State of New York
Office of the State Comptroller
Division of Management Audit

NEW YORK STATE BANKING DEPARTMENT

ISSUES IN THE CREDIT EXAMINATION PROCESS

REPORT 96-S-33

H. Carl McCall

Comptroller

State of New York
Office of the State Comptroller

Division of Management Audit

Report 96-S-33

Ms. Elizabeth McCaul
Acting Superintendent
New York State Banking Department
2 Rector Street
New York, NY 10006

Dear Ms. McCaul:

The following is our report on issues in the New York State Banking Department's credit examination process during the period January 1, 1994 through September 30, 1996.

This audit was done according to the State Comptroller's authority as set forth in Section 1, Article V of the State Constitution and Section 8, Article 2 of the State Finance Law. We list major contributors to this report in Appendix A.

Office of the State Comptroller
Division of Management Audit

September 26, 1997

Executive Summary

New York State Banking Department Issues In The Credit Examination Process

Scope of Audit

The New York State Banking Department (Banking) is responsible for supervising and regulating New York State chartered banking organizations, including commercial banks, trust companies, savings banks, savings and loan associations, credit unions, and other licensed/registered institutions. Banking's supervision and regulation are intended to prevent bank insolvency, ensure a healthy banking system, protect the interests of depositors and creditors, and maintain public confidence in the financial community. To this end, Banking's Examination Division (Division), with a staff of approximately 332 employees and a total budget of $21.3 million for 1995-96, conducts field examinations of banking organizations and other financial organizations such as foreign banks. The Division may independently verify the bank's assets and liabilities (a full-scope examination) or rely on unaudited data from the bank's managers (credit examination - a limited scope examination.) Some of these examinations are conducted independently, while others are conducted jointly with the Federal Reserve Bank of New York, and/or the Federal Deposit Insurance Corporation (FDIC). Rating services such as Moody's and Standard and Poor's and Certified Public Accountant firms (CPAs) also perform reviews and analyses of banking organizations' financial information.

We reviewed the process used by the Division to do examinations for the period January 1, 1994 through September 30, 1996.

Our audit addressed the following questions:

- Is Banking's Examination Division conducting quality examinations?
- Can Banking perform more full-scope examinations?

Audit Observations and Conclusions

Banking provides its staff with a manual that outlines the techniques and procedures to be followed in bank examinations. It requires the preparation of workpapers that will substantiate the assertions of fact or opinion contained in examination reports. Such workpapers are also useful as a means of evaluating the quality of the work done by the Examination Division. We found the workpapers we reviewed were not prepared according to Division policy. As a result, there was limited assurance that the conclusions reached in the examination reports reviewed by us were justified. Because the workpapers did not meet Banking's own requirements in its manual, we could not determine whether the examiners had duplicated work performed by others. In addition, even though Banking has the ability to perform full-scope

examinations, it has not been doing so. Such examinations require Banking to independently verify the bank's assets and liabilities and hence provide a more thorough and accurate assessment of a bank's financial condition. (See pp. 5-11)

We sought to verify that the Division had conducted all reviews required for banking organizations that Banking was responsible for overseeing at the time of our audit. We found that 673 examinations were reportedly performed for the 1995 cycle. However, because records were poorly kept, we have no assurance that all banking organizations requiring examinations had them. Banking officials also advised us that they consider most of the banking organizations as financial institutions, which according to them do not have to be examined at least once in each calendar year. However, these officials did not provide any information on how to distinguish a banking organization from a financial institution. (See pp. 13-15)

Comments of Banking Officials

Generally, Banking officials agreed with our report's recommendations. Their comments suggest that they recognized the importance of having quality workpapers. However, they disagreed with our findings and recommendations regarding the need for the Division to do more full-scope examinations.

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Introduction

Background

The New York State Banking Department (Banking) is responsible for supervising and regulating banking organizations, including commercial banks, trust companies, savings banks, savings and loan associations, credit unions, and other licensed/registered institutions. This supervision and regulation function is intended to:

- prevent bank insolvency,
- ensure a healthy banking system,
- protect the interests of depositors and creditors, and
- maintain public confidence in the financial community.

Banking approves acquisitions, branch expansions, mergers, and other forms of consolidation. It has the ability to levy fines, order discontinuance of unsound financial practices, and replace management; and it has the power to take possession of failing institutions and operate or liquidate them for the benefit of depositors and creditors.

These responsibilities are carried out through its administration, analysis and compliance, and regulations programs. The administration program provides direction and staff services, as well as electronic data processing services for the entire agency. Under the analysis and compliance program, which supports regulatory and supervisory activities, Banking receives and resolves consumer complaints and monitors the performance of financial institutions in terms of their obligation to meet the credit needs of local areas, as required by the Community Reinvestment Act.

