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STATE BANKING DEPARTMENT

MAY 1974

Joint Legislative Audit Committee

GOVERNMENT CODE: SECTIONS 10500-10504

California Legislature

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May 8, 1974

The Honorable Speaker of the Assembly
The Honorable President of the Senate
The Honorable Members of the Senate and the
Assembly of the Legislature of California

Members:

Transmitted herewith is the Auditor General's report pertaining to the operations of the State Banking Department. Periodic examinations of the state-chartered banks and trust companies is the primary activity of the department.

The department has not complied with Section 1900 of the Financial Code requiring the Superintendent of Banks to examine each bank, foreign banking corporation doing business in the state, trust company and trust department of every title insurance company at least once in every calendar year. In 1973, 25 percent of the banks and trust companies were not examined.

The department has requested 13 additional examiner positions for fiscal year 1974-75 to conduct all of their required examinations on an annual basis, at an estimated additional cost of approximately \$319,000.

However, the Auditor General found that based on the staffing levels used for its examinations in calendar year 1973, the department, if permitted by law, could examine all banks and trust companies within a 15-month period without an increase in staff. Since the Depression, there has not been a failure of any bank regulated by the department.

The Honorable Members of the Legislature
of California

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The Auditor General has concluded that the statistical improbability of a bank or trust company failure justifies an examination at least once every 15 months in lieu of an annual examination, and has therefore recommended that the Legislature amend the Financial Code to this effect. Implementation of this recommendation would eliminate the need for 13 additional examiner positions at an estimated cost of \$319,000 annually.

The department's audit resources are not being used effectively. There has been a lack of coordination between various separate bank audit agencies and a lack of reliance on the work of other audit agencies and firms. There has been a low priority placed on examinations of higher risk banks with problem loans. Further, there has been a failure to conduct reviews of real estate appraisals although 29 percent of the bank loans are secured by real estate.

The Auditor General has recommended that the department implement formal coordination procedures and place increased reliance on the audits of other agencies and firms, place more emphasis on audits of higher risk banks with problem loans, and request the use of real estate appraisers through interagency agreements through the State Department of Savings and Loans in order to conduct reviews of real estate appraisals.

Respectfully submitted,



VINCENT THOMAS, Chairman
Joint Legislative Audit Committee

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SUMMARY OF FINDINGS,
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To implement formal coordination and greater reliance on the audits of other audit agencies and firms conducting bank examinations, we recommend that the department:	
- implement formal coordination procedures and greater reliance on the audits of other agencies and firms	
- place more emphasis on audits of higher risk banks with problem loans, and	
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INTRODUCTION

In response to a legislative request, we have reviewed the operations of the State Banking Department. The department is a component of the Business and Transportation Agency, and its chief officer is the Superintendent of Banks.

For almost a century the department and its predecessor have sought to protect the public from economic loss resulting from bank and trust company failure. Periodic examination of the state-chartered banks and trust companies is the primary activity of the department.

As stated in Section 1900 of the Financial Code:

"On each annual examination the superintendent shall inquire as to the condition and resources of the bank or foreign banking corporation, the mode of managing its affairs, the actions of its board of directors, the investment and disposition of its funds, the safety and prudence of its management, the security afforded its depositors and creditors, and whether its articles of incorporation and all applicable provisions thereof are being complied with and into such other matters as the superintendent may determine."

FINDINGS

THE DEPARTMENT HAS NOT
COMPLIED WITH THE STATUTORY
REQUIREMENT OF ANNUAL EXAMINATIONS

Section 1900 of the Financial Code requires the Superintendent of Banks to examine each bank, foreign banking corporation doing business in the state, trust company and trust department of every title insurance company doing a trust business at least once in every calendar year.

Currently, the State Banking Department uses a flexible examination schedule whereby some banks and trust companies are examined more frequently than others. This schedule resulted in only 98 of the 130 banks and trust companies, or 75 percent, being examined during 1973.

The department estimated that 28,760 additional man-hours, or approximately 16 additional examiners, would have been required to perform the examinations that were omitted during calendar year 1973, and that will be required in the future. Assuming that indirect costs would not increase, we estimate that the additional staff required by these man-hours to comply with the statutory examination frequency would cost approximately \$350,000.

The department was authorized 10 additional examiner positions for fiscal year 1973-74, but filled only seven of these. For fiscal year 1974-75, the department has requested 13 more examiner positions including the three authorized but not filled the prior year. The estimated cost of these 13 additional examiner positions is \$319,000.

