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BY THE COMPTROLLER GENERAL

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# Report To The Congress

OF THE UNITED STATES

## Federal Examinations Of Financial Institutions: Issues That Need To Be Resolved

Five Federal agencies are responsible for supervising 41,000 privately owned financial institutions. Onsite examinations are the principal means used by these agencies to carry out their supervisory responsibility. The primary objectives of examinations are to evaluate the institutions' soundness and to determine whether applicable laws and regulations are complied with.



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While these objectives are similar, the concepts, approaches, scope, and frequency differ from agency to agency. The Congress established the Federal Financial Institutions Examination Council to promote uniformity in the examination and supervision of financial institutions. This report identifies several areas in the examination process which are not uniform and need attention.



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

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

This report identifies key issues which the Federal Financial Institutions Examination Council must address if it is to be successful in developing uniform examination principles and standards. The report describes certain examination philosophies and practices followed by five Federal regulatory agencies in examining financial institutions. It discusses how these philosophies and practices differ and what the effect is on the supervision of each institution. Finally, the report points out that the Examination Council is in the best position and in fact was established to bring about uniformity and consistency to the examination process.

We undertook this review to followup on certain aspects of our report on "Federal Supervision Of State And National Banks" (OCG-77-1; January 31, 1977). In that report we recommended that the Federal Deposit Insurance Corporation, the Federal Reserve System, and the Office of the Comptroller of the Currency jointly evaluate the Comptroller's new procedures which were being implemented as we completed our review. Initial followup on the 1977 report, however, indicated that no formal evaluation of the Comptroller's procedures had been made.

Copies of this report are being sent to the Chairman, Board of Directors of the Federal Deposit Insurance Corporation; the Chairman, Federal Home Loan Bank Board; the Chairman, Board of Governors of the Federal Reserve System; the Administrator, National Credit Union Administration; the Comptroller of the Currency; and the Chairman, Federal Financial Institutions Examination Council. In addition copies are being sent to the Secretary of the Treasury and the Director, Office of Management and Budget.

A handwritten signature in dark ink, reading "Thomas G. Statts".

Comptroller General  
of the United States





D I G E S T

Five Federal agencies 1/are responsible for supervising 41,000 privately owned financial institutions. Using onsite examinations as the principal means, the agencies monitor the activities of the institutions and identify problems that require corrective actions. GAO surveyed the practices followed by the agencies in examining the commercial activities of financial institutions and found that:

- There are differing practices among and even within the agencies regarding acceptance of examinations made by State regulatory agencies in lieu of their own. (See p. 10.)
- The agencies have different criteria for scheduling examinations which generally do not adequately weigh the risks of institutional failures or problems against the cost and burden of examinations with the result that some institutions may be examined more--or less--frequently than necessary. (See p. 15.)
- The use of timesaving techniques varies among the agencies. (See p. 19.)
- The agencies have different policies regarding reliance on institutions' internal review groups, with the result that some duplicate work that is competently performed by these groups. (See p. 21.)

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1/Office of the Comptroller of the Currency (OCC), Federal Reserve System (FRS), Federal Deposit Insurance Corporation (FDIC), Federal Home Loan Bank Board (FHLBB), National Credit Union Administration (NCUA).

--The amount of data included in the examination reports varied among the agencies and some data included in the reports did not appear to be useful to either the regulator or the financial institution. (See p. 24.)

--The agencies place varying emphasis on examining management activities in the institutions even though there appears to be little difference in examination objectives among the five Federal agencies. (See p. 33.)

--The agencies have different policies regarding specific guidelines for conducting and documenting examinations. (See p. 41.)

#### THE BURDEN OF EXAMINATIONS CAN BE REDUCED

Examinations of financial institutions--whether by a Federal or a State agency--are costly and disruptive to the operations of the institution. However, the Federal Financial Institutions Examination Council has opportunities to make examinations less burdensome. The functions of the Council are to establish uniform principles and standards and report forms for Federal examinations of financial institutions, to conduct schools for examiners, and to make recommendations for uniformity in other supervisory matters. The Council has established a subcommittee to study examination philosophies, concepts, and procedures and will be considering various proposals designed to promote consistency in the examination process. (See pp. 6 and 7.)

After studying the various approaches to examinations of financial institutions in use by the five Federal regulatory agencies, the Council would be in an excellent position to establish optimal examination principles and standards. The Council has an opportunity to reduce the cost and burden of examinations by establishing principles and standards which require the Federal agencies to

--rely more extensively on examinations performed adequately by State agencies,

- schedule examinations, to the extent possible, on the basis of a perceived need to examine rather than to comply with a static time frame,
- rely more on limited scope or modified examinations,
- rely more on work adequately conducted by institutions' internal review systems, and
- limit the information now included in the report of examination to that required by institutions and regulators.

SUPERVISORY ROLE NEEDS  
TO BE CLEARLY DEFINED

The Council also needs to consider the Federal supervisory role in overseeing institutions' management. Emphasis differs according to each agency's degree of concern about the time required to complete the examinations and about the likelihood that examination of management will infringe on the institutions' legitimate management decision-making process.

It is not clear from our review of the agencies' legislative mandates and their policies and procedures to what extent the examination process should properly influence the institutions' management decisions and activities or when such influence infringes on the prerogatives of management. Before the Council establishes uniform principles and standards, it should define the extent and nature of an appropriate Federal supervisory role in this area, especially with regard to institutions that may have management problems but are financially sound and in compliance with laws and regulations.

EXAMINATIONS NEED TO  
BE MORE STRUCTURED

Some agencies, by allowing their examiners considerably more discretion than do others in conducting examinations, have little assurance that examinations are conducted uniformly in all critical areas of the institutions' activities. Additionally, some agencies do not require docu-

mentation of examination procedures followed, tests performed, and information obtained. In establishing principles and standards for the Federal examination of financial institutions, the Council needs to establish standards to assure that examiners follow appropriate examination procedures and document their work.

#### RECOMMENDATIONS

GAO recommends that the Federal Financial Institutions Examination Council:

- Develop a Government-wide policy for assessing, monitoring, and accepting State examinations in lieu of Federal examinations when the State's work is considered adequate. (See pp. 25 and 26.)
- Develop a uniform system for scheduling examinations which is based on the need to examine an institution rather than on a fixed time frame. (See p. 26.)
- Develop examination standards which limit the amount of detailed work performed during a routine examination unless potential problems are detected. (See p. 26.)
- Develop examination principles which require Federal examiners to rely on functions adequately performed by others such as internal and external audit and internal loan review departments. (See p. 26.)
- Develop uniform standards for reporting the results of examinations which limit the amount of detailed data to that which is necessary for effective supervision. (See p. 26.)
- Define the supervisory role of the Federal agencies and, in particular, the extent to which they should attempt to influence the institutions in their management processes. (See p. 46.)
- Prescribe principles and standards which include the requirement that Federal

regulators develop structured examination procedures that clearly identify (1) examination objectives, (2) examination tasks required to achieve the objectives, and (3) documentation required to fully support report comments, conclusions, and recommendations. (See p. 47.)

#### AGENCY COMMENTS

The Federal Financial Institutions Examination Council generally agreed with the issues GAO identified and with GAO's assessment that the Council should address these issues in developing uniform principles and standards. The Council, however, did question whether it was appropriate for it to

--assess the acceptability of State examinations of financial institutions in lieu of Federal examinations and

--establish a Government-wide policy which requires Federal regulators to accept examinations that are competently conducted by State examiners.

While the Council has directed one of its task forces to explore ways in which the Federal regulators can place greater reliance on State examinations, it believes that any final decisions regarding the acceptability of State examinations in lieu of Federal examinations should be made by the Federal regulators.

Irrespective of whether final decisions on accepting State examinations are made by the agencies or the Council, GAO favors a strong role by the Council to avoid duplicative and possible inconsistent consideration and acceptance of State examination programs by the Federal regulators.

Federal regulators were in general agreement with GAO's proposal to increase reliance on limited scope examinations and on functions

adequately performed by internal and external audit and loan review departments.

The regulators also agreed with GAO's proposal to limit the amount of detailed data shown in examination reports even though some comments reflected a belief that they were already following some of these proposals. But, to varying extents, Federal regulators took exception with GAO's proposal to increase reliance on State agencies and to schedule examinations on the basis of perceived need rather than static time frames.

Federal regulators, with the exception of the Federal Deposit Insurance Corporation, did not basically disagree with the need for the Council to more clearly define how active Federal regulators should be in influencing management decisions regarding the operations of financial institutions. (See pp. 27 and 47 and app. I through VI for full text of all comments received.)

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ABBREVIATIONS

FDIC	Federal Deposit Insurance Corporation
FHLBB	Federal Home Loan Bank Board
FRS	Federal Reserve System
GAO	General Accounting Office
NCUA	National Credit Union Administration
OCC	Office of the Comptroller of the Currency



## Glossary

Financial institutions

Includes all commercial banks, savings and loan associations, and credit unions.

Management systems or activities

Includes management policies, plans, internal/external controls, including audit functions, and management information systems.

Examination programs

Includes the examination policies, manuals, procedures, questionnaires, and other guidelines.

Examination reports

Includes the regulators' letter to the institution, the report, and the confidential report section.



## CHAPTER 1

### INTRODUCTION

Five Federal regulatory agencies 1/ and various State agencies are charged with the supervisory responsibility of maintaining a sound banking system. Their specific responsibilities can range from chartering and examining financial institutions to liquidating failed institutions. Although the regulators' various supervisory responsibilities all play important roles, the examination is especially crucial in maintaining a sound system because it is the principal means for monitoring the activities of institutions and for identifying problems that require corrective actions by financial institutions' management. The examination process is the principal focus of this report.

### THE NATION'S BANKING SYSTEM

Financial institutions play a strategic role in our economy. They are the custodians of the deposits used in part to meet the financial needs of individuals, private businesses, and industry through loans and investments. The failure of a financial institution can affect depositors and borrowers in their immediate markets and, depending on the size of the involved financial institution, may reach beyond that market. To maintain public confidence in the banking system, Government supervision has long been viewed as a necessary mechanism to insure that safe and sound management and banking practices are followed in individual financial institutions.

About 41,000 commercial banks and thrift institutions are subject to the supervision of Federal regulatory agencies. The following table shows, by size, the number of commercial and mutual savings banks, savings and loan associations, and credit unions.

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1/Office of the Comptroller of the Currency (OCC), Federal Reserve System (FRS), Federal Deposit Insurance Corporation (FDIC), Federal Home Loan Bank Board (FHLBB), National Credit Union Administration (NCUA).

Number of Commercial and Mutual Savings Banks,  
Savings and Loan Associations, and Credit Unions

By Asset Size

	<u>1975</u>	<u>1978</u>	<u>Percent increase/ decrease</u>
<u>Commercial and mutual</u>			
<u>savings banks</u>			
Large banks with assets over \$1 billion	113	195	73
Medium banks with assets between \$100 million and \$1 billion	970	1,410	45
Small banks with assets below \$100 million	<u>13,903</u>	<u>13,110</u>	-6
Total	<u>14,986</u> =====	<u>14,715</u> =====	-2
<u>Savings &amp; loan (S&amp;L)</u>			
<u>associations</u>			
Large S & L's with assets over \$100 million	702	1,098	56
Medium S & L's with assets between \$10 and \$100 million	2,844	2,723	-4
Small S & L's with assets below \$10 million	<u>1,418</u>	<u>902</u>	-36
Total	<u>4,964</u> =====	<u>4,723</u> =====	-5
<u>Credit unions</u>			
Large credit unions with assets over \$5 million	1,513	2,338	55
Medium credit unions with assets between \$1 and \$5 million	4,331	5,219	21
Small credit unions with assets below \$1 million	<u>16,772</u>	<u>14,550</u>	-13
Total	<u>22,616</u> =====	<u>22,107</u> =====	-2

SUPERVISION OF FINANCIAL  
INSTITUTIONS--AN OVERVIEW

The broad objective of Federal and State regulators' supervisory efforts is to maintain a safe and sound banking system. To achieve this objective, Federal and State agencies

- charter financial institutions and approve expansion through branching and merger,
- promulgate regulations, rules, and policies to promote safe and sound practices,
- examine financial institutions or otherwise monitor their conditions and activities to determine the institutions' soundness and compliance with laws and regulations,
- require financial institutions to correct unsound or unsafe practices and conditions and violations of laws and regulations, and
- liquidate failed financial institutions.

Although Federal and State regulators perform various supervisory functions, the examination function is the foundation of the supervisory process. The information obtained during examinations is analyzed and evaluated to assess the institution's practices and conditions and adherence to laws and regulations. This analysis and evaluation form the basis for supervisory actions against the institutions. The examination and related information gathering, analyzing, and reporting tasks are, therefore, very important to the various supervisory agencies' ability to foster and maintain a sound banking system.

Examination responsibilities

Examination responsibilities are divided among Federal and State regulators. OCC, FHLBB, NCUA, and State agencies have the legal power to examine the institutions they charter. Most State-chartered institutions participate in Federal insurance programs and are subject to examination by the FHLBB, FDIC and NCUA. Some State-chartered banks are members of the Federal Reserve System and also subject to examination by FRS. FRS can also examine banks chartered by OCC because nationally chartered banks are members of the Federal Reserve System. Similarly, FDIC has authority to conduct special examinations of State member banks and national banks.

## Type of examination

Federal regulators use various types of examination programs to meet their responsibilities. The most common type of examination is called a commercial or safety and soundness examination and is used to analyze such financial institution operations as deposit-handling, loan-making, and securities investment, liquidity, capital adequacy, earnings, and management. Commercial examinations are also used to monitor internal controls, policies, procedures, and compliance with laws and regulations. Additionally, the regulators have developed special programs for examining trust and international departments, electronic data processing services, and compliance with consumer protection laws and regulations.

FDIC, FRS, and OCC customarily use two different types of commercial examinations. FHLBB uses one type of examination, for which the scope can be varied. NCUA uses a regular and an expanded comprehensive examination depending on individual circumstances. The two types of examination used by FDIC, FRS and OCC are as follows.

- Regular or general examinations: These examinations cover all aspects of a financial institution's administration and operation, and are intended to be conducted in sufficient depth to obtain a comprehensive understanding of a financial institution's policies, practices, and financial condition.
- Modified or special examinations: These examinations are more limited in depth than regular examinations, unless problems or significant changes are detected. Both OCC and FDIC use modified examinations that focus on all aspects of the financial institution but in less depth, especially in the loan review area. FRS uses a compacted examination that principally focuses on assets.

All five regulators complement their examinations with special supervisory visits. Generally, these short visits focus on problem situations requiring close supervision. Information derived from examinations and visits are sometimes further supplemented with reports or other data submitted by financial institutions.

## Other types of information sources

Financial institutions are required to periodically provide certain reports to the Federal regulators. For instance, banks are required to submit quarterly statements

of their financial condition. These reports tell the regulator about a bank's financial condition as reflected by its earnings, capital, investments, assets, liabilities, loans, and deposits.

Each regulator has a surveillance or early warning system. Information obtained through the statements of financial condition is entered into and analyzed by the system so that each regulator can monitor the financial institution's current condition in selected areas against its condition on previous occasions and in some cases against peer group averages. Some regulators also compare performance against their own standards.

When these surveillance systems identify adverse or unusual trends, the Federal regulators initiate followup actions. Generally, such actions consist of reviewing the last examination report or telephoning the involved financial institution to obtain an explanation for the trend. If the trend is of further concern, the regulator may elect to schedule a supervisory visit or even an examination to identify the severity of the potential problem and, if necessary, to initiate appropriate corrective measures.

#### Efforts to improve the examination process

The regulators are making efforts to improve their examination process by changing some aspects of their examination programs, as follows:

- FHLBB has implemented a limited scope examination program for relatively sound institutions. Examiners are given wide discretion in selecting the areas to be examined and the depth of the examination. If the examiners perceive a weakness, however, they are instructed to expand the examination to reach sound conclusions and arrive at a supportable rating of the institution.
  
- NCUA has implemented a more comprehensive examination in addition to its regular examination program. Unlike the regular examination, the comprehensive examination will be a complete balance sheet audit and will include an in-depth evaluation of internal controls, and an analysis of investments. Only credit unions with \$5 million or more in assets will be given a comprehensive examination; those credit unions with assets less than \$5 million will be given a regular examination.

- OCC has established a Multinational Banking Division that is fully responsible for the supervision and examination of banks with \$10 billion or more in assets and smaller banks that have major multinational activities. The actual examination functions will be performed by regional personnel, but examiners-in-charge will report directly to the division head.
- FRS is formulating revisions to its present commercial bank examination program and report. FRS is considering extending the amount of time between examinations for banks that are free of unsound conditions in order to make more efficient use of examination personnel and to devote more time to banks requiring increased supervision. As part of its commercial examination, FRS is also considering expanding the use it makes of sampling techniques in reviewing loans and increasing its reliance on the work of competent internal auditors.
- FDIC has implemented modified examination procedures which are similar in thrust to those implemented by the FHLBB discussed above. In addition, the basic guidelines for conducting examinations have been amended to focus more on problem banks and those of supervisory concern. It is also reviewing the feasibility of using sampling methods in its loan review process.

