered to, correct the situation. The Letter Agreement is not intended, and is not used, as a substitute for a formal written agreement entered

into under Section 8 of the Federal Deposit Insurance Act or cease and desist or termination of insurance proceedings, although the letter agreement may serve as a basis for such subsequent action. Its use is generally confined to corrective measures agreed to by a bank's board of directors when a bank first shows problem or near problem characteristics

In addition to the foregoing, the GAO report discusses the use of termination of insurance proceedings and states, in part, that canceling "a bank's deposit insurance does not solve its problems."

While this statement is perhaps literally true, it could be misleading. Termination of insurance authority has, through the years, proven to be an effective and useful remedial enforcement tool. The threat of instituting and the institution of such a proceeding has, in the vast majority of cases, been the vehicle for forcing a recalcitrant and/or poorly managed bank to take effective corrective measures.

The table in the report dealing with the GAO sample of 54 FDIC-supervised problem banks shows that a request for a formal response to reported deficiencies was made in 44% of the cases, that progress reports were requested in 41%, that a meeting with the bank's directors was requested in 30%, that there were written communications with 54%, 6% of the banks were visited, and that no credit is given for special examinations. We do not believe that the table presents an accurate picture of FDIC supervisory efforts. In point of fact, the Regional Director transmits a letter to each bank, reiterating the problems

disclosed, and requesting appropriate corrective efforts. Frequently, in the letter to bank management, the Regional Directors request periodic progress reports which often lead to other exchanges of correspondence or meetings with respect to progress, or lack of it, shown in the reports, a board meeting may be scheduled, or visitations or a follow-up examination may be held.

We note that the table shows that meetings with directors were held in only 30% of the banks. It is the FDIC's policy to have a board meeting in all problem situations. As indicated previously, in 1975, conferences were held with the management of banks on approximately 1,745 occasions, and 1,750 in 1976.

The GAO report, among other things, questions whether banks that remain on the problem list for a period of time are indeed problems. At year-end 1974, 76% of the FDIC supervised banks on our problem list had been on the list for less than two years, and at year-end 1975, 82%. In addition, at year-end 1975 only 16 banks had been on the problem list in excess of three years (out of a total of 8,925 FDIC-supervised banks.) To summarize, some form of formal supervisory action was taken in seven, or 44%, of the sixteen cases and informal supervisory actions achieved improvements in another seven, or 44%, of the sixteen cases. Correction of the problems in the remaining two banks is to a large degree dependent upon improvement in the severely depressed economy of the banks' market area. In calendar year 1976, two of the sixteen banks were rehabilitated and, since they

no longer warranted problem designation, were removed from the FDIC problem list. In addition, two others were removed from the list--one through merger into a healthy institution and the other was closed.

We also note in passing that a limited number of banks may present financial and/or supervisory problems of a continuing nature which, despite aggressive corrective efforts, do not lend themselves to a permanent and wholly acceptable solution. In such cases, the banks are not in serious enough condition to warrant either termination of their insured status or of their charter. It seems clear, however, that these banks should be continued as problem banks and receive special supervisory attention.

APPENDIX III

Recommendations (page 8-18)

We recommend that the Board of Directors, FDIC, the Board of Governors, FRS; and the Comptroller of the Currency establish more aggressive policies for using formal actions. Written guidelines should be developed to identify the types and magnitude of problems that formal actions could appropriately correct.

FDIC Response

Congress granted cease and desist powers in 1966 w h the enactment of Section 8(b) of the Federal Deposit Insurance Act. For several years thereafter, there was some reluctance to utilize Section 8(b) powers due mainly to a general misunderstanding of its purpose and usefulness. Prior to enactment of Section 8(b), the FDIC's only experience with formal administrative corrective measures was the termination of insurance proceedings, a severe form of action which could result in the removal of the deposit insurance coverage of a bank. Because of its severity, the Section 8(a) proceeding was used judiciously and only after all other means for accomplishing correction were exhausted. Apparently, albeit erroneously, that same rationale was largely applied to Section 8(b) proceedings. In addition, there was to a lesser extent an unwillingness to try something new. Commencing in 1970, a program to educate FDIC personnel as to the usefulness of Section 8(b) action was begun. The FDIC first used its cease and desist authority in 1971 and between 1971 and 1975 issued 38 cease and desist orders and three formal written agreements. In contrast, in a recent renewed effort to

foster the use and to test the effectiveness of cease and desist powers, in calendar year 1976 alone FDIC issued 24 such orders and five emergency orders. In addition, at year-end 1976, 18 more cease and desist actions were in various stages of process.

While cease and desist action is in most cases effective as a corrective measure, there are some instances where it may be of little or no use and could perhaps be counterproductive. For example, the recently experienced worst economic period since the great depression caused severe problems to the banking industry, many of which did not lend themselves to correction through use of the cease and desist powers. In short, it is not a panacea for the removal of all problems experienced by the banking community.

The recommendation for adoption of criteria for use in formal actions, contained in the last sentence of the recommendation, is troublesome. We would recommend against adopting formal criteria for use of Section 8, because the statutory criteria are adequate. The facts and circumstances of bank problems seem so varied, and the remedial actions can differ so much according to the problem, it would be inhibiting to have to work within the confines of additional written criteria. The adoption of such criteria could give the banks additional bases for contesting Section 8 actions.

Recommendation (page 8-49)

We recommend that the Board of Directors, FDIC, the Board of Governors, FRS, and the Comptroller of the Currency develop uniform criteria for identifying problem banks.

FDIC Response

We believe our general comments clarify the posture of the three federal bank regulatory agencies with respect to problem banks, including those which pose supervisory problems as well as those which present inordinate financial risk to the FDIC. Moreover, we do not believe there is confusion or wide disagreement among the bank regulatory agencies as to which banks should be accorded close surveillance and supervision by the respective agencies and that, except in a failing bank, and to a limited extent in a bank holding company situation, there is virtually no overlap of regulatory jurisdiction at the federal level. Furthermore, the need to develop common criteria for problem banks is not obvious and indeed may not be appropriate.

It is, we believe, appropriate and useful for the FDIC as an insurer to view what constitutes a problem bank from a somewhat different perspective than the other two federal bank regulatory agencies. In addition, the extent to which the three federal bank regulatory agencies use somewhat different approaches to the issue of banks in need of increased and intensified supervision could foster a greater degree of innovation in this area of supervisory endeavor and could serve as a

check and balance in the promotion of the widest coverage of such banks. Finally, the objectives and detached review process conducted by FDIC of all types of examinations, in order to assess the degree of financial exposure to the insurance fund, provides an overall review of all banks without imposing across-the-board guidelines which may not be suitable for the three agencies on an individual basis.

