BY THE COMPTROLLER GENERAL

Report To The Congress

OF THE UNITED STATES

Statutory Requirements For Examining International Banking Institutions Need Attention

The Edge Act enables commercial banks to engage in international banking and financial operations. Edge Act corporations are required by law to be examined annually. Federally licensed branches and agencies of foreign banks are subject to a similar requirement.

These requirements were established by the Congress when U.S. banks had little experience with international financial activities. Since then, banks have gained considerable experience, and most Edge Act corporations and federally licensed branches and agencies of foreign banks are in good condition.

Because of the rising number of poorly rated domestic commercial banks, it is increasingly important to direct relatively scarce bank examination resources to those financial institutions in poor condition. Accordingly, GAO recommends that the requirements for annual examinations of Edge Act corporations and for federally licensed branches and agencies be removed.

In addition, although required by law, the Federal Reserve does not bill Edge Act corporations for the costs it incurs in examining these institutions. GAO therefore recommends that the Federal Reserve comply with this requirement.

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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

In the past few years, international banking activities of U.S. financial institutions have increased dramatically and have attracted considerable interest. This growth has affected the examination responsibilities of the federal bank regulatory agencies.

As part of an inquiry into international banking, we reviewed the federal supervision of two types of financial institutions engaged in international banking: Edge Act corporations and federally licensed branches and agencies of foreign banks. This report recommends that the Congress repeal certain statutory requirements to examine these institutions which prevent the Federal Reserve and the Office of the Comptroller of the Currency from using their examination resources more efficiently. It also discusses the Federal Reserve's practice of not charging Edge Act corporations for examination costs as required by law. Our review was conducted pursuant to the Federal Banking Agency Audit Act (31 U.S.C. 67).

Copies of this report are being sent to the Director, Office of Management and Budget; the Chairman, Board of Governors of the Federal Reserve System; the Comptroller of the Currency; and the Chairman, Federal Deposit Insurance Corporation.

Milton J. Socolar

Acting Comptroller General
of the United States

COMPTROLLER GENERAL'S
REPORT TO THE CONGRESS

STATUTORY REQUIREMENTS FOR EXAMINING INTERNATIONAL BANKING INSTITUTIONS NEED ATTENTION

D I G E S T

GAO reviewed the Federal Reserve's supervision of Edge Act corporations and the Office of the Comptroller of the Currency's (OCC's) supervision of federally licensed branches and agencies of foreign banks. Edge Act corporations are banking institutions created specifically to offer international banking services to domestic and foreign customers. Federally licensed branches and agencies of foreign banks operating in the United States are licensed by OCC.

GAO conducted this review to assess how examining these institutions affects the resources of the federal regulatory agencies, particularly in light of the recent growth in international banking activities and in the number and size of Edge Act corporations and of federally licensed branches and agencies of foreign banks. During this review GAO found that

--The statutory requirements to examine annually Edge Act corporations and federally licensed branches and agencies of foreign banks are less flexible than the frequency standards set by the Federal Reserve and OCC for other institutions and limit the optimal use of scarce examination resources. (See pp. 10-15.)

--The Federal Reserve does not comply with its legal requirement to bill Edge Act corporations for examination costs. (See pp. 16-18.)

RECENT LEGISLATIVE CHANGES HAVE ENCOURAGED MORE UNIFORM REGULATORY TREATMENT BETWEEN U.S. AND FOREIGN-OWNED BANKS

Financial institutions located in the United States, whether domestic- or foreign-owned, have expanded their international banking activities in recent years. Domestic banking institutions have increasingly used Edge Act corporations to provide

international financial services to their customers. Foreign-owned financial institutions conduct the majority of their international banking activities in the United States through branches and agencies of their parent banks.

Legislation was enacted in 1919 to allow banks to form Edge Act corporations as federally chartered corporations that could engage in international banking and financial operations. The Edge Act can enhance the competitive position of U.S. banks by permitting them to establish these corporations outside the bank's home state. To help Edge Act corporations compete with foreign-owned financial institutions, the International Banking Act of 1978 (IBA) and subsequent Federal Reserve regulations relieved Edge Act corporations of certain restrictions, such as prohibiting branches of a corporation. The number of Edge Act corporations has grown dramatically since the late 1960s. As of December 31, 1982, 239 Edge Act corporations and branches had been established, with total assets of $23.4 billion. (See pp. 1-4 and 12.)

Until 1978, the licensing, supervision, and regulation of U.S. branches and agencies of foreign banks was solely a state, not a federal, responsibility. The IBA provided that these foreign-owned institutions could, at their option, be licensed and regulated by OCC. By December 31, 1983, 67 such institutions with more than $10.8 billion in total assets, were in operation. In addition, the IBA limited the operations of foreign-owned financial institutions in the United States by restricting the activities of their interstate branches and requiring their branches and agencies to establish deposit reserves. These provisions resulted in foreign-owned institutions being treated more like those owned by domestic commercial banks. The foreign-owned banks could also form Edge Act corporations to take advantage of those corporations' permitted interstate business activity. (See pp. 2-4.)

STATUTORY REQUIREMENTS HINDER OPTIMUM USE OF EXAMINATION RESOURCES

The Federal Reserve and OCC are required by law to examine Edge Act corporations and federally licensed branches and agencies of foreign banks,

respectively, at least once each calendar year. These examinations are conducted to assure the safety and soundness of these institutions. The annual examination requirement for Edge Act corporations was included in the original Edge Act of 1919. The Congress perceived a need to examine these financial institutions closely because U.S. banks, at that time, had limited experience in international finance. The annual requirement for federally licensed branches and agencies of foreign banks is contained in the IBA of 1978.

These statutory requirements limit the regulators' flexibility in scheduling bank examinations. As both GAO, in an earlier report, and the bank regulators have stated, examination frequencies should be based on factors such as the size, management, and financial condition of institutions rather than on strict time intervals. Both the Federal Reserve and OCC, as well as the Federal Deposit Insurance Corporation (FDIC), now have statutory authority to schedule other commercial bank examinations based on need rather than on fixed time frequencies (OCC having received such authority in 1980). In addition, Edge Act corporations and federally licensed branches and agencies of foreign banks have gained experience in international banking, and most are in good condition. Therefore, the annual examination requirements are no longer necessary. (See pp. 9-12.)

If criteria similar to that used for other financial institutions were used for examining Edge Act corporations and federally licensed branches and agencies of foreign banks, less frequent examinations would be conducted, fewer examination resources would be expended on those institutions, and these resources could be directed to institutions in most need of scrutiny. This redeployment would be particularly beneficial in light of the recent increase in the number of poorly rated banks. GAO estimates that in 1982, the Federal Reserve could have redeployed where needed approximately $1 million in Federal Reserve resources if it could have scheduled Edge Act corporation examinations using the flexibility it has for other commercial bank examinations. GAO could not estimate the amount of resources that could be allocated where most needed if the annual examination frequency for federally licensed branches and

agencies of foreign banks was changed because OCC is currently altering the scope of some of these examinations. (See pp. 10 and 12-15.)

The adverse impact of the statutory examination requirements would probably increase if the number of Edge Act corporations and federally licensed branches and agencies of foreign banks grows in the 1980s. While Federal Reserve officials believe growth in the number of Edge Act corporations may moderate, OCC officials foresee a continued rapid increase in federally licensed branches and agencies of foreign banks. Therefore, the ability of the agencies to schedule examinations based on need may take on even greater significance in the years ahead.

