Texas Department of Banking
Testimony

Testimony Of Catherine A. Ghiglieri Banking Commissioner State Of Texas On Behalf Of The Conference Of State Bank Supervisors Before The Financial Institutions And Consumer Credit Subcommittee Of The House Banking And Financial Services Committee, United States House Of Representatives

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Good morning, Chairwoman Roukema and members of the Banking Committee. I am Catherine A. Ghiglieri, Banking Commissioner for the State of Texas. I am pleased to be here today to discuss the role of the state bank supervisor in bank examination.

I testify today on behalf of the Conference of State Bank Supervisors. CSBS is the professional association of state officials who charter, regulate and supervise the 6,802 state-chartered banks an more than 400 state-licensed foreign banking offices nationwide. While CSBS itself is not a regulator, through this association the 54 banking departments in the United States and its territories ave been able to work together to facilitate coordination of examination procedures among the states as well as with the federal regulatory agencies. CSBS is also the central source of state bank examiner training, through its state-of-the-art training center in Dallas, Texas.

Throughout the buoyant economy of the 1990s, the state banking departments and CSBS have worked hard to use the lessons of the past to refine a regulatory and supervisory system that continues to protect the safety and soundness of our banking system while encouraging economic growth. Through landmark cooperation and coordination among the state and federal banking regulatory agencies, smarter use and leveraging of technology, improved and continued examiner training, and an enhanced accreditation program of state banking departments, the state banking system is better poised than ever to handle supervisory and economic challenges of the future.

Overview

Regulation and supervision of banking in the United States, like banking itself, evolved over time, largely in reaction to historical events with no grand structure or design. As a result, the Unit d States today has a multiplicity of supervisory agencies at both the state and federal levels.

Critics of this system of multiple regulators have called it redundant and inefficient. On the contrary, CSBS believes that, with coordination and cooperation, a diversity of regulators actually strengthens the U.S. banking system by providing an environment that nurtures innovation and flexibility in both regulation and banking products and services. In protecting the safety and soundness of the nation's banking system, we believe that two sets of eyes are better than one. The comparatively lower failure rate for state banks versus national banks during the late 1980s and early 1990s, we believe, demonstrates the particular value that is brought to the examination process by the shared responsibilities of the states with the FDIC and the Federal Reserve.

The lack of a monopolistic regulatory environment has also created a healthy dynamic tension among regulators, resulting in a wider range of products and services available to consumers, lower regulatory costs, and more effective, more responsive supervision.

Choice in the regulatory environment can have many of the same benefits that it has in the business environment. Knowing that banks have a choice, regulators work smarter and more effectively. Dedication to safety and soundness of the financial institutions we regulate is our committed goal, and it is essential that we have the necessary resources to ensure that safety and soundness is protec ed. However, without an alternative, it would be easy for an expensive, inefficient and arrogant regulatory regime to develop that would burden and restrict financial institutions - disadvantaging hem in the marketplace - resulting in a less healthy banking system.

Role of the State Bank Regulator

State banking departments, in their role as primary regulators, serve a vital role in the examination and supervision of state-chartered institutions, licensed foreign banking operations, and bank holding companies that have affiliate banks chartered by the state. While the states' primary goal is to examine for safety and soundness, they may also examine for compliance with consumer laws and community reinvestment (CRA).Bank examinations collect current information that shows a bank's financial condition at the time of an exam; monitor the bank's compliance with state and federal rules and regulations; and evaluate the bank's policies and procedures for effective risk management. A bank examination is not an audit; state and federal regulators recommend or require that financial institutions have external audits in addition to their examinations.

Since the late 1980s, the focus of bank examination has changed from a historical overview - an analysis of trailing indicators - to a more proactive review of bank strategies, risk management practices, and internal controls. By the time an institution's capital is impaired, it is often too late to prevent broader problems within the institution; our goal now is to identify unsound practices and early warning signs before they cause more serious problems within the institution.

A particular attribute of the state banking system worth highlighting is the experience that state banking departments have regulating and supervising a broad range of banking and other financial entities.

Consolidated Supervision/Functional Regulation

As you mention in your letter of invitation, the Congress is now considering legislation that would allow broad affiliations between banks, securities firms, insurance companies and commercial entities. For many years, the states have been adapting their regulatory regimes to accommodate diversified financial institutions. In a number of states, the banking and securities commissioner are on and the same, and several state commissioners supervise both banking and insurance.