The major objectives of the regulations program are to maintain a strong banking industry in New York State and to ensure that the State's businesses and residents have access to adequate financial services. The regulations program includes ten operating divisions and one executive division. Each is responsible for a distinct segment of the banking industry. One of these, the Examination Division (Division) with a staff of approximately 332 employees and a total budget of $21.3 million for 1995-96, conducts annual field examinations of State-chartered banks and other financial organizations such as foreign banks. The Division does independent examinations, joint examinations with the Federal Reserve Bank of New York (FRBNY), and alternate-year joint examinations with both the FRBNY (including foreign branches and agencies) and the Federal Deposit Insurance Corporation (FDIC). The intent of these various examinations is to ensure "strong and satisfactory" institutions. According to Division officials, during 1995, 123 of the 673

examinations done in the State by Banking's Examination Division, FRBNY, and/or FDIC were conducted independently by the Division.

Rating services such as Moody's and Standard and Poor's and Certified Public Accountant firms (CPAs) also perform reviews and analyses of banks' financial information.

Audit Scope, Objectives and Methodology

We reviewed the process the Division used to conduct examinations for the period January 1, 1994 through September 30, 1996. The objectives of our audit were to determine whether:

- the Division could rely on information gathered by other entities for part of its examinations;
- the required number of examinations had been performed for the 1995 cycle; and
- the Division was performing quality examinations.

To accomplish our objectives, we interviewed Banking officials; compared the examination process with related work performed by CPAs and financial rating services; sampled completed examinations to determine which activities duplicated work done by others; and reviewed pertinent Banking records.

We did our audit according to generally accepted government auditing standards. Such standards require that we plan and do our audit to adequately assess those Banking operations which are included within the audit scope. Further, these standards require that we review Banking's internal control system and compliance with those laws, rules and regulations that are relevant to Banking's operations which we include in our audit scope. An audit includes examining, on a test basis, evidence supporting transactions recorded in the accounting and operating records and applying such auditing procedures as we consider necessary in the circumstances. An audit also includes assessing the estimates, judgments, and decisions made by management. We believe that our audit provides a reasonable basis for our findings, conclusions and recommendations.

We use a risk-based approach when selecting activities to be audited. This approach focuses our audit efforts on those operations that we have identified through a preliminary survey as having the greatest probability for needing improvement. Consequently, by design, finite audit resources are used to identify where and how improvements can be made. Thus, we devote little audit effort to reviewing operations that may be relatively efficient or effective. As a result, our audit reports are prepared on an "exception basis." This report, therefore, highlights those areas needing improvement and does not address activities that may be functioning properly.

Comments of Banking Officials

We provided draft copies of this report to Banking officials for their review and formal comment. Their comments were considered in preparing this report and are included as Appendix B.

Generally, Banking officials agreed with our report's recommendations. Their comments suggest that they recognized the importance of having high quality workpapers. However, they disagreed with our findings and recommendations regarding the need for them to do more full-scope examinations.

Within 90 days after final release of this report, as required by Section 170 of the Executive Law, the Superintendent of the New York State Banking Department shall report to the Governor, the State Comptroller and the leaders of the legislature and its fiscal committees, advising what steps were taken to implement the recommendations contained herein, and where recommendations were not implemented, the reasons therefor.

Quality of Examinations

The examination of most types of banks (commercial, savings, savings and loan associations, credit unions, and investment companies) focuses on five critical areas of bank operations commonly referred to by the acronym "CAMEL": capital adequacy, asset quality, management capability, earnings, and liquidity. Some of the aspects examined in each of the five areas are as follows:

(**C**)apital adequacy - The nature, trend, and volume of marginal and sub-quality assets; off-balance sheet activities; balance sheet composition; growth and planning; management; earnings retention and access to capital markets.

(**A**)sset quality - The level, distribution, trend, and severity of past-due or troubled debt; adequacy of valuation reserves and concentration of credits, investments, transfer and off-balance sheet risk.

(**M**)anagement capability - Management's competence and leadership; compliance with statutes; management information systems; compliance with internal policies; quality of internal and external audit; internal controls; management depth and adequacy of board of director supervision.

(**E**)arnings - Analysis in terms of quality and quantity, to determine whether earnings are normally recurring or extraordinary; also in terms of level and trend, as well as sufficiency to support present and future operations; ability to cover losses; the adequacy of additions to valuation reserves; vulnerability of earnings to changes in interest rates and the reasonableness of an institution's dividend policy.

(**L**)iquidity - Determining an institution's ability to meet its operating expenses; volatility of deposits; credit demand; accessibility to money market or alternative funds; location and size of the institution; competition and local economic cycle.