EDGE ACT CORPORATIONS NOT BILLED FOR EXAMINATIONS BY THE FEDERAL RESERVE, AS REQUIRED BY LAW

According to section 25(a) of the Federal Reserve Act (the Edge Act), the cost of examining Edge Act corporations, including the compensation of examiners, must be fixed by the Federal Reserve and paid by the Edge Act corporations. While its practices regarding such charges have changed from time to time, the Federal Reserve does not currently bill Edge Act corporations for their examinations. (See pp. 16-18.)

Federal Reserve officials maintain that the statute can be interpreted to give the agency the discretion to waive these assessments, as is the case for examination costs of member commercial banks. However, GAO believes that the statute requires the agency to charge Edge Act corporations for examination costs. The language in the statute and its legislative history offer nothing to contradict the explicit statutory direction to bill Edge Act corporations for these costs, including the compensation of examiners.

Federal Reserve officials also maintain that billing Edge Act corporations would conflict with one purpose of the IBA, which is to eliminate restrictions that hinder Edge Act corporations in competing with foreign-owned financial institutions. But the Congress, instead of eliminating the Edge Act corporation billing mandate, provided in the

IBA for charging examination costs to foreign competitors having a federal license (federally licensed branches and agencies of foreign banks); OCC charges for these institutions' examination costs. In addition, state banking authorities generally impose assessments for examinations on state licensed branches and agencies of foreign banks. Thus, since their competitors are charged for examinations, Edge Act corporations would not be at a competitive disadvantage if they were also billed for examination costs. (See p. 18.)

Billing Edge Act corporations for examinations would not only comply with the law but would also provide additional revenue for the Federal Reserve. In 1982, billings for all Edge Act corporation examination costs would have totaled $3.1 million. If the annual examination mandate were to remain, these costs would be expected to rise with any growth in the number of Edge Act corporations. Although billing revenue would be smaller if, as GAO suggests above, Edge Act corporations were examined less frequently, billing them would still offset the costs to the Federal Reserve for conducting the examinations. (See p. 19.)

RECOMMENDATION TO THE CONGRESS

GAO recommends that the Congress repeal the requirements for annual examinations, allowing the Federal Reserve and OCC to schedule examinations of Edge Act corporations and of federally licensed branches and agencies of foreign banks on the basis of factors such as the institution's size, management and financial condition. Specific legislative language to implement this recommendation is included as appendix IV to this report.

RECOMMENDATION TO THE CHAIRMAN OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

GAO recommends that the Chairman of the Board of Governors of the Federal Reserve System comply with the requirement to bill Edge Act corporations for examinations, including for the compensation of examiners, as provided in Section 25(a) of the Federal Reserve Act. (See p. 20.)

AGENCY COMMENTS

The Federal Reserve, OCC, and FDIC concur with the recommendation that the statutes requiring annual examinations of Edge Act corporations and federally licensed branches and agencies of foreign banks be repealed. (See p. 15.)

In its written comments the Federal Reserve restated that it believes the Edge Act gives it discretion to decide the extent of charges to make for examination costs, if any. As stated earlier, GAO does not believe the statutory language or legislative history provides for any such discretion.

The Federal Reserve also raised several policy reasons to support its current practice of not billing for these expenses. The Federal Reserve reiterated that, considering all these reasons, Edge Act corporations might be competitively disadvantaged if they were billed. GAO does not agree with those reasons. Both the federal and state-licensed competitors of Edge Act corporations are assessed for examination costs. Therefore, charging Edge Act corporations would not put them at a competitive disadvantage. (See pp. 20-22.)

If the Federal Reserve believes there are compelling reasons for not charging, then it should recommend a legislative change to the Congress.

Contents

APPENDIX

ABBREVIATIONS

FDIC	Federal Deposit Insurance Corporation
GAO	General Accounting Office
IBA	International Banking Act of 1978
OCC	Office of the Comptroller of the Currency

CHAPTER 1

INTRODUCTION

As part of a broader review of international banking, the General Accounting Office (GAO) examined the regulation of two types of competing international financial institutions operating in the United States: Edge Act corporations and federally licensed branches and agencies of foreign banks. The Edge Act enables both domestic- and foreign-owned banks to engage in international banking and financial operations through offices located outside as well as inside their home states. Foreign banks can also engage in similar activities in this country by establishing federally licensed branches and agencies.

In this report, we focus on the statutory requirements to examine both types of institutions and on the requirement to bill Edge Act corporations for examination costs.

DOMESTIC- AND FOREIGN-OWNED BANKS COMPETE FOR INTERNATIONAL BANKING BUSINESS

International banking activities can be conducted in the United States by both domestic- and foreign-owned financial institutions. Believing that foreign-owned institutions possessed competitive advantages over domestic ones, Congress passed the International Banking Act of 1978 (IBA). This act and subsequent regulations issued in 1979 by the Federal Reserve attempted to remove the advantage by making these competing foreign financial institutions subject to the same regulations as domestic institutions.

The Edge Act permits U.S. banks to engage in international banking

Edge Act corporations were initially authorized in 1919 with the passage of Section 25(a) of the Federal Reserve Act (12 U.S.C. 611 et.seq.), also known as the Edge Act. Before 1919, U.S. commercial banks could engage in international banking activities through their home offices. Branching restrictions, however, prohibited these operations outside the banks' home states. The Edge Act changed this: it allowed commercial banks to form federally chartered corporations that could engage in international banking and financial operations outside the state of their parent bank. In addition, Edge Act corporations could establish foreign branch offices outside the United States to conduct international banking or financing. Edge Act corporations are wholly owned subsidiaries of commercial banks and must be capitalized with at least $2 million in equity. At the same time, banks cannot invest more than 10 percent of their own equity capital in Edge Act corporations.

The Edge Act expands the international banking opportunities for U.S. banks. Non-New York banks, for example, have opened Edge Act corporations in New York City because of its importance as a center for international finance. Miami and Houston, which have recently emerged as growing financial centers for international activity, have also attracted Edge Act corporations.

Because Edge Act corporations' activities must be directed towards international or foreign banking, domestic activities are greatly restricted. Domestic banking activities must be "incidental" to international or foreign business. For example, Edge Act corporations can grant domestic business loans supporting the production of U.S. goods for export, but only if valid orders exist supporting the exports. Edge Act corporations' deposits can be used to pay international bills, such as those that arise from trade transactions; however, those deposits cannot be used by U.S. businesses to pay solely domestic bills, such as for the payroll or utilities of a U.S. office.

Edge Act corporations can also expand investment opportunities for U.S. banks abroad. U.S. commercial banks, forbidden to invest directly in foreign nonbank financial enterprises, can form Edge Act subsidiaries to make such investments.

Foreign-owned banks compete for international banking business

While U.S. financial institutions engage in international banking, foreign-owned institutions have located subsidiary banks, branches of their parent banks and agencies of their banks in the United States. Subsidiary banks are separately incorporated commercial banks owned by foreign individuals and institutions that are regulated and supervised like any other U.S. commercial bank. Branches of foreign banks can conduct all commercial banking activities engaged in by U.S.-owned domestic banks, such as lending, deposit taking and foreign exchange; agencies of foreign banks, however, are prohibited from accepting deposits.

Until the IBA was enacted in 1978, these foreign competitors of U.S. banks enjoyed significant advantages when operating in the United States since, unlike U.S. banks, they were not subject to federal regulation. Foreign-owned institutions, with the exception of their U.S. subsidiary banks, were regulated and licensed solely by the states in which they operated. State banking statutes determined the nature of foreign-owned banking offices permitted in their jurisdictions. Some states permitted the operation of branches; some only of agencies; still others authorized no foreign banking presence within their boundaries.

