

# House Committee on Appropriations

## **Fiscal 2004-2005 Budget Hearing**

*Material Provided during Testimony of:*

Randall S. James

Banking Commissioner

Texas Department of Banking

*February 25, 2003*

# **LIST OF HANDOUTS PROVIDED**

- ✓ **Letter from Vernon Bryant, President and CEO, TexasBank**
- ✓ **History of the Eighties – Lessons for the Future - A study prepared by the FDIC's Division of Research and Statistics published in December 1997.**



**TexasBank®**  
*With us, it's personal!*

February 25, 2003

The Honorable Talmadge Heflin  
Texas House of Representatives  
P.O. Box 2910  
Austin, Texas 78768-2910

Dear Sir:

I am Vernon Bryant, President and Chief Executive Officer of TexasBank, a 1.15 billion-dollar, state-chartered bank operating 26 locations in the Fort Worth, Parker County, and surrounding areas.

I have served on the State Finance Commission for the past two and one-half years and was appointed as Chair of that commission last week by Governor Perry.

If mandated, the agencies under the Finance Commission can and will make the necessary budget cuts that you have asked all state agencies to make.

I am sure you are aware of the consequences of this decision. Most (approximately 80%) of the expense of the Department of Banking goes for salaries, and some 9% goes to travel. Therefore, if we cut the budget the amounts the Governor has requested, this will result in a reduction in employees, with a resulting reduction in financial oversight.

As you are well aware, the economic conditions as they are currently are not what they were two years ago; otherwise, the state's general funding would not be down. Do we really want to reduce the supervision responsibilities mandated by FIDICIA and by state law during times of distressing economic times?

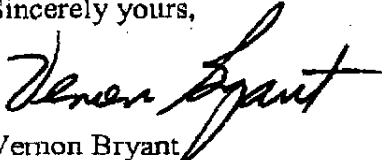
If these cuts must be made, they can be, but we may or may not like the results in the future. If the cuts are made, this will not create excess revenue for the general fund, as most of the dollars collected by these agencies are limited to the cost of regulation; therefore, there are no excess dollars. Should you delete that part of the statute, then we would have state-chartered banks and savings banks paying a tax that national banks do not pay.

We must never forget the 1980s, which were preceded with reduced regulation and then a severe downturn in the economy.

Chairman Talmadge Heflin  
February 25, 2003  
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Your consideration of these facts will be greatly appreciated.

Sincerely yours,



Vernon Bryant  
President & Chief Executive Officer, TexasBank  
Member, Texas Finance Commission

VB/jb

History of the Eighties -- Lessons for the Future  
a study prepared by the FDIC's Division of Research and Statistics  
published in December 1997

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Volume I: An Examination of the Banking Crises of the 1980s and Early 1990s  
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Volume II: Symposium Proceedings, January 16, 1997  
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Volume I: An Examination of the Banking Crises of the 1980s and Early 1990s <http://www.fdic.gov/bank/historical/history/voll.html>

Part 1: Overview and National Issues

Part 2: Sectoral and Regional Crises

- 9. Banking Problems in the Southwest (443kb)
- 12. Bank Examination and Enforcement (424kb)
- 13. Off-Site Surveillance Systems (361kb)

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Volume II: Symposium Proceedings, January 16, 1997  
<http://www.fdic.gov/bank/historical/history/vol2.html>  
Panel 1 Examination and Enforcement (173kb)

Panel 2 Off-Site Surveillance Systems (241kb)

Panel 3 Lessons of the 1980s: What Does the Evidence Show? (208kb)

Panel 4 The 1980s in Retrospect (194kb)  
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Volume I.  
Chapter 1. The Banking Crises of the 1980s and Early 1990s: Summary and Implications [http://www.fdic.gov/bank/historical/history/3\\_85.pdf](http://www.fdic.gov/bank/historical/history/3_85.pdf)

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Effectiveness of Supervisory Tools: Examination and Enforcement

The evidence suggests that bank examination ratings provided a reasonably accurate indication of the prospect of failure if the ratings were based on recent examinations. But in the early and middle 1980s many banks were not examined frequently, and the ratings available for them at any point tended to be obsolete. Troubled banks that were properly identified, however, were generally subject to enforcement actions that appear to have been effective in reducing (...) losses. **The critical issues, therefore, are the frequency and use of examinations, the effectiveness and limitations of CAMEL ratings, and the effectiveness of follow-up enforcement actions.**