CHAPTER 9

The GAO report states:

"A recent FDIC study of 92 banks that failed between 1960 and September 1976 showed that 57.6 percent were caused by improper loans to officers, directors or owners, or by loans to out-of-territory borrowers...."

The experience noted above led to the issuance by FDIC in 1976 of a regulation entitled "§337.3 Insider Transactions," as part of the Corporation's "Unsafe and Unsound Banking Practices" regulations.

CHAPTER 10

The following is a brief summary of the operation of the FDIC Training Facility:

The Division of Bank Supervision (DBS) Training Center located in Rosslyn, Virginia, was established in February 1970 and presently has a permanent staff complement of seventeen. The training programs which it conducts are directed toward achieving professional proficiency and the maintenance of a highly qualified bank examination staff.

Career training is accomplished, in balance with field examination experience, primarily through our bank examination schools which are comprised of seven different schools or courses of study. Each school has a duration of two to three weeks. Subject schools include the basic examination schools: School for Assistant Examiners, designed for newly employed examining personnel; the School for Senior Assistant Examiners, which provides training in accounting, EDP, and consumer protection laws; the School for Examiners, which is designed for the development of the commissioned examiner; and the Basic Trust School, which deals with the basics of trust department examination. In addition, more senior training is provided through the Advanced Trust School, the Course in Examining a Computerized Bank, and the School for Commissioned Examiners. Subject matter within the various bank examination schools is well structured both with respect to material to be covered in the daily presentations as well as the pre-course study expected. Students ordinarily spend eight hours a day Monday through Friday in classroom and related work.

During the six-year period 1970 through 1975, 189 school sessions were held involving nearly 5,100 students. For the 1976 school year, we held 46 school sessions with approximately 1,200 students attending. Training is directed primarily towards FDIC personnel. However, during the period 1970 through 1975, training was provided for 549 state bank examiners, 28 students nominated by foreign government banking authorities, and 13 FRB examiners. The related figures for 1976 are 157, 22, and 7, respectively.

An additional and important operation of the Training Center is the Progress Evaluation Program for senior assistant examiners who are being considered for career advancement to the status of commissioned examiner. This program assesses a candidate's knowledge and proficiency in rules, regulations, and policies; loan analysis; and development of conclusions and recommendations after review of a report of examination. The program includes both written and oral portions. Findings of the progress evaluation are weighed as one of several factors in considering a senior assistant examiner for promotion to commissioned examiner status. Between 100 and 200 such candidates are evaluated annually. The evaluation utilizes a three-member panel of examiners over a three-day period for each candidate.

Recommendation (page 10-6)

We recommend that where feasible the Comptroller of the Currency; the Board of Directors, FDIC; and the Board of Governors, FRS, combine their examiner schools and standardize their curriculums.

FDIC Response

Although we find the comments and recommendations contained in the report on examiner training provocative, on balance we believe they did not afford sufficient treatment or depth to the various examiner training and educational programs offered by the FDIC.

We are especially dismayed by the fact that the GAO study largely ignores the operation of the FDIC Division of Bank Supervision (DBS) Training Center. The FDIC Training Center is undoubtedly the best bank examiner training program in the country. Nevertheless, because of our burgeoning training needs, the FDIC is considering constructing its own, larger facility with resident dormitory quarters. The FDIC has approached the FRS and the OCC to join with the Corporation in a cooperative training facility. Both the FRS and the OCC have evidenced interest in this project and discussions on a cooperative training effort are going forward. A brief summary of the operation of the FDIC DBS Training Center is included with our general comments.

Recommendations (page 10-11)

We recommend that the Board of Governors, FRS, (1) establish a full-time training office to operate its examiner training program and (2) carry out the revision of examiner school curriculums which it has recognized as needed for sometime.

We also recommend that the Comptroller of the Currency; the Board of Directors, FDIC; and the Board of Governors, FRS; increase their training in EDP, law, and accounting, as desired by their examiners.

FDIC Response

We plan to give further attention to this apparent need. It is worth pointing out in passing, however, that, at least with respect to EDP training, in addition to the regular basic EDP courses (Course in Examining a Computerized Bank (CECB) I and II), an advanced eight-week technical EDP school, known as Field Examiner Advanced Automation Training (FEAAT), is presently offered to examiners who have a desire to become highly proficient technically in EDP matters.

CHAPTER 11

The GAO report indicates that a cooperative effort among the federal bank regulatory agencies in the development of monitoring systems may have "speeded development" and mentions the need for continued coordination.

Each agency is in the process of developing or has developed monitoring systems and each has learned from its own experiences. We agree that there should be coordination among the agencies in these efforts and would point out that a significant amount of sharing and exchange of concepts and ideas has already been effected. However, as pointed out previously, there is also merit to the three agencies developing systems independent of one another. Innovation is fostered and a healthy competition to have the best system available could be beneficial to all the agencies. In addition, although the major objectives of the three federal bank regulatory agencies are similar, there are unique characteristics of each which may render the development of a system common to all inappropriate. While we do not presume to comment on the unique needs of the OCC and FRS, central to the FDIC's needs is the development of a system to cope with the substantial number of small and medium sized as well as a significant number of large sized banks under our direct supervision. Thus, in the case of FDIC, a system that is sufficiently flexible to meet the needs of supervising large sophisticated banks, as well as smaller less complicated banks, is apparently what is required.

Of course, adequate staffing and gathering accurate data on a timely basis are two vital elements in the development, implementation, and maintenance of any monitoring system. The FDIC is moving forward in its efforts to satisfy these essential elements. Finally, FDIC has, in the main, completed the testing phase of our monitoring systems and is in the process of integrating them into our examination process.

The GAO report states that an OCC official indicated that the interagency system for processing bank data was inadequate because banks were not meeting established reporting deadlines and FDIC took approximately four months to keypunch and computer-edit the system.

The FDIC does maintain the bank reported financial data for all insured banks supervised by the OCC, FRS and FDIC. Data submitted by the national and state member banks are initially processed by the FRS and submitted to the FDIC for edit testing and acceptance into the finalized data base from which all of these agencies draw information. The OCC is correct in asserting that the FDIC has taken up to four months to process all of the reports from some 15,000 insured banks and to produce a final data base. However, delays in receipt of correction data from the OCC and FRS where edit tests have failed on banks under their respective supervision have been a major factor in the finalization of the data base. Efforts are being made to

obtain agreement among the agencies on edit-check criteria so that corrections can be made on a more timely basis.

