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UNITED STATES GENERAL ACCOUNTING OFFICE  
WASHINGTON, D.C. 20548

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FOR RELEASE ON DELIVERY  
Expected at 11:00 A.M. EST  
Tuesday, November 29, 1977

STATEMENT OF  
ELMER B. STAATS  
COMPTROLLER GENERAL OF THE UNITED STATES  
BEFORE THE  
COMMITTEE ON GOVERNMENTAL AFFAIRS  
UNITED STATES SENATE

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on

H.R. 2176, A Bill to amend the Accounting and Auditing Act of 1950 to provide for the audit, by the Comptroller General, of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency.

We appreciate the opportunity to give you our views on H.R. 2176 which authorizes and directs the Comptroller General to audit the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency.

First, let me say that we strongly endorse H.R. 2176 and recommend its favorable consideration by your Committee and the Senate. The General Accounting Office has for some

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time favored legislation to give it continuing authority to review the operations of the bank regulatory agencies. Estimated operating expenses of these organizations for 1977 are as follows:

Federal Reserve System--	
Board of Governors	\$ 42,700,000
Federal Reserve Banks	704,800,000
Office of Comptroller of the Currency	89,400,000
FDIC	83,200,000

These agencies carry out important functions in our system of government and regulation and we share the view that our Office, as an arm of the Congress, should be empowered by law to audit their operations. H.R. 2176 provides such authority, although with some restrictions.

The General Accounting Office made a comprehensive study last year of Federal supervision of State and national banks and our report on it was submitted to the Congress on January 31, 1977. This study was made at the specific request of several congressional committees. We received many favorable comments on this work, including those from the Federal Reserve, the Comptroller of the Currency, and the FDIC. We believe that our successful experience in this effort not only underscores the desirability of providing our Office with continuing authority to review the supervisory

policies and practices of the three bank regulatory agencies but also other operations as set forth in the House-passed bill.

We are well aware of the difficulties involved in drafting a bill which gives GAO adequate authority and access to records and at the same time gives due consideration to concerns about confidentiality of information and independence of the Federal Reserve System in matters of monetary policy. H.R. 2176, we believe, accomplishes both objectives well. While we generally prefer, and normally have, unrestricted access to the activities and records of the agencies we audit, we realize that the Congress sometimes finds exceptions necessary.

The bill provides adequate protection against unauthorized disclosure of information about individual banks and their customers. GAO is prohibited from reviewing monetary policy operations of the Federal Reserve System. Yet, the bill provides us sufficient authority to make useful reviews of the agencies' bank supervision activities and other operations.

RESTRICTIONS ON AUDIT AUTHORITY

The specific audit restrictions included in the bill are:

1. Transactions conducted on behalf of or with foreign central banks, foreign governments, and nonprivate international financing organizations;
2. Deliberations, decisions, and actions on monetary policy matters, including discount window operations, reserves of member banks, securities credit, interest on deposits, and open market transactions;
3. Transactions made under the direction of the Federal Open Market Committee, including transactions of the Federal Reserve System Open Market Account;
4. Those parts of communications dealing with these activities; and
5. On-site examinations of banks without written consent of the agency concerned.

In addition, GAO is restricted from publicly disclosing information in a form which would identify a specific open bank or open bank holding company or their customers.

Additionally, the identity of customers of closed banks or bank holding companies could be disclosed by the GAO to the public only if the customer had a controlling interest in the management of a closed bank or bank holding company.

I would like to comment briefly on these restrictions.

We have never registered any objection to the proposed restriction on our audit authority with respect to transactions

conducted by Federal Reserve banks on behalf of or with foreign central banks, foreign governments, and non-private international financing institutions because of their sensitivity from an international standpoint. The Federal Reserve banks generally conduct these transactions as agents for the foreign central banks or governments.

Also, the bill provides that our audit will not include open market transactions conducted at the direction of the Federal Open Market Committee. The open market transactions are the largest category of financial transactions carried out by the System. During the calendar year 1976, for example, outright purchases of U.S. Government securities and Federal agency obligations totalled over \$20 billion. At December 31, 1976, the Federal Reserve banks had on hand over \$100 billion in such securities--an increase during the year 1976 of nearly \$10 billion. On that date, these securities represented about 80 percent of the combined assets of the 12 Federal Reserve banks. At September 30, 1977, the banks had over \$112 billion in such securities.