Evolution in the frequency and use of examinations. In the late 1970s and early 1980s, the bank examination process was affected by two key policy changes embraced particularly by the OCC and the FDIC: (1) relatively more reliance was placed on off-site monitoring and relatively less on on-site examination, and (2) examination resources were concentrated on those institutions that posed the greatest threat

to the insurance fund and to the stability of the financial system. These changes were made partly because it was believed that comprehensive Call Report data and the use of computer technology would enhance off-site surveillance and enable the agencies to reduce the examination burdens on banks and on their own staffs. Further, the decision to concentrate resources on the larger and the more-troubled banks was seen as an efficient allocation of resources. **(Both the FDIC and the Federal Reserve also made increasing use of state bank examinations for nonproblem institutions.)** Another important change took place at the OCC, where the traditional emphasis on a detailed audit and verification system was replaced by a focus on the quality of management and internal policies. The OCC also placed increased weight on targeted examinations, which focused on a particular aspect of a bank's operations, rather than full-scope examinations.

These policy changes implied that fewer examiners would be needed. In addition, both the Carter and Reagan administrations restricted federal hiring in an attempt to reduce the size of the federal government. In this climate, the FDIC and the OCC froze examiner staffing levels in 1981. As a result, **between 1979 and 1984 the total number of examiners [page 57] in federal and state banking agencies declined** by 14 percent (see table 1.9). Among the agencies, the reductions varied in size: examiner staffing at the FDIC declined by 19 percent, at the OCC by 20 percent, **and at state agencies by 12 percent.** At the Federal Reserve, examiner staffing was largely unchanged. **While examination forces were being reduced, the total number of troubled banks was increasing** from 217 in 1980 to 1,140 in 1985. In the mid-1980s, therefore, the FDIC and the OCC began to rebuild examiner staffs--but several years of training are required to produce qualified examiners, so it was not until the late 1980s that the examiner forces at those two agencies were restored to 1980 levels in number and experience. . . . These trends in examiner staffing contributed to marked changes in the number and frequency of examinations. Between 1981 and the low point of 1985, the number of examinations declined from approximately 12,300 to 8,300. The decline was particularly sharp for state nonmember banks; for national banks and state member banks it was less severe. In 1979, the average length of time between examinations was 379 days, or 13 months (see table 1.10). **By 1986, the average interval had increased to 609 days, or 20 months.** The greatest change was for CAMEL 1-rated banks, whose average interval increased from 392 days to 845, or from 13 to 28 months. The increase in examination intervals was greatest at the OCC and the FDIC and smallest at the Federal Reserve. As the agencies built up their examination staffs in the late 1980s, intervals between examinations shortened once again, and by 1990, the average interval was 411 days (14 months) for all banks; for all banks with CAMEL ratings below 2, it was one year or less. In 1991 FDICIA reinforced the return to greater frequency of examinations by requiring annual full-scope examinations for all [page 58] banks, except that for small banks with satisfactory ratings an 18-month interval could be substituted.

For some banks during the mid-1980s, these changes meant that CAMEL ratings and other information derived from examinations were sometimes obsolete and unrepresentative. CAMEL ratings are a measure of the condition of a bank essentially at the time it is examined; as a bank's condition changes, old ratings become increasingly inaccurate as indicators of its current health. **Problems developing at some banks in the 1980s were not identified on a timely basis;** this view is supported

by examiners interviewed for this study, who indicated that extended examination intervals and increased demands on staff resources meant that some banks received insufficient attention. For example, banks that were well rated but deteriorating might not receive attention until it was too late to prevent serious losses. In Texas, which had the largest concentration of bank failures and losses to the insurance fund, the problem of extended examination intervals was particularly acute. The severe problems of some Texas banks might have been recognized sooner if examinations had been more frequent.

The reduced frequency of examinations limited the usefulness not only of information derived from the examinations but also of the financial reports used in off-site monitoring. On-site examiners are able to evaluate the quality of the loan portfolio and verify the data [page 59] on nonperforming loans and loan charge-offs that banks report in Call Reports. In other words, on-site examinations are needed to ensure the accuracy of bank financial reports. If examinations are less frequent, the accuracy of off-site monitoring systems using Call Report data suffers. .... [page 68] Effectiveness of Supervisory Tools: Off-Site Surveillance

**The disadvantages of off-site monitoring systems are that they provide no direct evaluation of management, of individual loan characteristics, of underwriting practices, or of internal controls and procedures.** Moreover, the accuracy of the financial reports on which they are based, particularly the quality of loan portfolios, is dependent on periodic on-site examinations.