In order to meet both the monitoring and other needs dependent on bank reported financial data, it would, of course, be to the benefit of all agencies to derive a set of editing criteria which would produce an acceptable financial data base with greater alacrity.

Recommendation (page 11-8)

We recommend that either (1) the Board of Directors, FDIC; the Board of Governors, FRS; and the Comptroller of the Currency jointly establish a more effective mechanism to combine their forces in undertaking significant initiatives to improve the bank supervisory process or in attacking and resolving common problems; or (2) the Congress enact legislation to establish a mechanism for more effective coordination. We would be glad to assist the committees in drafting appropriate legislation.

FDIC Response

We recognize the merit of resolving common problems of the three agencies through closer coordination and cooperation. Indeed, there is at the present time a substantial exchange of information between the agencies' headquarters as well as at the field levels. However, if there is any merit to the concept of separate federal supervisory agencies, and to a dual banking system with state and federal supervision of banks, the benefit would seem to be the opportunity to try different approaches and to have a diversity of examination and supervisory procedures. The possibility of useful innovation and improvement in the bank examination and supervisory processes is greater if there are several agencies trying different approaches than if every change in examination methodology required approval of all the agencies. Nevertheless, the possibility of establishing a particular vehicle for the agencies to resolve common problems and take joint efforts in new initiatives will receive serious consideration.

FDIC ADDENDUM

We note that the draft GAO report is silent with respect to the planning and modernization efforts undertaken by FDIC in recent years to keep our supervisory activities abreast of economic, technical, and social developments. We have attached a digest of our planning and implementation of those planning efforts.

In 1965, an exhaustive analysis of the examination and supervision functions of the Corporation, similar in many respects to the Haskins and Sells study of the OCC, was undertaken by a committee of three experienced field examiners who were detailed to the Washington Office. Some of the recommendations flowing from that study were:

- Increased emphasis on examination-by-exception techniques with at least an annual visitation to each bank under our supervision
- Mutual interchange of (non-confidential) data with state banking departments
- The establishment of effective guidelines for the volume of loans which should be analyzed in a given bank
- Development of a program of procedural audits of certain banks and furnishing audit assistance by the Corporation to some banks upon request
- Revision of the report of examination to make it more usable to bank managements and the supervisory functions of the Corporation
- Adoption of recommended policies by the Corporation in regard to asset reserves, common capital stock, classification of assets, and utilization of termination of insurance proceedings
- Publication of the Corporation's policies
- Limitation of field investigations of statutory applications to those which are of significance in respect to competitive and bank soundness considerations
- Development of more efficient application and investigation forms

- Streamlining and expediting of application processing within the Corporation
- Delegation of authority to the Regional Directors for acting on certain statutory applications
- Restructuring of the geographic and managerial composition of the Regions
- Internal revisions designed to follow a specialized, functional approach promoting better communications and training
- Utilization of automated systems to aid in scheduling examinations, the review of examination reports, and gathering information in connection with statutory applications
- Expansion of EDP training programs, and the selection and training of examiner personnel in the managerial aspects of computer operations
- Strengthening of requirements for commissioned examiners as well as revisions of the centralized evaluating process
- Expansion and intensification of training of examiner personnel, including the executive levels
- Conducting periodic staff meetings to include both Regional and Washington Office senior personnel
- The interchange of senior examining personnel with other Federal agencies for short periods of time
- The revision and enhancement of expense allowances for travel and relocations.

Long range planning programs have been continuous since the 1965 study. The Projects and Planning Branch of the Division of Bank Supervision was established in 1971, and the Board of Directors created the Office of Corporate Planning in 1974. Developments at the Corporation within the past five years or so, flowing from planning efforts, and paralleling recommendations in the Haskins and Sells study, include:

- Implementation of completely revised examination report formats for commercial banks (late 1969) and mutual savings banks (late 1972)
- Development in 1970 of an extensive training center for our personnel as well as those of the Federal Reserve, Comptroller, State Banking Departments, and some foreign students
- Reorganization of the Washington Office of the Division of Bank Supervision along functional lines and the addition of a legal counsel to our Regional structure in 1971
- Extensive revision of the Manual of Examination Policies was begun in 1972
- New forms for filing and investigating statutory applications were developed and implemented between 1971 and 1973
- Delegation in 1973 of specifically defined authority to the Regional Directors for approval of all statutory applications except those involving mergers and the granting of deposit insurance
- Limitation on actual field investigations of statutory applications to those situations where the competitive or overall bank soundness considerations made them necessary

- Dissemination of the Corporation's policy statements and decision guidelines was begun in 1970
- The development of automated early warning, trend analysis, consumer loan evaluation, and review-by-exception systems was initiated in 1971
- Emphasis was substantially increased on training programs and specialization, particularly in the areas of automation, trust, and international activities (although FDIC has limited direct involvement in the international field)
- The development of guidelines and the initiation of experimentation with an examination-by-exception program which emphasizes the evaluation of management and systems
- Study, experimentation, and implementation of statistical sampling as part of the examination process
- More widespread application of disclosure requirements in connection with securities offerings by banks
- The development of a new examination report for trust departments and a complete revision of the Manual of Examination Policies relating to trust activities, and selection of Trust Specialists in order to provide more expertise in this complex area of bank examination.

Other FDIC planning efforts include reviewing considerations of overlapping regulatory functions resulting in the development of a recommendation for regulatory reform, the experimental Selective Withdrawal

from Examination Program, and an experiment in conducting separate compliance examinations, aimed largely at measuring adherence by banks with consumer-oriented laws, regulations and policies.

A separate Office of Bank Customer Affairs was created in early 1975 to oversee a variety of depositor and consumer-oriented functions. In addition, a Consumer Affairs Unit within the Division of Bank Supervision was established in 1971 and continues in operation.

Additionally, our examination staff has been expanded from about 900 in 1960 to approximately 2,000 at year-end 1975, and we expect to add approximately 150 more examination personnel annually during the next few years, spaced so as to allow efficient assimilation into our examination corps.

Considerable effort has been expended on the development of information systems, and data contained in Call and Income and Dividend Reports have been available to the public since 1972.

Along with the development of early warning systems, the Corporation has increased its emphasis on the potential risks to the insurance fund flowing from larger banks, liquidity, earnings performance as an indicator of overall bank soundness, and failure to use or untimely use of enforcement measures. Early and more detailed review of problem and near-problem situations at the Board level has led to an expanded review staff, and our experiences in problem situations prompted issuance of a regulation governing insider transactions in banks under our direct supervision.

