Chapter 6
Bank Examination and Supervision

Banking in the United States today is probably more decentralized yet more closely regulated than in any other nation. Each of the approximately 15,000 banks in the United States is examined on a regular basis by at least one federal or state bank regulatory agency. On the federal level, the Office of the Comptroller of the Currency, the Federal Reserve, and the FDIC are, respectively, responsible for the examination and supervision of national, state member and insured nonmember banks. State banks are also examined and supervised by a state bank regulatory agency.

In addition to bank safety and soundness examinations, these agencies carry out compliance, electronic data processing and trust examinations and conduct numerous other supervisory functions as well as collecting and processing financial data. The system in place today has grown and evolved considerably from its modest beginnings in the early 1800s.

Historical Overview

In the early 1800s, banks were usually required to submit occasional financial reports to the state legislature or some other authority so that it could be determined whether they were operating within the powers of their charters. Actual examinations were undertaken only when suspicions were aroused. Even then, however, the examinations were quite superficial and generally ineffective because adequate enforcement powers were lacking.

Other reasons for state supervision related to the taxation of bank profits, state ownership of bank stock and the note-issuing role of state banks. In addition to the states' financial interests in bank operations, there developed concern that bank failures could adversely affect other banks and the public as a whole and that small depositors, in particular, could not adequately assess their exposure.

The New York Safety Fund was created in 1829, and in addition to being the first deposit insurance system, it was the basis for the present system of regular bank examination. Bank supervision, in connection with this fund as well as the others that followed, was more effective than previous attempts because the members of these generally small mutual organizations had a direct stake in minimizing losses. Thus, member bankers were not likely to overlook the misdeeds of a fellow member and were somewhat more appreciative of the role of supervision.[1] As these funds expired, though, so did their supervisory structures.

Federal bank supervision began in 1863 when national banks were authorized under the National Currency Act (which became the National Bank Act in 1864). The newly formed Office of the Comptroller of the Currency was empowered to supervise national banks and was generally credited with more effective supervision than were the state supervisory systems. A majority of banks soon became subject to the more stringent federal supervision since the taxation of state bank notes caused many banks to switch from state to federal charters. By the late 1800s, when the state banking systems had rebounded, the overall quality of state bank supervision was significantly improved. In 1863, there had been only five states that examined banks regularly; however, by 1914 every state performed this function.[2]

Despite improvements in the overall quality of bank supervision, intermittent high rates of failure continued. These failures often resulted in contractions in credit and the money supply, which prolonged recovery from recessionary periods. In 1913, as a response to this problem, the Federal Reserve System was created. State banks were given the option of Federal Reserve membership, which permitted for the first time direct federal supervision of state banks. Thus, by year-end 1913 the "special" nature of banking had resulted in a regulatory apparatus that included two federal agencies as well as the state supervisory systems. This situation was particularly noteworthy given that government regulation of business generally was extremely limited. Initially, however, the Federal Reserve was more concerned with its responsibilities as central bank, and it was not until the 1930s that it regularly exercised its bank examination rights.

Apparently the political compromise that led to the creation of the FDIC did not permit taking any supervisory authority away from existing federal or state agencies, so in 1933 the

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[1]Golembe, "Origins of Deposit Insurance," p. 116.

[2]Benjamin J. Klebaner, *Commercial Banking in the United States: A History* (Hinsdale, Illinois: The Dryden Press, 1974), p. 89.

FDIC became the third federal bank regulatory agency, responsible for some 6,800 insured state nonmember banks. The agency also had more limited regulatory responsibility relating to its role as insurer of national and state member banks. In addition to the supervisory goals of the other federal and state banking agencies, the FDIC had the more clearly defined goal of minimizing the risk of loss to the deposit insurance fund.

The financial debacle of the 1930s and the cautious atmosphere that subsequently characterized banking and the regulatory environment importantly influenced FDIC examination policies during its first several decades. Bank examiners continued to review bank balance sheets in a comprehensive manner, focusing particular attention on problem loan situations even when their potential impact on the insurance fund was likely to be minimal. During the first 15 years following World War II, the economy was relatively strong, loan losses were modest and bank failures were rare. In more recent years, though, bank competition began to increase, and so too did the exposure of the insurance fund. The analysis of individual loans became secondary to assessment of the risk exposure associated with overall bank loan and investment policies.

Today, the frequency of FDIC examinations, particularly for better performing, well-managed banks, has been reduced, and greater reliance is placed on the analysis of financial reports submitted by banks. Resources are now more heavily allocated to dealing with existing and potential problem bank situations. While part of the supervisory role of the FDIC relates to overseeing bank activities to ascertain compliance with the law, the principal purpose continues to be to assess the solvency of insured banks to better protect insured depositors and guarantee the continued solvency of the deposit insurance fund.[3]

Admission Examinations

The standards that were established for initial admission into the deposit insurance system were quite lenient relative to those that were to be applied in subsequent years. In order to be certified by the Secretary of the Treasury and thus qualify for in-

[3]The American Assembly conference on *The Future of American Financial Services Institutions* in 1983 included in its recommendations the statement, "The insurer should have the right to protect its interest by such means as examining and supervising the institution, requiring it to maintain a specified amount of capital . . . . The supervisory authority should rest only in the insurer." (p.8).

surance, a state nonmember bank had to present a certificate of solvency from its state supervisor, and the FDIC had to find that the current value of the bank's assets were at least equal to its liabilities. In other words, banks with unimpaired capital of zero or more were eligible for insurance. This lenient approach was in obvious recognition of the unstable condition of the banking industry and was necessary if the FDIC was to be successful in helping to reestablish public confidence in the industry. Too strict a qualifying standard would probably have prompted more failures by accelerating deposit outflows from those banks least able to withstand them. In fact, 10 percent of the state nonmember banks granted insurance had no capital funds.

