FDIC
Federal Deposit Insurance Corporation
Washington, D.C. 20434 Office of Inspector General

October 19, 1999

MEMORANDUM TO: Chairman Tanoue

FROM: Gaston L. Gianni, Jr.
Inspector General

SUBJECT: Audit Memorandum – Results of OIG Review of the Backup Examination Process and DOS's Efforts to Monitor Megabank Insurance Risks

We are issuing this audit memorandum to communicate the results of our review of the Division of Supervision's (DOS) efforts to monitor risk at insured institutions for which the FDIC is not the primary federal regulator. Our review focused on the backup examination process for insured thrifts, national banks and state member banks, and DOS's efforts to monitor the risks associated with the nation's largest and most complex financial institutions, often referred to as the "megabanks." DOS has defined the "megabanks" as insured institutions with $25 billion or more in total assets. This memorandum offers suggestions for your consideration regarding the need to strengthen the cooperation between the FDIC and the other federal banking regulators, and to improve the effectiveness with which DOS carries out the Corporation's responsibility to monitor its insurance risk. We consider these issues to be extremely important, and my office will continue to monitor and evaluate developments in these areas.

In reviewing the process whereby the FDIC participates in safety and soundness examinations in a backup capacity, we focused on assessing the level of cooperation DOS has received from the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (FRB), and the Office of Thrift Supervision (OTS). For the 42-month period ending March 31, 1999, we identified 90 instances of backup activity. Overall, we found that DOS regional managers believe that they have good working relationships with the other federal regulators, and that when dealing with small and medium-sized institutions, there have been few substantive problems in sharing information and gaining access to banks. The most troubling situation involved the events leading to the closing of The First National Bank of Keystone, Keystone, West

Virginia. On September 1, 1999, the OCC closed Keystone, a $1.1 billion institution, after finding evidence of apparent fraud that resulted in the depletion of the bank's capital.

Regarding megabank monitoring, we found that the DOS case managers (CMs) generally describe the level of cooperation they receive from their federal regulatory counterparts as satisfactory, and they generally receive the information they request. At the same time, however, the CMs are not sure of the universe of available information maintained by the primary regulators nor are they aware of the full range of a bank's off-balance sheet activities. Through numerous interviews with the CMs, we learned that there is a substantial gap between the CMs' perceptions of what they believe DOS Washington expects from them, in terms of being knowledgeable about their assigned institution(s), and their actual level of knowledge. According to many CMs, Washington's expectations are not being met, primarily because much of the information that they have access to is dated and/or does not contain sufficient detail on which to assess risk. Given the information constraints under which the CMs operate, DOS Washington management believes the CMs are doing a good job in meeting goals and expectations.

We also noted that DOS's approach to monitoring the insurance risks posed by megabanks is based on a decentralized strategy that relies on the abilities of its case managers to develop effective relationships with their regulatory counterparts. The effectiveness of these relationships is subject to a range of factors, including the experience levels and personalities of the individuals involved and the fact that the 23 megabanks supervised by the OCC are centrally managed from Washington. Finally, we noted that the guidance DOS Washington has provided to the CMs is rather general relative to the goals and objectives for monitoring the insurance risks posed by megabanks.

Over the past several years, the nation's banking industry has experienced unprecedented consolidation which has created a number of extremely large and complex financial conglomerates. Of the $4.5 trillion in assets controlled by the 39 largest institutions, the FDIC is the primary regulator for only $77 billion in 2 institutions. Consolidation in the banking industry may present increased risks for the FDIC as the deposit insurer because the deposit insurance funds face larger potential losses from the failure of a single large consolidated institution. Since the Corporation does not have a presence in the other 37 institutions, it is heavily dependent on the OCC, the FRB, and the OTS to provide the FDIC with the information needed to monitor the insurance risks associated with megabank activities.

We have developed suggestions for your consideration to address the concerns we have identified. These suggestions are included on pages 8, 16, and 17 of the attached document which presents the results of our review. The suggestions are intended to strengthen the cooperation between the FDIC and the other primary regulators and improve DOS's effectiveness in carrying out the Corporation's responsibility to monitor its insurance risk.

We wish to thank DOS management for the cooperation and courtesies extended during the course of this review. My management team is available at any time to meet with you and DOS to discuss the issues addressed in this document.

