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BY THE COMPTROLLER GENERAL

Report To The Congress

OF THE UNITED STATES

Despite Recent Improvements, Bank Supervision Could Be More Effective And Less Burdensome

Using new laws, regulations, technology, and procedures, the three Federal bank regulatory agencies have significantly improved the essential processes of bank supervision--gathering information on institutions they supervise, identifying problems in those institutions, and taking actions to solve the problems. However, some information now reported by banks is unnecessary and could be eliminated. New computer-based systems used to analyze banks' financial conditions need to be evaluated to determine the most cost-effective way by which to integrate them into the supervisory process. Each agency should assure that new modified examination procedures are used appropriately and should consider staff training needs. Finally, regulators need to make more specific recommendations to banks at an early stage to better enable them to deal with problems.

GAO recommends changes in legislation to ease some reporting requirements now levied on banks, changes in examinations policies to help banks deal with problems more quickly, and evaluations designed to improve the integration of new techniques into the supervisory process.

UNITED STATES GENERAL ACCOUNTING OFFICE

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

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

This report evaluates changes made in the supervision of banks since the General Accounting Office's 1976 Task Force on Federal Supervision of Banks. Although many improvements have been made, we recommend further ones, including an amendment to current banking law.

We undertook this review because we had not rendered an opinion on whether bank supervision has improved overall, and many legislative, regulatory, and procedural changes have occurred since our January 1977 task force report.

Copies are being sent to the Chairman, Board of Governors of the Federal Reserve System; the Executive Secretary of the Federal Financial Institutions Examination Council; the Chairman of the Federal Deposit Insurance Corporation; the Comptroller of the Currency; and the Secretary of the Treasury.

Charles A. Bowsher

Comptroller General
of the United States

COMPTROLLER GENERAL'S REPORT TO THE CONGRESS

DESPITE RECENT IMPROVEMENTS, BANK SUPERVISION COULD BE MORE EFFECTIVE AND LESS BURDENSOME

DIGEST

Federal bank regulatory agencies have improved bank safety and soundness supervision since the General Accounting Office's last comprehensive study in 1976. They have used new laws, procedures, and systems to better gather data, identify bank problems, and effect solutions to those problems.

However, the Congress and the bank regulatory agencies need to reevaluate these laws and procedures to alleviate unnecessary reporting by banks and to make the supervisory process more efficient and effective.

Since GAO's 1976 study, the Congress and the three Federal bank regulatory agencies--the Comptroller of the Currency (Comptroller), the Federal Deposit Insurance Corporation (FDIC), and the Federal Reserve System--have made significant changes in the legislation and procedures used to supervise commercial banks. Although GAO has studied different aspects of supervision in the intervening time period, it has not determined comprehensively the overall effect of these changes. This report gives GAO's assessment of agency progress and makes recommendations for further improvements.

KEY IMPROVEMENTS MADE IN ALL AREAS OF SUPERVISION

In each of three major functional areas of bank supervision--gathering information on banks, identifying bank problems, and influencing banks to solve problems--the bank regulatory agencies have made significant improvements, some made possible by new legislation.

One way the agencies get better information on banks they supervise is by using computerized monitoring systems to analyze data regularly reported by banks. These analyses give supervisors a better picture of the banks' and their holding companies' financial conditions and trends. (See p. 9.)

The agencies identify bank problems usually well before they reach a critical stage and are paying more attention to bank management practices that cause financial problems. But they still equate quality of management to a bank's financial condition, an equation that GAO has found could be misleading. (See p. 20.)

Regulators, using more structured guidelines, are taking more formal actions against banks with problems. They employ new supervisory powers granted by the Congress, though the full flexibility envisioned when the legislation was passed has not been realized. (See p. 32.)

POLICY NEEDED ON MODIFIED EXAMINATIONS

Resource limitations have forced agencies to spend less time on the premises of banks in good condition. Consequently, each regulator modified the scope of its bank examinations to lessen its resource requirements. Though use of modified examinations varies, over half the examinations conducted now are of this type.

But one potential problem may limit the extent to which modified examinations can be used. Junior examiners, felt to be somewhat unqualified by bankers GAO surveyed, receive degraded on-the-job training from modified examinations. Thus, the agencies should incorporate training needs into their policies for using modified procedures. (See p. 13.)

REPORTING REQUIREMENTS UNNECESSARILY BURDENSOME

A report required by 1978 legislation to be filed by banks on loans to executive officers and shareholders is not necessary for supervisory purposes and therefore may be unduly burdensome on the banks. (See p. 14.) Agency personnel do not need the report to augment regular examination procedures in order to identify improper extensions of credit.

INFORMAL METHODS OF SOLVING PROBLEMS COULD BE MORE EFFECTIVE

Regulators defer formal actions until a bank's financial condition deteriorates significantly, so they use informal persuasion to influence a bank to solve its management weaknesses that could lead to more serious problems. These informal efforts could be made more effective if the agencies made more specific recommendations to banks to solve problems--a practice they now avoid. (See p. 41.)

BETTER EVALUATION OF SURVEILLANCE SYSTEMS NEEDED

The Federal bank regulatory agencies are using and expanding computerized surveillance systems without fully defining their uses or evaluating their costs versus benefits. These systems were designed to provide better information to examiners on banks--which they do--provide early warning of bank problems--which is questionable--and, in the case of the Comptroller's system, monitor the progress of banks known to have problems--which it is not used for. (See p. 48.)

Though conceptually useful, surveillance is limited in its ability to evaluate bank management and asset quality. Moreover, the agencies have not performed the requisite justification and cost-benefit analyses normally a part of sound system development. (See p. 49.)

RECOMMENDATIONS

GAO recommends that the Congress amend Title IX of the Financial Institutions Regulatory and Interest Rate Control Act (12 U.S.C. 1817 (k)) and section 22(g) of the Federal Reserve Act (12 U.S.C. 375a) to eliminate unnecessary reports submitted by banks on loans to executive officers and shareholders or, alternatively, to just amend section 22(g) to eliminate duplicate reporting of information by banks. (See p. 18.)

GAO recommends that the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation:

--Determine the impact of modified scope examinations on staff training and integrate the results into policies on their use. (See p. 19.)

--Require supervisory staff to make nonbinding but specific recommendations to banks in writing on ways to improve management weaknesses. (See p. 46.)

--Perform cost-effectiveness evaluations of computerized surveillance systems as part of developing a better definition of the role and use of such systems. (See p. 58.)

AGENCY COMMENTS

The Federal Reserve, the FDIC, and the Federal Financial Institutions Examination Council agreed with GAO's recommendation to reduce the reporting requirements on insider transactions. They have expressed similar opinions in legislative proposals to congressional committees. (See p. 19.) The Comptroller did not comment on this recommendation.

The bank regulatory agencies expressed differ ing views with regard to GAO's recommendation to develop modified scope examination policies that consider training needs. The Comptroller agreed that this policy should be evaluated in light of training needs. FDIC shared GAO's concerns and agreed to include training needs in the criteria for determining the scope of the examination. The Federal Reserve said it already considers training needs in scheduling modified scope examinations; however, GAO found no written policy on incorporating training needs and few modified scope examinations being performed. The Federal Reserve should, as FDIC agreed to do, formulate a policy and make it known to its district banks. (See p. 19.)

None of the agencies agreed with the recommendation to adopt policies encouraging examiners to make more specific written recommendations to banks on ways to improve management weaknesses. They supported their current practices and emphasized their beliefs that most banks should be able to manage without extensive examiner involvement. GAO agrees that unnecessary interference should be avoided and that most banks are adequately managed. However, for banks of supervisory concern, such as the ones GAO reviewed, earlier attention could help. Information obtained from bank officials indicates that they find both the examination process and examination reports to be lacking in this area, confirming GAO's case study observations. (See p. 46.)

Both the Federal Reserve and FDIC disagreed with the recommendation to perform a cost-benefit analysis of their surveillance systems. They are committed to using computerized surveillance, although they have made continual reviews of and changes to the systems. The Comptroller agreed to perform the analyses, but only on future systems changes. Since the surveillance systems were developed without appropriate studies required by accepted system development criteria, the agencies should formally assess whether the benefits received can justify the costs to develop and operate the systems. (See p. 58.)

C o n t e n t s

ABBREVIATIONS

FIRA	Financial Institutions Regulatory and Interest Rate Control Act of 1978
FDIC	Federal Deposit Insurance Corporation
GAO	General Accounting Office
IMS	Integrated Monitoring System
JAWS	Just A Warning System
NBSS	National Bank Surveillance System

CHAPTER 1

INTRODUCTION

Since 1976, when the General Accounting Office (GAO) made its first study of Federal bank supervision, many changes have taken place in the supervisory process. The Congress has given the three Federal bank regulatory agencies new powers. The agencies have formulated new regulations and supervisory procedures, and they have devised new information systems to aid them.

Although in the intervening years GAO has reviewed various aspects of bank supervision, it has not attempted to determine if the Federal agencies have improved the essential supervisory functions of gathering information, identifying bank problems, and effecting solutions. This report gives our assessment of progress and makes recommendations for further improvements.

1976 GAO STUDY EVALUATED BANK SUPERVISION

In reaction to an increase in the size and number of bank failures and problem banks in the early 1970s, several congressional committees requested that GAO make a broad study of Federal bank supervision. GAO formed a task force and reviewed various aspects of the supervisory operations of the three Federal bank regulatory agencies--the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Federal Reserve System. We issued two reports in 1977 based on our task force work. In them we covered many diverse topics, including bank chartering, competence of examiners, interagency cooperation, bank examinations, how agencies deal with bank problems, and what happens when a bank fails. 1/ We also made recommendations in many of those areas.

Though the scope of our 1976 task force was much broader than our current study, a considerable portion of the earlier work concerned basic supervisory functions: gathering information on banks, identifying problems they may have, and taking actions to solve the problems. Although we discussed the newly developing computerized bank surveillance systems, they were not far enough along to warrant evaluation. In our 1977 report we identified the need for better interagency coordination, and we recommended as one alternative new legislation to establish a

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1/GAO issued two reports, "Federal Supervision Of State And National Banks," OCG-77-1, and "Highlights Of A Study Of Federal Supervision Of State And National Banks," OCG-77-1a, both dated January 31, 1977.

mechanism to facilitate it. That mechanism was created in 1978 in the form of the Federal Financial Institutions Examination Council.

This current report is organized differently from our task force reports. However, in the following chapters we have incorporated information from our 1976 work in order to evaluate changes made since then.

AMONG THEIR DIVERSE DUTIES, AGENCIES HAVE COMMON BANK SUPERVISORY RESPONSIBILITIES

Each of the three Federal bank supervisory agencies has many responsibilities regarding the banks it supervises, some unique and some common to all three. In this review, we focused on the common supervisory functions of gathering information about the banks, identifying potential or actual problems in them, and taking action to solve those problems.

The Comptroller of the Currency (Comptroller) was created in 1863 after a period of State-controlled, so-called "free bank chartering." 1/ The Comptroller charters and supervises the 4,425 national banks. 2/

The Federal Reserve System was created in 1913 3/ to carry out monetary policy, provide central banking services for banks and for the U.S. Government, and improve the supervision of banking. Later, the Federal Reserve also was given the responsibility for approving bank holding company formations and for supervising them. Although national banks are members of the Federal Reserve, it normally restricts its supervisory attention to the 997 State-chartered members, 2/ the 3,057 bank holding companies, and about 130 other corporations conducting international banking. 4/

The Federal Deposit Insurance Corporation (FDIC) was created in 1933 to insure small depositors against losses resulting from bank failures. 5/ FDIC also acts as receiver for closed

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1/12 Stat. 665 (1863), superseded by 13 Stat. 99 (1864).

2/As of December 31, 1980, according to the Federal Deposit Insurance Corporation (FDIC) 1980 Annual Report, Table 107.

3/38 Stat. 251.

4/As of December 31, 1980.

5/48 Stat. 168.

insured banks. It normally supervises federally insured State-chartered banks that are not members of the Federal Reserve System, some 9,013 banks. 1/

Though each agency was created for different reasons, all three perform common supervisory functions. These functions and their components may be categorized as follows:

Gathering information

Each agency uses a variety of ways to gather information on banks it supervises, including

--periodic reports from banks,

--examinations and other visits to banks, and

--computer-based surveillance systems that process and analyze data collected.

All this information is used to ascertain the current condition of a bank, provide indications of industrywide conditions and trends, and ascertain the bank's compliance with various laws and regulations. Perhaps the most important use of the information, though, is to spot potential or actual problems in the bank that would lead to the deterioration of its financial condition.

Identifying problems

Most banks at some time encounter some problems, though in most instances those problems are not serious enough to warrant special action by the supervisory agencies. Two major objectives in bank supervision are to identify problems in banks and to effect solutions before the problems become serious.

Problems can be of many types, but, though aggravated by economic conditions, studies have shown that they usually are caused by improper or ill-advised management decisions. The problems most often cited by examiners in one or more of the agencies in cases we studied were

--poor quality loans or other assets,

--violations of laws and regulations,

1/As of December 31, 1980, according to the FDIC 1980 Annual Report, Table 107.

--poor internal controls,

--inadequate capital,

--poor liquidity,

--poor loan management,

--concentrations of credit, and

--management ineffectiveness.

Studies by FDIC and GAO's 1976 task force and our current case studies show that almost all the problems result from bad management decisions, poor procedures and controls, or, in some cases, self-dealing by insiders. Since the sooner a problem or a potential problem is identified, the better the chance of solving it before its effects on a bank's condition become serious, GAO has in past reports emphasized the importance of early identification of underlying causes of problems, such as poor management policies.

Effecting solutions to problems

A bank's management and board of directors have the ultimate responsibility to solve its problems. But bank supervisors can use a variety of methods to influence bank officials to take action.

Most banks solve their problems without much prodding by supervisors, but if the bank managers are unwilling or unable to do so then the supervisory agencies begin to exert pressure. In most cases varying degrees of persuasion are sufficient. However, occasionally bank officials are, in the supervisor's view, so recalcitrant and the bank's condition so threatened that the supervisor must employ stronger administrative or legal methods. These range from memorandums of understanding between banks and their supervisors to the issuance of cease and desist orders or civil money penalties.

OBJECTIVE, SCOPE, AND METHODOLOGY

The general criteria, scope, and approach we used are presented below. Greater detail on our scope and methodology is contained in chapter 6.

Objective

Our overall objective was to answer the question, "Is supervision better now than during our 1976 task force study?"

The definition of "better supervision" is based on observations of supervisory processes--gathering information, identifying problems, and effecting solutions--rather than on the overall impact of supervision on the financial industry--e.g., the number of bank failures, the number of banks with problems, or the general condition of banks. This is because many factors affect the overall condition of financial institutions, so the success of the bank supervisory agencies cannot be determined solely on the basis of industry statistics. In spite of any action taken by regulators, the condition of a bank and its potential to fail are determined primarily by the quality of its management. Moreover, economic downturns, beyond the control of the agencies, exacerbate bank problems.

The supervisory agencies' success in getting bank problems corrected depends largely on how willing and cooperative bank managers are to change those practices and policies which caused the problems. As we found in 1976, it is difficult for an agency to influence particularly recalcitrant managers to solve their problems, no matter what actions the agency takes. This is an inherent characteristic of a free enterprise industry.

Significant increases in bank problems and failures are related to the country's general economic condition. For example, after the early 1970s recession the number of bank failures reached the highest level since 1942. Recent problems besetting the industry stem from unprecedented volatility in interest rates causing a great increase in the cost of funds and a transfer of deposits to other forms of investment.

Scope and methodology

Though it is difficult to assess the quality of supervision by looking at overall industry statistics, supervisors' efforts can be evaluated by studying their functions as applied to specific cases. In this way, we can ascertain if the changed laws, regulations, and procedures are having the desired effects. If we judge the effectiveness of a new law, regulation, etc., in a sample of specific cases, then we can state whether supervision overall has been improved.

In evaluating changes in bank supervision, we asked two questions as general criteria:

--Are the changes working as intended?

--Does applying the changes improve the way supervisors identify and deal with bank problems as compared to our observations in our 1976 task force study?

If the changes in laws, procedures, and systems are working as designed or intended, and if we observe on a case-by-case basis better handling of problems than we did in 1976, then we can conclude that supervision has improved.

We used a three-step process to choose the changes on which to focus. First, we identified all the changes that had occurred as of the date of our review from other GAO work, annual reports published by each agency, and lists prepared for us by the agencies. Next, we categorized them by common agency supervisory function as described above. Finally, we selected for emphasis in our case studies and questionnaires those changes that had the most significant impact on those functions.

We used two methods to study how the three Federal bank regulatory agencies employed the supervisory changes we chose. First, we sent questionnaires to a statistical sample of bankers and to all senior bank examiners. The bankers' questionnaire was designed to elicit from high-level bank executives their perceptions of certain aspects of Federal supervision. In the other questionnaire, we asked senior bank examiners at all three agencies to describe how they used new supervisory tools and procedures and to evaluate those tools. Second, we studied a sample of cases to evaluate supervisors' handling of banks warranting special attention. Our case studies began with statistical analyses of a sample of 105 banks on Federal bank supervisors' lists of institutions warranting special attention. From this sample we selected 17 cases for a detailed review of the history of problems and agency actions pertaining to those banks.

Our review was performed in accordance with GAO's current "Standards for Audit of Governmental Organizations, Programs, Activities, and Functions."

Caveats

Because of resource constraints, the scope and methodology we chose for this review imposed certain limitations on our analysis. Those limitations are related to inherent characteristics of questionnaires and to the number and type of bank cases we selected to study.

A basic characteristic of questionnaire results is that they elicit opinions and observations of other parties without the presence of our own staff. Responses are, therefore, more subject to the interpretations and biases of the individual respondents. In order to minimize the effects of this characteristic, we pretested both questionnaires, in the presence of our staff, with bank officials and examiners.

Unlike our 1976 task force study, in this review we did not look at a sample of cases drawn from all banks; we concentrated our analysis on banks requiring special attention by supervisors. We did so for two reasons: first, the staffing requirement for case studies is quite high, and second, we were most interested in supervisory changes pertaining to the discovery and correction of bank problems.

However, we recognize that choosing this methodology excluded our reviewing cases in which the supervisory agencies may have identified and helped banks correct emerging problems before they became serious enough to warrant placing the banks in a program of increased supervision. In addition, it should be pointed out that only a small percentage of banks--3.91 percent as of June 1981--warrant the concern such as that given the banks in our case sample universe.

We attempted to amplify the results of the case studies through our questionnaires. The questions we directed to bankers asked them to evaluate bank examination for all banks, not just special attention banks. Our analyses distinguished between answers from banks warranting special attention and those from banks in general. In addition, the questions we asked of bank examiners concerned the way they examine banks in general, not just special attention banks.

CHAPTER 2

DATA GATHERING IMPROVED, BUT PROCESS

COULD BE MORE EFFECTIVE, LESS BURDENSOME TO BANKS

Overall, regulators now get a better and more complete picture of the banks they examine than they did during our task force review. Our case studies showed that examiners are getting adequate data on banks that are developing problems. The financial analyses made by new computer-based surveillance systems are more sophisticated than those that were previously available using noncomputerized methods. The Federal Reserve is inspecting holding companies with more regularity, using standard procedures, obtaining data not previously collected, and using surveillance to make more extensive financial analyses than before.

Agencies have attempted to streamline their information collection by modifying the scope and procedures used in onsite examinations. Modified examinations have been shown to effectively utilize agency resources, and the agencies are not yet using them as extensively as they should. However, potential difficulties with regard to examiner training may limit the extent to which agencies can expand use of modified methods.

Information collected on insider transactions and reported by banks exceeds supervisors' requirements. Under a 1978 law prompted by the revelation of abuses, banks are required to maintain information and report to Federal supervisors on loans to executive officers and principal shareholders. Federal regulators have recommended simplifying these requirements, and our review indicates that one report filed with regulators by banks is not actually necessary for examiners to obtain adequate information on insider loans.

CHANGES IN DATA COLLECTION AND ANALYSIS HAVE IMPROVED INFORMATION ON BANKS

Compared to the period covered by our 1976 task force study, the Federal banking regulators are getting better and more complete information on the institutions they regulate. Agencies still use the same basic sources for information they did in 1976--onsite examinations and periodic data reported by banks. However, the scope, types, and frequencies of examinations have changed, and the periodically reported data is now analyzed by computer-based surveillance systems. Whereas in 1976 we found little had been done to obtain complete information on bank holding companies, new reports, procedures, and systems are being employed in this area, too. A general trend in gathering information exists: an increased emphasis on offsite data gathering and an associated decrease in onsite examinations.

Surveillance systems give supervisors better data on banks' financial conditions

Compared to what was available before the surveillance systems were developed, agency personnel now have a better picture of a bank's financial condition and performance trends. The systems offer a much greater level of sophistication and are perceived as a valuable tool.

Supervisors were using financial ratio analyses at the time of our 1976 study to evaluate various aspects of a bank's condition, such as capital adequacy, income, and liquidity. These ratios had been calculated by hand, thus limiting the extent to which financial profiles could be developed. However, even then the agencies had begun to create computer systems to calculate the ratios and perform analyses to provide a more extensive, in-depth picture of each bank.

Since that time, each Federal banking agency has developed its own surveillance system, though an attempt is being made through the Federal Financial Institutions Examination Council to standardize them. The systems vary in design and concept, but each attempts to use financial ratio analysis to evaluate a bank's financial condition, show performance trends, and spot potential problems.

The Comptroller's National Bank Surveillance System (NBSS), primarily designed for the early detection of banks requiring special attention and as a supervisory and administrative system, consists of three computer-based elements. The Bank Performance Reports are produced from a data base obtained from reports submitted periodically by banks and bank examiners. The Bank Performance Reports show financial data and ratios calculated for each bank and for peer groups against which each bank's position is compared. The Anomaly Severity Ranking System, the early warning device for NBSS, monitors banks between examinations to detect those banks which show abnormal positions when compared to their previous status and to their peers. This is accomplished by a computerized scoring system which allocates the highest score to those banks having the most abnormal positions, changes, and trends in performance or composition. Those banks receiving the highest scores receive greater supervisory attention. The third element, the Action Control System, is a management information system that records the problems identified in a bank and shows the progress of the efforts being made to correct these conditions. Bank conditions which have been entered into the system for monitoring cannot be removed until corrected. Once removed from the active file, the conditions are retained in a historical record.

FDIC's Integrated Monitoring System (IMS) was developed to supplement the examination process by providing a method of monitoring bank performance. By monitoring banks between examinations, the IMS can alert FDIC to the presence of a deteriorating situation before it reaches a serious level, facilitating a faster response by the agency. The primary component of the IMS, Just A Warning System (JAWS), acts as an initial screening device for data supplied by the banks. This data is furnished to staff via computer terminals, before FDIC corrects bank reporting errors that often occur, so they can immediately begin to determine the validity of the data as well as to perform preliminary analyses using the JAWS tests. JAWS consists of certain selected tests intended to measure capital adequacy, liquidity, asset-liability mix/growth, and profitability. The bank "fails" the tests if its calculated financial ratios do not meet certain thresholds. The tests are then analyzed and forwarded to each region to assist in completing review and analysis. Another IMS component, the Comparative Performance Report, was designed to provide bank management with a statistical and analytical tool for use in evaluating performance and generating decisions. The report is produced from information submitted by the banks and compares individual bank data to peer group data.