Although the initial qualifying standard was quite straightforward, a heavy commitment of resources was necessary in order to evaluate the condition of each of the numerous banks applying for deposit insurance coverage. Bank examination consumed nearly all of the FDIC's efforts in the months prior to the establishment of the temporary fund on January 1, 1934. National banks (of which there were 5,061) and state banks that were members of the Federal Reserve System (802) were already being examined on an ongoing basis by their respective federal regulators and, upon certification by the Secretary of the Treasury, were automatically accepted for deposit insurance. State-chartered nonmembers, however, had to apply for insured status, and by the end of 1933 about 85 percent of these banks had done so. The FDIC, therefore, was faced with the rather prodigious task of examining 7,834 banks within a three-month period.

The Division of Examinations was created on October 1, 1933, and sought adequate permanent and temporary personnel from a variety of sources. Examiners from the Office of the Comptroller of the Currency and from the various state supervisory departments were transferred or loaned to the FDIC. Experienced bankers and others with previous examiner experience were also recruited. Field offices were established in 47 cities around the nation, mostly located in state supervisory offices or in offices of the Reconstruction Finance Corporation. At its peak in December of 1933, this temporary force contained nearly 1,700 examiners and 900 other field office support personnel.

The task of completing these admission examinations was largely accomplished as intended by the end of 1933. Of the 7,834 applicant nonmember banks, 83 percent were approved for insurance, 12 percent were rejected, four percent were still pending decisions and less than one percent remained to be examined. Virtually all of the 977 banks that were rejected were found to have liabilities exceeding their assets and were thus technically insolvent. The FDIC set up a special department to work with these banks to help them correct the impairments that prohibited admission to the fund. The corrective efforts included: (1) raising local funds, (2) director's guarantees, (3) purchase by local interests of bad assets and (4) investment in capital obligations by the RFC. The efforts were quite successful and, within a short period of time, only 140 of these banks were unable to qualify for insurance.

National and state member banks were admitted for insurance provided they were certified by the Secretary of the Treasury. In late 1933 the RFC was actively supplying capital funds to these banks (as well as to nonmembers), but as the year came to a close it was apparent that as many as 2,000 banks did not merit certification. President Roosevelt had told the nation that "the banking capital structure will be built up by the government to the point that the banks will be in sound condition when the insurance goes into effect."[4] Jesse Jones of the RFC was afraid that if it were disclosed that 2,000 banks were still unsound, public confidence would be severely undermined. Therefore, he arranged with Secretary Morgenthau to certify these banks in exchange for a promise from the RFC that they would be made sound within the following six months. In all, the RFC supplied $1.35 billion in bank capital during late 1933 and early 1934.

Capital Rehabilitation

After the initial admission examinations had been completed, the Division of Examinations dismantled its temporary examination force. By the end of 1934, field offices had been reduced from 47 to 15 and field office personnel had declined from nearly 2,600 to about 600, including 450 examiners. In early 1934, the FDIC shifted the emphasis of its examination function from determining minimal acceptability to the strengthening of weaker banks, particularly in the area of capital adequacy.

It was determined that minimal safety required banks to have net sound capital equal to at least 10 percent of deposits. Net sound capital was defined as equity, capital notes, debentures

[4]Jesse H. Jones, *Fifty Billion Dollars: My Thirteen Years with the RFC, 1933-1945* (New York: The Macmillan Company, 1951), pp. 28-30.

and reserves, less assets classified as worthless or of doubtful value, including bond depreciation. Based upon admission examination findings, all banks not meeting this standard were reexamined during the first six months of 1934.

Of the state nonmember banks admitted to the fund, 35 percent were found to be undercapitalized. Subsequent examinations and rehabilitative efforts reduced this ratio to just 13 percent by the end of 1934. Many other banks recorded significant improvements though they still fell short of the 10 percent standard. For example, 20 percent of the initial applicants had net sound capital of less than five percent, but by year-end 1934 only three percent were under this level.

The same cooperation accorded to banks initially rejected for deposit insurance was given to those insured banks requiring capital rehabilitation. During 1934, insured nonmember banks wrote off adversely classified assets equal to 20 percent of their total capital, but total capital increased by more than eight percent. The RFC supplied most of the funds used to offset these write-offs, while the remainder was supplied by local interests and earnings retention.

By the end of 1934, the concept of federal deposit insurance was generally accepted, even by many of its former detractors. As one measure that public confidence had been restored in the banking system, bank runs were no longer a significant problem, although they did not disappear altogether. Local concerns about the solvency of an individual bank still gave rise to occasional bank runs. In some instances, fears were aroused when it was felt that bank examiners had overstayed their "normal" visit to a bank, although these concerns were usually groundless.[5]

Safety and Soundness Examination Policy

After completing its first two examination tasks — admissions and capital rehabilitation — the FDIC again shifted its examination focus and concentrated on developing permanent examination policies and procedures. The purposes of these examinations were fivefold:

1. appraise assets in order to determine net worth;
2. determine asset quality;
3. identify practices which could lead to financial difficulties;
4. appraise bank management; and
5. identify irregularities and violations of law.

