United States Government Accountability Office

Report to Congressional Requesters

September 2020

BANK SUPERVISION

FDIC Could Better Address Regulatory Capture Risks

Accessible Version

GAO-20-519

GAO Highlights

Highlights of GAO-20-519, a report to congressional requesters

September 2020

BANK SUPERVISION

FDIC Could Better Address Regulatory Capture Risks

Why GAO Did This Study

FDIC supervises about 3,300 financial institutions to evaluate their safety and soundness. Some analyses by academic researchers have identified regulatory capture in supervision as one potential factor contributing to the 2007–2009 financial crisis. Regulatory capture is defined as a regulator acting in the interest of the regulated industry rather than in the public interest.

GAO was asked to review regulatory capture in financial regulation. This report examines FDIC's (1) processes for encouraging transparency and accountability in the bank examination process, (2) processes to minimize potential conflicts of interest among examination staff, and (3) agency-wide efforts to address the risks of regulatory capture and compromised independence. GAO reviewed FDIC's policies and enterprise risk management framework, analyzed bank examination workpapers, and interviewed supervisory staff.

What GAO Recommends

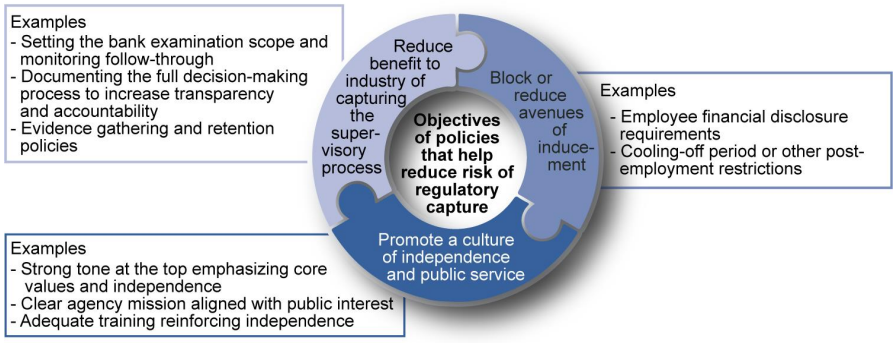
GAO is making four recommendations to FDIC related to managing the risk of regulatory capture, including improving documentation of banks' progress at addressing FDIC recommendations and revising examiner-departure processes. FDIC neither agreed nor disagreed with these recommendations, but described actions it would take in response to them. FDIC's actions, if fully implemented, would address two of the four recommendations.

View GAO-20-519. For more information, contact Michael Clements at (202) 512-8678 or clementsm@gao.gov.

What GAO Found

The Federal Deposit Insurance Corporation (FDIC) has designed policies to address the risk of regulatory capture by reducing the potential benefit to industry of capturing the examination process, reducing avenues of inducement, and promoting a culture of independence and public service (see figure).

Framework for Reducing Risk and Minimizing Consequences of Regulatory Capture



Source: GAO. | GAO-20-519

FDIC has several policies for documenting bank examination decisions that help promote transparent decision-making and assign responsibility for decisions. Such policies are likely to help reduce benefits to industry of capturing the examination process. However, GAO found that some examinations were not implemented consistent with FDIC policies and that gaps in FDIC policies limited their effectiveness. For example, GAO found that managers sometimes did not clearly document how they concluded that banks had addressed recommendations. By improving adherence to agency policies, FDIC management could better address threats to capture in the examination process.

GAO found that FDIC has policies to address potential conflicts of interest that could help block or reduce avenues of inducement. For example, FDIC has post-employment conflict-of-interest policies designed to prevent former employees from exerting undue influence on FDIC and to reduce industry's ability to induce current FDIC employees with prospective employment arrangements. One such policy requires the agency to review the workpapers of examiners-in-charge who accept employment with banks they examined in the prior 18 months. However, FDIC has not fully implemented a process for identifying when to review the workpapers of departing examiners to assess whether independence has been compromised. In particular, FDIC does not have a process for collecting information about departing employees' future employment. By revising its examiner-departure processes, the agency could better identify when to initiate workpaper reviews.

FDIC has identified regulatory capture as a risk as part of its enterprise risk management process. The agency has documented 11 mitigation strategies that could help address that risk. Identified mitigation strategies include rotating examiners-in-charge, national examination training, and ethics requirements.

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Abbreviations

CAMELS	capital adequacy, asset quality, management capability, earnings sufficiency, liquidity position, and sensitivity to market risk
ERM	enterprise risk management
FDIC	Federal Deposit Insurance Corporation
Federal Reserve	Board of Governors of the Federal Reserve System
MRBA	Matter Requiring Board Attention
OCC	Office of the Comptroller of the Currency
OGE	Office of Government Ethics
OIG	Office of Inspector General
OMB	Office of Management and Budget
RMIC	Risk Management and Internal Controls branch
RMS	Division of Risk Management Supervision

U.S. GOVERNMENT ACCOUNTABILITY OFFICE
441 G St. N.W.
Washington, DC 20548

September 4, 2020

The Honorable Maxine Waters
Chairwoman
Committee on Financial Services
House of Representatives

The Honorable Al Green
Chairman
Subcommittee on Oversight and Investigations
Committee on Financial Services
House of Representatives

As we have noted in prior work, an effective federal regulatory system should ensure that any entity responsible for regulation is independent from inappropriate influence.[1] We have previously found that weakness in federal supervision of large banks was among the factors that contributed to the financial crisis of 2007–2009.[2] Some analyses of the crisis have noted that inappropriate influence in the form of regulatory capture was a potential cause of this weakness.[3] While definitions vary, we define regulatory capture as a condition that exists when a regulator acts in service of private interests, such as the interests of the regulated industry,

[1]See, for example, GAO, *Large Bank Supervision: OCC Could Better Address Risk of Regulatory Capture*, GAO-19-69 (Washington, D.C.: Jan. 24, 2019); *Large Bank Supervision: Improved Implementation of Federal Reserve Policies Could Help Mitigate Threats to Independence*, GAO-18-118 (Washington, D.C.: Nov. 6, 2017); and *Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System*, GAO-09-216 (Washington, D.C.: Jan. 8, 2009).

[2]GAO, *Bank Regulation: Lessons Learned and a Framework for Monitoring Emerging Risks and Regulatory Response*, GAO-15-365 (Washington, D.C.: June 25, 2015).

[3]For example, see S. Pagliari (ed.), *Making Good Financial Regulation: Toward a Policy Response to Regulatory Capture* (London: International Centre for Financial Regulation, 2012); J. Kwak, "Cultural Capture and the Financial Crisis," in D. Carpenter and D. Moss (eds.*), Preventing Regulatory Capture: Special Interest Influence and How to Limit It* (New York, N.Y.: Cambridge University Press, 2013); and testimony of Robert C. Hockett before the U.S. Senate Committee on Banking, Housing and Urban Affairs, Subcommittee on Financial Institutions and Consumer Protection, 113th Cong., 2nd sess., Nov. 21, 2014.

at the expense of the public interest due to actions taken by the interested parties.

Banks in the United States receive federal supervision by one of three regulatory bodies—the Board of Governors of the Federal Reserve System (Federal Reserve), the Office of the Comptroller of the Currency (OCC), and the Federal Deposit Insurance Corporation (FDIC). Of these, FDIC supervises about 64 percent of U.S. banks and about 18 percent of all bank assets, as of December 2019.

You asked us to examine issues related to regulatory capture in the financial services industry, and this report is the third in a series. Our prior reports focused on the threats of regulatory capture in the large bank examination process at the Federal Reserve and OCC.[4] This report focuses on regulatory capture in the examination of both large and small banks at FDIC. Specifically, this report examines the extent to which FDIC (1) has policies that encourage transparency and accountability in the bank examination process and has implemented those policies to achieve their intended outcomes; (2) has policies to minimize the risks of conflicts of interest that could threaten the independence of bank examination staff and has implemented those policies to achieve their intended outcomes; and (3) has developed an agency-wide focus to address the risks of regulatory capture and compromised independence.

To address the first objective, we analyzed FDIC policies for the bank examination process to identify elements that helped promote transparency and accountability. In addition, we reviewed bank examination documentation for two large banks and eight small banks in two FDIC regions—New York and Atlanta—to assess the completeness of documentation and whether examinations documented high-risk areas identified during the examination planning process. We defined large banks as those with $10 billion or more in assets, which are subject to continuous examination procedures under FDIC policy. Small banks, which typically have less than $10 billion in assets, are subject to point-in-time examinations that occur at periodic intervals. We selected the small banks using a judgmental sample to allow for a variety of asset-size categories, diversity in geographic locations, and certain bank characteristics, such as having a large percentage of commercial real

[4]See GAO-18-118 and GAO-19-69.

estate lending.[5] Our analysis of the sample banks' documentation was not generalizable to the FDIC bank examination process overall. We assessed the bank examination documentation against FDIC policy requirements for conducting bank examinations and federal internal control standards.