FEDERAL FINANCIAL INSTITUTIONS  
EXAMINATION COUNCIL--AN INTERAGENCY  
COORDINATION MECHANISM

In our 1977 report, 1/ we recommended that either the regulators or the Congress establish a mechanism for more effective coordination. Subsequently, an Interagency Supervisory Committee, comprising representatives of FDIC, FHLBB, FRS, NCUA, and OCC, was formed and held its first meeting on March 4, 1977. The new Committee provided a more formal framework at the working level to improve the supervisory process and to resolve common problems. The Committee held monthly meetings and created task force groups to study various issues.

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1/"Federal Supervision of State and National Banks"  
(OCG-77-1, January 31, 1977.)



In November 1978, the Congress formalized the existing interagency coordination efforts by establishing the Federal Financial Institutions Examination Council (12 U.S.C. 3301). The Examination Council, which began operation on March 16, 1979, was mandated to prescribe uniform principles and standards for the Federal examination of financial institutions, to make recommendations to promote progressive and vigilant supervision of financial institutions, and to conduct schools for examiners.

The Examination Council is composed of top officials from all five Federal regulators. In March 1979, at its first meeting, the Council established five task force groups to deal specifically with issues involving supervision, surveillance, examiner education, consumer compliance, and reports. Each task force subsequently has identified one or more projects dealing with items of current interest, and one--the Task Force on Supervision--deals with the review of examination philosophies, concepts, and procedures.

#### OBJECTIVES, SCOPE, AND METHODOLOGY

We initiated this review because we wanted to assess the changes made by the bank regulatory agencies since our 1977 study. When we completed our prior study, the agencies were making numerous changes in their examination approaches. In our 1977 report we made several recommendations to improve bank examinations, including a recommendation that the three bank agencies jointly evaluate the OCC examination procedures being implemented at that time. However, no formal evaluation was ever made. In addition, none of the agencies had collected empirical data on their various examination programs to determine if they were accomplishing their fundamental objective.

After we began our review, the Examination Council initiated its own study of existing examination philosophies and programs. Accordingly, we limited the scope of our work to identify those issues related to the frequency, depth and breadth of examinations which we believe the Examination Council needs to address and to provide some observations on those issues. We did this in order not to duplicate the work of the Examination Council or inhibit it from accomplishing its congressional mandate of developing uniform principles and standards for Federal examinations of financial institutions. Therefore, our work did not include a comprehensive analysis of each issue and did not make specific recommendations to each of the Federal regulators.

Our review covered the five Federal regulatory agencies, but with minor emphasis on the review of FHLBB and NCUA examination philosophies and programs. We deemphasized FHLBB and NCUA because of time constraints and our special interest in the three

bank regulators since our 1977 report. We conducted the majority of our work in Washington, D.C., and in San Francisco, California. We selected San Francisco primarily to test OCC's examination approach and to compare it with the examination approaches of the other regulators. In addition to Washington and San Francisco staff, we interviewed agency personnel at various organizational levels in Atlanta, Georgia; Chicago, Illinois; and St. Louis, Missouri, in order to identify ways to reduce the burden of examinations.

We also observed an OCC and FDIC examination and reviewed several randomly selected examination reports of financial institutions to identify the process each regulator followed and the breadth and depth of the reports. Additionally, we attempted to determine if Federal regulators could extend the interval between examinations or reduce the scope of examinations without impairing their ability to ensure the soundness of financial institutions. We did this by analyzing examination frequency data in relationship to the condition of the bank and to the number of problem institutions, use of supplemental data generated from surveillance systems and offsite reviews, and use of modified examinations.

We contacted some State supervisory agencies and selected financial institutions to obtain their views on the cooperative examination programs that the Georgia and Indiana banking agencies have with FDIC and FRS for examining State-chartered banks. We did not evaluate the various examination programs of the 50 States. However, on the basis of our discussions with agency officials and others, we determined that some States perform examination functions better than others, some of which are comparable to those of Federal regulators and could be an acceptable substitute for Federal examination efforts.

Also, we reviewed and analyzed the Federal banking laws to determine congressional intent as it related to objectives and authority and responsibilities of the five Federal regulatory agencies. Finally, we did not assess the entire supervisory process but rather focused on the examination process.

## CHAPTER 2

### THE BURDEN OF EXAMINATIONS CAN BE REDUCED

Federal regulators have not determined the optimal examination effort needed to effectively supervise financial institutions while minimizing supervisory cost. In many respects, the determination of an effective level of supervisory effort requires Federal regulators to weigh the risks of institutional failures or problems against the cost of Federal examinations and the disruption that examiners may cause to financial institutions' employees normal work routines. The regulators must also consider that each depositor in an insured institution is protected by deposit insurance on all deposits up to a maximum amount. Although the optimal amount of acceptable risk is difficult to determine, Federal regulators could do more to establish an examination effort that is commensurate with the condition of financial institutions. Furthermore, Federal regulators could improve the effectiveness of their supervisory efforts by

- relying more extensively on examinations performed adequately by State agencies,
- scheduling examinations, to the extent possible, on the basis of a perceived need to examine rather than to comply with a static time frame,
- relying more on limited scope or modified examinations,
- relying more on work adequately conducted by institutions' internal review systems, and
- limiting the information now included in the report of examination to that required by institutions and regulators.

FEDERAL REGULATORS CAN RELY  
MORE ON STATE EXAMINATIONS

Many financial institutions examined by the Federal regulatory agencies 1/ are also examined by State agencies. The Federal regulatory agencies have not made any comprehensive study of the States' examination programs to determine which States' examinations could be accepted as substitutes for Federal examinations. The extent to which States' examination functions are accepted by Federal agencies varies from agency to agency and sometimes from office to office within an agency. For example, NCUA essentially accepts the examinations made by State agencies in lieu of its own, while the other three Federal agencies either conduct separate examinations from State agencies or participate with States in various types of cooperative programs. In our opinion, a significant potential exists for reducing the Federal examination effort by greater acceptance of States' examination reports.

Efforts to reduce the  
overlap in the examination of  
State-chartered institutions

Federal regulators use several types of cooperative programs designed to reduce the burden of examinations. The most commonly used cooperative programs are the joint and concurrent examinations with States. Under these programs, State and Federal examiners examine the institutions together and generally share the work. In joint examinations, they prepare a single report; whereas, in concurrent examinations the State and Federal examiners each prepare separate reports.

From 1974 through 1976, FDIC was involved in an experimental program with three States designed to reduce its examination efforts. During the first two years of the

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1/OCC is the only Federal financial regulatory agency that does not examine State-chartered institutions.

program, FDIC did not conduct any examinations of selected State-chartered banks, but received State examination reports of those banks. In the third year of the program, FDIC examined those banks it had not examined during 1974 and 1975, to determine their condition and evaluate the effectiveness of the States' examinations. FDIC concluded that State-prepared reports could possibly disclose deterioration in a bank's condition before it reached a serious level, however, this could not be assured over a longer period of time. One FDIC official said that with the improvements made in their monitoring systems since 1976, such a program would be workable today.

In 1977, FDIC initiated a divided examination program on a limited basis. Until January 1980, the program involved three States but has since been expanded to six States with three more pending. Under that program, FDIC and the State alternate examinations of nonproblem banks and accept each other's examination reports. Also, FRS has an arrangement with a State in which it largely relies on the State examinations of banks located in certain sections of the State. In this program, one FRS examiner accompanies the State examiners to observe their work and to perform tasks of special interest to FRS. The FRS examiner does not prepare a separate report but discusses any area of concern in a separate letter to the bank. FDIC and FRS perform at least some joint or concurrent examinations with about one half of the Nation's State banking authorities. FHLBB conducts joint or concurrent examinations with most States that have State-chartered savings and loan associations.

Several problems are hampering the expansion of cooperative examinations. FDIC has extended its examination interval for nonproblem banks to once in every 18-month period, but many States require an annual examination. In those instances, States must conduct some examinations independently to comply with State law or FDIC must conduct examinations more frequently than the 18-month goal. Finally, one State refuses, for undetermined reasons, to participate in any joint examination effort, even though such arrangements appear beneficial to both Federal and State agencies.

A September 1979 report of an FDIC commissioned study of State and Federal regulation of commercial banks contained several recommendations dealing with cooperative State and Federal examination programs. One recommendation stated that the Federal and State agencies should develop much closer working relationships in the examinations of State banks with a view to reducing the burden of examinations. The report noted that combined annual savings to the FDIC, FRS, and the States could exceed \$13 million.

To illustrate the need for closer working relationships, the report notes that three out of five State member banks and three out of four State nonmember banks were examined three or more times during the 2-year period 1977-78 by State and Federal examiners. On the other hand, only one national bank in five was examined that frequently. The report noted that smaller State banks, in which the inherent risk to the banking system is low, are examined most frequently. The report also noted that as each agency satisfies its own examination frequency standards independently of the other, the State bank is subject to more examinations than either agency believes is necessary.

### Reluctance to accept State examination efforts

The extent to which Federal agencies are able to reduce the burden and cost of their examinations is related to the competency of the State agencies to adequately examine the institutions. Federal regulators do not maintain information on the adequacy of State examination programs. However, FDIC told us that 16 States would qualify for its divided examination program if the States desired to participate. Furthermore, FDIC field officials indicated that over half of the States had examination systems comparable to or almost comparable to the Federal system.

Despite the apparent competency of several States, Federal agencies have been reluctant to accept State examinations in lieu of their own. Illustrations of this reluctance follow.

#### 1. Close interval between Federal and State examinations

We obtained information from three FDIC regions on the scheduling of examinations by both FDIC and State authorities. We found that the interval between the Federal and State examinations at times varied from within 1 to 9 months. This occurred in spite of the agency's goal of examining problem banks every 12 months and nonproblem banks once in every 18-month period. In these regions we also noted some examples where there was a very short interval between the State and Federal examinations.

In one FDIC region the Federal or State agency in some cases began an examination within 1 or 2 weeks after the other agency had completed its examination even though Federal officials believed that State had a good examination program. The following table illustrates this problem.

Bank	State examination		FDIC examination		Staff hours
	Began	Completed	Began	Completed	Spent by FDIC
A	12/4/78	12/11/78	12/16/78	12/22/78	194
B	7/2/79	7/6/79	7/11/79	7/16/79	60
C	6/4/79	6/15/79	6/25/79	7/18/79	209

Similarly, we noted that FRS performed an examination of a bank considered to have sound management and to be in sound condition 3 months after the State examined the bank. The State was considered to have a competent examination system by FRS as well as FDIC officials. We discussed both the scheduling and scoping of the examination with an FRS official and found that no consideration had been given to the State examination completed 3 months earlier. Such a practice of examining banks is an ineffective use of resources and unnecessarily distracts bank employees from performing their day-to-day operations.

2. State examinations in Georgia are accepted by FDIC but not FRS

The FDIC regional office participates with Georgia in a cooperative divided examination program in which they each examine half of the nonproblem banks by alternating examinations each year. FDIC regional officials said that examination and related work done by Georgia State examiners is very satisfactory, including tests to determine if banks comply with Federal laws. Further, both the FDIC and State officials said they believe that they have mutually benefited from this program. They cited time savings which enhance their ability to carry out other supervisory responsibilities.

The FDIC regional office estimated that the program saves at least \$1 million per year in staff resources, travel, and administrative costs such as processing and reviewing examination reports and a reduction or stabilization in the number of examiners required to do the same job. The State also believes that the program has provided it with more flexibility to concentrate examiner resources on problem bank situations. In this regard the State noted that, due to time savings resulting from the program, it has been able to send its examiners to problem banks three times per year.

FRS examines Georgia State member banks independently or concurrently with State examiners but it does not participate with Georgia in any cooperative arrangement similar to the FDIC program with Georgia. Although FRS officials said that the State of Georgia has an above average banking

department, they did not favor participation in a divided examination program. These officials said that personnel changes at the top levels of the State banking department or the State government could disrupt the continuity of the department and could, therefore, be detrimental to the working relationship between FRS and the State.

3. State examinations in Indiana are accepted by one FRS district but not another district

The Chicago FRS district bank participates with Indiana in an accompanied examination program whereby one or two FRS examiners observe and participate in the commercial examination of a State member bank conducted by State examiners. Whereas previously well over 50 percent of FRS examiners' onsite time was spent reviewing assets, State examiners now review and assemble the credit information. FRS examiners review the State results and focus on those areas considered necessary, such as bank management, policies and practices, previously criticized loans and other loans, and compliance with FRS regulations. The major purpose of this program is to reduce detailed work done by FRS examiners and to establish an overview role for FRS examiners which allows them to monitor the general condition of banks as effectively as possible.

The Chicago FRS district bank's program with Indiana includes 31 State member banks and applies only to commercial examinations of those banks. The Chicago FRS district bank stated that its experience in this program has been very satisfactory with regard to the State's examination scope, capability of examiners, and quality of examination reports. The Chicago FRS district bank said that the two main advantages resulting from this program are savings in examiner staff time and freeing the examiner to review the bank as a whole, that is, to review operational deficiencies, liquidity, and other changes occurring between examinations.

In contrast to the Chicago FRS district bank, the St. Louis FRS district bank, which supervises eight State member banks located in southern Indiana, does not participate with Indiana's banking department in a cooperative examination program. The St. Louis FRS district bank has decided not to participate with Indiana in a cooperative examination program, because it believes that examination responsibilities should not be shared with the State. The St. Louis FRS district bank also claims that Indiana examiners do not examine banks for compliance with Federal consumer-oriented regulations, even though the Chicago FRS district bank gets around the problem by letting the FRS examiner perform the consumer compliance examinations.



In addition to this unusual situation within the FRS, the Chicago FDIC regional office also does not participate with Indiana in an accompanied examination program because it considers such programs unsuitable in fulfilling its responsibilities. Instead, the Chicago FDIC regional office has proposed a divided examination program, but Indiana rejected the proposal because it feels responsible for the examination of banks it charters.

FEDERAL REGULATORS' EXAMINATION  
FREQUENCY STANDARDS CAN BE MORE  
FLEXIBLE

Federal regulatory agencies appear to rely too heavily on fixed time frames for scheduling examinations. This procedure encourages regulatory agencies to examine well run institutions more frequently than necessary. We believe that the Examination Council should develop a system for scheduling examinations which bases the scheduling of examinations, to the extent possible, on a perceived need to examine rather than to comply with a fixed time frame. In this way the agencies can concentrate their examination efforts on those institutions that need their attention.

Staffing Constraints--Key Factors In  
Establishing Examination Frequency And  
Scope Standards

Federal regulators have no statutory requirement to examine institutions within given frequencies; however, prior to 1977, they, for the most part, have examined institutions annually under a full-scope or regular examination program. Since that time, the Federal regulators have begun to use more limited scope or modified examinations in sound institutions. With the exception of the FRS, they have also implemented new frequency goals which stretched out the monthly interval between examinations. As shown below, most new frequency goals bear some relationship to the institution's soundness.

Monthly Interval  
Between Commercial Examinations

<u>Regulator</u>	<u>Financial Institutions With</u>	
	<u>Problems</u>	<u>No Problems</u>
FDIC	12	18
FHLBB	6	16
FRS	6	12
OCC	6	a/18
NCUA	16	b/24

a/Banks with assets over \$100 million are to be examined every 12 months.

b/Credit Unions with assets over \$1 million are to be examined every 16 months.

Budgetary and staffing constraints in the face of increasing work and regulatory responsibilities appear to be one of the principal reasons why most regulators changed their policies regarding the frequency and scope of their examinations. The regulatory responsibilities have increased chiefly because of consumer protection and equal rights legislation. Examiner time is now required to insure that financial institutions are complying with legislation such as the Truth in Lending Act of 1974, the Equal Credit Opportunity Act of 1974, and the Community Reinvestment Act of 1979.

In our opinion, another factor impacting on staff resources has been the introduction of more comprehensive examination procedures and surveillance systems. While aiding the examination process by pin-pointing some potential weaknesses, surveillance systems require staff resources to identify, monitor and follow up on changing conditions in institutions.

We believe the regulators have been correct in stretching out the frequency of examinations and using more limited scope examinations. However, they have done it for budgetary and staffing reasons and not because the institution was well run and the risk of failure low. We believe the regulators could do more to cut back on examining such institutions.

Timing and frequency of examinations

As discussed above, most regulators have a single frequency standard for scheduling examinations for problem institutions and a single frequency for nonproblem institutions. However, no further differentiation is made in each category and some institutions may be examined more frequently

than necessary. For example, some nonproblem institutions may have excellent internal controls, very conservative policies, and strong management, while others may be weak in these areas, thus raising the question of whether the well managed institutions could be examined less frequently than the weaker institutions under a more sophisticated scheduling system.

Another indication of too frequent examinations can be seen in the differences of the five regulators' frequency standards for similarly rated institutions. For instance, the FRS and FHLBB policy is to examine all nonproblem institutions every 12 and 16 months, respectively. FDIC's goal is to examine all nonproblem institutions once in each 18-month period. OCC's goal is to examine nonproblem banks with assets exceeding \$100 million annually and those with \$100 million or less once every 18 months. NCUA examines its institutions every 16 months; however, credit unions with assets less than \$1 million are to be examined every 24 months.

Yet another indication that the frequency of examination standards could be stretched out beyond the agencies' current standards without exposing the institutions to undue risk can be seen from an analysis of recent OCC experiences. The average interval between examinations of similar type institutions differed significantly from region to region. For example, we noted that for the 12-month period ending December 31, 1979, the average interval between examinations of the best rated banks which had assets of less than \$100 million ranged from a low of 10 months at one region to a high of 20 months at another region.