[5]Interview with Neil Greensides (former Chief, Division of Examinations), Washington, D.C., August 16, 1983.

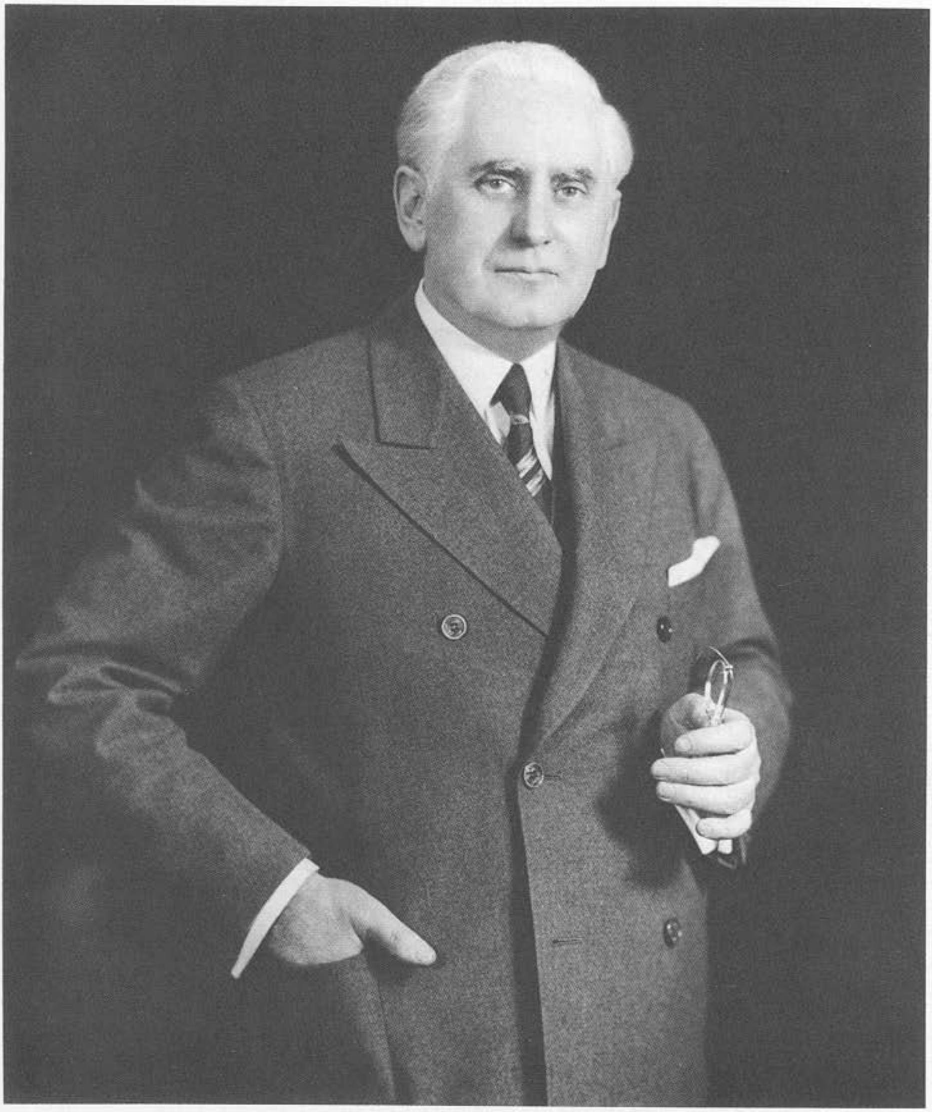
In addition to completing and reviewing its own examinations, in 1936 the FDIC began reviewing examination reports of national and state member banks because the FDIC had insurance exposure for these banks supervised by the Comptroller of the Currency and the Federal Reserve.

Some analysts came to the conclusion that supervisory policies in the 1930s were unduly harsh, and that recessionary periods were not the proper time to pressure banks to sell depreciated assets and reduce risk. Such a practice, it was felt, would lead to a restriction of credit as well as otherwise unnecessary bank liquidations or forced mergers. These concerns had been expressed to the Comptroller of the Currency in 1931, but policy directives at that time were generally ineffective.

A sharp recession had begun in 1937, rekindling these criticisms of bank examination policy, and in 1938 Secretary Morgenthau called for a conference of federal bank regulators. This time around, policy changes were strictly translated into examination procedures, resulting in more lenient asset valuation techniques. It was agreed that most bonds would be appraised at book value rather than market value, a policy believed to be more reflective of long-term investment quality. Moreover, a larger proportion of classified assets were to be included in the capital ratio computation. These policy shifts caused only a slight increase in aggregate capital/asset ratios (12.8 percent under the new method versus 12.6 percent under the old), but the difference at individual banks, particularly marginal performers, could be critical.

The 1938 Conference also led to a revision in the nomenclature of asset classification, establishing the four groups which have remained essentially unchanged: (I) not mentioned, (II) substantial and unreasonable risk, (III) loss is probable and (IV) uncollectible (immediate charge-off). Since 1949, categories II, III, and IV have been referred to respectively as substandard, doubtful, and loss.