The objective of the Federal Reserve's Bank Surveillance Program is to identify member banks with current or potential financial problems. The Program was developed to detect deteriorating financial conditions of member banks, to aid in scheduling examinations for State member banks, and to support the examination process through bank performance reports. The screening component of the system identifies existing and emerging financial problems through the analysis of changes in financial ratios and a composite score relative to peer group statistics. The information for these screens is submitted by the banks and is generated by the Comptroller for the Federal Reserve. The Comptroller's NBSS supplies Bank Performance Reports for State member banks. Reports for those banks that failed ratios are sent to the Federal Reserve banks for further review and analysis.

New procedures improve data on holding companies

In contrast to findings in our task force study, the Federal Reserve now has standard criteria for scheduling bank holding company inspections (examinations) and a standard inspection report. This gives the agency a much better picture of holding company operations that may affect subsidiary banks.

Until the mid-1970s the Federal Reserve had not been very active in examining bank holding companies. In 1975 only 13 percent of the companies were inspected, and most of these inspections were made by only 3 of the 12 Federal Reserve banks. Because the Federal Reserve had no effective systemwide procedures, our 1976 task force study found that

--nine of the district banks had no written guidelines detailing the scope of inspections,

--five did not evaluate nonbank subsidiary assets, and

--seven restricted all holding company supervisory activities due to budgetary constraints.

Since that time, the Federal Reserve has significantly increased its holding company supervision. It has developed a standard holding company inspection manual. Its inspectors use a systemwide report of inspection and rate companies using a standard rating system.

The Federal Reserve has developed and installed a computer-based holding company surveillance system. Each Federal Reserve bank has a corps of holding-company-oriented staff responsible for inspecting and monitoring the companies. Finally, the Federal Reserve has designed special holding company training courses.

USE OF MODIFIED SCOPE EXAMINATIONS SHOULD BE EXPANDED, BUT AGENCIES SHOULD BE AWARE OF POTENTIAL PROBLEMS

Limited or modified scope examinations, designed to evaluate a bank's condition using fewer agency staffdays, are being used and are perceived favorably by field staff. Though we did not evaluate the modified scope procedures in this study, previous GAO work and comments by examiners show this concept should be expanded. However, some limits may have to be placed on the use of modified scope examinations. A less than full-scope examination limits on-the-job training for new staff members, and new examiners' experience has been questioned by bankers. Also, examiners feel that modified scope procedures should only be used for certain banks and even then not every time they are examined.

Each of the three Federal bank regulatory agencies has developed a modified version of its usual full-scope examination procedures. Although they differ from agency to agency, the intent of each is to limit the amount of work performed onsite at better institutions unless examiners find something that requires further attention. The Comptroller calls these "specialized" examinations, the FDIC calls them "modified" examinations, and the Federal Reserve refers to them as "compacted" examinations. We have used the general term "modified scope" examinations.

In a previous GAO report we concluded that modified scope examinations effectively reduce examination time. 1/ In that report we brought out that FDIC, for the first 6 months of 1979, reduced its examination time by an average of 20 percent using modified scope procedures. We also reported that two Federal Reserve banks, San Francisco and Chicago, had shown us significant reductions in time and staffing requirements using their own modified scope examinations.

Senior bank examiners we surveyed felt that modified scope examinations were effective at saving time and resources. Seventy-four percent of all examiners surveyed thought that modified scope examinations were "effective" or "very effective" in accomplishing this objective. The proportion of Federal Reserve examiners, however, rating their modified scope examinations highly was smaller than the proportion at the other agencies.

This may be attributable to the fact that fewer Federal Reserve examiners are using modified scope examinations. The GAO report referred to above reported that inconsistencies existed among the agencies in three regions visited--San Francisco, Chicago, and Atlanta. In our current review, we also found a wide variety of usage. Although over 77 percent of the examiners in general told us they used modified scope procedures in half or more of their examinations, the Comptroller's examiners used them much more often than those in the Federal Reserve and the FDIC. Ninety-one percent of the Comptroller's examiners said

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1/"Federal Examination Of Financial Institutions: Issues That Need To Be Resolved" (GGD-81-12, Jan. 6, 1981), pp. 20-21.

half or more of their examinations conducted over the 2-year period prior to the survey were modified scope, as compared to 75.7 percent of FDIC examiners. Only 10 percent of the Federal Reserve examiners responded similarly. This may be due to the fact that, as we have reported before, the Federal Reserve has not experienced resource constraints as severe as those encountered by the other two agencies. 1/

These modified scope examinations usually have been sufficient for evaluating banks. Most examiners we surveyed reported that they normally have not had to expand modified scope examinations in order to adequately appraise a bank's overall condition. In fact, 73.8 percent said that, in the last 2 years, they have had to expand such examinations in about half or in fewer than half of the times they have used them. Of course, even when the examinations were expanded, the resulting time spent would not necessarily have equaled the time spent for a full-scope examination.

Even though modified scope examinations offer benefits, some factors do serve to limit the number that can be substituted for full-scope examinations. First, modified scope examinations offer less on-the-job training for newer examiners. Second, examiners point out that some banks are better candidates than others for receiving modified scope examinations. Third, modified and full-scope examinations probably should be interspersed to maintain an adequate level of knowledge about a bank.

A few FDIC examiners and other agency officials told us that modified scope examinations do not provide the level of training for new staff that full examinations do. One FDIC examiner, in a comment on our questionnaire, stated that this problem "may lead to a weakening of the Corporation because new employees do not get in-depth training in a modified exam." Higher level agency officials acknowledged that the ability to train examiners while using modified scope examinations is a matter for concern. According to one, FDIC regions do some full-scope examinations to accommodate training needs even when the banks are eligible for modified scope examinations. Still, he added that FDIC might have to consider revising its examination procedures in order to preserve full-scope examinations as appropriate.

1/"Federal Structure For Examining Financial Institutions Can Be Improved" (GGD-81-21, Apr. 24, 1981), pp. 24-30.

This could be an important consideration, because bankers we surveyed were critical of the experience levels of subordinate Federal examiners. In 6 of the 10 areas in which we asked them to rate subordinate examiners, at least 20 percent of the bankers felt they were less than adequate or very much less than adequate. (See app. I, quest. 4.) In two other areas, almost 20 percent had the same opinion.

Officials at the Comptroller's office and at FDIC told us that they recognize that a problem exists, but as yet none of the agencies has determined how it will relate on-the-job training requirements to using such examinations. However, this factor is one that would tend to limit the number of modified scope examinations performed.

Although the bank examiners we surveyed were generally encouraging about using modified scope examinations, comments by a few of them indicate other possible limitations on the extent to which modified scope procedures can be employed. Some of the examiners stated that modified scope examinations should be used mostly with larger banks and banks in good condition. Several mentioned that the area that suffers most in the modified scope examinations is the evaluation of loans. Consequently, examiners expressed the belief that these examinations should not be given consecutively to the same bank; instead they should be alternated with full-scope examinations in order to maintain a certain level of knowledge about the bank.

Each agency's policies are flexible enough to allow its field offices to consider all these factors in scheduling modified scope examinations. The Comptroller categorizes banks into three priority levels and specifies which may receive modified scope examinations, depending on their sizes and conditions. The FDIC also has the equivalent of a three-tier system based on condition designed to increase the use of modified scope examinations. The Federal Reserve's policy, updated in February 1981, is the least explicit and merely "authorizes and encourages" Reserve banks to alternate use of modified scope procedures with full-scope ones for eligible State member banks.

LEGAL REPORTING REQUIREMENT SHOULD BE RELAXED

Revelations of past abuses by bank officials taking advantage of their positions as insiders prompted passage of legislation that requires what is now seen by regulators as unnecessary reporting of insider transactions. Though some of the information reported may be useful, increased emphasis by the agencies on scrutinizing insider transactions during examinations renders much of what is reported excessive for supervisory needs. Our case studies also lead us to conclude that one of the reports is not needed by supervisors.

Highly publicized bank failures in the early 1970s and revelation of certain activities of a former Government official prompted the Congress to pass stricter legislation aimed at abuses by bank insiders. The Congress noted that insider abuses had been shown to be the greatest cause of bank failures and problems. In our 1977 task force report, we pointed out that improper or self-serving loans were the most significant causes of failures we studied. FDIC statistics also support this finding.

In reaction to this, the Congress in 1978 passed Titles VIII and IX of the Financial Institutions Regulatory and Interest Rate Control Act (FIRA) (Public Law 95-630). Title VIII limits loans to a bank's directors, officers, and owners from correspondent banks. 1/ It also requires bank officials and owners of at least 10 percent of a bank's stock to make a written report to the bank of all outstanding extensions of credit from correspondent institutions. The bank is then required to file the information with its primary regulator. Title IX requires each bank to report to its primary regulator a list of certain stockholders and a list of executive officers and shareholders who have extensions of credit from the bank and the aggregate amount of such credit. This title further requires the banks and the agencies to make the information available to the public on request.

Through their interagency coordination organization, the Federal Financial Institutions Examination Council, the supervisors developed forms on which the information could be compiled and reported. Data to be given by bank officials to their boards of directors under title VIII is reported on Council form FFIEC 004. Data reported by banks to their regulators, and made available to the public, is compiled on form FFIEC 003.

1/A correspondent bank performs certain banking services, such as obtaining coin and currency, for another bank.

The bank regulatory agencies and the Council have questioned the need for the form FFIEC 003 and its data. One reason is that it partially duplicates a reporting provision of section 22(g) of the Federal Reserve Act (12 U.S.C. 375a). That section requires member banks to submit periodic reports on loans made to their executive officers. Another reason why the regulators believe that form FFIEC 003 is unnecessary is that their normal examinations for insider loan abuses, with the renewed emphasis and new regulations that have been passed since the mid-1970s, are sufficient to uncover insider abuses. Finally, the agencies report that they have received few requests from the public for the information, and they believe that the form in which it is reported is noninformative and misleading, since it only aggregates loan data.

Our review of reports filed under section 22(g) of the Federal Reserve Act confirmed that most of the information is duplicated on the form FFIEC 003. The 22(g) report for each bank simply lists the number of loans and extensions of credit to executive officers, the total dollar amounts involved, and the range of interest rates charged. The form FFIEC 003 lists executive officers as well as applicable principal shareholders, but still aggregates the indebtedness. Thus, most of the 22(g) information is subsumed in the form FFIEC 003 information.

Our detailed case studies showed that the form FFIEC 003 information required by title IX is not needed by examiners to uncover insider abuses. Six banks we reviewed with recognized financial difficulties had problems with insider loans, none of which were disclosed by forms FFIEC 003. In three cases the abuses existed prior to the use of the reports and were discovered without them, in two cases the design of the report did not allow disclosure of the problem, and in one case inaccurate information on the insider activities was disclosed by the bank.

In one of our cases, insider loans had been a problem since 1977. The examiner felt the new reports did not make a difference in the examining process because it was a simple procedure to look at this bank's insider loans. According to the regional counsel, the bank's form FFIEC 003 did not show anything unusual on the surface. In another case, although insider abuses occurred before the report was required, the examiner felt the form would not have helped detect them. He explained that during an examination field examiners check the reports for technical compliance from the bank records anyway, but the reports are not used to help discover abuses.

One other bank's insider loan report showed nothing unusual on the surface, and the following examination report indicated that loans to directors, executive officers, and related interests were made with terms and rates commensurate with those available to the outside borrowers. Employees, however, were given preferential rates on installment and mortgage loans, something that would not have been identified through the form FFIEC 003.

In one final case, examiners discovered a poor loan to a business associate of the bank president, using their normal examination procedures. The president denied the association, which was later admitted by the borrower. Since the president did not think an insider relationship had existed, the situation did not show up on the insider loan form.

Since the mid-1970s, all three agencies have taken steps to enhance their scrutiny of insider transactions, steps they feel render the title IX reports unnecessary. Officials at each of the agencies assured us that since the highly publicized abuses of the preceding decade, their examiners have taken a more aggressive approach in their review of insider transactions and correspondent lending practices. Both the Comptroller and FDIC have also formulated new examination procedures which detail more specifically how examiners should search for improper self dealings. The Federal Reserve has not changed its examination procedures in this regard but does instruct its examiners to review insider transactions thoroughly. This strengthening of awareness and procedures, added to the insider loan review methods previously in place, give the agencies, in their opinions, sufficient tools to minimize abusive self dealings.

CONCLUSIONS

Federal bank regulators are obtaining more and better information on banks and bank holding companies they supervise than they were when we conducted our 1976 study. However, improvements can be made in two areas.

Of the two purposes for establishing title IX reporting requirements--providing information to regulators and disclosing insider loans to the public--the former is served adequately without the reports and how well the latter is served is subject to question. We believe that the form FFIEC 003 can be eliminated as an excessive report requirement without adversely affecting the regulators' ability to scrutinize insider loans. However, the value of public disclosure is a policy issue that should be decided by the Congress. At the very least, the reporting under section 22(g) of the Federal Reserve Act should be discontinued in favor of the more inclusive reporting encompassed under Title IX of FIRA. It is not clear from our case study information or from a review of the design of the FIRA reports that they would disclose insider abuses which might exist. Therefore, the deterrent value of public disclosure may be diminished.

Alternative legislative options exist. First, the insider reporting requirement can be eliminated entirely by eliminating both the section 22(g) and the FIRA reports. Second, if the Congress feels that public disclosure by banks themselves is important, only the redundant reporting of section 22(g) of the Federal Reserve Act should be eliminated.

Modified scope examinations have been shown to use agency resources more efficiently while still assuring the safety and soundness of banks. However, various factors limit the arbitrary application of modified scope procedures.

None of the agencies' policies integrate staff training needs into procedures for using modified scope examinations. Since on-the-job training is important, and since bankers perceive a real lack of experience in subordinate examiners, the agencies should develop guidelines for incorporating training into the use of modified procedures.

RECOMMENDATION TO THE CONGRESS

We recommend the following alternatives to the current legal structure for having banks report on insider transactions:

- --Unless the Congress remains convinced of the value of public disclosure, in addition to supervisory oversight, as a deterrent to insider abuses, we recommend that it eliminate the requirement under section 22(g) of the Federal Reserve Act (12 U.S.C. 375a) for banks to submit periodic reports to their primary regulators on loans made to their executive officers. In addition, we recommend that it eliminate the requirements under section 7 of the Federal Deposit Insurance Act (FIRA title IX reports) that a bank report to its primary regulator a list of certain stockholders and a list of executive officers and shareholders who have extensions of credit from the bank and the aggregate amount of such credit, and that the banks and the agencies make the information available to the public on request. This would eliminate all requirements for reporting extensions of credit to executive officers and principal shareholders that are applicable to all banks.

- --If the Congress believes in the value of retaining public disclosure by the banks themselves, we recommend that the Congress only eliminate the section 22(g) requirement for banks to submit periodic reports to their primary regulator on loans made to their executive officers, while retaining the requirements for

FIRA title IX reports on extensions of credit and public disclosure of such reports.

Appendix VIII contains suggested legislative language to achieve these recommendations.

RECOMMENDATION TO THE BANK REGULATORY AGENCIES

We recommend that the Comptroller of the Currency, the Chairman of the Board of Governors of the Federal Reserve System, and the Chairman of the Federal Deposit Insurance Corporation ascertain the impact of modified scope examinations on staff training and develop policies on their use that consider training needs.

AGENCY COMMENTS

The Federal Reserve, the FDIC, and the Federal Financial Institutions Examination Council supported one or both of the alternative recommendations to reduce the insider transactions reporting requirements. As they and we pointed out, the agencies and the Council have submitted legislative proposals to the appropriate congressional committees incorporating similar amendments.

With regard to our recommendation on developing policies on using modified scope examinations,

--the FDIC agreed to emphasize this need to its regional offices (see app. V, p. 94);

--the Federal Reserve said it already considers training needs in scheduling modified scope examinations (see app. VII, p. 99.); and

--the Comptroller agreed that the impact of his modified scope examinations policy on training needs should be evaluated, though he emphasized that a primary consideration for using them still must be the efficient use of resources (see app. IV, p. 91).

We cannot verify the Federal Reserve's contention since we found no written policy on incorporating training needs, and we found that the Federal Reserve banks use few modified scope examinations, anyway. Because the Federal Reserve's policies give greater latitude to its field offices than do the other agencies' policies, we still feel the Federal Reserve should, as the FDIC agreed to do, at least formulate a policy and make it known to its district banks.

CHAPTER 3

PROBLEMS IDENTIFIED EARLY, BUT EMPHASIS STILL ON BANKS' FINANCIAL CONDITIONS

Federal agencies usually identify bank problems before they become too serious to correct. However, though the agencies are paying more attention to the competence of bank management and its policies that cause problems, they still equate the quality of management to the current condition of a bank. This is an equation that, as we found both in our task force cases and in our current study, can be misleading, because it fails to consider the inordinate vulnerability of the bank to problems. It also fails to motivate agency action until financial conditions deteriorate.

New surveillance systems, designed in part to give early warning of bank problems, are limited in their ability to do so. They cannot expose management incompetence until a bank's condition is adversely affected, and they cannot evaluate the quality of a loan. They do, however, usually indicate financial problems before the point at which agencies find it necessary to take formal actions to correct them.

BANK PROBLEMS READILY IDENTIFIED; MANAGEMENT NOT EMPHASIZED ENOUGH UNTIL FINANCIAL CONDITION DETERIORATES

Federal regulators usually identify a bank as having problems before the bank's financial condition deteriorates to an extent warranting special concern. Compared to our 1976 study, the regulators are paying more attention to management weaknesses that cause financial losses. But they are still focusing on financial condition--the effects of management weaknesses--as the primary indicator of management competence. The emphasis on effects is one valid way to judge bank management, but it can be misleading, especially in evaluating a manager's ability to solve problems.

In our 1977 report, we noted that examiners often did not cite management weaknesses in their reports until the effects were manifest on the bank. For example, examiners did not criticize a bank for inadequate loan policies unless the bank actually had classified loans. 1/

1/If an examiner believes that some factor adversely affects the quality of a loan, he/she may "classify" the loan as being "substandard," "doubtful," or "loss," in order of severity of the problem.

The reason we were concerned about this in 1976 was that our study of failed banks showed that poor management practices left banks inordinately vulnerable to the economic fluctuations that precipitated the increase in the number and size of failures in the early 1970s. Thus, even though a bank's financial condition may not immediately reflect bad management, the bank is nonetheless in a situation that could ultimately imperil its condition.

Equating management competence to a bank's financial condition, though an important measure, still can be misleading, as we found in our current case studies. In one of them, for example, the bank originally was designated as warranting special attention as the result of an October 1975 examination, cited for poor asset quality, poor liquidity, and insider loan abuses. No particular emphasis was placed on the causes of the problems, and the bank was removed from a program of increased supervision once its financial condition had improved.

However, in September 1978, when an examination revealed that the condition had deteriorated again, the bank was once more listed as requiring closer attention. Poor assets, low liquidity, and insider abuses were cited again by examiners, just as they had been in 1975. But this time the examiners directly cited and emphasized the causes--poor policies and lax implementation of them--and the agency required the bank to correct them.

In our sample of 105 banks, we noted that examiners cited situations warranting attention in those banks well before their conditions dictated selecting them for special attention. However, though the examiners did cite some management weaknesses before that point, their overall evaluations of management were still closely linked to the banks' financial conditions. For example, some kind of management policy and procedural problems were cited as early as three examinations before the banks were designated as needing closer supervision in 64.4 percent of those examinations. But, by the time the banks were considered to be of supervisory concern, the agencies were identifying these management problems 84.5 percent of the time.

Moreover, the Federal Reserve identified management concerns later than the Comptroller and FDIC did. Three examinations prior to the banks being regarded as institutions in need of closer attention, the Federal Reserve cited management policy and procedural weaknesses in 48.0 percent of the cases, compared to 60.6 percent and 81.2 percent for the Comptroller and FDIC, respectively. In the examination just before the banks were designated to be of supervisory concern, the Comptroller and FDIC both recognized management deficiencies about 88.0 percent of the time, while the Federal Reserve pointed out the same types of problems in 76.7 percent of its banks.

In the statistics cited above, the management-type problem noted the most by examiners three examinations prior to special attention designation was inadequate internal routines and controls, singled out in over half the cases. The other indicators of poor management cited in examinations we reviewed were incompetent or inexperienced management, inadequate staff, poor responsiveness to problems, dishonesty, and poor asset/liability management. As the following figure shows, as the banks' conditions deteriorated to the point at which they were designated as being of special concern, criticisms of management increased.

MANAGEMENT CRITICISMS COMPARED

TO OVERALL BANK CONDITION

Management area criticized	Percent of cases criticized 3 exams before designation	2 exams before	1 exam before
Incompetence, inexperience	22.3	24.8	58.1
Inadequate staff or structure	5.3	7.6	15.2
Poor internal routines and controls	53.2	51.4	61.9
Poor responsiveness to problems	4.3	4.8	15.2
Dishonesty	0	1.9	1.0
Poor asset/liability management	5.3	7.6	21.9
Poor loan policy	34.0	44.8	57.1

Since the poor loan policy criticism can be compared directly to a specific effect, classified loans, we analyzed how often each was cited by examiners in examination reports. Two examinations before the banks were cited as needing close attention, the three agencies were citing classified loans without commenting on inadequate loan policies 27.6 percent of the time. Both poor loan policies and classified loans were identified in 38.1 percent of the cases. But only 6.7 percent of the time did the agencies identify the poor loan policies before the effects (classified loans) were criticized.

In the examination immediately preceding "close attention" designation, a similar situation existed, though by this time more policy criticisms were made. Concerns about classified loans without concern for loan policy were disclosed 35.2 percent of the time, while classified loan levels and poor loan policies together were revealed in 51.4 percent of the banks. Again, the agencies identified poor policies alone in only 5.7 percent of the cases.

After the banks were designated as being of supervisory concern, loan policy was cited in even fewer cases. In the examination following designation, the regulators criticized classified loans without mentioning loan policy concerns 43.4 percent of the time. Both the existence of classified loans and inadequate loan policies were identified in 37.3 percent of the cases. Poor loan policies without classified loans were cited 6.0 percent of the time.

The Comptroller's staff was the most aggressive of the three agencies in identifying loan policy problems before loans actually deteriorated. In the examinations conducted just before banks were designated as warranting special attention, only his staff criticized loan policies without also criticizing actual bad loans (six cases). In the examination preceding this, examiners from the Comptroller's office considered loan policies to be inadequate in five out of the seven cases in which the cause alone was mentioned, as compared to one case each for the other two agencies. After problem designation, the Comptroller's examiners identified poor loan policies in four out of the five cases in which the cause alone was mentioned.