With respect to problem banks, we analyzed OCC's list of banks requiring special supervisory attention to see if there was a relationship between the frequency at which banks were being added to the list and the frequency of examination. There was no apparent relationship between the average frequency of examination and the frequency at which banks developed problems; that is, regions that examined banks less frequently than others did not necessarily have more banks with problems.

We also discussed with Federal officials current frequency standards and several officials believe that the standards could be extended further. OCC and FDIC regional officials said that some nonproblem banks in their region are operated so soundly that, under certain conditions, they could be examined under general procedures once every 3 years. Chicago FRS district bank officials believe that 3 of the largest banks and 185 other well managed banks could be examined once every 2 years. They said it is not necessary to

examine a bank if its performance history has been satisfactory and there have been no material changes, particularly with regard to management and loan control procedures. Chicago FDIC regional office officials also thought that the optimum examination frequency was anywhere from 18 to 24 months for nonproblem banks by relying more extensively on such techniques as surveillance systems, visitations and results of State examinations.

#### Alternative methods for scheduling examinations

We believe that there are two alternatives to the present method of scheduling examinations which the Examination Council should consider. One method, which essentially is a refinement of the existing method, is to base frequency goals on many factors and conditions at the institutions rather than merely dividing institutions into problem and nonproblem institutions and large and small institutions.

One mechanism that could be used to refine frequency goals is the rating system that the five Federal agencies have adopted. Under this system, examiners assess and rate the institution's capital, assets, management, earnings, and liquidity and determine a composite rating which reflects the institution's soundness. At the present time, the composite rating, ranging from 1 to 5, is used to distinguish between problem and nonproblem banks and to determine examination frequency. However, the agencies have established their own criteria to determine which banks are problem banks and the frequency with which they should be examined. We believe that uniform standards could be developed which take into account the individual and composite ratings.

This method of establishing frequency goals would need to be supplemented by data generated from the agencies' surveillance systems. Each of the bank regulators has a computerized monitoring system that is intended to be a management tool as well as a means for detecting problems in banks. The systems vary in their sophistication and the extent to which they can be utilized in the examination process.

Another method of determining when an institution needs to be examined is to make more use of offsite bank reviews whereby the examiner makes an abbreviated analysis of what has happened at the bank since the last onsite examination. For example, OCC, in May 1979, recognizing that it could not achieve its goal of examining nonproblem banks with assets less than \$100 million every 18 months, established remote examination procedures and guidelines. The remote examination

is an offsite review of the institution. According to OCC, one purpose of the remote examination was to assist regions in prioritizing banks for onsite examination.

Under remote examination procedures, the examiner was required to thoroughly review financial data about the bank produced from the agency's computerized early warning system, reports of condition and income, most recent general and subsequent specialized examination reports, and all correspondence files. Additionally the examiner was required to review certain Securities and Exchange Commission reports, annual reports to shareholders, FRS examination reports, and internal audit reports. OCC's procedures provided that

"All major areas of concern should be addressed in a manner that explains the history, current status and future of the subject being discussed. For example, if capital shows a downward trend over the past few years, but is currently at an acceptable level, discuss the bank's plan for maintaining an adequate capital base. Earnings, capital, asset growth rate, loan growth rate, asset mix changes, liability mix changes and balance sheet composition should be examined and commented upon. Management and ownership should be evaluated, and an opinion as to the general condition of the bank should be provided."

One OCC official said that it typically takes about 1 day to conduct a remote examination. The official also said that for historically sound banks a remote examination plus a 1 or 2 day visit to the bank would be sufficient to ensure that (1) the bank is in sound condition or (2) the bank has problems which warrant an onsite examination.

#### FEDERAL REGULATORS CAN MAKE MORE USE OF LIMITED SCOPE EXAMINATIONS

Most Federal regulators have developed examinations that have a limited scope as compared to full scope examination programs. The manner in which modified examinations are used vary from agency to agency and sometimes from field office to field office within an agency. Since most institutions do not have serious problems, we believe that the Federal regulators could reduce the burden of examinations by routinely using modified examination programs with the provision that these are expanded only when there are indications that the institution may be getting in trouble or has weaknesses which need correction.

## What are modified examinations?

The term "modified examinations" has somewhat different meanings to each agency. The type of modified examination which we believe could routinely be performed in lieu of regular examinations would require enough work to permit examiners to form an opinion of the overall condition of the institution. It would not require the examiner to perform all detailed examination steps unless there are indications of significant problems in the institution's condition.

A different type of modified examination is FHLBB's minimum examination. It is one example of a modified examination with reduced documentation requirements. Under the regular FHLBB examination program, examiners are required to complete a series of detailed examination programs. Each program includes a checklist of items to be examined. By using the modified approach, FHLBB reduced the number of examination programs that must be completed and the amount of documentation that must be collected.

## Modified examination reduces time

Modified examination procedures effectively reduce examination time. While nationwide data is not readily available, regulators have been monitoring the impact of modified procedures on examination times as discussed in the three examples below.

--FDIC has completed its first full 18-month examination cycle using its current procedures. The latest available data--for the first 6 months ended June 30, 1979--indicates that the modified examination procedures reduced examination time by an average of 20 percent. This figure is distorted by the inclusion of eight large banks with assets over \$100 million that were examined during that period. If the eight large banks are eliminated from the summary statistics, the savings in examination time increases to 40 percent.

--At the time of our review, the San Francisco FRS district bank had used its abbreviated examination at only two banks. For the first bank, with assets of \$95 million, the amount of staff time required was reduced 39 percent. For the second bank, with assets of \$672 million, the total staff time was reduced 26 percent. The Chicago FRS district bank said

that about 12 percent of examiner staff time is saved by using modified scope examinations. It said that the use of modified examinations saved time and reduced the requirement for five additional examiners.

- The San Francisco FHLBB began using its revised examination procedures in June 1979. For the first 15 savings and loan institutions examined under the new procedures, staff time was reduced an average of 19 percent. When the data were adjusted to reflect the growth in the assets of the savings and loan institutions, staff days spent on examinations for each million dollars of assets was reduced 37 percent.

#### Inconsistent use of modified examinations

Federal regulators are inconsistent on how or when to use modified examinations. FDIC used modified examination programs on approximately 63 percent of the nonproblem banks it examined during the first 6 months of 1979. In FDIC's San Francisco region, nearly all examinations of nonproblem banks are now modified in scope. According to FDIC officials in Chicago and Atlanta, situations in these cities are the same.

The San Francisco FRS's district bank policy also permits the use of modified examinations in nonproblem banks. However, the Atlanta FRS district bank does not use modified scope examinations. In contrast, the Chicago FRS district bank uses them significantly.

Similarly, the OCC San Francisco region has been alternating full scope and modified scope examinations of nonproblem banks. However, another region that is not as well staffed in relation to its workload routinely makes modified scope examinations of nonproblem banks.

#### FEDERAL REGULATORS CAN PLACE GREATER RELIANCE ON INTERNAL REVIEW SYSTEMS

Adequate internal review systems, whether they take the form of an internal audit, external audit, or an internal loan review group, can reduce the time spent examining institutions, and regulators should maximize their reliance on adequate internal systems. While all three bank regulators appear to consider the work performed by internal review

systems in their review of loans, only OCC recently began to accept the bank's loan review in lieu of its own. Since most of the examiners' time is spent reviewing loans, a good part of the total examination time can be reduced if the regulators increase their reliance on the work of good internal loan review groups.

As discussed later in this report, OCC uses a different approach to bank examinations than FDIC and FRS do. This difference directly affects the extent examiners can confidently rely on the work of a bank's internal loan review group to decrease the amount of work they might otherwise have to do. In several recent examinations, OCC determined that a bank's loan review department was competent in detecting problem loans, and the agency limited its loan review to a small sample of the bank's loan portfolio. For example, in the examination of a large California bank, OCC reviewed 315 loans or about 10 percent of the total dollar value of the loan portfolio. Normally, the examiners would have reviewed 70 to 80 percent of the total dollar value of the loan portfolio and loan review would have consumed 40 to 75 percent of the total time spent on examining the institutions. When the examiner found no discrepancies between the way he graded the loans and the way the loan review department had graded the loans, he terminated his loan review and incorporated the bank's figures on classified assets into his examination report.

FDIC and FRS examiners do not systematically review the loan review department and do not substantially change their approach to loan reviews even for banks that the two agencies acknowledge have competent loan review departments. However, FDIC and FRS examiners may review fewer loans or reduce the verification of information in the loan file. For instance, the New York FRS district bank, in examining New York money market center banks, reduces the analysis of loans and accepts, in part, the work of the banks' internal loan review groups. As a result, FRS examiners spend as much as 50 percent less time examining loans in these large banks. The New York FRS district bank is considering expanding this program to include smaller banks in the district.

As of June 30, 1979, FDIC supervised 22 State nonmember banks with assets totaling \$1 billion or more. According to FDIC, most of the banks had adequate internal loan review groups. FDIC said it uses the work of 12 internal loan review groups to varying degrees. For example, some of the internal loan review work is used



- to help examiners analyze risk and determine overall competence of loan officers and management,
- to serve as a crosscheck of the examiner's independent loan analysis,
- to spot problem loans of less than \$100,000,
- to classify nonproblem loans without extensive review and problem loans with extensive review, and
- to identify smaller problem loans.

For the most part, FDIC thought that internal loan review groups were not independent from loan management and cited this most frequently as the reason for not placing more reliance on such work. Other reasons mentioned were

- internal loan review group was not refined to the point that it could detect special mention and substandard loans early,
- FDIC examiners believe they are responsible for assessing the quality of the assets on an independent basis,
- FDIC examiners have to make an independent analysis of loans anyway in order to judge the adequacy of the internal review work, and
- bank management wants an independent examination.

OCC and FRS officials disagree with FDIC and agree that they can place increased reliance on banks' internal loan review groups. In our opinion, each institution's internal loan review group has to be evaluated on a case-by-case basis. If the results of that evaluation indicate that the loan review group is competent, we believe the agencies should place increased reliance on its work. Therefore, we believe that the Council, in developing uniform principles and standards for the Federal examination of financial institutions, should establish standards which provide for testing internal and external reviews of the institutions and relying on work adequately performed by others.

## FEDERAL REGULATORS CAN STREAMLINE EXAMINATION REPORTS

Preparation of examination reports consumes a significant amount of the time an examiner spends on examinations. The examination reports may contain more detail than necessary. FHLBB and NCUA prepare rather brief narrative reports, whereas, the three banking regulators prepare very detailed reports and spend considerable time and effort writing reports. The benefit to either the regulator or the banks of including some data appears to be minimal. Consequently, we question whether the inclusion of all the detail now in the reports is a prudent use of examiner time.

This question would seem especially pertinent to reports dealing with relatively well managed banks. In one examination, we noted that OCC spent 2,351 staff days to examine a large bank. The examination report contained no major recommendations for improving the institution's loan activities. The report stated that the condition of the bank had improved since the last examination, and the amount of criticized assets had decreased. Nevertheless, the report contained 91 pages of detailed discussion of criticized assets.

During the course of the examination, the examiner apparently discussed each loan with bank officials in an effort to reach agreement on proper loan classifications. The examiner's workpapers contain key information supporting the classification of each loan. Since no record existed of any followup with the bank between examinations to monitor these loan activities, we question, from a supervisory viewpoint, the usefulness of the detailed data in the report.

### CONCLUSIONS

The burden of examinations can and should be reduced. Federal regulatory agencies have never determined how frequently financial institutions should be examined but instead have reacted more to budgetary and manpower restrictions. The agencies do not agree how frequently financial institutions should be examined, and the burden is compounded when financial institutions are subject to both a Federal and State examination.

The Federal regulators do not rely enough on examinations adequately performed by State agencies and often overlap each other's work. In some States, however, Federal and State agencies have worked out several types of mutually beneficial arrangements for examining banks. But more needs to be done, because Federal agencies do not uniformly accept these arrangements.

Federal regulatory agencies also appear to rely too heavily on static time frames for scheduling examinations. This method may result in examining some institutions more frequently than necessary and some not enough. Most agencies have different frequencies for problem and nonproblem institutions and for large and small institutions. But there may be a need to examine some problem institutions more or less frequently than others and to examine some nonproblem institutions more or less frequently than others. The existing scheduling system does not address this need. To further illustrate this point, some agencies have been forced to stretch their time frames beyond their own standards. Yet there has been no apparent increase in problem or failed institutions. To assure that the most efficient and effective utilization is made of the Government's examiner staff, we believe that a better scheduling system is needed to identify and direct examinations to those institutions which have the greatest apparent need and will benefit from the examinations.

Federal regulatory agencies should make greater use of limited scope examinations. Currently, each agency uses such examinations differently. Since most institutions do not have serious problems, we believe routine use could be made of limited scope examinations with the requirement to expand them when there is some indication that an institution may be getting in trouble or have some weaknesses which need correction. Prudent use of limited scope examinations can result in time savings and in more efficient and consistent use of examiner resources.

The Federal regulatory agencies also make insufficient use of functions adequately performed by others. Adequate internal review systems, such as internal or external audit groups or internal loan review groups, can reduce the amount of time examiners spend examining banks. Yet only one of the three bank regulators uses the work of such groups systematically and to any great extent. Additionally, the Federal regulators appear to include more data in reports of examination than is actually needed by the institution and the regulator.

#### RECOMMENDATIONS TO THE FEDERAL FINANCIAL INSTITUTIONS EXAMINATION COUNCIL

We recommend that the Council:

- Develop criteria for Federal regulators to assess the quality of examinations performed by State agencies, and to monitor the States' examination programs to assess changes which may affect the

acceptability of the States' programs for Federal needs.

- Develop a Federal Government-wide policy under which Federal regulators, using the above criteria, would assess and monitor the quality of State examinations and accept examinations that are competently performed by State agencies in lieu of their own. The Government-wide policy should authorize Federal regulators to make special examinations of any State-chartered financial institutions whenever in the judgment of the agency such examinations are necessary. The policy should emphasize that the special examination authority should only be utilized in exceptional cases and should not be used to perform regular periodic examinations of the institutions.
- Develop a system for determining the timing of examinations which is based on a perceived need to examine rather than on the basis of a static time frame.
- Develop examination standards which limit the amount of detailed work performed during a routine examination unless potential problems are detected.
- Develop examination principles which require Federal examiners to rely on functions adequately performed by others such as internal and external audit and internal loan review departments. The Council should develop criteria for testing and assessing the quality of these systems before the agencies could rely on them.
- Develop uniform standards for reporting the results of examinations which limit the amount of detailed data to that which is necessary for effective supervision.

## AGENCY COMMENTS AND OUR EVALUATION

The Examination Council is in general agreement with the theme of our report. The Examination Council stated that its Task Force on Supervision has a study underway which will result in recommendations to increase uniformity in such matters as the timing and the scope of examinations and other policy matters. The Council stated that when the Task Force completes its study, our recommendations will have been appropriately addressed, with the possible exception of two recommendations related to Federal regulators accepting examinations made by State regulatory agencies in lieu of their own examination. With regard to accepting State examinations, the Council requested the Task Force on Supervision to explore ways in which agencies can place greater reliance on examinations of banks and thrift institutions performed by the States.

In our draft report, we proposed that the Council:

- Assess the quality of examinations performed by State agencies and develop a Federal Government-wide policy which requires Federal regulators to accept examinations that are competently performed by State agencies in lieu of their own.
- Develop criteria for the continued monitoring of the States' examination programs to assess changes which may occur which would affect the acceptability of the State's program for Federal needs.

The Examination Council believes that Title X of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 does not empower it to evaluate State agencies directly. It further believes that Federal regulators' statutory responsibilities require them, rather than the Council, to make any final determination regarding the use of examination reports completed by competent States in lieu of their own.

We directed our proposals at the Council rather than at each regulator because (1) past experience shows that Federal regulators have not uniformly accepted State examinations and (2) it would be a wasteful duplication of effort for each of the five Federal regulators to individually evaluate the various State examination programs. However, in view of the Council's commitment to explore ways in which the agencies can place greater reliance on examinations performed by States, we have modified our position to recommend that the Council develop the criteria necessary for the uniform evaluation of State examinations and to monitor the Federal regulators'

efforts to determine the acceptability of State examination programs and reports. By placing additional responsibility on the Federal regulators for evaluating, monitoring, and accepting State examination reports in lieu of their own examinations, we believe these modifications may overcome some of the concerns expressed by the Council about our proposals and at the same time provide the Council with sufficient flexibility to accomplish the objective we are seeking. As stated in the report, however, we advocate only that Federal regulators rely on State examinations that are competently performed. We did not envision the Council developing a Government-wide policy that would be so inflexible that a Federal agency could not examine institutions when it had some specific need even if the State had a competent examination program. Our recommendation was intended to preclude routine examinations of banks that are being adequately examined by State agencies.

Notwithstanding our modifications of the recommendations we continue to favor a strong Examination Council role in monitoring Federal regulators and in seeking extensive inter-agency coordination, if not joint studies, to evaluate the quality of State agencies. In our view, a strong role is not only consistent with the legislative intent establishing the body as a central policymaking and coordinating mechanism, but also with the practical realities of avoiding duplicative and potentially inconsistent evaluation efforts on the part of Federal regulators.