Impact of World War II. The participation by the United States in World War II affected both the FDIC and the state banks that it supervised, and some of these effects carried on well past the 1940s. The short-term effects included such things as moving some headquarters' personnel to Chicago to vacate Washington office space for the war effort. The FDIC also suffered the same personnel shortage felt by many government agencies resulting from military enlistments and transfers to defense-oriented programs. A shortage of examiners meant that



Leo T. Crowley served as FDIC Chairman from 1934 to 1945. He had previously headed Wisconsin's Banking Review Board, which handled problem bank situations.

the FDIC was unable to fulfill its policy of annual bank examinations. Even after the war, government hiring restrictions and rapid growth in the economy led to a shortfall of qualified examiners, and it was not until 1951 that the FDIC was again able to examine all of its banks annually.

Another temporary effect of the war effort was the transfer to the FDIC of responsibility for the supervision and examination of about 4,000 federal credit unions, though the FDIC did not insure their deposits. Federal credit unions had previously been supervised by the Farm Credit Administration. In 1948, after six years of FDIC supervision, this responsibility was transferred to the Federal Security Agency.

FDIC Chairman Leo Crowley had come to be regarded by President Roosevelt as one of the best administrators, in or out of government, and he accepted numerous wartime responsibilities. While retaining his FDIC post, Mr. Crowley held nine separate government positions, including those of Alien Property Custodian and head of the Foreign Economic Administration, the latter a Cabinet-level post that included the lend-lease program. Thus, all foreign economic dealings, and assets and authorizations totaling more than $40 billion were administered from Mr. Crowley's FDIC office in the Press Building on Fifteenth Street. His ability as an administrator was typified by the fact that, despite his varied and awesome wartime responsibilities, Mr. Crowley invariably concluded his workday at 5 p.m. One evening each week was reserved for a poker game that included Jesse Jones of the RFC and the Ambassador from Brazil.

A more lasting effect of the war was a rapid decline in bank capital ratios, which had been on a downward trend for more than 50 years. However, the same process that led to rapid bank expansion — government financing — reduced the riskiness of bank investment portfolios. By the end of 1944, cash and U.S. government obligations had grown to 79 percent of bank assets. Between 1934 and year-end 1944, the capital/asset ratio of banks had declined from 13.2 to 5.9 percent. Despite the decline in capital ratios, bank examiners were not particularly critical of bank behavior due to the quality and liquidity of bank assets.

Post-World War II Supervision. At the end of 1946, bank loans comprised only 16 percent of assets. However, lending increased steadily, reaching 40 percent in the mid-1950s and 50 percent by the early 1960s. Throughout this period loan losses remained relatively small. Net charge-offs averaged considerably less than one-tenth of one percent of outstanding loans during the 1950s (see Table 6-1). As a result, no more than five banks failed in any year. Bank supervision, which was based on policies and procedures rooted in the banking crises and economic chaos of the 1930s, probably was overly conservative in the relatively prosperous 1950s and early 1960s. Bank lending had increased, but banks were still operating within traditional markets, and risks to the soundness of the banking system as well as to the deposit insurance fund were minimal, even during recessionary periods. Bank failures that did occur often received a great deal of attention, including Congressional hearings in some instances. This concern was reflected in the strict supervisory posture that prevailed during this period, but most bankers were content to accept tight regulation in exchange for the restraints it placed upon competition among banks and with nonbank financial institutions.

In the 1960s, banking began to diversify in a number of different ways. Branching accelerated, new liability instruments were developed and investments were broadened — facilitated by the development of holding companies, secondary markets and more widespread loan participations and purchases. Intensified competition and higher costs of funds put pressure on interest margins, and greater risks were assumed in order to increase portfolio yields. Banks in general, and large banks in particular, had become more susceptible to the effects of business downturns (as reflected in loan loss rates) and interest rate fluctuations. Beginning in 1973, the size and number of bank failures began to increase. The 1973-1975 recession resulted in sharply increased loan losses in 1975 and 1976.

The demands on bank supervision had increased, and it was becoming increasingly difficult to effect adequate supervision (risk assessment and reduction of excessive risk) within the confines of policies and procedures designed for the less diversified, less dynamic industry of previous decades. Edward Roddy, who served as the Director of the Division of Bank Supervision from 1971 until his death in 1975, was credited by many as having been particularly aware of the changes that were taking place in the 1960s and 1970s and of the growing inadequacy of existing supervisory policies. It was largely through his efforts that policies were overhauled in the early and mid-1970s, the first substantive changes in several decades.