To address the second objective, we reviewed relevant federal ethics statutes and regulations and FDIC's supplemental standards for ethical conduct. We also analyzed agency documentation on departing bank examination employees, interviewed agency ethics officials, and reviewed selected ethics policies and procedures at other federal financial regulators. We assessed this information against FDIC policy requirements.

To address the third objective, we reviewed agency documentation on training, performance management, and strategic planning. We also reviewed documentation provided by FDIC's Risk Management and Internal Controls branch (RMIC) and interviewed agency officials on FDIC's approach to enterprise risk management (ERM). We assessed these documents against Office of Management and Budget (OMB) guidance on risk management and federal internal control standards.

To address all three objectives, we interviewed officials from the Division of Risk Management Supervision (RMS)—the FDIC unit responsible for bank examinations. In addition, we interviewed 44 bank examination staff members based in regional offices holding the positions of examiner (including examiner-in-charge), case manager, or assistant regional director. Although we cannot generalize these staff members' views to all bank examination staff at FDIC, the individual perspectives we received provided context about the real-world application of policies and procedures. Appendix I provides more detail on our scope and methodology.

[5]We selected three banks with less than $1 billion in assets, four banks between $1 billion and $3 billion in assets, and one bank with more than $3 billion but no more than $10 billion in assets. We and the federal banking regulators have previously identified commercial real estate lending as a risk factor for banks. See GAO, *Commercial Real Estate Lending: Banks Potentially Face Increased Risk; Regulators Generally Are Assessing Banks' Risk Management Practices*, GAO-18-245 (Washington, D.C.: Mar. 15, 2018), and Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency, *Statement on Prudent Risk Management for Commercial Real Estate Lending* (Washington, D.C.: December 2015).

We conducted this performance audit from April 2016 to September 2020 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Background

Regulatory Capture Risk in Banking Regulation

Some experts argue that banking regulators may be particularly susceptible to regulatory capture.[6] Reasons for this include the size and profitability of regulated banks and their ability to offer regulatory staff attractive employment opportunities (i.e., the revolving door) or other inducements. Experts generally agree that capture is a potentially significant threat to an agency's efforts to regulate industry effectively.[7] For example, banking regulator employees who are captured may make examination decisions that inappropriately benefit the banks they regulate by overlooking risky practices or not imposing appropriate penalties. Therefore, regulatory capture poses a risk to banking regulators since it may prevent agencies from achieving their objectives.

The academic literature on regulatory capture suggests that there are several potential channels of capture (see table 1). Industry can target individuals at all levels of the hierarchy, including the top, or the agency as a whole. Inducements in all cases can be either financial or nonfinancial. Nonfinancial channels of inducement can take various forms. The regulated industry can capture elements of the regulatory agenda through influential policy research. In another example, bank executives can make adversarial situations unpleasant for bank examiners, which could lead examiners to soften examination findings to avoid further unpleasant interactions. Financial and nonfinancial inducements can stem from individual regulated entities or intermediaries

[6]For example, see Daniel Hardy, *Regulatory Capture in Banking*, IMF Working Paper, WP/06/34 (International Monetary Fund, January 2006).

[7]For example, see D. Carpenter and D. Moss (eds.), *Preventing Regulatory Capture: Special Interest Influence and How to Limit It* (New York, N.Y.: Cambridge University Press, 2014).

such as industry associations, law firms, consulting firms, or research institutions.

Table 1: Potential Channels of Regulatory Capture at Institutional and Individual Levels

Category	Financial	Nonfinancial
Institutional level	• Threats to change the bank charter to a new regulator[a]	• Influencing scientific or policy research to shape the regulatory agenda or policy options considered acceptable
Individual level	• Future career opportunities (i.e., "revolving door") • Stocks (for example, through previous employment) • Loans with below-market terms	• Use of status to impress or intimidate • Manipulation of personal relationships • Making adversarial situations difficult and cooperative ones socially or intellectually rewarding to the extent that adversarial situations are inappropriately avoided

Source: GAO analysis of literature on regulatory capture. | GAO-20-519

[a]Some banking regulators charge fees to cover the cost of bank examinations, and therefore a change in the bank charter would deprive the regulator of revenue. The Federal Deposit Insurance Corporation does not charge bank examination fees because examination costs are funded by the agency's Deposit Insurance Fund.

The form and target of capture can depend on a variety of factors, including the entity that is attempting capture, its goals, and the nature of the interaction between regulators and the regulated industry. For example, a large bank seeking leniency from its line examiners who are embedded with the bank might apply pressure through the social ties formed by the embedded relationship, or through a more transactional promise of future career opportunities to targeted examiners.[8] While small banks may not have the same prestige, resources, or constant contact with examiners to draw upon, they have other forms of financial and nonfinancial inducement available to them. In particular, they can amplify their influence through intermediaries.[9] For example, professional service firms such as law firms, consulting firms, or accounting firms may offer

[8]James Kwak, "Cultural Capture and the Financial Crisis," in D. Carpenter and D. Moss (eds.), *Preventing Regulatory Capture: Special Interest Influence and How to Limit It* (New York, N.Y.: Cambridge University Press, 2013); Ernesto Dal Bo, "Regulatory Capture: A Review," *Oxford Review of Economic Policy* vol. 22, no. 2 (2006): 203-225.

[9]Luigi Zingales, "Preventing Economists' Capture," in D. Carpenter and D. Moss (eds.), *Preventing Regulatory Capture: Special Interest Influence and How to Limit It* (New York, N.Y.: Cambridge University Press, 2013); Kenneth W. Abbott, David Levi-Faur, and Duncan Snidal, "Theorizing Regulatory Intermediaries: The RIT Model," *The ANNALS of the American Academy of Political and Social Science* vol. 670, no. 1 (2017): 14-35.

jobs on behalf of their financial-institution clients.[10] In other cases, bank examiners may apply less scrutiny to institutions that have hired professional services firms that employ former examiners.

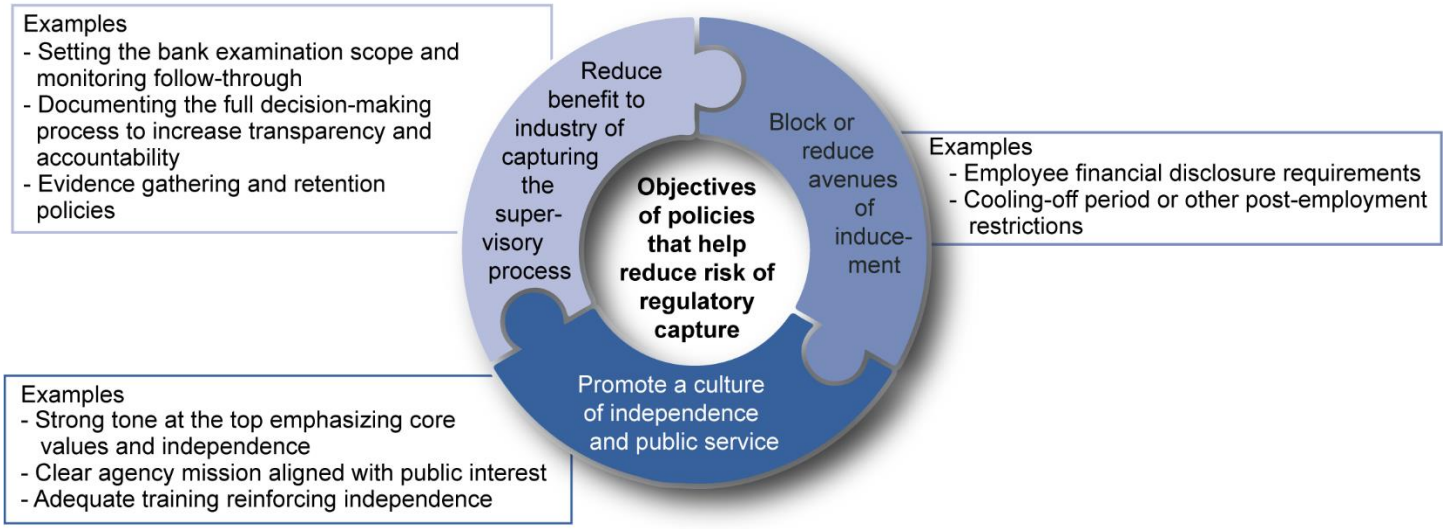
Responding to the Risk of Capture

To respond to risks such as regulatory capture, agencies can apply the principles of internal control through control activities, including policies and procedures. *Standards for Internal Control in the Federal Government* requires that agencies identify, analyze, and respond to risks relatedto achieving their objectives. The standards also indicate that agencies should apply the principles of internal control through control activities, including policies and procedures. We previously assessed the literature on preventing collusion to identify the control activities that can help mitigate regulatory capture.[11] As part of our analysis, we identified three approaches an agency can take to help mitigate the risk of capture: (1) reduce the potential benefits to industry of capturing the regulatory process; (2) block or reduce avenues of inducement; and (3) promote a culture of independence and public service. (See fig. 1.)