Federal regulators were in general agreement with our recommendation to increase reliance on limited scope examinations and on functions adequately performed by internal and external audit and loan review departments. The regulators also agreed with our recommendation to limit the amount of detailed data shown in examination reports even though some comments reflected a belief that they were already following some of these proposals. But, to varying extents, Federal regulators took exception to our recommendation to increase reliance on State agencies and to schedule examinations on the basis of perceived need rather than static time frames.

Before discussing the agencies' major concerns, we believe the report should be placed in proper perspective. We also have some general comments on the Council's role as perceived by the Federal regulators. These comments seem necessary because OCC stated that the report has not adequately supported the premise that the regulatory agencies have not balanced supervisory needs with supervisory costs. OCC as well as FHLBB and NCUA believe that the report should

identify the regulator(s) with problems and direct recommendations to them rather than making seemingly all-inclusive recommendations to the Council.

We do not believe that these comments are valid for this report. As we pointed out in the scope section, our efforts were never intended to be a comprehensive analysis of each issue. We did not want to duplicate the work of the Examination Council nor in any way inhibit it from accomplishing its congressional mandate of developing uniform principles and standards for Federal examinations of financial institutions. Accordingly, the report identifies broad issues we believe the Council needs to address and provides some observations on these issues, but does not recommend specific actions for each of the five Federal regulators.

In commenting on our draft report, OCC and FDIC question whether some of the issues raised in our report are proper issues for the Council to address. OCC does not believe that it is appropriate for the Council, in prescribing uniform examination principles and standards for the Federal examination of financial institutions, to address areas of frequency and scope of examination. OCC believes that decisions regarding these matters should be left to the regulatory agencies. It stated that

"\* \* \* we do not believe that the Council is empowered under 12 U.S.C. 3305(a), to prescribe uniform supervisory practices, especially in the areas of determining the frequency and scope of examinations. These supervisory functions are left to the discretion of each of the individual agencies because of the differing limitations of the agencies."

FDIC took exception to our recommendation that the Examination Council define the supervisory role of the Federal financial institutions' regulatory agencies and the extent to which those agencies should influence management processes of the financial institutions supervised.

The comments of these two regulators raise a serious question regarding the role of the Council as perceived by the agencies. In our view it is essential that the Council address such areas as frequency, scope, and thrust of examination. The Council concurs in this view. However, the work of the Council is accomplished by staff from the five Federal regulatory agencies and if these officials perceive a different role for the Council, we believe that it would be in the Council's interest to define the phrase "principles and standards for the Federal examination of financial institutions."

With regard to our proposals concerning State examinations, FDIC, FHLBB and FRS did not believe that greater reliance could be placed on examinations made by State agencies. All three Federal regulators pointed to their extensive reliance on State agencies through the use of joint, concurrent or divided examination programs. Several reasons were given in support of the agencies' position; however, some misunderstanding appears to underlie much of their concern. The regulators apparently interpreted our proposal to mean that Federal agencies should withdraw totally from examining any financial institutions in States which had competent examination programs. For example, FDIC stated that:

"As we read the GAO's recommendation that the FFIEC assess the quality of State agencies and require the Federal regulators to accept examinations competently performed by the States in lieu of their own, it seems to imply a complete withdrawal of the Federal agencies in some States from the examination function."

We do not mean that FDIC or any other Federal regulator should completely withdraw from the examination of financial institutions, and we have revised our recommendations to clarify our intent. While we believe that some agencies could rely more on State examinations in lieu of their own, we are also concerned that staff shortages may have forced the NCUA into a position where it may not adequately monitor and examine State-chartered, federally insured credit unions because its reliance on States is almost absolute.

At the same time, we recognize that for some financial institutions the use of joint or divided examination programs may be the only practical way to share the examination burden with States. However, we also believe that in other instances some States are ready and able to carry much more of the examination function. This does not mean that, even in those States that are capable of carrying much of the examination burden, Federal regulators should totally abrogate their examination function. For example, for banks in a portion of one State, FRS essentially relies on the State examination but they do send one or two examiners along with the State examiners to observe their work and to perform tasks of special or sole interest to FRS.

Coupled with offsite or remote examinations, information received from the regulators' surveillance systems, previous State examination reports, and reports and information received from financial institutions and other sources, we believe FRS's accompanied examination program could be one cost-effective way to provide for periodic onsite examinations and to monitor the safety and soundness of financial institutions. Furthermore, even under



such an examination program, Federal regulators may have justifiable reason for their own comprehensive but less frequent examination of financial institutions otherwise examined by competent State agencies.

In connection with the State issue, FDIC disputes our contention that Federal regulators have been reluctant to accept State examinations despite the apparent competency of several States. FDIC said that

"\* \* \* the discoverable facts do not support the GAO assertion that the three illustrations evidence a reluctance on the part of the Corporation to accept State examinations."

We did not intend the three illustrations in one FDIC region to fully support our position. As we pointed out in the report, in three FDIC regions we found that the interval between the Federal and State examinations at times varied between 1 and 9 months even though FDIC's goal is to examine problem banks every 12 months and nonproblem banks every 18-month period. But even without further support, we believe two of the three illustrations demonstrate the absence of a formal ongoing coordination program with the State. FDIC even acknowledges that its examination of two of the banks should never have been started, let alone completed. We believe the three cases are not isolated because from 1977 to 1979 FDIC and the States conducted examinations within 3 months of each other in 70 banks in 3 States. In our view this demonstrates a reluctance to accept State examinations.

Next, the FDIC, FHLBB, OCC and NCUA disagreed with our recommendation to develop an examination scheduling system for determining examination dates which are based on a perceived need rather than on the basis of static time frames. FDIC, OCC and NCUA maintained that shorter and more frequent examinations are preferable to infrequent comprehensive examinations. In their view more frequent examinations enhance their ability to maintain a dialog with the management of financial institutions and result in the identification of changes in a financial institution which might lead to problems.

We do not necessarily disagree with Federal regulators that shorter and more frequent examinations are a good way to keep abreast of changes in financial institutions. As discussed in the report, however, we believe the Examination Council should identify and assess alternate examination scheduling methods and develop a scheduling system based on need rather than the current static time frames.

In connection with the development of such a scheduling system, OCC considered our suggestion premature that remote examinations could complement onsite examinations of financial institutions. At the time of our review OCC was in the process of reviewing remote examinations. In our report, we did not infer that we had fully evaluated the process or that we totally endorsed it. Rather, we suggested that the remote examination process might be a desirable tool to assist agencies in scheduling examinations and that the Council should explore this as a possible improvement over the present static time frame system.

### CHAPTER 3

#### OTHER ISSUES AND PROBLEMS IN ESTABLISHING

#### UNIFORM PRINCIPLES AND STANDARDS FOR

#### EXAMINATIONS

The Congress has charged the five Federal regulators' with fostering and maintaining a safe and sound banking system. However, the question of what examination approach, program, and reports are needed to make supervision most effective in achieving this broad objective as it relates to individual institutions is still debated among the agencies. As a result, the regulators appear to place differing amounts of emphasis on the assessment of financial institutions' management decisions and systems and on the examination structure that is required to make such assessments, even though their broad regulatory objectives are similar.

The Examination Council is in a position to resolve this debate. The Congress has charged the Examination Council with developing uniform and progressive examination principles and standards to assure a consistent approach to the supervision of financial institutions. Two basic questions have to be resolved:

- What is the Federal regulator's appropriate supervisory role in the examination of financial institutions' management decisions and systems in the form of policies, controls, and future plans, etc.?
- What examination guidelines are needed to best meet the information requirements dictated by that supervisory role and to ensure a consistent level of examination effort?

#### FEDERAL REGULATORS' SUPERVISORY ROLE NEEDS TO BE MORE CLEARLY DEFINED

The five regulators place differing amounts of emphasis on the existence of sound management systems in financial institutions. To varying degrees, they agree that their principal supervisory role is to maintain a sound banking system. They also agree that preventing and correcting unsound financial conditions and management practices in individual institutions is a correlative objective. But the regulators differ in their views regarding the need to actively promote sound banking or management practices in institutions that lack any apparent unsound conditions.

OCC, FHLBB, and NCUA more actively promote sound management systems, because they routinely and more systematically examine institutions' management activities. They said that such an approach should result in fewer institutions having significant financial problems through the early identification and correction of systemic weaknesses. While FDIC and FRS also support sound management systems, they tend to be less active in their promotion and systematic examination. They reason that a more active examination approach increases the likelihood that regulators will infringe on the prerogatives of the institution's management. Additionally, FDIC is concerned that, as a practical matter, it may not be efficient to routinely and systematically examine management systems because it is costly, and most supervised institutions are small and are unlikely to have extensive systems.

The Examination Council has to decide how active the regulators should be in influencing management decisions regarding the operation of financial institutions. The congressional mandate concerning this issue is not clear.

Authority to promote sound management practices is limited

The overall regulatory structure has gradually evolved over more than a century. Consequently, much of the legislation that established the present structure was originally passed to address the varying circumstances of the Nation's changing economic and financial history.

Although our survey of the legislation revealed no set of objectives common to all regulators, it did reveal that the regulators' supervisory objectives were strikingly similar. Four objectives that appear generally applicable to all regulators are

- promoting safety and soundness in the financial industry and minimizing unsound banking practices and excessive institutional failures,
- promoting economic stability and growth and minimizing financial instability,
- promoting compliance with laws and regulations, and
- promoting a socially responsive financial industry capable of providing equitable services to all sectors of the community.

Despite the similarity of the regulators' objectives, their roles remain unsettled due to the still emerging body of Federal financial regulatory law. One unsettled area is the role of the regulators in effecting sound banking policies and practices. In examining pertinent legislation and legislative histories, we have been unable to find any clear congressional mandate stating that the regulators should promote sound management practices. The law instead appears to stress a supervisory role that focuses on the correction of unsafe and unsound practices.

#### Different emphasis on the examination of management systems

Over the years, Federal regulators have increased their emphasis on management systems in the examination of financial institutions. Traditionally, the principal focus of examinations has been to assess an institution's adherence to laws and regulations, the quality of its assets, its ability to meet depositors' and borrowers' demands, and its management. Assessment of management was primarily based on the institution's performance.

Federal regulators, however, have now expanded their examination of management. The examination continues to assess an institution's solvency and liquidity, but now it also evaluates to varying degrees the adequacy of an institution's administrative and operational policies, various management controls, and management decisions. Some regulators even review the institution's future plans, personnel management systems, and management information systems in an effort to assess the institution's total operation.

FDIC and FRS both view their principal supervisory role to be one of identifying and seeking correction of unsound financial conditions. While the two regulators require their examiners to review operational policies, plans, and controls, they do not believe that it is their role to be management consultants and to routinely and systematically analyze management systems. Instead, the decision to do so is left up to the examiner. The two regulators reason that the law did not intend them to become enmeshed in areas (1) that pose no obvious threat to the soundness of the institutions and (2) that traditionally have been left to management. OCC, FHLBB, and NCUA view their supervisory roles more broadly.

OCC cited the following two basic reasons for adopting a more system or management oriented examination approach in 1976.

--First, OCC wants to concentrate its examination efforts on phases of banking activities which deserve greater emphasis because of their impact on soundness. This concentration requires increased reliance on the internal and external review functions of the bank so as not to waste resources on work adequately performed by others.

--Second, OCC wants to concentrate on the future prospects of each national bank rather than merely on present conditions, because it believes the speed with which a bank's condition can deteriorate has increased significantly.

In November 1978, OCC took a further step in making management evaluation a central part of examinations when it created a multinational division to review the management decisions and strategic planning of the 10 largest national banks. With regard to the special emphasis of the new division's efforts, the Comptroller of the Currency noted:

"This special emphasis will facilitate a scanning of the present and prospective activities of multinational banks relative to all the financial environments in which they operate, thereby providing a more contemporary picture of the entire multinational banking area \* \* \*."

Differences in emphasis are further illustrated in the following cases comparing selected regulators' examination approaches and procedures. These differences in emphasis ask: How far should Federal regulators go in the examination of financial institutions?

#### Internal audits

Both OCC and FRS have examination procedures for evaluating the adequacy of institutions' internal audit activities. But FRS procedures were used only to a limited extent because adequate time had not been budgeted to complete the suggested examination steps. Furthermore, as is illustrated in the following comparison, OCC reported more extensively on the adequacy of the internal audit activities than did FRS.

In the FRS case, the examiner reported serious weaknesses in the bank's internal control system but judged the internal auditor's work as adequate. The examiner

provided no further explanation regarding the adequacy of the internal auditor's efforts to improve the weak internal controls, except to say that the auditor's work was generally ignored by management.

On the other hand, an OCC examiner reported no major weaknesses in another institution's internal controls and audit functions. Nevertheless, the examiner went to great lengths in explaining his assessment process of the internal audit, describing even minor weaknesses and changes. For instance, the examiner found it necessary to report that:

"\* \* \* a review of the audit functions disclosed that the length of time between audits of the Master Charge Department was in excess of 18 months, while the length of time between audits of the East Office collateral was 18 months. Because of considerable growth in the former area and some minor internal control problems noted by the auditor, it is recommended that such audits be conducted more frequently."

#### Personnel management

Adequate compensation, staff size, and staff development are important aspects of personnel management that are necessary to successfully operate a financial institution. The emphasis given this management area, however, varies between regulators. For instance, FHLBB's examination program requires examiners to complete various steps to determine (1) the adequacy of staff, (2) the existence of policies insuring staff development, and (3) the clarity of position descriptions and assigned responsibilities. The steps include a review of compensation schedules to determine whether employee compensation is generally commensurate with assigned responsibilities.

FDIC examination procedures, on the other hand, do not specify any examination steps requiring the review of personnel management, even though one question in the examination report requires the examiner to reach a conclusion concerning the adequacy of employee compensation. With regard to that question, the examination manual states that the examiner's conclusion should be based on his/her opinion of the abilities of the personnel, the size of the institution and the ability of the institution to pay. But the examination procedures leave the depth of the analysis process to the examiner and tend to indicate that the area of salary management is basically a matter to be decided by management. This is reflected in the following statement from the FDIC examination procedure manual:

"The money-making aspects of banking are essentially matters for bank management rather than bank supervisors. It is the function of bankers to determine rates of interest to be charged and paid, salaries to be authorized, and whether or not a particular schedule of service charges will be adopted. For the Bank Supervisor or Examiner to intrude into the details of this aspect of banking is to encroach seriously upon the prerogatives of bank management. So long as the bank is adhering to sound policies, maintaining adequate capital, operating in accord with applicable laws and regulations, and serving the community, the banker as a businessman should be subject only to competitive controls."

### Operating expenses

All five regulators' examination programs require examiners to perform reviews of the institutions' income and expense accounts. OCC, FHLBB, and NCUA examination procedures provide the examiner with specific objectives and procedural steps for analyzing income and expense. For instance:

- OCC procedural objectives require examiners to:
  - (1) analyze the financial position and operations of the bank and investigate any unusual fluctuations and (2) determine if accounting policies, practices, procedures, and internal controls relating to income and expenses are adequate.
- FHLBB procedural objectives, among others, are to: (1) obtain satisfactory explanations for all material variances of the current financial statements from those of prior periods and from class averages and (2) review, understand, and explain the genesis of all significant matters disclosed by the financial statements.
- NCUA objectives ask the examiner to: (1) determine if policies, practices, and procedures regarding income and expenses are adequate; (2) analyze the relationship between the cost of capital and the income generated from this capital; and (3) initiate corrective action when policies, practices, and procedures are inadequate or when exceptions to the accounting manual, law, regulations, and policy statements are disclosed.



The following discussion of an OCC and FRS examination report dealing with operating expenses shows how different examination procedures impact on the report. Both banks were having problems because of poor earnings. However, OCC's examination approach was more in-depth and produced more specific recommendations.

FRS examined one bank and reported that its 1978 net income was down 49 percent from 1977. The examiner attributed this decline to heavy loan losses and a dramatic increase in non-interest operating expenses from \$491,000 in 1977 to \$831,000 in 1978. The examiner urged management to formulate policies designed to increase efficiency and to control expenditures but did not indicate what caused the dramatic increase in expenses or what remedial actions management could take.

OCC examined the other bank and reported that certain operating expenses increased substantially over a 1-year period. But unlike the FRS examiner, the OCC examiner then identified the causes and listed specific remedial actions for management to take. He noted that the bank president's expenses accounted for 97 percent of the total business expenses and that certain business development related expenses were questionable. As a remedial action, the examiner recommended that the board of directors validate and approve all operating expenses over a certain amount.

Other considerations in deciding  
on the need to routinely examine  
management systems

In recent years, congressional committees have expressed concern about the soundness of bank management. After the 1975 failure of the Franklin National Bank of New York, congressional scrutiny of bank regulators increased. Together with a growing number of problem institutions, the bank's failure led Congress to question the adequacy of Federal bank supervision.

At the same time, OCC instituted changes in both its supervisory processes and its examination programs. One of the presumably primary reasons for OCC's revision of its examination program was to facilitate the early identification of causes of problems before the bank's soundness had been adversely affected. An OCC official, in explaining the revised examination procedures at a bank convention in 1976, stated that:

"A key feature of future supervisory techniques will be the timeliness of the identification of problems and deficiencies. By waiting until the quality of a

loan has sufficiently deteriorated to merit classification before he calls it to the bank's attention, the examiner is limiting the options available to the bank in attempts to collect the credit. The examiner has waited too late to help the bank when he simply identifies operating losses and requires that they be charged off of the bank's books. In many cases, it is too late for the office to require that a bank acquire new capital when the need is too desperate. Many experts point out that capital is often most difficult and expensive to sell when it is most needed. Examination reports of the future will key strongly on the identification of conditions and deficiencies which if left unattended will likely result in classified assets, losses and insufficient capital."