SURVEY OF COMMERCIAL BANKERS

We sampled commercial bankers' opinions about Federal bank supervision and examination. We mailed a questionnaire to a randomly selected sample of commercial banks operating as of December 31, 1975. Our sample was drawn from lists of banks supervised by the three Federal agencies.

SAMPLE DESIGN

From our lists of banks we drew two samples. One sample comprised banks which were receiving special supervisory attention at the end of 1975--the so called "problem banks." We randomly selected about 50 percent of these banks (203) regardless of their deposit size.

The other sample comprised banks which were not receiving special supervisory attention (1,475). They were selected to provide a representative sample of banks of different deposit sizes. (See ch. 12.) In all, the questionnaire was sent to the chief executive officers of 1,678 banks, and 1,501, or nearly 90 percent were returned.

THE QUESTIONNAIRE

Following is a copy of our questionnaire. The percents associated with each response represent all banks who answered a given question.

U.S. GENERAL ACCOUNTING OFFICE

SURVEY OF COMMERCIAL BANKS

INSTRUCTIONS:

The purpose of the questionnaire is to identify the perceptions and attitudes of bank management on the examination and supervisory processes as they affect bank operations. You will be asked to consider the impact of examining personnel on your bank, the effectiveness of communications between the supervisory agencies and banks, and your assessment of possible positive and negative aspects of these same supervisory/regulatory processes.

The completed questionnaire should represent the views of senior bank management.

We would like you to respond to each question. Some questions may appear to require a review of records in order to respond. Please do not perform any extensive review but rather provide your most informed estimate.

The questionnaire is numbered only to permit us to delete your bank's name from our list when we receive your completed questionnaire and thus avoid sending you an inappropriate follow-up request.

There are numbers printed beside the response boxes to assist our keypunchers in coding the responses for computer analysis. Please disregard these numbers.

I. BANK CHARTER AND NEW BRANCH APPLICATIONS

1. For how many years has your bank held its present charter? *(Check one.)*

   1) ☐ 5 years or less 8.5
   2) ☐ 6-10 years 5.0
   3) ☐ 11-15 years 6.3
   4) ☐ 16-20 years 2.6
   5) ☐ more than 20 years 77.5

2. Was your bank previously chartered at another governmental level, within the last 10 years, i.e., if currently a national bank, did bank previously hold a state charter; if currently a state bank, did bank previously hold a national charter? *(Check one.)*

   1) ☐ yes 4.0
   2) ☐ no 96.0

3. About how many applications to open new branches have you made within the last 10 years? *(Check one.)*

   1) ☐ none **(go to question 6)** 57.4
   2) ☐ 1-5 29.5
   3) ☐ 6-10 6.6
   4) ☐ 11-15 2.8
   5) ☐ 16-20 0.8
   6) ☐ over 20 2.9

4. What is the typical length of time between the date of application for a new branch and the date of approval or rejection of that application? *(Check one.)*

   1) ☐ 2 months or less 21.2
   2) ☐ 3-4 months 46.7
   3) ☐ 5-6 months 19.8
   4) ☐ 7-12 months 8.8
   5) ☐ 13-18 months 2.2
   6) ☐ over 18 months 1.3

5. How reasonable does the length of time between application and approval/rejection seem to you? *(Check one.)*

   1) ☐ very reasonable 40.2
   2) ☐ somewhat reasonable 36.5
   3) ☐ undecided 4.9
   4) ☐ somewhat unreasonable 15.1
   5) ☐ very unreasonable 3.3

II. BANK'S PERCEPTIONS CONCERNING THE EXAMINATION PROCESS

6. How does your bank usually first learn of the plans for an impending Federal examination? *(Check one.)*

    1) ☐ written notice 0.4
    2) ☐ telephone call 1.1
    3) ☐ personal visit 0.9
    4) ☐ arrival of examiners at the bank 97.5
    5) ☐ other *(please describe)* ______ 0.1

7. In general how much advance notice of an examination does your bank receive? *(Check one.)*

    1) ☐ no advance notice 98.1
    2) ☐ some notice but less than 2 days 0.9
    3) ☐ 2-5 days 0.5
    4) ☐ 6-10 days 0.2
    5) ☐ 11-15 days 0.1
    6) ☐ 16-20 days 0.1
    7) ☐ more than 20 days 0.1

8. Which of the following best describes the kind of preparation required of your bank prior to the arrival of the Federal bank examiners? *(Check one, or more if necessary.)*

    78.9 1) ☐ no preparation necessary
    4.1 2) ☐ preparation for a minimal amount of manual retrieval of data
    1.5 3) ☐ preparation for an extensive amount of manual retrieval of data
    3.2 4) ☐ preparation for production of a minimal number of computer printouts
    1.9 5) ☐ preparation for production of an extensive number of computer printouts
    1.1 6) ☐ extensive rescheduling of personnel and activities to meet examiner's plans

9. To what extent, if any, do Federal examinations place a burden on bank operations, personnel time, customer time and convenience? *(Check one for each row)*

BURDEN	1. Little or no extent	2. To some extent	3. To a moderate extent	4. To a large extent	5. To a very large extent
1. Bank operations	17.7	36.0	35.0	9.9	1.4
2. Personnel time	6.6	32.7	42.5	15.4	2.8
3. Customer time and convenience	61.0	25.9	11.0	1.6	0.5

10. In a typical examination, about how long are at least some bank examiners present on bank premises? *(Check one.)*

    1) ☐ less than 2 weeks 68.6
    2) ☐ from 2 to less than 4 weeks 20.2
    3) ☐ from 4 to less than 6 weeks 5.8
    4) ☐ from 6 to less than 8 weeks 2.6
    5) ☐ from 2 to less than 3 months 1.7
    6) ☐ from 3 to less than 4 months 0.7
    7) ☐ from 4 to less than 5 months 0.3
    8) ☐ more than 5 months 0.1

11. In general, how would you rate the Federal examiners with respect to (1) their knowledge of banking and (2) their professional demeanor?