[10]An empirical study of patent officers found that lower-quality patents were offered to clients of law firms located in regions that the patent officer eventually went to work for, suggesting that patent officers were concerned with currying favor with the law firms associated with patent applicants, not the applicants themselves. See Haris Tabakovic and Thomas G. Wollmann, “From Revolving Doors to Regulatory Capture? Evidence from Patent Examiners,” NBER Working Paper 24638 (Cambridge, MA: National Bureau of Economic Research, 2018).

[11]See GAO-19-69, app. I for a discussion of our framework, which was based on theoretical economic literature on preventing collusion, including regulatory capture, through well-designed contracts.

Figure 1: Policy Objectives and Examples of Policies That Help Reduce Risk of Regulatory Capture



Source: GAO. | GAO-20-519

Reduce Benefits to Industry of Capturing the Bank Examination Process

Agencies can help reduce the risk of industry capturing the bank examination process by implementing policies that reduce the benefits of industry capturing agency staff or make it more difficult to do so. These policies can limit the effect any one individual can have on an examination by, for example, having layers of review to help ensure that decision-making is not concentrated with a single employee. They also include steps in the examination process to increase the likelihood that an agency will identify an examiner whose decisions are industry-biased. The agency can accomplish these goals by implementing policies to increase transparency and accountability in the decision-making and work processes, particularly by focusing on decisions that affect industry profitability and interactions between agency and industry staff. The policies can include

- layers of review that involve individuals with differing perspectives, incentives, and relationships with industry;
- regulatory decisions and rationale that are transparent to lower-level staff, with appeal rights for lower-level staff who believe a decision is biased;

- documentation of the full decision-making process for consequential decisions, including the retention of divergent views and the rationale or evidence used to resolve any divergent views;
- rotation of staff in key decision-making roles, so as to mitigate the impact of any one employee;
- controls around management to ensure they cannot override internal controls relevant to capture; and
- documentation of contacts with the regulated industry (both routine regulation-related contact and unsolicited contact by industry that attempt to influence the regulator).

Block or Reduce Avenues of Inducement

Agencies can also seek to block or reduce industry's ability to offer regulators inducements—such as future employment opportunities—in exchange for preferential treatment. However, these strategies are generally difficult to implement and may be too narrow in scope to adequately protect the agency from capture. For example, because regulators must interact with the regulated industry, contact between the two cannot be fully barred. Similarly, too many restrictions on financial holdings and allowable career paths can restrict the pool of talent available to the regulator. Nonetheless, some policies can reduce avenues of inducement, including

- prohibiting employees from holding a direct financial interest in a regulated entity, including requiring recusals for those who are exposed to the conflict of interest;
- monitoring employees' financial holdings through disclosure requirements; and
- instituting cooling-off periods—which bar certain employees from employment at or representation before their former agencies for specified periods of time—or other post-employment restrictions.

Promote the Public Interest

Additionally, agencies can mitigate the risk of regulatory capture by promoting a focus on their mission to serve the public interest and their values of transparency, accountability, and independence. Some avenues to do this include

- cultivating a culture of public service;

- ensuring that the agency's mission is clear and well aligned with the public interest;
- having a strong, clear tone at the top that emphasizes the agency's core values;
- establishing incentive structures (such as in pay and promotion decisions) that reward employees who demonstrate a commitment to the public interest, independence, and agency mission; and
- providing adequate training to support individuals' abilities to execute their duties in an independent manner in line with the public interest, particularly for those coming from industry.

FDIC's Bank Examination Process

FDIC is the primary federal regulator for state-chartered banks that are not members of the Federal Reserve System. As of December 31, 2019, FDIC served as primary regulator for about 3,300 banks, including 47 that have more than $10 billion in assets.[12] Within FDIC, the Division of Risk Management Supervision (RMS) has primary responsibility for the safety and soundness of FDIC-supervised institutions. RMS also conducts specialty examinations that cover such areas as trust department operations, information technology controls, and institution compliance with the Bank Secrecy Act. These specialty examinations often are performed concurrently with the safety and soundness examinations. RMS has six regional offices, each of which oversees multiple field offices where examiners are based, and a Large Bank Supervision unit based in FDIC's national headquarters. RMS operates independently from FDIC's Division of Insurance and Research, which is responsible for monitoring the fiscal soundness of FDIC's Deposit Insurance Fund. Agency officials say this allows the insurance division to provide an independent perspective on bank examination results.

Examiners review an institution's condition using the Uniform Financial Institutions Rating System, also known as the CAMELS rating system, which is an acronym made up of the six components on which a bank is rated. These components are capital adequacy, asset quality, management capability, earnings sufficiency, liquidity position, and

[12]FDIC is not the primary federal regulator for any of the eight U.S.-based banks that were designated in 2019 as Globally Systemically Important Banks by the Financial Stability Board.

sensitivity to market risk. Evaluations of CAMELS components consider an institution's size and sophistication, the nature and complexity of its activities, and its risk profile. Regulators provide an overall safety and soundness rating, known as a composite rating, as well as ratings for each of the six individual components.[13] Banks are not charged a fee for FDIC's safety and soundness examinations. Instead, the examinations are funded from the deposit insurance premiums that banks pay to insure depositors' accounts against loss.

FDIC makes supervisory recommendations to banks on its views about changes needed to their practices, operations, or financial condition.[14] Supervisory recommendations must be presented in writing, and most are generally correctable in the normal course of business. The agency has instructed its examination staff that these recommendations must address meaningful concerns and must discuss corrective action needed to address the identified concerns. A subcategory of supervisory recommendations, called Matters Requiring Board Attention (MRBA), are used to identify issues or risks of greater significance that typically would require more effort to address than those correctable in the normal course of business and that would need to be brought to the attention of the bank's board and senior management.[15]

The examination process can differ, depending on a bank's condition and whether a bank is subject to FDIC's Large Bank Supervision procedures for banks with assets of more than $10 billion. Banks not included in the Large Bank Supervision procedures—which we characterize as small banks in this report—make up about 99 percent of all banks for which FDIC is the primary federal regulator. Small banks are examined periodically, with bank examination staff typically on-site at the bank for at least a portion of the examination. The banks are required to receive an

[13]Ratings are assigned on a 1-to-5 scale, with "1" indicating strong ratings, "2" indicating satisfactory ratings, "3" indicating less than satisfactory or needing improvement, and "4" and "5" indicating deficiencies. See FDIC, "RMS Manual of Examination Policies," Section 1.1 (Federal Deposit Insurance Corporation: Washington, D.C., 2019).

[14]FDIC, *Statement of FDIC Board of Directors on the Development and Communication of Supervisory Recommendations* (Washington, D.C.: July 29, 2016).

[15]For more serious concerns, or for concerns that small banks or large banks have not addressed after receiving a supervisory recommendation, FDIC can take corrective actions against banks. FDIC's corrective actions fall into two categories—informal actions and formal actions—and either can be used to correct noted safety and soundness deficiencies or ensure compliance with federal and state laws.

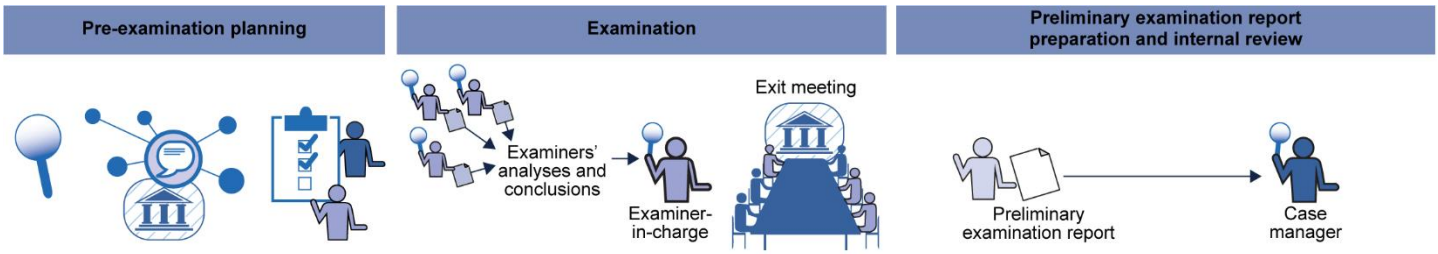
examination every 12 months, though FDIC can extend this period to 18 months for banks with less than $3 billion in total assets if certain other conditions are met.[16] Banks receive a report of examination after the examination concludes.