Since foreign-owned branches and agencies were not subject to a uniform, national system of regulation, and in particular to federal restrictions on branching, foreign-owned institutions were able to establish networks of branches and agencies throughout the country wherever permitted by state law. They could thereby conduct both domestic and international business in more than one state. Moreover, they were not required to meet any "internationally related" test for their business, as required of the Edge Act subsidiaries of U.S. banks.

Foreign-owned branches and agencies in the United States were also not subject to the reserve requirements[1] imposed on U.S.-owned banks (at that time just on members of the Federal Reserve System), which gave foreign-owned branches and agencies a competitive advantage in relation to U.S. institutions.

THE INTERNATIONAL BANKING ACT ENCOURAGES MORE UNIFORMITY IN REGULATORY TREATMENT

With the growth in number and size of foreign banking institutions, the Congress became concerned that only minimal federal regulation was applicable to them. The Congress saw a need for parallel regulatory treatment for both domestic and foreign financial institutions in order to eliminate any competitive advantages that foreign banks might enjoy. In an effort to achieve greater regulatory equality, the Congress passed the IBA of 1978. This act imposed restrictions on the operations of foreign-owned banks in the United States and reduced some of the regulations on U.S.-owned banks and, in particular, on their Edge Act subsidiaries.

Under the IBA, foreign banking networks in the United States became subject to the same deposit restrictions as U.S. commercial banks and their Edge Act corporations. This act required foreign banks operating in the United States to choose one state as their "home." Foreign banks are now permitted to accept domestic deposits only in branches within their home state. In branches elsewhere in the country, foreign banks can accept only those types of deposits allowed Edge Act corporations--that is, those predominantly international in character.

The IBA also authorizes the Federal Reserve to impose reserve requirements for all U.S. branches and agencies of large foreign

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[1]A reserve requirement is the percentage of customer deposits that banks must set aside in cash in their own vaults or with the Federal Reserve district bank in the form of non-interest earning reserves.

banks. As a result, most U.S. branches and agencies of foreign banks are required to maintain the same level of reserves as domestic-owned banks.

The IBA gives U.S. branches and agencies of foreign banks the option of being licensed by a federal authority--the Office of the Comptroller of the Currency (OCC). Therefore their option to choose either a federal or state license now mirrors that available to U.S. commercial banks. As of December 31, 1983, 67 branches and agencies of foreign banks, with more than $10.8 billion in total assets, were federally licensed and 385, with total assets of about $217 billion, were state-licensed.

The IBA also modified restrictions on Edge Act corporations that the Congress believed were hindering them in their competition with foreign financial institutions. It lifted the minimum 10 percent reserve requirement that had been placed on Edge Act corporation deposits, changing the level to that which applied to all Federal Reserve member banks. Subsequent regulations issued in 1979 by the Federal Reserve under this act permitted Edge Act corporations to establish branches across state lines. While banks could previously establish separate Edge Act corporations in different states, each had to be incorporated with at least $2 million in capital. The revised regulations permitted an individual Edge Act corporation to branch throughout the country, with only a single $2 million in capital required. This change could potentially aid smaller banks in opening Edge Act corporations.

While enhancing the competitive position of Edge Act corporations, the IBA also permitted foreign-owned institutions to own Edge Act corporations for the first time as well. Foreign-owned institutions are thereby able to establish Edge Act corporations in states that would restrict their agency or branch operations.

The following table summarizes the activities permitted and the restrictions imposed on domestic- and foreign-owned institutions in the United States that conduct international banking:

Activities and Restrictions on Financial Institutions Conducting International Business

Activity or restriction	Financial Institution: Domestic commercial banks	Financial Institution: Edge Act corporations	Financial Institution: Foreign banks: Branches	Financial Institution: Foreign banks: Agencies
Domestic deposit-taking	Permitted	Not permitted	Permitted only in home state	Not permitted
International deposit-taking	Permitted	Permitted	Permitted	Not permitted
Domestic lending	Permitted	Not permitted	Permitted	Permitted
International lending	Permitted	Permitted	Permitted	Permitted
Interstate branching	Not permitted[a]	Permitted	Permitted	Permitted
Reserve requirements	Required	Required	Required	Required[b]
Charged examination fees	Yes	No	Yes	Yes

[a]Though prohibited from establishing full-service banking facilities across state lines, some large banks have been able to conduct interstate banking activities by various other means, for example, by establishing loan production offices and credit card operations, and by acquiring failing banks in other states.

[b]The Federal Reserve is authorized to impose reserve requirements on all depository institutions eligible for FDIC insurance. However, agencies of foreign banks with total world-wide banking assets of $1 billion or less are not required to maintain reserves.

SUPERVISORY RESPONSIBILITIES FOR INTERNATIONAL BANKING ARE DIVIDED AMONG REGULATORY AGENCIES

In general, the supervisory responsibilities for domestic- and foreign-owned institutions operating in the United States rest with the same regulatory agencies. These responsibilities--indicated in the following chart--vary according to whether an institution is federally or state-chartered or licensed, whether it belongs to the Federal Reserve, and whether it is federally insured.

Supervision of Financial Institutions

	U.S.-owned financial institutions	Foreign-owned financial institutions
Federally chartered or licensed	OCC	OCC
State-chartered or licensed		
Federal Reserve member	Federal Reserve & states	Federal Reserve & states
Insured, non-Federal Reserve member	Federal Deposit Insurance Corporation (FDIC) & states	FDIC & states
Uninsured, non-Federal Reserve member	States	States

In addition, the Federal Reserve has residual authority over all branches and agencies of foreign banks to insure full compliance with the IBA. With this authority the Federal Reserve can, if it considers it necessary, review all domestic activities of a multi-state foreign bank operation. This consolidated approach can be useful when different regulators individually supervise a foreign bank's operations in different states.

Edge Act corporations are in a unique position, since they are regulated and supervised solely by the Federal Reserve, irrespective of the agency supervising the parent institution. When Edge Act corporations were authorized in 1919, American

financial institutions were entering international banking and foreign financing on a broad scale for the first time. Since these institutions lacked experience in such areas, the Congress believed Edge Act corporations should be placed under a national, uniform system of supervision. The then-recently-created Federal Reserve Board was charged with this responsibility. This national, uniform system of supervision by the Federal Reserve would, it was believed, enhance Edge Act corporations' standing abroad so that U.S. trading partners would have confidence in them.

OBJECTIVES, SCOPE, AND METHODOLOGY

We initiated this review to determine the impact of Edge Act corporation examinations on the federal bank regulatory agencies, especially in light of the recent growth in the number and size of Edge Act corporations. In a previous report, GAO recommended that to efficiently use resources agencies schedule examinations based on factors such as an institution's size, management and financial condition rather than strict time intervals.[2] In this review we therefore looked at how examinations of Edge Act corporations were scheduled. At the same time, we reviewed examination requirements for other financial institutions in light of our previously expressed position. This included the statutory provision to examine federally licensed branches and agencies of foreign banks annually. Although foreign banks also conduct business in the United States through subsidiary banks as mentioned on page 2, we did not focus on them in this report because they are examined like any other U.S. commercial bank.

Our review was conducted at OCC and the Federal Reserve, the agencies responsible for examining federally licensed branches and agencies of foreign banks and Edge Act corporations, respectively. We reviewed examination reports at the New York and Atlanta Federal Reserve Banks. We discussed specific reports as well as general examination issues with officials in these locations, as well as with the Federal Reserve Board in Washington. We also discussed examination issues relating to federally licensed branches and agencies of foreign banks with OCC officials in its New York regional office and in its Washington headquarters.