FEDERAL EXAMINERS	1. More than adequate	2. Adequate	3. Borderline	4. Inadequate	5. Very inadequate
1. Knowledge of banking	24.0	67.8	6.4	1.4	0.4
2. Professional demeanor	29.5	63.1	6.4	0.8	0.2

12. More specifically, how would you rate the competence of the Senior Federal examiner in the following areas? *(Check one rating for each row.)*

COMPETENCE OF THE SENIOR FEDERAL EXAMINER	1. More than adequate	2. Adequate	3. Borderline	4. Inadequate	5. Very inadequate
1. Ability to determine quality of loans	27.6	66.5	5.1	0.7	0.1
2. Knowledge of banking laws and regulations	42.6	56.0	1.3	NR	0.1
3. Ability to assess capital adequacy	25.3	66.3	7.2	0.9	0.3
4. Ability to assess adequacy of internal controls	20.2	68.4	10.3	1.0	0.1
5. Ability to evaluate the competence of management	19.0	67.4	11.7	1.4	0.5
6. Ability to evaluate the integrity of management	20.8	67.5	9.5	1.5	0.6
7. Ability to evaluate the impact of growth on bank soundness	18.4	67.7	11.5	2.1	0.3
8. Ability to evaluate the adequacy of liquidity	25.5	65.9	7.2	1.1	0.3
9. Ability to determine the impact of self-dealings on soundness	25.3	68.0	5.7	0.7	0.3
10. Ability to integrate detailed information into a comprehensive picture of bank operations	20.1	68.1	10.0	1.4	0.4
11. Other (please describe)					

NR– No Response

13. In general, how adequate or inadequate is the Senior Federal Examiners' understanding of the following specialized areas? *(Check one rating for each row.)*

SENIOR FEDERAL EXAMINER, SPECIALIZED AREAS	1. More than adequate	2. Adequate	3. Borderline	4. Inadequate	5. Very inadequate	6. Not applicable
1. Trust operations	20.3	68.4	9.7	1.3	0.3	
2. Electronic data processing	9.3	65.9	19.7	4.2	0.9	
3. International operations	17.8	70.7	8.6	2.6	0.3	

14. Listed below are several possible purposes or objectives of bank examinations. First, review this list. Then check the five items which you consider to be the most important, regardless of the agency's priorities. *(Be sure to mark all your selections in column 1. Second, and conversely, again review the list, but this time check the five items which you consider to be the least important in column 2.)*

	RANK	Most Important	Least Important	RANK
1. Assurance that external pressures are not leading to unsound banking practices	8	24.2	37.7	5
2. Evaluation of internal control, including internal audit	5	42.1	13.9	10
3. Presentation of an integrated picture of bank operations	13	7.3	64.0	2
4. Determination of existence of conflicts of interest	11	11.7	28.4	7
5. Protection of the safety of depositors' funds	1	64.5	4.7	14
6. Evaluation of portfolio balance/imbalance	12	10.2	44.1	4
7. Determination of existence of self-dealings	10	17.6	22.9	8
8. Forecast of trends in the banking industry	15	2.6	76.1	1
9. Compliance with laws and regulations	3	59.4	5.8	13
10. Evaluation of deposit volatility	14	5.0	52.1	3
11. Evaluation of capital adequacy	6	35.6	10.1	11
12. Evaluation of asset quality	2	63.3	4.4	15
13. Evaluation of management	4	50.1	9.8	12
14. Evaluation of liquidity	7	29.4	15.0	9
15. Evaluation of earnings	9	21.4	30.1	6
16. Other (Please specify)				

15. To answer this next question, we ask you to again consider this list, but from a different point of view. From your experience, which five items do you think the agency considers to be the most important? *(Indicate your answer by checking the appropriate boxes in column 1.)* Conversely, which five do you think the agency considers to be the least important? *(Check five boxes in column 2.)*

	RANK	Most Important	Least Important	RANK
1. Assurance that external pressures are not leading to unsound banking practices	10	12.6	43.7	4
2. Evaluation of internal control, including internal audit	5	42.0	13.6	10
3. Presentation of an integrated picture of bank operations	13	5.2	63.4	2
4. Determination of existence of conflicts of interest	9	20.0	22.3	7
5. Protection of the safety of depositors' funds	4	48.5	6.2	12
6. Evaluation of portfolio balance/imbalance	12	12.3	39.1	5
7. Determination of existence of self-dealings	8	20.5	19.2	8
8. Forecast of trends in the banking industry	15	1.8	70.5	1
9. Compliance with laws and regulations	1	73.7	1.9	15
10. Evaluation of deposit volatility	14	4.3	53.4	3
11. Evaluation of capital adequacy	3	55.1	4.5	14
12. Evaluation of asset quality	2	57.5	5.2	13
13. Evaluation of management	7	32.5	14.7	9
14. Evaluation of liquidity	6	35.3	10.7	11
15. Evaluation of earnings	11	12.4	37.1	6
16. Other (Please specify)				

APPENDIX IV

16. Does the examiner spend enough time in examining your bank?

1)	☐ yes	72.2
2)	☐ probably yes	23.2
3)	☐ undecided	1.5
4)	☐ probably no	2.2
5)	☐ no	0.9

17. Indicate whether or not you feel the bank examiner pays the appropriate amount of attention to each area. *Do this by checking one of the scale positions on the numbered boxes provided below. For example, if you feel the examiner spends either too little or too much time in a particular area, you should check an appropriate box at the end, or near the end of the scale. On the other hand, if you feel the examiner's time is appropriately allocated, check either a middle box or one of the boxes near the middle.*

Too much attention (left) — Too little attention (right)

Area	1	2	3	1–3 total	4	5	6	7	5–7 total
1) Loan Assessment	7.5	12.7	21.2	41.4	52.3	3.9	1.8	0.6	6.3
2) Capital Adequacy	5.8	9.7	19.3	34.8	55.5	6.3	2.9	0.5	9.7
3) Internal Control	3.8	7.8	18.8	30.4	47.0	13.7	7.0	1.9	22.6
4) Management Assessment	3.1	4.9	15.2	23.2	48.3	15.9	10.3	2.3	28.5
5) Compliance with Banking Laws and Regulations	8.7	13.1	18.2	40.0	50.3	5.5	3.2	1.0	9.7
6) Other *(Specify)*	☐	☐	☐		☐	☐	☐	☐	

18. From the viewpoint of bank management, how useful is the bank examination process? *(Check one.)*

1)	☐ of little or no use	1.0
2)	☐ a small degree of use	6.6
3)	☐ a moderate degree of use	33.3
4)	☐ a high degree of use	46.1
5)	☐ a very high degree of use	13.0

19. To what extent would you agree or disagree with the following statements about the Federal examination process? *(Check one for each row.)*

	1. Strongly agree	2. Moderately agree	3. Neither agree nor disagree	4. Moderately disagree	5. Strongly disagree
1. The examination process is useful in providing an independent appraisal of bank soundness	43.3	47.2	6.1	2.6	0.8
2. The examination process is useful to bank management in preventing bank failure	20.9	40.9	20.6	12.6	5.0
3. The examination process is useful in providing recognition and encouragement of the quality of officer and employee performance	8.0	27.8	32.6	21.9	9.7
4. The examination process is useful to bank management in forecasting future trends	2.1	11.2	33.3	33.5	19.9
5. The examination process is useful to bank management through recommending a course for future action	7.4	37.9	27.2	19.2	8.3
6. The examination process is useful to bank management in identifying potential problems	26.9	57.4	9.6	4.8	1.3
7. Other **(Please specify)**					

IF YOUR BANK IS A NATIONAL BANK, PLEASE GO TO No. 22.