Based on the examiners' review of these critical areas, a report is prepared for the bank that contains a composite numerical rating ranging from 1 to 5. This rating system is interpreted, by those supervising banks, as an overall indication of the bank's financial condition. A rating of 1 indicates a strong financial condition, while a rating close to 5 is an indication that the bank has financial problems. Different rating systems are used for other types of banking organizations, such as bank holding companies and agencies of foreign banks.

To substantiate these ratings and the assertions of fact or opinion contained in examination reports, according to the Banking manual, examiners' workpapers must include supporting documentation for each conclusion reached in the report, contain notations of sources and conclusions, display indications of supervisory review, and be cross-referenced. Such workpapers are also useful

as a means of evaluating the quality of the work done. In addition, according to Banking practice, the work plan prepared before the examination is to include the time budget for the examination as a whole, as well as the amount of time to be spent in each area of the review; and the checklists to be used throughout the examination process evidencing that all required components of the examination process were done.

We found that the workpapers we reviewed provided limited assurance that the conclusions reached in the associated examination reports were supported. Moreover, the workpapers did not meet Banking's internal manual requirements. We have cited such deficiencies in previous audit reports. Banking officials, although acknowledging there were problems with the workpapers, have not acted to address them. Therefore, the problems continue to exist.

During the course of this audit, we selected six banks to review the work done by Banking examiners and to determine whether they had duplicated work performed by other regulators or external auditors. Our sample included a domestic commercial bank, a thrift/savings bank, a foreign bank, a newly chartered bank, a bank receiving a rating of "3" or greater in its most recent review, and a small bank located outside New York City. We found that the workpapers for four of the six examinations we reviewed were missing supporting documentation, unclear, and not well-organized. In addition, the workpapers did not indicate the amount of time examiners worked on any of the six examinations. Since this documentation/information was missing, we could not determine what work had been done, whether the work had been duplicative of the work done by other regulators or external auditors, or how much time had been spent doing the work which may have duplicated the work of others. In our review of workpapers that had been prepared for these six banks, we found the following:

- At one bank, we could not determine what work had been done in the prescribed areas of capital adequacy, liquidity, and management capability, and there was no documentation substantiating the conclusions stated in each of these areas. For example, we did not see any workpapers indicating that steps required by Banking's manual, such as a comparison of the salaries and bonuses paid to the officers with similar information from an appropriate peer group, were done. Therefore, there was no assurance that the conclusions reached in these areas were valid.
- At another bank, the workpapers consisted of reports, schedules, memos, etc., that had been prepared by others, such as bank personnel, CPAs, or a consultant. There was no indication that the bank examiners had performed any work themselves to assess the accuracy of the information contained in these documents, yet they relied on this as a basis for their report conclusions.

- At four banks, there was no breakdown of the time examiners had taken to review each of the critical areas. Therefore, we could not determine how much time had been spent on those particular areas.

After encountering such deficiencies, we decided to visit four other banks to determine the impact of the workpaper problems on the quality of the examinations performed. To substantiate the examiners' assertions of facts or opinion in the examination reports, we looked for six key features, such as supporting documentation, the use of checklists, etc., for each area of review. All of these were either required by the examination manual or standard Banking practices. We found that most of the information/documentation was missing from the workpapers. The following table is a breakdown of the deficiencies we found in the workpapers:

	Bank A	**Bank B**	**Bank C**	**Bank D**
No or Inadequate Supporting Documentation	X	X	X	X
Missing or Incomplete Checklists	X	X	N/A	X
No Supervisory Review		X	X	X
No Source and/or Conclusion	X	X	X	X
Improper Cross-Referencing	X	X	X	
Missing or Erroneous Time Budget	X	X		X
N/A - Federal auditors completed areas for which checklists were required.				

As the table indicates, workpapers at all four banks lacked supporting documentation for conclusions stated in the reports, as well as sources and other conclusions that should have been included. Records at three of the four had no evidence of supervisory review, missing or incomplete checklists, workpapers that were improperly cross-referenced, and missing or erroneous time budgets.

- At Bank "A," the workpapers did not have supporting documentation for some of the conclusions stated in the report; nor were they cross-referenced properly. For example, the report concluded that the number of past-due loans had declined because the bank had been vigilant about monitoring and renegotiating problem loans. There was no documentation to support this statement. In addition, there was no source or other supporting documentation to substantiate the dollar amount cited for past due loans. Additionally, while the examination report indicated the "loan loss reserved to total loans and leases ratio was well above the Peer's 1.94 %," the supporting workpapers showed a 1.39 % ratio for the Peer's group. Therefore, we had no assurance that the number of past-due loans had even declined, or that the statement made about the Peer's group ratio was correct.

- At Bank "B," the workpapers contained inadequate documentation for the conclusions cited in the report. Workpapers pertaining to capital, earnings, liquidating, and internal controls were all missing. As a result, we could not ascertain that the conclusions cited in the report were justified.