Section 25(a) of the Federal Reserve Act and the International Banking Act of 1978 provide the legal bases for the annual examination and billing requirements. We reviewed the

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[2]Federal Examinations of Financial Institutions: Issues that Need to be Resolved (GGD-81-12, Jan. 6, 1981).

legislative histories of the two acts and discussed applications of the pertinent statutory provisions with cognizant Federal Reserve and OCC officials.

We gathered expenditure data for 1982 from the agencies reflecting resources spent--such as salary and other costs--on examinations of Edge Act corporations and federally licensed branches and agencies of foreign banks. We estimated changes in these resource requirements if the annual examination mandate for Edge Act corporations was rescinded. This estimate was based on Federal Reserve officials' judgment that Edge Act corporations would probably be examined at the same frequency as state member banks. Because OCC is currently altering the scope of some of its examinations, we could not project changes in resource requirements for examining federally licensed branches and agencies of foreign banks if their annual mandate were repealed.

The review was conducted in accordance with generally accepted government auditing standards.

CHAPTER 2

STATUTORY FREQUENCY REQUIREMENTS HINDER OPTIMUM USE OF EXAMINATION RESOURCES

Federal regulators of financial institutions are responsible for assuring the safety and soundness of the nation's banking system. One important means of evaluating the condition of financial institutions is through on-site examinations. Scheduling and conducting examinations, however, depends on the availability of sufficient staff resources. As we previously reported, staffing constraints at the bank regulatory agencies have caused them to reduce the frequency with which they examined well-run financial institutions so that they could direct resources toward examinations of more troubled institutions.[1]

In recent years, the regulatory agencies have reduced reliance on fixed time frames for conducting examinations, preferring to base the frequency of examination on the condition of a bank. However, statutory requirements limit the agencies' discretion in setting their own examination schedules for examining Edge Act corporations and federally licensed branches and agencies of foreign banks. The Federal Reserve must examine all Edge Act corporations annually; OCC is required to examine federally licensed branches and agencies of foreign banks at least once each calendar year. Removing these requirements would permit the agencies to more flexibly deploy their examination resources.

EXAMINATIONS SHOULD BE SCHEDULED ACCORDING TO NEED

In our 1981 report on examinations, we recommended that the bank regulatory agencies schedule examinations of financial institutions considering a variety of factors, such as an institution's size, financial condition, and management, rather than in compliance with a static time frame. Given limited resources, if institutions are examined on a rigid time frame, well-run institutions might be visited too frequently and those in worse condition not often enough. A more flexible schedule would allow examination resources to be directed to those institutions most in need of scrutiny. Some could be examined more than once a year if necessary.

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[1]Federal Examinations of Financial Institutions: Issues that Need to be Resolved, (GGD-81-12, Jan. 6, 1981).

This flexibility could become more important because the number of banks having problems has been increasing. Federal bank regulators rate commercial banks on a scale from 1 to 5, with 1 being the best rating. A 4 or 5 rated bank is one that is generally characterized by unsafe, unsound or other unsatisfactory conditions and carries a relatively high possibility of failure or insolvency. From December 1980 to May 1984, the number of banks rated 4 or 5 has increased from 218 to 690.

Both the Congress and the bank regulatory agencies have taken steps to improve the flexibility and efficiency of commercial bank examination policies. The agencies have used the discretionary authority available to them to set the frequency of commercial bank examinations based on need. This flexibility has also enabled these regulatory agencies to adjust to staffing and budgetary constraints.

Until 1980, the frequency with which OCC examined national banks was statutorily mandated. Each national bank had to be examined twice every calendar year, although every 2 years one examination could be waived. The Depository Institutions Deregulation and Monetary Control Act of 1980 (Public Law 96-221) removed this requirement and gave the agency the discretion to set policies for examination frequency. GAO had recommended and OCC had supported such a legislative change.[2] Currently, national banks must be examined "as often as the Comptroller . . . shall deem necessary" (12 U.S.C. 481.)

OCC's examination policy is currently based in part on banks' conditions and amounts of assets. Examination frequencies range from 8 months for all banks in poor condition (those with a rating of 4 or 5) and larger banks in marginal condition (those with a rating of 3), to 36 months for a small, well-run bank (those with a rating of 1 or 2).

The Federal Reserve may examine member banks "at its discretion" (12 U.S.C. 248(a)). Its policy allows the period between examinations of a well-run state member bank to be extended to 18 months if no significant changes have occurred in the bank's financial condition, ownership or control, or senior management structure. All other banks are examined every 12 months, except those requiring special supervisory attention; these banks are examined at least twice a year.

The Federal Deposit Insurance Corporation (FDIC) is allowed to examine an insured state nonmember bank "whenever in the judgment

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[2]See GAO report, Federal Supervision of State and National Banks (OCG-77-1, Jan. 31, 1977).

of the Board of Directors an examination . . . is necessary" (12 U.S.C. 1820(b)). FDIC bases its examination frequency and scope on the condition of the bank. A well-run bank is to have either a full or modified examination at least once in each 18-month period, while a bank that is of special concern to the agency must receive at least one full examination every 12 months.

LEGISLATED ANNUAL EXAMINATION REQUIREMENTS ARE NO LONGER NEEDED

The statutory mandates to conduct annual examinations prevent the regulatory agencies from using need as a determinant of examination frequency. These examinations are conducted by the agencies to assess the safety and soundness of the financial institutions. While the original reasons for the frequency requirements were valid, they are no longer compelling.

In 1919, when the Edge Act was passed, U.S. banks were just beginning to become involved in international banking. Desiring close scrutiny of a banking system which was entering new lines of business, the Congress required annual examinations of Edge Act corporations to insure that these new lines of business did not adversely affect banks' safety and soundness.

Since then, U.S. banks have gained considerable experience in international banking, not only through Edge Act corporations, but also through banks' own subsidiaries located overseas. The latest figures available to us show that as of November 30, 1982, 551 foreign branches of U.S. banks, with assets of over $468 billion, reported to the Federal Reserve. This is in addition to Edge Act corporations and their branches (shown on page 12).

Moreover, experience has shown that the original level of scrutiny required by the 1919 Edge Act is no longer necessary. According to the Federal Reserve, almost all Edge Act corporations are in good condition. The Federal Reserve rates the condition of Edge Act corporations on a scale from 1 to 5, with 1 as the best rating. This rating represents a summary of the examiners' evaluation of the asset quality, earnings, and management of the corporation. According to Federal Reserve officials, only one out of 107 Edge Act corporations subject to examination in 1982 was rated any worse than a "2." (These examinations included coverage of the branch offices of Edge Act corporations.)

The annual examination requirement for federally licensed branches and agencies of foreign banks was one of the few exceptions in the IBA to a generally parallel regulatory treatment between these institutions and U.S. national banks. Both are supervised by OCC; yet Section 4(b) of the IBA requires OCC to examine federal branches and agencies "at least once in each

calendar year" (12 U.S.C. 3101(b)(1)). This approach enabled federally licensed branches and agencies of foreign banks to avoid a more frequent examination requirement that existed at that time for national banks. The Monetary Control Act of 1980 has since removed this statutory requirement for national bank examinations, giving OCC the discretion to vary examination frequencies for them. Federally licensed branches and agencies of foreign banks, however, are still required to be examined annually.