As one other measure of the equation of management to financial condition, we compared the ratings given to bank managers by the agencies to ratings given to financial aspects of their banks. 1/ In 87.5 percent of our cases, management was rated the same as the financial elements three examinations

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1/The agencies, using a standard internal system, rate each bank in five areas: capital adequacy, asset quality, management, earnings, and liquidity. The rating scale is from 1 to 5, 1 being the best. The agencies also prepare a composite rating for each bank, which employs the same 1 to 5 rating scale.

before the banks were designated as being of supervisory concern. Once the banks were considered to be in need of closer supervision, the management rating reflected the other ratings 75.7 percent of the time, while in 22.3 percent of the cases management was rated more harshly than the financial elements.

In the examination after the banks were considered to be in need of closer supervision, management was rated poorer than the other elements 27.7 percent of the time, as compared to the above-mentioned 22.3 percent. For the examination following that, managers received a lower rating 30.6 percent of the time. Therefore, as the banks' conditions weakened over time, the regulators evaluated management generally more harshly.

As part of the questionnaire we sent to bankers, we asked them to rate the effectiveness of the Federal examination process in performing a number of examination functions. The list of functions encompassed major evaluations and reviews that examiners perform to determine the condition of a bank and quality of its management. Some of the functions are "effects-oriented" in that they are used as tools to find current problems but do not usually address underlying causes. Most of the remaining functions serve as a means to pinpoint the source of problems (e.g., bad management). These latter functions we have labeled "cause-oriented."

A majority of bankers perceive the evaluations of cause-oriented functions as effective, though less so than other examination functions. Officials at 75.9 percent of the commercial banks we surveyed thought that examiners' evaluations of management were "effective" or "very effective," and 65.4 percent thought evaluations of internal controls were in the same categories. Although encouraging, these results are lower than opinions of some effects-oriented and other examination functions. For example, 85.5 percent of the bankers thought that evaluations of asset quality were "effective" or "very effective," and 90.3 percent thought that examinations were effective or better at assuring compliance with laws and regulations. The following figure compares all the effects- and cause-oriented functions we asked bankers about.

Bankers' Ratings of Agencies' Effectiveness in Performing Cause- and Effects-oriented Examination Functions

Effects-oriented functions	Percent rating agencies "effective" or "very effective"
Evaluation of investment portfolio balance/imbalance	64.5
Evaluation of deposit volatility	56.1
Evaluation of capital adequacy	78.2
Evaluation of asset quality	85.5
Evaluation of liquidity	83.2
Evaluation of earnings	73.4
Assurance of compliance with laws and regulations (other than consumer)	90.3
Cause-oriented functions	
Evaluation of internal controls, including internal audit	65.4
Determination of the existence of conflicts of interest	76.3
Evaluation of loan policies and procedures	75.3
Evaluation of management	75.9
Evaluation of investment policies and procedures	66.4
Other functions	
Assurance of safety of depositors' funds	88.2
Assurance that insider loan limits and reporting provisions of FIRA are being met	93.1

In the preceding chart, as well as in charts that follow, the numbers do not match those in the relevant appendixes because the charts were adjusted for nonresponses and for those who responded, "no basis to judge."

In another section of the bankers' questionnaire, we requested that bank officials indicate the degree of importance they think examiners place on the major areas they review during the course of an examination. These areas can also be divided on the basis of cause versus effect. Reviews of such indicators as liquidity and earnings can identify the effects of bad management and policies while evaluations of management itself might trace the root of a bank's problems. The responses to this question, therefore, give some indication of whether bankers feel examiners emphasize cause-oriented or effects-oriented areas.

By stratifying the responses to this question by supervising agency, we found that the Comptroller was perceived by bankers we surveyed as placing more emphasis on evaluating banks' managements. As was pointed out in a previous GAO report, 1/ the Comptroller has revised his examination procedures to place greater emphasis on evaluating a bank's management than either the Federal Reserve or FDIC. Accordingly, in some instances the proportion of national bank officials who thought the Comptroller's examiners emphasized cause factors was larger than that of Federal Reserve- and FDIC-supervised banks. As the following figure shows, the Comptroller was seen to emphasize evaluations of management competence and of a bank's policies and procedures more than were the Federal Reserve and FDIC. This difference was not as apparent in the three agencies' evaluations of banks' internal controls, however.

1/GGD-81-12, page 35.

Bankers' Perceptions of Importance

Placed by Examiners on Areas They Review

Area of operations	Percent perceiving "great" or "very great" importance placed by examiners Comptroller	Federal Reserve	FDIC
Effects-oriented areas			
Condition and structure of assets	74.3	75.3	73.0
Structure of liabilities and capital	67.7	62.3	59.5
Liquidity	66.0	60.9	58.8
Earnings	58.5	49.3	39.8
Compliance with laws and regulations (other than consumer)	80.4	77.5	75.0
Cause-oriented areas			
Management policies and procedures	75.1	60.5	50.3
Internal controls, including internal audit	66.8	63.9	51.7
Management competence and expertise	71.4	57.4	57.6

But the bankers apparently did not equate attention to effectiveness. As the following figure shows, the percentages of national bank officials rating the Comptroller as being effective in performing cause-oriented evaluations were higher than percentages for FDIC's and the Federal Reserve's banks, but there is less difference among the agencies here than in the previous figure for cause-oriented areas.

Comparative Ratings of Agencies' Effectiveness

in Cause-oriented Examination Functions

Cause-oriented function	Percent of bankers rating agencies "effective" or "very effective" Comptroller	Federal Reserve	FDIC
Evaluation of internal controls, including internal audit	74.9	68.4	60.0
Determination of the existence of conflicts of interest	82.4	69.7	73.9
Evaluation of loan policies and procedures	81.3	76.8	72.0
Evaluation of management	81.3	73.0	73.3
Evaluation of investment policies and procedures	73.7	65.1	62.7

Although agreeing with our observations, officials at one or more of the bank regulatory agencies gave us three primary reasons for not criticizing management before a bank's condition deteriorates. First, it is hard to convince a bank's board of directors that managers are doing anything wrong if the bank is in good condition. Second, until a bank's management is challenged with adversity, it is hard to tell how good it is. Today's economic conditions are giving bankers challenges they have hitherto not had to face. Finally, regulators do not want to appear to be interfering with management decisionmaking prerogatives.

Although it may be difficult to evaluate or challenge a manager's performance, that, nonetheless, is one of the regulatory agencies' responsibilities. Statements in examination policies developed by all three agencies indicate the importance of assessing the quality of a bank's directors and officers. Waiting for the effects of bad management to manifest themselves before criticizing managers--i.e., letting the bank deteriorate--is not the best way by which to fulfill supervisory responsibilities.

We agree that regulators should avoid unduly interfering with bank officers' legitimate prerogatives. But since the agencies do have the responsibility to evaluate the safety and soundness of the banks they supervise, and since the key to the condition of a bank is its management, then it is incumbent upon them to make an objective, independent evaluation of management as one part of their overall assessment of the bank. Such an evaluation need not interfere with managers any more than would the adverse classification of a loan. One expresses the regulator's opinion of processes and the other an opinion of the results.

SURVEILLANCE SYSTEMS HAVE LIMITED VALUE AS EARLY WARNING OF BANK PROBLEMS

Computer-based offsite surveillance systems are inherently limited in their ability to provide early warning of bank problems. Though not designed to replace onsite examinations, the systems were touted as between-examinations indicators of developing problems. Experience to date demonstrates limits on their value for this mission because they do not identify management weaknesses until manifest as changes to a bank's condition. Systems also cannot evaluate the quality of individual loans, an important indicator of a bank's potential condition.

Computer-based systems were originally conceived as one way, but not the only way, to spot bank problems before they become serious. Specifically, they were to help spot potential problems between onsite examinations, perhaps allowing a longer interval between examinations.

Our study disclosed that, although the systems did detect manifestations of problems before they became too serious to correct, offsite surveillance did not identify them until they had affected banks' financial conditions. In 12 of our 17 detailed case studies, surveillance systems indicated or could have indicated problems in the banks before those banks had to be placed on special attention lists. In only one of those cases did surveillance--a special regional analysis--cause the agency to change a bank rating and consider a bank to be of particular concern, independent of an examination. The other 11 cases exemplified surveillance's more usual role in problem identification--as a complement to the examination process, confirming conditions already detected during onsite examinations or soon to be detected by a routinely scheduled examination.

Because, as agency officials pointed out, surveillance systems analyze financial data but do not directly evaluate management or the quality of assets, they cannot pick up management weaknesses until they have adversely affected a bank's financial condition. This is why bank examiners we surveyed felt that the systems were least effective in identifying problems at an early stage or helping prevent problems from developing at a bank. Only 44.5 percent felt systems were effective or very effective at identifying current problems at an early stage, and only 29.4 percent thought they were effective or very effective in helping prevent problems from developing. These percentages are considerably lower than the perceived effectiveness for other surveillance functions. (See app. III, quest. 12.)

Moreover, agency officials told us that their staffs do not rely on surveillance systems to monitor the progress of problem banks because they follow those banks closely, anyway. The officials feel that the monitoring of banks with problems through surveillance is duplicative of the other supervision given to these banks. Once a bank is identified as having problems, other methods are used to keep the agency informed of the bank's condition. These include informal methods, such as progress reports and bank visits, and formal actions, like written agreements and cease and desist orders. Through these means the agencies are able to obtain information that is more current and more tailored to the bank's specific problems than the data supplied by surveillance.

In 16 of our 17 detailed case studies, at least one of the above methods was used to monitor the banks' progress. The agencies generally requested progress reports from the banks, and examiners visited them to check on specific areas of concern. Using these tools, the agencies are able to obtain and review bank information on a monthly or bimonthly basis--more often than the surveillance systems allow.

CONCLUSIONS

Even though they pay more attention to bank management as a cause of problems, agencies still equate the quality of management with the condition of a bank. Our analyses of sample data showed that examiners often cited problems at a bank without criticizing management practices, but as the problems worsened, the examiners began criticizing management more. Agencies rarely criticized management practices unless problems had already developed. One reason this occurred was that, in the view of bankers themselves, examiners placed a bit less emphasis during an examination on evaluating management. But the major reason was that the agencies are reluctant to criticize a bank's managers unless the bank's financial condition is deteriorating. Although it is hard to criticize management if a bank is doing well financially, our concern is, as it was in our 1976 study, that a bank's management should be evaluated separately from its financial condition. This is because a dip in the economy could have an unnecessarily severe impact on an institution that is poorly managed.

We are also concerned that focusing attention on management problems after a bank's condition deteriorates denies the agencies an opportunity to help solve management weaknesses at an early stage. In chapter 4 we discuss a way in which we believe the agencies could be more effective in helping banks solve problems at an early stage. But implementing this requires placing more emphasis on management problems before the agencies find it necessary to take formal measures to force actions on bank managers.

Though experience has shown that surveillance systems can disclose a bank's financial deterioration before it reaches dangerous levels, the systems cannot disclose management weaknesses until they manifest themselves as financial problems. Therefore the agencies will, as they have stated in the past, have to maintain a mix of onsite visits and surveillance to assure banks' safety and soundness in today's regulatory environment. Onsite visits should naturally be aimed at areas that surveillance cannot effectively evaluate. In chapter 5 we discuss problems encountered by the agencies in integrating surveillance into their supervisory programs.

AGENCY COMMENTS

In oral comments, the Comptroller's officials pointed out that some of our cases occurred at a time when new examination procedures were still evolving. They believe that they are now emphasizing management more. We understand that any new procedure might go through a transitional phase during its evolution. At present, not enough "post-transitional" case studies exist to make a judgment on whether the Comptroller's examiners now emphasize management more often than they did during the "transitional phase."

Although we made no recommendations in this chapter, FDIC chose to offer a comment interpreting our evidence to support its methods of assessing bank management. Pointing to figures cited in paragraph 5 on page 21, the FDIC stated that it was "'bottom line' evidence of the comprehensive nature of FDIC's management evaluation process." (See app. V, p. 93.) Actually, what the figures show is that the agencies mention management problems before a bank's condition deteriorates and that FDIC appears to do this more often than do the other two agencies.

But our main point is that the agencies do not act upon those findings until a bank's financial condition deteriorates, and we offer further evidence of this, applicable to all three agencies. (See pp. 22 to 29.) Our recommendation as to what the agencies should do is in our next chapter, and we discuss agencies' comments on that recommendation on page 46.

CHAPTER 4

FORMAL ACTIONS IMPROVED, BUT INFORMAL METHODS SHOULD BE MADE MORE EFFECTIVE

The Federal banking agencies are taking more formal actions to influence banks to solve problems. Their more aggressive attitude is aided by a more structured approach to using their supervisory powers and by new legal authority given them by the Congress.

Still, agencies use formal actions only after a bank's financial condition has deteriorated appreciably. At the earliest stages of a problem, agencies still use informal persuasive techniques, and they still avoid using what could be an effective aid to banks--making more specific, useful recommendations for correcting conditions that could lead to more serious problems.

FORMAL ACTIONS USED MORE OFTEN, BUT ONLY AFTER FINANCIAL CONDITION DETERIORATES

In 1977, GAO concluded that the Federal bank regulators could have used their formal enforcement powers sooner and more often to effect solutions to bank problems. We recommended that they establish more aggressive policies and more structured guidelines for using the powers.

Using new powers granted by the Congress in 1978, the agencies have become more aggressive and have established more structured guidelines. But they still wait to use their formal powers until a bank's condition has deteriorated significantly. This is caused by a desire to develop a strong case before applying legal sanctions.

We have grouped as formal actions "administrative" and "legal" enforcement measures. We have defined administrative actions as understandings between a bank and its supervisory agency on ways to solve problems. They include memoranda of understanding and the more formalized written agreements. Legal enforcement actions are specifically authorized by law and are used as a last resort to induce bank managers to solve their problems. They include cease and desist orders, civil money penalties, and removal and suspension of bank officials. We have also included the new authority allowing agencies to disapprove prospective bank purchases because it could be punitive in nature and was designed as a safety and soundness measure. The agencies can deny a bank's application (for a new branch, for example) as an enforcement action. However, we have not considered such actions here because, in the application process, banks may be discouraged from filing if they know their applications would not be accepted. Since documentation of that informal exchange between bankers and regulators might be fragmentary at best, we could not quantify its use.

Taken as a group, these formal actions are used when informal persuasion fails to influence bankers to solve problems.

Formal actions used more often

Each of the agencies has increased its use of formal actions in recent years, especially considering the fact that the number of banks requiring special attention has declined from the high in the mid-1970s. The following table shows the number of formal actions taken by the agencies over the last 10 years:

Formal Actions: 1971-1980

	'71	'72	'73	'74	'75	'76	'77	'78	'79	'80
Memoranda of Understanding (notes a and b)	-	-	-	-	-	-	-	24	31	68
Written Agreements	5	5	10	19	20	24	40	54	57	59
Cease and Desist Orders	8	15	13	6	14	40	61	53	68	67
Civil Money Penalties (note c)	-	-	-	-	-	-	-	-	2	10
Removal and Suspension of Management	-	7	11	7	17	7	0	4	3	1
Totals	13	27	34	32	51	71	101	135	161	205

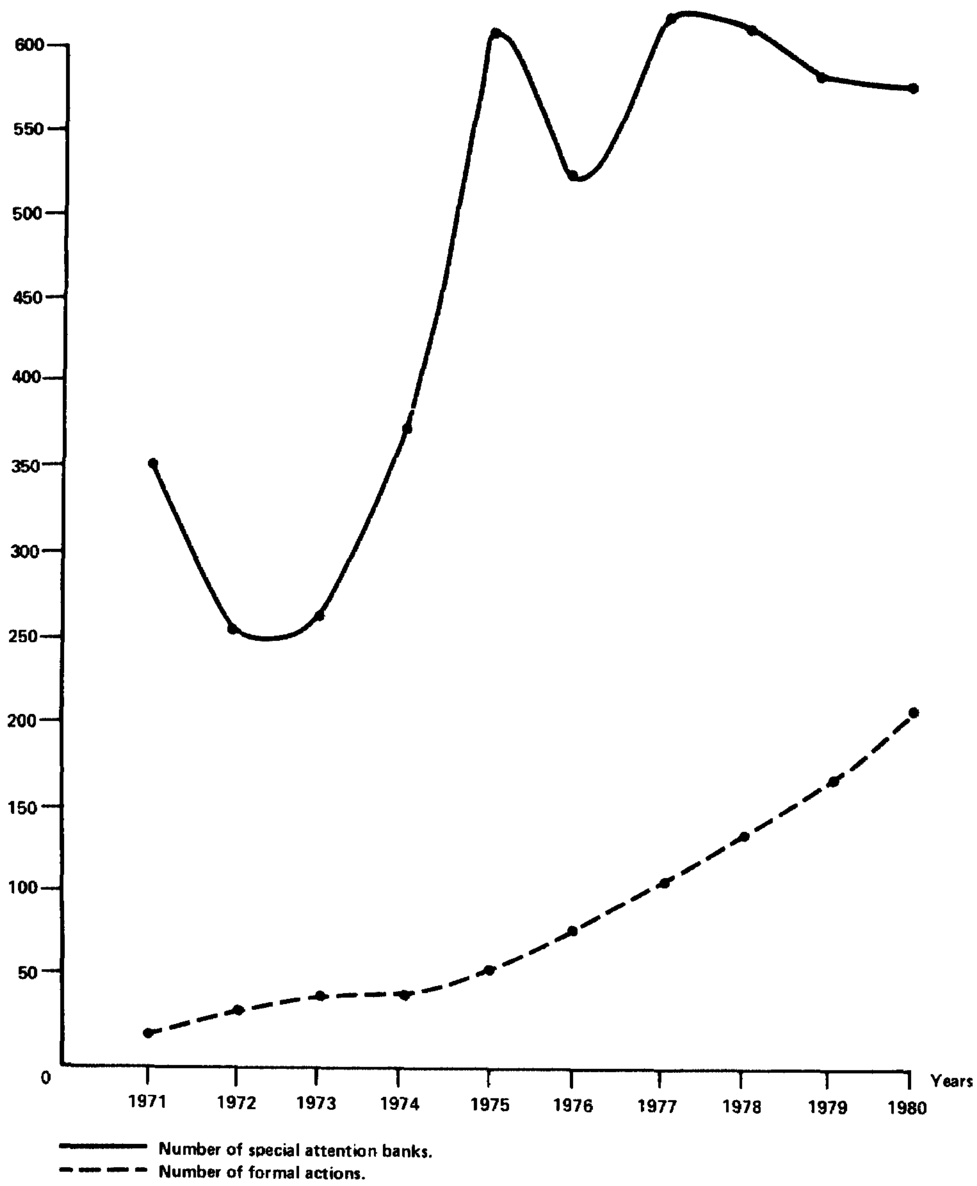
a/Data for 1971-1977 not readily available.

b/An FDIC official said that in the last 2 years FDIC has resumed using memoranda of understanding after a lapse of some years. Data not readily available.

c/New supervisory tool, instituted with FIRA (Nov. 10, 1978).

The following graph compares the number of banks requiring special attention over the same period to the number of formal actions shown on the previous page:

BANKS REQUIRING SPECIAL ATTENTION AND FORMAL ACTIONS TAKEN



In the previous graph, special attention figures are combined totals taken from lists maintained by each of the agencies. FDIC includes national and State member banks on its problem bank lists, in addition to State nonmember banks--for which they have supervisory responsibility. However, the special attention figures represent only the State nonmember banks on FDIC's problem bank lists. National and State member special attention bank figures were obtained from the Comptroller and the Federal Reserve, respectively.

As the graph shows, considering the total number of these banks has been stable or slightly decreasing since 1977, the use of formal actions has increased significantly.

Formal actions linked to financial condition

Reinforced by new structured guidelines for using formal actions, the agencies use the actions only after a bank's condition has deteriorated significantly. They are, therefore, not used at the earliest stages when potential problems could be solved, perhaps by correcting management weaknesses.

In our 1977 report, we observed that the banking agencies had delayed using formal actions until a bank's problems had become very severe, especially in cases in which the banks eventually failed. 1/ We reported that for the banks listed as problems on November 30, 1976, and against which the agencies took formal actions, 2/ an average of 57 months elapsed from the date of the problem designation to the date the action was taken.

Using a new procedure adopted by all three agencies, regulators are taking actions faster. During 1979, the regulators set up policies for the use of formal legal and administrative actions. These guidelines were established to assure greater uniformity among the field offices and to set forth minimum standards for the treatment of banks requiring more than normal supervision. The policy statements require the field offices to implement or consider some type of supervisory action after giving the bank a "3," "4," or "5" rating. (See footnote on p. 23 for explanation of ratings.)

1/OCG-77-1, page 8-17.

2/Formal actions as defined in our 1977 report did not include memoranda of understanding.

Our sample analyses show that the regulators are taking action faster after the first "3," "4," or "5" rating now than they did before the new procedures were adopted. Of those sample banks that had a formal action taken against them under the new policy, 87 percent of the actions were taken within 6 months of the ending date of the examination. This compares with 53.7 percent for actions taken before the new procedures were implemented. Under the new procedures, in 78.3 percent of the sample cases in which the agencies took formal action, it was before the next examination started. The regulators took action before the next examination in only 61.0 percent of the sample cases before the new policy was instituted.

However, our detailed cases showed that the agencies still do not take formal actions until a bank's condition has deteriorated. Formal action, either by the Federal agency or the State bank supervisor, was taken in 13 of our 17 cases. In all of them, the regulators waited until the effects of the problems became evident before designating the banks as institutions requiring special attention and taking formal actions.

Officials at all three agencies agreed that formal actions generally are not used until a bank's financial condition has been affected. They apply moral suasion to bank management until the effects of the bank's problems are serious, at which time they will take formal action.

This reluctance is induced by a concern for building a strong case before applying legal sanctions. According to agency officials, legal actions go through numerous agency reviews before they are issued against banks. There is concern about building enough support for the action should the bank dispute it. One of the Comptroller's officials stated that a case for a legal enforcement action could not be sustained unless the bank's condition had deteriorated. Regarding one of our detailed case studies, an FDIC official explained that the State regulators can act more quickly on a legal action than the Federal agency because of the long process and many reviews the Federal agency must go through. When State laws are less cumbersome, the Federal agency may let a State take action against a State-chartered bank. A Federal Reserve official expressed a similar position.

<u>Anticipated flexibility in new legal powers partly realized</u>

The Congress attempted in 1978 to give the bank regulators new flexibility to deal with the primary cause of bank problems--bad managers--before banks suffer serious financial harm. The new tools given to the regulators--improved cease and desist authority, civil money penalties, easier removal and suspension of officers, and control over changes in ownership of banks--have proved useful, but not necessarily to the extent originally envisioned.

Cease and desist still most used

One legal sanction used by regulators to deal with a bank's problems is the cease and desist order, which requires the bank to stop an action that the regulator believes is harming the bank. Cease and desist authority was improved by applying it to individuals as well as to institutions. 1/ This was prompted by agency complaints that previous cease and desist authority, aimed only at institutions, was often inappropriate.