States have developed their own models of functional regulation, but we have no single model of what functional regulation should look like. For example, in Texas, state banking and securities regulators have cooperated in investigations, enforcement proceedings, and information-sharing. Now that banks are in the insurance business in Texas, we have instituted a similar process with the stat insurance department. All three agency heads and staff meet and communicate regularly about consumer complaints, unauthorized activities and exchanging confidential information. We are currently rafting confidential information-sharing agreements and protocols for consumer complaints to formalize our successful informal process. It has been our experience that cooperation and communication not agency turf concerns, best protect the citizens of our state. That said, we continue to believe strongly that one regulatory agency must retain responsibility for the overall safety and soundness of any financial institution. Functional regulation works well when examining an institution from the bottom up - from the consumer's point of view - but it is no substitute for reviewing the institution from the top down. To ensure safety and soundness, a regulator must be able to examine all the financial relationships between an insured institutions and its subsidiaries and affiliates.

The experience of examining a broad range of financial institutions and financial products has added to many state bank supervisors' ability to regulate for safety and soundness. The knowledge supervisors gain from regulating other institutions and services - ranging from banks, thrifts, credit unions, and consumer finance companies to securities, insurance, and real estate - keeps the supervisors aware of developing supervisory concerns in areas outside the traditional banking sector.

State and Federal Cooperation in the Examination

In 1991 the Federal Deposit Insurance Corporation Improvements Act (FDICIA) was enacted, requiring annual federal or state examinations for certain banks. Many states already had similar requirements for the examination cycle, and in almost all states, state and federal regulators shared this responsibility on either an alternating or a joint basis. In 1992, to standardize this system and me t the statutory requirement in a way that best used state and federal resources and limited regulatory burden, CSBS, separately with the Federal Reserve System and the FDIC, agreed to a system of cooperative examination among state and federal regulators. These working agreements generally identified those state-chartered banks to be examined on an alternating basis - with the state and federal regulators accepting each other's exams as their own -- and those to be examined on a joint or concurrent basis. The agreements also coordinated information-sharing and the division of labor among the states, the FDIC and the Federal Reserve. Overall, these agreements aimed to foster closer supervisory cooperation between the state banking departments and the FDIC and Federal Reserve in fulfilling the mandatory requirements of FDICIA for annual fu l-scope examinations.
For smaller banks with CAMELS supervisory ratings of 1 or 2, either the state or the FDIC or Federal Reserve may now conduct examinations on an alternating 18-month basis. They do, however, retain he option to examine these institutions concurrently or jointly.
For banks with lower CAMELS ratings (3,4 or 5) the state and the FDIC or Federal Reserve may each conduct independent examinations as they deem necessary, but coordinate them wherever possible to av id redundancy. These examinations can be conducted as frequently as found necessary, which could include monthly monitoring. In Texas, a bank with a rating of 3, 4 or 5

are examined every six months, with the state and the FDIC (or the Federal Reserve) alternating exams.
For large, complex banks, state and federal regulators often recognize the need to combine resources and conduct joint examinations, regardless of the institution's CAMELS rating.

On-Site and Off-Site Examination

A benefit of the dual banking system has been the innovation and experience that varying state and federal regulatory approaches have brought to bank examination and supervision.
For instance, the Office of the Comptroller of the Currency was a major innovator in supervision through off-site monitoring. This is an effective way to get a general overview of a bank's condition without the time and expense of an on-site examination. While the experiences of the banking industry in the 1980s demonstrated that off-site monitoring cannot be a substitute for on-site examination, both state and federal regulators now use a combination of on-site and off-site monitoring. In fact, CSBS has helped pave the way for coordination between the federal regulators in developing a number of new automated examination tools that will both strengthen the exam and allow better use of on-site time.
Improved Use of Technology in the Exam While nothing can substitute for the intangible benefits of on-site examination, federal and state banking regulators (through CSBS) have been working together to develop a number of new automated examination tools that offer the simultaneous benefits of making the supervisory process less burdensome for banks and more effective and efficient for bank regulators.

ALERT/Workstation

The Federal Reserve and the FDIC independently developed automated systems that extract loan information from the data bases of banks and allow examiners to review the loan data off-site. These pro rams reduce the amount of time that examiners spend transcribing data in the bank - time that the examiners can more productively use doing analyses.