The condition of federally licensed branches and agencies of foreign banks, as measured by OCC, also evidenced no need for annual examinations. While OCC's rating system for these institutions is being changed, during 1982, 33 of 38 federally licensed branches and agencies of foreign banks examined were rated as satisfactory, the highest rating, with only one considered in poor condition.[3]

FEDERAL RESERVE RESOURCES COULD BE REDEPLOYED IF EXAMINATION MANDATE WERE REMOVED FOR EDGE ACT CORPORATIONS

The growth in the number of Edge Act corporations and branches has required commitment of substantial examination resources. The number of Edge Act corporations became significant in the 1960s and 1970s as U.S. banks markedly increased their international activities. The growth is illustrated in the following chart:

Number and Assets of Edge Act Corporations[a]

At year end	Number	Assets (billions)
1960	15	$0.6
1968	63	2.5
1972	92	6.0
1979	125	18.6
1980	157	18.8
1982	239	23.4

[a]Includes head offices and branches after December 31, 1979.

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[3]Not all of the 54 federally licensed branches and agencies of foreign banks established by December 31, 1982 were examined. An OCC official stated that some were not examined because of staffing constraints. Others were not examined because new branches and agencies are not examined until a few months after they obtain their federal licenses.

The IBA and subsequent Federal Reserve regulations encouraged further Edge Act corporation growth. By authorizing branching, the regulations restructured the organization of Edge Act corporations, as some existing independent Edge Act corporations were converted into branches of others, and new branches were also opened. These structural changes are reflected in the figures above for 1980 and 1982. Federal Reserve officials believe that further growth in the number of Edge Act corporations may moderate.

In 1982, the Federal Reserve spent more than 8,400 examiner staff-days on Edge Act corporation examinations. Costs for Edge Act corporation examinations that year--including supervision, travel, and overhead--totaled about $3.1 million.

If no annual examination mandate existed, Federal Reserve officials believe they would probably examine Edge Act corporations no more frequently than they examine state member banks. The Federal Reserve examines banks with high ratings at least every 18 months. If Edge Act corporations had been examined at a similar frequency in 1982, the $3.1 million examination expense would have been incurred over 18 months, resulting in a pro-rated yearly expense of $2.1 million. Thus, approximately $1 million in Federal Reserve resources could have been redeployed in that year. Furthermore, if the number of Edge Act corporations continues to grow in the future, the amount of resources that could be redirected would increase.

THE REQUIREMENT TO EXAMINE FEDERALLY LICENSED BRANCHES AND AGENCIES OF FOREIGN BANKS ANNUALLY LIMITS OCC'S ABILITY TO MAXIMIZE THE USE OF ITS RESOURCES

The increase in the number of foreign banks choosing a federal license for their branches and agencies, combined with the requirement to examine them annually, has made it difficult for OCC to schedule examinations. OCC has taken certain steps to minimize the impact of the annual examination requirement on its operations. But eliminating the mandate itself would give the agency the discretion to schedule such examinations when needed.

The impact of the annual examination mandate on OCC's operations was not significant until more foreign banks began to open or convert their operations to federally licensed institutions. The first federally licensed branch or agency of a foreign bank opened in 1980. However, growth in the number of these institutions since then and the requirement to examine them annually have increasingly drawn on OCC examination resources. By December 31, 1982, 54 branches and agencies of foreign banks, with total assets of more than $6.2 billion, had acquired a federal license. OCC expended about 1,200 staff-days (approximately $250,000 in examiners' salar-

ies and benefits) for the 1982 examinations of these institutions. Other resources associated with the examination process, such as overhead, were not readily available from OCC.,

The resource demands on OCC may well increase in future years if the number of federally licensed branches and agencies of foreign banks continues to grow. As of January 31, 1984, 71 federally licensed branches and agencies of foreign banks were in operation; 13 more had been approved but had not yet started operations; and applications for 13 others were pending approval. OCC officials expect a continued rapid increase in the number of federally licensed branches and agencies of foreign banks.

Believing that the annual examination requirement could have an adverse effect on the utilization of its resources, OCC is working within the statutory constraints to minimize this impact. Although the statute requires federally licensed branches and agencies of foreign banks to be examined at least once in each "calendar year," OCC can schedule examinations of the same federal branch or agency up to 23 months apart (January of year one, December of year two) if it determines that no greater frequency is required.

While this strategy can limit use of agency resources in the short run, it is of limited value when looked at from a longer perspective (i.e., in year three, an examination would be required in 12 months or less). Over time, the statutory requirement would still result in 10 examinations in 10 years.

To further alleviate the burden of annual examinations, OCC is planning to reduce the scope of some federal branch and agency examinations. This move would allow OCC to limit the scope of examinations when an institution is in good condition and to concentrate on those branches and agencies needing more frequent or extensive examinations. Nevertheless, any examination, no matter how structured, will require some level of resources, and to the extent the examination is conducted more frequently than necessary, these resources are not efficiently used.

The staggering of examinations within the calendar year requirement and the planned decrease in the scope of some federally licensed branch and agency examinations make it difficult to project the amount of resources that could be allocated to institutions in greater need of scrutiny if the annual mandate were removed. In general, OCC officials have indicated that they see no reason for federally licensed branches and agencies of foreign banks to be examined any more frequently than national banks, for which the period between examinations is as long as 36 months. By eliminating the annual examination mandate, OCC can better utilize its examination resources.

CONCLUSION

The statutory requirements for annual examinations of Edge Act corporations and of federally licensed branches and agencies of foreign banks do not allow the optimum use of examination resources by the Federal Reserve and OCC. These mandates force the agencies to schedule examinations in compliance with a static time frame, rather than on the basis of factors such as the institution's size, management and financial condition. Removing them would allow the agencies the same discretion to determine the frequency of examinations that they already have for other types of financial institutions they supervise; furthermore, it would enable them to direct resources to problem institutions most warranting scrutiny.

RECOMMENDATION

We recommend that the Congress repeal the legal requirements to conduct annual examinations of Edge Act corporations and federally licensed branches and agencies of foreign banks, thereby allowing the Federal Reserve and OCC to schedule these examinations on the basis of the soundness of the institution.

With regard to Edge Act corporations, GAO specifically recommends that Section 25(a), paragraph 19, of the Federal Reserve Act, as amended (12 U.S.C. 625), be further amended to eliminate the annual examination requirement and require examinations at such times as may be deemed necessary by the Federal Reserve System.

With regard to federally licensed branches and agencies of foreign banks, GAO recommends that Section 4(b) of the International Banking Act of 1978 (12 U.S.C. 3102 (b)) be amended to eliminate the annual examination requirement and thereby allow OCC more flexibility in scheduling examinations.

Legislative language to implement these recommendations is contained in appendix IV of this report.

AGENCY COMMENTS

The Federal Reserve, OCC, and FDIC concur with our recommendation that the statutes requiring annual examinations of Edge Act corporations and federally licensed branches and agencies of foreign banks be repealed. They agree that these statutory examination requirements restrict the flexibility that the Federal Reserve and OCC need to schedule examinations based on factors such as the size, management and financial condition of the institution, and thereby allocate available resources more effectively. The Federal Reserve and OCC do not believe their supervisory responsibilities would be compromised if examination frequencies were based on the same criteria used to examine the other financial institutions.

CHAPTER 3

EDGE ACT CORPORATIONS' EXAMINATION COSTS NOT BILLED BY THE FEDERAL RESERVE

Besides being required to examine Edge Act corporations every year, the Federal Reserve is statutorily mandated to bill these institutions for the costs of their examinations, including examiner compensation. The Federal Reserve's policy regarding these costs has changed several times since the Edge Act was passed in 1919. However, since 1969, it has not billed Edge Act corporations for any examination costs.