Table 6-1. Loan Loss Experience of Commercial Banking Industry, 1950-1982

Year	Gross Loan Charge-Offs ($ Millions)	Gross Loan Loss Rate (%)[1]	Net Loan Loss Rate (%)[2]
1950	80.7	.1656	.0589
1951	85.7	.1516	.0614
1952	88.2	.1418	.0558
1953*	121.0	.1807	.0881
1954*	118.8	.1704	.0637
1955	116.6	.1460	.0619
1956	155.5	.1730	.1024
1957*	143.5	.1526	.0760
1958*	152.5	.1545	.0618
1959	147.8	.1355	.0490
1960*	300.2	.2524	.1735
1961	280.7	.2267	.1535
1962	268.9	.1959	.1217
1963	353.1	.2301	.1553
1964	426.6	.2463	.1452
1965	465.7	.2338	.1624
1966	576.9	.2625	.1899
1967	629.5	.2675	.1897
1968	654.9	.2513	.1625
1969	697.9	.2473	.1732
1970*	1,237.0	.4235	.3360
1971	1,404.5	.4412	.3415
1972	1,251.0	.3380	.2397
1973	1,548.0	.3481	.2607
1974*	2,418.3	.4245	.3435
1975*	3,790.2	.6548	.5602
1976	4,190.6	.6763	.5653
1977	3,607.2	.5103	.3955
1978	3,575.9	.4365	.3054
1979	3,771.3	.4077	.2782
1980*	4,888.1	.4916	.3629
1981*	5,320.7	.4842	.3445
1982*	8,152.7	.6894	.5546

* Denotes a predominantly recessionary year.

[1] The ratio of actual gross losses (charge-offs) to the volume of average gross loans.

[2] The ratio of net losses (gross losses − recoveries) to the volume of average gross loans.

In an important shift in FDIC policy, it was decided that smaller, sound, well-managed banks did not require annual full-scope examinations and that it would be preferable to concentrate examination resources on those banks presenting greater risk to the insurance fund. Banks of any size with known supervisory or financial difficulties would continue to be examined at least once a year. Banks with assets exceeding $100 million would have one full-scope examination in every 18-month period, with no more than 24 months between examinations. Banks under $100 million would undergo alternating full-scope and modified examinations, also once in every 18-month period with no more than 24 months between examinations. The modified examinations were to focus on areas of greatest exposure and on management policies and their effectiveness rather than on asset verification and appraisal.

In more recent years, an increased reliance on examination reports of other agencies and off-site monitoring have permitted FDIC examination schedules to be lengthened further. In 1983, the maximum permissible examination interval for the soundest banks was extended to 36 months, with one visitation or off-site review in each 12-month period in which the bank is not examined. Marginally unsatisfactory banks are examined at least once every 18 months with a visitation or review every six months. Banks with known serious problems continue to be examined annually, with visitations at least every three months. Bank size is no longer an overriding factor, but in all cases the Regional Director retains considerable discretion to order more frequent or thorough examinations.

Examination Procedures. While bank supervision policy changes have been relatively few, examination procedures have undergone frequent change, dictated primarily by the growth of branch banking, bank portfolio shifts and diversification. The number of banks insured by the FDIC has remained remarkably constant, generally between 14,000 and 15,000, but the number of branch offices has grown from about 3,000 in 1934 to over 41,000 today. For many years, all bank branches were examined annually, at the same time as the main office. More recently, both the frequency and scope of most branch examinations have been reduced, a situation made possible by automated and centralized record keeping at most multi-office banks.

Until recently, most examinations relied upon a "surprise" factor to reduce the likelihood that anyone in the bank would be able to cover up illegal practices. Examiners would appear without prior notice at the opening or close of business to examine bank records on an "as is" basis. Because a banker might have had sympathetic friends throughout the town who might warn him about an impending examination, examiners sometimes stayed in a nearby town or registered in hotels under a fabricated company name. Today, banks are often notified by the FDIC of an impending examination so that the bank can assemble the needed records. Obviously this is not the procedure when supervisory suspicions have been aroused or when a bank is in danger of failing (although frequent contacts are maintained in the latter situation). There have also been cases that required concurrent examinations of affiliated banks, most recently in early 1983 that resulted in the closing of several Tennessee banks.

Compliance, EDP and Trust Examinations and Other Supervisory Functions

The complexity of laws and regulations under which banks must operate increases the difficulty of the part of the examination that verifies a bank's compliance with these laws. In fact, in 1977 the FDIC separated much of this function from the basic safety and soundness examination, and compliance examinations are now conducted for this sole purpose. The responsibility of the compliance examiner is to enforce the consumer and civil rights statutes affecting state nonmember banks. These statutes include: the Truth in Lending Act, the Fair Credit Reporting Act, the Fair Housing Act, the Community Reinvestment Act, the Home Mortgage Disclosure Act, the Fair Debt Collection Practices Act, the Electronic Funds Transfer Act and the Equal Credit Opportunity Act.[6]

The problems addressed by these Acts are significant, but the solutions have often been reflective of the political, judicial or popular opinion that can change considerably over time. What is initially viewed favorably as strict enforcement may soon be interpreted as overregulation. Moreover, while the federal bank regulatory system might provide a convenient conduit for the enforcement of many consumer and civil rights statutes, it is possible that there are other more appropriate enforcing agencies

[6]A more thorough discussion of consumer legislation enforcement may be found in the FDIC's 1977 *Annual Report*, pages 25-27.

for these laws, which reflect concerns that are only marginally within the purview of bank supervision.

If technological development, primarily in the use of computers, has been a catalyst for bank growth and diversification, so has it aided examiners in developing procedures to keep pace with a changing industry. As the cost of electronic data processing (EDP) systems has declined, even smaller banks have found computers affordable. Banks that choose not to own their own computer system invariably purchase these services from other banks or non-bank suppliers. As with compliance, the FDIC now undertakes separate EDP examinations. As banks have become more reliant upon computers, the potential for computer-based theft or embezzlement has increased at least as much. EDP examinations focus on the adequacy of internal controls and physical security. The federal bank regulators perform joint or alternating examinations of data centers that service banks supervised by different agencies.