In our 1977 report on Federal supervision of banks, we endorsed OCC's approach to examining banks. On the basis of our comparison of OCC, FDIC, and FRS examination programs, we concluded that OCC's

--new examination approach will provide that examiners will systematically and comprehensively examine banks' policies, procedures, controls, and audits to identify weaknesses in bank management which could lead to serious problems (see p. 7-23), and

--revised examination procedures should provide the regulator 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. (see p. 7-24.)

We continue to support the concept of systematic examinations, but we also feel that the increased cost of conducting such examinations should produce some benefits. For example, OCC's examination procedures have been in place for about 3 years, but our limited work has not revealed any agency-developed empirical data which clearly shows benefits in terms of better managed institutions or fewer failed or problem institutions. Therefore, our basic questions are (1) how successful have the regulators been in the early identification of systemic weaknesses in institutions when the impact of these weaknesses are not yet quantifiable and (2) how successful has OCC been in getting the banks to correct these problems.

Furthermore, the need to examine small institutions' management systems should be addressed. FDIC has periodically questioned the wisdom of using scarce resources on such examinations unless examiners note systemic weaknesses that threaten an institution's soundness. OCC, FHLBB and NCUA, however, do not share this view and believe that examining the adequacy of management systems in small institutions is necessary because these institutions often lack competent and sound management.

In any event, the Examination Council is going to have to define the appropriate supervisory role for the regulators. Once it does this, it can then determine what examination guidelines and programs are needed by the regulators to consistently and uniformly satisfy that role.

EXAMINATION PROCEDURES NEED  
TO BE MORE HIGHLY STRUCTURED

In conducting examinations, some regulators provide specific guidelines to examiners while other regulators leave it to the examiner's judgement to get the job done. OCC, FHLBB, and NCUA provide examiners with specific procedures, checklists, and questionnaires to insure a systematic examination process. FDIC and FRS have less structured programs and place more reliance on the examiner's discretion as to what needs to be done and how it gets done. As a result, these programs provide limited assurance that examinations are conducted uniformly in all critical areas of the institution's activities.

In our 1977 bank study, we reported on the unstructured nature of the three bank regulators' examinations, noting that each allowed considerable discretion to examiners in establishing examination procedures. We also noted that regulators provided examiners with general examination procedures but no guides for what other material--schedules, records of interviews, etc.--should have been obtained or how the examination should have been prepared and organized. Since OCC was implementing new examination procedures that provided its examiners with more detailed guidelines, we recommended that FDIC and FRS also develop standards for the preparation, maintenance, and use of examination workpapers.

Both regulators responded that their examiners were provided with proper training on workpaper documentation. FDIC commented that

"\* \* \* 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 commented that

"\* \* \* in the vast majority of examinations, the examination workpapers and line sheets prepared are adequate to meet the System's needs."

We agree that in many cases the examiner's efforts may be adequate; however, we also believe that more structure is needed if regulators are to achieve more uniform examinations. This seems warranted in light of observed differences in the structure of examination programs and inability to determine if examiners followed appropriate examination procedures.

#### Current structure of examination programs

All five regulators have examination programs that serve as informational manuals, guides, and references for their examiners. The manuals provide a general description of the policy, philosophy, and nature of examinations. The manual states what examiners should be doing, or be aware of, while conducting the examination. OCC, FHLBB and NCUA examination programs provide examiners with specific procedures, checklists, and questionnaires which serve as a guide for determining what needs to be done and how it is to be done. These examination programs also specify the objectives to be achieved in each examination area.

FDIC and FRS examination programs generally afford their examiners considerable discretion on the type of information gathered and the depth to which this information is analyzed. FDIC and FRS field officials agreed that their examination programs are less structured but noted that the examination report itself sometimes serves as a guide in conducting the examination. For example, the examination report requires examiners to answer specific questions, and as such, it could also serve as the examination program.

Is there a need for more structured examination programs?

The answer appears to be "yes" for FDIC and FRS. Management consultants that have reviewed Federal regulators' examination programs have commented on the importance of structure and workpaper documentation to support conclusions in reports and to provide a basis for supervisory reviews. FRS' internal auditors reported that examination workpapers were not (1) identified as to source and purpose and (2) properly indexed to support the examination report's comments and conclusions.

The need for structured examinations also became apparent from our observations of each regulator's examination program and workpapers and from our discussions with various field officials and examiners. For instance, along with financial results and asset quality, examiners stated that they reviewed management policies, internal controls, and the internal audit function. While OCC and FHLBB examiners were able to provide us with workpapers in support for that contention, FDIC and FRS examiners could not consistently produce workpapers showing what they actually did in reviewing the institutions' management systems.

Where workpaper schedules and documents were in evidence at FDIC and FRS, we could not always tell the extent supervisory reviews were conducted. And FDIC and FRS supervisory examiners stated they basically relied upon the integrity and experience of their staff to follow all appropriate examination procedures. The following example of an OCC and FDIC examination of a bank's internal controls demonstrates both structure and the lack of structure.

OCC bank

OCC's structured examination program requires examiners to evaluate a bank's internal controls by completing a series of internal control questionnaires and assessing the results. On the basis of this assessment, the examiners conclude whether the degree of control exercised by the institution is adequate. As the following case illustrates, OCC's examiner appears to fully explain existing internal control problems.

In this case, the OCC examiner reported significant exceptions in the deposit account and correspondent bank account areas. Regarding the deposit accounts, he reported that the bank's exceptions to overdraft and uncollected funds policies were liberal and potentially unsound. He supported

his conclusions with specific examples demonstrating the exceptions and noted that bank officials agreed to correct them. Finally, he fully disclosed the bank's internal control problems and the causes for the problems in a letter to the board of directors.

### FDIC bank

FDIC examiners are also required to determine the adequacy of a bank's internal control system. They make this determination by answering a series of questions in the examination report. FDIC's examination program requires the examiner to expand the examination beyond these questions, if deemed necessary; however, the program does not stipulate what examination procedures examiners must follow to evaluate the internal controls and to reach supportable conclusions. The following two FDIC examinations of this bank illustrate that, because of the wide discretion given FDIC examiners, the institution's internal control problems may not have been fully disclosed.

In the first examination, the FDIC examiner reported on several weak internal controls. For instance, the examiner noted that negotiable collateral, such as stocks and bonds, were not under proper accounting control; not all employees were prohibited from both receiving deposits and posting them, except on automated posting machine operations; and the dormant deposit accounts were not maintained under dual control. The examiner also reported that employees lacked general knowledge of internal controls and therefore suggested training to improve employee skills and knowledge of internal controls. The examiner stated that the problems were discussed in a meeting with the bank's board of directors. However, in the report section which is not given to the bank's board of directors, the FDIC examiner raised what appeared to be more serious concerns about the bank's internal controls, as follows:

"The bank's internal controls in most areas are so weak as to be considered non-existent \* \* \*. Management's control of the branches appears almost nonexistent, at present, and as in the past each branch appears to operate autonomously with very little central control exerted. The bank historically has operated two good branches, \* \* \* and \* \* \* Branches and they continue in this status while the head office, \* \* \* Branch and the \* \* \* Branch appear to function with little or no direction.

The present condition of the bank, with its highly classified position, excessive losses, inadequate and poorly trained staff, management posture and other deficiencies all reflect adversely upon the future prospects of the bank."

The FDIC examiner could not show us his analysis nor explain why these weaknesses were not disclosed in the examination report to the bank's board of directors even though he agreed with us that the weaknesses, if uncorrected, could present future problems. However, he suggested that bank management was probably informed in broad terms when he discussed the need for training.

In the followup examination of this bank, the FDIC examiner did not comment extensively on the internal control concerns raised in the confidential section of the previous examination report. The examiner told us that, instead, he concentrated on the large volume of classified loans and only conducted a minimum amount of work in the internal control area. The examiner said the weaknesses noted in the previous examination were no longer apparent, and he assumed that management had corrected them.

#### CONCLUSIONS

The Federal regulatory agencies that supervise and examine financial institutions have similarly mandated objectives, but each has formulated its own examination approach and program. Over the years, OCC, FHLBB and NCUA have implemented examination programs that apparently place greater emphasis on the routine and systematic examination of management systems than FDIC and FRS programs do. These three regulators' examination programs also provide for a more systematic information collecting, analyzing, and reporting process.

As in the past, we support the concept of systematic examinations emphasizing management systems. In our opinion, such examinations should provide greater assurance that management weaknesses are identified and corrected early, thereby reducing the number of institutions that subsequently develop problems that threaten their soundness. Before deciding whether such a concept has merit, the Examination Council should resolve several issues.

--Is such an approach cost effective, especially in small institutions?

--Is such an approach encouraging examiners to question matters that are outside the legitimate concerns of a regulator and more the prerogative of management?

--Is such an approach structured enough to assure that examiners followed appropriate examination procedures?

After considering these issues, the Examination Council should carefully assess the benefits of more systematic and structured examination programs. In times of scarce financial and staff resources, any trend to increase examination coverage of areas traditionally left to management must be carefully weighted against the potential benefits before it is accepted as the most effective and appropriate approach.

Although the Congress has established the five Federal regulators' broad objective of fostering and maintaining a safe and sound banking system, congressional intent to promote good management practices is unclear. The examination procedures used by some regulators increase the likelihood that examiners will influence the institutions decisionmaking processes. It is not clear at what point such influence infringes on the prerogatives of management as opposed to being a legitimate regulatory concern. Some congressional guidance on this matter seems to be needed.

#### RECOMMENDATIONS TO THE FEDERAL FINANCIAL INSTITUTIONS EXAMINATION COUNCIL

We recommend that the Examination Council

- define the various regulators' supervisory role, in particular as it relates to the routine and systematic examination of management in financial institutions without unsafe and unsound financial conditions;
- define, with the guidance of the congressional legislative oversight committees, how forcefully the regulators should promote the establishment and maintenance of sound management;
- prescribe uniform principles and standards consistent with the above identified supervisory role and commensurate with an acceptable level of risk and cost; and



--include in its prescribed principles and standards the requirement that Federal regulators develop examination procedures that clearly identify (1) examination objectives, (2) examination tasks required to achieve the objectives, and (3) documentation required to fully support report comments, conclusions, and recommendations and to provide a basis for supervisory review.

#### AGENCY COMMENTS AND OUR EVALUATION

The Examination Council stated that its Task Force on Supervision will address our recommendations in an ongoing study. With regard to comments from the Federal regulators, the principal questions about this chapter were raised by FDIC. FDIC pointed out that it is working with the Examination Council's various task forces toward more structure in the examination process in terms of procedural guidance, checklist and workpaper documentation. But FDIC also questioned several aspects of our draft report.

FDIC interpreted our report as a continued endorsement of OCC's structured and management system-oriented examination program. It questioned our position in light of the reported lack of empirical evidence showing such programs to be more effective than FDIC's in identifying problems earlier in financial institutions. We do not entirely agree with FDIC's interpretation of our position. In our view, the report does not endorse any regulator's examination program but rather raises the issue of the appropriateness of system-type examinations for Federal regulators because of (1) uncertain cost benefits, especially in small banks and (2) questionable authority of regulators to promote the establishment of management systems.

FDIC was also concerned that our report may give the impression that the Corporation views the examination of financial institutions' management practices and policies as minor aspects of its supervisory function. We do not intend to give such an impression; however, as FDIC acknowledges, differences do exist among regulators and in their emphasis on the evaluation of management systems. Our report illustrates these differences in terms of prevailing or perceived examination philosophies, methods and procedures.

In connection with our discussion of system type examinations, FDIC interpreted our draft report to imply that it has periodically questioned the wisdom of using scarce resources on small bank examinations unless examiners note systemic weaknesses that threaten the institution's soundness. FDIC stated that it is firmly committed to periodic onsite examinations of all banks under its jurisdiction. We did not intend to imply that FDIC is not committed to periodic examinations but rather that some FDIC officials have questioned the routine examination of management systems in small banks. FDIC appears to share this point of view to some extent because its comments raise the question that the addition of "extensive checklists, questionnaires etc. impact small bank examinations unnecessarily more than large banks, both in terms of increased total examination hours and burden on the examined institution." To eliminate any ambiguities, however, we have clarified the report to show that FDIC's comments concern the routine examination of small banks' management systems.

Next, in connection with our discussions of the need for more structured examination programs, FDIC questioned the accuracy of information used in the report to illustrate that the wide discretion given examiners may not result in the desired followup of presumably well founded criticisms contained in the confidential section of the previous examination report. FDIC stated that its review of examination reports established that the responsible examiner made an independent determination that corrections were being made by bank management. In support, FDIC cited a reduction in the number of criticisms from 8 in the 1977, to 7 in the 1978, and to 5 in the 1979 examination reports. Although agreeing that corrective actions by the bank were perhaps not as swift as desirable, the regulator concluded that we "misspoke when the report characterized that statement of the examiner of the followup examination in terms that he assumed management had made correction."

We disagree with FDIC's conclusion. We fail to see how a mere tallying of criticisms, which shows a slight reduction in their number, is sufficient evidence that bank management is making corrections of the magnitude that would appear necessary to correct the weaknesses noted by the examiner. Furthermore, we fail to see how FDIC can

conclude that the examiner made an independent determination that the bank corrected severe weaknesses in the internal controls noted in the confidential section of the previous examination report.

With regard to the specific weakness identified in the bank's internal controls, the followup report attests to the adequacy of the bank's audit and supervision over its branches. Neither the followup report nor the workpapers, however, provide evidence as to the depth of the examination made of the actions taken by the bank to correct the weaknesses identified in the previous examination. Additionally, the examiner responsible for the report was unable to tell us the detailed steps taken during the followup examination to provide adequate assurance that bank management had corrected all severe criticisms of internal controls identified in the confidential section of the previous examination report. Consequently, we do not believe that we misspoke in the report when we characterized the examiner's process as "assumed" even though we agree that deductive reasoning might be more appropriate.

Federal Financial Institutions Examination Council, Washington, D.C. 20219

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Summary of GAO Recommendations

GAO Draft Report: "Improvements  
Needed in Federal Examinations of  
Financial Institutions"

A. GAO specifically recommends that the Council:

1. Assess the quality of examinations performed by State agencies and develop a Federal Government-wide policy which requires Federal regulators to accept examinations that are competently performed by State agencies in lieu of their own.
2. Develop criteria for the continued monitoring of the States' examination programs to assess changes which may occur which affect the acceptability of the State's program for Federal needs.
3. Develop a system for determining the timing of examinations which is based on a perceived need to examine rather than on the basis of a static timeframe.
4. Develop examination standards which limit the amount of detailed work performed during a routine examination unless potential problems are detected.
5. Develop examination principles which require Federal examiners to rely on functions adequately performed by others such as internal and external audit and internal loan review departments. The Council should develop criteria for testing and assessing the quality of these systems before the agencies could rely on them.
6. Develop uniform standards for reporting the results of examinations which limit the amount of detailed data to that which is necessary for effective supervision.
7. Define the various regulators' supervisory role, in particular as it relates to the routine and systematic examination of management systems in financial institutions without unsafe and unsound financial conditions.
8. Define, with the guidance of the congressional legislative oversight committees, how forcefully the regulators should promote the establishment and maintenance of sound management systems.

Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Federal Home Loan Bank Board,  
National Credit Union Administration, Office of the Comptroller of the Currency

Federal Financial Institutions Examination Council, Washington, D.C. 20219

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September 8, 1980

Mr. William J. Anderson, Director  
General Government Division  
United States Government Accounting  
Office  
Washington, D.C. 20548

Dear Mr. Anderson:

The GAO's draft report entitled, "Improvements Needed in Federal Examination of Financial Institutions" contains numerous recommendations for action by the Federal Financial Institutions Examination Council. For purposes of reference, we have summarized these recommendations, which are listed on pages 25-26 and 38-40 of your report in the enclosed outline.

In response to the first two recommendations, we have asked the Task Force on Supervision to explore ways in which the Agencies can place greater reliance on examinations of banks and thrift institutions performed by the States. However, the Council believes that Title X of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 does not empower the Council to evaluate State agencies directly. Also, while the Council can promote uniformity of approach by the Federal agencies in carrying out their supervisory responsibilities, the statutory responsibilities imposed upon those agencies require that they make any final decision regarding the use of examinations performed by the States.

With respect to the remaining recommendations, they relate primarily to fulfillment of the Council's legislative mandate. The Task Force on Supervision has had underway since May 1979 a study which highlights the similarities and differences in the on-site examinations of the FFIEC member agencies. When this study is completed, the principles and standards of supervision which underlie the examination of institutions of various sizes and types of operation will have been thoroughly delineated. In June 1980, the same group undertook to devise a common examination report for the use of examiners in all five agencies. A draft report is being reviewed by staff in each agency, as well as by staff in several state agencies. Upon completion of this work, the next step is for members of the Task Force on Supervision to make recommendations to the Council toward increasing uniformity in such matters as the timing of examinations, their scope, and other policy matters as will promote consistency in the examination process. When this process is completed, it is believed that the recommendations of the GAO will have been appropriately addressed.