In addition to the large volume of transactions in Government securities, the Federal Reserve System also has very sizable purchases and sales of foreign currencies.

These transactions are also carried out through the System's Open Market Account under authorizations and directives of the Federal Open Market Committee. For calendar year 1976, for example, foreign currency purchases amounted to about \$900 million. At the end of 1976, the System held the equivalent of \$170 million in such currencies. For the period February through July 1977, purchases amounted to \$151 million and at August 31, 1977, the system held the equivalent of \$55 million in such currencies.

The restriction on auditing discount window operations of the Federal Reserve was added during the House debate on the bill. Through these operations, member banks can obtain or repay loans or advances from the Federal Reserve to adjust their reserve requirements.

The discount window is sometimes used as a supervisory tool to assist commercial banks that are having financial difficulties. In its role as "lender of last resort" the Federal Reserve has a responsibility to provide funds to banks when the consequences of failure to do so would aggravate or lead to a financial crisis. Under the provisions of H.R. 2176, we would be precluded from reviewing this aspect of the supervisory function.

With reference to the provision requiring approval of the supervisory agencies for GAO to conduct onsite examinations of banks and bank holding companies, we believe delays in carrying out audit work may result, but we hope they will not unduly hamper our efforts.

We appreciate the regulators' concern about the public disclosure of information on specific open banks and bank holding companies and their customers and understand the need for the restrictions. The restrictions in the bill are similar to those imposed on us during our study of the bank regulatory agencies last year and we do not believe they will preclude us from effectively reporting on our audits.

AGENCY VIEWS ON THE BILL

We are pleased to note that two of the supervisory agencies involved--the Federal Deposit Insurance Corporation and the Comptroller of the Currency--no longer oppose regular GAO audits as provided by H.R. 2176. The Department of the Treasury, of which the Office of the Comptroller of the Currency is part, supports the bill.

The Board of Governors of the Federal Reserve System continues to oppose H.R. 2176 and GAO audit authority over

any of its operations generally. We understand that the Board's position is based on the following five suppositions:

1. GAO presence would be a step toward compromising the independence of the Federal Reserve System;
2. The Federal Reserve System is already adequately audited;
3. Increases in productivity suggest that additional audits are not needed;
4. GAO audits would have an adverse impact on the effectiveness of bank regulation and supervision; and
5. GAO audits would increase the possibility of unauthorized disclosure of information about banks and their customers.

We disagree with these suppositions for reasons that I would like to explain in more detail.

First, as to independence of the Federal Reserve System, we recognize the need for the independence from political influence afforded the Federal Reserve System by the Banking Act of 1933. But, we do not see how GAO audit authority as proposed could in any manner lessen that independence. The GAO audits other regulatory bodies such as the Federal Home Loan Bank Board, SEC, CAB, FTC, and ICC which are also supposed to be independent of political influence and, as far as we know, they are no less independent as a result.



Independence from political influence does not mean immunity from adequate oversight, review, and evaluation. Also, it is a serious misunderstanding of the GAO, its mission, and its operations to imply that the incidence of GAO audits would increase or decrease with the degree of congressional displeasure over the Federal Reserve's monetary policy decisions and actions. There is an active forum for discussion of monetary policy in the hearings before cognizant congressional committees and I assume and hope that these will continue.

The Federal Reserve states that it is already subject to extensive audits and that there is no need for additional auditing by GAO. Normally, there is little duplication of the work by GAO and internal auditors in Federal agencies for which we have statutory audit responsibilities. The internal auditor performs his work as part of management's system of internal control and the needs of management officials for information. GAO auditing is an independent appraisal made for the Congress of the manner in which Federal agencies discharge their responsibilities. A basic purpose is to assist the Congress in carrying out its oversight responsibilities.

Our auditors make every effort to keep abreast of work performed and planned by internal auditors, inspectors, or other internal review groups in determining the direction of our audit effort. It is our understanding that, except for the opinion of the CPA firm on the financial statements of the Board of Governors which is included in the Board's annual report, no reports on the auditing being performed within the Federal Reserve System are being submitted to the Congress.