20. How are State examinations typically conducted?

17.7 1) ☐ Coordinated but not conducted concurrently with the Federal agency.

41.6 2) ☐ concurrently with the Federal agency

40.7 3) ☐ independently of the Federal agency

21. From your experience, how much better or worse are the state examinations than the Federal examinations from each of the following aspects?

ASPECTS OF STATE EXAMINATIONS	1. Much better than Federal	2. Better than Federal	3. About the same as Federal	4. Worse than Federal	5. Much worse than Federal
1. Usefulness of state examinations	3.1	6.2	75.3	13.6	1.8
2. Scope of state examinations	1.8	6.6	80.6	9.4	1.6
3. Competence of examining personnel	1.6	5.1	64.0	25.2	4.1
4. Other (please specify)					

22. Some observers have asserted that there are inconsistencies in communications received by banks from the Federal supervisory agencies. Others disagree. They feel that in general communications are basically consistent. To what extent, if at all, has your bank experienced the communications problems characterized by the various situations described below?

COMMUNICATION PROBLEMS	1. Little or no extent	2. To some extent	3. To a moderate extent	4. To a large extent	5. To a very large extent
1. Disparity between guidance given in the examination report and other written guidance from <u>same</u> supervising agency	77.8	15.0	5.2	1.3	0.7
2. Disparity between <u>formal</u> communications from an agency and <u>informal</u> contacts with personnel from that <u>same</u> agency	69.1	20.2	7.3	2.4	1.0
3. Disparity between communications received from two or three <u>different</u> Federal agencies a/	57.4	26.0	11.1	3.7	1.8

a/ We believe that an unknown percentage of respondents interpreted the phrase "different Federal agencies" to mean other Federal agencies such as the Internal Revenue Service, and Securities and Exchange Commission, and not merely the three Federal bank supervisory agencies. This belief is based on conversations we held with several national and state nonmember bankers who answered this question.

APPENDIX IV

III. EXAMINATION REPORT AND COMMUNICATION

23. a) In the last 5 years how many times has your bank been examined? *(Indicate your answer by circling a number.)*

NO. OF TIMES BANK EXAMINED

3 or less 4 5 6 7 8 9 10 or more

24. a) In how many examination reports, if any, have you noticed a situation where major deficiencies, as noted in the text, were left out of the "comments and conclusions" page? *(Check one.)*

NO. OF REPORTS WHERE DEFICIENCIES WERE LEFT OUT

0 1 2 3 4 5 6 7 8 9 10 or more

25. a) Also in how many of these reports, if any, have you noticed a situation where deficiencies reported in "comments and conclusions" page were not supported by the text? *(Circle one.)*

OF REPORTS WHERE DEFICIENCIES WERE NOT SUPPORTED

0 1 2 3 4 5 6 7 8 9 10 or more

26. To what extent if at all do the bank examiners discuss their findings with the bank management before leaving to write their report? *(Check one.)*

0.6	1) ☐	little or no discussion
8.1	2) ☐	some general discussion of content area
27.0	3) ☐	general discussion of content area
22.6	4) ☐	detailed discussion of content area
41.7	5) ☐	detailed discussion of content area and findings

a) DATA NOT AVAILABLE FOR QUESTIONS 23, 24, and 25.

27. How long after the examination is completed do you usually have to wait for the report? *(Check one.)*

1) ☐	less than a month	18.4
2) ☐	from 1 to less than 2 months	59.0
3) ☐	from 2 to less than 3 months	16.4
4) ☐	from 3 to less than 4 months	4.3
5) ☐	from 4 to less than 5 months	1.1
6) ☐	from 5 to less than 6 months	0.7
7) ☐	six months or more	0.1

28. Rate the clarity with which the examination reports usually explain the nature and extent of the problems, if any. *(Check one.)*

1) ☐	very clear	32.3
2) ☐	generally clear	63.5
3) ☐	borderline	3.8
4) ☐	generally unclear	0.3
5) ☐	very unclear	0.1

29. In your opinion, how effective or ineffective is the Federal supervisory process, including examinations, in achieving each of the following objectives? *(Check one for each row.)*

	a) RANK	1. Very effective	2. Effective	3. Borderline	4. Ineffective	5. Very ineffective
1. Assurance that external pressures are not leading to unsound banking practices	13	6.6	45.6	32.8	12.3	2.7
2. Presentation of an integrated picture of bank operations	15	4.3	42.2	36.7	14.4	2.4
3. Evaluation of internal controls, including internal audit	6	11.4	59.9	23.5	4.9	0.3
4. Determination of existence of conflicts of interest	10	8.3	56.4	28.1	6.8	04
5. Protection of the safety of depositors' funds	3	21.6	64.9	12.0	1.4	0.1
6. Evaluation of portfolio balance/imbalance	9	8.7	56.9	28.7	5.2	0.5
7. Determination of existence of self-dealings	8	10.0	57.5	25.5	6.0	1.0
8. Forecast of trends in the banking industry	16	1.7	18.3	40.3	28.8	10.9
9. Evaluation of international operations	12	7.5	50.4	27.7	9.6	4.8
10. Compliance with laws and regulations	1	33.0	61.7	4.7	0.5	0.1
11. Evaluation of deposit volatility	14	5.3	46.7	36.3	10.2	1.5
12. Evaluation of capital adequacy	5	16.0	66.5	14.0	3.1	0.4
13. Evaluation of asset quality	2	18.8	70.0	9.6	1.3	0.3
14. Evaluation of management	11	8.3	56.2	27.4	6.9	1.2
15. Evaluation of liquidity	4	15.3	69.1	12.7	2.5	0.4
16. Evaluation of earnings	7	8.8	59.7	23.6	6.6	1.3
17. Other (Please specify)						

a) The rank order is based on the sum of the "very effective" and "effective" responses.