As early as 1935, the FDIC organized and trained specialized trust department examiners. Trust department examinations are also separated from regular safety and soundness examinations, though they are usually conducted concurrently.

The FDIC also is responsible for reviewing a variety of applications from insured nonmembers. These include applications for new branches, changes of office location and retirement of capital. Beginning in 1964, these banks had to notify the FDIC if they underwent a change of control (ownership), and in 1978 the FDIC was given authority to deny such a change. The Bank Merger Act of 1960 gave the FDIC the authority to approve or disapprove mergers in which the surviving institution would be under its supervision. In recent years, authority to approve applications for insurance, branches and some mergers has been delegated to the Regional Directors, reducing both the amount of required FDIC resources and processing time. The application forms also have been streamlined and require considerably less information.

Enforcement Powers

Bank examinations frequently uncover situations or practices that are unsafe or even illegal. Except in those instances that require criminal prosecution, the FDIC has several options available to rectify the situation: informal discussions, memoranda of understanding, cease-and-desist orders and termination of insurance.

Following each examination and at other times as needed, examiners meet with bank officials to discuss any problems which were noted during the examination. These informal discussions, often referred to as "jawboning," are usually successful in resolving minor infractions.

For banks found to be in marginally unsatisfactory condition, the FDIC requires written assurance from the bank that specific actions will be taken by the bank to correct its shortcomings. These agreements are referred to as memoranda of understanding (MOUs). They are still viewed as voluntary compliance by the banks but represent the final step before formal enforcement proceedings are begun.

For state nonmember banks found to be in unsatisfactory condition (or others which refuse to enter into an MOU), the FDIC can issue cease-and-desist orders to correct specific situations. A thirty-day notice is given and a hearing is set in the interim. If the order becomes effective and the violations persist, the FDIC may then go to federal court to obtain an injunction. The FDIC also has the authority to issue temporary cease-and-desist orders in the most severe situations. These orders become effective immediately and are made permanent only after the bank has had an opportunity for a hearing. Cease-and-desist orders were authorized by Congress in 1966, but it was not until 1971 that the FDIC issued its first order. The effectiveness of these orders was soon realized, though, and they have been used substantially more frequently in recent years. Because of an increase in problem banks and an aggressive approach to enforcement actions, a record 69 cease-and-desist orders were issued in 1982, and this number was equaled during the first half of 1983.

During its first twenty months of operation, the FDIC had no enforcement authority available to it other than "toothless" coercion of offending bankers, many of whom were opposed both to the concept of deposit insurance and to additional regulation. The Banking Act of 1935 gave the FDIC the authority to terminate a bank's insured status, and this remained the FDIC's sole enforcement authority until cease-and-desist powers were granted in 1966. However, in order to avoid this ultimate sanction, procedures were established to give any offending bank ample opportunity to correct its infractions. If a solution could not be agreed to during informal discussions, the FDIC would then notify the bank's primary supervisor (state or federal), and the bank had 120 days (or less, if so decreed by the supervisor) to correct the problem. At the end of this period, the bank would be reexamined. If the problem persisted, thirty-day notice of insurance termination was given and a hearing date set in the interim. Unless the hearing uncovered contradictory evidence, termination proceeded as scheduled. After notice of termination had been given to depositors, deposits as of that date continue to be insured for two years; any new deposits are uninsured. From 1934 through 1982, the FDIC began only 281 termination proceedings, including 18 in 1982. In about half of these 281 cases the necessary corrections were made, and in most of the others the banks merged or otherwise ceased operations before the termination date was set. In just 15 instances was insurance terminated or banks ceased operations after the date was set.

Cease-and-desist orders have several advantages over insurance termination as enforcement powers. First, they can be aimed at specific infractions. Second, they can be carried out in a more timely fashion, since actual termination of insurance can take more than two years. Third, they provide for involvement of (and therefore review by) the federal courts. Fourth, they can contribute to more safe and sound banking practices without the negative effects that termination proceedings might have. It should be noted, though, that insurance termination remains a viable and sometimes necessary alternative that is still used on occasion. In fact, it remains the FDIC's only significant enforcement power against national and state member banks. The Comptroller of the Currency and the Federal Reserve have cease-and-desist authority over these banks, and generally their supervisory actions protect the interests of the FDIC. As an insurer, though, the FDIC may interpret certain risk situations differently, but the more cumbersome termination proceeding is currently the FDIC's only alternative.[7]

Termination proceedings and cease-and-desist orders are almost always initiated for multiple infractions or problems. While the banking environment might have changed substantially over the years, the unsafe and unsound practices leading to termination proceedings or cease-and-desist orders have changed very little. In 1936, the most frequently cited problems were inadequate capital, excessive insider lending, excessive volume of poor loans, inadequate credit documentation, and incompetent management. In a survey forty years later (1976),

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[7]Legislation to give the FDIC the full range of enforcement powers over all insured banks is pending in Congress.

these same problems were cited, along with inadequate liquidity and consumer credit law violations.

The Corporation also has the authority to remove or suspend a bank director or officer. This power is infrequently utilized, however, because it can be warranted only by personal dishonesty or willful disregard for the safety and soundness of the bank.