Off-site surveillance systems, despite their distinct advantages, did not play a very helpful role in the 1980s. On the contrary, belief in their usefulness and their potential [page 69] helped reinforce the idea that fewer on-site examinations were necessary. In addition, with the large number of failed and troubled banks already straining supervisory resources, targeting banks for additional examinations was not a high priority (staff limitations meant that resources were unavailable to examine any additional banks targeted by off-site systems). Off-site systems appear to have worked best when the number of problem institutions and failures was not large and when examination resources were sufficient for identified banks to be examined. .... [page 81] Concluding Comment

.... In view of these overall results, several lessons can be drawn about the performance of bank regulators in the 1980s.

**1. Problems in the operations of depository institutions must be identified at an early stage if serious deterioration in the institutions' condition is to be prevented, and early identification requires continuous and sometimes burdensome monitoring of the institutions' activities.** Partly to support the objective of reducing the federal work force and partly because of presumed efficacy of off-site monitoring, the number of bank [page 82] examiners and the frequency of on-site examinations were reduced in the first half of the 1980s, at the very time when the number of troubled banks and bank failures began to rise rapidly. As a result, emerging problems were not always identified on a timely basis, some failures occurred that might have been averted, and losses to the insurance fund were probably

increased. Examination forces were rebuilt and the frequency of examinations was increased in the second half of the 1980s, even before legislation requiring such action was passed by Congress in 1991. Up-to-date, on-site examination results appear to yield information on banks not available through other means, and they help maintain the integrity of Call Report and other publicly available bank data. In the 1980s, they provided reasonably accurate advance warning of future banking problems, and their accuracy increased during the period. .... [page 83] 5. Bank regulation can limit the scope and cost of bank failures but is unlikely to prevent failures that have systemic causes. The rise in the number of bank failures in the [page 84] 1980s had many causes that were beyond the regulators' power to influence or offset. These included broad economic and financial market changes, ill-considered government policy actions, and structural weaknesses that inhibited geographic diversification and made many banks vulnerable to regional and sectoral recessions. Earlier implementation of uniform capital standards and other improvements in regulation might have reduced the number of failures in the 1980s, but it could not have prevented a great many of them. Legislation permitting geographic consolidation was a major step toward correcting existing structural weaknesses in the banking system. However, if significant new structural weaknesses or serious economic problems are allowed to develop in the future, bank regulation alone will not be able to prevent a major increase in the number of bank failures. ....

#### Chapter 12. Bank Examination and Enforcement

[http://www.fdic.gov/bank/historical/history/421\\_476.pdf](http://www.fdic.gov/bank/historical/history/421_476.pdf)

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Bank Supervisory Policies, 1980-1994

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Through the early 1970s, all banks, regardless of size and condition, received an examination approximately every 12 months. But in the middle to late 1970s, bank supervision policy changed significantly, and the change remained in place through the first half of the 1980s. The banking agencies began placing relatively more weight on off-site [page 423] surveillance and relatively less on on-site examinations.... These decisions had widespread implications for subsequent examiner staffing levels and examination frequency, both of which were being reduced during the first half of the 1980s. By the latter half of the decade, however, off-site analysis had become relatively less important in the bank evaluation process vis-à-vis on-site examinations; and with passage of FDICIA, frequent on-site examinations again became required, this time as a matter of law.

Other important changes in supervisory activity also occurred during the 1980s. Both the Office of the Comptroller of the Currency (OCC) and the FDIC sought to concentrate more examination resources on banks that posed greater systemic risk and relatively less on nonproblem institutions. All three agencies began cooperative examination programs during the early 1980s. Both the FDIC and the Federal Reserve System increasingly made use of state bank examinations for nonproblem institutions, often alternating examinations with state regulators in a move to increase efficiency. .... [page 426] Examination Staffing and Frequency