Attachment

cc: Vice Chairman Hove
John F. Bovenzi
James L. Sexton

Attachment

RESULTS OF OIG REVIEW OF THE BACKUP EXAMINATION PROCESS AND DOS'S EFFORTS TO MONITOR MEGABANK INSURANCE RISKS

BACKGROUND

Financial Market Dynamics Are Expanding the FDIC's Information Needs

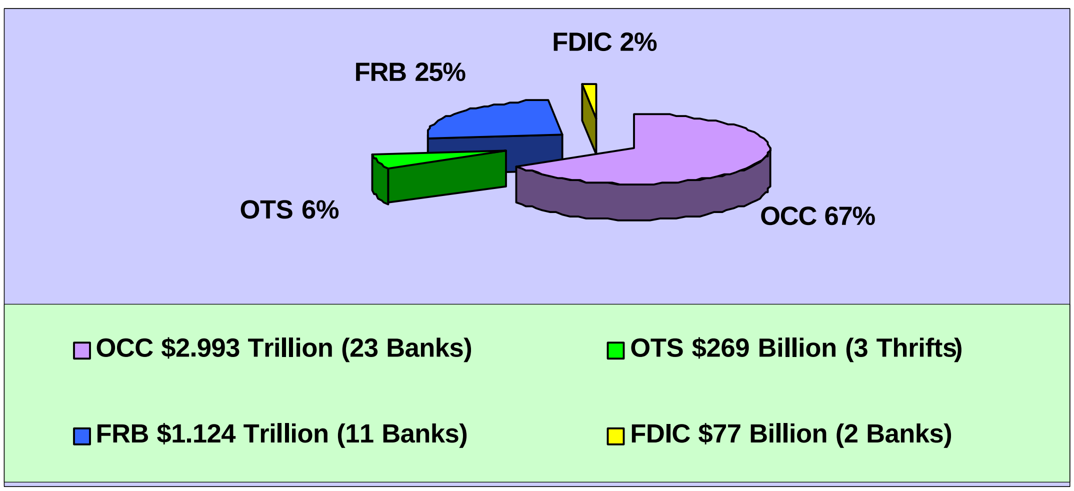
In recent years, major banks have been rapidly developing into enormous and complex financial conglomerates. The total value of bank mergers in 1998 alone, $233 billion, exceeds the combined total from the previous 6 years. The banking industry has recently undergone such a widespread consolidation that as of March 31, 1999, only 39 institutions controlled half of the country's banking assets, almost $4.5 trillion dollars. This trend toward the consolidation of financial resources is proceeding in dramatic fashion and will continue to place increasing risks on the deposit insurance funds.

In testimony before the House Committee on Banking and Financial Services (March 25, 1999), the Director of the FDIC's Division of Insurance pointed out that megabanks are commanding an increasing presence in the U.S. economy. The Director stated that, "While 41 banking companies held 25 percent of total domestic deposits in 1984, it took only 11 companies to account for the 25 percent share by the end of 1997." After the large mergers announced in 1998, just 7 banking companies hold 25 percent of domestic deposits. The Director also stated that the consolidation of banks serving different markets can diversify risk, decrease earnings volatility, and moderate the effect of economic downturns on the largest institutions, thereby decreasing the likelihood of their failure. However, consolidation in the banking industry may also increase risks for the FDIC because the deposit insurance funds face larger potential losses from the failure of a single large consolidated institution. Insurance is based on the concept of diversifying risk, and as industry assets become more concentrated in fewer institutions, the FDIC's risk becomes less diversified.

Today's megabanks not only control a high percentage of banking resources but also are frequently involved in non-traditional and highly complex business activities. In today's fast-moving environment, the financial conditions faced by the largest banks can change direction with very little warning. The near collapse of Long-Term Capital Management in September 1998 underscores the dangers that exist and highlights the need for the banking regulators to cooperate with each other and share information. Despite the risks to the deposit insurance funds posed by this crisis, the FDIC was not a party to the recapitalization talks. Only afterwards was the FDIC able to work with the other regulators to assess the extent of exposure to insured institutions and identify the risks involved. As the banking industry becomes increasingly affected by rapidly developing global financial forces, the need for the regulators to cooperate and share timely information will continue to increase in importance.

Of the $4.5 trillion in assets controlled by the 39 largest financial institutions, the FDIC is the primary federal regulator for only $77 billion in two institutions[1] (see Table 1). Because the FDIC does not have a presence in 37 of the country's 39 megabanks, it is almost totally dependent on the other federal regulators for monitoring the largest risks to the insurance funds. The failure of a megabank, along with the potential closing of closely-affiliated smaller institutions, could result in huge losses to the insurance funds and create a crisis that the FDIC would be responsible for resolving.

Table 1
Total Assets Owned by Megabanks
(by Primary Federal Regulator)
as of March 31, 1999



Source: DOS data – Financial Institutions with Assets of $25 Billion or More as of March 31, 1999.

Because of the risk each megabank poses to the deposit insurance funds, FDIC should have the most up-to-date information available on the activities of these megabanks, information that goes beyond the point-in-time snapshots of events that the Corporation presently receives from the other federal regulators to assess risk. Banks today are subject to market dynamics that move much more quickly than quarterly financial information is able to track. As the FDIC Chairman pointed out in testimony given on

[1] These two institutions are Regions Bank, Birmingham, Alabama, and Branch Banking and Trust Company, Winston-Salem, North Carolina.

the crisis involving Long-Term Capital Management, the regulation and supervision of the financial industry must be as dynamic as the industry itself. [2]

Effective supervision of the nation's largest financial institutions, some with worldwide operations, requires continual monitoring and the commitment of extensive resources on the part of the Office of the Comptroller of the Currency (OCC), the Federal Reserve Board (FRB), and, to a lesser extent, the Office of Thrift Supervision (OTS). Although the FDIC is not the primary regulator of 37 of the nation's 39 largest financial institutions, it would be called on to deal with the failure of a megabank and its catastrophic consequences. Thus, the Corporation has a compelling need to become more familiar with the activities of these institutions and with the current condition of any developing risks. Because it is not feasible for the FDIC to attempt to duplicate the efforts of the other regulators, nor would the law permit such duplication, we believe the Corporation needs to develop closer ties to its regulatory counterparts and work toward obtaining real-time information relative to megabank financial activities. We also feel that for the FDIC to be successful in working more closely with the other regulators, any efforts undertaken to enhance regulatory cooperation will need to be initiated and pursued by the highest levels of corporate management.