The FDIC also may impose fines on banks or bankers for failure to comply with cease-and-desist orders or with other FDIC rules and regulations. For example, a violation of regulations governing insider lending can result in fines of up to $1,000 per day.

Problem Banks

One of the basic purposes of federal bank examination is to identify banks that pose a greater risk of loss to the federal deposit insurance fund. Banks found to be operating with a deteriorated financial condition, or in a manner likely to lead to such a condition, are subject to more thorough regulatory scrutiny. As has been the case since 1934, the primary supervisory tool is more frequent examination. This affords regulators the best opportunity for verifying the implementation of corrective procedures, measuring their effectiveness and, perhaps most importantly, maintaining communication with management. There are many factors that can cause a bank to be classified as a problem, but over the years the most frequent cause has been poor loan quality, resulting from incompetent or self-serving management.

Prior to 1978, the FDIC used a three-tiered system for problem bank classification.

Serious Problem - Potential Payoff: An advanced serious problem with an estimated 50 percent or more chance of requiring financial assistance by the FDIC.

Serious Problem: A situation that threatens ultimately to involve the FDIC in a financial outlay unless drastic changes occur.

Other Problem: A situation in which a bank has significant weaknesses but the FDIC is less vulnerable. Such banks require aggressive supervision and more than ordinary attention.

In 1978 a new bank rating system was established by the federal supervisory agencies.[8] On the basis of the safety and soundness examination, banks are rated from 1 to 5 in each of five areas: (1) adequacy of capital and reserves, (2) loan and investment quality, (3) management quality, (4) earnings and (5) liquidity. This rating is known by the acronym CAMEL, for Capital, Assets, Management, Earnings and Liquidity. In addition, a bank is given an overall, or composite, rating in the 1 to 5 range. Ratings of 1 or 2 are favorable and represent basic soundness; a 3 rating is marginally unsatisfactory. Ratings of 4 or 5 indicate problem bank status, with a 5 rating designating a high probability of failure.

The FDIC has maintained a confidential list of all insured banks that are considered problem banks. This list is constantly changing, but it generally represents less than four percent of the insured bank population. An analysis of the problem list during a seven-year period in the 1970s revealed these facts about banks in the most serious category:

- 34 percent eventually failed;
- 10 percent were merged into healty organizations without FDIC financial assistance;
- 1 percent received FDIC financial assistance to avert failure; and
- 53 percent improved to a less serious rating or were removed from the problem list altogether.

This system of problem bank identification, coupled with more aggressive supervision of these institutions, has undoubtedly prevented numerous failures. However, many other failures occur in banks not previously identified as problems. In some cases a bank's condition can deteriorate so rapidly that even a 12-month interval between examinations proves too lengthy. Most of the time, these failures relate to fraudulent behavior. Fraud or embezzlement is more difficult to detect at an early stage. In part, this is because bank examinations are not accounting audits; thus, they are not likely to expose accounting-related malfeasance. In the 1940s and 1950s, however, many smaller banks were still not being audited, either internally or externally, on a regular basis, and examiners may have been more attuned to identifying shortages. The FDIC, in

[8]The terminology of the rating system was modified slightly in 1980 to accommodate all depository institutions, including thrifts.

In W.C. Fields' movie, "The Bank Dick," stalwart bank examiner J. Pinkerton Snoopington overcame numerous diversionary shenanigans by guard Egbert Sousé. "I would go into tse-tse fly country if there were books to be examined," he asserted. Photo: Universal Pictures fact, had several examiners who were particularly skilled in this area and were utilized as trouble-shooters, traveling to banks around the country that were suspected of improprieties.[9]

In 1977, the FDIC implemented an early warning system to assist in the detection of problem or potential problem banks. The Integrated Monitoring System (IMS), utilizes selected financial ratios from the Reports of Condition and Income as well as examination information in order to identify possible adverse trends in a particular bank or in the industry in general.[10] Its primary use is in monitoring banks between examinations. IMS is computer-based and runs a number of separate tests to determine whether a bank meets minimally acceptable test levels of capital adequacy, liquidity, profitability and asset-liability mix/growth. A bank that "fails" one or more particular test (that is, it does not reach a minimally acceptable level) is referred for further analysis, possibly leading to earlier examination or visitation.

An additional supervisory tool, the uniform bank performance report (UBPR), was developed jointly by the federal bank regulatory agencies in 1982. The report is generated from financial data contained in regularly submitted reports of condition and income and provides a ratio analysis (on a current and trend basis) of an individual bank as well as a percentile ranking for each bank with respect to all banks of a similar size in the same geographic area. These reports, which impose no increased reporting burden, have facilitated the cutback in on-site examinations. In 1983 and 1984, changes in the Report of Condition will provide more detailed asset and liability information, increasing the usefulness of IMS and UBPRs, as well as other analytical systems and tools.

Federal and State Cooperation

Since the FDIC has exercised limited supervisory authority over member banks and shares supervisory responsibility for insured nonmember banks with the banking supervisors of the

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[9]Interview with John Early (former Director, Division of Bank Supervision), Washington, D.C., August 31, 1983.

