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STATEMENT OF
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BEFORE THE
SUBCOMMITTEE ON GENERAL OVERSIGHT
AND RENEGOTIATION
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
HOUSE OF REPRESENTATIVES



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Mr. Chairman:

I am pleased to appear today before this subcommittee to discuss differences in the examination processes of the Federal regulators of financial institutions and the need to consider alternatives to the present organizational structure for examining financial institutions. On January 6, 1981, we issued a report to the Congress 1/ in which we identified several underlying examination differences which the Federal Financial Institutions Examination Council must address if it is to successfully develop uniform examination principles and standards. In another report to the Congress 2/ on April 24, 1981,

1/"Federal Examinations of Financial Institutions: Issues That Need To Be Resolved" (GGD-81-12, January 6, 1981).

2/"The Federal Structure for Examining Financial Institutions Can Be Improved" (GGD-81-21, April 24, 1981).

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we discussed problems with the present Federal structure for examining financial institutions and suggested some alternatives.

The subjects of the two reports are interrelated in that adoption by the Federal regulators of uniform examination approaches and procedures would facilitate restructuring the workforces that perform onsite examinations. While we cannot anticipate what action might ultimately be taken on our recommendations, we are concerned about the lack of action thus far. I would like to briefly discuss each report as well as the agencies' reactions to our proposals.

EXAMINATION STANDARDS AND PROCESSES
SHOULD BE MORE UNIFORM

At present, the examination standards and processes of the Federal regulators are not uniform. The so-called "commercial" or "safety and soundness" examination is the principal means by which Federal regulators evaluate the soundness of financial institutions and their compliance with laws and regulations. While all regulators have similar objectives, the concepts, approaches, scope, and scheduling criteria for examinations differ from agency to agency. We believe that uniform Federal examination standards and processes could be designed which would significantly reduce the cost and burden of examinations without materially reducing the agencies' ability to supervise the institutions.

Council should define supervisory role

The regulators place differing amounts of emphasis on the assessment of financial institutions' management decisions and systems. Greater emphasis on assessing management could result in early detection of situations that might lead to serious problems. Correction of these problems could prevent some institutions from becoming problem institutions or failing. On the other hand, increased emphasis on management activities might encourage examiners to question matters that are outside the legitimate concerns of a regulator and are more properly the prerogatives of management. It is not clear at what point such influence infringes on the prerogatives of management as opposed to being a legitimate regulatory concern.

Before the Council can develop uniform examination principles and standards, we believe it should work with the agencies to determine their supervisory role, in particular as it relates to the extent that Federal regulators should question management's decisions and direction.

Federal agencies should rely more on State regulators' examinations

A second difference among regulators concerns the extent to which they make use of State examinations. At the time of our review there was no systematic evaluation made of State examinations. The amount of reliance on State examinations varied from agency to agency and, at times, from one field office to another within the same agency. The National Credit Union

Administration essentially accepts the examinations made by State agencies in lieu of its own; but the Federal Deposit Insurance Corporation, Federal Reserve Board, and Federal Home Loan Bank Board either conduct examinations separate from State agencies or participate with States in various types of cooperative programs.

The differences in acceptance of State examinations within an agency can be illustrated by the situation in Indiana. When we made our review, the Federal supervision of State member banks in Indiana was split between the Federal Reserves' Chicago and St. Louis district banks. The Chicago district bank had an arrangement with the State supervisor under which one or two Federal examiners accompanied the State examiners, reviewed the State examiners' work, and focused on any areas considered necessary. Thus, the Chicago district essentially accepted the State examination in lieu of its own. The St. Louis district bank, on the other hand, did not have a similar arrangement for supervising banks located in southern Indiana because it did not believe that examination responsibilities should be shared with the State.

Our January 1981 report discussed additional examples where Federal agencies were reluctant to accept State examination efforts. For example, we noted instances where although a Federal bank examination began 1 or 2 weeks after the State completed its examination, the State examination was not used. In other cases, one Federal agency had some form of cooperative program with a particular State, but other Federal regulators which

supervise institutions in the State did not participate in such programs.