For large banks, FDIC does not conduct an annual point-in-time examination of the institution. Rather, it conducts ongoing examination activities that are made up of higher-risk areas identified for targeted review and ongoing monitoring of other functions to evaluate an institution's operating condition, management practices and policies, and compliance with applicable laws and regulations. As targeted reviews are completed during the annual examination cycle, large banks are provided with target conclusion letters that describe examiners' findings, and these targeted conclusion letters may include supervisory recommendations that banks are expected to address. CAMELS ratings are communicated in the report of examination, which is prepared annually.

Examination teams, whether for large bank or small bank examinations, are led by an examiner-in-charge who is responsible for overseeing the planning and conduct of the examination (see fig. 2). Before the examination begins, the examiner-in-charge schedules a meeting with bank management to identify key issues that impact the bank's condition, any changes in the bank's operation, and management's views on the highest-risk areas for the bank. The examiner-in-charge also reviews the bank's recent performance data and obtains input from the bank's case manager, who is an RMS staff member responsible for monitoring the condition of banks within a set portfolio.

[16]*See* 12 U.S.C. § 1820(d) and 12 C.F.R. § 327.12(b). For example, the conditions for the 18 month examination cycle include that the FDIC found the institution to be well managed at its most recent examination and that the institution is not subject to a formal enforcement proceeding or order by FDIC or another federal banking regulator.

Figure 2: Steps in the Federal Deposit Insurance Corporation's Bank Examination Process



- Review data and recent examination results to identify risks and areas of focus for each bank
- Discuss with field supervisor the resource needs (e.g., number of examiner hours needed)
- Discuss plan with field supervisor and obtain his/her approval

- Review bank data and meet with bank management as needed
- Document observations and analysis (workpapers are retained electronically)
- Hold exit meeting with bank officials to discuss preliminary observations and gain management commitment to correct deficiencies

- Prepare preliminary examination report (includes examination ratings and evidence supporting each rating)
- Determine whether to include supervisory recommendations or to recommend consideration of informal or formal enforcement actions
- If applicable, note bank management's commitment to address identified deficiencies
- Review of draft examination report by case managers, and higher-level reviewers as needed

Source: GAO analysis of Federal Deposit Insurance Corporation bank examination policies. | GAO-20-519

The examiner-in-charge prepares a memorandum that describes these areas of input—bank management, performance data, and FDIC case managers—and identifies the high-risk areas that the examination team should focus on during the examination. The memorandum serves as the scoping plan for how the examination will be conducted and is forwarded for approval to a field supervisor, who heads the field office responsible for conducting the examination. For large bank examinations, planning the examination scope takes place several months before the start of each annual examination cycle. These memorandums generally are much longer than those for the small bank examinations and specify the rationale for which areas will be selected for targeted review. Large bank scoping plans also are reviewed by assistant regional directors in the regional office, which is a higher-level official than field supervisor, and by managers in the Large Bank Supervision branch at FDIC's headquarters.

During the on-site portion of the examination, the examination team analyzes bank documents, such as a sample of the loan portfolio, and various bank policies. Examiners meet with bank management, as needed, to ask questions and gain management's perspective on bank-specific issues. FDIC policies also instruct the examination team to encourage participation at meetings from members of the bank's board of directors. The final activity of the on-site part of the examination is an exit meeting with management. Examiners discuss their findings and recommendations with management, though these findings are not official until the report of examination is issued.

The examiner-in charge prepares a draft report of examination that discusses the findings and recommendations, as well as draft ratings for each CAMELS component and the overall examination rating. For areas where deficiencies are identified, the draft report of examination also generally describes any commitments made by management to address the issues cited. The draft reports are reviewed by a case manager, who considers whether the evidence presented is consistent with the ratings proposed by the examiner-in-charge. Case managers can revise the proposed ratings before finalizing the report of examination, though these changes are documented and discussed with the examiner-in-charge and must be approved by regional office management.

Finally, the case manager prepares a transmittal letter to the bank that is sent in conjunction with the final report of examination. These transmittal letters highlight certain elements of the report for the bank's directors, such as emphasizing particular supervisory recommendations, explaining expected time frames for banks' responses to identified issues, and identifying directors' responsibilities for overseeing management activities to address identified issues. Case managers also are responsible for reviewing banks' written responses to the report of examination and for tracking banks' progress in addressing the supervisory recommendations, including MRBAs. When banks' actions in response to MRBAs are insufficient or unreasonably prolonged, case managers are instructed to raise these issues with regional office management. Banks can be subject to increased monitoring by regulators or increased supervisory action if their actions are not sufficient to address the identified weaknesses in their practices, operations, or financial condition.

FDIC Policies Address Capture Risks in Bank Examination, but Weaknesses Exist in Documentation and Transparency

FDIC Has Policies That Could Help Address Risks of Regulatory Capture

FDIC has several policies that require transparency in decision-making and that assign responsibility for decisions in the bank examination process, which are likely to reduce the benefits to industry of capturing the bank examination process. Such policies can limit any individual's influence over the examination process and improve the agency's

capability to identify improper actions by examination staff. These policies apply before the examination begins, during the examination process, and after the examination has been completed.

Before the Examination

Prior to the examination, FDIC requires that examiners prepare a written scoping plan that describes the examination's areas of focus based on the institution's high-risk areas. These scoping plans help to make decisions about the planned examination agenda transparent, and they can enhance the visibility of any deviation between the pre-examination agenda and the execution of the examination.

The format and content of scoping plans differ between small banks that are examined periodically and large banks that undergo continuous examination. Small bank scoping plans all use a similar format that includes analyses of key metrics—such as non-performing loans and ratios of assets to growth. Each of the eight small bank scoping plans we reviewed included analyses of these key metrics to determine the high-risk areas that merited analysis during the examination process. Large bank scoping plans are prepared for each annual examination cycle and describe the high-risk areas identified for targeted examination in the upcoming year, as well as plans for ongoing monitoring of other activities. For both small and large banks, FDIC requires that agency management review and approve these plans prior to the start of on-site examinations. This process, which makes scoping decisions transparent and requires layers of review, can make it more difficult for industry to capture the examination process.

During the Examination

FDIC has policies for rotating staff assigned as the examiner-in-charge, who plays a key decision-making role both in overseeing the work of others and in drafting the preliminary report of examination. Examiners-in-charge of large bank safety and soundness examinations serve in the role for 5 years, after which they rotate off of that bank for at least 24 months. In 2019, FDIC added a policy that examiners-in-charge for small banks could not serve in that role for the same bank for more than two consecutive examinations.[17] Policies to rotate examiners-in-charge can

[17]The 2019 FDIC policy memorandum outlining the two-examination maximum said the rule formalized the use of rotational policies that previously had largely been an informal policy.

help block or reduce avenues of inducement by limiting the benefits of capturing individuals who serve in this role.

FDIC also has established policies for how to analyze bank information and document results of that analysis, which can help foster transparent decision-making during the preparation of bank reports of examination. FDIC and regional offices have created reporting templates for analyzing information and reporting conclusions. These templates help maintain consistency in documenting conclusions, which aids in the transparency of findings for reviewers and other internal users of the information. Examination documentation is saved in an online database, which enhances transparency by making the documentation accessible for the on-site examination team and reviewers in regional offices or FDIC's headquarters.

FDIC also has produced a Manual of Examination Policies and guidance memorandums and has established training modules, all of which describe expectations for examiners when conducting bank examinations. Like the requirements for a written scoping plan, this information describes general approaches for conducting the bank examination. These expectations about analyzing and documenting bank examinations would make it harder for captured examiners to ignore or minimize areas where the bank's safety or soundness may be vulnerable or to downplay the severity of evidence. Therefore, these policies and training modules help increase the likelihood that FDIC could identify individuals who are captured by banks or other interested parties.

After the Examination Is Completed

After the examination team completes its analysis, FDIC has policies designed to hold case managers accountable for reviewing both examination teams' work and banks' responses to recommendations made in the report of examination. These policies help promote transparency and accountability in decision-making by specifying that case managers must document their reviews and any changes to the examination teams' findings.

Case managers are responsible for reviewing whether the examination was performed according to the scope. FDIC policy requires that case managers determine, to the extent possible, whether the examination was conducted in accordance with prescribed procedures in the scoping memorandum. Significant variations in the scope should be explained in a confidential section of the examination report that does not go to the

bank, according to FDIC policy. However, no documentation is required if no differences between the scope and the examination are observed.

FDIC also has policies that require case managers to review the evidence presented and to determine whether the examination teams' proposed CAMELS ratings, supervisory recommendations, and corrective actions are appropriate to the information discussed in the draft examination report. If case managers decide that significant changes are needed, FDIC policy requires that they discuss those differences with examiners-in-charge. Unresolved differences must be brought to the attention of the regional director or to an individual designated by the regional director for resolution prior to completion of the review. Any changes to CAMELS ratings—even if the examiner-in-charge ultimately agrees with a case manager's change—are to be documented in a database used to track examination results. As a result, this policy can help to limit the effect any one individual can have on an examination by making key decisions available for review, thereby reducing the risk of capture.