- At Bank "C," the workpapers were not cross-referenced and there was no indication of supervisory review. In addition, we found no supporting documentation for some of the conclusions cited in the report.

- At Bank "D," when we checked the cross-referencing, we found two instances in which the numbers in the workpapers did not match the numbers in the report. For example, the workpapers cross referenced to the "Total Potentially Volatile Liabilities" showed 7 percent or $3,543 while the report showed 9 percent or $4,124 for this category. This inconsistency underscored the need for supervisory review, but there was no indication that a supervisor had reviewed the material. Also, certain supporting documentation and time budgets were missing.

Our visits to the second sample of four banks corroborated our initial evaluation of the quality of the examinations conducted by the Division teams. The workpapers reviewed did not assure us that the conclusions reached in the examination reports were justified. Furthermore, when reviewing a bank's financial condition, the Division performed a credit examination which relies on unaudited data from the bank's managers.

We also found that only one of the 525 examinations from the 1995 examination schedule was a full-scope examination. (This represented a significant decrease from 1989 when the examination schedule showed that 68 of the 298 (23 percent) examinations were full-scope examinations. In full-scope examinations examiners independently verify the bank's assets and liabilities, thus providing a more thorough and accurate assessment of the bank's financial condition.)

Even with the increase in the examination schedule from 298 in 1989 to 525 in 1995, we question whether the decrease in the number of full-scope examinations from 68 to 1 was reasonable.

In addition, because the workpapers were prepared inadequately, we were unable to determine what work had actually been done or whether the examiners' work had duplicated work performed by others. Therefore, we were limited to the review of work plans and the examination reports to determine whether Banking examiners had duplicated work performed by other regulators or external auditors. Based on our review of work plans and/or examination reports for ten credit examinations conducted for the 1995

examination cycle, we found that the Division includes a review of the bank's internal controls in each credit examination it conducts. The following procedures were typically followed when examiners sought to assess internal controls:

- Interview the in-house internal auditor.
- Review current internal audit program.
- Note any exceptions cited by internal auditors.
- Review lines of communication to board/head office.
- Review current proposed audit plan.
- Review external auditors' report.
- Complete appropriate exam report pages.

Some workpapers had more detailed descriptions of the work to be performed. For instance, they detailed the steps to be performed in reviewing the internal audit function, such as:

- An assessment of staff competency.
- A description of the policy and standards.
- A review of a sample of internal audit reports sent to the Board of Directors.

However, we would not consider these procedures effective enough to uncover any information that would not have been discovered by the external auditors.

In responding to the draft report, Banking officials labeled our findings on the workpaper prepared by the examiners as "de mininus in nature." We disagreed. These deficiencies were found in the workpapers prepared by the examiners to determine the bank's rating which is an overall indication of the bank's financial condition, and therefore, Banking should not minimize the fact that errors or omissions could have affected the accuracy of the rating.

Some of these deficiencies, including the lack of supporting documentation and cross-referencing, have been cited in our previous audit reports issued to Banking (Reports Nos. 94-F-13, 92-S-113, 91-S-38 and 88-S-119). Banking officials indicated in their replies to our reports that they recognized the deficiencies in their workpapers and would take steps to rectify the situation.

However, Banking's officials have not acted to correct the previously cited problems. They now indicate that they believe their credit examinations are reliable. However, they did not provided us with evidence, such as the results of an internal quality assurance review, to support their belief. We also believe that the reliability of the examination process is further compromised by Banking's heavy reliance on unaudited data that is provided by the very people who are being examined. As a result, there is limited assurance that the conclusions reached in the examination reports reviewed by us are justified.

In responding to the draft report, Banking officials recognized the importance of having quality workpapers. They mentioned that adherence to workpapers procedures will be emphasized as well as remedial training for those examiners whose work product falls short of standards. They also indicated that "the recommendation to establish a quality control assurance unit has merit." Therefore, they have taken the necessary steps to create this unit.

Recommendations

1. Take corrective actions to ensure that the conclusions cited in examination reports are accurate and adequately supported in the workpapers.

2. Ensure that the examiners are trained on how to prepare their workpapers in accordance with Banking's policies and procedures.

3. Develop a formal mechanism, such as an internal quality assurance review, to ensure that all credit examinations are reliable.

4. Reassess the process for the type of examinations done to identify how it can be changed in order to increase the number of full-scope examinations.

Required Examinations of Financial Institutions

Section 36 of the Banking law requires that banking organizations (banks, trust companies, private bankers, savings banks, safe deposit companies, savings and loan associations, credit unions, and investment companies) must be examined at least once in each calendar year. Currently, Banking oversees 3,933 such organizations as well as other financial institutions. During 1995, the Division reportedly examined 673 banking organizations.