Sincerely,

  
Robert J. Lawrence  
Executive Secretary

Enclosure  
Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Federal Home Loan Bank Board,  
National Credit Union Administration, Office of the Comptroller of the Currency

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9. *Prescribe uniform principles and standards consistent with the above identified supervisory role and commensurate with an acceptable level of risk and cost.*
  10. *Include in its prescribed principles and standards the requirement that Federal regulators develop examination procedures that clearly identify (1) examination objectives, (2) examination tasks required to achieve the objectives, and (3) documentation required to fully support report comments, conclusions, and recommendations and to provide a basis for supervisory review.*
- B. *In regard to the GAO favored concept of examinations emphasizing an analysis of management systems, the Council should determine whether such an approach:*
1. *is cost effective, especially in small institutions;*
  2. *encourages examiners to encroach on management prerogatives;*
  3. *is structured enough to assure that examiners are following appropriate procedures.*



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Comptroller of the Currency  
Administrator of National Banks

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Washington, D. C. 20219

August 29, 1980

Mr. William J. Anderson  
Director  
General Government Division  
United States General Accounting Office  
441 G Street, N.W.  
Washington, D.C. 20548

Dear Mr. Anderson:

We appreciate the opportunity to review and comment on your preliminary report under the cover letter dated July 30, 1980. After completing our review, we conclude that our examination procedures and policies are consistent with many of the recommendations outlined in the draft report. However, we question a few of your specific suggestions and their applicability to the OCC. Our concern is due to certain ambiguities in the report occurring through the use of broad generalizations to categorize the agencies. We believe that the recommendations in the digest and chapters should be specifically directed to the applicable regulatory agencies. Without these specifics, the reader associates each agency with a recommendation regardless of its applicability. We also suggest that the material in Chapter 3 dealing with the examination of the management process be moved into Chapter 2. This philosophical difference between the agencies has a direct impact on the frequency and extent of examinations discussed in Chapter 2.

GAO's Recommendations to the Examination Council

Throughout this report, the GAO recommends that the Examination Council undertake the review of many supervisory issues and alternate examination systems. We believe that this review is appropriate for the issues which relate to examination principles and standards. However, we do not believe that the Council is empowered under 12 U.S.C. 3305(a), to prescribe uniform supervisory practices, especially in the areas of determining the frequency and scope of examinations. These supervisory functions are left to the discretion of each of the individual agencies because of the differing limitations of the agencies.

Mr. William J. Anderson  
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### Chapter 1

We feel the GAO has made a material omission in the report when discussing the supervisory process. In reviewing the regulators' efforts to maintain a safe and sound financial system, the GAO ignored the agencies' powers to promulgate regulations, rules, and policies which are also primary tools used to promote safe and sound practices.

We believe the report overemphasizes the role of on-site examinations in not balancing the examination function, which is basically a monitoring function, with these greater supervisory powers. For example, a new regulation automatically will be complied with by the vast majority of institutions regardless of the frequency of any on-site examinations. We believe that this emphasis is an oversight on GAO's part because Chapter 2 of the report suggests changes to the examination process which would be inexpedient if the examination is the "foundation of the supervisory process".

The definition of OCC specialized examinations used in this chapter is inaccurate. These examinations are designed to detect significant changes in the condition or operations of the banks under examination. Therefore, the scope of these examinations will be limited only when significant change is not detected. The scope of specialized examinations categorically cannot be described as limited because it significantly varies in depth depending on the condition and operations of the bank under examination.

### Chapter 2

We believe that GAO has not adequately supported their premise that the regulatory agencies have not balanced supervisory needs with supervisory costs. We also believe that GAO's call for uniform examination priorities is not timely due to the varying impact of recent major changes in laws affecting the operations of financial institutions. The report oversimplifies the issues of establishing examination priorities and scheduling by categorizing all of the relevant components under vague references and generalities such as "acceptable risk" and "examination effort commensurate with the condition". Nevertheless, the GAO does not mention that the OCC uses a scheduling policy which is virtually identical with those recommended.

OCC believes that defining priorities beyond the existing factors of size and bank condition is impractical and results in unnecessary resource expenditures. The OCC examination priorities policy establishes minimum frequency standards which are further defined by its regions commensurate with their needs and resources. Generally, the regions define their priorities based on the nature of problems and activities of their banks. The impracticality of a



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detailed formula based on a national or uniform examination policy is further compounded by the varying regional effects of recent major changes in banking rules, which are drastically changing the industry's competitive environment.

GAO's recommendations focus too heavily on the frequency of examinations in relation to a bank's condition without adequately addressing the purpose and scope of examinations. OCC examination philosophy is preventative rather than corrective regulation, and our specialized examinations are designed to focus on changes in an institution which might lead to problems. The rate of change in the banking system and the economy is increasing and OCC believes that shorter, more frequent overview examinations are preferable to infrequent, comprehensive examinations.

GAO recommends remote reviews as a complement to on-site examinations and cites OCC's program as an example. However, we are still analyzing the effectiveness of this program and believe that a uniform recommendation to all agencies is premature. The success of these reviews depends on the integrity of the financial data received from the banks. For smaller banks which may be unfamiliar with accrual accounting and which may not be audited by a Certified Public Accountant, the accuracy of data submitted is questionable. Therefore the OCC may not be able to rely on remote reviews in smaller institutions as a means to significantly delay on-site examinations. However, since the GAO has recommended that we expand our remote review process, we would welcome the opportunity to discuss their evaluation criteria since our own review is not yet completed.

The OCC agrees with GAO's recommendation on streamlining examination reports. The OCC report cited for extraneous material in the draft is over two years old. Since that examination, we have taken steps to reduce the volume of non-essential material. The most recent examination of that same bank took significantly less time and the report contained 76% fewer pages dealing with criticized assets.

### Chapter 3

With the exception of the Council issues commented on earlier, we agree with most of the issues raised in this section. However, two areas warrant comment.


We take exception to the reference to OCC examiners as management consultants. This is an inappropriate term to characterize the examination role. Consultants are concerned with the efficiency of operations in a given area while examiners are concerned with operations from a safety and soundness basis. However, examiners must understand the operations before they can evaluate their soundness. In that process, examiners may discover inefficiencies which they may convey to management but the objective is one of "soundness".

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The OCC has not attempted to gather empirical data on the affect of its exam procedures on the management process because of the difficulty in measuring this variable. The OCC cannot conduct controlled experiments which eliminate the affects of numerous other variables, such as changing competition, the economy, etc. However, published banking literature has indicated that our examination procedures have been a major impetus in educating the industry on the benefits of certain management processes such as planning, budgeting, loan review, and developing written policies. A recent survey of bankers conducted by Leonard Lapidus and others indicated that OCC examination reports are more useful in managing their banks than the reports of the FDIC or the FRB. The survey also indicated that a majority of the managements of national banks thought that the new procedures were better than the old and they cited reasons such as "more comprehensive" and "policy and planning oriented" as the basis of their opinions. The OCC would welcome any suggestions GAO may have on developing a program which would help us in this area.

We appreciate the opportunity to comment on your draft and would be willing to elaborate on our comments with you or your staff.

Sincerely,



John G. Heimann  
Comptroller of the Currency

## Federal Home Loan Bank Board



1700 G Street, N.W.  
 Washington, D.C. 20552  
 Federal Home Loan Bank System  
 Federal Home Loan Mortgage Corporation  
 Federal Savings and Loan Insurance Corporation

JAY JANIS  
 Chairman

September 15, 1980

The 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:

The draft GAO report entitled "Improvements Needed in Federal Examinations of Financial Institutions" draws conclusions and makes recommendations regarding five federal agencies which regulate three dissimilar types of financial institutions. Banks, savings and loans, and credit unions have differing functions, asset and liability structures, investment opportunities, and operating practices. In turn, the five regulatory agencies have differing missions and responsibilities. However, the GAO report uses generic terms such as "federal regulators" or "federal regulatory agencies" which mislead the reader into believing that the report's conclusions and recommendations are applicable equally to all five agencies. Furthermore, although the report notes that some agencies have more efficient examination processes than other agencies, the recommendations of the report do not take that fact into account.

As an alternative to the draft recommendations, I propose that it would be more efficient for GAO to note:

- o specific actions already taken or planned by each agency.
- o specific improvements necessary for each agency to improve its examinations.
- o suggested improvements applicable to all agencies.

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Without this sort of differentiation, the GAO would in effect penalize and in some cases regrettably delay agencies which have either taken or are about to take progressive and innovative action. Those agencies would have the choice of either (1) awaiting Federal Examination Council (FEC) action on the recommendations, or (2) undertaking their improvements, recognizing that they may very well have to alter their procedures significantly in the near future. The FHLBB, as noted in the report, has already implemented or planned several of the suggested improvements; consequently, we are very much concerned that our actions will be futile, if the GAO's recommendations stand as they are. On the other hand, if the FHLBB has, in GAO's view, not measured up to standards in some areas, we would very much want to work with the other agencies in developing more effective examination measures. In any event, I urge the GAO to specify which recommendations apply to which agencies.

Page 8 of the draft lists five actions which could improve the effectiveness of supervisory efforts. The paragraphs below discuss our comments on each.

1. Rely more extensively on examinations performed adequately by state agencies.

The bases for this recommendation seem to be to avoid duplication of effort between state and federal examiners, to maximize the limited resources of each level of government, and to reduce the examination burden on the industry. The FHLBB fully endorses this approach, but we suggest that accepting state examinations may not be the best way to accomplish this goal. Frequently, state agencies have different legislative or regulatory requirements that differ from federal requirements. In addition, both levels of government are accountable to their respective legislators for certain ends. Furthermore, some states have indicated that, because of budgetary constraints, they will have to rely more on the FHLBB in the immediate and foreseeable future.

Of the 45 states and territories which have examining staffs and state-chartered associations, 33 (73.3%) join with the Board's examiners in making examinations. In an additional 9 states, examinations are simultaneous, although we do not produce joint reports. There are only three states where we do not now have either joint or concurrent programs. All three have consistently refused to consider either program.

During 1980, we extended our efforts to arrange joint programs. As a result, we recently reached agreement to examine jointly with Mississippi. In addition, as a prelude to commencing a joint program with Florida, we are providing on-the-job training to the examiners for that state who will be involved in the program. As a result of the adoption of a variable examination schedule, Maine has agreed to conduct some joint examinations. Finally, in one large state which has suffered substantial staff reductions, we have agreed to provide extra staff in order to continue the joint program.

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For nearly two years, in order to put state and federal examiners on an equal footing, the FHLBB has been actively training state examiners (and funding this training). The table below shows training provided by the FHLBB for the period October 1, 1979 through August 31, 1980.

<u>Description</u>	<u>No. of State Examiners</u>
New examiner training school	35
Appraisal training	40
Advanced civil rights	125
Specialized career development	<u>67</u>
Total	<u>267</u>

In addition, state examiners will attend a new course covering forward commitments commencing during September and we have committed to fund training in computer auditing. A special training course in EDP examination is in final process of video taping so that it can be presented conveniently to state examiners by their agencies.

We have also sponsored a federal/state joint committee on examinations (JCE). In addition to planning and monitoring the programs for training state examiners, the JCE provides a forum for discussing and solving common examination problems.

2. Schedule examinations, to the extent possible, on the basis of a perceived need to examine rather than to comply with a static timeframe.

Beginning late in the first half of 1980, the FHLBB began a variable cycle in scheduling examinations. Our cycle ranges from six months for the most serious problem cases to sixteen months for the majority of institutions which are relatively problem free. (The examination frequency cycles cited at pages 5 and 16 of the draft do not correctly state the existing standards.)

3. Rely more on limited scope or modified examinations.

The GAO report correctly describes the Board's use of limited scope examinations. Furthermore, we recently revised our instructions to permit the examiner-in-charge to exercise greater judgment in establishing examination scope. We also have started using "mini" examinations, which are probes into an institution for which we have an indication of developing problems. Depending on the results of the mini examination, we may commence an immediate full-scale examination or accelerate the schedule for a regular examination.

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4. Rely more on work adequately conducted by institutions' internal review system.

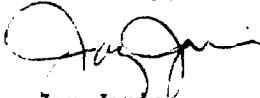
The FHLBB, I believe alone among the federal regulators, has always required an audit. Since 1963, we have requested audits by acceptable internal auditors or independent public accountants. Further, we continue to rely on independent, third party review of data processing centers, rather than on special examinations for this purpose, as conducted by the three banking agencies.

5. Limit the information now included in the report of examination to that required by institutions and regulators.

Although the comments in the draft indicate that the FHLBB's reports of examination are not "overly detailed," we recognize that the elimination of unnecessary reporting will contribute significantly to reducing examination time. Our goal is to include those schedules and exhibits needed to support and explain the narrative. For example, every examination report contains a balance sheet and operating statement. This information is certainly known by the institutions. We have the same data in our computer. We are now working toward producing these report pages by computer, rather than manually.

In summary, the FHLBB agrees with the substance and thrust of the recommendations, and we have already taken great strides in putting them into effect. We only ask that the GAO carefully reconsider whether, under those circumstances, its recommendations should indicate specific recommendations aimed at specific agencies together with any remaining suggestions targeted for all the financial regulatory agencies.

Sincerely,



Jay Janis



FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, D.C. 20429

OFFICE OF THE CHAIRMAN

August 28, 1980

Mr. William J. Anderson  
Director  
General Government Division  
United States General Accounting Office  
Washington, D.C. 20548

Dear Mr. Anderson:

The attached paper represents the comments of the staff of the Federal Deposit Insurance Corporation on the GAO's draft report entitled "Improvements Needed in Federal Examinations of Financial Institutions."

I wholeheartedly endorse the proposition that the regulatory authorities should work diligently toward achieving the goals of optimizing examination effort for effective bank supervision and minimizing supervisory costs. As the attached paper indicates, the Corporation has undertaken a variety of programs to attain this goal. During my tenure as Chairman of the FDIC, the achievement of a balanced approach to our statutory responsibilities to periodically examine State nonmember insured banks consistent with cost considerations has been and will continue to be a top priority matter. The expansion of the divided examination programs with State banking authorities and the increased utilization of modified examination techniques are tangible evidence of the Corporation's efforts in this regard. Moreover, our current policy on the scheduling of examinations has been designed to provide for the most efficient deployment of examiner resources and, at the same time, ensure our supervisory responsibilities are not abrogated. Undoubtedly more can be done by the Corporation to improve the examination process. However, I believe that the record of improvements by the FDIC is by any standard impressive.

Sincerely,

Irvine H. Sprague  
Chairman

Attachment

We appreciate the opportunity to review and comment upon the Draft Report entitled, "Improvements Needed in Federal Examinations of Financial Institutions."

As we read the GAO Draft Report, the central criticism is that Federal regulators "have not determined the optimal examination effort needed to effectively supervise financial institutions while minimizing supervisory costs." GAO urges that Federal regulators could improve the effectiveness of their supervisory efforts by relying more extensively on examinations by State agencies, scheduling examinations more on the basis of perceived need rather than a static time frame, relying more on limited scope or modified examinations, relying more on work adequately done by institutions' internal review systems, and limiting the information now included in the report of examination to that required by institutions and regulators. As an outgrowth of these criticisms, GAO recommends that the Federal Financial Institutions Examination Council ("FFIEC") take various actions to address these stated deficiencies.

The Corporation agrees that the optimization of our examination effort to achieve effective supervision of banks while minimizing supervisory costs is desirable. Recognizing that there is always room for improvement, we are distressed that GAO has not fully acknowledged the significant initiatives instituted by the FDIC over the past few years to improve our examination effort within a cost effective framework. A brief discussion of those major initiatives follows.

Prior to October 1976, Corporation policy for examination frequency, priority and scope stated that all insured nonmember banks should be examined once and, where Corporation interests required, problem banks twice or more in each calendar year. That policy was amended in 1976 to create in effect a two-tier system. Banks presenting supervisory concern or financial problems were to be examined at least once every 12 months and banks not posing such problems were to be examined once in each 18-month period with no more than 24 months between examinations. Modified examinations were authorized for the latter tier banks, but could only be conducted on an alternate examination basis and even then only if the bank met certain criteria based on, among other things, size.

After gaining more experience, the policy was again substantially amended, effective January 1979, to institute the equivalent of a three-tier system. Under this current policy, banks designated as problems are to be examined at least every 12 months; banks evidencing supervisory concern (nonproblem banks rated 3, 4 and 5 under the Uniform Interagency Rating System) are to receive a full-scope examination every 18 months; and all other insured nonmember banks are to be examined, either on a full-scope or modified basis, at least once in each 18-month period. This latter stretching out of examination frequency for these so-called third-tier banks permits a theoretical time interval of up to 36 months between examinations. These changes permitted our Regions considerable latitude in scheduling examinations of soundly operated banks based upon information manifesting need gleaned from the



FDIC's computerized bank monitoring system, intervening State examinations, and other bank monitoring sources. The amended policy also increased the potential for employing modified examinations by eliminating the alternate examination requirement and deleting many of the criteria which generally served to limit the actual use of modified examinations. This Corporation policy, like others, is reviewed on an on-going basis and is currently in the process of being amended to base examination frequency, scope and priority solely on the Uniform Interagency Rating System.