The cease and desist order is still the most often used legal power, and it is still used mostly against institutions, not individuals. Examiners, overall, participated in examinations in which more cease and desist orders were recommended than any other formal legal action. The results of our survey show that 58.7 percent of the respondents said that in the past 5 years they have participated in at least one examination in which the examiner-in-charge recommended a cease and desist order. But, in 1980, only 7 of the 67 cease and desist orders issued by the Federal bank regulators were directed at individuals by name. Of course, in some other orders, individuals may have been affected even if not named as respondents.

Cease and desist authority is still felt by examiners to be the most effective legal measure to discourage improper acts and influence banks to solve problems. Of the examiners surveyed, only 28.5 percent had experience with a civil money penalty and 27.6 percent with a removal or suspension. Almost 58 percent thought that their agency's authority to issue cease and desist orders helped them discourage, to a great or very great extent, illegal or unsound banking practices. Also, 67.2 percent of the examiners felt, to a great extent or more, this same authority helped influence banks to address problems within a reasonable time; and 64.4 percent indicated that, to the same extent noted above, the authority to issue cease and desist orders helped their agencies influence banks to solve problems before they endangered bank solvency. As can be seen by referring to the following figure, examiners rated the deterrent capabilities of cease and desist orders considerably higher than they rated the other legal actions.

1/Public Law 95-630, Sec. 107.

Examiners' Views of Deterrent

Capabilities of Legal Methods

Objective	Percent rating deterrence level of "great" or "very great" extent: Cease & desist	Civil penalty	Removal/ suspension
Discouraging illegal or unsound banking practices	57.8	33.4	43.2
Influencing banks to address problems within a reasonable time	67.2	38.3	46.4
Influencing banks to solve problems before they endanger bank solvency	64.4	36.7	47.1

Comptroller primary user of civil penalties

The Congress gave the agencies authority to levy civil money penalties as an intermediate power. Before, the regulators, faced with certain violations of laws or regulations, had to choose to either take no legal action or impose an unduly harsh penalty. Daily money penalties were thought of as deterrents to violations and a more flexible alternative to treat their occurrence. In its task force report, GAO endorsed the granting of authority to impose civil money penalties.

The examiners have had less experience with the civil penalty power, but the Comptroller's examiners have had more than those of the other two agencies. Forty-six percent of the Comptroller's examiners surveyed said they had participated in one or more examinations in which a civil money penalty was recommended as compared to 10.4 percent of the Federal Reserve examiners and 12.3 percent of the FDIC examiners. According to officials at all three Federal banking agencies, the reason the Comptroller has used this power more is that he must enforce more Federal banking laws than do the other two agencies. Still, the Comptroller's staff told us they would have imposed more civil money penalties if they had more personnel to develop cases, and headquarters officials at all the agencies consider them to be effective deterrents.

Removal and suspension still difficult

The Congress expanded removal and suspension authority in order to make it easier to deal with officers and directors who were not necessarily dishonest but were nonetheless detrimental to their banks. In the past, agencies could only remove bank officials if they had evidence of personal dishonesty. They could not remove them merely for gross negligence even if they had caused problems. The 1978 law allowed removal proceedings against those whose actions demonstrate "a willful or continuing disregard for the safety or soundness of the bank" if "the agency determines that the bank has suffered or will probably suffer substantial financial loss or other damage or that the interests of its depositors could be seriously prejudiced * * *." 1/ GAO also supported this new authority in its task force report.

In practice, though the new legal enforcement authority is less restrictive, the agencies still feel they must wait until a bank's condition has been substantially impaired before they can take action. According to one official, a bank must be in poor condition before removal action can even begin. We were told that a court would never rule in favor of an agency removing someone just because he/she was a bad manager. Showing that management actions caused, or would have caused, damage to a bank is extremely difficult, the agencies said, and the standard of proof is very strict. Because of the hurdles that must be overcome and the time-consuming process involved, agencies use alternatives to their removal authority. An FDIC official said they issue cease and desist orders to have banks' boards of directors hire management acceptable to an agency, and they can influence the boards to deal with managers on their own.

Change-in-control authority used effectively

Calling the lack of control over transfers of bank ownership one of the most glaring regulatory gaps, the Congress gave the banking agencies authority in the Change in Bank Control Act to deny a purchase by an individual for any of several reasons. 2/ The reasons for disapproval include the determination that the proposed owners might jeopardize the financial

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1/Public Law 95-630, Sec. 107(d)(1).

2/Under the Bank Holding Company Act, the Federal Reserve already had authority to approve or deny bank purchases by business organizations that qualified as holding companies.

stability of the bank or are of questionable competence, experience, or integrity. 1/

Though seldom used, this authority has proven effective when it has been employed. In one of the cases we reviewed in detail, the change-in-control authority was used to prevent an individual from buying a controlling interest in a national bank. The individual who applied for the purchase was president of another bank in the immediate community and chairman of a bank corporation. The Comptroller denied the request based, in part, on information provided by FDIC and the Federal Reserve. The bank of which the prospective buyer was president was under an FDIC memorandum of understanding, and a cease and desist order was about to be initiated. Federal Reserve officials informed the Comptroller that the bank corporation which controlled the aforementioned bank was itself in unsatisfactory financial condition. The Comptroller's denial stated that the competence, experience, and integrity of the applicant were in question and that his ownership might substantially lessen competition in the community. Had the change-in-control authority not been granted to the agencies, they could not have prevented the purchase by an individual known to have caused problems in a bank he already owned.

In two other cases, damaging purchases were made before change-in-control authority was granted, and the new power could have prevented problems that developed. The Comptroller had unconfirmed information on the potential owner of one bank, suggesting that he might be detrimental to the bank's condition. At that time, the Comptroller could not disapprove the purchase but was aware that the bank had the potential for problems caused by the new controlling group. Eleven months after the change in ownership, the Comptroller's staff detected major problems in the bank, which were attributed to new management's policies and procedures, its influence over junior officers, and its apparent control over the board of directors.

In the second case, if the Comptroller had received information on the financial position of the prospective buyers of a bank and had the power to act on it, he might have been able to prevent or at least anticipate the problems that ensued. The individuals who purchased the bank had need of funds and eventually gave themselves inordinately high salaries and preferential loans to directors, using the bank for their own purposes. These insider abuses were discovered in an examination 1 year

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1/Public Law 95-630, Title VI.

after the purchase. Since the Change in Bank Control Act requires that prospective buyers furnish financial information to the regulators, presumably the potential for trouble would have been disclosed.

Officials at all three banking agencies believe the change-in-control power has been useful. The agencies reported to the Congress in March 1981 on their use of the change-in-control authority over almost a 2-year period. Although his experience with the Change in Bank Control Act was limited, the Comptroller considered it to be a valuable and effective tool, having a deterrent effect on unqualified individuals attempting to enter the banking sector. Both FDIC and the Federal Reserve felt the act has generally fulfilled its purpose. FDIC believed it did this without undue burden on the marketplace; the Federal Reserve was not certain that the additional burdens it created were justified by the benefits to the public. The agencies also reported that the act had functioned as a mechanism for preventing nine potential purchasers with questionable or inadequate credentials from acquiring control of banks over the same period, and it had caused others to withdraw applications or not apply at all.

INFORMAL METHODS SHOULD BE MADE MORE EFFECTIVE THROUGH MORE SPECIFIC RECOMMENDATIONS

Because the banking agencies still use formal actions only after a bank's condition has deteriorated significantly, in order to address the management policies that cause problems before conditions worsen, the agencies must be as effective as possible with their informal methods. One way, which we pointed out in 1977, is to make more specific recommendations to bankers for solving their problems. Though bankers we surveyed found the examination process effective in many areas, clearly they perceived the regulators were much less effective at recommending useful solutions to bank problems. They also believed this was the worst aspect of examination reports.

Agencies have avoided specificity for reasons that have some merit, but we believe that the pitfalls perceived by the agencies can be avoided while providing more useful recommendations to banks.

Agencies not making specific, useful recommendations until problems become serious

Results of our survey of commercial banks and our case studies show that bank regulators now, as in our task force study, do not make specific, useful written recommendations to bank officials to solve problems until the effects are serious enough to warrant formal action. In 1977, we reported that examiners generally did not recommend how banks could correct problems. We stated our belief that examination reports should give banks, in a concise and straightforward fashion, recommendations for corrective action. 1/

Bankers today feel that, of the six objectives of the examination process we asked about, recommending useful solutions was still one of the least effectively achieved. Only 40.8 percent of bankers in general and 38.8 percent of bankers affiliated with banks warranting special attention rated the process effective or better in this area.

Both bankers in general and those affiliated with banks warranting special attention rated the clarity of reports in recommending solutions to problems lower than they rated the clarity of the other three report areas. Over 59 percent of bankers in general and 55 percent of "special attention" bank officials thought the reports were generally clear or very clear with regard to problem solutions. Although these percentages are not alarmingly low in themselves, when compared to the relatively high ratings given the other areas by bankers, they are cause for some concern, as shown in the following table:

1/OCG-77-1, pages 6-2, 6-12.

Bankers' Ratings of Examination Report Clarity

Clarity of reports in	Percent rating reports "clear" or "very clear": Banks in general	Special attention banks
Explaining the nature and extent of any problems	94.0	89.2
Explaining the causes of any problems	74.5	68.1
Recommending solutions to any problems	59.5	55.0
Describing the bank's overall condition, which may include nonproblem areas	80.5	71.8

In comments returned with the questionnaires, a number of bankers praised the examination process and felt it was beneficial to them, but others complained it was not. Typical of the latter group's comments were the following:

> "[The examiners] infrequently identify causes or make in-depth recommendations."
>
> Examiners are "not helpful in providing solutions to management problems."
>
> "Emphasis is on negative aspects of examination process with almost no attempt to make positive recommendations to management."

We reiterate that we received favorable comments in several areas; however, those such as the ones above (one was from a special attention bank) concern us in light of the lower rating all bankers rendered in this area.

Written recommendations in case study documents we reviewed were relatively nonspecific. Examiners at all three agencies generally did not supply the banks with specific information on how to improve the banks' condition. They cited areas of concern and recommended general changes, like "improve existing problem loans" or "improve audit procedures." However, the examiners did not give specific recommendations or solutions to guide the banks towards resolving their problems. For example, in one case examiners recommended that the bank establish a program to maintain an adequate level of liquidity, but they did not supply guidance on how to design or implement the program. An examiner recommended in another case that the bank reduce the volume of loans to a more acceptable and manageable level, but he did not advise the bank of ways to do this.

In a few instances, the examiners did supply the banks with somewhat more specific recommendations. For example, in one case the examiner recommended reducing loan volumes, then went on to suggest how this could be done--by curtailing new credit advances, weeding out weaker borrowers, and selling residential real estate loans on the secondary market. In another case, the examiner noted that improvement in internal controls could be accomplished by rotating personnel, separating duties, and segregating accounts.

When banks deteriorate to the point at which formal action is required, Federal supervisors become very specific. In our case studies we found that agencies spelled out more specific policies, procedures, and requirements for banks in memoranda of understanding, written agreements, and cease and desist orders. Although the agencies allowed the banks some freedom in setting up their new policies and procedures, the regulators pinpointed more specifically the types of items that should be included. For instance, one bank was told in a memorandum of understanding to obtain and maintain current and satisfactory credit information on loans mentioned in the examination report. This information was to include, but not necessarily be limited to,

--the purpose of the loan;

--the source of repayment;

--income and cash flow information;

--the terms of the loan; and

--signed current financial statements for borrowers, endorsers, and guarantors.

In another case, the bank was instructed to formulate a program to strengthen its capital structure. The written agreement listed the following items that were to be included in the program:

--The circumstances under which dividends would be paid, as well as the dates and amounts.

--A comprehensive budget for the current and following year.

--Procedures by which to monitor adherence to this budget.

--Plans to cover growth and operating assumptions for 3 years.

--Plans specifying at which points and under what circumstances additional capital would be provided, along with the amounts.

Agencies avoid specific recommendations

Federal regulators have been reluctant to make more sprcific recommendations before a bank's condition seriously deteriorates. Officials at the Federal banking agencies explained that they avoid making very specific recommendations for two reasons. First, they want to avoid interfering with the legitimate prerogatives of bank management. Second, the Comptroller's officials said they are afraid litigation would result from a bank's following advice and consequently suffering a financial setback.

All three regulators expressed concern that, by making specific recommendations for action, they would interfere with bank managers' prerogatives. FDIC officials felt that a well-rated bank should be able to find solutions on its own, and that FDIC did not want to cross the line between being a regulator and being a consultant. Federal Reserve officials feel that if the agency's staff were to make specific recommendations then the staff, not the bankers, would be running the banks. The Federal Reserve's job, said its officials, is to determine if a bank is operating safely and is in compliance with the law. The Comptroller's staff pointed out that a bank's board of directors might arbitrarily impose a regulator's suggestions on operating officers, thereby unfairly usurping the officers' authority.

Officials at both FDIC and the Comptroller's office expressed apprehension about what would happen if bankers followed their recommendations and still encountered problems. The Comptroller's officials felt that the banks would sue the Federal agencies, but they presented no evidence that would support this contention.

CONCLUSIONS

The agencies have taken positive steps to increase their use of formal action, though a certain reluctance persists. The point at which an agency should use formal enforcement measures can never be precisely defined. Legal due process does require adequate evidence to justify sanctions, and the most tangible evidence is a demonstrated deleterious effect on a bank's financial condition.

Given that fact, the only way to deal with management weaknesses before they adversely affect a bank is to use the informal techniques as effectively as possible. Accordingly, it is more constructive to offer suggestions rather than to wait, as regulators do now, until the bank has deteriorated.

By making nonspecific recommendations to bankers about solving their problems, agencies miss a useful opportunity to help correct weaknesses at an early stage. Although the regulators should, of course, avoid managing the banks themselves, they can avoid doing that and still make nonbinding but more useful recommendations. The regulators themselves have pointed out that these are uniquely challenging times for bankers, especially those in small banks. Assistance by banking experts with a broad perspective should be welcome if it is not presented in the form of an ultimatum.

We are not persuaded that bankers would respond to this help by launching litigation. As our survey of commercial bankers showed, they are the least satisfied with the agencies' efforts to help find useful solutions for bank problems. Presumably they would welcome a properly conceived policy to aid them.

RECOMMENDATION TO THE BANK REGULATORY AGENCIES

We recommend that the Comptroller of the Currency, the Chairman of the Board of Governors of the Federal Reserve System, and the Chairman of the Federal Deposit Insurance Corporation require examiners to make nonbinding but specific written recommendations to banks in examination reports or related correspondence on ways to improve management weaknesses.

AGENCY COMMENTS

All three Federal bank supervisory agencies maintained that their current practices are adequate. They all restated their beliefs that most institutions should be able to manage without detailed recommendations, and the regulators reiterated their desire to avoid unnecessary encroachment into bank management. The Comptroller stated that our recommendation crossed the line between the regulators' accepted role and that of bank management. The Comptroller also interpreted our report as advocating the use of formal enforcement procedures sooner and took exception to this. (See app. IV, p. 91; app. V, p. 94; and app. VII, p. 99.)

We have not asserted a role for bank regulators that usurps bank officers' prerogatives. We recognize, for example, that regulators must use their formal powers only when ample evidence of serious problems develops; that is why we recommended using a better informal tool to address management weaknesses. We agree that unnecessary interference with bank managers should be avoided and that most banks are adequately managed. But special supervisory situations, such as the ones we reviewed, require more active agency involvement; earlier, more useful guidance could help.

In many cases, as the Federal Reserve and the Comptroller point out, supervisors may give suggestions in meetings and correspondence. But the results of the questionnaires we sent to bank executives indicate they find both the examination process and examination reports to be lacking in this area, confirming our own observations.

The bank examination process by its nature is an incursion into the realm of bank management. Bank officers deserve the benefit of examiners' constructive suggestions as well as their criticisms. When an examiner does note management weaknesses in a bank, he/she has specific criteria in mind when doing so. In essence, our recommendation only requires them to share these criteria with bankers.

CHAPTER 5

ROLE OF OFFSITE SURVEILLANCE NOT YET DEFINED; BENEFITS NOT EVALUATED

The Federal bank regulatory agencies have designed, developed, and implemented computer-based systems to monitor banks using periodically reported data. Though this effort began in the early- to mid-1970s, there is as yet no clear-cut role defined for these systems in the supervisory process. Degrees of use and acceptance vary among agencies. As pointed out in chapter 3, the systems' value in detecting bank problems at an early stage is limited. System reports are often not timely. Peer groups of banks used for comparative analyses have been criticized as being nonrepresentative. Moreover, the systems are not being used to allocate agency examination resources.

The reason for these uncertainties is that the systems were not developed or evaluated properly. They grew piecemeal from what was considered a good idea, one used by private firms for evaluating the financial condition of banks. The agencies did not formally specify or quantify benefits and compare them to the costs of developing and operating the systems. Moreover, the Federal Reserve and FDIC did not adequately train their staffs to utilize and accept the systems.

SURVEILLANCE SYSTEMS EVOLVED PIECEMEAL WITH NO COST-BENEFIT EVALUATIONS

The concept of computerized surveillance systems as an adjunct to onsite examination has evolved since the mid-1970s. The Comptroller's system was created in the most organized fashion, but even that system has never undergone a rigorous cost-benefit analysis. Consequently, though each agency's staff believes that the systems are beneficial, there is no structured body of evidence to prove this contention.

The Comptroller's system, the NBSS (see p. 9 for description), grew from a recommendation in a study made in 1974 and 1975 by the public accounting firm of Haskins & Sells (now Deloitte, Haskins & Sells). To implement the recommendation, the Comptroller established a small staff of examiners and Haskins & Sells employees in September 1975. They generally followed the concepts in the study report and by mid-1976 began operating a limited system with a 5-year data base. By October 1976 the system was fully operational, and since then data has been added to the system.

At the time of our 1976 task force study, the Federal Reserve Board of Governors had developed three major computer systems that screened and monitored functions of banks and bank holding companies. They became operational in late 1976 and early 1977, but since then the Board has made changes to the systems. At the same time, various Federal Reserve banks developed individual computerized monitoring systems. Over the years, the Board has centralized the computer monitoring function at its headquarters. Now, in addition to its own systems, the Federal Reserve receives NBSS Bank Performance Reports from the Comptroller on Federal Reserve State member banks, and the Federal Reserve also has access to FDIC's data base through on-line computer terminals.

Also, at the time of our 1976 task force study, FDIC had in operation and under development several systems to monitor bank performance for adverse trends and to identify banks with potential problems. These systems were designed to utilize different methodologies and were, to some extent, competing. After some evaluation, FDIC combined and rearranged the pilot monitoring systems into what it felt was a workable package. The early warning segment of FDIC's system ended up conceptually different from the Comptroller's. The latter system focuses on banks exhibiting significant changes and on banks whose conditions differ from their peers, while the former focuses on banks that have financial ratios exceeding certain tolerance limits.

No cost-benefit studies made

None of the Federal banking agencies performed, either prior to or during the development of their surveillance systems, any evaluations of the costs and benefits of the systems that normally should be part of a sound system design and development plan. Agency personnel feel the systems have been helpful and that their utility will increase, but they believe that no quantitative evidence could be developed.

Proper system development procedures require an analysis that compares costs to potential benefits and an organized method to validate that results are attainable. The typical computer system proposal enumerates expected savings, quantifies tangible benefits, and lists intangible benefits without attaching a price. It is recognized that the intangibles may well be the most compelling reason for approving the proposal. The next step is estimating the probability that the system will achieve the benefits listed. 1/ Finally, the benefits and their expected achievement should be measured against the costs of operating the system. This process should include the consideration of alternative systems capable of producing the same or similar benefits.

Agency officials have acknowledged that their systems were not developed using the structured approach described above. The Comptroller's system development effort, though the most organized and structured, never included a cost-benefit justification. It grew logically from a perceived need to better monitor an increasingly fast-paced industry, but it did not always consider alternative solutions. For example, one subsystem of NBSS, the Action Control System, grew from the perceived need to ensure that regional offices follow up on bank problems in a consistent and timely fashion. The team that designed the Action Control System always assumed that it should have been an automated system. But in a separate report, GAO has questioned that reasoning in light of the fact that the system is not being fully used, yet regions do appear to be adequately tracking bank problems without it. 2/

FDIC officials admitted their system grew up piecemeal in that they simply began building it around the data they were already receiving in periodic reports from banks. They also have performed no formal justification or cost-benefit studies. They expressed the belief that if FDIC saves one bank because of surveillance, then the system is justified.

The Federal Reserve had a special development problem in that several of the relatively autonomous Federal Reserve banks were developing their own systems while the Board of Governors headquarters staff worked on what eventually became the Federal Reserve-wide system. No overall cost-benefit or justification studies have been made, even though Board staff believes that surveillance is cheaper than examination and has improved the quality of supervision.

In fact, officials at all three agencies believe that surveillance systems are beneficial and justifiable, but they have no objective evidence. And an official at the Comptroller's office pointed out that surveillance will become even

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1/The Successful Computer System, Joseph Orlicky, McGraw-Hill Co., 1969, pp. 72-73.

2/"The Comptroller Of The Currency Should Decide The Extent To Which His Action Control System Is Needed" (GGD-81-93, Sep. 28, 1981).

more useful as the time between onsite examinations lengthens due to agency resource constraints. Staff at the Federal Reserve felt that a formal justification analysis would be difficult to perform because it is hard to quantify the benefits of "better supervision."

INADEQUATE TRAINING HAS LED TO INCOMPLETE ACCEPTANCE

Our review disclosed a wide variety of acceptance and use by agency personnel of surveillance results. Part of the reason is that system reports are often too late to be fully useful. (See below.) However, staff training at FDIC and the Federal Reserve was not completed in time to insure proper use or acceptance by examiners. Those agencies are continuing their training efforts.

Users of new systems usually should be trained early in the system development process. Since the organization's employees must support the system in order for it to be successful, it is important to educate them sufficiently before the system becomes operational.

Our examiners' surveys showed that the Comptroller's examiners have found their system more useful than did the other agencies' examiners in five of the six areas in which surveillance is used for planning examinations, as the following figure shows.

Usefulness of Surveillance in Planning Examinations

Area of examination	Percent rating useful to a "great" or "very great" extent		
	Comptroller	Federal Reserve	FDIC
Adequacy of the level of earnings	70.8	41.1	36.9
Adequacy of liquidity	17.0	12.7	26.6
Trends in earnings performance	81.2	40.0	47.3
Adequacy of capital	48.5	23.6	23.0
Future expansion/ contraction of bank	13.2	9.1	7.8
Asset and liability management	28.7	12.7	23.8

The next figure shows that the Comptroller's examiners also find the system more effective at performing seven of the eight functions of examination and supervision.