THE FEDERAL RESERVE IS REQUIRED BY LAW TO BILL EDGE ACT CORPORATIONS FOR EXAMINATIONS

The Federal Reserve Act requires the Federal Reserve to charge for the costs of Edge Act corporation examinations, including for the services of examiners. Section 25(a), paragraph 19, of the Federal Reserve Act, as amended (12 U.S.C. 625), provides that

> "Every such corporation . . . shall be subject to examination once a year and at such other times as may be deemed necessary by the Board of Governors of the Federal Reserve System by examiners appointed by the Board of Governors of the Federal Reserve System, the cost of such examinations, including the compensation of the examiners, to be fixed by the Board of Governors of the Federal Reserve System and to be paid by the Corporation examined." (Emphasis added.)

The language in the statute is without qualification or exception in stating that the Board is to assess the expenses of examinations against the Edge Act corporations examined. In particular, we find nothing in the Edge Act or in its legislative history to contradict the explicit statutory direction to include the compensation of examiners in the examination charge.

Had the Congress intended to make the assessment of these costs discretionary, it could have done so in clear and unmistakable language. Congress did give the Federal Reserve discretion in billing state-chartered member banks for examination costs. Although the Federal Reserve was originally required to assess examination costs against state-chartered member banks as well (40 Stat. 232), in 1930 the Congress rescinded this requirement, giving the Federal Reserve authority to waive these

charges, when deemed advisable (46 Stat. 814). This action was intended to prevent state-chartered member banks from being billed twice, since state banking authorities examined and charged these financial institutions. Edge Act corporations, however, are federally chartered and are examined only by the Federal Reserve. So, there would be no double billing, and the statutory language for billing Edge Act corporations remains the same as in 1919.

THE FEDERAL RESERVE DOES NOT BILL EDGE ACT CORPORATIONS FOR EXAMINATION COSTS

The Federal Reserve does not charge Edge Act corporations for examination costs. The Board of Governors maintains that it has always interpreted the Edge Act as giving it discretion as to how much it can charge, if anything. Documents given to us by the Federal Reserve do not provide a clear chronological record of its policy on billing Edge Act corporations. They do indicate that from 1919, when the act was passed, to 1934, the few Edge Act corporations that existed were generally not charged for examinations. From 1934 to 1950, the Board requested that OCC examine Edge Act corporations, still few in number, and the Board normally imposed no charges.

The documents also reveal that not until 1951 did the Federal Reserve explicitly address the issue of whether it had discretion to waive charges for Edge Act corporation examinations. In 1951, the Board's Legal Division found that the wording of the Edge Act gave the Board "some reasonable discretion" in fixing the amount of charges. Shortly thereafter, the Board, in accordance with this opinion, decided to charge Edge Act corporations and their foreign branches for only the transportation, subsistence, and incidental expenses related to examinations. The Legal Division's opinion, however, also noted that the Edge Act "apparently contemplates inclusion of salaries of examiners in the cost of such [Edge] examinations and that there may be some legal doubt whether their salaries should be excluded."

In 1958, the Board stopped examining foreign branches of Edge Act corporations. Since travel by Board personnel and examiners had therefore substantially diminished, the Board, relying on the 1951 opinion, did not assess Edge Act corporations for examination costs from that point on.

After making a 1969 pilot study, the Board resumed examining foreign branches of Edge Act corporations. However, it now no

longer billed these branches for even the transportation and subsistence costs incurred. Since that date the Federal Reserve has not charged Edge Act corporations for any examination costs based on its belief that it can fix these costs at any amount, or at zero. The Edge Act, however, calls specifically for the inclusion of the compensation of examiners in these costs. Examiner costs are identified in the Federal Reserve's expense system, so it is difficult to understand how they can be fixed at zero.

COMPETITORS OF EDGE ACT CORPORATIONS PAY FOR EXAMINATIONS

Another reason given to us by Federal Reserve officials for not charging Edge Act corporations was that the IBA was adopted, in part, to enable those corporations to compete effectively with similar foreign-owned financial institutions--chiefly, branches and agencies of foreign banks. In the officials' view, requiring Edge Act corporations to pay for examinations would put them at a competitive disadvantage with foreign-owned institutions. However, since most Edge Act corporation competitors do pay for the cost of their examinations, this factor would not disadvantage Edge Act corporations.

In 1978, after considering the competition between U.S. and foreign financial institutions, the Congress espoused in the IBA the doctrine of national treatment. According to this doctrine, financial institutions competing in this country, whether domestic- or foreign-owned, should be treated equally. In considering the IBA, the Congress reviewed the Edge Act and modified several restrictions affecting Edge Act corporations. It did not, however, delete the requirement to bill Edge Act corporations, but instead provided for billing federally licensed branches and agencies of foreign banks for examination costs. According to an attorney in OCC's Legal Advisory Services Department, OCC's position is that the IBA mandates charging for these branch and agency examinations. OCC therefore charges for these examination costs through a semiannual assessment based on total assets of the branch or agency.

Similarly, most Edge Act corporation competitors licensed by states would reap no significant advantage if Edge Act corporations were billed. Almost 90 percent of state-licensed branches and agencies of foreign banks are located in states where banking authorities assess examination costs.

With both their federally and state-licensed competitors subject to assessments for examination costs, Edge Act corporations should not be competitively disadvantaged if they were billed.

THE FEDERAL RESERVE WOULD INCREASE ITS INCOME BY CHARGING FOR EDGE ACT CORPORATION EXAMINATIONS

Complying with the statutory provision to assess Edge Act corporations for examination costs would provide the Federal Reserve with additional income. Charging Edge Act corporations for examination costs in 1982, for example, would have increased the Federal Reserve's earnings by about $3.1 million. This figure represents all costs incurred by the Federal Reserve in examining these institutions, as accumulated by its planning and control system.

The Federal Reserve System receives no direct appropriation. The primary source of income for the Federal Reserve System is interest on U.S. government securities held by the Federal Reserve banks. It also receives fees for services such as check clearing, interest on loans to banks, and other miscellaneous income. From this, the Federal Reserve deducts its expenses and returns the balance to the Treasury. In 1982, the Federal Reserve returned $15.2 billion (out of total earnings of $16.5 billion). So, the more income the Federal Reserve earns, the more it either could return to the Treasury or use in its own operations.

The amount of income gained, however, would depend significantly on whether or not the annual examination requirement remains in effect. If the mandate to examine Edge Act corporations annually remains, these annual costs can be expected to grow, with any growth in the number of corporations. On the other hand, if the annual examination mandate is repealed and Edge Act corporations were examined less often, the annual income gain would be less. Assuming that Edge Act corporations experience no growth and discounting any other cost increases, an Edge examination frequency of 18 months, for example, would generate the $3.1 million over a year and a half rather than over a year, resulting in annual income of approximately $2.1 million.

CONCLUSIONS

In spite of a statutory requirement, the Federal Reserve is not charging Edge Act corporations for the costs of examinations. The Edge Act does not provide the Board with authority to waive this requirement, nor has the Congress seen fit in subsequent deliberations on the Edge Act to modify the billing provisions.

By billing for these examination costs, the Federal Reserve would not only comply with the law, but would also realize additional income. At the same time, Edge Act corporations would not suffer competitively by paying for examination costs, since similar charges are generally imposed on their competitors.

RECOMMENDATION

We recommend that the Chairman of the Board of Governors of the Federal Reserve System comply with the statutory requirement to bill Edge Act corporations for examination costs, including for the compensation of examiners, as provided in section 25(a) of the Federal Reserve Act.

AGENCY COMMENTS

After reviewing a draft of our report, the Board's staff produced additional documents about the development of its fee-charging policy upon which it based its comments. We incorporated our analysis of those documents on pages 17 and 18 of this report.