Our report recommended that the Council develop criteria for Federal regulators to (1) assess the quality of State agencies' examinations and (2) monitor States' examination programs to assess changes that affect their acceptability for Federal needs. We also recommended that the Council develop a policy under which Federal regulators, using the above criteria, would accept examinations in lieu of their own. Implementation of our recommendations should result in FDIC, FHLBB, and FRS placing greater reliance on State examinations and thus reducing their own examination efforts. Conversely, NCUA may find that some State examinations are not adequate for its need and thus NCUA may have to perform examinations of State-chartered credit unions that are now being examined only by the State regulator.

Since we completed our review, the FDIC has significantly expanded a cooperative program that it had with a few States. FDIC and these States alternate annual examinations of nonproblem banks and accept each other's examination reports. The Federal Reserve announced recently that it has established a similar plan. Although the divided examination program does not eliminate the Federal regulators from the examination process, it does result in more efficient use of the combined Federal and State examination resources. We are concerned, however, that the FDIC and Federal Reserve cooperative examination programs are being implemented before the Council has established criteria for assessing the quality and acceptability of State examinations.

Council should expedite development of examination principles and standards

In November 1978, the Congress formalized the existing interagency coordination efforts of the five Federal regulators by establishing the Federal Financial Institutions Examination Council. The Examination Council, 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 with issues involving supervision, surveillance, examiner education, consumer compliance, and examination reports. Each task force subsequently identified projects of current interest. The task force on supervision initiated a project to review the examination philosophies, concepts, and procedures of the five Federal regulators. The review was divided into two phases and was originally expected to be completed by mid-1980. During the first phase, the task force was to ascertain what agencies were currently doing. In the second phase, the task force was to identify and recommend uniform principles and standards for examining financial institutions. To date, the project has not resulted in the Council's adoption of any examination principles or standards even though the project was originally expected to

be completed a year ago.

Our report identifies agency differences in examination approaches, scope, frequency, structure, and documentation. In commenting on our report, the Council stated that our concerns would be addressed in the project's study. We believe the Council should expedite the completion of this project.

FEDERAL AGENCIES SHOULD SHARE
EXAMINERS AND CONSIDER CON-
SOLIDATING EXAMINATION FORCES

I would now like to briefly discuss our report on the Federal structure for examining financial institutions. We found that the present structure, where each agency maintains its own national network of examiners to conduct periodic onsite examinations of financial institutions, has several inherent problems which can be solved through some form of restructuring.

Under the present structure where each agency maintains its own field network, it is very difficult to locate field examiners so as to minimize the burden and costs of extensive travel and to effectively manage workloads. All or several agencies may have a regional, district, or field office in the same city. Yet, in other cities, none of the agencies can support a field office because of the small number of institutions each supervises. The agencies, however, could support a consolidated field office to examine all institutions in and around such cities.

Under the present structure, the three bank regulators spend \$26 million annually for travel, and these costs have been increasing each year. While we did not attempt to estimate how

much salary is paid to examiners while traveling, this is also extensive. The extensive travel requirement has adversely affected the examiners' quality of life and is one reason given by examiners for finding employment elsewhere. One Federal Reserve district bank experienced a 32 percent turnover rate for its examiners. This turnover is costly in that replacements have to be hired and trained.

In our report we make reference to a Federal Reserve study on examiner turnover. Recognizing that a high turnover rate can prevent regulators from developing experienced staff, the study report stated that the most important impact of inexperienced staff is on work quality. The report stated that inexperience may limit the examiner's ability to identify problems at the institutions. Because the Dallas region had the highest turnover rate for any field office of FDIC, FRS, and OCC, we analyzed the experience level of the examiners who participated in examinations of our sample banks at that region. We found that 53 percent of the FDIC examiners, 69 percent of the FRS examiners, and 66 percent of the OCC examiners had less than 3 years of experience.

Since each agency maintains its own field offices, managing workloads can be difficult. Because of the limited staff at each office, managers may not have much flexibility to adjust to changing demands.