We frankly disagree with the GAO assertion that examination scheduling should only be premised on perceived need without any fixed time frame for examining soundly operated banks. As the primary surveillance mechanism, in most instances it is the on-site examination that informs the FDIC of near or actual supervisory concerns or financial problems in banks. We are not aware of any monitoring system that is capable of supplanting examinations as a tool in bank surveillance. Furthermore, we are convinced that even healthy banks must receive on-site examinations on an on-going basis and within a prescribed time span in order that the Corporation may maintain a continuing dialogue with managements, at least with respect to their reaction to changing economic conditions and industry practices. We do not mean to imply that the current time spans are immutable. However, current FDIC examination frequencies represent our best estimates at this time in keeping with our supervisory responsibilities.

From its inception in October of 1976 through and including 1978, the modified examination technique expressed in our written policy was not used extensively by the Corporation. However, since the elimination of the alternate examination requirement and certain other criteria constricting its use together with the issuance of modified examination procedures in May of 1979, the use of the modified examination technique has increased significantly. The rationale for employing modified examinations is well stated in the Corporation's procedural guidelines: "Modified examinations are designed to allow more effective use of examining resources, so that those resources may be concentrated more on banks presenting financial risk and supervisory concern and made available for performance of other assigned duties." The procedures are also designed to permit some tailoring to the specific needs of the individual bank and expansion where circumstances so indicate. Modified examinations were conducted in 52 percent of the Corporation's safety and soundness examinations performed in 1979, up from 14 percent in 1978. The latest figures available to the Corporation show that for the first quarter of 1980 approximately 60 percent of all the safety and soundness examinations conducted by the Corporation were modified in scope. Clearly, in terms of sheer numbers and, as a consequence of those numbers, in terms of reliance, the modified examination technique has become an integral and indispensable supervisory tool.

We also agree with the goal that it is desirable to rely more extensively on the examinations performed adequately by State agencies. The FDIC's divided examination program fulfills the GAO's stated goal, while preserving the

Corporation's and participating States' statutory responsibilities. The Corporation's program is grounded on the concept of reliance, but reliance which is mutually shared by the FDIC and the States rather than, as suggested by GAO, reliance on the part of the Corporation alone.

Historically the FDIC has fostered cooperation with State supervisors to the greatest extent possible to, among other things, eliminate or minimize unneeded overlap. Depending upon State law, manpower resources and perhaps most importantly the preference of the State supervisors, the Corporation conducts examinations on a joint, concurrent, independent or divided basis. Concurrent and joint examinations are conducted in precisely the same way, except that in concurrent examinations separate examination reports are prepared.

The progenitor of the divided examination program was the selective examination withdrawal experiment begun in 1974 and initially performed on a 13-month experimental basis. This experiment, which is mentioned on pages 9 and 10 of the GAO Draft Report, was conducted in cooperation with the Conference of State Bank Supervisors ("CSBS") and the States of Iowa, Washington and Georgia. The essence of the selective withdrawal was that the Corporation withdrew from examinations in a certain percentage of nonmember insured banks in each of the three States named. The knowledge and experience gained through the withdrawal experiment lead directly to the institution of the divided examination program. Under the divided examination program, problem banks and those showing other supervisory concern are examined both by the State and FDIC at least once each year. The remaining nonmember insured banks are divided about equally between the State and FDIC and examinations alternated annually. The results of the examinations are, of course, shared.

From a modest beginning in 1977, the divided examination program has grown and the Corporation now has formal agreements with eight States. Divided examinations are also being conducted in four other States, although no formal agreement has been finalized.

The expansion of the divided examination program evinces the FDIC's commitment to reduce overlap and redundancy in the bank examination process, while at the same time maintaining the high caliber of that process. Not all States are willing and able to participate in the divided examination program. However, where possible the Corporation intends to implement it. As part of that implementation the Corporation's Regional Offices have been directed to evaluate continually State banking departments within the respective Regions for possible candidates in the divided examination program. We expect to add more States to the program by year-end. Some of the criteria the Regional Offices must consider in evaluating a State banking department are State laws, current examination arrangements, staff members, staff capabilities, and the quality of examinations. Furthermore, in a divided examination context, the Corporation's written policy for frequency, scope and priority of examinations allows a full-scope examination conducted by a State authority to be substituted for an FDIC full-scope examination and also

provides that agreements entered into under the divided examination program that dictate the frequency and scope of examinations take precedence over any other instructions contained in the FDIC's written policy.

It is noteworthy that in the last paragraph on page 10 and the first paragraph on page 11 of the Draft GAO Report mention is made of a report of an FDIC-commissioned study of State and Federal regulation of commercial banks. That study is generally known as the Lapidus Study. The Lapidus Study, which appears to be cited with approval in the GAO Draft Report, describes the FDIC's divided examination program as the "most attractive of the prototypes for State/Federal cooperation." That Study, after characterizing withdrawal of Federal agencies from examination in favor of State agencies as a less attractive proposal, concluded: "On balance the divided program with its ability for each agency to adjust its examining presence to the condition of the banks and to its faith in its sister agency, strikes the best balance of responsibility and accountability, low cost, and the need for coordination."

With respect to the GAO recommendation of limiting information now included in the examination report, in 1977 the Corporation substantially condensed examination reports prepared in connection with modified examinations. After careful study, effective January 1, 1979, the Corporation made significant changes to the content of the report of examination, eliminating a number of pages from its supervisory or confidential portion. In addition, under current policy only pages 1 through 4 are transmitted to the bank at full-scope examinations, unless other pages are needed to support a criticism on page 1 of the report. Finally, the Task Force on Supervision of the FFIEC is in the process of developing a core examination report for use by the five constituent members of the Council and the Corporation is actively involved in this effort.

Undoubtedly more can be done by the Corporation, particularly in relying more on work adequately performed by banks, to make additional improvements in the Corporation's examination process. However, the record of improvements by the FDIC as capsulized above is by any fair test impressive.

As we read the GAO's recommendation that the FFIEC assess the quality of State agencies and require the Federal regulators to accept examinations competently performed by the States in lieu of their own, it seems to imply a complete withdrawal of the Federal agencies in some States from the examination function. We believe that the recommendation goes beyond the authority of the FFIEC to prescribe "uniform principles and standards and report forms for the examination of financial institutions which shall be applied by the Federal financial institutions regulatory agencies." (12 U.S.C. 3305(a)) Accordingly, in our judgment the FFIEC could not validly issue a policy which requires Federal regulators to accept examinations performed by State agencies in lieu of their own.

Our reading of the legislative history of the examination authority of the Corporation convinces us that Congress has mandated that FDIC perform on-site

examinations of State nonmember insured banks. The Corporation was given examination authority by the Banking Act of 1935. In discussing that authority, the House Committee on Banking and Currency stated that the provision required the Corporation to examine nonmember insured banks (H.R. Rep. No. 742, 74th Cong., 1st Sess. 3 (1935)). In 1950, the examination authority of the Corporation was substantially amended to, among other things, give the Corporation the authority to make a special examination of any State member and any national bank. However, the legislative history of that examination authority clearly shows that it was carefully circumscribed and was only to be exercised after FDIC review of Federal Reserve or Comptroller of the Currency examination reports (H.R. Rep. No. 3049, 81st Cong., 2nd Sess. 3, 4 (1950)). No similar indication by Congress is expressed or implied regarding Corporation reliance on examination reports of State authorities in its oversight of nonmember insured banks. It would seem to follow, therefore, that discoverable Congressional intent is that the Corporation meet its responsibilities as insurer and bank supervisor of State nonmember insured banks by, among other things, performing on-site examinations.

Our remaining comments are directed at the body of your Draft Report and generally following its numbering scheme:

1. Digest -- Comments on the criticisms and recommendations made by GAO in this part of the Draft Report have been largely covered in our opening remarks. However, the following additional comments are offered.
  - a) Page ii, third paragraph -- GAO alleges that Federal and State examinations are not adequately coordinated and that their examinations frequently are conducted too close together. In the course of conducting examinations of approximately 9,000 insured nonmember banks and coordinating those examinations among 50 State supervisors and the FDIC, undoubtedly some mistakes will be made and some examinations may be conducted too close together. Nevertheless, it should be recognized that the FDIC makes every effort to coordinate the examination process with every State irrespective of whether a divided, joint, concurrent or independent program is in effect. Typically, State and FDIC officials meet at the beginning of each year to plan and coordinate the examination program of each of the agencies for the ensuing 12 months. All individuals having scheduling responsibilities within each agency are aware of these plans and make every effort to schedule examinations of individual banks in accordance with them. As examinations are conducted, each agency is, in most instances, advised of the date and general findings of each examination as well as most supervisory actions taken. As a practical matter this involves an exchange of correspondence of each agency with the bank and generally includes the exchange of examination reports. Although our efforts in this

regard might be improved upon, coordination is seriously and carefully pursued to achieve a reasonable interval not only between State and FDIC examinations but also external audits as well.

- b) Page iii, last paragraph -- GAO recommends that the FFIEC define the supervisory role of the Federal financial institutional regulatory agencies and the extent to which those agencies should influence management processes of the financial institutions they supervise. Congress has established the supervisory role of each of the five constituent agencies of the FFIEC. The FFIEC has no authority to expand or contract those roles. Further, the matter of management evaluation is currently being considered by the Task Force on Supervision of the FFIEC.
- 2. Chapter 1 -- It is our understanding that certain changes recommended by Corporation staff will be incorporated on pages 1, 2, 3, 4, 5, 6 and 7 of the Draft Report. Additionally, you may wish to add to the objectives listed on page 3 the insurance function and the protection of depositors.
  - 3. Chapter 2 -- Comments on the general theme of this chapter have been mostly covered in our opening remarks. Additional specific comments follow.
    - a) Pages 11 and 12 -- On the bottom of page 11, GAO asserts that the Federal financial institutions regulatory agencies have been reluctant to accept State examinations despite the apparent competency of several States. Three illustrations of this alleged reluctance are cited, all of which occurred within one Region of the FDIC. In all candor, the first two examples cited were simply mistakes which never should have occurred. For whatever reasons, the Corporation's Regional Office was not informed of the two State examinations and, by the time knowledge was gained, the FDIC examinations had already commenced and were permitted to continue to completion. In the third instance, the bank withdrew from membership in the Federal Reserve System and, as required by law, had to apply to the Corporation if it desired to retain deposit insurance coverage. Under such circumstances, the Corporation must treat the application as if it were a new bank and consider it in light of the six statutory factors. In this case, the last examination report of the Federal Reserve District Bank indicated that the applicant bank was experiencing some significant difficulties. The Regional Office concluded that, because of these apparent difficulties, an examination of the bank was appropriate.

Clearly, the discoverable facts do not support the GAO assertion that the three illustrations evidence a reluctance on the part of the Corporation to accept State examinations. In fact, the FDIC has never ignored the examination of any State supervisor. Indeed, commencing in January of 1980 the Corporation entered into a divided examination agreement with the State involved and, as indicated previously, such a program is based in large measure upon reliance on and faith in the examination capability of the State supervisor.

- b) Page 18 -- In the first four paragraphs of this page, GAO discusses with apparent approval a remote examination procedure employed by the Office of the Comptroller of the Currency ("OCC"). Overlooked in this discussion is a similar program utilized by the FDIC since the establishment of our computerized bank monitoring system in 1977. Under the procedures initially established, all nonmember insured banks were to receive an annual financial review at least once each year. By written instruction issued in May 1980, the annual reviews are currently required only for those banks which either (i) are not examined in a particular year or (ii) which have not been reviewed under the Corporation's computerized monitoring system. As in the case of the OCC's procedure, the purpose of this FDIC program is to monitor those nonmember insured banks not otherwise examined or analyzed.
- c) Pages 21 - 23 -- The thrust of these pages is to support the fifth recommendation on page 25 of the Draft Report calling for the development of examination principles requiring Federal examiners to place increased reliance on internal review systems of the institutions they examine, such as internal and external audit and internal loan review. The FDIC has been moving in that direction and agrees that more can be done. The Corporation, however, has provided guidance in this area, structured more in terms of examiner discretion than absolute requirements. Hence, the modified examination procedures state in relevant part:

"Key elements of the modified examination procedure are the adequacy of bank policy, of audit (internal and/or external) and of internal controls, with particular emphasis on internal controls. . . . The degree of examiner review and analysis accorded to any segment of the examination must be directly related to the adequacy of audit and control procedures applicable to that segment. A modified examination should consist principally of evaluating the adequacy of bank policy, audit procedures and internal control procedures accompanied by sufficient testing to determine that policy and control procedures are being properly followed."

In addition, the Manual of Examination Policies contains 11 pages of instructions on the evaluation of internal routine and controls, including approximately three pages on audit techniques, more than two pages on fraud detection and 30 pages of accounting bulletins published by the Bank Administration Institute.

On page 22 of the Draft Report, GAO apparently recognizes that the Corporation uses internal loan review systems but is critical that no "systematic approach" is employed. Perhaps there is a need on the part of the Corporation to be more systematic. However, whether the FDIC employs a more systematic approach or not, internal loan review systems of a bank which are not independent will be afforded little or no reliance by the Corporation.

#### 4. Chapter 3

The general thrust of this Chapter tilts in the direction of more structured examinations along the lines utilized by the OCC. Indeed on page 33 of the Draft Report, GAO recites that it endorsed the OCC's approach to examining banks in its 1977 report and also seems to continue that support, although couched in terms of supporting "the concept of systematic examinations." Our intention is not to criticize the approach to examinations employed by the OCC. However, it appears GAO's endorsement of that approach is somewhat anomalous in light of an apparent admission by GAO that its implementation is more expensive and that GAO knows of no empirical evidence showing that the endorsed approach is any more effective in identifying problems earlier or promoting soundness.

The FDIC is working toward more structure in our examination process in terms of procedural guidance, check lists and workpaper documentation through participation in the FFIEC and its various Task Forces. The major difficulty is in achieving a balance between two seeming antithetical purposes, namely enhancement of the structure of the examination process and reduction in the time and cost of examinations. No firm conclusions can be reached on the delicate balancing needed until the process of evaluating and studying all the issues is concluded. Among the considerations with which the FDIC must be concerned is the costliness of a highly structured program, especially in light of the fact that we have supervisory responsibilities for over 9,000 banks, the vast majority of which are relatively small. It may be that the addition of extensive check lists, questionnaires, etc. impacts small bank examinations more than large banks, both in terms of increased total examination hours and burden on the examined institution.

- a) Pages 26 - 27 -- Under the heading "Federal Regulators' Supervisory Role Needs to be More Clearly Defined," GAO attempts to delineate the differences in approach of the Federal financial institution regulatory agencies to the evaluation of managements of financial institutions. Given that differences exist, the Corporation is

concerned that GAO may have inadvertently presented a distorted view of the Corporation's supervisory efforts regarding bank managements and, therefore, might create the impression that the Corporation views management practices and policies as relatively minor aspects of its supervisory function.

FDIC's Manual of Examination Policies categorically affirms the impact of management on the condition and operation of banks: "The quality of management is perhaps the single most important element in the successful operation of a bank." Similarly, various other sections of the FDIC's Manual of Examination Policies, including those dealing with loans, liabilities, capital, earnings, and securities, are replete with guidance on the essential need to evaluate the policies of management in these areas. The Corporation's so-called CAMEL system, which was instituted in July 1978, and is employed in connection with rating a bank, expressly prescribes that management is to be rated in accordance with the following criteria: "(a) technical competence, leadership and administrative ability; (b) compliance with banking regulations and statutes; (c) ability to plan and respond to changing circumstances; (d) adequacy of and compliance with internal policies; (e) depth and succession; (f) tendencies toward self-dealing; and (g) demonstrated willingness to serve the legitimate banking needs of the community." The management rating afforded a bank is a critical part of its overall composite rating. The Corporation's modified examination procedures, discussed above, also state, in relevant part: "Generally, the primary purposes of bank examinations are to protect depositors, provide an objective evaluation of a bank's soundness, appraise the quality of bank management and ensure compliance with applicable laws and regulations." Although comments by FDIC examiners in the open section of the examination report might not, in many cases, directly evaluate management, that assessment is always contained in the examiner's confidential remarks through the assignment of ratings and explanatory remarks. Moreover, virtually all of the recommendations made in the examiner's comments and conclusions in the open section of the report are concerned with weaknesses or problem areas stemming from inept or inadequate management policy and/or performance, are always dealt with in that context, and discussed with management prior to the completion of the report.

In sum, the Corporation does routinely and as a matter of course examine management systems and practices, formal and informal, albeit not in a manner as structured as the OCC. Our methodology is to allow our examiners to exercise discretion within the limits of prescribed policy guidelines rather than a step-by-step, "how to do it" type of procedure. Our examination procedures reach those aspects of management performance and systems that directly or indirectly impact on the practices and condition of the bank. They include at a minimum



a review and analysis of policies, internal and external audits and procedures, management information systems, and all committee and board of directors minutes since the last examination. As indicated previously, perhaps the Corporation's methods and procedures may need more structure and definition. Again as stated above, the FFIEC's Task Force on Supervision is presently considering this entire subject matter. In any event, our supervisory methods regarding bank management have uncovered and, in the vast majority of cases, brought about correction of unsafe or unsound management practices and policies before the effects of those practices and policies seriously affected the condition of the banks concerned.