Backup Examination Authority

As early as 1950, the Board of Directors of the FDIC had the unilateral authority to examine any insured bank without concurrence by other regulators. Section 10(b)(3) was added to the Federal Deposit Insurance Act by Public Law No. 797, effective September 21, 1950. This subsection, Special Examination of Any Insured Depository Institution, provides that FDIC examiners shall have power, on behalf of the Corporation, to make any special examination of any insured depository institution whenever the Board of Directors determines a special examination of any such depository institution is necessary to determine the condition of such depository institution for insurance purposes. That unilateral authority still exists pursuant to the Federal Deposit Insurance Act.

In 1982, the Board authorized the Division of Bank Supervision (DBS, now DOS) to assign FDIC examiners to participate in the examination of a national or state member bank when invited by the OCC or the FRB, respectively, and to negotiate with the OCC and the FRB on the "triggering points" for the issuance of such invitations. Subsequently, on December 23, 1983, the FDIC Board of Directors authorized FDIC examiners to participate in the examination of national banks, pursuant to certain terms and conditions contained in the "Cooperative Examination Program" agreed to by the OCC Senior Deputy for Bank Supervision and the FDIC Director of DBS as of December 2, 1983.

[2] Chairman Tanoue's testimony on Long-Term Capital Management, L.P., before the Committee on Banking and Financial Services, United States House of Representatives, October 1, 1998.

In August 1989, the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) created the Savings Association Insurance Fund and extended FDIC's special exam authority to cover insured savings associations. In connection with these changes, the FDIC Board of Directors delegated authority to the DOS Director to: (1) initiate an examination or special examination of any insured savings association to determine its condition for insurance purposes; and (2) work toward establishing a cooperative examination program with the OTS for insured savings associations. During 1989 through 1990, the FDIC examined many federally chartered savings and loan associations throughout the country pursuant to a directive from FDIC Chairman Seidman.

The enactment of FIRREA also caused the composition of the FDIC Board of Directors to be increased from 3 to 5 members. The Vice Chairman and the Director of the Office of Thrift Supervision were positions added to the Board.

In 1993, the FDIC Board of Directors rescinded the earlier delegations of special exam authority and decided not to perform any special examinations unless extraordinary threats to a deposit insurance fund could be demonstrated. Any such examination would require Board approval.

During 1995, the Board delegated authority to the Director of DOS to perform examinations, visitations, and/or other examination activities if concurrence exists with the primary federal regulator. The DOS Director, in turn, redelegated this authority to the Deputy Director(s), Associate Director(s), Regional Directors, and Deputy Regional Directors. Consequently, should DOS identify emerging risks or have serious concerns relative to an institution's risk profile, DOS cannot participate in any safety and soundness examination activity, other than offsite analysis, without the concurrence of the primary federal regulator unless a case to the Board of Directors is prepared, accepted and approved.

DOS'S BACKUP EXAMINATION ACTIVITIES – THE EVENTS LEADING UP TO THE CLOSING OF KEYSTONE DEMONSTRATE THE CRITICAL NEED FOR COOPERATION BETWEEN THE REGULATORS

In reviewing the process whereby the FDIC participates in safety and soundness examinations in a backup capacity, we focused on assessing the level of cooperation the Corporation has received from the OCC, the FRB and the OTS. For the period October 1, 1995 through March 31, 1999, we identified 90 instances where DOS participated in backup exams in 67 banks. While the asset size of the banks for which data was available ranged between $14 million and $1.5 billion, many of the banks were in the $100 million to $300 million asset-size range. Table 2 summarizes backup exam activity by DOS region during the 42-month period reviewed.

Table 2
Instances of Backup Examinations
10/95 through 3/99

DOS Region	OCC	OTS	FRB	*Totals*
Atlanta	11	8	1	*20*
Boston	0	0	0	*0*
Chicago	3	4	2	*9*
Dallas	11	1	4	*16*
Kansas City	0	1	0	*1*
Memphis	5	0	0	*5*
New York	1	2	0	*3*
San Francisco	13	21	2	*36*
Totals	*44*	*37*	*9*	*90*

Overall, we found that DOS regional managers believe they have good working relationships with the other federal regulators, and that when dealing with small and medium-sized banks, there have been few substantive problems regarding information sharing and gaining access to banks. We learned of 3 instances during the period reviewed where DOS proposed to join another federal bank regulator in a safety and soundness examination and was initially denied permission. Two cases involved the OCC and the remaining case involved the OTS. In all 3 instances, the other regulators reversed their initial positions within 6 months and DOS resolved the matters before taking these cases to the Board.

Two additional requests to the OCC for permission to participate in safety and soundness exams (both made by the same regional office during April 1999) were unresolved at the time we concluded our review. The responsible OCC district office had denied DOS's initial requests and referred them to its Washington office for further consideration.

The First National Bank of Keystone

The most notable case where the OCC initially denied DOS permission to participate in an exam involved The First National Bank of Keystone, Keystone, West Virginia (Keystone). This case illustrates how the FDIC's backup authority can be subject to constraints imposed by the primary regulator that can limit the FDIC's ability to assess risks to the deposit insurance funds.