Another post-examination policy that helps promote transparency of decision-making involves FDIC's requirements for case managers to document banks' progress in addressing MRBAs and determine when banks have fully addressed FDIC's concern. FDIC uses the tracking database to document banks' progress on addressing MRBAs and requires that case managers summarize banks' actions to facilitate nationwide monitoring of the use of MRBAs. This tracking policy is intended to aid FDIC in identifying when banks' corrective actions are not sufficient to address supervisory concerns expressed in MRBAs. When banks do not address the supervisory concern, they are subject to increased monitoring and could be subject to additional supervisory action, according to the policy.

Other Policies

We identified other FDIC policies that promote transparency and accountability in the decision-making process that but that do not occur at specific points in the examination process:

- **Internal inspections.** The Division of Risk Management maintains an Internal Control Review Section whose tasks include reviewing a sample of the examinations conducted in each regional office. These reviews generally occur once every 3 years for each of the six regional offices. The section prepares written reports of its reviews, which are provided to the regional director

and often contain suggestions for improving examination performance, including improvements in documentation of consequential decisions.

- **Controls around examinations conducted by state agencies**. Case managers are expected to review the results of state-led examinations, including when states alternate examinations with FDIC. In addition, FDIC has policies for evaluating states' capacity for conducting effective examinations that includes evaluating training requirements and funding for the examination process, among other factors. FDIC case managers' review of state examination processes and examination conclusions affords FDIC the opportunity to maintain a layer of review of the consequential decisions made by state banking agencies.

Weaknesses in Some Examination Policies and Practices May Increase Risks of Capture

Our review of selected bank examination documentation found that examinations sometimes were not executed or reviewed in ways that fully complied with certain FDIC policies. In addition, some FDIC policies had gaps that may limit their effectiveness in addressing the threat of regulatory capture.

Observed Deviations from the Examination Scope Were Not Documented

As previously discussed, FDIC policy requires case managers to review the report of the examination for consistency with the planned scope of the examination—a control that helps limit the effect that any one individual can have on the examination process. Our review of eight small bank examinations found that two of these examination reports did not

address all high-risk elements identified in the scoping plan, but that both contained documentation that said the scoping plan had been followed:[18]

- One report did not address three out of six high-risk areas that had been identified in the scoping plan. All three of these areas pertained to the bank's Sensitivity to Market Risk.[19]
- Another report did not address four out of eight identified high-risk areas that had been identified in the scoping plan, which were related to interest-rate risk.[20]

For both banks, the examination scoping plans stated that these areas would be reviewed.

The fact that an examination report omits discussion of some high-risk areas suggests that either (1) the scoping plan was not followed or (2) examiners scrutinized but did not find problems in these high-risk areas and therefore did not mention those areas in the report. FDIC officials said that they do not expect to comment on all aspects of an examination in the report and that the discussion generally focuses on adverse findings.

Federal internal control standards state that management should design control activities to achieve objectives and respond to risks. FDIC's policy is that case managers review examination reports for accuracy, and the reports should document deviations from the scope of an examination. However, in cases where the examination report does not address all

[18]We identified a total of 48 high-risk areas among the scoping plans for these eight examinations and found that 41 of the 48 were discussed in the report of examination as having been reviewed by the examination team. The number of high-risk areas for each of the eight bank scoping plans ranged from two to nine. In addition, we identified a total of 20 high-risk areas included in the scoping plans for four large-bank targeted reviews that we analyzed. (We reviewed two targeted reviews for each of the two large banks in our sample.) We found that all 20 high-risk areas were addressed by the examination teams in the documentation we reviewed.

[19]Sensitivity to Market Risk is the CAMELS rating category that assesses the bank's risk level with respect to changes in asset valuations that often are outside of the bank's control, such as the risk of changes to the prevailing market-based interest rate, which is known as interest-rate risk. For this examination, the Sensitivity to Market Risk component rating was increased to the highest rating on the five-point rating scale used for CAMELS ratings—which signifies "strong" performance—from the second-highest during the prior examination, which signifies "satisfactory" performance.

[20]The report of examination did not describe the team's analysis of risks of large deposits, mortgage prepayment risks—which, if interest rates changed, could negatively impact bank capital or earnings—or two other high-risk areas identified in the scoping plan.

high-risk areas, there is ambiguity as to whether the case manager determined whether examination teams followed the planned scope. By requiring case managers to document how all high-risk areas were considered by examiners, FDIC could better ensure that examination reports comply with the requirement to document scope deviations and improve the transparency of case managers' reviews—controls that help mitigate the risk of industry capture of the examination process.

Case Managers Did Not Document Their Rationale for Determining Selected Banks Had Addressed MRBAs

We found that for selected banks, case managers did not document their rationale for determining that banks had fully addressed prior MRBAs. Of five MRBAs we reviewed that FDIC case managers had deemed "completed"—that is, fully addressed by the bank—none contained documentation in FDIC's tracking system that was sufficient to understand how banks had satisfactorily addressed FDIC's concerns.[21] Specifically, documentation for two completed MRBAs described bank plans for future actions that would address FDIC's recommendation, but these planned actions had not yet been completed. Tracking system documentation for three other MRBAs deemed completed did not provide sufficient detail to understand what specific actions banks had taken to address them, though FDIC subsequently provided us with additional information that was housed in a different data system. For four other MRBAs we reviewed that were not designated as completed, FDIC managers generally did document banks' specific progress toward addressing the MRBA.

FDIC's policy for tracking and documenting MRBA decisions helps make case managers' assessments of banks' progress toward addressing supervisory concerns more transparent. However, for the MRBA-tracking documentation we reviewed, we found that case managers did not always comply with FDIC's policy to document their assessment of how banks have addressed MRBAs. Federal internal control standards state that management should design control activities to achieve objectives and respond to risks.[22] FDIC uses on online tracking system to document

[21]The MRBAs we reviewed were those contained in reports of examination for the eight small banks in our sample. Those examinations resulted in nine MRBAs, five of which were deemed completed and four of which were not deemed completed and therefore would continue to be monitored, per FDIC policy.

[22]GAO-14-704G.

banks' responses to MRBAs and facilitate FDIC staff follow-up. Adding appropriate controls—such as supervisory review—to monitor case manager compliance with this documentation policy could help ensure FDIC achieves its goal of transparency in the determination of whether banks have addressed MRBAs.

Documentation Generally Is Deleted after One Examination Cycle

FDIC's document retention policies require that examination documentation for banks rated as satisfactory generally should be deleted after one examination cycle has elapsed, except for the final report of examination.[23] Agency officials explained that once a new examination is completed, FDIC views the prior information as obsolete, given that the final report is retained, and the final reports make up the official record of the examination. FDIC officials said purging the obsolete files helps to protect sensitive bank information contained in examination documentation. Officials noted that the documentation-retention policy has exceptions for ongoing concerns—for example, when the documentation would support the need for corrective action or might contain evidence of past insider abuse.

However, FDIC's document retention policy creates challenges in assessing and addressing the risk of regulatory capture. Purging documentation after one examination cycle reduces transparency in the decision-making process and makes it difficult to identify accountable parties after the examination has been completed. For example, this policy could limit FDIC's ability to review workpapers that go back more than one examination cycle to investigate longer-term patterns of potentially improper actions. Federal internal control standards state that management should design control activities to achieve objectives and respond to risks.[24] For example, this includes documentation of significant events—such as bank examiners' workpapers—in a manner that allows the documentation to be readily available for review. Expanding the length of time that workpapers are routinely retained would ensure FDIC has the ability to review examiners' work if concerns come to light after more than one examination cycle, which could benefit efforts to detect and address potential regulatory capture. To ensure that sensitive bank information remains protected, FDIC could limit access to this retained

[23]As noted earlier, the length of time between FDIC examinations can vary by bank, ranging from 12 months to 36 months.

[24]GAO-14-704G.

documentation by making it available only for the purposes of any necessary future review.

FDIC Has Policies to Mitigate Threats to Independence but Has Not Fully Implemented a Process for Reviewing Departing Examiners' Workpapers

FDIC Has Ethics Policies Designed to Address Potential Conflicts of Interest

Employees' individual conflicts of interest can undermine their independence in performing supervisory duties. FDIC implements ethics policies and procedures to comply with federal statutory and regulatory requirements on preventing conflicts of interest.[25] These policies are designed to limit some of the most direct forms of influence the banking industry might exert in an attempt to capture FDIC employees.