Based on the staffing levels used for its examinations in calendar year 1973, the department, if permitted by law, could examine all banks and trust companies within a 15-month period without staff increases.

The frequency of examination that is necessary to protect depositors cannot be precisely determined. There has not been a failure of a bank regulated by the department since the time of the Depression. The two major bank failures within California during the last decade, the United States National Bank and the San Francisco National Bank, were both regulated by the federal government. However, the department claims that during the last three years its examinations and resulting immediate forceful regulatory actions were necessary to prevent a number of bank failures.

The financial impact of the failure of a state regulated bank would be the same as for the failure of a federally regulated bank. That is, the stockholders would lose their equity and, depending on the size of the deficit, depositors with balances in excess of the Federal Deposit Insurance Corporation's \$20,000 maximum insured amount could sustain losses. Except during extreme economic conditions, this is unlikely to occur. While during the Depression over 9,000 banks failed in this country, only 57 banks failed in the entire country during the 13-year period 1960 to 1972.

In our judgment, the statistical improbability of failure of a bank or trust company and resulting depositor loss justifies lengthening the time period in which each bank and trust company must be examined. Such an improbability, however, does not justify the department's failure to comply with the required annual examinations prescribed by statute.

RECOMMENDATION

We recommend that the Legislature amend the Financial Code to provide that all banks and trust companies be examined by the Superintendent of Banks at least once every 15 calendar months.

SAVINGS

Implementation of this recommendation would eliminate the need for 13 additional examiner positions at an estimated cost of \$319,000 annually.

AUDIT RESOURCES ARE
NOT USED EFFECTIVELY

Ineffective use of staff is evidenced by the following:

- A lack of coordination between various separate bank audit groups and a lack of reliance on the work of other audit agencies and firms
- The low priority for examinations of higher risk banks with problem loans
- Failure to conduct reviews of real estate appraisals although 29 percent of the bank loans are secured by real estate.

Lack of Coordination Between Various
Separate Bank Audit Groups and a Lack
of Reliance on Other Audit Agencies and Firms

The 1938 annual report of the Federal Reserve Board described the governmental regulation of financial institutions as a "crazy quilt of conflicting powers and jurisdictions". The applicability of this description of 36 years ago to current audit activities is evident from Table 1, which relates the various bank examiners to the banks they examine.

Table 1

Bank Examinations

<u>Examiner</u>	<u>Banks Chartered By</u>		
	<u>Federal Government</u>	<u>State and Which Are:</u>	
		<u>Members of Federal Reserve System</u>	<u>Nonmembers Of Federal Reserve System</u>
Federal Controller of the Currency	all annually	never	never
Federal Reserve Board	optional	optional	never
Federal Deposit Insurance Corporation	optional	optional	optional
State Banking Department	optional	all annually	all annually
Independent auditor	optional	optional	optional
Internal auditor	optional	optional	optional
Board of Directors	not required	all annually	all annually

A substantial part of the bank examination work consists of a series of verification steps with little significance attached to whether the individual examiners are state, federal, independent accountants, or bank audit department employees. The differences in to whom and how examination findings are communicated are more significant than the differences in the day-to-day activities of the various examiners. The low degree of reliance placed by the department upon the examinations by others is evident from the lack of information regarding this work in the department's records. In order to obtain this information, we (1) requested each bank to complete a questionnaire regarding examinations by others and (2) interviewed supervisory audit personnel responsible for examinations. The following information was developed:

- Some banks were subject to a number of examinations during each year, while others had not been examined by anyone, except the bank's board of directors, in over a year;
- Some examiners place substantial reliance on the work of others including that of the department while some conducted their examinations as if there were no other examinations;
- The number of separate examining entities and the lack of coordination of this total effort prompted one of the independent accounting firms to conclude in its pre-audit program for banks a step to ascertain that its examination would not conflict with the examination of others.

Several audit firm representatives interviewed concurred that coordination of the various bank examinations would increase the total effectiveness, and this could be achieved most effectively by the following:

1. The Superintendent of Banking should make known to internal and external auditors the detailed steps and criteria to be used in the examinations to satisfy the state's requirements.
2. Rather than continuing a program of cyclical examinations of individual banks, the department should first ascertain the adequacy of the proposed examination to be performed for all state banks by others.
3. This examination work should be reviewed by the department as it progresses with notification of any departures from examination plans.

4. The department should perform examinations only to the extent necessary to eliminate the deficiencies revealed by the review of programs and examinations discussed in 2 and 3 above.