On September 1, 1999, the OCC closed Keystone, a $1.1 billion institution, after finding evidence of apparent fraud that resulted in the depletion of the bank's capital. The FDIC was named receiver and the resulting loss to the Bank Insurance Fund is estimated to range from $750 to $850 million. Keystone was a non-traditional independent bank that was heavily involved in acquiring and securitizing FHA Title I loans (subprime property improvement loans). The FDIC had been concerned about Keystone's risk to the deposit insurance fund since 1995, as indicated by DOS lowering the OCC's overall composite ratings of Keystone three times.

The FDIC notified the OCC of Keystone's first rating change in November 1995, lowering the bank's composite rating from a 2 to a 3. This downgrade was partially based on the bank's inability to reconcile its $130 million volume of FHA Title I loans obtained from various loan originators throughout the country through its wholly-owned mortgage subsidiary, Keystone Mortgage Corporation. The OCC reported that the absence of basic accounting controls, such as account reconcilements, and poor management information systems could have resulted in a reduction in bank capital of approximately $8.3 million. Equity capital at the bank as of March 31, 1995, totaled $28.3 million and total assets equaled $208 million.

In February 1996, the FDIC requested to participate in the next OCC examination, with DOS's role limited to a review of Keystone's FHA Title 1 program and related issues. DOS examiners participated in a backup capacity in the OCC's June 1996 examination of the bank. After reviewing the Title 1 program, the FDIC examiners concluded that the credit risk was minimal and loss exposure after FHA insurance was reasonable. Based on the examination findings, the overall deficiencies cited in the 1995 exam had been addressed, with one exception related to an outside audit. The OCC assigned the bank a composite rating of 2, and DOS concurred.

In September 1997, DOS Atlanta received a letter regarding the assignment of Keystone to the OCC's Washington Office, based on its condition. DOS received the OCC's July 1997 report of examination in December 1997. The OCC's report cited a number of managerial and operational deficiencies that DOS believed presented an increasing risk to the Bank Insurance Fund. The risk profile depicted in the OCC's July 1997 examination report was high, with serious weaknesses noted in asset quality, earnings, and management. Due to the magnitude of the bank's problems, the FDIC changed the composite rating the OCC had assigned to Keystone from a 3 to a 4.

On February 13, 1998, as a result of serious safety and soundness concerns, DOS requested the OCC to allow 3 FDIC examiners to participate in the next full-scope examination scheduled during 1998. In a response dated February 26, 1998, the OCC's Washington Director, Special Supervision, denied the request stating that there was no evidence to indicate that Keystone's capital was significantly threatened by the bank's operational and managerial deficiencies. The letter also stated that the FDIC's participation in the next exam would be unnecessarily burdensome to the bank and that if DOS believed that participation was necessary, its case should be presented to the FDIC Board. Under FDIC policy, the DOS Director was required to request backup authority from the FDIC Board of Directors, in light of the denial. As a result, DOS prepared a Board case for backup examination. In June 1998, prior to the case's presentation to the Board, the OCC reversed its position, but allowed only 2 DOS examiners to participate in the examination of Keystone as of August 31, 1998.

According to DOS, pre-examination discussions between the FDIC and the OCC concerning the August 31, 1998 examination indicated that the examiners would remain on-site until all questions about the bank's accounting and record-keeping were answered and conclusions to examination objectives were completed. However, the OCC withdrew all of the examiners from the on-site portion of the examination after only 15 workdays, leaving Keystone's accountants to continue their work with respect to account balancing and residual valuation. The examination revealed that conditions at Keystone had continued to deteriorate and the OCC assigned the bank a composite CAMELS rating of 4. The FDIC lowered the composite rating to a 5 based on a range of factors that included: brokered deposits acquired in apparent violation of the law,[3] poor asset quality based on a concentration of high loan-to-value loans and by-products, poor data integrity, questionable capital, overstated earnings, and weak management.

In the months following the 1998 examination, DOS continued to experience problems gaining the OCC's full cooperation. Because of the seriousness of Keystone's problems, DOS had asked the OCC to notify DOS of meetings that were scheduled by the OCC to discuss/evaluate the Keystone situation and to provide DOS with copies of all correspondence between the OCC and the bank. However, DOS noted instances where meetings were held to which the Division had not been invited. Additionally, in reviewing the OCC's online Supervisory Monitoring System (SMS), DOS learned of correspondence that had been exchanged between the OCC and Keystone, copies of which had not been provided to the Division.

Due to the bank's steadily worsening condition, the OCC started a safety and soundness examination of Keystone in June 1999, in conjunction with its review of the bank's Year 2000 readiness. At this point, the OCC was cooperating fully with the FDIC and allowed the DOS Atlanta office to participate in the exam with as many examiners as DOS deemed necessary.

Conclusion

The events leading to the recent failure of Keystone demonstrate the critical need for the FDIC to receive the full cooperation of the primary federal regulator at the first sign of a substantive safety and soundness issue, regardless of the institution's size. The OCC's reluctance to allow DOS examiners to evaluate a number of concerns relative to the bank's heavy concentration in subprime property improvement loans may have prolonged the bank's period of operation and added to the projected insurance fund loss. Post-failure analyses will likely conclude that the Keystone situation could have been managed more effectively and that cooperation between the OCC and the FDIC was inadequate. Keystone's closing may serve to heighten awareness of the benefits of coordination among regulators whenever an institution presents a significant insurance risk.

[3] Section 29 of the FDI Act requires adequately capitalized banks to obtain a waiver from the FDIC before accepting brokered deposits, and prohibits undercapitalized banks from accepting any brokered deposits.

