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Only about 130 of the 14,000 U.S. banks had overseas branches and/or foreign subsidiaries at the end of 1975, and most of these are either national banks supervised by the Comptroller of the Currency or State member banks supervised by the Federal Reserve. GAO reviewed the bank examination reports on 18 national banks and 12 State member banks having substantial international operations. The most prevalent problems in international operations found by examiners were: a high percentage of classified assets; inadequate controls over foreign exchange operations; and inadequate overall internal controls. The Federal Reserve Board of Governors and the Comptroller of the Currency need to use all available information to develop and use a single approach for classifying loans subject to "country risk." Procedures should be implemented to examine (where permitted by the country involved) major foreign branches and subsidiaries onsite. They should be examined periodically and whenever adequate information about their activities is not available at the home office. The Federal Reserve Board of Governors and the Comptroller of the Currency should utilize each other's examiners to cut expenses for foreign examinations. Some clarifying legislation on the interagency use of examiners might be necessary. (Author/QM)

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STATEMENT OF
FRED D. LAYTON
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BEFORE THE
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
SUPERVISION, REGULATION AND INSURANCE,
COMMITTEE ON BANKING, CURRENCY AND HOUSING
U.S. HOUSE OF REPRESENTATIVES

MR. CHAIRMAN:

We are pleased to be here today to discuss further the GAO study of Federal supervision of State and national banks. We will direct our comments this morning specifically to supervision of international operations of banks by the Comptroller of the Currency, the Federal Reserve System and the Federal Deposit Insurance Corporation.

As you know, our study was requested last year by several congressional committees, including this one, and our report was submitted by the Comptroller General to the Congress on January 31, 1977.

IMPORTANCE OF INTERNATIONAL OPERATIONS
TO THE BANKING INDUSTRY

During the period covered by our study, international banking operations increased substantially. Assets held by foreign branches of Federal Reserve Member Banks increased from $61 billion at December 31, 1971, to $176 billion at December 31, 1975—a threefold increase.

Foreign loans of domestic banks more than doubled—from $27 billion at the end of 1971 to $60 billion at the end of 1975.

These assets are held by relatively small number of banks. At the end of 1975, only about 130 of the 14,000 U.S. banks had overseas branches and/or foreign subsidiaries. Foreign branches of the 20 largest banks had almost [illegible] percent of total foreign branch assets.

Most of the banks involved in international operations are either national banks supervised by the Comptroller of the Currency or State member banks supervised by the Federal Reserve.

Scope and Purpose of the GAO Review in the International Area

Our primary concern was in determining whether bank examinations of international operations were of sufficient scope to identify banks which were likely to run into serious managerial or financial difficulties. Therefore, our attention was directed towards the methodology used by the supervisory agencies for monitoring international operations of U.S. banks. In our study, we reviewed the examination reports on 18 national banks and 12 State member banks which had substantial international operations.

It is important that your Subcommittee understand our arrangements with the three agencies for making this study. A principal condition of the agreements was that we would not disclose any information about specific banks, bank officers, or customers. We also agreed that we would not examine any banks ourselves but would accept the facts found by the three agencies' examiners. We made no attempt to independently evaluate the soundness of any of the banks in our samples or to evaluate the credit-worthiness of any of the bank customers. We depended on the examiners' experience in identifying bank problems.

How do Examiners Review International Operations of Banks?

Both the Comptroller of the Currency and the Federal Reserve System approach international examinations in much the same way. Both perform international examinations in two phases. Some examinations are performed at the bank's main office in the U.S. This phase includes evaluating large international extensions of credit and reviewing foreign exchange activities of the main office. The credit examinations rely heavily on the overseas branches providing the main office with duplicate credit files on overseas loans. These examinations can be made in conjunction with the regular domestic examination or they may be done separately. A few banks have decentralized their operations and thus the regulator must make the credit examinations at the banks overseas regional centers.

The other phase of international examinations are on-site examinations conducted at the foreign branches. They consist of examining smaller extensions of credit by the branches, examining foreign exchange activities of the branches, evaluating main office control over foreign branch activities, and checking internal operations. These examinations occur much less frequently than the regular examination at the main office.

Because of their special risk, the foreign exchange activities of the banks were of major concern to the examiners. The regulators are concerned that the volume of foreign exchange activities may be excessive or that the bank has taken an unwarranted risk in foreign exchange transa..ions.

How are Examiners Trained to Make International Examinations?

The agencies provide their examiners who make international examinations with special training in foreign exchange transactions and in evaluating foreign credits. The Federal Deposit Insurance Corporation does not offer specialized international training; officials said that most of the banks supervised by the Corporation tend to be small and are therefore unlikely to be engaged in international banking. The Corporation used the Comptroller of the Currency training program to provide international training when needed.

Bank examiners we questioned generally thought the internal courses provided were useful; however, some did say more training in foreign exchange transactions would be helpful. We received responses from 1,500 banks to a questionnaire on various aspects of bank supervision. Eighty-nine percent of the banks responding thought the examiners' understanding of international operations was adequate or more than adequate.

What Problems did the Examiners Find in the International Area?

The examination reports for the 30 banks included in our study showed that the most prevalent problems in international operations found by examiners were: (1) a high percentage of classified assets, (2) inadequate controls over foreign exchange operations, and (3) inadequate overall internal controls.