Low Priority for Examination
Of Higher Risk Banks With Problem Loans

During the five years, 1968-72, the percentage of banks examined by the State Banking Department decreased by 30 percent while the percentage of total assets examined decreased by only approximately 13 percent. This disparity results from including in each year's audit program the three largest banks with statewide branches. The productivity of the amount of assets examined per man-hour expended is substantially higher for the examination of these large banks than for smaller banks.

A major factor affecting bank solvency is the condition of the outstanding loans receivable. In that loan losses reduce the amount of the stockholders' equity, a high ratio of problem loans to capital and reserves indicates poor conditions. The other banks in southern California have consistently had higher ratios of problem loans than either the three largest banks or the other banks in northern California and have therefore been considered as higher risk banks. However, the major part of the department's reduced audit coverage has been in the examination of the other southern California banks.

During 1968, the department examined all three of the largest and approximately 90 percent of the other banks in both northern and southern California. Five years later, in 1972, the department was still examining the three largest banks and 74 percent of the other northern California banks, but only 48 percent of the southern California banks. The department's 1972 examinations covered all the assets of the three largest banks, 74 percent of the assets of the other northern California banks, but only 30 percent of the assets of the other southern California banks. Staff increases enabled more complete audit coverage during 1973 when the three largest banks, 67 percent of the other northern California banks, and 81 percent of the other southern California banks were examined.

Failure to Conduct Reviews of
Real Estate Appraisals Although
29 Percent of Bank Loans
Are Secured by Real Estate

Table 2 shows the changes in the number of savings and loan institutions and banks subject to state regulation during the last six years and evidences a significant difference in trend.

Table 2State Regulated Financial Institutions

<u>Year</u>	<u>Banking</u>				<u>Savings And Loan Institutions</u>
	<u>Banks</u>	<u>Branches</u>	<u>Trust Companies</u>	<u>Foreign Bank Offices</u>	
1968	80	549	7	22	191
1969	82	597	8	22	154
1970	85	656	8	23	137
1971	97	690	9	28	116
1972	107	723	10	36	105
1973	119	773	11	40	102

During the last five years the number of banks, branches, trust companies and foreign bank offices has increased substantially, while the number of savings and loan institutions regulated by the state has been reduced by almost one-half. At present the number of man-hours spent by the State Department of Savings and Loan in the financial examinations of savings and loans is nearly the same as the State Banking Department devotes to the examination of banks and trust companies. However, in addition to financial examinations, the Department of Savings and Loan, with its staff of 34 appraisers, reviews the lending and appraisal policies and the appraisals made by savings and loan associations.

Although 29 percent of the total loans of the state regulated banks are real estate loans, the Department of Banking has no appraisers on its staff and therefore does not perform these reviews.

In our judgment, the department's (1) lack of more effective coordination and reliance on the work of other bank audit groups, (2) the lack of sufficient emphasis being given to audits of banks with problem loans, and (3) the failure to use real estate appraisers in examining real estate loans, has resulted in its examiners not being used in the most effective manner possible.

RECOMMENDATION

To implement formal coordination and greater reliance on the audits of other audit agencies and firms conducting bank examinations, we recommend that the department:

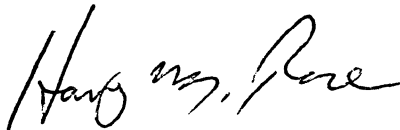
- implement formal coordination procedures and greater reliance on the audits of other agencies and firms
- place more emphasis on audits of higher risk banks with problem loans, and
- request the use of real estate appraisers through interagency agreements with the Department of Savings and Loan in order to conduct reviews of real estate appraisals.

SUMMARY OF COMMENTS OF
THE SUPERINTENDENT OF BANKS

1. The department's present staff could examine all banks and trust companies in a 14-month period. However, the statutory requirement for annual examinations should be retained. The 12-month examination cycle is the most relaxed in the country; some states require two examinations a year. At present, there is no evidence or criteria to suggest that lengthening the examination cycle would be appropriate.

2. The department's examiners rely on the work of auditors just as the auditors rely on the work of the examiners. There is some duplication of work but auditors hired by the banks lack the motivation to tell banks they are not strong enough to open another branch or that they need more capitalization, and they are not qualified to determine loan collectability which is a key element of bank examinations.

3. The State Department of Savings and Loan needs appraisers while the banking department does not because savings and loan companies look to the real property collateral as security for loans, while banks look to the solvency of the borrowers.


Harvey M. Rose
Auditor General

May 8, 1974

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