DOS's role in conducting backup examinations provides an important internal control function for the deposit insurance funds. Under FDI Act section 10(b)(3), the FDIC's Board of Directors can authorize FDIC examiners to conduct any special examination of any insured depository institution for insurance purposes. While DOS's usual practice is to review and rely on the examination reports of the other regulators, this special examination provision of the Act serves as an internal control checkpoint by which the FDIC, as insurer, can provide a secondary level of onsite review for institutions posing a higher risk profile to the deposit insurance funds. However, the current delegation of authority from the Board to DOS reduces the effectiveness of this internal control.

To conduct special exam activities under the current delegation, DOS must first obtain the concurrence of the primary federal regulator or go through the process of preparing a Board case and seeking Board approval. As demonstrated in the case of Keystone, the restrictions imposed by the current delegation can allow the primary federal regulator to significantly influence the timing and scope of the FDIC's backup examination, reducing the benefit of the secondary level of review. Requiring concurrence by the primary federal regulator may impair the FDIC's independence, may limit the control value of the secondary level of review, and could be viewed as an organizational conflict. Requiring Board approval on a case-by-case basis could delay the FDIC's exam in potentially critical situations, delay the start of action based on examination results, and detract from the control aspect.

Accordingly, to ensure that the internal control offered by the special examination provision functions as provided by law and that the FDIC takes the most effective approach to monitoring risks to the deposit insurance funds, the FDIC needs to be given expanded authority to conduct special examinations that supplement the exams of the other regulators. A delegation from the Board could allow the FDIC to make an independent decision to initiate special exam activities based on criteria of increased or unusual risk to the funds, and not require case-by-case concurrence by the primary federal regulator or the Board's approval.

Suggestion:

To strengthen FDIC's secondary review function for insurance purposes, we suggest that the Chairman, FDIC:

1. Request delegated authority from the FDIC Board of Directors to the Chairman to initiate special examinations of insured institutions that pose significant safety and soundness concerns, without having to secure the concurrence of the primary federal regulator or the approval of the Board; or, seek a legislative change to vest this authority in the Chairman.

BARRIERS THAT LIMIT THE EFFECTIVENESS OF DOS'S MEGABANK MONITORING PROGRAM

As previously discussed, fewer and fewer financial institutions are controlling an increasing percentage of the nation's banking resources. Accompanying this trend has been the development of new and significant risks to the deposit insurance funds as a result of interstate banking and branching, greater use of financial derivative products, expansion into foreign markets, and the emergence and rapid advancement of electronic banking activities. DOS managers have serious concerns about the Corporation's limited knowledge of the risks posed by the activities of megabanks. Concerns expressed to us included that the OCC and the FRB are not sharing all of the information that is available to them and that much of the information that is made available to the FDIC is summary in nature and historical in context. Thus, the preponderance of information available to the FDIC does not focus on an institution's present and future risk profile. As a result, some DOS managers believe that a full-time FDIC on-site presence is necessary in the very largest and most complex financial institutions to properly assess risk to the deposit insurance funds and that this presence would represent an inevitable outgrowth of the Corporation's fiduciary responsibilities to the funds. DOS's role would be to supplement the primary federal regulator's efforts and focus on the institution's risk profile from an insurance perspective.

In performing our review, we pursued two key issues facing DOS in assessing insurance fund risks in megabanks. First, we attempted to assess the effectiveness of the case manager approach DOS has employed to monitor megabank activities and their insurance risks. Second, we attempted to identify the types of information that DOS requires from the primary regulators for monitoring purposes but does not get.

The foundation of DOS's decentralized approach to megabank monitoring is based on the personal relationships that case managers have developed with their counterparts in the other regulatory agencies. A May 28, 1999 best practices memorandum from DOS Washington to all regional directors dealing with this subject states that "A case manager's (CM) ability to develop strong and effective working relationships with primary regulator (PR) counterparts is considered critical to properly evaluate institution and systemic risks and to ensure that the FDIC's supervisory and insurance concerns are effectively and expediently communicated to the PR." This best practices memo resulted from an effort undertaken during the latter part of 1998. According to DOS management, as a result of an agreement in late 1998 between the former DOS Director and representatives from the OCC and the FRB, CMs for the 40 largest institutions developed communications plans with their primary regulator counterparts. These communication plans specify the frequency with which case managers are scheduled to meet with their counterparts and list examination reports, memoranda, and other types of information that the PR will routinely be providing to DOS. The May 28th memo summarized the best practices and procedures that DOS Washington believes to be particularly effective in enabling the CMs to appropriately evaluate covered institutions.

We asked a number of DOS managers to articulate the types of information that they believed they require from the other regulators to assess institutional risks but were not receiving. We were told that no one in DOS has a complete understanding of all of the information that is collected by the other regulators and that the types of information that are needed to monitor a specific institution depend on the bank's activities, initiatives and plans at any point in time, and that these factors are continually being revised as bank management reacts to and anticipates changing economic and competitive conditions. According to DOS management, when DOS asks the OCC or the FRB what information is available, their response has been, "Tell us what you need." DOS Washington management suggested that the issue of what DOS needs might be clarified by discussing the circumstances involving specific institutions with the responsible case managers.