Comparison by Agency of Examiners' Ratings

of Surveillance Systems' Effectiveness in

Performing Certain Functions

Systems and/or report functions	Percent of examiners rating systems and/or report functions "effective" or "very effective"		
	Comptroller	Federal Reserve	FDIC
1. Identifying changes in a bank's current position relative to other banks.	86.1	75.0	77.6
2. Identifying changes in a bank's performance since the last examination.	77.1	62.5	57.8
3. Identifying long-term trends in a bank's performance.	82.1	46.4	68.5
4. Identifying changes in a bank's assets and liabilities since the last examination.	76.2	60.7	60.1
5. Helping you identify current problems in a bank at an early stage.	51.7	30.4	36.9
6. Helping you identify potential problem areas in a bank.	60.8	35.7	53.1
7. Helping you prevent problems from developing at a bank.	33.8	17.9	24.2
8. Providing you with evidence that can be used as support in discussions with bank management.	74.3	66.1	79.9

Although these figures could indicate a difference in potential quality of the systems, our discussions with examiners and other agency officials lead us to believe that differences in training and acceptance cause much of the variance. In comments included with their responses to our questionnaire, two senior FDIC examiners stated that training in the use of monitoring systems was inadequate. FDIC introduced its Integrated Monitoring System (IMS) in 1977 to its examiners without any training, which caused some initial reluctance to use the system. In early 1979, a bank analysis course was offered, and about 50 to 60 percent of the senior examiners had taken it at the time of our review. An introductory course is also given after about 6 months in the examiner program. Overall training has aided the acceptance of the IMS by agency personnel. Examiners are required to fill out an analysis page in the examination report with ratios from the IMS, so they are forced to use the system to some degree.

Although acceptance of the Federal Reserve's surveillance system has increased, resistance still exists. The Federal Reserve revised its training program in 1979, and the examiners that were not commissioned at the time that the new training began received surveillance training. As a result, the newer examiners have been trained to examine banks with knowledge of surveillance tools, while some of the more experienced examiners have not been given the training needed to make full use of surveillance. It is primarily the latter group of examiners, therefore, that resists surveillance. The Federal Reserve has been giving training in financial and ratio analysis and surveillance to its senior examiners and hopes to complete this by mid-1982. In the future, Federal Reserve examiners will be forced to use surveillance more, just to complete forms requiring surveillance information.

The Comptroller's NBSS, with the exception of the Action Control System, has essentially been accepted by agency staff. Training began in 1976 when the new examination procedures were introduced, and all the Comptroller's examiners have received training by now. Most regions do not use the Action Control System because they have already implemented some other type of system that supplies followup information on banks. The Comptroller is considering changes to the system, and we have issued a separate report to him on this subject. 1/

1/GGD-81-93.

TIMELINESS, PEER GROUPINGS LIMIT SURVEILLANCE EFFECTIVENESS

Inherent problems of timeliness and peer group validity limit the usefulness of surveillance to some extent. The lack of timeliness was the biggest flaw examiners in our survey found in the systems. Only 23.3 percent of examiners in general rated their system's timeliness "good" or "very good;" a greater proportion, 36.6 percent, felt the surveillance systems were "poor" or "very poor" in this regard. Dividing examiners on the basis of agency affiliation shows that the percent (41.3) of the Comptroller's examiners rating the timeliness of NBSS poorly was greater than the percent of examiners from the Federal Reserve (31.3) and FDIC (32.5) who found their systems to be untimely. This last finding, however, might be partially explained by the tendency, discussed earlier, of the Comptroller's examiners to use surveillance system data in examination preparation to a greater extent than the other agencies' examiners. If the Comptroller's examiners do rely more heavily on the data, then it would seem reasonable to conclude that they would consider timeliness to be more critical.

Poor timeliness is caused by the period needed by the agencies to process the data supplied by banks in their periodic reports ("call" reports). The relatively poor quality of the data received from the banks requires extensive editing. Although processing time varies by agency, banks are generally allowed 30 days after the end of the reporting period to submit their reports. About 2 months are required for the agencies to process the data and supply the analyses to their field offices. By the time the agencies' field offices receive initial bank data from the reporting period, it is at least 3 months old. The availability of final analyses varies, but at the earliest it is 4 months after the end of the reporting period.

The agencies have tried with mixed results to use unedited data to speed the process. FDIC supplies preliminary edited but uncorrected data to the regions via on-line computer terminals so that initial analysis can be done. This allows the regional analysts to review and analyze that data they feel is reliable, with the help of the edited copy from the previous reporting period. Although the Comptroller's staff has experimented using raw bank data for NBSS analyses, it dropped the idea because reporting errors on the experimental data sometimes ran as high as 50 percent. The loss of confidence in the data due to not verifying it was not worth the time savings achieved, they believed.

Peer groups, used to compare a bank's performance to that of similar banks, have been found to be of somewhat limited value. A number of bankers voiced their discontent with the peer groups in written comments they included with their survey responses. The complaint cited most often was that the peer groupings were too broad to be of much value to them. For example, some felt that the variety of bank sizes within the grouping was too large, while others thought that the peer groups should be confined to a limited geographical area. Other complaints we received were that the reports

--were not taking enough factors into account,

--had inaccurate breakdowns,

--used static rather than average figures, and

--incorporated banks with dissimilar functions.

Examiners also had reservations about the peer groupings, and some even questioned their overall usefulness. One FDIC examiner we talked to thought that all banks included in the same peer groups were not necessarily comparable. Another examiner said that some banks were being compared to other banks located in parts of the country with vastly different economic characteristics. The examiner felt that such comparisons might unduly alarm a banker when his bank does not compare favorably to those which realistically are not his peers. Finally, one examiner said that some bankers place more reliance on regional breakdowns which they can obtain from other sources.

But peer groups can be quite useful. As two examiners pointed out, discussions of a bank's problems with its management are more persuasive if the bank's position among its peers is shown to be unfavorable.

Agency officials believe that peer groupings can never satisfy everyone, but the groups are still useful. If the agencies tried to satisfy all possible grouping criteria, the groups would become too numerous. If viewed in perspective, they say, the groups provide valuable indicators of bank performance.

SURVEILLANCE NOT USED TO ALLOCATE RESOURCES

Agencies' field offices make adjustments to examination schedules based on surveillance information, but officials at all three agencies told us that surveillance will not be a primary resource allocator. This is because the agencies believe in the necessity of regularly scheduled onsite examinations for all banks, though the period between examinations for sound banks is being lengthened.

Field office officials told us that they make relatively minor adjustments to examination schedules based on surveillance data. Schedules in one agency, for example, are established 6 months or more in advance. Since a bank's condition is considered when the schedules are set, and since the field offices usually know their banks reasonably well, surveillance results may cause a bank to be examined sooner than originally planned. For instance, after a September 1979 IMS report and a December 1979 call report showed serious problems in an FDIC-supervised bank, a planned August 1980 examination was rescheduled for April. The one exception to this pattern that we observed was a case in which one of the Comptroller's regions performed a specialized examination to investigate capital problems detected by an NBSS test that the region itself had designed.

As resource constraints lengthen the time between examinations, the regulators hope that surveillance can substitute for some onsite work. The Comptroller's staff said it will probably use more offsite analysis as a supplement to fewer examinations to pinpoint areas of concern. According to one official, NBSS will supplant onsite examinations to a certain extent when it becomes more of a forecaster and a risk assessor. Similarly, the Federal Reserve is studying the possibility of limiting onsite examination time by making more use of offsite surveillance and financial analysis techniques. However, according to one official, the surveillance timeliness problem must be solved before more offsite analysis can supplant onsite work.

The agencies' belief in the necessity of regularly scheduled onsite examinations will preclude them from using surveillance as a primary resource allocator. In response to a previous GAO report, 1/ the FDIC stated that it is

> "* * * not aware of any monitoring system that is capable of supplanting examinations as a tool in bank surveillance. Furthermore, [FDIC is] 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, * * *."

1/GGD-81-12, page 63.

In the same report, the Comptroller stated that the increasing rate of change in the banking system and the economy may make more frequent but shorter overview examinations preferable.

FEDERAL COUNCIL WILL NOT SOLVE PROBLEMS SOON

The Federal Financial Institutions Examination Council, established by the Congress in 1978 to better coordinate policies of the Federal financial regulators, is addressing some of the concerns we have raised here about surveillance systems. But prospects for an early successful completion of this task are not sanguine.

The Council was created in Title X of Public Law 95-630, and part of its function is to prescribe uniform principles and standards for the Federal financial institutions regulators. As one of its projects, the Council established its Task Force on Surveillance Systems to help formulate goals, objectives, and priorities for facilitating the development and sharing of computer-based and other surveillance procedures.

However, according to the task force's chairman, the Council will not soon find solutions to the problems we have raised. He said his task force cannot establish a uniform surveillance system until the agencies agree on a common examination philosophy. Another task force working on that question, we found out, is well behind schedule and is finding it difficult to reach agreement on common philosophies. Until they do, according to the surveillance task force chairman, his group cannot decide what they want surveillance to do and how it should complement onsite examinations.

CONCLUSIONS

Though the agencies have designed, developed, and implemented computer-based surveillance systems, there is as yet only an incomplete demonstration of their use or usefulness. The agencies feel that surveillance systems do offer advantages, and we have noted evidence of some of those advantages. But, it is not clear just how well those advantages can and will be integrated into supervision.

Moreover, we are concerned that the development process took place without the necessary justification studies being performed, and no cost-benefit data has been collected.

It is reasonable to assume that computer-based surveillance could play an important role in an era that will see fewer onsite visits to banks due to resource limitations by the regulators. However, the time is past due for a formal and rigorous evaluation of the capabilities and role of surveillance systems. The Federal Financial Institutions Examination Council has a task force working on this problem, but major philosophical differences among the agencies inhibit an early satisfactory solution to this issue. In the meantime, we believe each of the Federal regulators should study the cost effectiveness of its surveillance system.

Officials at FDIC and the Federal Reserve are cognizant of the reluctance by some examiners to use the surveillance systems. Much of this resistance is due to incomplete training. The two agencies have introduced training courses to aid in the acceptance of the systems by agency personnel. At the time of our review, this training had not been given to all of the examiners that should be using the surveillance systems. Agency officials recognize that this deficiency exists, and they should continue and extend the training process so that the examiners requiring the surveillance knowledge receive it.

RECOMMENDATIONS TO THE BANK REGULATORY AGENCIES

We recommend that the Comptroller of the Currency, the Chairman of the Board of Governors of the Federal Reserve System, and the Chairman of the Federal Deposit Insurance Corporation formally assess the costs and benefits of their surveillance systems using recognized methods of systems analysis. Much of the data for such an analysis may already have been collected through the routine operations of the systems. The formal study, by focusing the agencies' attentions on this specific aspect of the supervisory process, could accelerate the proper integration of surveillance and onsite examinations.

AGENCY COMMENTS

Neither the Federal Reserve nor the FDIC was willing to perform a cost-benefit analysis of its surveillance system. They are committed to using them, although the FDIC is now going to "* * * overhaul the surveillance system operating procedures, and precisely define how and where the system fits into [its] overall supervisory mission * * *." (See app. V, p. 96.) The Federal Reserve said "* * * the role and benefits of monitoring and surveillance have been under continual review * * *." (See app. VII, p. 99.)

The Comptroller, on the other hand, agreed that cost effectiveness evaluations are desirable and also agreed to perform them as system improvements are made. (See app. IV, p. 90.)

As we previously stated, the process used by the Federal bank regulatory agencies to develop their surveillance systems did not meet accepted systems development criteria. As a result, the systems are evolving by trial and error. We agree, in fact, that these systems may offer distinct advantages. But instead of perpetuating the processes that led to the current difficulties, the agencies should be using a more formalized, disciplined approach that requires surveillance systems to meet the same rigorous test that all systems should: the benefits accrued by using them must be proven to justify their development and operations costs.

We are pleased that the Comptroller has agreed to perform evaluations on future improvements. However, this does not substitute for a comprehensive cost-benefit study of the surveillance system in relation to its role in the bank supervisory process.

CHAPTER 6

SCOPE AND METHODOLOGY

Since the use of statistical sampling techniques and computer analyses was integral to this review, we are presenting in this chapter details of our scope of work and methodology used, including limitations and interpretive comments. Our work was divided into three segments. First, from a universe of all commercial banks supervised by the Federal Reserve, Comptroller of the Currency, and FDIC, we selected random samples to receive questionnaires surveying bankers' opinions about various aspects of supervision. Second, we sent another questionnaire to senior Federal commercial bank examiners at the same agencies asking some different questions and some that were similar to those asked of the bankers. Third, from the universe of commercial banks added to the agencies' lists of institutions warranting special attention between July 1978 and June 1980, we selected a sample for case studies by our evaluators.

SURVEY OF COMMERCIAL BANKERS

We chose two disproportionately stratified random samples of bankers to participate in the survey. The first was a general sample drawn from the universe of all commercial banks as it existed on November 3, 1980. The second consisted of banks randomly selected from the most current (December 1980) lists of special attention banks maintained by the agencies. These banks were not eliminated from the general universe and therefore a few appeared in both samples.

Because the three supervising agencies supervise differently and because different size banks behave differently, our samples take these factors into account. We disproportionately stratified both bank universes first by supervising agency and then by five asset size categories, ranging from assets less than $25 million to assets greater than $1 billion. This stratification assures that projections can be made to agency and bank size subpopulations as well as to the universe. It resulted in each universe being divided into 15 different strata. We then calculated separate sample sizes for each stratum.

The following figure lists the universe, sample sizes, and number of respondents for all strata in the general sample. The next figure shows information for the special attention bank sample, summarized by agency. Although we had also stratified our special attention sample by asset size, we have not presented those figures in order to avoid the inadvertent disclosure of bank identities pursuant to Public Law 95-320.

GENERAL SAMPLE

Supervisory agency and asset size	Number of banks: Adjusted universe	Number of banks: Sample	Number of respondents	Percent responding
Comptroller:				
Less than $25 million	1,594	162	150	92.6
$25 million to $99.9 million	1,946	164	152	92.7
$100 million to $499.9 million	625	156	151	96.8
$500 million to $999.9 million	85	85	83	96.5
Over $1 billion	115	114	107	93.8
	4,365	681	643	94.4
Federal Reserve:				
Less than $25 million	458	159	138	86.8
$25 million to $99.9 million	342	117	110	94.0
$100 million to $499.9 million	110	56	49	87.5
$500 million to $999.9 million	22	22	22	100.0
Over $1 billion	32	32	30	93.7
	964	386	349	90.4
FDIC:				
Less than $25 million	5,267	162	143	88.3
$25 million to $99.9 million	2,934	164	150	91.5
$100 million to $499.9 million	498	127	112	88.2
$500 million to $999.9 million	45	44	42	95.4
Over $1 billion	24	24	23	95.8
	8,768	521	470	90.2
Total	14,097	1,588	1,462	92.1

SAMPLE OF SPECIAL ATTENTION BANKS

Supervisory agency	Number of banks Universe	Number of banks Sample	Number of respondents	Percent responding
Comptroller	317	89	79	88.8
Federal Reserve	98	55	46	83.6
FDIC	151	62	55	88.7
Total	566	206	180	87.4

FDIC staff generated the general sample of banks from that agency's computer files according to our specifications. A separate random starting point and skip interval process was employed for the selection of each stratified sample, with the exception of the two large bank categories, in which all banks were selected. Both FDIC and GAO analysts agreed that the order in which the banks appeared in the file did not threaten the validity of the sample.

We used computer-generated random numbers to select by hand the special attention banks from the lists provided by the agencies with the exception again of large banks, all of which were selected. We first divided each list according to our asset size categories and then employed separate groups of random numbers to choose the samples from the smaller asset groupings.

The analyses of the data from the general and special attention samples were performed separately. In both samples, different proportions of banks from each stratum were included. The results were therefore weighted in order to project sample results to

--all banks supervised by each agency,

--all banks within a given asset size, and

--the total population of banks.

The following example illustrates our weighting methodology. In one stratum we sampled 129 of the 462 banks. We calculated the weighting factor by dividing the number of banks in the stratum by the stratum sample size (462/129 = 3.58). Therefore, any observed condition about one sampled bank from this stratum could be projected to 3.58 banks from that stratum.

The weighted proportions used in the report are estimates because they are based on a statistical sample rather than a complete enumeration. The figures presented are subject to sampling errors of up to about ±5 percent at the 95-percent level of confidence.

SURVEY OF COMMERCIAL BANK EXAMINERS

We surveyed bank examiners in order to obtain some insight into how recent supervisory changes are used. Examiners selected were those who have experienced conditions before and after these changes were made and who have also played an important role in their implementation. They included all of each agency's high-level examiners who, for the Comptroller and FDIC at least, met certain experience-related criteria.

Specifically, we selected all FDIC's and the Comptroller's examiners who, as of June 1980, were in the supervisory grade levels, had at least 10 years of experience, and were currently involved primarily in commercial examinations. This group of examiners included all FDIC Field Offices' Supervisors and most of the Comptroller's examiners who headed subregional offices. FDIC and the Comptroller considered all of these examiners to be senior level.

Because of the Federal Reserve banks' relative autonomy and short supply of experienced examiners, our criteria for choosing their examiners to be surveyed differed from those used for the Comptroller and FDIC. Federal Reserve banks maintain their own personnel systems, and consequently no standard grade classification system exists for Federal Reserve examiners. Therefore, we could not identify Federal Reserve senior or supervisory examiners on the basis of grade designation. Hence, we surveyed commercial examiners designated as senior or supervisory by their banks. Also, because relatively few Federal Reserve examiners have 10 or more years of experience, we did not use a length-of-service criterion in choosing participants from that agency. This decision was necessary in order to assure a large enough representation of Federal Reserve examiners for the survey.

The following chart lists the number of examiners surveyed and the number who replied:

	Number surveyed	Number of respondents	Percent responding
Comptroller	281	273	97.1
Federal Reserve	62	56	90.3
FDIC	265	246	92.8
Total	608	575	94.6

The analysis of the examiners' survey results was straightforward since questionnaires were sent to the entire group of examiners we identified as senior level.

CRITERIA FOR INTERPRETING RESULTS

As part of our bankers' questionnaire analysis we sought to determine if differences existed in perceptions related to the supervisory agency, condition of the bank, or size of bank. For the examiners' questionnaire we looked for possible differences in responses by agency and by field office within each agency.

Our general criterion was that we considered a difference of at least 10 percentage points in our responses to be an indication of noteworthy differences among the variables listed above. For the bankers' surveys, in order to make sure that the differences were not due to sampling error, we tested them with appropriate statistical tests at the 95-percent level of confidence.

SPECIAL ATTENTION BANK CASE STUDIES

We drew a random sample of 105 banks warranting special attention in order to assess case-by-case how the agencies dealt with these institutions, including how they used new laws, policies, and procedures developed since our task force study. For the entire sample of banks, we reviewed examination reports and related correspondence in order to ascertain what the problems were and how the agencies treated them. Our evaluators reduced the information gathered to standard data collection documents which were keypunched for computer analysis. In 17 of the sample cases that presented particularly good opportunities to focus on specific changes, we conducted further review procedures, including interviews with cognizant agency officials in headquarters and field offices.

The sample of 105 banks was drawn randomly from the universe of banks added to the agencies' special attention lists between July 1, 1978, and June 30, 1980. 1/ The earlier date was chosen with the expectation that after then the changes in procedures, systems, and legal authority we wanted to study would have played a part in identifying problems or dealing with them. The later date was selected as a cutoff because cases chosen after this would have been put into a program of increased supervision too recently to have allowed for agencies to have acted to resolve problems before our review began.

The following table shows the universe and sample size by agency:

Agency	No. banks added (universe)	Sample size
FDIC	161	35
Federal Reserve	47	30
Comptroller	192	40
Total	400	105

The number of sample case studies chosen was not designed to support statistical inference projections to the universe of all banks. Rather, it was designed to enable us to obtain a valid randomly chosen set of cases that exemplified agencies' actions vis-a-vis special attention banks.

1/FDIC's sample was taken from special attention lists through May 31, 1980.

SURVEY OF COMMERCIAL BANKERS--GENERAL SAMPLE

The following is a copy of the questionnaire we sent to the chief executive officers of banks from a sample drawn from the universe of all commercial banks.

The questionnaire shows the percentages of those who responded to the survey who checked each of the cells for each of the items. Some of those who answered the survey did not complete each question, and these were classified as nonresponses. Since they were relatively small, we did not print the percentages of the nonresponses. Thus, the proportions shown for most of the items will not add up to 100 percent.

In addition, although we stratified the data by asset size and supervising agency, these stratifications are not presented in this appendix. Instead, they are contained in the main body of this report, where appropriate.

The numbers in the appendix do not exactly match those in corresponding charts in the main body of the report because the charts were adjusted for nonresponses and for those who responded, "no basis to judge."

GENERAL SAMPLE

U.S. GENERAL ACCOUNTING OFFICE
SURVEY OF COMMERCIAL BANKS

INSTRUCTIONS:

The purpose of this questionnaire is to obtain the views of bank management on the Federal examination and supervisory processes as they currently affect bank operations. You will be asked to consider the impact on your bank of full scope, general commercial examinations by your current Federal supervisory agency. The competence of the Federal examiners, and the usefulness of the information on your bank's performance provided by the Federal regulatory agency will be addressed. In addition, there is a question on special purpose examinations which may also take place in your bank.

The completed questionnaire should represent the views of senior bank management. We would like you to respond to each question.

The questionnaire is numbered only to aid us in our follow-up efforts and will not be used to identify you with your response.

Throughout this questionnaire there are numbers printed within parentheses to assist our keypunchers in coding responses for computer analysis. Please disregard these numbers.