In its comments on the draft report, the Federal Reserve maintained that, since the enactment of the Edge Act over 60 years ago, it has interpreted the act as giving it "discretion" in deciding whether and to what extent it should charge Edge Act corporations for examination costs. As the Federal Reserve documents given to us indicate, this position was most clearly expressed in 1951 in an opinion by the Board's Legal Division. However, as we stated earlier, we do not believe the act grants such discretion.

The Federal Reserve also noted that there are "sound policy reasons" for not billing Edge Act corporations for examination costs.

First, according to the Federal Reserve, such charges "could be viewed as a double assessment," since the parent banks of Edge Act corporations are often assessed for examination expenses by their primary supervisor based on a percentage of the bank's consolidated assets, including those of its Edge Act corporation. However, these assessments are designed to cover the supervisors' costs of examining the parent banks (and other supervisory agency costs) but not the costs of examining Edge Act corporations. Because only the Federal Reserve examines Edge Act corporations, fees assessed by it for that purpose would not duplicate fees assessed by other regulators charging to cover other costs. Moreover, not all supervisors assess for the costs of examinations based on a percentage of assets. For example, the New York State Banking Department charges banks directly for staff-days and other examination costs incurred; since the department does not examine Edge Act corporations, it does not charge banks for them. Thus, we do not believe billing Edge Act corporations for examination costs would be a double assessment on their parent banks.

Second, the Federal Reserve argued that while Edge Act corporations are required to maintain interest-free reserves, they do not have the same borrowing access to the Federal Reserve using the discount window as U.S. banks and branches and agencies of foreign banks. The Federal Reserve implied that this is an inequity which should be compensated for by not charging Edge Act corporations for examination costs. We question whether it is appropriate to attempt to offset the lack of borrowing access by waiving charges for examination costs. If Edge Act corporations are in fact competitively disadvantaged by their limited borrowing access, that issue should be addressed directly rather than indirectly. Accordingly, the Federal Reserve has proposed easing the restriction on Edge Act corporation borrowing access, although Congress has not yet acted on this proposal.

Furthermore, Edge Act corporations have indirect borrowing access through their parent banks. Those owned by Federal Reserve member banks can obtain access indirectly through the member bank, as the Federal Reserve pointed out in a study required by the IBA and transmitted to the Congress on June 13, 1979.[1] Similarly, since nonmember banks were granted direct access by the Monetary Control Act of 1980, their Edge Act subsidiaries would have indirect borrowing access as well.

Third, the Federal Reserve restated its view that charging Edge Act corporations for examination costs appears inconsistent with the IBA provision requiring the Board "to remove restrictions" that hamper Edge operations and to make Edge Act corporations more competitive with foreign-owned banking institutions. However, Edge Act corporations' competitors--foreign-owned institutions--generally are assessed for examination costs. Moreover, the Congress did not alter the Edge Act corporation billing requirement in the IBA, but instead provided for OCC and the Federal Reserve to bill the competitors for examination costs.

Although the IBA authorized the Federal Reserve to eliminate or modify its own policies that disadvantage or restrict Edge Act corporations in competing with foreign-owned institutions, the Congress reserved to itself the authority to alter

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[1]"Staff Report on the Advisability of Edge Corporation Membership in the Federal Reserve System," Board of Governors of the Federal Reserve System, June 13, 1979.

provisions of the Edge Act. Since the provision requiring the Federal Reserve to charge Edge Act corporations for examination costs remained in the Edge Act without revision, the Federal Reserve does not have the authority to waive this statutory directive.

If the Federal Reserve believes compelling reasons exist for not charging Edge Act corporations for examination costs, then it should recommend a legislative change to the Congress.

APPENDIX I

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

ADDRESS OFFICIAL CORRESPONDENCE
TO THE BOARD

February 8, 1984

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

Dear Mr. Anderson:

The Board of Governors appreciates the opportunity to comment on the draft General Accounting Office ("GAO") report, "Statutory Requirements for Examining International Banking Institutions Need Attention." We believe that it is especially useful to review such requirements in the context of the current international banking environment in order to assure that supervisory and examination resources are utilized in an effective and efficient manner.

The expansion of international activities by both U. S. and foreign banking organizations has resulted in a substantial increase in System resources devoted to the regulation and supervision of such activities. These activities can be expected to continue as an area of supervisory concern and therefore it is important that the agencies be permitted flexibility to respond to needs as they arise. As noted in the draft report, the GAO and the federal banking agencies are in agreement that the frequency of examinations of financial institutions should be based on factors such as the size, financial condition, and adequacy of the management of the institution rather than on a mandated time schedule. At present, the Federal Reserve System examines most State member banks on an 18-month cycle, with more frequent examination if the condition of the bank warrants closer attention. With respect to commercial banks, examination based on need has worked well in allocating resources and in reducing burden to the examined institutions.

With respect to Edge Corporations, examinations are conducted annually, as required by statute. For a number of reasons, however, less frequent examinations may be appropriate. Experience indicates that Edges as a whole are in very satisfactory condition. Edge Corporations are more heavily capitalized than are banks. In particular, the Edge Act requires an Edge Corporation to have minimum capital of

$2.0 million, an amount larger than is required for capitalizing a de novo commercial bank. The Board's Regulation K also imposes a 7 percent risk-asset ratio on any Edge Corporation engaged in banking. However, in fact, many Edges have capital ratios two to three times higher than the required minimum. In addition, because the majority of Edge Corporations are wholly-owned subsidiaries of large internationally-oriented banks, Edges have available to them or are able to attract experienced management and support personnel.

These factors all contribute to the generally very sound condition of Edge Corporations and are reflected in the examination results of the companies. Particularly because of the strong condition of Edge Corporations, the Board believes that it is reasonable to adopt the same flexibility now permitted with respect to examinations of State member banks. Any change in current practice must, of course, permit the Board to examine as frequently as necessary those Corporations whose condition or operations require supervisory attention. In this way, the Board can more efficiently perform its functions without sacrificing adequate supervision.

For these reasons, the Board strongly endorses the GAO recommendation that the requirement in the Edge Act mandating examinations on a yearly basis should be eliminated and that the Board should be given discretion to examine Edge Corporations as deemed necessary.

The draft report also recommends that the Board charge Edge Corporations for the cost of examinations and states that such charges are required by statute.

The Edge Act, which provides for international banking corporations to be chartered, supervised and examined by the Federal Reserve Board, resulted from a recommendation made by the Board to the Congress. For over 60 years, since the enactment of the Edge Act, the Board has interpreted the examination provision as providing discretion to charge all or some of the expenses of an examination to the Corporation or to absorb such expenses. A review of Board actions in this area (information on which has been provided to your staff) indicates that the practice as to the extent of charges for Edge examinations has changed from time to time in connection with review of and changes in other international examination policies. These practices have ranged from absorbing all costs of Edge examinations to charging for incremental expenses such as travel.

APPENDIX I

We believe that there are sound policy reasons to support the current practice of not billing such expenses. Most Edge Corporations are subsidiaries of commercial banks that are subject to an assessment for examination and other expenses by their primary supervisor. Such assessments are commonly made on the basis of the bank's consolidated assets, including the Edge Corporation. To impose additional charges on the Edge Corporation subsidiaries of such banks for the expenses of Federal Reserve examinations could be viewed as a double assessment of the Edge Corporation, a practice that the Board has consistently opposed. A policy against dual assessment was endorsed by the Congress in 1930 when, in response to a Board request, section 9 of the Federal Reserve Act was amended to provide the Board with the discretion to assess examination costs against State member banks or to absorb the costs of examination.