At the suggestion of CSBS, representatives from the FDIC, the Federal Reserve and the state banking departments are now working to merge the FDIC's ALERT and the Federal Reserve's Examiner Workstation into a comprehensive examination tool that can be used by all examiners.

Training examiners to use these programs has been a top priority for state banking departments and the federal regulators. A recent CSBS survey indicated that a vast majority of state banking departments are now trained to use the FDIC's ALERT, or will be shortly. ALERT will form the basis for the comprehensive program, which I will discuss further in a moment.

ELVIS

The Federal Reserve Board, the FDIC and the state banking departments began full implementation of a common risk-focused process for the examination of state-chartered community banks on October 1, 1997.

The process targets the activities posing the highest level of risk at each institution and enhances examiners' ability to diagnose emerging problems. The process will provide greater consistency in examinations conducted by the Federal Reserve, the FDIC and the states, and is expected to result in examinations that are more efficient and effective.

This new program has been developed to assist examiners in their analysis of six of the most important activities of community banks, including loan portfolio management, securities, management and internal controls, earnings and capital. Supplemental modules review activities such as electronic banking , mortgage banking, and international banking.

The program emphasizes evaluation of a bank's risk management ability, so that examiners can better diagnose emerging problems. The program also allows for in-depth analysis if problems are identified after completing a core analysis, and makes it possible to document the examiner's decision-making process more thoroughly.

This new analytical tool has been automated for use on virtually all laptop computers through a stand-alone software program called "ELVIS" (Examiner Laptop Visual Information System). Training on his risk-based examination process has included examiners from all of the state banking departments.

GENESYS

A third tool, GENESYS - whose development originated in the FDIC - will build on the advances of ALERT/Workstation and the ELVIS program. It is an automated examination package that draws analytical data from agency mainframes, provides examiners with new ways to analyze the data by computer, and produces an examination report. The FDIC, CSBS, and the Federal Reserve are now working closely together to produce a product that we can all use, and that can draw data from either the FDIC or the Federal Reserve's mainframes. The FDIC is estimating that they will go into a full production release of GENESYS by the fourth quarter of 1998.

Interstate Supervision

Coordination and cooperation have been hallmarks of supervisory developments in the 1990s. The cooperative atmosphere that has developed will certainly continue to improve the quality of examinations and enhance our ability to protect the safety and soundness of the banking system.

With Reglue-Neal's enactment in 1994, CSBS, on behalf of the state bank supervisors, began a collaborative state/federal project to create a seamless supervisory system for state-chartered banks operating on an interstate basis.

CSBS formed, with the FDIC and the Federal Reserve System, the State-Federal Working Group. The stated goal of the working group was to minimize conflicts and duplication among the state and federal bank regulators in supervising interstate, state-chartered banks.

Separately and through the State-Federal Working Group, the state banking departments developed and signed two separate agreements: the Nationwide Cooperative Agreement, among the state banking departments, and the Nationwide State/Federal Supervisory Agreement for the coordinated supervision of multi-state, state-chartered banks. The agreements have served as a model for cooperation and coordination between the states and the federal regulators. The result of this collaborative effort has been an enormous reduction in regulatory burden for state-chartered banks.

Signed in November 1996, the Nationwide Agreements - unanimously agreed to by the state banking departments, the Federal Reserve and the FDIC - were the culmination of two years of work toward a system of "seamless supervision" for the interstate operations of state-chartered banks.

The agreements provide a single regulatory point of contact at both state and federal levels for state-chartered banks that branch across state lines. Under the agreements, home state law will appl in almost every area; state-chartered banks must comply with host state laws governing intrastate branching, community reinvestment, consumer protection and fair lending. Under the agreements, Federal regulators also work in a similar fashion, designating a single point of contact for the overall supervision of a multi-state bank.

When the State-Federal Working Group was formed, it created four subgroups to address specific issues related to interstate bank supervision: Applications, Examinations, Professional Development (examiner training), and Technology. Now, two years later, the subgroups have accomplished almost all of their goals, and their achievements have benefited far more than just interstate banks.

The Examinations subgroup's work has produced the State-Federal Supervisory Protocol, the series of regional state-federal supervisory agreements, and finally the landmark Nationwide State-Federal Agreement for interstate supervision signed last fall. The subgroup has also conducted a pilot for large and small bank supervision programs.