I. BANK CHARTER

1. For how many years has your bank held its present charter? *(Check one.)* *(7)*

1. ☐ 5 years or less 5.8
2. ☐ 6 - 10 years 7.1
3. ☐ 11 - 15 years 3.3
4. ☐ 16 - 20 years 6.7
5. ☐ More than 20 years 70.5

II. PERCEPTIONS CONCERNING THE BANK EXAMINATION PROCESS

2. How effective or ineffective is the Federal examination process in achieving each of the objectives set forth below? *(Check one for each row.)*

OBJECTIVES OF THE EXAMINATION PROCESS	Very effective 1	Effective 2	Borderline 3	Ineffective 4	Very ineffective 5	No basis to judge 6	
1. Providing bank management with an independent appraisal of bank soundness	15.6	66.9	14.0	1.6	0.7	0.5	*(8)*
2. Helping management forecast the future condition of its bank	2.5	31.7	36.8	19.6	4.1	4.6	*(9)*
3. Identifying potential problems for bank management	8.7	59.8	25.2	3.3	0.9	1.4	*(10)*
4. Recommending to bank management useful solutions to the problems identified	6.5	33.4	38.7	14.2	5.0	1.8	*(11)*
5. Helping management comply with laws and regulations	20.4	54.2	18.3	5.3	1.0	0.4	*(12)*
6. Helping management prevent its bank's failure	7.8	40.4	19.5	7.4	2.2	20.9	*(13)*
7. Other *(Please specify)* ____________							*(14)*

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II. PERCEPTIONS CONCERNING THE BANK EXAMINATION PROCESS (Continued)

3. In the following areas, how would you rate the competence of the SENIOR FEDERAL EXAMINER participating in your most recent Federal commercial examination? *(Check one rating for each row.)*

COMPETENCE OF THE SENIOR FEDERAL EXAMINER	Very much more than adequate 1	More than adequate 2	Adequate 3	Less than adequate 4	Very much less than adequate 5	No basis to judge 6	
1. Ability to determine quality of loans	8.6	32.9	53.9	2.9	0.7	0.7	(15)
2. Ability to assess the quality of investments	5.7	28.0	55.5	6.7	0.8	3.2	(16)
3. Knowledge of banking laws and regulations	15.5	47.3	34.4	1.9	0.0	0.7	(17)
4. Ability to assess capital adequacy	8.1	31.4	50.0	7.7	0.7	1.9	(18)
5. Ability to assess adequacy of internal controls	5.6	27.1	56.6	7.8	0.1	2.5	(19)
6. Ability to evaluate the competence of management	6.1	25.4	51.7	9.0	1.2	6.4	(20)
7. Ability to evaluate the impact of growth on bank soundness	4.4	19.1	54.9	11.8	0.8	8.3	(21)
8. Ability to evaluate the adequacy of liquidity	6.5	31.5	55.9	4.2	0.5	1.0	(22)
9. Ability to determine the impact of self-dealings on soundness	8.2	29.0	46.2	4.9	0.9	10.4	(23)
10. Ability to integrate detailed information into a comprehensive picture of bank operations	3.9	25.0	50.4	13.4	0.9	5.4	(24)
11. Other *(Please describe)* ______							(25)

4. In these same areas, how would you rate the examiners, OTHER THAN THE SENIOR EXAMINER, who participated in your most recent Federal commercial examination? *(Check one rating for each row.)*

COMPETENCE OF SUBORDINATE FEDERAL EXAMINERS	Very much more than adequate 1	More than adequate 2	Adequate 3	Less than adequate 4	Very much less than adequate 5	No basis to judge 6	
1. Ability to determine quality of loans	1.9	13.2	61.1	18.4	1.2	3.6	(26)
2. Ability to assess the quality of investments	1.6	12.7	59.3	17.8	2.6	5.9	(27)
3. Knowledge of banking laws and regulations	3.7	20.5	60.9	10.2	1.2	3.0	(28)
4. Ability to assess capital adequacy	2.2	12.9	56.4	16.8	2.2	9.1	(29)
5. Ability to assess adequacy of internal controls	2.0	12.5	61.0	17.1	1.7	5.5	(30)
6. Ability to evaluate the competence of management	1.5	9.5	48.3	22.4	5.0	12.7	(31)
7. Ability to evaluate the impact of growth on bank soundness	1.1	7.1	52.3	21.7	3.9	13.4	(32)
8. Ability to evaluate the adequacy of liquidity	1.5	12.6	63.1	12.5	2.2	7.4	(33)
9. Ability to determine the impact of self-dealings on soundness	1.4	11.7	54.7	13.6	2.5	15.6	(34)
10. Ability to integrate detailed information into a comprehensive picture of bank operations	0.7	9.3	49.1	24.1	4.1	11.4	(35)
11. Other *(Please describe)* ______							(36)

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II. PERCEPTIONS CONCERNING THE BANK EXAMINATION PROCESS (Continued)

5. To your knowledge, do the Federal examiners discuss their examination results with any members of your bank's Board of Directors routinely, only when problems are identified, or not at all? *(Check one.)* *(37)*

72.1 1. ☐ Routinely, whether or not problems are identified
14.0 2. ☐ Only when problems are identified
9.9 3. ☐ Not at all (GO TO QUESTION 7)

6. When the Federal bank examiners discuss the examination results with your bank's Board of Directors, who from the Board is typically present? *(Check one.)* *(38)*

72.3 1. ☐ All or most of the members of the Board
1.2 2. ☐ The Board's Audit Committee only
8.4 3. ☐ An Executive Committee, including members of the Board
4.9 4. ☐ A limited group of members of the Board, other than an Audit or Executive Committee
0.2 5. ☐ The Chairman of the Board only

7. How clear or unclear was the most recent Federal commercial examination report prepared for your bank, in the following respects? *(Check one for each row.)*

CLARITY OF REPORTS IN:	Very clear 1	Generally clear 2	Borderline 3	Generally unclear 4	Very unclear 5	No basis to judge 6	
1. Explaining the nature and extent of any problems	39.2	52.2	4.5	0.8	0.5	2.1	*(39)*
2. Explaining the causes of any problems	21.4	48.9	18.0	4.6	1.5	4.9	*(40)*
3. Recommending solutions to any problems	15.7	40.4	27.3	7.0	3.9	5.3	*(41)*
4. Describing your bank's overall condition, which may include nonproblem areas	25.7	53.3	13.9	3.0	2.2	1.2	*(42)*

II. PERCEPTIONS CONCERNING THE BANK EXAMINATION PROCESS (Continued)

8. Consider the examination process, examination report, and discussions held between examiners and top management. Please check the degree of importance you think examiners placed on each of the following possible areas during the most recent full scope Federal commercial examination in your bank. *(Check one for each row.)*

DEGREE OF IMPORTANCE TO EXAMINERS

AREAS	Very great importance 1	Great importance 2	Moderate importance 3	Little importance 4	Very little or no importance 5	No basis to judge 6	
1. The condition and structure of assets	23.1	49.8	22.8	2.8	0.6	0.6	(43)
2. The structure of liabilities and capital	15.8	46.0	32.6	3.7	1.1	0.6	(44)
3. Liquidity	17.1	43.3	32.7	4.7	0.8	0.9	(45)
4. Earnings	11.3	34.4	41.9	8.9	1.9	1.0	(46)
5. Compliance with laws and regulations (other than consumer)	29.5	46.5	20.5	2.0	0.3	1.0	(47)
6. Management policies and procedures	13.3	44.9	33.5	6.4	0.7	0.7	(48)
7. Internal controls, including internal audit	13.3	43.1	33.8	7.4	0.7	1.3	(49)
8. Management competence and expertise	14.8	44.2	28.2	6.4	1.5	4.7	(50)

9. Now reviewing the same list, check the degree of importance you place on the same areas for assuring the safe and sound condition of your bank. *(Check one for each row.)*

DEGREE OF IMPORTANCE TO YOU

AREAS	Very great importance 1	Great importance 2	Moderate importance 3	Little importance 4	Very little or no importance 5	No basis to judge 6	
1. The condition and structure of assets	54.5	40.3	4.6	0.1	0.0	0.1	(51)
2. The structure of liabilities and capital	38.6	48.7	12.2	0.1	0.0	0.0	(52)
3. Liquidity	38.5	43.7	16.8	0.5	0.0	0.0	(53)
4. Earnings	49.7	39.9	9.4	0.6	0.0	0.0	(54)
5. Compliance with laws and regulations (other than consumer)	25.7	39.2	28.6	4.6	1.0	0.4	(55)
6. Management policies and procedures	34.5	51.4	12.8	0.6	0.0	0.0	(56)
7. Internal controls, including internal audit	28.0	45.4	24.9	1.0	0.1	0.0	(57)
8. Management competence and expertise	57.8	37.6	3.4	0.0	0.0	0.7	(58)

II. PERCEPTIONS CONCERNING THE BANK EXAMINATION PROCESS (Continued)

10. In your opinion, how effective or ineffective is the current Federal examination process in performing each of the following functions? *(Check one for each row.)*

EXAMINATION FUNCTIONS	Very effective (1)	Effective (2)	Borderline (3)	Ineffective (4)	Very ineffective (5)	No basis to judge (6)	
1. Evaluation of internal controls, including internal audit operations	7.8	56.3	28.5	4.7	0.8	1.5	*(59)*
2. Determination of existence of conflicts of interest	13.5	57.8	18.6	3.3	0.3	6.3	*(60)*
3. Assurance of the safety of depositors' funds	17.4	68.3	9.1	2.0	0.5	1.6	*(61)*
4. Evaluation of investment portfolio balance/imbalance	8.1	55.2	27.3	6.1	1.5	1.6	*(62)*
5. Assurance that insider loan limitations and reporting provisions of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 are being met	30.6	59.5	5.2	1.2	0.3	2.7	*(63)*
6. Assurance of compliance with laws and regulations (other than consumer)	24.0	65.2	8.8	0.8	0.0	0.9	*(64)*
7. Evaluation of deposit volatility	5.9	47.4	31.5	8.4	1.8	4.2	*(65)*
8. Evaluation of capital adequacy	13.8	62.5	16.8	3.6	1.0	1.9	*(66)*
9. Evaluation of asset quality	13.3	71.5	12.7	1.6	0.0	0.7	*(67)*
10. Evaluation of loan policies and procedures	11.7	61.9	20.8	2.8	0.5	2.0	*(68)*
11. Evaluation of management	9.9	60.4	17.0	3.9	1.4	6.7	*(69)*
12. Evaluation of liquidity	12.3	69.0	13.2	3.0	0.2	1.5	*(70)*
13. Evaluation of earnings	7.9	63.9	21.8	3.2	1.0	1.9	*(71)*
14. Evaluation of investment policies and procedures	7.6	56.5	25.5	5.9	1.0	2.5	*(72)*
15. Presentation of a comprehensive picture of a bank's overall condition	11.9	58.6	20.8	4.8	1.2	1.2	*(73)*

11. To what extent, if at all, are the following types of special purpose examinations useful to your bank's operations? *(Check one for each row.)*

SPECIAL PURPOSE EXAMINATIONS	To a very great extent (1)	To a great extent (2)	To a moderate extent (3)	To some extent (4)	To little or no extent (5)	No basis to judge (6)	
1. Trust	3.3	9.5	12.5	3.6	8.6	56.5	*(74)*
2. EDP	4.0	10.9	17.3	7.3	11.9	43.5	*(75)*
3. International	0.4	2.1	3.5	0.9	7.3	78.7	*(76)*
4. Consumer compliance	10.1	30.4	24.4	16.5	14.9	2.8	*(77)*

APPENDIX I

III. COMPUTER-GENERATED PERFORMANCE REPORTS

The Federal bank regulatory agencies normally provide your bank with computer-generated performance reports (NBSS Bank Performance Reports for national banks and State member banks or Comparative Performance Reports for State nonmember banks). These reports contain both performance information that pertains specifically to your bank and information that pertains to your bank's position within its peer group.

The questions in the LEFT column deal with the information pertaining SPECIFICALLY TO YOUR BANK that you obtain from the performance report. The questions in the RIGHT column deal with the information pertaining to YOUR BANK'S POSITION WITHIN ITS PEER GROUP.

12. Please rate the information contained in the reports that pertains specifically to your bank on each of the following characteristics. *(Check one for each row.)*

QUALITY OF INFORMATION	Very good 1	Good 2	Borderline 3	Poor 4	Very poor 5	
1. Accuracy	31.5	59.1	3.8	0.3	0.6	*(78)*
2. Timeliness	15.0	47.0	21.5	8.7	3.4	*(79)*
3. Clarity	21.6	56.6	14.4	2.5	0.4	*(80)*
4. Conciseness	22.2	60.0	10.8	1.6	0.6	*(81)*

13. Please rate the information contained in the reports that pertains to your bank's position within its peer group on each of the following characteristics. *(Check one for each row.)*

QUALITY OF INFORMATION	Very good 1	Good 2	Borderline 3	Poor 4	Very poor 5	
1. Accuracy	28.7	56.7	7.0	1.2	1.0	*(82)*
2. Timeliness	14.3	46.7	22.3	7.8	3.7	*(83)*
3. Clarity	20.2	54.3	16.6	2.9	0.8	*(84)*
4. Conciseness	21.3	57.3	13.1	2.1	0.8	*(85)*

14. To what extent, if at all, is this information, pertaining specifically to your bank, useful for making decisions in the following areas? *(Check one for each row.)*

DECISIONS CONCERNING:	To a very great extent 1	To a great extent 2	To a moderate extent 3	To some extent 4	To little or no extent 5	
1. Adequacy of earnings	10.6	35.6	30.1	11.9	7.8	*(86)*
2. Adequacy of liquidity	5.6	27.7	39.0	13.4	10.5	*(87)*
3. Adequacy of earnings performance	10.8	38.5	28.1	11.6	7.3	*(88)*
4. Adequacy of capital	6.1	29.0	35.6	15.8	9.8	*(89)*
5. Future expansion and/or contraction	3.3	13.2	36.1	19.2	24.5	*(90)*
6. Asset and liability management	5.2	23.2	35.6	19.3	12.8	*(91)*

15. To what extent, if at all, is this information, pertaining to your bank's position within its peer group, useful for making decisions in the following areas? *(Check one for each row.)*

DECISIONS CONCERNING:	To a very great extent 1	To a great extent 2	To a moderate extent 3	To some extent 4	To little or no extent 5	
1. Adequacy of earnings	10.8	34.0	29.4	13.3	8.3	*(92)*
2. Adequacy of liquidity	5.1	26.7	36.8	15.3	11.9	*(93)*
3. Adequacy of earnings performance	12.2	32.7	29.1	13.6	8.0	*(94)*
4. Adequacy of capital	6.5	25.3	36.1	16.4	11.5	*(95)*
5. Future expansion and/or contraction	3.2	15.3	33.1	19.0	24.4	*(96)*

USER-GENERATED PERFORMANCE REPORTS (Continued)

16. How much, if any, of this information pertaining specifically to your bank, does your bank also generate internally? *(Check one.)* *(97)*

%	
21.1	1. ☐ All or almost all
28.6	2. ☐ Most
17.6	3. ☐ About half
22.9	4. ☐ Some
6.5	5. ☐ Almost none or none

17. How much, if any, of this information pertaining to your bank's position within its peer group, does your bank also generate internally? *(Check one.)* *(98)*

%	
4.9	1. ☐ All or almost all
12.1	2. ☐ Most
7.7	3. ☐ About half
30.8	4. ☐ Some
41.1	5. ☐ Almost none or none

18. How much, if any, of this information pertaining specifically to your bank, do you also obtain from other outside sources? *(Check one.)* *(99)*

%	
12.7	1. ☐ All or almost all
15.2	2. ☐ Most
10.3	3. ☐ About half
37.6	4. ☐ Some
20.9	5. ☐ Almost none or none

19. How much, if any, of this information pertaining to your bank's position within its peer group, do you also obtain from other outside sources? *(Check one.)* *(100)*

%	
13.4	1. ☐ All or almost all
16.0	2. ☐ Most
9.2	3. ☐ About half
37.2	4. ☐ Some
20.9	5. ☐ Almost none or none

IV. OTHER

20. If you have additional comments on any of the items within the questionnaire or topics not covered, please express your views below on this page. *(101)*

Your answers and comments will be greatly appreciated.

Please return the completed questionnaire in the enclosed, self-addressed envelope within 10 days. If you have any questions, you may call Joyce Corry, collect, at (202) 275-3641.

The address is:

Ms. Joyce Corry
U.S. General Accounting Office
Room 3864
441 G Street, N.W.
Washington, D.C. 20548

SURVEY OF COMMERCIAL BANKERS--

SPECIAL ATTENTION SAMPLE

The following is a copy of the questionnaire we sent the chief executive officers of banks from a sample drawn from the universe of all banks identified by Federal regulators as needing special attention as of December 1980. It is identical in format to the one we sent to a sample of banks in general and subject to the same provisions explained in appendix I.

SPECIAL ATTENTION SAMPLE

U.S. GENERAL ACCOUNTING OFFICE

SURVEY OF COMMERCIAL BANKS

INSTRUCTIONS:

The purpose of this questionnaire is to obtain the views of bank management on the Federal examination and supervisory processes as they currently affect bank operations. You will be asked to consider the impact on your bank of full scope, general commercial examinations by your current Federal supervisory agency. The competence of the Federal examiners, and the usefulness of the information on your bank's performance provided by the Federal regulatory agency will be addressed. In addition, there is a question on special purpose examinations which may also take place in your bank.

The completed questionnaire should represent the views of senior bank management. We would like you to respond to each question.

The questionnaire is numbered only to aid us in our follow-up efforts and will not be used to identify you with your response.

Throughout this questionnaire there are numbers printed within parentheses to assist our keypunchers in coding responses for computer analysis. Please disregard these numbers.

I. BANK CHARTER

1. For how many years has your bank held its present charter? *(Check one.)*

(7)

7.5 1. ☐ 5 years or less
12.6 2. ☐ 6 - 10 years
2.4 3. ☐ 11 - 15 years
15.7 4. ☐ 16 - 20 years
56.2 5. ☐ More than 20 years

II. PERCEPTIONS CONCERNING THE BANK EXAMINATION PROCESS

2. How effective or ineffective is the Federal examination process in achieving each of the objectives set forth below? *(Check one for each row.)*

OBJECTIVES OF THE EXAMINATION PROCESS	Very effective 1	Effective 2	Borderline 3	Ineffective 4	Very ineffective 5	No basis to judge 6	
1. Providing bank management with an independent appraisal of bank soundness	20.4	59.1	12.5	5.4	2.3	0.0	*(8)*
2. Helping management forecast the future condition of its bank	3.1	37.6	39.0	15.5	4.9	0.0	*(9)*
3. Identifying potential problems for bank management	20.6	49.1	20.8	7.0	2.2	0.0	*(10)*
4. Recommending to bank management useful solutions to the problems identified	6.7	31.9	34.0	16.5	10.3	0.0	*(11)*
5. Helping management comply with laws and regulations	21.3	54.0	15.1	7.6	2.1	0.0	*(12)*
6. Helping management prevent its bank's failure	9.7	47.9	23.3	4.0	7.7	6.5	*(13)*
7. Other *(Please specify)* ________							*(14)*

1

II. PERCEPTIONS CONCERNING THE BANK EXAMINATION PROCESS (Continued)

3. In the following areas, how would you rate the competence of the SENIOR FEDERAL EXAMINER participating in your most recent Federal commercial examination? *(Check one rating for each row.)*

COMPETENCE OF THE SENIOR FEDERAL EXAMINER	Very much more than adequate 1	More than adequate 2	Adequate 3	Less than adequate 4	Very much less than adequate 5	No basis to judge 6	
1. Ability to determine quality of loans	12.7	41.5	34.1	7.1	3.3	0.2	*(15)*
2. Ability to assess the quality of investments	10.3	29.2	48.7	9.0	0.6	1.3	*(16)*
3. Knowledge of banking laws and regulations	22.6	41.2	32.3	2.0	0.6	0.4	*(17)*
4. Ability to assess capital adequacy	13.9	27.2	42.2	11.9	2.9	1.4	*(18)*
5. Ability to assess adequacy of internal controls	8.8	28.0	44.0	14.7	0.6	2.1	*(19)*
6. Ability to evaluate the competence of management	9.9	26.3	42.0	16.8	1.6	2.8	*(20)*
7. Ability to evaluate the impact of growth on bank soundness	3.1	25.0	41.8	19.0	3.7	6.8	*(21)*
8. Ability to evaluate the adequacy of liquidity	9.1	31.5	44.6	9.8	2.3	1.7	*(22)*
9. Ability to determine the impact of self-dealings on soundness	13.2	26.0	44.8	4.3	2.4	7.8	*(23)*
10. Ability to integrate detailed information into a comprehensive picture of bank operations	9.5	27.7	41.3	11.5	4.6	3.3	*(24)*
11. Other *(Please describe)* ______							*(25)*

4. In these same areas, how would you rate the examiners, OTHER THAN THE SENIOR EXAMINER, who participated in your most recent Federal commercial examination? *(Check one rating for each row.)*

COMPETENCE OF SUBORDINATE FEDERAL EXAMINERS	Very much more than adequate 1	More than adequate 2	Adequate 3	Less than adequate 4	Very much less than adequate 5	No basis to judge 6	
1. Ability to determine quality of loans	2.4	24.0	51.9	15.9	3.6	1.6	*(26)*
2. Ability to assess the quality of investments	0.0	19.3	56.6	51.2	5.3	2.5	*(27)*
3. Knowledge of banking laws and regulations	5.2	25.6	55.7	9.9	1.3	1.8	*(28)*
4. Ability to assess capital adequacy	2.5	17.4	45.1	18.7	7.2	8.5	*(29)*
5. Ability to assess adequacy of internal controls	3.0	19.9	50.0	18.7	4.4	2.3	*(30)*
6. Ability to evaluate the competence of management	3.1	13.9	41.7	21.5	9.6	9.0	*(31)*
7. Ability to evaluate the impact of growth on bank soundness	1.0	14.0	39.9	25.0	8.1	10.9	*(32)*
8. Ability to evaluate the adequacy of liquidity	1.7	21.1	50.7	14.1	5.7	6.0	*(33)*
9. Ability to determine the impact of self-dealings on soundness	3.0	14.9	54.3	11.4	4.0	11.9	*(34)*
10. Ability to integrate detailed information into a comprehensive picture of bank operations	1.5	10.8	48.9	21.3	6.7	8.7	*(35)*
11. Other *(Please describe)* ______							*(36)*

2

II. PERCEPTIONS CONCERNING THE BANK EXAMINATION PROCESS (Continued)

5. To your knowledge, do the Federal examiners discuss their examination results with any members of your bank's Board of Directors routinely, only when problems are identified, or not at all? *(Check one.)*

(37)

75.1 1. ☐ Routinely, whether or not problems are identified
16.8 2. ☐ Only when problems are identified
3.0 3. ☐ Not at all (GO TO QUESTION 7)

6. When the Federal bank examiners discuss the examination results with your bank's Board of Directors, who from the Board is typically present? *(Check one.)*

(38)

88.4 1. ☐ All or most of the members of the Board
1.1 2. ☐ The Board's Audit Committee only
2.2 3. ☐ An Executive Committee, including members of the Board
1.2 4. ☐ A limited group of members of the Board, other than an Audit or Executive Committee
3.0 5. ☐ The Chairman of the Board only

7. How clear or unclear was the most recent Federal commercial examination report prepared for your bank, in the following respects? *(Check one for each row.)*

CLARITY OF REPORTS IN:	Very clear 1	Generally clear 2	Borderline 3	Generally unclear 4	Very unclear 5	No basis to judge 6	
1. Explaining the nature and extent of any problems	41.1	47.6	8.5	1.7	0.6	0.0	(39)
2. Explaining the causes of any problems	24.0	43.3	21.9	7.8	1.8	0.5	(40)
3. Recommending solutions to any problems	19.5	33.5	24.8	12.1	6.5	3.1	(41)
4. Describing your bank's overall condition, which may include nonproblem areas	23.7	47.0	18.1	5.8	3.9	1.0	(42)

3

II. PERCEPTIONS CONCERNING THE BANK EXAMINATION PROCESS (Continued)

8. Consider the examination process, examination report, and discussions held between examiners and top management. Please check the degree of importance you think examiners placed on each of the following possible areas during the most recent full scope Federal commercial examination in your bank. *(Check one for each row.)*