In addition, Edge Corporations are required to maintain interest-free reserves with the Federal Reserve System, maintenance of which itself is a cost to the corporation. However, Edge Corporations do not have the same access to the Federal Reserve discount window as U. S. banks and U. S. branches and agencies of foreign banks. Rather, they can borrow only in "unusual and exigent circumstances" - the restrictive standard applicable to entities other than depository institutions.

Charging for examination costs in these circumstances would not appear to be consistent with the Congressional mandate to the Board in the International Banking Act of 1978 to remove restrictions that hamper the operations of Edge Corporations and to make Edge Corporations more competitive with foreign institutions. For these reasons, it appears to us appropriate to have established the policy of not specifically charging for the expenses of examinations of Edge Corporations.

Again, we wish to express our appreciation of the opportunity to comment on the draft report. If you or your staff have any further questions in connection with these matters before your report is finalized, please feel free to contact Board staff to assist you.

Very truly yours,

William W. Wiles
Secretary of the Board

Comptroller of the Currency
Administrator of National Banks

Washington, D C 20219

February 13, 1984

Mr. William Anderson
Director, General Government Division
U. S. General Accounting Office
441 G Street, N.W., Room 3866
Washington, D.C. 20548

Dear Mr. Anderson:

We are pleased to respond to the draft report entitled "Statutory Requirements for Examining International Banking Institutions Need Attention". Our comments pertain only to the specific recommendations and conclusions regarding federal branches and agencies. Edge Act Corporations, as the report notes, are supervised directly by the Federal Reserve.

The comments in the report directly relating to supervision of federal branches and agencies are, for the most part, factually correct. The Office of the Comptroller of the Currency (OCC) concurs with GAO's recommendation that the present requirement of annual examinations for federal branches and agencies be eliminated. Statutory annual examination requirements have the potential of unduly hampering the flexibility the agency needs to direct examination resources in the most efficient and effective manner. The OCC does not foresee any potential problem if federal branch and agency examinations were based on the existing criteria used for national banks. Resources then would be concentrated on examining on-site the most problematic institutions more frequently, while well-run institutions would be examined on-site less frequently.

The Federal Reserve System has oversight responsibility for all branches and agencies of foreign banks in the United States. A critical part of that oversight responsibility is the review of branch and agency examination reports conducted by this Office and state regulators. Nevertheless, we do not believe that the Federal Reserve's ability to monitor foreign bank activity in the United States would in any way be jeopardized by less frequent on-site examinations of well-run branches and agencies.

APPENDIX II

Consistent with the need to allocate better the resources expended on examinations, the OCC has been developing a parallel system to the CAMEL rating for federal branches and agencies. While not fully compatible with the CAMEL system, it is nonetheless similar. This system, once fully developed, should assist in categorizing branches and agencies in such a way as to form a basis for determining examination frequency.

We thank you for the opportunity to comment on the draft report.

Sincerely,

C. T. Conover

C. T. Conover
Comptroller of the Currency

APPENDIX III

FDIC
Federal Deposit Insurance Corporation
Washington, DC 20429
Division of Bank Supervision

50 Years of Confidence 1933 - 1983

January 27, 1984

Honorable William J. Anderson
Director
General Government Division
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Anderson:

This is in response to your letter of January 9, submitting for our review and comment copies of a draft report entitled "Statutory Requirements for Examining International Banking Institutions Need Attention." The report recommends that the Congress repeal the legal requirements for annual examinations of Edge Act corporations and Federal branches and agencies and that the Federal Reserve comply with the statutory requirement to bill Edge Act corporations for examination costs.

We support the recommendation that the Federal Reserve and the Office of the Comptroller of the Currency be granted discretionary authority to examine Edge Act corporations and Federal branches and agencies on the basis of perceived need. Certainly, the statutory requirements for annual examinations of these entities are unnecessarily rigid and no doubt result in an inefficient allocation of resources. The FDIC for some time has had discretionary authority to examine insured nonmember banks under our supervisory jurisdiction and we feel this authority has been very useful in helping us to carry out our supervisory responsibilities in an efficient manner.

With regard to the question of the Federal Reserve billing Edge Act corporations for examination costs, we offer no opinions or views on the matter.

Sincerely,

Robert V. Shumway
Director

PROPOSED LEGISLATION

A. GAO Proposal to Amend the Federal Reserve Act to Allow for More Flexible Frequency Standards for Edge Act Corporation Examinations

Section 25(a), paragraph 19, of the Federal Reserve Act, as amended (12 U.S.C. 625), is further amended to read as follows:

> "Every corporation organized under the provisions of this section [12 U.S.C. Sec.611-631] shall hold a meeting of its stockholders annually upon a date fixed in its bylaws, such meeting to be held at its home office in the United States. Every such corporation shall keep at its home office books containing the names of all stockholders thereof, and the names and addresses of the members of its board of directors, together with copies of all reports made by it to the Board of Governors of the Federal Reserve System. Every such corporation shall make reports to the Board of Governors of the Federal Reserve System at such times and in such form as it may require; and shall be subject to examination [once a year and] at such [other] times as may be deemed necessary by the Board of Governors of the Federal Reserve System by examiners appointed by the Board of Governors of the Federal Reserve System, the cost of such examinations, including the compensation of the examiners, to be fixed by the Board of Governors of the Federal Reserve System and to be paid by the corporation examined."

The bracketed language would be deleted by the proposed amendment to Section 25(a), paragraph 19. This amendment would eliminate the annual examination requirement for Edge Act corporations; the change would provide the Federal Reserve Board with the authority to set more flexible frequency standards for Edge Act corporation examinations.

B. GAO Proposal to Amend the International Banking Act of 1978 to Allow for More Flexible Frequency Standards for Foreign Branch and Agency Examinations

Section 4(b) of the International Banking Act of 1978 (12 U.S.C. 3102(b)) is amended to read as follows:

"(b) In establishing and operating a Federal branch or agency, a foreign bank shall be subject to such rules, regulations, and orders as the Comptroller considers appropriate to carry out this section, which shall include provisions for service of process and maintenance of branch and agency accounts separate from those of the parent bank. Except as otherwise specifically provided in this Act [12 U.S.C., ch. 32] or in rules, regulations, or orders adopted by the Comptroller under this section, operations of a foreign bank at a Federal branch or agency shall be conducted with the same rights and privileges as a national bank at the same location and shall be subject to all the same duties, restrictions, penalties, liabilities, conditions, and limitations that would apply under the National Bank Act to a national bank doing business at the same location, including the requirements of section 5240 of the Revised Statutes (12 U.S.C. 481), except that (1) [the requirements of section 5240 of the Revised Statutes (12 U.S.C. 481) shall be met with respect to a Federal branch or agency if it is examined at least once in each calendar year] any limitation or restriction based on the capital stock and surplus of a national bank shall be deemed to refer, as applied to a Federal branch or agency, to the dollar equivalent of the capital stock and surplus of the foreign bank, and if the foreign bank has more than one Federal branch or agency the business transacted by all such branches and agencies shall be aggregated in determining compliance with the limitation; (2) a Federal branch or agency shall not be required to become a member bank, as that term is defined in section 1 of the Federal Reserve Act [12 U.S.C. Sec. 221]; and (3) a Federal agency shall not be required to become an insured bank as that term is defined in section 3(h) of the Federal Deposit Insurance Act [12 U.S.C. Sec. 1813 (h)]."

The underscored language, which is new, and the bracketed language, which would be deleted, constitute the proposed amendment to Section 4(b). This amendment would eliminate the annual examination requirement for federally licensed branches and agencies of foreign banks; the change would provide OCC with the authority to set more flexible frequency standards for such examinations.

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