Our meetings with 20 case managers in 3 regions covered a variety of issues including the case managers' relationships with the other primary federal regulators, the types of information they use to monitor their assigned banks, their level of knowledge relative to megabank business activities, their workloads, the types of information they need from the other regulators, the resident examiner concept, and the Large Insured Depository Institution (LIDI) program.

CMs' Effectiveness in Monitoring Megabanks Is Not Meeting DOS Washington's Expectations

During our discussions, DOS's case managers characterized their relationships with their primary regulator counterparts as cooperative, open, satisfactory, good, and, in several instances, excellent. The CMs have arranged to meet with their OCC, FRB, and OTS counterparts on a quarterly basis and to exchange phone calls and e-mail. In terms of the frequency of meetings, the CMs feel 4 meetings a year is sufficient to stay knowledgeable about their assigned institutions. We were told that the other regulators are generally responsive to information requests and that the CMs get what they ask for. We heard of only one instance where a request was denied. In this situation, a case manager asked an OCC examiner for permission to review the minutes of a bank's Board of Director meetings and was told he could not. Bank board minutes are generally available to other CMs.

The CMs told us there are 2 primary sources of information that they use to monitor bank activities and any corresponding risks. The first source is information that is available to the general public: 10K and 10Q reports (annual and quarterly financial statements filed with the Securities and Exchange Commission), press releases, newspapers and periodicals, and the internet, which includes news stories, stock quotes/analyses, and reports from investment brokers. The second source of information is the PR. Information routinely received includes reports of examination and the accompanying transmittals, quarterly risk assessments, and various reports prepared by the banks. DOS managers refer to many of these information products, including information obtained from the OCC's online Supervisory Monitoring System, as "filtered" because they are written, synopsized, or interpreted by the PR before they are made available to DOS.[4] In reviewing the CM communication plans, we also noted that some CMs are receiving more information from their PR contacts than other CMs, and that this condition is being addressed by DOS through the issuance of its May 28, 1999 best practices memorandum.

Almost all of the CMs told us that the usefulness of the PR examination reports is limited because they present examination results in more general terms than do FDIC reports, and because they do not contain enough detail on the risks associated with a bank's various business activities. In addition, these reports and other products received from the PRs present information that is several months old and provide little insight concerning a bank's present or future activities.

As a result, almost all of the CMs we spoke with felt that the knowledge they possess on their assigned megabanks is considerably less than what they believe DOS Washington expects of them. On a scale of 1 to 10, with 10 representing complete knowledge of an institution and its risks, many CMs believed they fell within the 5 to 6 knowledge range. Several said they would place themselves lower on the scale, in the 2 to 4 range, and several believed they rated an 8. Almost all of the CMs believe that on the scale we described, Washington's expectation ranges between 8 and 10. According to DOS Washington management, the CMs are doing a good job in meeting goals and expectations, given the information constraints under which they operate.

Another principal factor limiting the CMs' level of knowledge relative to megabanks is their workload. While some CMs devote most of their time to their assigned megabanks, others do not. We noted that 8 of the 20 CMs we interviewed are responsible for between 45 and 94 other banks and have to divide their time accordingly. These CMs told us that they are only able to allot 40 to 60 hours per quarter to their megabank, and that the majority of this time is used in preparing their LIDI report. Most of their remaining time is devoted to other assigned responsibilities such as monitoring their non-megabank institutions, processing applications, and attending to Year 2000 issues.

Although the CMs expressed concerns about not being able to meet Washington's expectations regarding their level of knowledge on their megabanks, we believe the current condition will continue based on our conversations with the CMs and on our assessment of the recently prepared communication plans and information-sharing arrangements. While these documents indicate that DOS is taking a step in the right direction, they also demonstrate that the CMs will continue to evaluate risk exposures by using data that is limited in detail and historical in perspective. An experienced CM summed up the situation by saying that the information DOS is getting is useful to an extent, but it does not tell the CMs where the banks are placing "their current and future bets." Having access to current information is especially critical today when trying to gauge risk in a financial institution because of the speed with which shifts in investment focus can occur and electronic transactions can take place.

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[4] The OCC is replacing SMS with a system named ExaminerView, currently under development. The FRB is also developing an information system named Bank Online National Database (BOND). Neither system is currently available to DOS and developmental work is continuing.

In our judgment, the CMs did not appear to be overly concerned regarding their perceptions of the risks inherent in megabanks today. The CMs' attitudes and perceptions appeared to be strongly influenced by the solid financial condition of the megabanks and the diversity of the megabanks' activities. Thirty-seven of the 39 megabanks have been accorded a composite CAMELS rating of 1 or 2 (the other 2 banks are rated a composite 3), the economy is healthy, bank operations have been highly profitable, and many of the banks are predominantly involved in conservative activities. In addition, some CMs pointed out that the largest banks, both conservative and aggressive, are being closely watched on a full-time basis by other federal regulators that have committed as many as 30 to 80 examiners to supervise a single institution. The CMs are also confident that if they need to find out something they do not know, they know whom to call to quickly get that information.

We also asked the CMs what types of information they feel they need from the other regulators but are not receiving. The predominant response was that it is difficult to know what to ask for if you don't know what is available. They provided us with no specific types of information that they need but are not getting. Some CMs mentioned, however, that their knowledge of off-balance sheet items, such as derivative and hedge fund products, was minimal. Several CMs doubted that the PRs knew much more than they did about these items.