The audit by the CPA firm consists only of an examination of the financial statements of the Board of Governors. It includes tests of financial transactions and accounts and analysis and verification work as needed to arrive at an opinion on those financial statements. However, it does not embrace the financial operations of the Federal Reserve banks and their branches which make up, by far, most of the System in terms of resources managed, expenditures, and volume of operations.

As to productivity, we have no basis for questioning the statement that the Federal Reserve System has made improvements over the past few years. We are just not familiar with their productivity measurement system. We do not

agree that the claimed increases in productivity of the System obviates the desirability of or the need for GAO auditing on behalf of the Congress. For example, our study of the three bank regulatory agencies last year identified several areas where we concluded the Federal Reserve's operations could be further improved. As one example, we recommended that the Federal Reserve Board implement a system of bank holding company supervision based on onsite inspection of bank holding companies and strengthen its oversight of Federal Reserve Bank supervision of holding companies. We also concluded that the three agencies were not devoting enough attention to monitoring banks' compliance with consumer protection laws and regulations. In all, we made 22 recommendations about the Federal Reserve's supervision of banks and bank holding companies based on our review. A list of these recommendations is attached to my statement.

The Federal Reserve expressed concern that regular audits by the GAO would have an adverse impact on its ability to regulate banks. It has stated that for the bank examination process to be successful and effective, there must be frank and uninhibited communications between bank officials and bank examiners. They contend that making the examination

process subject to review by GAO auditors will inhibit these communications. Based on our experience last year in making the special study of bank regulation, we do not agree that our auditing work will adversely affect the ability of banks and regulators to communicate with each other. Rather we would view our work as a means for stimulating more effective regulation of banks.

We fully recognize the desirability of meaningful communications between bankers and regulators. In our January 1977 report to the Congress on the Federal Supervision of State and National Banks, we pointed out that the success of the supervisory process depends greatly on how examination results are disclosed to those responsible for correcting the problems--in particular, the boards of directors of the banks. It was for this very reason that we expressed concern about some of the regulators' reporting practices. We found that their examination reports contained "confidential" sections which set forth criticisms which were not included elsewhere in the reports and the confidential sections were not made available to officials of the examined banks.

We found that bank examiners were more critical of bank management in these confidential sections than they were

in the sections of the report that were furnished to the banks' boards of directors. Incompetent management has been a major cause of bank failures and bank problems and can best be dealt with by the boards of directors of the banks.

We also found that the agencies did not frequently meet with the banks' boards of directors to discuss the results of their examinations. For example, in our sample of 200 banks supervised by the Federal Reserve, we found that the regulator met with the banks' directors for only nine percent of the banks. In our report we made several recommendations to the regulators to improve their process for communicating the results of their examinations to banks. The enactment of H.R. 2176 would, in our opinion, provide GAO with the continuing opportunity to make such suggestions to improve the regulation of banks.

We question the Federal Reserve's position that their examination process is dependent upon bankers discussing their problems freely with the regulators. It is difficult for us to envision bankers freely disclosing their problems to the examiners and thereby running the risk of a cease and desist order against the bank, removal of a director or officer from the bank, a decrease in or cut-off of the supply of Federal funds to the bank, or other actions to force the bank to correct such problems.

The new examination approach adopted by the Comptroller of the Currency is, in our judgment, a more systematic and in-depth analysis of bank operations to identify weaknesses in management policies and procedures.

The new approach to examinations places greater emphasis on evaluating the banks' system of internal controls and management policies. While this approach does involve obtaining oral information from bank officials about bank operations, it provides detailed procedures for verification of the oral information obtained.

In our January 1977 report we pointed out various benefits that could be obtained from the new examination procedures developed by the Comptroller of the Currency and recommended that the Federal bank regulatory agencies jointly evaluate the new approach. In the event of a favorable assessment of the new procedure, we further recommended that the FDIC and the Federal Reserve revise their examination procedures to incorporate the concepts of the Comptroller's approach. It is our understanding that the three agencies have not yet jointly evaluated this approach.

Finally, the Federal Reserve expressed concern about the possibility of unauthorized disclosure of highly sensitive

information about banks and their customers that may arise from our auditing. We believe the provisions of H.R. 2176 are strong enough to protect the confidentiality of this information. During our study of bank supervision last year, there were no instances where confidential information was disclosed. In fact, we were commended by each of the supervisory agencies for the manner in which we protected the confidential data we reviewed.