IV. OVERALL OPINION ON BANK SUPERVISION

30. There are both advantages and disadvantages to Federal supervision of banking. In the following three questions, we have listed some of these. You are asked to consider the advantages and disadvantages and then to rate em according to the amount of advantage disadvantage brought to the banking industry as a result of Federal supervision.

(1) First, consider the advantages. How great or how small are the advantages that are realized by the banking industry? *(Check one for each row.)*

ADVANTAGES	1. Very small or no advantage	2. Some advantage	3. Moderate advantage	4. Substantial advantage	5. Very great advantage
1. Availability of supervisory agency personnel for advice and consultation	16.0	30.7	24.3	22.7	6.3
2. Restriction of the extremes in competition	27.9	27.2	29.7	12.0	3.2
3. External review of Bank's internal audit and control procedures	8.3	27.3	33.4	25.7	5.3
4. Contribution toward the prevention of bank failure	7.4	23.2	28.8	30.5	10.1
5. Protection of the industry by an entrance screening to reject unsound applicants	17.7	21.9	24.0	25.5	10.9
6. Protection of the industry by maintaining a deposit insurance fund	3.8	9.4	11.4	28.3	47.1
7. Other (specify)					

(2) Second, consider the disadvantages listed below. How great or how small do you think these disadvantages are? Consider each of the disadvantages separately. *(Check one for each row.)*

DISADVANTAGES	1. Very small or no disadvantage	2. Some disadvantage	3. Moderate disadvantage	4. Substantial disadvantage	5. Very great disadvantage
1. Supervision restricts flexibility of bank operations	44.6	33.1	16.9	4.4	1.0
2. Examination takes up time of bank personnel	35.4	38.3	18.1	6.7	1.5
3. Examining personnel use bank facilities	55.5	26.8	12.8	4.0	0.9
4. Examination makes a possible contribution to the continued operation of inefficient banks	58.0	22.4	14.4	3.6	1.6
5. Examination duplicates other types of external review	52.8	24.9	15.9	4.1	2.3
6. Other (specify)					

(3) Third, consider both the advantages and disadvantages to the banking industry. Do you think the advantages outweigh the disadvantages, or do you think the converse is true? *(Check one.)*

48.2 1) ☐ Advantages substantially outweigh the disadvantages

41.0 2) ☐ Advantages outweigh the disadvantages

7.8 3) ☐ Advantages and disadvantages balance equally

2.7 4) ☐ Disadvantages outweigh the advantages

0.3 5) ☐ Disadvantages substantially outweigh the advantages

31. The following are four possible alternatives for organizing bank supervisory agencies. Consider each, and indicate the degree to which you oppose or support the particular alternative. *(Check one for each row.)*

ORGANIZATION ALTERNATIVES	1. Strongly oppose	2. Generally oppose	3. Neither oppose nor support	4. Generally support	5. Strongly support
1. Present situation with three Federal supervisory agencies and State supervisory agencies	9.4	15.6	16.6	32.4	26.0
2. The present three Federal supervisory agencies but no State supervisory agencies	49.2	26.0	13.3	8.0	3.5
3. Only one Federal supervisory agency and retain present State supervisory agencies	25.2	18.6	14.2	23.3	18.7
4. Only one Federal supervisory agency and no State supervisory agencies	65.4	15.9	8.0	4.9	5.8
5. Other (specify)					

32. The following are possible changes to the existing Federal examination process. Do you support or oppose these changes? *(Check one for each row.)*

POSSIBLE CHANGES	1. Strongly support	2. Generally support	3. Undecided	4. Generally oppose	5. Strongly oppose
1. Restricting examinations to only very large banks	1.4	2.6	3.5	26.9	65.6
2. Restricting examinations to only medium sized banks	0.8	1.7	3.9	26.6	67.0
3. Restricting examinations to only smaller banks	0.6	0.8	2.9	23.8	71.9
4. Restricting examinations to only banks requiring special supervisory attention	3.0	7.4	6.8	29.2	53.6
5. Increasing the frequency of examinations for all banks	1.5	4.3	7.9	38.2	48.1
6. Decreasing the frequency of examinations for all banks	5.7	18.7	15.7	34.8	25.1
7. Providing the opportunity for banks to be examined on their request, in addition to the regular examination	17.0	44.9	20.5	7.4	10.2
8. Other (specify)					

33. In the following question, you are asked to evaluate several possible changes to Government involvement in the banking industry. *Do this by checking one of the scale positions on the numbered boxes provided below. For example, if you feel a possible change would be "Beneficial" or "Detrimental," you should check an appropriate box at the end, or near the end of the scale. On the other hand, if you feel there is little choice, check either a middle box or one of the boxes near the middle.*

Indicate the degree to which you feel the changes are beneficial or detrimental.

(Scale: 1 = Beneficial ... 7 = Detrimental)

Item	Beneficial (1–3) total	1	2	3	4	5	6	7	Detrimental (5–7) total
1) Elimination of chartering by the Federal Government	10.6	5.5	2.3	2.8	19.0	6.3	17.2	46.9	70.4
2) Elimination of chartering by State Governments	11.9	6.1	2.7	3.1	16.5	4.5	16.8	50.3	71.6
3) Elimination of the requirement for government approval for bank branches	13.8	6.3	3.3	4.2	13.4	7.0	17.5	48.3	72.8
4) Elimination of the requirement for government approval for bank mergers	10.2	4.2	2.5	3.5	12.2	8.4	20.0	49.2	77.6
5) Elimination of all governmental bank examinations	5.4	3.1	1.0	1.3	6.8	2.9	13.7	71.2	87.8
6) Elimination of bank regulations entirely	5.4	3.4	0.6	1.4	5.2	3.8	9.5	76.1	89.4
7) Elimination of bank supervision entirely	4.3	3.1	0.8	0.9	5.1	2.7	10.3	77.1	90.1

8) Other *(specify)*

Beneficial 1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐ 6 ☐ 7 ☐ Detrimental

V. ADDITIONAL COMMENTS

34. If you have additional comments on any of the items within the questionnaire or topics not covered, please express your views below on this page. Your answers and comments will be greatly appreciated.