DEGREE OF IMPORTANCE TO EXAMINERS

AREAS	Very great importance 1	Great importance 2	Moderate importance 3	Little importance 4	Very little or no importance 5	No basis to judge 6	
1. The condition and structure of assets	39.8	44.4	13.9	1.0	1.0	0.0	(43)
2. The structure of liabilities and capital	31.4	39.1	22.8	5.1	1.5	0.2	(44)
3. Liquidity	19.8	45.0	29.0	4.7	1.5	0.0	(45)
4. Earnings	23.4	36.1	31.1	5.2	3.7	0.0	(46)
5. Compliance with laws and regulations (other than consumer)	31.4	47.1	19.1	2.5	0.0	0.0	(47)
6. Management policies and procedures	24.5	48.7	22.2	3.8	0.9	0.0	(48)
7. Internal controls, including internal audit	19.4	37.5	36.6	5.8	0.7	0.0	(49)
8. Management competence and expertise	24.5	44.6	23.8	3.7	1.3	2.2	(50)

9. Now reviewing the same list, check the degree of importance you place on the same areas for assuring the safe and sound condition of your bank. *(Check one for each row.)*

DEGREE OF IMPORTANCE TO YOU

AREAS	Very great importance 1	Great importance 2	Moderate importance 3	Little importance 4	Very little or no importance 5	No basis to judge 6	
1. The condition and structure of assets	62.0	32.9	5.1	0.0	0.0	0.0	(51)
2. The structure of liabilities and capital	46.5	41.6	10.9	1.0	0.0	0.0	(52)
3. Liquidity	37.7	42.4	18.0	1.8	0.0	0.0	(53)
4. Earnings	58.6	32.4	7.0	1.0	0.0	0.0	(54)
5. Compliance with laws and regulations (other than consumer)	26.2	47.7	23.1	1.9	0.6	0.0	(55)
6. Management policies and procedures	35.9	45.0	16.5	2.3	0.0	0.0	(56)
7. Internal controls, including internal audit	29.9	47.4	20.3	2.3	0.0	0.0	(57)
8. Management competence and expertise	62.5	32.5	2.7	1.4	0.0	0.9	(58)

II. PERCEPTIONS CONCERNING THE BANK EXAMINATION PROCESS (Continued)

10. In your opinion, how effective or ineffective is the current Federal examination process in performing each of the following functions? *(Check one for each row.)*

EXAMINATION FUNCTIONS	Very effective 1	Effective 2	Borderline 3	Ineffective 4	Very ineffective 5	No basis to judge 6	
1. Evaluation of internal controls, including internal audit operations	9.6	59.5	25.3	5.6	0.0	0.0	(59)
2. Determination of existence of conflicts of interest	19.6	48.1	24.6	4.0	0.4	3.2	(60)
3. Assurance of the safety of depositors' funds	22.2	55.6	13.8	7.9	0.5	0.0	(61)
4. Evaluation of investment portfolio balance/imbalance	10.0	51.6	29.3	5.8	0.6	1.6	(62)
5. Assurance that insider loan limitations and reporting provisions of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 are being met	37.4	54.1	6.1	1.2	0.0	1.2	(63)
6. Assurance of compliance with laws and regulations (other than consumer)	29.0	63.5	7.1	0.2	0.0	0.2	(64)
7. Evaluation of deposit volatility	12.9	39.7	33.6	8.5	3.8	1.5	(65)
8. Evaluation of capital adequacy	21.6	47.0	19.3	7.7	3.5	1.0	(66)
9. Evaluation of asset quality	22.1	57.1	15.0	4.5	1.5	0.0	(67)
10. Evaluation of loan policies and procedures	20.4	53.5	19.7	5.4	1.0	0.0	(68)
11. Evaluation of management	16.7	49.7	19.7	8.8	0.9	3.8	(69)
12. Evaluation of liquidity	17.2	60.1	14.4	7.2	0.6	0.0	(70)
13. Evaluation of earnings	15.2	51.4	24.4	5.4	3.5	0.0	(71)
14. Evaluation of investment policies and procedures	5.5	59.7	25.0	7.0	1.5	0.8	(72)
15. Presentation of a comprehensive picture of a bank's overall condition	17.2	51.7	19.5	7.4	3.1	0.5	(73)

11. To what extent, if at all, are the following types of special purpose examinations useful to your bank's operations? *(Check one for each row.)*

SPECIAL PURPOSE EXAMINATIONS	To a very great extent 1	To a great extent 2	To a moderate extent 3	To some extent 4	To little or no extent 5	No basis to judge 6	
1. Trust	4.0	6.6	10.7	2.3	6.1	65.9	(74)
2. EDP	3.3	7.0	23.1	12.5	11.5	39.7	(75)
3. International	1.3	2.9	2.6	1.2	4.4	83.0	(76)
4. Consumer compliance	7.8	39.2	19.2	18.1	13.0	1.9	(77)

III. COMPUTER-GENERATED PERFORMANCE REPORTS

The Federal bank regulatory agencies normally provide your bank with computer-generated performance reports (NBSS Bank Performance Reports for national banks and State member banks or Comparative Performance Reports for State nonmember banks). These reports contain both performance information that pertains specifically to your bank and information that pertains to your bank's position within its peer group.

The questions in the LEFT column deal with the information pertaining SPECIFICALLY TO YOUR BANK that you obtain from the performance report. The questions in the RIGHT column deal with the information pertaining to YOUR BANK'S POSITION WITHIN ITS PEER GROUP.

12. Please rate the information contained in the reports that pertains specifically to your bank on each of the following characteristics. *(Check one for each row.)*

QUALITY OF INFORMATION	Very good 1	Good 2	Borderline 3	Poor 4	Very poor 5	
1. Accuracy	33.1	54.7	7.8	0.2	0.5	*(78)*
2. Timeliness	12.1	40.9	32.2	7.0	2.8	*(79)*
3. Clarity	19.6	58.1	15.0	2.6	0.5	*(80)*
4. Conciseness	18.9	61.0	13.7	2.2	0.0	*(81)*

13. Please rate the information contained in the reports that pertains to your bank's position within its peer group on each of the following characteristics. *(Check one for each row.)*

QUALITY OF INFORMATION	Very good 1	Good 2	Borderline 3	Poor 4	Very poor 5	
1. Accuracy	26.8	54.3	11.0	2.6	0.2	*(82)*
2. Timeliness	13.0	40.9	31.6	6.8	3.0	*(83)*
3. Clarity	18.4	54.6	19.0	2.2	1.6	*(84)*
4. Conciseness	18.8	59.4	14.2	2.7	0.7	*(85)*

14. To what extent, if at all, is this information, pertaining specifically to your bank, useful for making decisions in the following areas? *(Check one for each row.)*

DECISIONS CONCERNING:	To a very great extent 1	To a great extent 2	To a moderate extent 3	To some extent 4	To little or no extent 5	
1. Adequacy of earnings	9.1	32.2	33.9	15.5	6.0	*(86)*
2. Adequacy of liquidity	6.5	27.6	34.0	18.1	10.6	*(87)*
3. Adequacy of earnings performance	9.7	36.0	33.2	12.8	5.1	*(88)*
4. Adequacy of capital	8.9	27.5	36.5	16.6	7.1	*(89)*
5. Future expansion and/or contraction	3.0	12.6	42.5	15.8	21.3	*(90)*
6. Asset and liability management	6.5	27.7	35.0	16.8	10.1	*(91)*

15. To what extent, if at all, is this information, pertaining to your bank's position within its peer group, useful for making decisions in the following areas? *(Check one for each row.)*

DECISIONS CONCERNING:	To a very great extent 1	To a great extent 2	To a moderate extent 3	To some extent 4	To little or no extent 5	
1. Adequacy of earnings	10.9	31.4	31.9	15.9	6.6	*(92)*
2. Adequacy of liquidity	7.3	20.8	36.9	19.2	12.1	*(93)*
3. Adequacy of earnings performance	11.1	29.2	34.1	16.5	5.9	*(94)*
4. Adequacy of capital	9.7	22.3	33.7	21.5	9.6	*(95)*
5. Future expansion and/or contraction	2.6	13.4	45.6	15.2	19.0	*(96)*

6

III. COMPUTER-GENERATED PERFORMANCE REPORTS (Continued)

16. How much, if any, of this information pertaining specifically to your bank, does your bank also generate internally? *(Check one.)* → *(97)*

22.7 1. ☐ All or almost all
29.5 2. ☐ Most
17.8 3. ☐ About half
23.4 4. ☐ Some
3.7 5. ☐ Almost none or none

17. How much, if any, of this information pertaining to your bank's position within its peer group, does your bank also generate internally? *(Check one.)* *(98)*

5.1 1. ☐ All or almost all
7.8 2. ☐ Most
8.7 3. ☐ About half
38.8 4. ☐ Some
35.5 5. ☐ Almost none or none

18. How much, if any, of this information pertaining specifically to your bank, do you also obtain from other outside sources? *(Check one.)* → *(99)*

10.6 1. ☐ All or almost all
15.2 2. ☐ Most
11.0 3. ☐ About half
42.7 4. ☐ Some
17.7 5. ☐ Almost none or none

19. How much, if any, of this information pertaining to your bank's position within its peer group, do you also obtain from other outside sources? *(Check one.)* *(100)*

12.1 1. ☐ All or almost all
15.8 2. ☐ Most
8.4 3. ☐ About half
41.6 4. ☐ Some
18.2 5. ☐ Almost none or none

IV. OTHER

20. If you have additional comments on any of the items within the questionnaire or topics not covered, please express your views below on this page. *(101)*

Your answers and comments will be greatly appreciated.

Please return the completed questionnaire in the enclosed, self-addressed envelope within 10 days. If you have any questions, you may call Joyce Corry, collect, at (202) 275-3641.

The address is:

Ms. Joyce Corry
U.S. General Accounting Office
Room 3864
441 G Street, N.W.
Washington, D.C. 20548

7

SURVEY OF COMMERCIAL BANK EXAMINERS

Reprinted on the next few pages is a facsimile of the other questionnaire we fielded--this one to the entire universe of senior commercial bank examiners. We chose as participants for this survey all senior commercial examiners who met certain experience-related criteria. (See ch. 6, p. 63.)

Just as the two bankers' questionnaires, the examiners' questionnaire shows the percentages of those who responded to the survey who checked each of the cells for each of the items. The examiners' questionnaire is also similar to the bankers' questionnaire in that we did not print the percentages of non-respondants (see app. I for explanation of this). The proportions for most items will likewise not sum to 100 percent.

We also stratified the examiner data--this time by the examiner's agency and field office affiliation. These stratifications are also not presented here, but are included in the main body of the report, where appropriate.

The numbers in the appendix do not exactly match those in corresponding charts in the main body of the report because the charts were adjusted for nonresponses and for those who responded, "no basis to judge."

U.S. GENERAL ACCOUNTING OFFICE

SURVEY OF COMMERCIAL BANK EXAMINERS

INSTRUCTIONS

The purpose of this questionnaire is to obtain the views of bank examiners on several aspects of the commercial bank examination process as well as to determine how some phases of examinations are actually conducted. You will be asked to answer questions dealing with examination preparation, effectiveness and scope. In addition, you will be requested to consider the impact of some of the recent innovations in the examination process. Finally, you will be asked to relate your experiences with your agency's process for recommending changes in examination procedures. At the end of the questionnaire, there is a space for you to consolidate any additional comments you might have on topics we have covered as well as those we have not covered.

The questionnaire is numbered only to aid us in our follow-up efforts and will not be used to identify you with your response.

Your responses are completely confidential. Only aggregate data will be reported to anyone outside the General Accounting Office.

Please return the completed questionnaire in the enclosed, self-addressed envelope within 10 days after you receive it. If you have any questions, call Ed Laughlin or Joyce Corry on FTS (8) 452-2833 directly, or through your FTS operator. (If FTS service is not available, you may call collect on (202) 452-2833.)

I. BACKGROUND INFORMATION

1. What are your current major responsibilities as an examiner? (Check as many as apply.)

100.0%	1. /__/	Commercial (safety and soundness) examinations	(7)
7.7%	2. /__/	Trust examinations	(8)
9.6%	3. /__/	Consumer examinations	(9)
5.9%	4. /__/	EDP examinations	(10)
8.2%	5. /__/	International examinations	(11)
13.9%	6. /__/	Reviewing examinations	(12)
17.9%	7. /__/	Other (Please specify) ________ ________________	(13)

2. If your major responsibilities are commercial examinations, for how long have you been performing them? (Write in the number of years and months. If you are not primarily involved in commercial examinations, check "Not applicable.")

/ 1 / 6 / years, / 0 / 5 / months
(14-15) (16-17)

/__/ Not applicable (18)

THIS QUESTIONNAIRE IS CONCERNED WITH COMMERCIAL BANK EXAMINATIONS ONLY. IF COMMERCIAL BANK EXAMINATIONS ARE NOT YOUR MAJOR RESPONSIBILITY AND IF YOU CHECKED "NOT APPLICABLE" IN QUESTION 2, PLEASE DO NOT COMPLETE THE REST OF THE QUESTIONNAIRE, BUT RETURN IT IN THE ENCLOSED ENVELOPE. THANK YOU FOR YOUR COOPERATION.

3. Approximately how many commercial (safety and soundness) examinations have you participated in during the past 12 months? (Write in the number of examinations.)

/ 1 / 9 / (19-20)

4. During the past 12 months, which of the following types of banks did you primarily examine? (Consider only commercial examinations.) (Check one.) (21)

40.3%	1. /__/	Small banks (assets under $100 million)
7.1%	2. /__/	Medium-sized banks (assets between $100 million - $500 million)
12.0%	3. /__/	Large-sized banks (assets over $500 million)
40.5%	4. /__/	A combination of more than 1 of the above types of banks

5. During the past 12 months, in approximately how many of the commercial examinations in which you participated were you the examiner-in-charge? (Write in the number of examinations.)

/ 0 / 8 / (22-23)

6. Approximately how many of the examinations you participated in during the past 12 months resulted in the bank receiving a composite CAMEL rating of 3, 4, or 5? (Write in the number of examinations.)

/ 0 / 2 / (24-25)

APPENDIX III

II. PREPARATION FOR EXAMINATION

7. On the average, approximately how much time, if any, are you able to spend preparing for an examination before entering a bank? (Check one.) (26)

5.2%	1.	/__7	More than 2 days
4.2%	2.	/__7	2 days
15.0%	3.	/__7	1 day
53.6%	4.	/__7	A few hours
21.0%	5.	/__7	I usually do not spend any time preparing for an examination before entering a bank.

8. On the average, approximately how much time, if any, are you able to spend preparing for an examination after entering a bank? (Check one.) (27)

8.3%	1.	/__7	More than 2 days
5.0%	2.	/__7	2 days
18.1%	3.	/__7	1 day
44.3%	4.	/__7	A few hours
23.0%	5.	/__7	I usually do not spend any time preparing for an examination after entering a bank.

9. Is the total amount of time you checked in questions 7 and 8 more, less, or about the right amount of time needed? (Check one.) (28)

0.0%	1.	/__7	Very much in excess
0.3%	2.	/__7	Somewhat in excess
65.7%	3.	/__7	About right
28.7%	4.	/__7	Somewhat insufficient
4.5%	5.	/__7	Very insufficient

III. MONITORING OR SURVEILLANCE SYSTEMS AND REPORTS

The Federal bank regulatory agencies normally use the following systems and reports: the National Bank Surveillance System, including the Bank Performance Report, used by OCC and FRS; and the Integrated Monitoring System and the Comparative Performance Report, used by FDIC. These systems and reports provide examiners with bank performance information, and other types of data. You are asked to answer the following questions based on your own experience with the information provided by the systems and reports used by your agency.

10. How would you rate the information contained in the systems and reports, used by your agency, on the following characteristics? (Check one for each row.)

QUALITY OF INFORMATION	Very good 1	Good 2	Borderline 3	Poor 4	Very poor 5	Do not use 6	
1. Accuracy	23.3	63.	11.	0.5	0.2	1.4	(29)
2. Timeliness	2.8	20.	39.1	28.0	7.8	1.2	(30)
3. Clarity	15.7	61.7	17.9	1.7	0.7	1.6	(31)
4. Conciseness	15.1	60.5	18.4	2.6	1.2	1.4	(32)

11. To what extent, if at all, is the information you obtain from these systems and reports useful in deciding on the depth of the examination of the following areas of bank operations? (Check one for each row.)

AREAS	To a very great extent 1	To a great extent 2	To a moderate extent 3	To some extent 4	To little or no extent 5	Do not use for this purpose 6	
1. Adequacy of the level of earnings	15.0	38.1	25.9	12.0	4.5	3.8	(33)
2. Adequacy of liquidity	3.3	17.2	36.7	23.3	13.2	5.4	(34)
3. Trends in earnings performance	20.0	42.1	20.3	9.9	3.8	2.8	(35)
4. Adequacy of capital	7.1	27.8	35.7	15.7	9.6	3.5	(36)
5. Future expansion and/or contraction	1.2	9.2	29.0	24.9	22.6	12.2	(37)
6. Asset and liability management	2.6	22.3	34.4	24.7	11.1	4.2	(38)

APPENDIX III

12. In your opinion, how effective or ineffective are the systems and/or reports used by your agency in performing each of the following functions? (Check one for each row.)

SYSTEMS AND/OR REPORT FUNCTIONS	Very effective 1	Effective 2	Borderline 3	Ineffective 4	Very ineffective 5	Do not use for this purpose 6	
1. Identifying changes in a bank's current position relative to other banks	21.4	59.8	12.9	3.0	0.7	2.1	(39)
2. Identifying changes in a bank's performance since the last examination	14.4	52.5	25.2	4.2	1.4	1.6	(40)
3. Identifying long-term trends in a bank's performance	18.3	53.9	20.7	3.1	0.5	2.6	(41)
4. Identifying changes in a bank's assets and liabilities since the last examination	15.7	51.8	23.8	5.2	0.5	2.4	(42)
5. Helping you identify current problems in a bank at an early stage	7.3	35.7	40.3	9.6	3.7	2.8	(43)
6. Helping you identify potential problem areas in a bank	7.3	47.5	32.3	8.2	2.1	2.1	(44)
7. Helping you prevent problems from developing at a bank	2.4	25.6	45.6	17.0	4.9	4.0	(45)
8. Providing you with evidence that can be used as support in discussions with bank management	18.4	57.0	20.3	2.1	0.2	1.4	(46)

PLEASE CONTINUE WITH QUESTION 13, PAGE 4

IV. COMMERCIAL EXAMINATIONS

13. In your opinion, how **effective or ineffective** is the current Federal examination process in performing each of the following functions? (Check one for each row.)

EXAMINATION FUNCTIONS	Very effective 1	Effective 2	Borderline 3	Ineffective 4	Very ineffective 5	No basis to judge 6	
1. Evaluation of internal controls, including internal audit operations	16.0	56.9	23.1	3.1	0.3	0.2	(47)
2. Determination of existence of conflicts of interest	12.5	57.7	25.4	2.6	0.3	0.5	(48)
3. Assurance of the safety of depositors' funds	30.4	60.5	7.0	0.9	0.2	0.5	(49)
4. Evaluation of investment portfolio balance/imbalance	21.7	64.5	12.9	0.5	0.0	0.2	(50)
5. Assurance that insider loan limitations and reporting provisions of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 are being met	25.7	53.0	18.8	1.2	0.5	0.5	(51)
6. Assurance of compliance with laws and regulations (other than consumer)	21.4	64.2	12.7	0.9	0.0	0.5	(52)
7. Evaluation of deposit volatility	15.0	58.6	23.3	2.3	0.2	0.0	(53)
8. Evaluation of capital adequacy	25.0	59.8	12.9	1.2	0.7	0.2	(54)
9. Evaluation of asset quality	39.5	50.1	6.6	2.4	0.7	0.0	(55)
10. Evaluation of loan policies and procedures	27.7	60.7	9.7	1.2	0.0	0.3	(56)
11. Evaluation of management	25.4	63.1	8.5	2.3	0.2	0.2	(57)
12. Evaluation of liquidity	15.8	60.7	20.5	2.1	0.3	0.2	(58)
13. Evaluation of earnings	25.0	67.1	7.5	0.2	0.0	0.0	(59)
14. Evaluation of investment policies and procedures	18.4	64.7	15.0	1.4	0.0	0.2	(60)
15. Presentation of a comprehensive picture of a bank's overall condition	28.9	62.4	7.1	0.7	0.3	0.0	(61)

V. LIMITED SCOPE, MODIFIED OR SPECIALIZED EXAMINATIONS

To make better use of limited resources, bank regulatory agencies sometimes substitute modified or specialized examinations for full scope examinations. Please answer the following questions which pertain to the use of limited scope, modified or specialized examinations as a substitute for full scope examinations.

14. Of all the commercial examinations in which you have been involved in the last 2 years, approximately how many have been limited scope, modified or specialized? (Check one.) (62)

20.2% 1. /_/ All or almost all

32.7% 2. /_/ Most

22.6% 3. /_/ About half

14.4% 4. /_/ Some

7.5% 5. /_/ Almost none or none

2.3% 6. /_/ No basis to judge (Go to Question 16)

15. In how many of the limited scope, modified, or specialized examinations in which you participated over the past 2 years, was it necessary to expand one or more portions of the examination in order to adequately appraise a bank's overall condition? (Check one.) (63)

9.9% 1. /_/ All or almost all

15.1% 2. /_/ Most

11.1% 3. /_/ About half

35.3% 4. /_/ Some

24.3% 5. /_/ Almost none or none

 APPENDIX III

16. In your opinion, how effective or ineffective are limited scope, modified, or specialized examinations in helping your agency save time and examination resources? (Check one.) (64)

23.3%	1. /_7	Very effective
49.0%	2. /_7	Effective
19.0%	3. /_7	Borderline
4.7%	4. /_7	Ineffective
1.7%	5. /_7	Very ineffective
1.7%	6. /_7	No basis to judge

VI. EXTENSIONS OF CREDIT TO OFFICERS, DIRECTORS AND SHAREHOLDERS

The Financial Institutions Regulatory and Interest Rate Control Act of 1978 requires the filing of certain reports designed to disclose extensions of credit to executive officers, directors, and principal shareholders. Please answer the following questions which deal with the required reporting of these extensions of credit.

17. Have the reporting requirements made it easier or more difficult for you to determine whether abuses have taken place in a bank? (65)

7.0%	1. /_7	Very much easier
39.8%	2. /_7	Somewhat easier
43.3%	3. /_7	Neither easier nor more difficult
7.0%	4. /_7	Somewhat more difficult
2.6%	5. /_7	Very much more difficult

18. To what extent, if any, do the reporting requirements help provide you with better access to information on extensions of credit to officers, directors, and shareholders than before? (Check one.) (66)

3.0%	1. /_7	To a very great extent
17.2%	2. /_7	To a great extent
35.5%	3. /_7	To a moderate extent
18.8%	4. /_7	To some extent
25.0%	5. /_7	To little or no extent

19. In your opinion, to what extent, if any, have the reporting requirements helped increase the awareness of banks' boards of directors concerning the credit being extended to officers, shareholders and directors? (Check one.) (67)

9.7%	1. /_7	To a very great extent
30.4%	2. /_7	To a great extent
29.2%	3. /_7	To a moderate extent
13.2%	4. /_7	To some extent
13.6%	5. /_7	To little or no extent
3.5%	6. /_7	Do not know

VII. FORMAL ACTIONS

20. In the 5-year period between 1976 and now, how many times, if any, did you participate in an examination where the examiner-in-charge recommended one or more of the following actions? (Check one for each row.)