FDIC employees involved in the bank examination process are subject to criminal conflict-of-interest statutes that apply to federal employees. The key conflict-of-interest statute prohibits employees from participating personally and substantially in an official capacity in any particular matter where the employee or the employee's spouse or minor child, among others, has a financial interest if the particular matter will have a direct and predictable effect on that financial interest.[26] Employees with financial conflicts of interest must disqualify themselves from participating in any such matter or divest themselves of the financial interest to comply with the statute. Another statute applies only to federal financial institution examiners and imposes criminal penalties on examiners if they accept a

[25]Congress enacted legislation intended to prevent conflicts of interest to help ensure that federal employees act in the interest of the public. Congress also created the Office of Government Ethics (OGE) in 1978 to provide direction to executive branch agencies in developing policies related to preventing conflicts of interest. This report focuses on policies and procedures to promote compliance with the conflict-of-interest restrictions for current employees in 18 U.S.C. §§ 208 and 213, the post-employment restrictions in 18 U.S.C. §207 and 12 U.S.C. § 1820(k), and related federal regulations. This report does not address other federal ethics laws, such as those related to bribery and those involving the representation of foreign entities.

[26]*See* 18 U.S.C. § 208(a); 5 C.F.R. § 2635.402(a).

loan from an institution they have examined, with some exceptions.[27] FDIC employees are also subject to standards of conduct and regulations issued by the Office of Government Ethics (OGE).[28]

In addition, FDIC has supplemental standards of conduct that generally prohibit bank examiners, their spouses, and minor children from having a loan or extension of credit from any FDIC-insured state nonmember bank or its subsidiary.[29] These standards also prohibit all FDIC employees, their spouses, and minor children from acquiring, owning, or controlling the securities of any bank or savings association insured by FDIC, or certain other companies, including bank holding companies and financial holding companies regulated by the Federal Reserve. Some exceptions exist that allow bank examiners to obtain certain credit cards and home loans, but employees are still prohibited from applying for credit at a bank the examiner is assigned to examine.[30] Other exceptions include permitting employees to retain loans, extensions of credit, and securities that were acquired prior to FDIC employment.

To monitor for potential conflicts of interest, FDIC collects and reviews information on employees' finances through the following forms:

- **OGE financial disclosure form.** FDIC bank examination staff complete a confidential financial disclosure form—OGE Form 450—when they begin employment and annually thereafter.[31] OGE Form 450 requires filers to report current assets, liabilities,

[27]This restriction does not apply to certain primary residential loans and credit cards. 18 U.S.C. § 213(a).

[28]OGE issues regulations that implement federal statutes intended to prevent conflicts of interest. In addition, Executive Order 12674 (as modified by Executive Order 12731) set out fourteen basic principles of ethical conduct for Executive Branch personnel and directed OGE to establish a single, comprehensive, and clear set of executive branch standards of ethical conduct. OGE's Standards of Ethical Conduct for Employees of the Executive Branch, 5 C.F.R. pt. 2635, apply to FDIC employees. FDIC employees are also subject additional standards of conduct under the FDIC regulation at 5 C.F.R. part 3201—issued jointly with OGE—which supplements the Executive Branch-wide Standards.

[29]The prohibition also extends to loans or extensions of credit from any officer, director, or employee of these banks or subsidiaries. *See* 5 C.F.R. § 3201.102(c).

[30]*See* 5 C.F.R. § 3201.102(c)(2).

[31]*See* 5 U.S.C. App. § 107(a) and 5 C.F.R. §§ 2634.903, 2634.904. Certain higher-level employees are required to submit separate, public financial disclosure forms using OGE Standard Form 278. *See* 5 U.S.C. App § 101 and 5 C.F.R. §§ 2634.201, 2634.202.

and any income earned from outside sources in the previous year, among other things, for themselves, their spouses, and their minor children.[32]

- **FDIC financial disclosures**. Employees are required to separately report all non-credit-card financial obligations owed to an FDIC-insured depository institution. These reports are filed annually and may include obligations that employees are not required to report on their OGE Form 450.[33] Employees are also required to report on a separate form any interests in the securities of an FDIC-insured depository institution or depository institution holding company, or financial interests in these entities held through a pension or retirement plan, trust, or other arrangement. Employees must submit this form upon joining FDIC and within 30 days of acquiring a new interest in an FDIC-insured institution or divesting themselves of a previously reported interest.

Deputy ethics counselors review both the OGE and FDIC financial disclosure forms for potential conflicts of interest and counsel employees on how to resolve any identified conflicts.[34] According to officials, potential financial conflicts of interest are commonly resolved by having the employee divest securities, refinance credit obligations, or seek a reassignment of duties. Employees complete and file OGE and FDIC financial disclosure forms using an electronic system, and ethics counselors use this system to review the forms of their assigned employees.

In addition, federal law prohibits federal employees from participating in particular matters in which an organization with which the employee is

[32]Filers are only required to report assets and income that exceed $1,000 and liabilities that exceed $10,000.

[33]For example, the OGE Form 450 does not require disclosure of certain liabilities—such as mortgages, student loans, or credit card accounts—which are granted on terms made available to the general public. The OGE Form 450 also does not require disclosure of loans secured by personal property—such as automobiles, household furniture, or appliances—unless the loan exceeds the purchase price of the item it secures. With OGE's approval, agencies may require additional confidential financial disclosures to supplement the OGE Form 450, if necessary because of special or unique agency circumstances. *See* 5 C.F.R. §§ 2634.601(c), 2634.901(c).

[34]Deputy ethics counselors are generally higher-level managers who are trained to serve as ethics counselors to employees in their region in addition to their normal work responsibilities.

negotiating or has any arrangement concerning prospective employment has a financial interest.[35] Employees are required to recuse themselves from a bank examination if they begin seeking or negotiating for employment with that same bank while the examination is ongoing.[36] Further, FDIC's Supplemental Standards prohibit new hires from supervised banks from participating in particular matters in which their former employer is a party or represents a party to the matter for 1 year.[37] In addition, employees are not allowed to participate in matters involving banks that employ their family members. FDIC officials said they encourage employees to consult with their ethics counselor about any potential conflict that could require a recusal from a particular matter.

In some cases, agency officials have the authority to waive conflict-of-interest requirements. For example, agency officials can waive certain statutory restrictions if the employee's conflict of interest is not so substantial as to be deemed likely to affect the integrity of the services the government may expect from the employee.[38] In addition, an authorized ethics manager at FDIC can waive the agency's supplemental restrictions relating to loans, extensions of credit, and securities holdings, in consultation with the legal division.[39] According to FDIC officials, examples of reasons why waivers would be issued include obtaining a home mortgage or assuming a mortgage after getting married.

We reviewed all 26 waivers issued by FDIC to FDIC employees from January 2017 through May 2019 and found that 19 of the 26 waivers were related to a mortgage on an employee's primary residence. Another six waivers were related to other types of loans secured by real property, such as mortgages on second homes and home equity lines of credit. One waiver was granted for a loan not secured by real property. However, the waiver noted that the terms of the loan were the same as those offered to other comparable borrowers and that there were no other institutions in the employee's area that offered this type of loan.

[35]Employees are prohibited from participating personally and substantially in an official capacity in such matters, if the matter would have a direct and predicable effect on the financial interest in question. *See* 18 U.S.C. § 208(a) and 5 C.F.R. § 2635.402(a).

[36]*See*, e.g., 5 C.F.R. §§ 2635.402(c), 2635.602(a)(1).

[37]*See* 5 C.F.R. § 3201.105.

[38]*See* 18 U.S.C. § 208(b)(1). See also 5 C.F.R. pt. 2640, sbpt. C.

[39]*See* 5 C.F.R. §§ 3201.102(e), 3201.103(d).

FDIC Has Policies to Address Post-Employment Conflicts of Interest

All employees who leave FDIC for private-sector employment are subject to statutory post-employment restrictions. Post-employment restrictions can help to mitigate the risk of regulatory capture in two ways: (1) to prevent former FDIC employees from engaging in activities that might exert undue influence on FDIC, and (2) to reduce industry's ability to induce current FDIC employees with prospective employment arrangements.

Former FDIC employees are prohibited from making any communication or appearance before FDIC on behalf of their new employer to influence a particular matter they were involved in during their time at FDIC.[40] Further, two other categories of FDIC employees are subject to additional restrictions:

- **Senior employees** are subject to a 1-year ban that prohibits them from making communications or appearances before FDIC on behalf of another employer regarding any matter with the intent to influence, regardless of whether they worked on the matter or not. Senior employees are employees whose salary exceeds a specific threshold set in statute.[41] Among FDIC employees involved in the bank examination process, the senior employee title may apply to some bank examiners and financial institution specialists, field supervisors in the regional offices, and other managers in the

[40]All former FDIC employees face a lifetime ban from making any communication or appearance before FDIC on behalf of another person in an attempt to influence a particular matter that they personally and substantially participated in as an FDIC employee, which involved a specific party or parties at the time of such participation. Employees must also observe a 2-year ban that prohibits them from making any communication or appearance before FDIC on particular matters that involved a specific party or parties and were pending under their official authority during their final year of FDIC employment, regardless of whether they personally and substantially participated in the matter. 18 U.S.C. §§ 207(a)(1)(2).

