

TESTIMONY OF
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Before the

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
AND CONSUMER CREDIT
of the
COMMITTEE ON BANKING AND FINANCIAL SERVICES

of the
U. S. HOUSE OF REPRESENTATIVES

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Statement required by 12 U.S.C. § 250:

The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

Madam Chairwoman and members of the Subcommittee, thank you for your invitation to participate in today's hearing. I commend you for holding these timely hearings on the supervision of foreign banks that operate in the United States. Inasmuch as the Office of the Comptroller of the Currency (OCC) was not involved in the supervision of Daiwa Bank, we have less direct information on that bank's difficulties than the State of New York and the Federal Reserve have. My statement, therefore, focuses on the general issues involved in supervising international banking activities, which include activities of the U.S. branch offices and agencies of foreign banks, foreign-owned banks chartered by the OCC and overseas activities of U.S. banks.

The OCC's supervision of international banking operations closely follows the supervision of domestic offices of national banks. We have taken an active role in the efforts conducted under the auspices of the Basle Committee on Banking Supervision to improve supervision of international banking. I have joined our career personnel at a number of meetings with the heads of supervision of major industrialized nations, and I will continue to give a high priority to such efforts.

The OCC has supervised international banking activities for seven decades. Prior to the late 1970s, however, federal bank regulators had virtually no role in supervising foreign banks. Supervision of foreign banks' activities in the U.S. was the domain of state regulators. Foreign banking organizations generally were not covered by many of the statutes and regulations that applied to U.S. banks, such as constraints on interstate branching and other provisions of the Bank Holding Company Act. Following rapid growth of activities by foreign banks in the U.S. during the 1970s, Congress enacted the International Banking Act of 1978 (IBA). The IBA gave federal bank regulators authority for comprehensive supervision of

activities of foreign banks in this country.

Under the IBA, the OCC has authority to issue licenses for foreign banking organizations to establish branch offices or to open agency offices across the country, wherever state law does not prohibit such offices. The IBA also implemented the "national treatment principle" whereby federal branches and agencies of foreign banks have the same rights and privileges and are subject to the same duties and responsibilities as national banks at the same location, unless otherwise provided by the Act or the OCC. Another provision of the IBA subjected foreign banking organizations to similar restraints on multi-state deposit taking as applied to U.S. banks.

The Foreign Bank Supervision and Enhancement Act of 1991 (FBSEA) amended the IBA to require entities seeking to establish a federal branch or agency to obtain prior approval by the Federal Reserve Board (FRB). The FBSEA set a number of requirements including that the applicant be subject to comprehensive supervision on a consolidated basis by home country authorities. FBSEA also gave the FRB the authority to order a foreign bank with a state branch, agency, commercial lending subsidiary, or representative office to terminate its activities or to recommend termination of a federal branch or agency to the OCC. The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 amended certain provisions of the IBA, particularly extending to foreign banks the interstate banking options of U.S. banks.

As of June 30, 1995, there were 554 U.S. branches and agencies of foreign banks, with \$798.4 billion in assets in the U.S. These branches and agencies accounted for 16.1 percent of all U.S. banking system assets. Japanese-owned branches and agencies accounted for 47.6 percent of the assets of all branches and agencies.

Of the 554 U.S. branches and agencies of foreign banks, the OCC supervises 72 federal branches and two federal agencies that operate in five states and the District of Columbia. Most of these federal branches--54--are located in New York City. As of June 30, 1995, federal branches and agencies had total assets of \$52.7 billion, total investments of \$6.1 billion, total loans of \$16.6 billion, and total deposits of \$29.5 billion. Of the 74 federal licensees, only 7 are federally-insured institutions.

My testimony today responds to each of the questions in your invitation letter, beginning with a discussion of how the OCC supervises and regulates federally-licensed branches and agencies. My statement describes the Risk Management, Operational Controls, Compliance, and Asset Quality (ROCA) rating system, which the OCC and the other federal banking agencies use to evaluate the U.S. operations of foreign bank branches and agencies. It also describes the OCC's actions to implement the FBSEA of 1991.

As requested, I will comment briefly on the supervisory lessons associated with the recent events relating to Barings and

the U.S. operations of Daiwa Bank. The OCC has devoted significant resources to implementing controls which would, we believe, substantially reduce the likelihood of a similar sequence of events at national banks and offices of foreign banks under our supervision. I will discuss the desirability of imposing an external audit requirement on all U.S. offices of foreign banks. At present, we believe we have the authority under existing law to regulate and supervise national banks and federally-licensed branches and agencies of foreign banks adequately; therefore, I do not discuss legislative changes to improve OCC supervision of federal branches and agencies.

Supervision of OCC-Licensed Federal Branches of Foreign Banks

Consistent with the national treatment principle established under the IBA, the OCC uses the same approach for supervision of branches and agencies of foreign banks that it uses to supervise national banks, but it accommodates practical differences where appropriate. The focus of OCC supervision is on risk--evaluating the quantity of risk exposure in an institution and determining the quality of the bank's risk management systems--an approach that we believe is necessary in today's environment. As the business of banking continues to change in response to structural changes, such as increased competition from non-bank providers and advances in information technology, it is important for supervision to accommodate new risks and different combinations of risk. Accordingly, the OCC is implementing a new supervisory program that identifies those activities and products that pose the greatest risk to an institution and evaluates the effectiveness of the institution's policies and processes to control the risks associated with those products and activities. Our examiners then communicate their findings and concerns to the foreign bank's management and follow up on those concerns to ensure that the institution carries out any necessary corrective measures.