Interestingly, several CMs told us that the most effective way for them to understand the risks posed by a megabank would be to have access to its middle management, to be able to ask questions of bank managers and discuss bank activities. Although the CMs meet with the PRs quarterly and some attend presentations made by bank officers, only 1 of the CMs we spoke with has attended meetings between the PR and the megabank when examination findings have been discussed. We feel it is important to note that none of the other CMs has asked to attend such meetings, although some said that they had dropped hints with the PR. The general feeling was that if the CMs asked, they would be told "no" because of PR comments to the affect that the FDIC's presence during discussions of examination findings might make the megabanks uneasy or create problems for the PR.

We also discussed the potential benefits of the FDIC establishing a full-time on-site examiner presence at the megabanks. The comments we received regarding this issue were divided fairly equally. About half of the CMs felt that resident examiners would provide beneficial information and improve the CMs' ability to monitor large institutions. The remaining CMs told us that resident examiners are not really necessary and would probably not provide much more insight than current practices. One CM of an extremely large and complex institution said that it really would not matter if he was in the bank on a full-time basis – the institution is so complex that he still would not understand everything that was going on. He noted that if the PR needed 80 people to track the bank's nationwide activities, 1 FDIC examiner would be wasting his time.

DOS management believes that some form of on-site presence in the largest and most complex institutions is necessary to obtain current information to effectively assess insurance risk. DOS management believes that on-site presence should only be requested in instances where DOS cannot obtain adequate information to fulfill the FDIC's deposit insurance responsibilities off-site. The form of on-site presence would vary depending on the institution, and could consist of participation in management or board meetings, participation in reviews of risk areas, or primary regulator workpaper reviews, for example. DOS's role would be to supplement the primary federal regulator's efforts and focus on the institution's risk profile from an insurance perspective. DOS evaluates risks to the insurance funds presented by all insured institutions, including megabanks, and shares its findings with the FDIC's interdivisional Financial Risk Committee, of which DOS is a member.

LIDI Reports Provide Insufficient Feedback

The primary means for CMs to communicate their observations and concerns to DOS Washington about megabank activities and insurance risks is the quarterly large insured depository institution (LIDI) report. The comments we received on the LIDI process were very similar to those received during a recent OIG study of the DOS Case Manager Program, the results of which were communicated to DOS in an evaluation report dated March 31, 1999. One DOS Washington manager summed up his opinion regarding the usefulness of the reports by saying that the information they deal with is not timely and provides little value to Washington. He also commented that without the LIDI reports, Washington would have nothing.

On June 2, 1999, DOS Washington issued a Regional Director Memorandum containing interim revisions to the LIDI program that were designed to improve the usefulness of the LIDI products and shorten processing times. On September 2, 1999, DOS Washington issued another Regional Director Memorandum on LIDI program enhancements. The OIG has not had an opportunity to evaluate the impact these memoranda have had on the LIDI program.

DOS Washington's Guidance to the CMs Has Created Uncertainty

Based on the work we have performed, we believe that the megabank CMs do not clearly understand what DOS management expects of them regarding the evaluation of insurance risks. In our meetings with the CMs, we discussed their views of Washington's expectations that pertain to understanding a megabank's risk profile. As we previously mentioned, most of the CMs believe they are not meeting Washington's expectations. We also reviewed the CMs' plans for obtaining information from and meeting with their PR counterparts (the communication plans).

The information obtained by DOS on a particular megabank has been largely left to the CMs' discretion, as was evidenced by differences in the level of detail in the communication plans they developed. The plans indicate that some CMs have been obtaining and evaluating more information than their peers do, even in the same region. DOS also noted these differences in its May 28, 1999 best practices memo, stating that not all CMs are aware of or receiving analytical products that are available through the PR. While the memo will help address this situation, it may not go far enough in terms of articulating what is specifically expected of the CMs in their efforts to monitor and assess insurance risks. For example, the memo states that DOS Washington has compiled a listing of essential types of information that the CMs may wish to request from their PR counterparts. This statement may raise a question in the minds of some CMs – if certain information is essential to understanding the risks posed by a megabank, why should obtaining and using this information be discretionary? Also, the memo does not address the fact that the megabanks supervised by the OCC are centrally managed from Washington, and what impact this arrangement should have in developing and refining communication plans.

We also noticed that the best practices memo may be sending an incomplete message to the CMs because it focuses on information products that many CMs consider to be of limited value, since they contain data that is historical in perspective and may be several months old. Because of the potential risks that can quickly occur in today's volatile financial markets, DOS management should stress to the CMs the importance of obtaining from the PR, to the extent feasible, real-time information on megabank activities. CM monitoring efforts might yield more effective results if greater emphasis is placed on currently developing risks as opposed to situations that existed 3 to 6 months ago.

The best practices memo also discusses CM requests to participate in bank/board meetings. It states that such requests should be generally limited to the largest and most complex institutions and those institutions in a troubled or deteriorating condition. We believe this guidance to the CMs may need further clarification. When the memo refers to the largest and most complex institutions, it is not clear whether DOS is referring to the 3 largest banks in the country, the 6 largest, or the 20 largest. It is also not clear whether the memo was referring to the largest banks in each region or the country as a whole.