This substantial reduction in staff, especially at the federal level, came about primarily by means of a series of freezes on the hiring of new examiners at the FDIC and the OCC in the late 1970s and the early 1980s; these freezes were consistent with the policies of increased off-site surveillance and with the desire of first the Carter administration and then the Reagan administration to lessen the size of government. [FN18--Under the directives of the Reagan administration in 1981, the OCC instituted a hiring freeze for all examiners. The FDIC, as an independent agency, was under no legal obligation to follow suit but chose to freeze its examination staff in 1981. In the late 1970s, the Carter administration had also attempted to limit the size of the federal work force.] As a consequence of the freezes, staff shortages developed in subsequent years and continued until and even beyond the mid-1980s. By year-end 1985, for example, staffing levels at the FDIC were 25 percent below authorized levels. In addition to freezes in hiring, high turnover rates among examiners also helped produce shortages in examiner staffs. The high turnover rates were due in part to the pay differential between the banking agencies and the private sector. Unfilled examiner vacancies persisted until the mid-1980s, when the agencies started to hire new examiners as the number of problem banks increased (rising from 217 to 1,140 between 1980 and 1985--more than a fivefold increase). Thus, during a period of rapidly growing instability in banking with an unprecedented number of problem banks, the agencies' examination staffs consisted of large numbers of inexperienced personnel. **As a consequence, experienced staff were forced to devote considerable effort to training new examiners and were correspondingly less available to conduct work on safety-and-soundness [page 427] examinations.** From 1986 to 1992, for example, approximately half of the supervisory staff at the FDIC consisted of assistant examiners with less than three years' experience.

Furthermore, as problem banks multiplied in the Midwest and Southwest, resources were shifted from areas with seemingly healthy banks, such as the Northeast. Experienced FDIC examiners in the Northeast routinely spent a quarter of their time out of the region assisting with problems elsewhere. Moreover, as bank failures increased, bank examination personnel were detailed to support bank resolution activities. In 1984, the FDIC deployed 11 percent of its total examination staff time to such matters. This shift of resources among regions and across functions placed additional pressure on the examination force's ability to detect problem banks, especially in a seemingly healthy area like New England, where a crisis was about to erupt.

Reductions in examination frequency are tantamount to extensions of examination intervals. Between 1979 and 1986, the mean examination interval in days for all commercial and savings banks increased dramatically from 379 to 609. The intervals were increasing for all CAMEL rating categories, but especially for highly rated institutions. For 1-rated banks, the interval increased from 392 to 845 days; for 2-rated banks, from 396 to 656 days. The interval also grew for poorly rated institutions, but not as much. . . . [page 429] These data indicate that the regulatory policy in the early 1980s of focusing more resources on the examination of troubled banks and thus reducing examination intervals for these organizations was generally not being carried out successfully. [FN20--A study specifically of Texas banks reaches the same conclusion (John O'Keefe, "The Texas Banking Crisis: Causes and Consequences 1980-1989," FDIC Banking Review 3, no. 2

[1990]: 12).] .... The reductions in examination frequency were most pronounced in the Southwest, particularly Texas, which had the largest concentration of problem and failed banks and [page 430] produced the greatest losses to the insurance fund. In Texas, for example, the average number of examinations for all banks declined from a high of more than 1,200 in 1983 to approximately 600 at year-end 1985 (see figure 12.3). This decline is reflected in the median number of days between examinations for all failed banks in the region (see figure 12.4). In the Southwest as a whole, the median interval for failed banks reached a high of 579 days in 1986; for failed Texas banks, it reached 667 days. The average for all U.S. banks that failed in the same year was substantially lower: 455 days. Bank examination staffs and examination frequency continued to increase during the second half of the 1980s and into the 1990s, as all of the agencies attempted to deal with the backlog of problem banks.

In summary, the decisions that caused examiner levels to be reduced during the first half of the 1980s were a public policy failure. Such policies reduced the ability of supervisors to detect problems early enough to take corrective action. This was especially true in Texas and the Southwest, where the economy was changing rapidly and the number of problem banks was increasing.

Several lessons can be drawn from this analysis about the bank supervisory system. First, hindsight shows that the public policy decisions to reduce examination resources in the early 1980s were a failure. Few could have anticipated the severity of the regional recessions or their attendant problems, but reducing examination staffs was a high-risk policy. Second, to identify risk early and ensure the integrity of bank financial reporting, frequent onsite examinations are necessary. Third, early detection of problem institutions increases the likelihood that supervisory monitoring and enforcement actions will be effective in stemming losses to the insurance fund. Fourth, the examination system needs to capture more risks systematically, including those posed by changes in local and regional economic conditions.