Also, it should be borne in mind that we have access to very sensitive information in our audit work in other Federal agencies, including that which is given the highest national security classification, proprietary private business information, and personal income tax data. We have strict procedures for safeguarding such information from unauthorized disclosure and there is no reason to believe that in the future we will treat confidential information contained in bank examination reports with any less care.

The bill does provide that otherwise prohibited disclosures can be made by GAO to a duly authorized committee or subcommittee of the Congress when sitting in executive session. This provision is apparently of concern to both the Federal Reserve and the Treasury Department. We

believe that the provisions allowing such disclosures are particularly within the prerogatives of the Congress, and therefore we have no recommendation to make as to whether it should be retained.

In our audits of the Federal Home Loan Bank Board, we have had access to examination reports for many years. The Board in testifying on this bill before it passed the House stated they were not aware of any occasion in which GAO's access to the reports resulted in a lessening of their confidentiality.

#### NATURE AND FREQUENCY OF AUDIT WORK

H.R. 2176 provides that our audits would be made under such rules and regulations as we would prescribe. The frequency and nature of specific audit work is not specified but is left to our judgment. This is a highly desirable way to write the law.

Under the laws which assign audit authority and responsibility to the General Accounting Office, for most Federal agencies we have the flexibility to determine the frequency as well as the scope of the auditing performed. These judgments are made in the light of congressional interests in specific activities and specific questions or problems as they become known to us and, as the Accounting and Auditing



Act of 1950 already requires, after giving "due regard to generally accepted principles of auditing, including the effectiveness of accounting organizations and systems, internal audit and control and related administrative practices."

I think it is important to emphasize this point in the light of the Federal Reserve's claim that its operations are already being adequately audited and that any auditing by GAO is not necessary. If this bill is enacted, our initial approach will be to systematically review and evaluate all aspects of the audit systems of the three agencies so as to avoid unnecessary duplication and enable us to make appropriate decisions on what we should examine in detail.

This concludes our statement, Mr. Chairman. We will be pleased to respond to the committee's questions.

RECOMMENDATIONS INVOLVING BOARD OF GOVERNORS OF THE FEDERAL  
RESERVE SYSTEM

1. "We recommend that the Board of Directors, FDIC, the Board of Governors, FRS, and the Comptroller of the Currency establish scheduling policies and procedures which would avoid setting examination patterns." (4-7)
2. "We recommend that the Board of Directors, FDIC, and the Board of Governors, FRS, adopt flexible policies for examination policies for examination frequency which would allow them to concentrate their efforts on banks with known serious problems." (4-9)
3. "We recommend that the Board of Directors, FDIC, and the Board of Governors, FRS, extend their current efforts to use State examinations and, if they do, we also recommend that they  
  
--develop minimum standards for State examiner training and examination procedures and  
  
--use only reports of State examinations meeting those standards." (4-13 - 4-14)
4. "We recommend that the Board of Directors, FDIC, and the Board of Governors, FRS, establish procedures to base the scope of each examination on the examiners' evaluation of the quality of the bank's controls, policies, procedures, and audit." (4-17)
5. "We recommend that the Board of Directors, FDIC, and the Board of Governors, FRS, develop standards for the preparation, maintenance, and use of examination workpapers." (4-19)
6. "We recommend that the Board of Governors, FRS, and the Comptroller of the Currency, using all available information, develop and use a single approach to classify loans subject to country risk." (4-33)