Entities that the Division did not review include mortgage bankers and brokers, licensed cashiers of checks, licensed lender offices, finance companies and agencies, and licensed transmitters of money. According to Banking officials, these are all financial institutions and, as such, the Division does not have responsibility for them. Banking officials did not define what distinguishes a banking organization from a financial institution until it responded to our draft report which was several months after our initial request and after the completion of our field work.

However, Division officials could not provide us with an accurate list of all the banking organizations subject to their annual examination according to their interpretation of Section 36 of the Banking law. We were provided lists from various functional units of Banking, not a master list prepared by a central managerial unit. In total, we were given or shown copies of 20 separate lists that had been prepared in different years or at unknown times. We were told these lists included all the banking organizations under Banking's supervision. We were also told that 14 of these lists contained the banking organizations subject to annual reviews by the Division - a total of 723 entities.

We expected that the Division would have records to support that it had conducted 723 reviews during its 1995 examination cycle. However, when we attempted to determine which entities had been reviewed, Division staff gave us copies of lists subject to various adjustments. Also, Division officials, as a result of our inquiries, gave us numerous explanations for the adjustments made that cast serious doubts on the Division's ability to demonstrate control over the number of banks to be examined. Finally, the number of banking organizations reviewed, which we were initially told was 723, was reduced to 673 entities as follows:

Independent	127 *
Joint (with Federal Reserve Bank of New York)	275
Alternate Year	257 **
Concurrent	8

Independent	127 *
Other (e.g., special visits to new banks)	6
Total Examinations Conducted	673

* 4 banks were independently done by the FRBNY.

** Joint examinations for strong and satisfactory institutions with both the FRBNY (including foreign branches and agencies) and the Federal Deposit Insurance Corporation (FDIC).

Clearly, Banking's record-keeping system for this important function is inadequate. It has not identified the number of banking organizations that it is required to review under Section 36 of the Banking law, and the number of banking organizations actually reviewed is subject to numerous adjustments and interpretations by Division officials.

In responding to the draft report, Banking officials claimed that they demonstrated to the auditors that the examination cycle was completed. The implication was that all banking institutions required to be examined, by Section 36 of the Banking Law, were reviewed by the Examination Division. We disagreed. Banking officials only provided us with numerous lists indicating the institutions examined by them. However, they never gave us a list of the institutions the Division was required to examine according to Section 36 of the Banking Law. Banking officials stated that "lists obtained from various sources outside the Examination Division may have contributed to the confusion." We believe that the Division should have its own list to eliminate such confusions. Moreover, even after receiving Banking's response to this draft, they only have indicated the types of banking institutions subject to their examination, but they have not named the specific banking institutions within the types listed that the Division is required to review according to Section 36 of the Banking Law.

During our field work, Divsion officials told us that they felt more comfortable relying on the work of their examiners to assess the bank's internal controls. However, in responding to the draft report, Banking officials stated that "the concept of utilizing the work of external and internal auditors to assess risks and focus the examination scope is one we fully endorse and believe we presently use."

Banking officials also stated that if more full scope examination were done Banking's examinations "would be duplicative of what is done by internal and external auditors, unduly burdensome to the institution being examined and extremely time-consuming and expensive." We believe these same objections could be made about their current examinations which are also performed by OCC (the Office of the Comptroller of the Currency), FRBNY, and FDIC. In

these cases, Banking decided to do some joint and alternative years examinations with these regulatory agencies to minimize the duplication and all its related effects on the institutions being examined. We believe that Banking should reconsider its position on the need for it to do more full-scope examinations because as previously noted, the 1995 examination schedule only had one full-scope examination out of 525.

Recommendations

5. Establish an accurate and reliable inventory system to track banking organizations requiring examinations.

6. Create a master list of all banking institutions subject to examinations and document all adjustments made.

Major Contributors to This Report

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May 19, 1997

Mr. David R. Hancox
Director of State & NYC Audits
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Dear Mr. Hancox:

As required by section 170 of the Executive Law, attached is the New York State Banking Department's response to your audit report 96-S-33 "Issues in the Credit Examination Process."

Very truly yours,

Gideon Weingarten
Director, Internal Audit

Enclosures

CC: Acting Superintendent McCaul
Deputy Superintendent Muccia
Associate Budget Examiner Taylor
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STATE OF NEW YORK
BANKING DEPARTMENT
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May 22, 1997

Mr. David R. Hancox
Director of State & NYC Audits
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Dear Mr. Hancox:

This letter is in reference to our response to your audit 96-S-33. After the response was issued, we noted an error which we would like to correct.

On Page 4 of the response where we list "Common Trust Funds" as being examined annually by law, this is inaccurate. The Cycle is 10 years or when accountings are rendered.

We apologize for the error and any trouble it has caused.