PRINCIPAL OFFICIALS RESPONSIBLE FOR ADMINISTERING ACTIVITIES DISCUSSED IN THIS REPORT

	Tenure of office	
	From	To
DEPARTMENT OF THE TREASURY		
SECRETARY OF THE TREASURY:		
W. Michael Blumenthal	Jan. 1977	Present
William E. Simon	May 1974	Jan. 1977
George P. Shultz	June 1972	May 1974
John B. Connally	Feb. 1971	June 1972
David M. Kennedy	Jan. 1969	Feb. 1971
OFFICE OF THE COMPTROLLER OF THE CURRENCY		
COMPTROLLER OF THE CURRENCY:		
Robert Bloom (acting)	July 1976	Present
James E. Smith	July 1973	July 1976
Justin T. Watson (acting)	Mar. 1973	July 1973
William B. Camp	Nov. 1966	Mar. 1973
FIRST DEPUTY COMPTROLLER (note a):		
Justin T. Watson	Sept. 1962	July 1975
FIRST DEPUTY COMPTROLLER FOR POLICY (note a):		
Robert Bloom	Aug. 1975	Present
FIRST DEPUTY COMPTROLLER FOR OPERATIONS (note a):		
H. Joe Selby	Aug. 1975	Present

	Tenure of office	
	From	To
FEDERAL DEPOSIT INSURANCE CORPORATION		
Board of Directors		
CHAIRMAN:		
Robert E. Barnett	Mar. 1976	Present
Frank Wille	April 1970	Mar. 1976
COMPTROLLER OF THE CURRENCY:		
Robert Bloom (acting)	July 1976	Present
James E. Smith	July 1973	July 1976
Justin T. Watson (acting)	Mar. 1973	July 1973
William B. Camp	Nov. 1966	Mar. 1973
DIRECTOR:		
George A. LeMaistre	Aug. 1973	Present
Vacant	Mar. 1973	Aug. 1973
Irvine H. Sprague	July 1968	Mar. 1973
Division of Bank Supervision		
DIRECTOR:		
John J. Early	Aug. 1975	Present
John J. McCarthy Jr. (acting)	June 1975	Aug. 1975
Edward J. Roddy	Sep. 1971	June 1975
John L. Flannery	Sep. 1969	Sep. 1971
FEDERAL RESERVE BOARD		
CHAIRMAN, BOARD OF GOVERNORS:		
Arthur R. Burns	Feb. 1970	Present
VICE-CHAIRMAN, BOARD OF GOVERNORS:		
Stephen S. Gardner	Feb. 1976	Present
George W. Mitchell	May 1973	Feb. 1976
J. L. Robertson	Mar. 1966	Apr. 1973

		Tenure of office	
		From	To
Division of Banking Supervision and Regulation			
DIRECTOR:			
Brenton C. Leavitt		Aug. 1974	Present
Frederic Solomon		Aug. 1959	Aug. 1974
GOVERNORS:			
David M. Lilly		June 1976	Present
J. Charles Partee		Jan. 1976	Present
Philip C. Jackson, Jr.		July 1975	Present
Philip E. Coldwell		Oct. 1974	Present
Henry C. Wallich		Mar. 1974	Present
Robert C. Holland		June 1973	May 1976
Jeffrey M. Bucher		June 1972	Jan. 1976
John E. Sheehan		Jan. 1972	June 1975
Andrew F. Brimmer		Mar. 1966	Aug. 1974
J. Dewey Danne		Nov. 1963	Mar. 1974
George W. Mitchell		Aug. 1961	Apr. 1973
Sherman J. Maisel		Apr. 1965	May 1972
William W. Sherrill		May 1967	Nov. 1971
FEDERAL RESERVE BANKS			
PRESIDENTS:	District bank		
F. E. Morris	Boston	Aug. 1968	Present
P. A. Volcker	New York	Aug. 1975	Present
A. Hayes	New York	Aug. 1956	July 1975
D. P. Eastburn	Philadelphia	Mar. 1970	Present
W. J. Winn	Cleveland	Sep. 1971	Present
Vacant	Cleveland	Nov. 1970	Aug. 1971
R. P. Black	Richmond	Aug. 1973	Present
Vacant	Richmond	Jan. 1973	Aug. 1973
A. N. Heflin	Richmond	Apr. 1968	Jan. 1973
M. Kimbrel	Atlanta	Feb. 1968	Present
R. P. Mayo	Chicago	July 1970	Present
L. K. Roos	St. Louis	Feb. 1976	Present
Vacant	St. Louis	Mar. 1976	Mar. 1976
D. R. Francis	St. Louis	Jan. 1966	Feb. 1976
B. K. MacLaury	Minneapolis	July 1971	Present

		Tenure of office	
		From	To
Vacant	Minneapolis	Feb. 1971	June 1971
H. D. Galusaa, Jr.	Minneapolis	May 1965	Jan. 1971
Roger Guffey	Kansas City	Mar. 1976	Present
G. H. Clay	Kansas City	Mar. 1961	Feb. 1976
E. T. Baughman	Dallas	Dec. 1974	Present
Vacant	Dallas	Oct. 1974	Dec. 1974
P. E. Coldwell	Dallas	Feb. 1968	Oct. 1974
J. J. Balles	San Francisco	Sep. 1972	Present
Vacant	San Francisco	June 1972	Sep. 1972
E. J. Swan	San Francisco	Mar. 1961	June 1972
VICE PRESIDENTS IN CHARGE OF BANKING SUPERVISION AND REGULATION:			
D. Aquilino, Senior Vice President	Boston	Oct. 1974	Present
L. J. Aubrey, Vice President	Boston	July 1969	Oct. 1974
F.W. Piderit, Jr. Senior Vice President	New York	July 1965	Present
T. K. Desch, Vice President	Philadelphia	Aug. 1972	Present
J. R. Campbell, Senior Vice President	Philadelphia	Jan. 1969	July 1972
H. W. Huning, Vice President	Cleveland	Oct. 1964	Present
W. S. Farmer, Senior Vice President	Richmond	June 1976	Present
J. L. Nosker, Senior Vice President	Richmond	Jan. 1961	May 1976
R. E. Heck, Vice President	Atlanta	Nov. 1972	Present
R. M. Stephenson, Vice President	Atlanta	July 1964	Oct. 1972
J. R. Morrison, Senior Vice President	Chicago	Jan. 1970	Present

APPENDIX V

		Tenture of office	
		From	To
H. E. Uthoff, Senior Vice President	St. Louis	Oct. 1970	Present
L. G. Gable, Vice President	Minneapolis	July 1967	Present
W. T. Billington, Senior Vice President	Kansas City	July 1971	Present
R. E. Scott, Senior Vice President (acting)	Kansas City	July 1970	July 1971
T. R. Sullivan, Vice President	Dallas	June 1962	Present
H. B. Jamison, Vice President	San Francisco	Nov. 1971	Present
I. L. Jennings, Senior Vice President	San Francisco	Jan. 1969	Oct. 1971