The most recent examination reports available for these banks at the time of our study showed that the 30 banks had outstanding loans to foreign Governments, businesses and individuals totaling $80.5 billion. The examiners had classified 3.7 percent of these loans as substandard, four-tenths of 1 percent as doubtful, and one-tenth of 1 percent as loss.

What Problems did GAO Find in the Way the Supervisory Agencies Monitored Foreign Operations of Banks?

In our study we found that the Federal Reserve and the Comptroller took different approaches to evaluating loans to foreign governments, businesses and individuals. These different approaches caused some bank loans to be classified differently than other bank's loans to the same country or foreign business. Even within the Federal Reserve System, two approaches were taken to evaluating loans subject to country risk.

The term "country risk" is used to describe the special risk involved when loans are made in different currencies because the borrower must repay the loan in the currency borrowed. The borrower's ability to obtain appropriate currency may be affected by the political and economic stability of the borrower's country.

At the New York Federal Reserve Bank, a committee of senior examiners evaluated country risks and assigned a general classification to loans made to borrowers in some of those countries. All loans to those countries and their businesses were classified the same unless the borrower's ability to obtain the repayment currency was independent of the country's stability or the loan was made in the local currency. If the loan was made in the local currency, it was judged according to the borrower's financial condition.

Except for the New York Federal Reserve Bank which used this committee approach, the other Federal Reserve Banks evaluated foreign loans individually. This approach led to inconsistent classifications within the Federal Reserve System. For example, a loan to one country was classified by San Francisco examiners, while examiners from New York, Philadelphia, and Richmond did not classify loans to the same country. Similarly, examiners from Boston, Chicago and San Francisco criticized loans to another country but the New York examiners did not. The basic problem here was that examiners were evaluating the loans based on their individual knowledge of the country.

The Comptroller of the Currency has also used a committee approach since 1974 for evaluating country risk. Each quarter senior international examiners met to evaluate the risk involved in loans to certain countries and to assign classifications to those loans. The examiners classify those loans if repayment appears to be as much dependent on the borrower's ability to obtain the appropriate repayment currency as on the borrower's financial condition. Classifications arrived at by the committee are then used for all loans to those countries.

Although the New York Federal Reserve Bank and the Comptroller have both used committee approach for evaluating country risk, they have often arrived at different assessments of loans to the same country. In July 1976, for example, the New York Fed's committee and the Comptroller's committee each developed ratings for loans to foreign countries. The Comptroller's committee concluded that certain loans to several countries should be classified as substandard; the New York Federal Reserve Bank assigned the substandard classification to loans of only one of them.

Using three country risk evaluation methods has resulted in different treatment of the banks that the Federal Reserve and the Comptroller supervise. Further, the method used by the Federal Reserve Banks depends on individual examiners keeping abreast of economic conditions in many countries and being able to judge loans in many countries. We believe that a team of experts who evaluate economic conditions in each country should produce more accurate and consistent results than numerous individuals who evaluate conditions on a case-by-case basis.

Therefore we recommended that the Federal Reserve Board of Governors and the Comptroller of the Currency, using all available information, develop and use a single approach for classifying loans subject to this country risk. In commenting on our report the agencies pointed out some special problems involving country risk evaluation, but they agreed that a uniform approach is desirable.

Are Examinations Made of Foreign Branches and Subsidiaries?

Federal Reserve and Comptroller examiners usually evaluates foreign loans from information at the home office of the parent banks. Both agencies required that banks maintain adequate records at the head office for the examiners to appraise the risk and exposure of the bank through their foreign operations.

In our review of the 30 banks with significant international operations, we noted that two State member banks were experiencing some problems which were related to foreign subsidiaries of the banks. Both banks' foreign activities had been examined by the Federal Reserve at the home office; however, the examiners had said the information available was inadequate. The subsidiaries were not examined onsite until after the banks had begun experiencing problems.

We believe that these subsidiaries should have been examined onsite as soon as possible, once the home office files were found inadequate. Early onsite examinations of the subsidiaries might have disclosed their problems before parent banks were injured.

We recommended that the Federal Reserve Board of Governors and the Comptroller of the Currency implement procedures to examine (where permitted by the country involved) major foreign branches and subsidiaries onsite--periodically and whenever adequate information about their activities is not available at the home office.

According to the Federal Reserve, it began in the fall of 1976 to make onsite examinations of foreign branches of State member banks where it had previously used information at the head office or from inspections made by State examiners. According to the Federal Reserve a number of foreign subsidiaries were directly examined for the first time with the agreement of the host government.

The OCC advised us that examinations to determine the quality of the bank's operations are made onsite overseas when necessary. According to the OCC, their examiners made on-site examinations during 1976 at 141 overseas branches and subsidiaries of 25 banks located in 37 countries.

The Comptroller of the Currency has a London office which is in charge of examining branches and subsidiaries in Europe. The Comptroller also uses staffs from its 14 regions to make onsite examinations of foreign branches and subsidiaries.

The Federal Reserve has international examiner staffs in New York, Chicago, and San Francisco.

We recommended that the Federal Reserve Board of Governors and the Comptroller of the Currency utilize each other's examiners to cut expenses when conducting examinations in foreign countries.

The Comptroller agreed that interagency use of examiners when conducting examinations in foreign countries would be beneficial but that some clarifying legislation might be necessary. We would be glad to work with the Committee on any legislation needed to clarify the authority for interagency use of examiners.

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