Very truly yours,

Gideon Weingarten
Director, Internal Audit

CC: Acting Superintendent McCaul
Deputy Superintendent Muccia
Associate Budget Examiner Taylor
Budget Examining Unit Head Cape

GENERAL COMMENTS

The Banking department has reviewed the draft audit report 96-S-33, which contains factual errors and unsupported and misleading conclusions. Moreover, the audit report's emphasis on having the Banking Department spend more time and resources in conducting verification and confirmation work is contrary to existing regulatory standards and the risk focused examination currently being adopted by the U.S. regulatory community. This basic misconception of the Banking Department's mission and procedures is particularly disappointing given the amount of time and resources expended by both Banking Department and OSC staff during the course of this audit.

Executive Summary – Audit Observations and Conclusions

While the Banking Department recognizes the importance of high quality workpapers, we also recognize that minor errors or omissions do not invalidate an examiner's work product. One must weigh the importance of the error or omission not just the fact that an error or omission occurred. The exceptions noted with the audit report are de minimus in nature. We will continue to emphasize the importance of workpapers to our staff and are currently exploring ways to enhance our quality assurance procedures (see our response to recommendation three for some specifics).

The Banking Department rejects the conclusion that "...because records were poorly kept, we have no assurance that all banking organizations requiring examinations had them." The Examinations Division maintains complete and accurate records of all examinations scheduled and completed. During the audit, OSC staff reviewed these records and agreed that the records indicated compliance with our schedule.

The report states... "Banking officials also advised us that they consider most of the banking organizations as financial institutions, which according to them do not have to be examined at least once in each calendar year. However, these officials did not provide any information on how to distinguish a banking organization from a financial institution." This comment is inaccurate and misleading. The definition of a banking organization is contained within the Banking Law. There is no ambiguity concerning which organizations must be examined on an annual cycle and which may be examined at the discretion of the Superintendent. We were not aware of

the auditors' confusion nor was a request for clarification of the law made to us during the audit. This comment is also contradictory to the auditor's own statement cited on page 9 of the report concerning Banking Law Section 36.

The Banking Department, along with the Federal Reserve Bank ("FRB") and the Federal Deposit Insurance Corporation ("FDIC"), the Office of Thrift Supervision ("OTS"), and the National Credit Union Administration ("NCUA") and other states, continue to explore ways in which the examination process can leverage off work accomplished by the external auditors. To date, however, none of the above named agencies have concluded that it would be wise to eliminate the review of internal controls as a standard examination function as suggested in this audit report. In fact, to the extent our internal control reviews emphasize process over transaction testing, all the regulatory agencies are moving toward more analysis of procedures and controls not less. SR 96-14 entitled "Risk- focused Safety and Soundness Examinations and Inspections" issued by the Board of Governors of the Federal Reserve Bank on 5/24/96, emphasizes that "An institution's internal control structure is critical to the safe and sound functioning of the organization in general and to its risk management system in particular." In addition, the current FDIC Report of Examination Risk Management Page contains a requirement for the examiner to "Assess the institution's internal controls...."

SPECIFIC COMMENTS

Quality of Examinations

Recommendations:

1. Division officials should take corrective actions to ensure that the conclusions cited in examination reports are accurate and adequately supported in the workpapers.

Response: Adherence to workpaper procedures will continue to be emphasized.

2. Division officials should ensure that the examiners are trained on how to prepare their workpapers in accordance with Banking's policies and procedures.

Response: Workpaper training is part of the Banking Department's core curriculum for all examiners. We will continue to ensure that all examiners attend this course and that those examiners whose work product falls short of standards, receive remedial training.

3. Develop a formal mechanism, such as an internal quality assurance review, to ensure that all credit examinations are reliable.

Response: While the Banking Department believes that our examinations are reliable, the Examinations Division thinks that the recommendation to establish a quality control assurance unit has merit. The executive Budget recommends additional resources and funding which should aid in the establishment of such a group. The Department recently submitted a budget proposal to substantially increase the staffing of the Examinations Division. Funding would free up the necessary resources to enable us to create this unit.

Required Examinations of Financial Institutions

* See Auditors' Note

4. Establish an accurate and reliable inventory system to track banking organizations requiring examinations.

Response: This section of the audit report is replete with factual errors. The auditors have confused the responsibilities of the Examinations Division with that of the administration of the entire Banking Department. They are confused over the requirements of the Banking Law. Simply stated the Banking Department supervises and regulates many different types of financial entities. Generally speaking, banks and other chartered entities that take deposits from the public are classified by law as 'banking organizations', while other service entities such as mortgage bankers and brokers, check cashiers, money transmitters, etc. which do not take deposits are not classified as 'banking organizations'. (See attached Legal Opinion for complete details)

Examinations Division currently has responsibility for the safety and soundness examinations of the following which are examined annually by law:

Banks and Trust Companies (including limited purpose trust COs).
Common Trust Funds
Private Bankers
New York Business Development Corporation
Investment Companies engaged in deposit taking
Mutual Trust Investment Companies
Savings Banks
Savings & Loan Associations

The following are examined by policy and the frequency is discretionary, from annual to every three years:

Bank Holding Companies
New York Branches & Agencies of Foreign Banking Corp.
New York Representative Offices of Foreign Banks
Investment Companies not engaged in deposit taking

Examinations does **not** have responsibility for the following:

Note: The responsibility for these areas is within other Divisions of the Banking Department and is outside the scope of this audit.