[10]Reports of Condition, which are detailed statements of assets, liabilities and capital, are collected quarterly from all insured banks (semi-annually from uninsured banks); Reports of Income, which detail year-to-date income and expenses, are collected quarterly from insured banks.

various states, there is a heavy reliance upon interagency cooperation. FDIC interaction with the other federal bank supervisors began almost with its inception in 1933. In fact, some degree of interagency cooperation was built into the original FDIC structure with the placement of the Comptroller of the Currency on the FDIC's three-person Board of Directors. Standardization among federal agencies was sought and largely established for Reports of Condition and Income, and standardization has been sought for examination forms and procedures. The latter, of course, has been the most difficult to standardize, given the complexities and qualitative nature of so many aspects of the examination process. Interagency conferences were held as early as 1934 to coordinate asset appraisal techniques. While the level of cooperation among the federal agencies has generally been adequate, Congress has occasionally (and perhaps more frequently in recent years) mandated forums to assure agency interaction and coordination.

The 1970s saw the establishment of the Interagency Supervisory Committee, which was superseded by the Federal Financial Institutions Examination Council in 1978. Federal legislation in 1980 created the Depository Institutions Deregulation Committee. All of these organizations have had the task of coordinating the development and application of agency rules and regulations.

National banks hold nearly 60 percent of the deposits in insured commercial banks but have traditionally been outside of the supervisory purview of the FDIC. In December of 1983, the FDIC and the Office of the Comptroller of the Currency entered into an arrangement for the FDIC and the Comptroller to conduct joint examinations of all problem national banks (those with a CAMEL rating of 4 or 5). The FDIC also will join in the examination of a representative sample of nonproblem national banks, including multinational and regional banks and their overseas offices.

The arrangement will greatly enhance the FDIC's ability to assess risks to the insurance fund. Also, because the FDIC will participate in examination-related meetings with national bank management and in meetings at which national bank enforcement actions are determined, the FDIC will have a more active role in helping to control the risks these banks might pose to the fund. Finally, the arrangement will enable FDIC personnel to have earlier access to more detailed information about failing national banks, permitting a more orderly handling of the failures as they occur.

FDIC-state cooperation has been most significant in the area of examination. Because insured state nonmember banks are subject to both federal and state supervision and examination, emphasis has been placed on reducing this dual regulatory burden as much as possible. In 1934, some states accepted copies of FDIC examinations in lieu of performing their own, and other states conducted their examinations jointly with FDIC examiners, sharing the results and greatly reducing any inconvenience to the bank. Some states resented what they viewed as an infringement by a new layer of federal regulation, but in a few instances financial considerations forced their capitulation. Many state banking departments were severely underfunded in 1934. In fact, the state banking departments were sometimes combined with the office of the state insurance regulator so that the bank supervisory functions could be underwritten to some extent by the fees paid by insurance companies.

While there still exists a great deal of variation among the state banking departments and regulatory structures, wherever feasible the FDIC has entered into programs of concurrent, joint or alternating examinations. In 1974, the FDIC entered into a two-year experiment with the states of Georgia, Iowa, and Washington, wherein the FDIC would withdraw from the examination of certain banks and would rely on the state examination reports. It was hoped that the experiment would prove beneficial not only to the banks, in terms of reduced regulatory burden, but also to the FDIC and the states, which might eventually be able to reduce or at least reallocate their resources. The experiment did not include problem banks or others requiring special supervisory attention, nor did it include banks with assets of more than $100 million. Thus, the intent was to devote fewer resources to smaller, non-problem institutions. Following the two-year period, the FDIC examined many of the participating banks and found that, in most instances, the state reports were sufficiently reliable. There are now 27 states participating in the divided examination program, in which the FDIC and the states examine banks during alternate examination cycles, relying on each other's reports in the interim.

Summary

Even before the banking crisis of the 1930s and the establishment of the FDIC, two other federal agencies and each of the states supervised commercial banks even though the pre-1930s environment was characterized by relatively free banking. The FDIC was established to protect depositors, to restore confidence in the banking system and to eliminate most of the secondary consequences of bank failures that had afforded the rationale for bank supervision. The establishment of the FDIC provided an additional rationale for bank supervision, which was monitoring and restricting bank risk to limit the exposure of the insurance system.

When banking stabilized and failures declined, banks remained very cautious as the Depression experience continued to influence bank behavior. Bank supervision contributed to this cautious behavior and, by restricting entry, helped insulate banking from competition. For an extended period following World War II, bank supervisors continued to examine virtually all banks, assess asset exposure and carry out audit-type functions even though few banks posed any potential risk to the insurance fund.

When banks began to become more aggressive and the number and size of bank failures increased, the FDIC began to reallocate resources, reducing examination coverage of better performing banks. Most of the major changes in FDIC examination procedures in the past decade have been oriented toward improved supervision of problem and potential-problem situations. An arrangement entered into in late 1983 calling for joint FDIC/Comptroller examinations of certain national banks reflects this shift in FDIC orientation. The increased use of cease-and-desist powers, the development of a computerized monitoring system and the development of a uniform rating system were all implemented to facilitate the concentration of resources in areas that posed the greatest exposure to the deposit insurance fund. The lengthened examination cycle for favorably rated banks, reduced attention to branch and routine merger approvals and the divided examination program are all areas where the FDIC has reallocated resources from areas where insurance fund exposure is minimal. The FDIC has moved to the position where it considers the principal purpose of bank examinations to be to limit the exposure of the deposit insurance fund.