The Technology subgroup helped coordinate joint agency projects for automated examinations, loan analysis tools, improved Internet communications among state and federal agencies, and the production of ELVIS, the automated risk-focused analysis tool discussed earlier.

The Professional Development subgroup issued a policy statement on examiner education and training standards, and identified the core training courses necessary for all examiners.

Finally, the Applications subgroup developed interagency forms for notice of change in control, notice of change in director and senior officer, and biographical and financial reports.

Now, the State-Federal Working Group will expand its efforts beyond interstate supervision, continuing to improve coordination in the supervision of all state-chartered banks. The group has recently decided to focus the Technology subgroup's attentions on improving and expanding automated examination procedures and communication via the Internet, and is addressing joint agency efforts on Year 000 compliance. The Examinations subgroup will expand its portfolio to include compliance and consumer issues, and a new subgroup will monitor emerging issues and activities.

Examiner Education

Basic and continuing education of the regulatory staff at all levels is a key factor in the quality of supervision. Examiners must stay current on emerging issues, new examination policies and practices, and new examination tools.

State bank commissioners across the country take their responsibility for staff training seriously. With limited resources, however, all regulators face a continuing challenge in balancing the need for training with the need to maximize examiner productivity. More than three years ago, CSBS set out to address this challenge with the development of revolutionary new training methods, designed o minimize examiner time outside the department while maximizing comprehension and retention. CSBS now offers 19 separate computer-based training programs in a multimedia format that allows examine s to work on a time frame that meets the department's needs. These programs help us meet the training needs of our beginning examiners, credit specialists and examiners-in-charge in the most effect ve and efficient manner.

The training programs are developed by state examiners, for state examiners. Through the State-Federal Working Group, we can ensure that our training meets or exceeds the quality of training provided by the FDIC the Federal Reserve; in fact, CSBS is now exploring ways the FDIC and the Federal Reserve can use our training technology. The multimedia format makes it easier to update these training programs as necessary and get new information into the hands of the examination force more quickly.

CSBS also provides advanced management and emerging issues seminars for senior department staff and for such specialty areas as legal, trust, and technology. We share these programs with our federal counterparts as well. Dozens of representatives from the Washington, D.C. and regional offices of the FDIC and Federal Reserve System participate in our Legal Seminar and regularly attend our Technology Seminar. Others attend our Advanced Management and Emerging Issues programs. When senior regulatory staff members join together in these programs, it enhances the regulatory process for all of us.

CSBS worked closely with the FDIC and Federal Reserve System to coordinate training for 112 state and federal examiners on the ELVIS program at our state-of-the-art training center in Dallas, Texas. CSBS staff specialists also developed the "Help" function for the ELVIS program, so that state and federal examiners in the field can receive immediate assistance in using this valuable risk-focuses examination tool.

In 1997 alone, CSBS will provide training to nearly 1,000 state banking department and federal agency personnel, from entry level bank examiners to the highest levels of management. In addition, nearly 400 bankers have used our computer-based training programs.

Next year, CSBS will release a new self-paced computer-based program on risk management, developed in close cooperation with the Federal Reserve. This program will allow us to disseminate training n this important new safety and soundness concept to thousands of examiners and bankers in a quick and effective manner that would be impossible through traditional means.

Finally, CSBS is developing the "Banking School of Hard Knocks," a program that will examine the systemic causes that led to the financial industry's crisis of the 1980s and 1990s. With the loss of senior examiners through downsizing and retirements, we do not want to forget or lose the hard-won experience and lessons of those years. The course will review and analyze past regulatory, legislative, and banking strategies and tactics; identify red flags and lessons learned; and attempt to answer the questions: How can it happen again? How can we spot developing problems and solve or temper them?

For state bank supervisors such as myself, one of CSBS's most important education programs is its oldest program, its Annual Meeting. Our Annual Meeting is a unique program that brings state and federal bank regulators together with concerned state bankers to address emerging issues and concerns. The CSBS Annual Meeting is the nation's largest yearly gathering of senior regulators, and an invaluable opportunity for us to receive direct feedback from the institutions we supervise.

Accreditation of State Banking Departments

To measure and enhance the professionalism of state banking departments and their personnel, CSBS sponsors a comprehensive state banking department Accreditation Program.