Just as it does for national banks, the OCC has the authority to impose formal and informal enforcement actions to address problems affecting federal branches and agencies. We have used our authority when necessary and have effected appropriate corrective action.

Supervision is a combination of off-site and on-site reviews and examinations. The OCC plans the on-site and off-site supervisory activities that it conducts at each institution, tailoring those activities to the institution's particular business activities and the types and levels of risks that we identify. As with national banks, we assign every foreign branch or agency to a specific examiner, who assumes ongoing responsibility for that institution. This system makes it easier for us to follow up on concerns, and it allows examiners to develop an in-depth understanding about their assigned institution.

The same staff that examines national banks also examines federal branches and agencies. This approach helps to ensure

consistent national treatment between national banks and federal branches and agencies and allows our examiners to leverage the expertise they have gained from examining both types of institutions.

If a national bank or federal branch or agency is engaging in capital markets activities, our examination team will include at least one examiner that specializes in evaluating those activities. Those examiners are trained under the OCC's capital markets program, which is designed to improve our supervision of capital markets activities and products, such as liability and interest rate risk management, bank investments in mortgage-backed securities, and securities dealer, derivatives, and foreign exchange activities. About 150 commissioned examiners participate in the program. The program includes a structured combination of on-the-job training, formal classes, graduate programs at universities, correspondence courses, and self-study courses such as the Chartered Financial Analysts program. The program also helps us to ensure that examiners are applying our policy guidance consistently.

As mandated by the IBA, the OCC conducts annual examinations of federal branches and agencies. In 1995, 252 OCC examiners spent 4,835 workdays supervising foreign branches and agencies. In addition to OCC examinations, the Federal Reserve banks also have the authority to examine federal branches and agencies. The OCC conducts a limited number of examinations of federally-licensed branches and agencies of foreign banks jointly with Federal Reserve System examiners, and we issue a joint examination report. Such joint supervisory activities reduce regulatory burden and improve examination efficiency.

As I have noted, OCC supervision takes into account the technical and practical differences between the operations of federal branches and agencies and national banks. The OCC has developed specialized supervisory policy and procedural guidance in certain areas that are unique to federal branches and agencies. The guidance covers such issues as the capital equivalency deposit, the allowance for loan and lease losses at federal branches and agencies, and the review of the activities of offshore branches that are managed or controlled by federal branches and agencies.

For example, branches and agencies are not separate corporate entities, and hence are not separately capitalized. To accommodate this difference, OCC rules implement statutory requirements by requiring that foreign banks maintain a capital equivalency deposit for the federal branch or agency. When the branch or agency opens, we require the amount of its capital equivalency deposit to be comparable to the amount of capital that we would require for a domestic national bank opening in the same location. Thereafter, as mandated by the IBA, the OCC requires the federal branch or agency to maintain its capital equivalency deposit at five percent of third-party liabilities.

Implementation of the Foreign Bank Supervision and Enhancement

Act of 1991 (FBSEA)

Two years ago, the OCC began a review of all our regulations to modernize them and eliminate unnecessary burdens, consistent with maintaining safety and soundness. On July 5, 1995, the OCC proposed for public comment revisions to the regulations that cover foreign banks operating through federal branches and agencies and to the regulations governing the international operations of national banks. That proposal also implements provisions of the Foreign Bank Supervision and Enhancement Act of 1991 (FBSEA) and the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 relating to federal branches and agencies. We also proposed changes that would enhance our supervisory, regulatory, and enforcement policies and procedures. For example, the proposal would strengthen the capital equivalency deposit rules, revise and update our federal branch and agency corporate policies, strengthen responsibilities for oversight of federal branch and agency activities by senior management at the head office, modify rules on deposit-taking by uninsured federal branches, clarify our requirements for asset maintenance, and provide guidance for liquidation and termination of federally-licensed offices. OCC staff have carefully reviewed the comments we received, and we are consulting with the FRB and FDIC as we implement the changes. We expect to issue a final rule in the next few weeks.

The Risk Management, Operational Controls, Compliance, Asset Quality Rating System for Branches and Agencies (ROCA)

The practical differences between foreign bank branches and agencies and domestic banks have also led the banking agencies to develop separate, but comparable, systems for rating them: CAMEL, which applies to national banks, and ROCA, which applies to branches and agencies. Both systems are founded on the same principles, but the ROCA system recognizes that a branch or agency of a foreign bank does not have the same degree of control over certain factors, such as capital or liquidity, as a domestic bank. In January of this year, the OCC began using the ROCA system to evaluate the operations of federal branches and agencies. The other banking agencies have also been using ROCA since January, 1995.