[41]*See* 18 U.S.C. § 207(c)(2)(ii). Senior employees include employees whose basic rate of pay is equal to or greater than 86.5 percent of the rate of basic pay for level II of the executive pay schedule, which is the pay schedule used for the highest-ranked appointed officials in the executive branch. As of January 2020, the senior employee salary threshold was set at $170,665 (86.5 percent of $197,300). The threshold is subject to change based on annual adjustments and other changes that affect the executive pay schedule.

Division of RMS, such as assistant regional directors and deputy regional directors.

- **Senior examiners** who leave FDIC are subject to a 1-year "cooling-off" period. Specifically, FDIC employees who serve as senior examiners of a depository institution for at least 2 of their final 12 months at FDIC are prohibited for 1 year from accepting employment with that depository institution or a related holding company.[42] Senior examiners are employees who have continuing, broad, and lead responsibility for the examination of an institution.[43] FDIC officials said examiners-in-charge for large bank examination teams generally are the only employees who meet the definition of senior examiners, since large banks are subject to an ongoing examination process and therefore the examiner-in-charge has continuing responsibility for their examination. Small and midsize bank examinations occur in 12 to 18 month intervals, so examiners-in-charge do not have continuing responsibility for examining these banks.

FDIC's Ethics Unit has a process to counsel departing employees on the post-employment restrictions and document their acknowledgment of the applicable restrictions. As part of this process, the unit identifies what type of post-employment briefing the departing employee should receive. We reviewed FDIC's implementation of the process for identifying employees who are subject to the 1-year cooling-off period. We found that FDIC correctly identified the four departing senior examiners to whom this restriction applied from January 2017 through June 2019. We also found that the agency had documentation confirming that the senior examiners received the appropriate briefing.

FDIC Does Not Collect Information Necessary to Fully Implement Its Workpaper Review Policy

FDIC does not have a process for collecting information about departing employees' future employment, which is necessary for determining whether reviews of those employees' workpapers are needed. FDIC

[42]12 U.S.C. § 1820(k).

[43]12 C.F.R. pt. 336 subpt. C. In addition, the employee must also be a commissioned examiner for FDIC and routinely interact with officers or employees of the institution they examine, and their duties with respect to the assigned institution must represent a substantial portion of their overall responsibilities.

policy requires the agency to review the workpapers of examiners-in-charge who accept employment with banks they examined in the prior 18 months.[44] The review process is intended to allow agency officials to assess whether the employee's independence may have been compromised due to a potential future employment opportunity with a bank.[45]

We found that FDIC's process would not necessarily identify all examiners-in-charge whose workpapers need to be reviewed. The agency does not instruct managers conducting exit interviews to ask all employees who have recently served as examiners-in-charge about their future employment plans, nor does the agency have a process for collecting these data.[46] FDIC officials said they rely on employees following federal recusal requirements to identify when a workpaper review is required. Specifically, if examiners-in-charge begin employment negotiations with a bank they are currently examining, they are required to recuse themselves from that bank examination, and FDIC policy encourages them to notify a supervisor of the recusal. However, FDIC may not identify when a workpaper review would be needed if an examiner-in-charge begins employment negotiations with a bank after the examination has concluded, since the recusal requirement would not apply.

[44]FDIC's workpaper review process applies for all examiners-in-charge who seek or accept employment with a bank they recently examined. According to FDIC policy, officials should analyze workpapers from the most recent examination of the institution and determine if the examiner's conclusions during the examination were sound, well supported, and well documented, and assess if any recommendations or follow-up supervisory actions made to the bank were reasonable.

[45]We previously reported that reducing the industry's ability to offer employees inducements—such as future employment opportunities—in exchange for preferential treatment can help reduce the risk of regulatory capture; see GAO-19-69. The "revolving door"—that is, frequent movement of personnel between the regulator and the regulated—can undermine effective supervision if regulators are enticed by desirable jobs at supervised institutions and therefore become less likely to challenge the institutions, as some experts have noted. Other experts have contended that the industry can gain an information advantage over their regulator by hiring away experienced staff and examiners to help them navigate the regulatory process.

[46]Ethics Unit post-employment procedures encourage managers to ask departing senior employees and senior examiners about their future employment plans. However, not all examiners-in-charge meet the criteria for designation as senior employees or senior examiners.

FDIC has not clearly established which division should be responsible for ensuring that the workpaper review policy is followed. When we asked about the process, RMS officials referred us to Ethics Unit guidelines on employees' recusal requirements. Ethics Unit officials told us it is the responsibility of RMS ethics counselors to ensure departing employees are aware of applicable restrictions. In addition, FDIC officials said they did not view it as necessary to have a systematic process for obtaining information about the future employment plans of departing employees given the agency's other processes, such as annual ethics training, conflict-of-interest counseling, and post-employment restrictions. FDIC officials explained that the agency previously required employees accepting private-sector employment to provide post-employment information. In 1993, FDIC discontinued the requirement after determining that the burden of enforcing the requirement outweighed its benefits.[47] However, the agency subsequently introduced its workpaper review procedures in 2004, which would not have been part of FDIC's 1993 evaluation.

As discussed earlier in the report, FDIC policy requires the agency to review the workpapers of examiners-in-charge who accept employment with banks they examined in the prior 18 months. However, none of the agency's other ethics policies, such as annual ethics training, conflict-of-interest counseling, and post-employment restrictions, would provide the agency with the information needed to help determine when a workpaper review is required of a departing examiner. Further, we previously reported that other banking regulators—OCC and some Federal Reserve Banks—have processes to request and document post-employment information from departing employees to identify when to initiate workpaper reviews.[48] For example, OCC uses bank employment

[47]58 Fed.Reg. 39625, 39626 (July 26, 1993).

[48]In our previous review of the threat of regulatory capture at the Federal Reserve, we reviewed the policies at four selected Federal Reserve Banks (Boston, New York, Richmond, and San Francisco) and the Board of Governors. We found that the Federal Reserve Banks of New York and Richmond systematically requested and maintained post-employment data for departing employees, that the Federal Reserve Banks of Boston and San Francisco had incomplete processes to collect this information, and that the Board of Governors did not collect it. We recommended that the Board of Governors systematically collect and maintain information on the institutions that supervisory employees work for before they are hired and after they leave the Federal Reserve. The Board of Governors said in September 2019 that it had begun to develop a more systematic approach to collect and monitor pre- and post-employment data through the use of an electronic system, which it said would be available to the Board and the Reserve Banks later in 2019. See GAO-18-118. For more information on OCC's process for requesting post-employment information, see GAO-19-69.

questionnaires that ask departing employees to identify their new employer and note if they previously participated in an examination of their new employer, among other things. These responses are used to determine if a workpaper review is required.

A process for collecting information on the future employment plans of departing employees would help FDIC consistently implement its policy to review the workpapers of examiners-in-charge who depart to work for a bank they recently supervised. In turn, this would improve FDIC's ability to assess whether an employee's independence may have been compromised due to a future employment opportunity with a bank.

FDIC Has Identified Regulatory Capture as an Agency Risk

FDIC Has Taken Steps to Implement Its Enterprise Risk Management Framework

Enterprise risk management (ERM) is a forward-looking management approach that allows an organization, such as a banking regulator, to assess threats and opportunities that could affect the achievement of its goals. An effective ERM program that supports the promotion of transparency, accountability, and independence can help protect the agency from the risk of regulatory capture.[49] FDIC originally established an enterprise risk management program office in 2011, and from 2011 through 2019, FDIC's Office of Inspector General (OIG) identified ERM as a top management and performance challenge. Further, in a July 2020 ERM program evaluation, FDIC's OIG again found weaknesses in FDIC's

[49]OMB, Circular No. A-123 encourages all non-executive-branch federal agencies to implement ERM and adjust their internal controls to align with GAO's updated *Standards for Internal Control in the Federal Government,* which includes a standard for identifying, analyzing, and responding to risks to achieving the agency's objectives. FDIC is an independent entity and is not subject to OMB's risk management guidelines, but an FDIC directive states that the agency embraces the spirit of ERM as outlined in OMB Circular A-123. Office of Management and Budget, Circular No. A-123: *Management's Responsibility for Enterprise Risk Management and Internal Control*, (Washington, D.C.: July 15, 2016).

implementation of its ERM program and made several recommendations for improvement.[50]

Since 2011, the ERM program office has undergone a number of changes, including a reorganization in 2017 in which FDIC formed the Risk Management and Internal Controls branch (RMIC) and moved the Chief Risk Officer position under the Division of Finance. The Chief Risk Officer, who directs RMIC, is responsible for ERM policy development, training programs, and overall administration of FDIC's ERM framework. In addition to ERM, RMIC is also responsible for internal control and management of risks in individual programs and projects across the agency.