This section of the memo may raise another relevant concern for the CMs when it states that a CM should not request to attend a meeting unless the bank is in a troubled or deteriorating condition. The purpose of continually assessing the risks present in the largest institutions is to be forewarned of pending trouble, and this would seem to be a valid reason for CMs to attend meetings on a routine basis. Waiting for the development of a deteriorating condition before attempting to fully understand all of the circumstances relating to a safety and soundness concern is inconsistent with an effective monitoring program designed to quickly identify and deal with problems as they arise.

The best practices memo also conveys the message that because the OCC does not want the FDIC present in its meetings with bank management, the CMs shouldn't ask. In meetings between our offices, DOS management explained that because of the insurance risks posed by this country's megabanks, the FDIC in its capacity as insurer has a clearly defined need to obtain all current information that the other PRs develop on their megabanks. We believe that the message conveyed to the CMs in DOS's May 28th memo may not reflect the commitment that DOS management expressed to us concerning their desire to gain access to all available information, including discussions with bank managers that pertain to examination results.

Conclusion

Over the past several years, the nation's banking industry has experienced unprecedented consolidation that has created a number of extremely large and complex financial conglomerates. Of the $4.5 trillion in assets controlled by the 39 largest institutions, the FDIC is the primary regulator for only $77 billion in 2 institutions. Since the Corporation does not have a presence in the other 37 institutions, it is heavily dependent on the other federal regulators to provide the FDIC with the information it needs to monitor megabank activities.

DOS's approach to monitor the growing risks posed by the megabanks is based on a decentralized strategy that relies on the abilities of its case managers, acting independently, to develop effective relationships with their regulatory counterparts. The case managers are responsible for obtaining information from the PRs, assessing insurance risk, and communicating their observations and concerns to DOS Washington in quarterly reports. The CMs have also been told that they are responsible for ensuring that the FDIC's supervisory and insurance concerns are effectively and expediently communicated to the PR.

Our assessment of the effectiveness of DOS's monitoring activities indicates that there is a substantial gap between the CMs' perceptions of what they believe DOS Washington expects from them (in terms of being knowledgeable about their assigned megabanks) and their actual level of knowledge. According to many CMs, DOS Washington's expectations are not being met, primarily because much of the information they have access to is dated and/or does not contain sufficient detail to assess insurance risk. The CMs describe the level of cooperation they receive from their regulatory counterparts as satisfactory, and they generally receive the information they request. However, the CMs are not sure of the universe of available information maintained by the PRs, nor are they aware of the full range of a megabank's off-balance sheet activities. Equally important, the CMs are generally not permitted to attend meetings between the PRs and bank management during which examination findings and supervisory concerns are discussed, thus preventing the CMs from gaining valuable insights into institutional operations and risks. Although the CMs have the information necessary to evaluate where a bank has been, they are not being provided the opportunity to see where a bank is placing its "current and future bets." The effect of the conditions under which the CMs operate is that DOS may not have a timely or comprehensive understanding of the emerging risks that may be developing in the largest banks – that is, the banks that present the greatest insurance risks.

Effective supervision of the largest financial institutions, some with worldwide operations, requires continual monitoring and the commitment of extensive resources on the part of the OCC, the FRB and, to a lesser extent, the OTS. Although the FDIC is not the primary regulator for most of the megabanks, it would be called on to deal with the failure of a megabank and the financial consequences. Thus, the Corporation has a compelling need to become more familiar with the activities of these institutions and with the current development of any potential risks. Because it is not feasible for the FDIC to attempt to duplicate the efforts of the other regulators, nor would the law permit such duplication, we believe the Corporation needs to develop closer ties to its regulatory counterparts and work toward obtaining real-time information relative to megabank financial activities.

In today's rapidly changing financial environment, the economic conditions faced by the largest banks can change direction with very little warning. The near collapse of Long-Term Capital Management and even the failure of Keystone underscore the dangers that exist and highlight the need for banking regulators to work with each other and share information. We believe, however, that the responsibility for raising the level of cooperation that currently exists between the FDIC and the other regulators should not be placed on the shoulders of DOS's case managers, whose effectiveness may be limited by factors that they cannot control, such as the willingness of their counterparts to share information. Nor should the case managers be solely responsible for communicating to the other regulators the Corporation's supervisory concerns relative to megabank issues.

We believe that for the FDIC to become more successful in working with the OCC, the FRB and the OTS, any efforts undertaken to enhance regulatory cooperation will need to be initiated and pursued by the highest levels of corporate management. This holds especially true for any information-sharing arrangements made with the OCC, since the numerous megabanks it supervises are centrally managed from Washington. We believe that developing detailed formal agreements with the other regulators would significantly improve the FDIC's ability to carry out its responsibility to monitor its insurance risk. Given the strong financial health of the economy and the banking industry, now would seem to be an opportune time for the FDIC to improve its information-sharing arrangements, before the industry faces the next downturn in the economic cycle and the regulators must deal with the ensuing problems.

Suggestions:

To improve the FDIC's monitoring of risks presented by megabanks and other insured institutions and to decrease the reliance on personal relationships between case managers and their counterparts in other regulatory agencies, we suggest that the Chairman direct DOS to:

2. Identify the specific information that DOS needs to monitor the insurance risk presented by megabanks and other insured institutions.

3. Work to develop agreements with the other bank regulatory agencies that will allow for the provision of a consistent, minimum level of information/access for all FDIC case managers.

4. Establish well-defined criteria for case managers to use in evaluating the insurance fund risks posed by the megabanks and other insured institutions, and clearly articulate DOS's monitoring goals and objectives.