Your invitation letter asks us to comment on the merits of using the ROCA system. The ROCA system is an improvement over its predecessor rating system (the AIM system, which rated asset quality, internal controls and audit, and management) because it places primary emphasis on risk management. It allows us to assess better the condition of a branch or agency within the context of the entire foreign banking organization, and more easily highlight the major areas of supervisory concern in a particular branch or agency. The OCC has conducted examiner training sessions on ROCA in 1995, and we will continue such training in 1996.

ROCA's approach to supervision reflects the OCC's focus on risk management. In October of 1993, the OCC issued Banking Circular 277 providing guidance on risk management. BC 277

requires bank management to have in place an effective risk management process, which includes systems that promote routine, consistent, and adequate risk measurement, monitoring, and control. Measurement systems should identify and quantify, in a timely manner, the major sources of risk that an institution faces. Risk monitoring systems should provide an accurate view of the amount of risk taken, compliance with risk tolerances established by management, and the potential impact on the organization of changes in the risk environment. Risk control systems should establish a comprehensive framework for risk limits and clearly identify lines of responsibility and accountability. Importantly, risk monitoring and control systems must be independent of the risk-taking function.

Recent Events related to Daiwa Bank and Barings PLC

Your letter of invitation asked me to comment on the recent losses at Daiwa Bank and Barings. Let me preface my remarks by noting that the OCC supervised neither of these institutions and consequently has less direct knowledge of the events surrounding these losses than the State of New York or the Federal Reserve. Based on published reports, it appears that the common elements in the Barings and Daiwa cases were a failure to separate the risk management and control functions from the risk-taking function and an inadequate level of oversight by senior management. In the case of Daiwa, the FRB has testified that one person had responsibility for both securities trading and custody operations as well as some related back office functions, hence creating the potential for misappropriation of customer and bank funds. In the case of Barings, the respective authorities have established that one person served as both trader and trade processor, presumably to save costs. In both cases, an alleged absence of proper controls, inadequate oversight by senior management, and amalgamation of duties gave an employee the opportunity to conduct unauthorized activities.

Any institution can have on its staff a rogue trader or dishonest employee. By ensuring that proper internal controls are in place and operational, banks and their supervisors can greatly decrease the likelihood that unauthorized activity will continue undetected. While proper risk management systems make it more difficult for dishonest employees to circumvent established controls and to conceal illegal activities, they cannot completely eliminate the possibility of fraud.

Banks can better align traders' interests with the long-term interests of the bank by carefully designing their trader compensation programs to ensure that they do not reward imprudent risk-taking. This month, the OCC will issue a supervisory policy on emerging market country product and trading activities that includes specific guidance on bank trader compensation policies. The policy applies to domestic national banks as well as to federal branches and agencies of foreign banks. Under the new examination guidance, senior management should consider several factors when establishing or reviewing compensation programs and when determining specific payments, such as bonuses. They include: an employee's compliance with bank policies, laws, and regulations; performance relative to the bank's stated goals,

relative quality of earnings (e.g., risk-adjusted returns); competitors' compensation packages for similar responsibilities and performance; an individual's overall performance; and the levels of risk inherent in and caused by relevant trading activities.

Cooperation and frank and timely communication between and among U.S. banking agencies and the home country bank supervisors are also important. The OCC has gone to great lengths to develop its relationships with home country supervisors of foreign banks that operate federal branches and agencies in the U.S. OCC senior managers and staff meet frequently with foreign bank supervisors, including supervisors of foreign banks that operate federal branches and agencies, to discuss supervisory policies and problems. We solicit their help in resolving problems at federal branches and agencies. When it is their practice, we welcome the visits of foreign supervisors to conduct on-site examinations of their banks' U.S. offices.

More generally, the OCC is active in international discussions on bank supervision. I personally attend the quarterly meetings of the Basle Committee of Banking Supervision to discuss issues in international banking supervision with the heads of supervisory agencies from other countries. Additionally, the OCC conducts annual, bilateral meetings with the Japanese Ministry of Finance and the Bank of Japan.

Desirability of an External Audit Requirement

Your letter of invitation also requested that we comment on whether branches and agencies of foreign banks operating in the U.S. should be subject to a mandated external audit requirement. As mandated by FDICIA, insured branches of foreign banks and insured domestic banks with greater than \$500 million in assets are subject to an external audit requirement. We believe that, based on safety and soundness grounds, we have the authority to require a foreign bank to obtain an external audit for its uninsured federal branch or agency. However, we believe that the requirement should be based on a need caused by specific, significant internal control, internal audit, or other management or operating deficiencies in the federal branch or agency.

Conclusion

As my statement describes, the OCC has devoted significant resources to improving our supervision of national banks and federal branches and agencies of foreign banks. For all entities we supervise, the focus of our supervision is on risk--evaluating the quantity of risk exposure in an institution and determining the quality of the bank's risk management system. In addition, the OCC places great emphasis on the need for banks to implement strong internal controls. Such controls can substantially reduce the likelihood of events similar to those occurring at Barings and Daiwa Bank. While unexpected losses are always possible, we do not believe there are significant legislative changes at this time that would make them less likely.