FORMAL ACTIONS	0 (1)	1-3 (2)	4-6 (3)	7-10 (4)	More than 10 (5)	
1. Cease and desist order	39.0	41.4	9.9	1.6	2.4	(68)
2. Civil money penalty	65.6	22.3	2.3	0.7	0.9	(69)
3. Formal removal or suspension proceedings against officers or directors	65.6	23.3	1.4	0.2	0.2	(70)
4. Memo of understanding	24.2	47.5	17.4	4.9	2.8	(71)
5. Written agreement	39.5	43.3	8.2	1.7	2.8	(72)

The following three questions refer to the deterrent capabilities of legal enforcement actions, that is, their effectiveness or ineffectiveness in discouraging illegal actions or influencing banks to take corrective action without their actual issuance or assessment.

21. In your opinion, to what extent, if any, does your agency's authority to issue cease and desist orders help it to achieve the following objectives? (Check one for each row.)

OBJECTIVES	To a very great extent (1)	To a great extent (2)	To a moderate extent (3)	To some extent (4)	To little or no extent (5)	No basis to judge (6)	
1. Discouraging illegal or unsound banking practices	17.4	37.0	23.0	10.8	6.1	5.2	(73)
2. Influencing banks to address problems within a reasonable time period	19.1	44.7	19.3	9.0	2.8	4.5	(74)
3 Influencing banks to solve problems before they endanger bank solvency	18.8	42.3	20.3	9.6	3.8	4.7	(75)

VII. FORMAL ACTIONS (continued)

22. In your opinion, to what extent, if any, does your agency's authority to assess civil money penalties help it to achieve the following objectives? (Check one for each row.)

OBJECTIVES	1 To a very great extent	2 To a great extent	3 To a moderate extent	4 To some extent	5 To little or no extent	6 No basis to judge	
1. Discouraging illegal or unsound banking practices	7.5	18.6	22.3	13.4	16.3	21.4	(76)
2. Influencing banks to address problems within a reasonable time period	7.3	22.8	21.2	15.0	12.2	21.0	(77)
3. Influencing banks to solve problems before they endanger bank solvency	7.5	21.0	20.9	15.0	13.4	21.7	(78)

23. In your opinion, to what extent, if any, does your agency's authority to formally remove or suspend bank officers or directors help it to achieve the following objectives? (Check one for each row.)

OBJECTIVES	1 To a very great extent	2 To a great extent	3 To a moderate extent	4 To some extent	5 To little or no extent	6 No basis to judge	
1. Discouraging illegal or unsound banking practices	9.9	26.1	22.3	13.0	12.2	15.8	(79)
2. Influencing banks to address problems within a reasonable time period	9.9	29.0	21.0	14.8	9.2	15.3	(80)
3. Influencing banks to solve problems before they endanger bank solvency	10.1	29.6	20.3	14.3	9.9	15.1	(81)

VIII. PROCESSES FOR CHANGE

24. In the course of your work, when the need for changes in bank examination procedures becomes apparent to you, what type of process, if any, does your region/district have for you to bring needed changes to the attention of your agency's management? (Check one.) (82)

15.8% 1. /__/ A standard process outlined in the examination manual or in other written procedures

55.3% 2. /__/ An informal process that is not outlined in the examination manual or in other written procedures

(Continue with Question 25)

17.0% 3. /__/ No process

7.3% 4. /__/ Do not know

(Go to Question 26)

3.0% 5. /__/ Other (please specify) ____________

(Continue with Question 25)

25. How is this process implemented in your region or district? (Check as many as apply.)

5.4% 1. /__/ Through filling out a standard form (83)

39.8% 2. /__/ Through preparing a written memo (84)

2.4% 3. /__/ Through following specific procedures other than 1 or 2 above (85)

39.0% 4. /__/ Through discussion at periodic meetings with agency management (86)

27.8% 5. /__/ Through ad hoc discussions with supervisors or agency management (87)

1.6% 6. /__/ Do not know (88)

2.8% 7. /__/ Other (please specify) ________ (89)

26. Regardless of whether your office has a process or not, please indicate which type of process, if any, you think should be available to examiners for bringing needed changes in the examination process to the attention of their agency's management? (Check one.) (90)

44.5% 1. /__/ A standard process outlined in the examination manual or in other written procedures

44.7% 2. /__/ An informal process that is not outlined in the examination manual or in other written procedures

0.3% 3. /__/ No process

4.0% 4. /__/ Other (please specify) ____________

2.1% 5. /__/ Do not know

6

 APPENDIX III

IX. COMMENTS

27. If you have additional comments on any of the items within the questionnaire or on topics not covered, please express your views below on this page. (91)

THANK YOU FOR YOUR COOPERATION.

Comptroller of the Currency
Administrator of National Banks

Washington, D. C. 20219

December 23, 1981

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

Dear Mr. Anderson:

We appreciate the opportunity to comment on your November 16, 1981 draft of a proposed report entitled "Despite Recent Improvements, Bank Supervision Still Could Be More Effective and Less Burdensome." In the draft report, GAO recommends changes in legislation to ease some reporting requirements now levied on banks and certain changes in examination policies, ostensibly to help banks promptly deal with problems. GAO also proposes evaluations designed to improve the integration of new techniques into the supervisory process.

The Office of the Comptroller of the Currency (OCC) shares GAO's concern for a more effective bank supervisory process and we offer these comments as one striving to achieve this objective.

As GAO notes in the draft report, the OCC's National Bank Surveillance System (NBSS) provides the agency with better data on banks' financial conditions. The objective of the NBSS is to give early warning through the identification and analysis of changing conditions or trends in a bank. GAO's primary criticism of the Federal banking agencies' surveillance systems centers on the absence of cost/benefit studies prior to or during their development. GAO specifically recommends that the agencies perform cost effectiveness evaluations as part of developing a better definition of the role and use of such systems. The OCC agrees that an evaluation of cost effectiveness is a desirable objective. Further enhancements are anticipated in the OCC's surveillance system and, as these improvements are made, cost effectiveness studies will be performed using more formalized methods.

Elsewhere in the draft report, GAO points out that the OCC's use of modified scope examinations has been effective in saving resources, however GAO recommends that each Federal banking agency determine the impact of modified scope examination on staff training and develop policies on the use of these examinations that consider training needs.

At the OCC, the specialized examination is an examining tool and not specifically intended as a training tool. In instances where specialized examination procedures are expanded to general procedures, an increased opportunity for training does result. Full general examinations continue to provide comprehensive on-the-job training and this type of examination accounted for 18% of the OCC's examinations in 1980 and 26% for the first nine months of 1981. We should point out, however, that we anticipate fewer general examinations in the years ahead in light of current and expected resource constraints.

The OCC agrees with GAO's observation that modified scope examinations limit training opportunities. At the OCC, policy on the use of modified scope examinations is set with the purpose of achieving efficient and effective bank supervision and is not limited by training needs. The impact of this policy on training should be evaluated and a determination made on how any resulting training needs will be met. This may be accomplished by conducting full scope examinations for training purposes or through other means.

The OCC provides specific training for new examining personnel through the training team concept which integrates formal and on-the-job training. We currently are revising and upgrading this training concept and developing a new uniform training program for all new examining personnel. The objectives of this program include training in the basics of all examination areas for non-commissioned personnel which will develop broader-based examiners, along with a better examination product.

In the draft report, GAO recommends that the OCC adopt new policies that encourage examiners to make non-binding but specific recommendations to banks in writing on ways to improve management. This recommendation causes great concern for the OCC and points to the philosophical issue of the role of the regulator. GAO's recommendation clearly crosses the line between a regulator's role in overseeing banks and the role of bank management in a private enterprise in which there is responsibility to shareholders. GAO's recommendation does not discern the regulator's responsibility in eliminating unsafe and unsound practices and in making recommendations to strengthen a bank's operations or condition, as contrasted to bank management's responsibility to provide decisions which govern a bank's direction and performance.

You should note that during the course of an examination, informal suggestions are offered by examiners for management's consideration. Prior to completion of the examination, examiners solicit from management -for inclusion in the report of examination- specific corrective action contemplated for the deficiencies noted. Corrective efforts of significant problems are addressed during the examination as well as monitored by the regional office after the examination. The identification of problems and concomitant corrective action weigh heavily in an examiner's assessment of the abilities of management.

The OCC believes that its procedures for evaluating management are dynamic and extremely well designed. When a specific bank supervisory response is indicated, appropriate action is taken. However, the decision-making process is a function and responsibility of bank management. In banks where management is considered competent, we reiterate the concern of making specific recommendations which include usurping bank management's authority. We will ignore for now the potential legal ramifications of implementing this recommendation. We are certain, however, that they are formidable and should be studied further by GAO.

In an apparent criticism of the agencies, GAO suggests that enforcement actions should be taken earlier to address management weaknesses that have potential adverse impact. Here, again, the OCC appears philosophically at odds with GAO. We believe that enforcement powers should not be used in inconsequential matters but rather should be reserved for those banks where serious problems are developing and showing an unsafe and unsound condition or violation of law. Again, GAO crosses the line into the bank management process -unnecessarily, we feel. As mentioned earlier, this line of demarcation is extremely important when viewing and evaluating effective bank supervision.

In closing, we concur with GAO that the agencies have improved bank supervision for safety and soundness since GAO's last comprehensive study in 1976. At the OCC, we specifically have implemented a dynamic examination process to reinforce the effectiveness of bank supervision. Where GAO's recommendations positively impact that process, the OCC is appreciative. Where there are differences, we would be willing to discuss our comments with you or your staff.

Sincerely,

C. T. Conover

C. T. Conover
Comptroller of the Currency

APPENDIX V

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

OFFICE OF DIRECTOR · DIVISION OF BANK SUPERVISION

December 14, 1981

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

Dear Mr. Anderson:

Chairman Isaac has asked me to comment on the GAO draft report ("Report") entitled "Despite Recent Improvements, Bank Supervision Still Could Be More Effective and Less Burdensome." Our responses to the principal findings are as follows.

Key Improvements Made in All Areas of Supervision

The agencies are credited with having made significant improvements in the supervisory process and identifying problems in banks before they reach a serious level. However, it is also concluded that evaluations of management are based on the financial condition of the bank, and formal supervisory actions are not utilized until there has been significant deterioration in a bank's condition.

That a causal relationship exists between a bank's condition and the capability of its management is acknowledged by GAO, although "emphasis on effects" is said to offer little insight into management's ability to solve problems. This is obviously true. However, the finding that the appraisal of management is "not emphasized enough until financial condition deteriorates" is less than convincing when it is noted that GAO's sampling shows that FDIC cited banks for management policy and procedural weaknesses in 81.2 percent of the cases at least three examinations prior to a bank being designated a problem institution. In our opinion, this constitutes "bottom line" evidence of the comprehensive nature of FDIC's management evaluation process.

The Report shows substantial increase in the usage of formal enforcement actions, which is attributed to the development of more specific enforcement guidelines. That formal actions are generally not taken until deterioration has occurred is convincingly demonstrated. The fact that the agencies feel a strong case must be made before pursuing legal sanctions is appropriately mentioned, as legal considerations are properly a crucial element in formal enforcement decisions. It is notable that despite a rather extensive discussion of the subject, the Report does not recommend that the agencies initiate formal enforcement action before a bank's condition has deteriorated significantly.

Policy Needed on Modified Examinations

The Report cites increased usage of modified scope examinations as an effective means of conserving agency resources, but raises a question as to whether the resulting reduced exposure to certain banking functions has an adverse impact on the training of junior bank examiner personnel. A recommendation is made that the agencies "ascertain the impact of modified scope examinations on staff training and develop policies on its use that consider training needs."

We share GAO's concerns in this area. The maintenance of a pool of highly trained examiners is essential to the proper discharge of our supervisory functions. Accordingly, a formalized training program has been developed which prescribes trainee and assistant examiner exposure to all of the basic functions of bank examination at appropriate stages in their career development through on-the-job training. Field training is supplemented with a variety of specialized in-house classroom courses. Regional Directors and Field Office supervisors are given wide latitude in scheduling full-scope examinations for the purpose of meeting training needs; no formal policies have been established because of the wide divergence in experience levels among the various Field Offices. However, we recognize the importance of the Washington Office making its position on this matter fully known to all Regional personnel and therefore intend to include training needs in the criteria for determining whether a full or modified examination should be conducted.

Reporting Requirements Unnecessarily Burdensome

The recommendation is made that Congress amend Title IX of the Financial Institutions Regulatory and Interest Rate Control Act (12 U.S.C. 1817(k)) to eliminate unnecessary and redundant reports submitted by bankers regarding loans to directors, officers and shareholders. In Chairman Isaac's October 30, 1981 testimony to Congress, a similar recommendation for legislation to eliminate this reporting burden was made.

Informal Methods of Solving Problems Could be More Effective

The Report indicates that bank regulatory agencies have been effective in utilizing informal persuasion to influence bank management to address deficiencies before they lead to serious problems requiring formal supervisory action. It is suggested, however, that these informal means could be made more effective by the increased use of specific written recommendations as to the method which bankers may employ to resolve these problems. The recommendation is set forth that the Corporation adopt new policies to encourage the use of ". . . non-binding but specific (written) recommendations to banks . . . on ways to improve management weaknesses."

It is recognized that the GAO views such nonbinding recommendations as a method of constructive criticism which will offer one or more possible methods that bank management may utilize in correcting deficiencies. We do not take exception to the suggestion that there is some room for improvement in the use of written comments, however, we do feel that in most well managed banks, the method of effecting corrective action should remain a management prerogative. Our examiners are expected to thoroughly analyze problem areas and to discuss these findings with bank management in order to obtain their assurance that prompt corrective measures will be taken.

The key element is, that after a problem has been identified, the implementation of corrective measures becomes our primary goal. Bank management is first given the opportunity to address the problems and develop solutions that are best suited for that particular financial institution. If this fails, and in those instances where bank management is not effectively addressing the problem, the Corporation utilizes a formal system whereby specific recommendations and management goals are set forth in a manner consistent with the severity of the individual situation. In our judgment, our present policy has proven to be effective and avoids unnecessary regulatory involvement in the daily operation and management decisions of the banking system.

Better Evaluation of Surveillance Systems is Needed

The Report suggests that surveillance systems have proven to be of little value as an early warning device, the system is not used to monitor the progress of problem banks, and the system's ability to evaluate asset quality and management is limited. GAO recommends that the Corporation conduct a cost/benefit analysis and expresses the view that such a study ". . . could accelerate the proper integration of surveillance and onsite examination."

The Corporation's Integrated Monitoring System was not intended to be used for tracking the progress of problem banks; this function is performed by periodic reports from the banks and more frequent examinations or visitations. That the system is of little help in evaluating asset quality is an obvious and inherent shortcoming; we fully recognize that an analysis of this important factor cannot be accomplished by offsite surveillance and, once again, this was not seen as a primary objective of the system. We do feel, however, that the system does provide a significant indication of management quality in the sense that management's financial decisions are reflected in the changing composition of the balance sheet and these decisions are, in turn, reflected in the income statement. Onsite examinations are of course necessary for a proper evaluation of management but the value of the surveillance system should not be so casually dismissed.

The system is intended to alert the Corporation to adverse trends or conditions which may develop between examinations and thus enable us to rearrange our supervisory priorities. Another objective is to provide examiners with an information package for use in pre-examination planning and thereby reduce the time spent on gathering/analyzing data during the examination.

It is recognized that the system has not fully met these objectives. However, we do not believe a cost/benefit analysis would be of any practical value at this time. The Corporation is committed to the use of offsite surveillance as a supplement to onsite bank examinations. More frequent and timely analysis of the financial condition of all banks is essential to effective supervision in this rapidly changing and increasingly complex environment. We feel that the Advanced Course in Bank Analysis which has been developed by our Training Center will provide our examiners with the basic knowledge to effectively utilize the surveillance system. A Surveillance and Analysis Unit has recently been established within the Division of Bank Supervision; its first priority is to overhaul the surveillance system operating procedures, and precisely define how and where the system fits into our overall supervisory mission. We are confident these actions will enable us to realize the substantial potential benefits which the Integrated Monitoring System has to offer.

We are grateful for the opportunity to respond to the Report. Although we do not wholly concur with the findings and recommendations we are nonetheless impressed with the quality of the Report and the professionalism of the GAO Auditors.

Sincerely,

Quinton Thompson
Director

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

December 4, 1981

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

Dear Mr. Anderson:

Although the General Accounting Office's draft report entitled, "Despite Recent Improvements, Bank Supervision Still Could Be More Effective And Less Burdensome" contains no recommendations to the Examination Council, the Council would like to comment on two matters in the report.

First, the Council agrees with the conclusion on page 16 in the report that the agencies have the ability to scrutinize insider lending at commercial banks without the reporting required by Title IX of FIRA. Moreover, the Council believes that the value to the public of such disclosures is minimal and is far outweighed by reporting burdens. Consequently, in legislative proposals recently recommended to the agencies, the Council has suggested that Congress should eliminate the reporting requirements of Title IX of FIRA.

Second, the Council does not believe that a review of the capabilities and of the role of surveillance systems at the agencies must await resolution of all of the differences in supervisory policies of the agencies as stated on page 56 of the report. Rather, it is believed that certain applications of surveillance systems can be successfully addressed in the existing environment. A preliminary review of the surveillance systems currently in use at the agencies has already been completed, and Council staff is developing some proposals that will be considered by the Council in the near future.

Sincerely,

Robert J. Lawrence

Robert J. Lawrence
Executive Secretary

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

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ADDRESS OFFICIAL CORRESPONDENCE
TO THE BOARD

December 15, 1981

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 draft GAO report dated November 16, 1981, concerning changes in bank supervision. The report reviews changes in Federal supervisory procedures and certain banking legislation within the last several years and gives GAO's overall assessment of agency progress since its initial study in 1976. The GAO concludes that the agencies have made significant improvements in gathering information on banks, identifying bank problems, and influencing banks to solve these problems. In light of these improvements, the report states that the Federal banking agencies now receive better information through computerized monitoring systems that provide analyses of bank financial condition and trends, identify bank problems in many instances before they become critical and take more formal actions to correct management practices that result in unsafe and unsound operations.

While noting these improvements, the GAO raises issues concerning the use of modified scope examinations in view of examiner training needs, the use of written recommendations to bank management to solve deficiencies at an early stage, and the costs and benefits of surveillance systems used by the agencies. Additionally, the GAO makes a recommendation to Congress to amend existing banking statutes to eliminate requirements on banks to report loans to officers, directors and shareholders. The GAO believes the statutory requirement is not necessary for supervisory purposes and results in an unnecessary burden on banks.

The Board supports the GAO's recommendation to reduce reporting burden and has testified before Congress on the need to reduce regulatory and reporting burdens on the banking industry. The Board believes that reporting requirements on insider transactions should be eliminated since a review of these transactions is an important element of the on-site examination. The Federal Reserve, together with other members of the Federal Financial Institutions Examination Council, has drafted proposed legislation to eliminate the reporting requirement and it is expected that this legislation will be submitted to Congress in the near future.

The Board generally agrees with the goals and overall direction of the report's other supervisory recommendations and believes that its existing procedures and practices essentially realize the same objectives. With respect to limited scope examinations, the GAO recommends that the agencies ascertain the impact of such examinations on examiner training and develop policies on their use that consider training needs. The Board believes that the most important considerations in determining the use of limited scope procedures are the condition of the bank, the quality of its internal systems and controls and the need for supervisory information. Nonetheless, the Federal Reserve does weigh on-the-job training considerations and resource constraints when appropriate in determining the use of limited scope examinations. Of course, many of the Federal Reserve's most important training needs will continue to be met through the System's and the Examination Council's examiner education programs. In this connection, the Board would like to point out that the Federal Reserve has taken a number of very significant steps within the last several years to upgrade and strengthen its examiner training programs and believes that it has a skilled and capable staff of senior and mid-level field examiners.

The GAO recommends that the Board adopt policies to make specific written recommendations to banks to solve problems prior to a deterioration in financial condition. The Federal Reserve has implemented policies concerning formal supervisory action for banks whose condition or managerial practices affect the safety and soundness of the institutions. Moreover, through comments in examination reports, supervisory letters to and meetings with management and boards of directors, and through written memoranda of understanding between Reserve Banks and bank management, the Federal Reserve makes recommendations for corrective action with respect to significant weaknesses as well as operational deficiencies that could lead to more serious problems in the future. The Board does believe, however, that supervisory intervention in the absence of clear cut problems or significant weaknesses could pre-empt legitimate management prerogatives and go beyond the proper role for a supervisory agency.

The GAO recommends that the Federal banking agencies analyze the costs and benefits of computerized surveillance systems in the context of defining the role and use of such systems in the supervisory process. The role and benefits of monitoring and surveillance techniques have been under continual review at the Federal Reserve for a number of years. Organizational and staffing changes as well as new procedures implemented within the last two years have been designed to integrate surveillance techniques into the supervisory and examination processes and to use these techniques where appropriate to improve the allocation of supervisory resources. For example, on-going monitoring techniques are used to identify banks, or areas within banks, that may require stepped up supervisory attention or special on-site examinations. The ability to spot trends and analyze large amounts of data through surveillance techniques has, in turn, helped the Federal Reserve to schedule examinations and target its supervisory resources on institutions most in need of supervisory attention. The Board believes that its surveillance activities have resulted in significant improvements in the cost-effectiveness of its supervisory efforts and will continue to explore ways to use computerized surveillance techniques to enhance the effectiveness of its overall supervisory program.

Sincerely,

William W. Wiles

William W. Wiles
Secretary of the Board

AMENDMENTS TO FEDERAL BANKING LAWS TO ELIMINATE DUPLICATE REPORTING OF INFORMATION BY BANKS AND PUBLIC DISCLOSURE OF CERTAIN INFORMATION

"Sec. 1. Section 22(g) of the Federal Reserve Act (12 U.S.C. 275a) is amended--

(a) by striking paragraph g thereof; and

(b) redesignating paragraph (10) as paragraph (g).

"Sec. 2. Section 7 of the Federal Deposit Insurance Act (12 U.S.C. 1817) is amended by striking paragraph (k) (as added by Title IX of the Financial Institutions Regulatory and Interest Rate Control Act of 1978)." 1/

or, alternatively

"Section 22(g) of the Federal Reserve Act (12 U.S.C. 275a) is amended--

(a) by striking paragraph g thereof; and

(b) redesignating paragraph (10) as paragraph (g)." 2/

1/This proposal would eliminate all requirements for reporting extensions of credit to executive officers and principal shareholders that are applicable to all banks, as well as the requirement for public disclosure of certain of these reports.

2/This proposal would only eliminate the section 22(g) requirement for reporting extensions of credit to officers and principal shareholders, while having in place the requirement for FIRA title IX reports on extensions of credit and public disclosure of such reports.

(233060)

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