Given the inherent problems with the present field structure for examining financial institutions, we tried to see what alter-

natives might exist to overcome or, at least, alleviate current problems. One concept which appeared to offer promise would involve consolidating the examiner forces of the agencies into a common pool of examiners that would be strategically located throughout the country to examine any type of financial institution. It appeared to us that a consolidated examiner force would overcome most of the problems with the present structure, and such a consolidated force would promote examination uniformity and consistency which was the basic objective of creating the Examination Council.

Before making our recommendation to the agencies and the Council, we recognized that many problems would have to be resolved before such a concept could be adopted. The agencies, in commenting on our draft report, further elaborated on such problems as accountability of examiners, separation of supervision and examination functions, and disruption of relationships with financial institutions.

We recognize that changing the present structure for examining financial institutions would be a major undertaking and that a final decision on the feasibility of consolidation should not be made until sufficient study and planning is completed. Moreover, it would not be desirable to consolidate examiner forces until the agencies agree on standard examination procedures and the Examination Council has adopted standard training courses for

the examiners. We believe, however, that with proper planning and study, problems associated with a consolidated examiner force can be solved and that the concept warrants the additional study and consideration that we recommend.

To illustrate the potential benefit of a consolidated examiner force, we selected four different geographic areas of the country comprising 16 States. In these 16 States we estimated that \$1.6 million annually could be saved by the three banking agencies in travel costs alone by having a common or consolidated examiner force. Additional savings should result from reduced salary costs for examiners traveling to and from the banks and from the elimination of some support and administrative costs by consolidating regional offices now located in the same cities.

While we believe that, in the long run, consolidation of the examiner forces offers the greatest potential for streamlining the Federal field structure, such a concept is at best several years away because of the need to study and resolve the problems we mentioned earlier. In the meantime, we believe the agencies should adopt a program under which, to the extent feasible, examiners from the closest agency location would examine an institution, irrespective of which agency is the responsible supervisor.

We recognize that such a concept would not be practical in all cases because of limitations of staff, scheduling conflicts, etc. There are areas in the United States where one Federal

regulator has a suboffice while another regulator does not. For example, FDIC has a suboffice in Grand Forks, North Dakota, but OCC, with only a few banks in that area, does not. As a result, eight OCC examiners traveled the 75 miles from Fargo, North Dakota, and five traveled the 250 miles from Minneapolis, Minnesota, to conduct examinations of a Grand Forks bank in fiscal year 1979.

Our proposal would authorize OCC to request FDIC to examine its banks in Grand Forks, thus avoiding this travel. We estimate that by sharing examiners the three Federal bank agencies could realize substantial savings in travel costs alone. Additional savings would accrue from reducing the amount of nonproductive time spent by examiners traveling to and from banks.

The barriers to an interchange of bank examiners appear much less formidable than those to a consolidated examination force. From a technical viewpoint, some types of examinations that the three agencies perform are essentially identical. For example, FDIC, FRS, and OCC perform separate bank examinations to determine compliance with consumer laws and adequacy of data processing operations. While their specific examination procedures are somewhat different, the general thrust of the examinations are the same. Also, the agencies currently exchange examination reports, and this procedure apparently works well. For example, OCC furnishes FRS and FDIC reports of examinations of national banks because these banks are also members of the Federal Reserve

and are insured by FDIC. Similarly, FRS furnishes FDIC its examination reports on State member banks because they are also insured by FDIC.

Our proposal, however, would probably require legislative change, but we do not believe that such a change would be as controversial as consolidating the examiner forces. In our review of the existing legislation we found that there is no clear authority for bank regulators to share examiners. Generally, the Federal statutes providing examination authority are specific only in authorizing examinations to be conducted by the examiners of the particular agency in question. While there are a few exceptions which appear to permit limited exchange of examiners, we believe general legislation is needed to authorize the agencies to examine, upon request, institutions which are supervised by other Federal regulators.

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In summary, I would like to point out that while our proposals for restructuring the agencies' examiner forces raise a variety of problems which must be studied and resolved, the present organizational structure has sufficient weaknesses to warrant the agencies' attention and support to explore ways to improve it. In our view the Federal Financial Institutions Examination Council, with its mandate to promote uniformity in

the examination process, provides the catalyst for the agencies to join forces in exploring reorganizational opportunities.

Mr. Chairman, that concludes our statement. We would be happy to answer any questions you might have.