CSBS developed this program during the early 1980s to recognize and encourage excellence in state regulation, and to boost confidence in state bank regulation. Today, the Accreditation Program involves a comprehensive review of the critical elements that assure a banking department's ability to discharge its responsibilities. The accreditation process includes an investigation of department a ministration and finances, personnel policies and practices, training programs, examination policies and practices, supervisory procedures, and statutory powers.

In setting high standards, CSBS is supporting public interest goals by identifying highly competent state banking departments and continually strengthening the capabilities of all departments. Stat banking departments use the accreditation process as a tool for improving their performance and ensuring that they maintain the resources necessary for professional, effective bank supervision.

As of October 1, 43 banking departments have been accredited. Twenty eight departments have received their first accreditation since 1990.

A banking department goes through a rigorous review conducted by an outside independent team of consultants comprised of individuals with both state and federal regulatory backgrounds. The steps for accreditation include:

- Completion of the Self-Evaluation Questionnaire: The department completes the questionnaire by grading itself on each of the questions and providing a brief narrative to explain the score.
- Visit by a Review Team: After receiving the completed Self-Evaluation Questionnaire, an independent Review Team is established to perform an on-site evaluation of a department. The Review Team interviews key personnel, evaluates examination reports, and grades the department on each of the Self-Evaluation questions. This team then writes a report to CSBS's standing Performance Standing Committee (PSC) summarizing its findings.
- Audit Team: An Audit Team (consisting of two-three current or former regulators) then meets to review the work performed by the Review Team. The Audit Team's role is to ensure consistency among reviews.
- Vote by the Performance Standards Committee: After receiving the recommendations from the Review and Audit Teams, the PSC then votes on the re-accreditation of the department.

The time to complete this process is roughly four to five months from the time CSBS staff receives the completed Self-Evaluation Questionnaire. The time needed for the department to complete the Questionnaire varies widely depending on the resources devoted to it.

An important aspect of the program is an annual review of each accredited department after its initial accreditation. Departments undergo a full on-site reaccreditation approximately every five years.

Foreign Bank Supervision

The states play a major role in the licensing and supervision of foreign banks operating in the United States. The states with the largest number of these entities are New York, Florida, Illinois, Georgia, California and Texas.

The Foreign Bank Supervision Enhancement Act (FBSEA) of 1991 gave the Federal Reserve System enhanced supervisory and regulatory authority over foreign banks operating in the United States. The states and the other federal agencies joined with the Federal Reserve Board to develop the Foreign Banking Organization (FBO) Supervision Program. The purpose of the FBO program is to improve and better coordinate supervision of these offices throughout the United States. The program creates a formal mechanism to facilitate information sharing among regulators about FBOs that have multiple locations across state lines. This new program is designed to give a common understanding of the entity in its entirety, and to coordinate supervisory activities. In particular, the program calls for supervisory agencies to increase interagency communication on examination plans, examination results and any follow-up actions.

The program was launched in March 1995, with all the states joining the Board and the other federal agencies in the implementation. The states and the federal agencies, through CSBS, sponsored a series of meetings held around the country to explain the enhanced supervision program to the foreign banks.

In addition to the FBO program, the states and the Federal Reserve jointly developed an updated supervision and examination manual that is now used by both the states and the federal agencies.

We believe that this coordinated approach is working well and has increased our collective supervision. The states have worked very hard to ensure that foreign banks have a streamlined examination system. We are now forming a Working Group that includes supervisory representatives from those states with large numbers of foreign banks, states with relatively few foreign banks, the Federal Reserve, other federal bank supervisory agencies and CSBS. The mission of the Working Group will be to introduce - where possible -- the kinds of efficiencies incorporated in the domestic Nationwide Cooperative Agreement for interstate branching, recognizing that there are fundamental legal and operating differences between state-chartered insured depository institutions and multi-state branches of foreign banks chartered outside of the U.S. The Working Group is expected to complete its work in six to nine months.

Conclusion

As evidenced by our pursuit of regulatory and supervisory coordination and cooperation, and our dedication to improved examination through the use of technology, enhanced examiner education, and our accreditation program, the state bank supervisors and CSBS have refined and improved our supervisory system to allow us protect and foster the nation's state banking system in both good times and bad.

Again, we appreciate this opportunity to testify on this very important subject and look forward to any questions you and the members of the committee might have.