- b) Page 28 -- In the first paragraph on this page, GAO states that it is unable to find any clear Congressional mandate that the regulators should promote sound management practices and that the law appears to stress correction of unsafe and unsound practices. We simply note in passing that it would seem, by any fair interpretation of the relevant law, that the correction of unsafe or unsound practices necessarily entails the promotion of sound management practices as well.
- c) Page 29 - Here GAO describes the OCC's rationale for developing its new methods and states that the OCC no longer concentrates "merely on present conditions." Although perhaps not intended, this discussion might imply that the FDIC concentrated only on present conditions and gives no consideration to the future prospects of the bank under examination. If so, it is simply incorrect. The main thrust of most FDIC examiner comments center on not only a review and analysis of present practices, policies and conditions but also on the future prospects and health of the institution and what corrective measures, if any, are needed to promote its health and viability in the future.
- d) Page 31 - 33 -- The discussion on these two pages under the heading "Operation Expenses" seems to be more in the nature of a discussion of financial analysis. While the Corporation probably needs to improve its capabilities in the field of financial analysis, much has been done to enhance our capabilities over the past three years and our efforts are continuing. For the past three years, the Corporation has conducted the so-called Gates-Lyons course, which is a course devoted to sophisticated financial analysis. The course curriculum is heavily oriented to the evaluation and analysis of expenses and earnings of commercial banks and bank holding companies. By the end of 1980, this course and the materials utilized in it will have been offered and taught to approximately 560, or more than 50 percent, of the FDIC's commissioned examiners. The knowledge gained from this course is designed to mesh with the entire spectrum of the Corporation's examination effort, including the computerized monitoring system, the enhancement of financial analysis through the use of external data, the increased time span between on-site examinations, and innovations such as the divided examination program. In keeping

with this relatively recent emphasis on financial analysis, comparative performance reports containing numerous financial ratios and other data (such as peer groups) are provided to bankers and FDIC examiners alike to assist in examination planning and execution and facilitate meaningful discussions between bank management and the examiner.

- e) Page 34 -- We are at a loss to explain the source of the GAO comment on the top of this page of the Draft Report to the effect that FDIC has periodically questioned the wisdom of using scarce resources on small bank examinations "unless examiners note systemic weaknesses that threaten an institution's soundness." The FDIC is firmly committed to ongoing, on-site examinations of all banks under our jurisdiction. The rationale of the Corporation policy establishing the frequency, scope and priority of examinations is that all banks, large and small, problem and nonproblem, must be examined within a given time frame. For those not evidencing problem status or other supervisory concern, the examination may be modified. We prefer this approach rather than discriminating against small banks. The examination process is not limited in its application to one covering problem situations. It has served and continues to serve as an instrument of instruction, especially for small banks, many of which do not find it cost effective to retain the expensive legal and technical advice available to larger banks. Furthermore, although the failure of a small bank may not get the nationwide notoriety of a large bank failure, the effect on the community does not argue well for singling out small banks for elimination of examinations. In addition, it is impossible to state with mathematical certainty the number of small banks that have not failed because of persistent supervisory action on the part of the FDIC, but it is clear that by any reasonable estimate the number is sizable over time.
- f) Page 34 -- The first paragraph under the heading "Examination Procedures Need to be More Highly Structured" might unwittingly create the perception that FDIC examiners conduct examinations with little or no training or guidance material. Conceptually, the Corporation does invest its examiners with discretion in the conduct of an on-site examination. However, that discretion is not unbridled but is to be exercised within the policy and instructional guidelines provided to the examiners both in writing and through various training courses. The Corporation's training center conducts a broad spectrum of courses for examiner personnel ranging from those which include basic introductory and accrual accounting to examination report preparation, and asset and management evaluation. In calendar year 1979, approximately 1,770 assistant and commissioned examiners attended the Corporation's training center. An integral part of our training structure is also carried out through on the job training and attendance by Corporation examiners at various seminars and graduate schools of banking. The Manual of Examination Policies provides broad guidance as well as

some limited "how to do it" features. In 1979, 159 Regional Director memoranda were forwarded to the Regions and in 1980 to date, 129 such memoranda. The vast majority of these memoranda provide policy and guidelines in key areas of bank supervision and are, in many instances, transmitted by the Regional Offices to examiner personnel in the Regions. Indeed, the examination report itself lends a certain structure to the examination process by forcing examiners to complete the various schedules and pages contained therein. Finally, as stated previously, procedures on modified examinations were issued in May of 1979 and the Uniform Interagency Rating System, coupled with the FDIC's CAMEL system for rating the five critical elements of capital, assets, liquidity, earnings and management, provide instruction on how to rate these five elements as well as how to make a composite rating for the institution itself. Accordingly, while the FDIC's examination process might need more structure, it is inappropriate to imply that no structure exists.

- g) Pages 37 - 38 -- Under the heading "FDIC bank," GAO discusses in the context of two consecutive examinations of the same bank, each examiner's treatment of the bank's internal control system. The GAO uses these two FDIC examinations as an illustration that "because of the wide discretion given FDIC examiners, the institution's internal control problems may not have been fully disclosed." A review of the two examination reports for the examinations discussed by GAO, together with the report which predates those two examinations, indicates that the internal routine and controls of the bank were a source of criticism over approximately a three-year period. The examinations covered 1977, 1978 and 1979. In the 1977 report, the examiner criticized the internal routine and controls of the bank under the examiner's comments and conclusions and also listed elsewhere in the report eight separate criticisms. All of these criticisms were contained in the part of the examination report which is and was transmitted to the bank. This examiner made no criticism in the confidential section of the report. In the 1978 examination report (the one which is designated as the first examination by GAO), the examiner also criticized the internal routine and controls of the bank in his comments and conclusions and listed seven separate criticisms elsewhere in the report. These criticisms were also contained in the open part of the report which was furnished to the bank and in addition the examiner made severe criticism in the confidential part which was not transmitted to the bank. In the 1979 examination report (designated by GAO as the followup examination), the examiner once again criticized the internal routine and controls of the bank in comments and conclusions and listed elsewhere five separate criticisms. Once again, these criticisms were in the open section of the report which is furnished to the bank, but made no criticisms in the confidential portion. Even a cursory reading of these examination reports establishes that the bank was notified that its internal routine and controls were less than satisfactory and that

correction was needed and expected. Admittedly, the criticisms in the examination report furnished to the bank were not as severe as those contained in the confidential part of the report, quoted on pages 37 and 38 of the GAO Draft Report. However, a simple tallying of the number of criticisms from the examination reports of 1977 through and including 1979 shows that the bank was making correction, although perhaps not as swiftly as might be desired. Thus, we believe GAO misspoke when, on page 38 of the Draft Report, it characterized the statement of the examiner of the followup examination in terms that he "assumed" management had made corrections. The facts, as disclosed in the relevant examination reports, establish that the examiner made an independent determination that corrections were being made and did not rely on assumptions.



BOARD OF GOVERNORS  
OF THE  
FEDERAL RESERVE SYSTEM

WASHINGTON, D. C. 20551

ADDRESS OFFICIAL CORRESPONDENCE  
TO THE BOARD

August 27, 1980

Mr. William J. Anderson  
Director  
General Government Division  
United States General Accounting Office  
Washington, D.C. 20548

Dear Mr. Anderson:

The Board appreciates the opportunity to respond to the GAO report entitled "Improvements Needed in Federal Examinations." The report raises a number of procedural matters concerning scheduling, timing, techniques and format used in the examination process. The Board fully agrees with the GAO's position that bank examinations be conducted in as efficient and effective a manner as possible.

The GAO recommends greater use of "limited scope" examinations and relating examination frequency to the condition of the bank rather than to a fixed time frame. Limited scope examinations are already being used by Reserve Banks, and the Federal Reserve is currently giving consideration to extending the time period between examinations of relatively trouble-free banks. We have proceeded cautiously in these areas and believe it is appropriate to do so. It should be pointed out that many of the procedural issues raised concerning the examination process are currently being addressed in studies undertaken by the Task Force on Supervision of the Federal Financial Institutions Examination Council. These studies will help to focus on any major interagency procedural differences and establish a framework for strengthening uniformity and equity in the Federal supervision of the nation's financial institutions.

In addition to procedural matters, the GAO recommends that the Federal agencies rely to a greater degree on the examinations and work performed by the States. The Board wishes to cooperate with the States to the fullest extent feasible and believes that the System has made significant progress over the last several years to expand the many areas in which there are joint efforts involving both the Federal Reserve and State supervisory authorities.

As the GAO report points out, the Federal Reserve has established joint or concurrent examination arrangements in almost one-half of the States in which it examines banks and takes steps to coordinate the timing of separate examinations in many other States. In the Board's view, this cooperative approach is appropriate in that it balances the need to achieve greater resource sharing and cooperation with the States with the Federal Reserve's statutory responsibility for promoting safety and soundness and compliance with banking and consumer laws

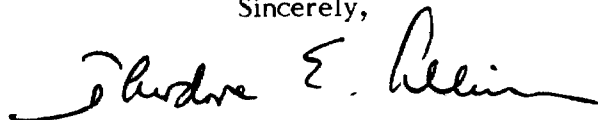
Mr. William J. Anderson

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and regulations. The conduct of joint and concurrent examinations and other steps taken to coordinate timing also serve to reduce the burden of examination on commercial banks. In addition to the number of such Federal-State arrangements, it should be noted that many of these cooperative efforts exist in States with a preponderance of large banks where sharing of resources is especially desirable, since neither agency has the resources to adequately examine the larger institutions independently. For example, the Federal Reserve Bank of New York recently reached an agreement to conduct joint examinations with the New York State Banking Department, an arrangement which should improve the efficiency and reduce the burden involved in the examination of the large money center State member banks. Moreover, the Federal Reserve System receives examination reports from States, and as a matter of policy permits Reserve Banks to accept where appropriate examinations conducted by State agencies as one of the two required annual examinations of problem banks.

The Board believes that the cooperative approach taken by the Federal Reserve has resulted in considerable improvement and resource sharing in the examination of State member banks. These arrangements are being entered into whenever they appear consistent with the Federal Reserve's statutory responsibilities for the safety and soundness of State member banks. An important goal of the Federal Reserve is to ensure that cooperative efforts are undertaken in a manner that does not detract from the role of the State agencies in the bank supervisory process.

Sincerely,



Theodore E. Allison  
Secretary of the Board



## NATIONAL CREDIT UNION ADMINISTRATION

WASHINGTON, D.C. 20456

EI/TAS:glw  
SSIC 5000  
September 4, 1980

Mr. William J. Anderson  
Director  
United States General  
Accounting Office  
Washington, D. C. 20548

Dear Mr. Anderson:

This is in response to your letter and enclosed report dated July 30, 1980, concerning "Improvements Needed in Federal Examinations of Financial Institutions." We appreciate the extension to September 5, 1980, for receipt of the National Credit Union Administration's (NCUA) comments.

NCUA is in general agreement with the findings and recommendations contained in the report unless otherwise indicated in this letter. We will comment upon the recommendations contained in the report concerning their applicability to NCUA in the order they appear on pages 25-26 and 38-40. We would like to point out that GAO will find that NCUA is already using, or is taking steps to implement, all of the recommendations contained in the report. Finally, in response to the recommendations concerning development of uniform examination principles, standards, procedures and reports, we believe these goals and objectives are worthwhile. However, complete uniformity may not be necessarily desirable or possible because of the unique differences between the three types of financial institutions. Nevertheless, you can be assured that NCUA will strive to achieve uniformity in examination matters with the other financial regulators whenever feasible.

The following recommendations were made to the Federal Financial Institutions Examination Council (Council):

1. "Assess the quality of examinations performed by State agencies and develop a Federal Government-wide policy which requires Federal Regulators to accept examinations that are competently performed by State agencies in lieu of their own."



NATIONAL CREDIT UNION ADMINISTRATION

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5. "Develop examination principles which require Federal examiners to rely on functions adequately performed by others such as internal and external audit and internal loan review departments. The Council should develop criteria for testing and assessing the quality of these systems before the agencies could rely on them."

This recommendation may not apply to NCUA. Few, if any, credit unions have internal review departments which are responsible for detecting problem loans. It is necessary for examiners to assess the collectability of delinquent loans. The review of current loans is limited to selected and random samples. A procedure is currently being tested which limits the number of current loans reviewed if certain ratios are not exceeded. If the procedure proves to be reliable, then we will implement it during all examinations.

6. "Develop uniform standards for reporting the results of examinations which limit the amount of detailed data to that which is necessary for effective supervision."

We are currently in the process of revising the examination report to report items only when a problem exists. We anticipate this revision will be implemented during September 1980. We believe the revised examination report will provide effective supervision and eliminate unnecessary schedules.

7. "Define the various regulators' supervisory role, in particular as it relates to the routine and systematic examination of management systems in financial institutions without unsafe and unsound financial conditions."

We believe the evaluation of management and management systems are an important part of any examination. Many times lack of management policy or control allow unsafe financial conditions to occur. NCUA plans to continue reviewing management systems during examinations.

8. "Define, with the guidance of the congressional legislative oversight committees, how forcefully the regulators should promote the establishment and maintenance of sound management systems."

We believe that credit union management in larger credit unions should have sound written policies covering all major areas of operation. In addition, internal control systems are necessary to assure that management policies are followed. We believe that examinations should go beyond looking at existing problems in financial areas and also uncover weaknesses in management systems which can cause financial losses.

9. "Prescribe uniform principles and standards consistent with the above identified supervisory role and commensurate with an acceptable level of risk and cost."

We believe the Comprehensive Examiner's Guide sets out the uniform principles and standards for the review of management systems. The EDP area is the only major management system that is not reviewed during comprehensive examinations.





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This may be a worthwhile project for the Council to consider. While it may not be a Council mandate to assess the quality of state examination programs, such an assessment could be beneficial to NCUA. Presently we accept state examination reports of federally insured state chartered credit unions. If an assessment of the states' examination programs proved that some programs were unacceptable, we could increase our review of these states' reports or decide to examine some of the more critical cases in the state. We believe NCUA should undertake an assessment of this type even if the Council does not. We would like to add that each agency should retain the right to determine whether to accept a particular state's examination reports in lieu of conducting its own.

2. "Develop criteria for the continued monitoring of the States' examination programs to assess changes which may occur which affect the acceptability of the State's program for Federal needs."

We believe this recommendation could be incorporated into the prior one. NCUA presently reviews all state examination reports and when questions arise concerning an examination, the state supervisor is contacted to obtain additional information. NCUA is planning to review the quality of state examination programs so we can concentrate our review/examination efforts on the weaker state programs.

3. "Develop a system for determining the timing of examinations which is based on a perceived need to examine rather than on the basis of a static timeframe."

There is a need for examinations to be prioritized. NCUA presently examines large credit unions and small problem credit unions over a 16 month cycle and small non-problem institutions over a 24 month cycle. We are continually re-evaluating the priorities and are planning to make some changes based on our findings. However, we do believe that there is a need to set a static timeframe by which any credit union must be examined. The most sophisticated early warning system can only point out financial problems. An on-site examination is necessary to determine quality of assets, compliance with law and regulations, and quality of management. Our present examination cycles are too long and we would like to decrease them to 12 and 18 months respectively. However, our limited staff prevents the agency from doing so.

4. "Develop examination standards which limit the amount of detailed work performed during a routine examination unless potential problems are detected."

NCUA presently has a regular examination for credit unions under \$5 million in assets and a comprehensive examination for those over \$5 million. We are working towards developing one examination which outlines the minimum level of work in each area with additional procedures for an area when a problem is disclosed.



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10. "Include in its prescribed principles and standards the requirement that Federal regulators develop examination procedures that clearly identify (1) examination objectives, (2) examination tasks required to achieve the objectives, and (3) documentation required to fully support report comments, conclusions, and recommendations and to provide a basis for supervisory review."

The Comprehensive Examiner's Guide and accompanying workpapers presently contain procedures that identify all of the items mentioned in the recommendation. We are working on clarifying various sections of the Guide and where necessary, will revise procedures to clearly identify the objectives, tasks and documentation.

GAO asked the Council to resolve the following issues prior to determining whether examinations should emphasize the review of management systems.

1. Is such an approach cost effective, especially in small institutions?

NCUA's review of management systems in smaller credit unions is not as time consuming or as detailed as the review in larger credit unions because smaller credit unions' activities are limited and the level of sophistication necessary for the management systems is not as great. Therefore, we believe a review of management systems in smaller credit unions is necessary because poor management is the primary reason for failure of small credit unions.

2. Is such an approach encouraging examiners to question matters that are outside the legitimate concerns of a regulator and more the prerogative of management?

We believe examiners are not questioning matters that are the prerogative of management solely. Examiners point out the consequences of policies or the lack of policies. NCUA does not mandate certain management decisions unless there is a violation of law or regulations, or unsafe and unsound conditions exist, or the credit union is on the verge of failing.

3. Is such an approach structured enough to assure that examiners followed appropriate examination procedures?

The Comprehensive Examiner's Guide and accompanying workpapers outline the required examination tasks, procedures and documentation for the review of management systems. We have found that this approach causes examiners to deal primarily with documented facts to support their opinions. We have found that a structured approach has been successful for the review of management systems.



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WASHINGTON, D.C. 20456

Page 5 of the draft indicated that the comprehensive examination includes an EDP audit. Presently a review of EDP operations is not completed during a Comprehensive Examination. This procedure is under development and will be implemented as staff limitations will allow.

We appreciate the opportunity to comment on the report. If you have any questions, please contact us.

Sincerely,

LAWRENCE CONNELL  
Chairman

**GAO note:** Page numbers and paragraph references throughout refer to the draft revisions and may thus not correspond with those in the final reports.

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