Credit Unions
Budget Planners
Check Cashiers
Insurance Premium Finance Companies
Licensed Lenders
Sales Finance Companies
Money Transmitters
Mortgage Bankers
Mortgage Brokers
Consumer Compliance and Community Reinvestment Act Exams

The audit report criticizes the Banking Department for the number of lists provided to the auditors in response to their inquiries and their subsequent confusion over the number of entities requiring examination. The Banking Department regrets any confusion it may have inadvertently caused. Timing differences between lists obtained from various sources outside the Examinations Division may have contributed to the confusion. We are confident, however, that we satisfied all the audit questions concerning the examination cycle and demonstrated to the auditors our completion of that cycle. Such assurance was given to the Department by the field auditor conducting the review.

5. Create a master list of all banking institutions subject to examinations and document all adjustments made.

* See Auditors' Note

Response: The Scheduling and Assignments Unit of the Examinations Division maintains a list of all entities for which it has responsibility to examine. The list is updated as official openings/closings are recorded in the Banking Department's Weekly Bulletin. In addition, the Divisions responsible for the on-going supervision of the entities examined by the Examinations Division review the examination schedule and act as a crosscheck both at the beginning and end of the examination

cycle. In addition, a further independent crosscheck is provided for most of the entities, since the examination schedule must be coordinated with the FRB and/or FDIC. With these added controls, the possibility of an examination being missed is greatly reduced. Nevertheless, we will explore ways to improve our current system, to make it more user friendly.

Coordination of Efforts

6. Assess the adequacy of the internal control evaluations done by CPAs. To the extent they can be relied upon, limit examinations of banking organizations' internal controls to the minimal testing and updating of work performed by external auditors. Use the time saved to conduct more complete reviews of banks assets and liabilities.

* See Auditors' Note

Response: The concept of utilizing the work of external and internal auditors to assess risks and focus the examination scope is one we fully endorse and believe we presently use. However, we believe the audit comment is flawed because it overestimates the degree of reliance we can place on external audits; confuses a review of the audit function with a review of internal controls; and, seems to be aimed at having the Examinations Division utilize any time saved to perform the verifications of assets and confirmations of liabilities.

Our procedures are in accordance with current generally accepted U.S. regulatory standards. Verification of assets and confirmation of liabilities are functions most appropriately performed by internal and external auditors. It is our function as examiners to review the performance of both external and internal auditors to gain some assurance as to the level and quality of audit coverage and the adequacy of the system of internal controls. If we found the audit coverage seriously lacking, we would take appropriate remedial action by increasing the level of transaction testing during the examination and/or ordering an independent review in accordance with our instructions or some combination thereof. No bank regulatory agency that we are aware of (including the Office of the Comptroller of the Currency ("OCC"), FDIC, FRB, OTS, NCUA, other states) performs full scope examinations on a routine basis or performs verification/confirmation work as suggested in the audit report. To do so would be duplicative of what is done by internal and external auditors, unduly burdensome to the institution being examined and extremely time-consuming and expensive.

EDITING ERRORS IN REPORT 96-S-33

The following errors in the report were noted and are brought to the attention of the OSC:

Page 1. Executive Summary

- Line 2 *all* should be replaced with *NYState Chartered*
- Line 4 *mortgage banks* should be omitted
- Line 4/5 delete *other financial institutions*, replace with *Other licensed/registered entities*
- Line 12 *licensing services* should be deleted, it has no meaning
- Line 14 delete *unaudited* since it is misleading. External and/or internal audit would have reviewed the Controls surrounding these functions.

Page 4. Background

- Line 9 (last Paragraph)- delete *licensing services*, it has no meaning.

Page 7. Quality of Examinations

The description of the CAMEL components and the UFIRS rating system have been inaccurately edited.

BANKING DEPARTMENT
GENERAL COUNSEL'S OPINION

This opinion addresses the authority of the Superintendent of Banks (the "Superintendent") to determine the examination schedules for persons or entities licensed by the Superintendent, or otherwise subject to the regulatory jurisdiction of the Superintendent or the Banking Department.

Banking Law Section 36 is one of several provisions dealing with the Superintendent's examination authority. Section 36 is a broad-reaching section, containing both specific subdivisions, relating to only certain types of banking entities, and general subdivisions, referring, for example, to matters involving a special investigation. Accordingly, when interpreting Section 36, we distinguish between those subdivisions applicable to all entities and those subdivisions applicable to only certain entities.