7. "We recommend that the Board of Governors, FRS, and the Comptroller of the Currency implement procedures to examine (where permitted by the country involved) major foreign branches and subsidiaries, including subsidiaries of Edge Act corporations, onsite--periodically and whenever adequate information about their activities is not available at the home office." (4-35)
8. "We recommend that the Board of Governors, FRS, and the Comptroller of the Currency utilize each others' examiners to cut expenses when conducting examinations in foreign countries." (4-35)
9. "We recommend that the Board of Directors, FDIC, and the Board of Governors, FRS, develop reports of examinations for EDP operations which present the problems found, corrective action needed and any necessary explanatory data in a clear and concise manner." (4-39)
10. "We recommend that the Board of Governors, FRS, implement a system of supervision which is based on onsite inspections of holding companies and their major nonbanking subsidiaries. We also recommend that the Board strengthen its oversight of Reserve Banks' holding company supervision by establishing
  - a system-wide manual of inspection procedures,
  - a standard inspection report, and
  - periodic onsite evaluations of Reserve bank supervisory activities." (4-51)
11. "We recommend that the Board of Directors, FDIC, and the Board of Governors, FRS, require their examiners to meet with the bank's board of directors or audit or examining committee after each examination." (6-5)
12. "We recommend that the Board of Directors, FDIC, and the Board of Governors, FRS, develop and use reports of examination which provide the banks with the results of the examination and any necessary supporting information." (6-13)

13. "We recommend that the Comptroller of the Currency invite FDIC and FRS to jointly evaluate its new examination approach. We further recommend that, in the event of a favorable assessment of the new process, the Board of Directors, FDIC, and the Board of Governors, FRS, revise their examination processes to incorporate the concepts of OCC's approach." (7-25)
14. "We recommend that the Board of Directors, FDIC, the Board of Governors, FRS, and the Comptroller of the Currency jointly staff a group to analyze shared national credits at State and national lead banks under Federal supervision and that the three agencies use the uniform classification of these loans when they examine the participating banks." (7-25)
15. "We recommend that the Board of Directors, FDIC the Board of Governors, FRS, and the Comptroller of the Currency work together to refine their monitoring systems and their approaches to examining compliance with consumer credit laws." (7-25)
16. "We recommend that the Board of Directors, FDIC, the Board of Governors, FRS, and the Comptroller of the Currency establish more aggressive policies for using formal actions. Written guidelines should be developed to identify the types and magnitude of problems that formal actions could appropriately correct." (8-18)
17. "We recommend that the Board of Directors, FDIC, the Board of Governors, FRS, and the Comptroller of the Currency develop uniform criteria for identifying problem banks." (8-49)
18. "We recommend that where feasible the Board of Directors, FDIC, the Board of Governors, FRS, and the Comptroller of the Currency combine their examiner schools and standardize their curriculums."
19. "We recommend that the Board of Governors, FRS, (1) establish a full-time training office to operate its examiner training program and (2) carry out the revision of examiner school curriculums which it has recognized as needed for sometime." (10-11)

20. "We also recommend that the Board of Directors, FDIC, the Board of Governors, FRS, and the Comptroller of the Currency increase their training in EDP, law and accounting, as desired by their examiners." (10-11)
21. "We recommend that the Board of Governors, FRS, also establish a formal evaluation process to measure the competence of persons seeking advancement to examiner status." (10-15)
22. "We recommend that either (1) the Board of Directors, FDIC; the Board of Governors, FRS; and the Comptroller of the Currency jointly establish a more effective mechanism to combine their forces in undertaking significant initiatives to improve the bank supervisory process or in attacking and resolving common problems, or (2) the Congress enact legislation to establish a mechanism for more effective coordination. . ." (11-8)

EXAMPLES OF FUNCTIONS AND ACTIVITIES OF THE FEDERAL RESERVE  
SYSTEM OTHER THAN THOSE PERTAINING TO BANK SUPERVISION

Board of Governors supervision of Federal Reserve Banks.

Clearinghouse operations.

Acting as depositaries and fiscal agents of the United States.

Acting as fiscal agents of Government departments and agencies in guaranteeing loans made by banks and other private financing institutions to finance procurement of materials and services for national defense.

Administration of the Bank Holding Act which is designed to control bank holding company expansion and prevent the expansion of bank holding companies into businesses not related to banking. (12 U.S.C. 1841-1850)

Approval of bank mergers. The Board shares this responsibility with the FDIC and the Comptroller of the Currency. The Board is required to approve mergers in which the acquiring, assuming, or resulting bank is a State member bank.  
(12 U.S.C. 1828c)

Establishing rules and regulations for carrying out the provisions of the Truth in Lending Act, whose purpose is to assure meaningful disclosure of credit terms to consumers, and other consumer credit laws. Enforcement is shared with the other bank regulatory agencies and the Federal Trade Commission.  
(15 U.S.C. 1601)