Among other things, Section 36 contains the examination requirements for "banking organizations", as that term is defined in the Banking Law. "Banking organizations" include: banks, trust companies, private bankers, savings banks, industrial banks, safe deposit companies, savings and loan associations, credit unions and investment companies. (Banking Law § 2(11)). Section 36(2) provides that the Superintendent shall cause every banking organization to be examined at least once in each calendar year. Section 36(2) does not apply to investment companies except under certain conditions enumerated therein. The Superintendent is authorized to extend the examination interval to once every 18 months for banking organizations with total assets of less than $250 million which also meet certain specified conditions (such as that they are well-capitalized, well managed, not subject to enforcement proceedings, etc.). (See generally § 36(2)).

Section 36(2), which by its terms, applies only to "banking organizations," mandates a statutory minimum frequency for examination of certain banking organizations. The Superintendent also has the authority to examine all such banking organizations more frequently, as he deems advisable. (§ 36(1)). The fact that Section 36 contains both a broad grant of authority for the Superintendent to examine banking organizations as he deems advisable (§ 36(1)), as well as the specific requirement that the Superintendent examine certain banking

organizations at minimum intervals (§36(2)), makes it clear that the specific requirements in § 36(2) to examine certain banking organizations at 12 or 18 month intervals apply only to the organizations referenced in that section. The legislature's deliberately dichotomous scheme – providing for both mandatory and discretionary examinations – is further evident in Section 36 and elsewhere in the Banking Law.

For example, Section 36(4) provides that the Superintendent shall have the power at any time to examine every agency, branch or office located in New York of any foreign banking corporation. Section 36(5) gives the Superintendent power to make such special investigations as he shall deem necessary to determine whether any individual, partnership, unincorporated association or corporation has violated any provision of the Banking Law. Section 36(5) is thus an example of a general provision which applies to all persons or entities, and not just a specified group. Similarly, Section 36(6) gives the Superintendent broad authority, when he deems it necessary or advisable to determine a corporate banking organization's financial condition, to examine affiliates of all such corporate banking organizations. The language in these sections evidences the legislature's intent to give the Superintendent discretion to examine the entities mentioned in these sections, as he deems necessary.

Further review of the Banking Law's various other Articles evidences a consistent legislative intent regarding the examination scheme. The Banking Law Articles that relate to the permissible activities of "banking organizations" do not themselves contain provisions pertaining to the examination of these organizations. (Article III – Banks and Trust Companies; Article IV – Private Bankers; Article VI – Savings Banks; Article VIII – Safe Deposit Companies; Article X – Savings and Loan Associations; Article XI – Credit Unions; Article XII – Investment Companies; (Article VII – Industrial Banks, has been repealed). The lack of specific provisions in these Articles relating to examination of these institutions suggests that the scheme set forth in Section 36 is intended to apply to such institutions.

On the other hand, those Articles of the Banking Law which relate to licensees other than "banking organizations" contain separate provisions concerning the examination of such licensees. (Article IX – Licensed Lenders (§ 348); Article XI-B – Sales Finance Companies: (§ 497); Article XII-B – Insurance Premium Finance Agencies (§ 560); Article XII-C – Budget Planners (§ 585); Article XII-D – Mortgage Bankers and Brokers (§ 596); Article XIII – Transmitters of Money (§646). Each of the examination provisions (noted in parentheses) contained in these Articles gives the Superintendent discretion to examine these entities as often as may be necessary or advisable. This also suggests that the

minimum frequency examination schedules set forth in Section 36 apply only to "banking organizations", as defined in the Banking Law.

In a handful of other cases, the Banking Law or the Banking Board's regulations mandate an examination frequency. Banking Law § 277-a in Article VI-A requires that the Superintendent examine savings bank life insurance departments and funds at least once every 3 years. Banking Law § 218 in Article V-A requires that the New York Business Development Corporation be examined annually. In addition, the Banking Board's regulations provide that common trust funds must be examined as of the close of the period covered by an account of proceedings (Part 22); and that mutual trust investment companies must be examined annually (Part 50).

Accordingly, it is our opinion that the Banking Law sets forth a bifurcated structure governing the examination of entities under the Superintendent's jurisdiction. In general, it is within the Superintendent's discretion to set examination schedules for all entities under his jurisdiction. Only with respect to "banking organizations" and savings bank life insurance departments is a minimum examination frequency mandated by the Banking Law, as discussed above. Even with regard to these entities, however, the Superintendent is authorized to conduct more frequent examinations.

Auditors' Note:

In assessing the agency response, we have adjusted our final report. Therefore recommendations 4, 5 and 6 stated in this response do not correspond to our final report.