In addition to the formation of RMIC, FDIC made a number of changes to its ERM policies and procedures, including updating them to explain how FDIC's ERM framework aligns with government-wide ERM standards and internal control standards.[51] For example, in 2019, the agency developed a set of ERM standard operating procedures that seek to outline the design of FDIC's ERM framework. The procedures include a description of roles and responsibilities, definition of ERM components, and explanation of how the six essential elements of ERM that we previously identified fit into FDIC's framework.

According to the procedures, RMIC coordinates with FDIC leadership, risk-related committees, and divisions to identify risks through the ERM framework. Table 2 below describes the key players and roles outlined in the procedures.

[50]We did not assess FDIC's ERM governance structure or the extent to which the agency's ERM policies and procedures have been implemented. FDIC did not agree with several of the OIG's recommendations. For the OIG's assessment of FDIC's ERM program, see FDIC Office of Inspector General, Office of Program Audits and Evaluations, *The FDIC's Implementation of Enterprise Risk Management*, no. EVAL-20-005.

[51]These standards include OMB, Circular No. A-123 and GAO's, *Standards for Internal Control in the Federal Government*, GAO-14-704G (Washington, D.C.: Sept. 10, 2014). The internal control standards explain that to identify risks, management considers the types of risks that impact the entity and considers all significant interactions within the entity and with external parties, changes within the entity's internal and external environment, and other internal and external factors.

Table 2: Key Roles and Responsibilities within the Federal Deposit Insurance Corporation's (FDIC) Enterprise Risk Management Framework

Key player	Example roles and responsibilities
FDIC Chairman	Confirms the agency's risk appetite statement, which outlines the amount of risk the agency is willing to accept in pursuit of its mission.
Operating Committee	Serves as the enterprise risk management (ERM) program's oversight body and is designated as FDIC's Risk Management Council.
Chief Risk Officer and Risk Management and Internal Controls branch	Responsible for ERM policy development, training programs, and overall program administration. Maintains the agency's risk appetite statement, risk profile, and risk inventory.
Divisions and offices (for example, Risk Management Supervision) and office points of contact	Retains direct responsibility and ownership for the six essential elements of ERM (which include risk identification, assessment, monitoring, and information sharing).
Risk-related committees	Serve as forums for considering internal and external risks of the greatest priority to the agency.

Source: GAO analysis of FDIC documentation. | GAO-20-519

FDIC Has Identified Regulatory Capture as a Risk and Identified Activities That May Mitigate It

FDIC identified regulatory capture as a risk in 2019 through its risk identification process. Identification of risks and the selection of risk responses—also known as "mitigation strategies"—are essential steps within an ERM framework and help bring risks such as regulatory capture to the attention of agency leadership, according to OMB risk management guidance. FDIC officials explained that the agency's process for identifying capture as a risk included researching the experiences of other banking regulators, particularly the Office of Thrift Supervision.[52] FDIC's risk appetite statement states that the agency has established a low appetite for risks that could threaten its independence or its ability to effectively examine banks for safety and soundness and consumer protection. This approach means that FDIC is conservative in its actions in order to maintain the public's trust, according to the statement.[53]

[52]The Office of Thrift Supervision was the primary federal regulator for federal- and state-chartered thrifts (except state-chartered mutual savings banks) until it was abolished in 2010. The agency was found to have made decisions that compromised effective regulation.

[53]According to OMB guidance, the risk appetite statement outlines the broad-based amount of risk an organization is willing to accept in pursuit of its mission/vision. It is established by the organization's most senior leadership and serves as the guidepost to set strategy and objectives.

In addition to identifying capture as an agency risk, FDIC officials identified 11 existing strategies that can help mitigate the risk of capture in its risk inventory (see table 3).

Table 3: Mitigation Strategies Identified by the Federal Deposit Insurance Corporation (FDIC) within the Agency's Risk Inventory to Help Reduce Risk of Regulatory Capture

Mitigation strategy	Description
Mitigation strategies that serve to reduce benefits to industry of capturing individuals within the bank examination process: Rotational requirements for dedicated examiners-in-charge	Examiners-in-charge of large bank safety and soundness examinations may not serve in the role for more than a 5-year term for the same bank.
Mitigation strategies that serve to reduce benefits to industry of capturing individuals within the bank examination process: Rotational requirements for nondedicated examiners-in-charge	Examiners-in-charge of small banks may not serve in the role for more than two consecutive examinations for the same bank.
Mitigation strategies that serve to reduce benefits to industry of capturing individuals within the bank examination process: Reviews by case managers and field supervisors for consistency and appropriateness in ratings	Case managers, who are not part of the examination team, review draft examination reports to consider whether the evidence presented is consistent with the proposed ratings. Field supervisors, who are involved in assigning examination staff and providing guidance to examination teams, also can review draft examinations as a check on quality control.
Mitigation strategies that serve to reduce benefits to industry of capturing individuals within the bank examination process: Periodic regional office reviews	Risk Management Supervision's Internal Control Review Section reviews a sample of the examinations conducted in each regional office. Reports describing results of these reviews contain suggestions for improving examination performance.
Mitigation strategies that serve to reduce benefits to industry of capturing individuals within the bank examination process: Regional and headquarters reviews of targeted review letters and reports of examination	The Large Insured Depository Institution program produces quarterly reports that summarize the results of targeted and ongoing reviews of large banks subject to an annual examination cycle. In addition, both regional office and headquarters officials review bank examination plans for the annual examination and draft reports of examination.
Mitigation strategies that serve to reduce benefits to industry of capturing individuals within the bank examination process: Alternating examinations with state examiners	Banks with less than $10 billion in assets and generally satisfactory ratings may be examined by state banking agencies during every other examination cycle. This alternation increases the number of different examiners participating in examinations over time.
Mitigation strategies that serve to reduce benefits to industry of capturing individuals within the bank examination process: Periodic national training	Examiner training programs seek to emphasize independence and critical thought.
Mitigation strategies that serve to reduce benefits to industry of capturing individuals within the bank examination process: Reviews conducted by FDIC's Risk Management and Internal Controls branch	Quality assurance reviews help ensure consistency, reasonableness, and completeness of the risk management activities of FDIC's offices and divisions.
Mitigation strategies that serve to reduce benefits to industry of capturing individuals within the bank examination process: Regional audit program	Each region has a review process to review its work to identify weaknesses.
Mitigation strategies that serve to block or reduce avenues of inducement: Reviews of departing employees' examination workpapers	FDIC reviews workpapers of examiners who leave the agency to accept employment at an institution they recently examined during their time at FDIC.

Mitigation strategy	Description
Mitigation strategies that serve to block or reduce avenues of inducement: Ethics requirements for examiners	Examiner requirements include ethics training, financial disclosures, conflict-of-interest recusals and waivers, and post-employment restrictions.

Source: GAO analysis of Federal Deposit Insurance Corporation documentation. | GAO-20-519

In addition to the 11 strategies identified in the risk inventory, we identified other FDIC efforts intended to help promote the agency's commitment to the public interest:

- **Promoting a mission and culture of public service.** FDIC's mission states that the agency will maintain stability and public confidence in the nation's financial system. Officials have stated that the notion of independence from banks is a core part of FDIC's mission. According to FDIC's values statement, FDIC and its employees have a tradition of distinguished public service. FDIC's core values include observing integrity, fairness, and accountability in the discharge of the agency's responsibilities. As we previously reported, promoting a culture of public service and having a clear mission can aid in the agency's ability to advance the well-being of the public.[1]
- **Establishing agency-wide training.** FDIC has established training that is intended to promote independence. This training encourages examiners and their supervisors to be assertive when engaging with bank officials. For example, examiners-in-charge are instructed on how to handle conflicts between examiners and bank officials and how to manage defensive behavior from bank officials when discussing unfavorable findings. Examiners-in-charge are also trained to encourage debate among examiners. As we previously reported, training can serve to promote an agency-wide focus on the public interest and the agency's mission and cultivate a supervisory mindset.[2]
- **Emphasizing public trust in its performance management program.** FDIC has taken steps to establish a performance management structure that the agency designed to recognize employees who demonstrate a commitment to advancing FDIC's mission of maintaining public trust. For example, to promote the public trust, some bank examiner competencies set expectations for examiners to defend examination findings in contentious situations, acknowledge differing opinions, and secure commitments from bank officials to remedy weaknesses. As we previously reported, establishing a

[1]GAO-19-69.

[2]GAO-19-69.

performance management program that recognizes a commitment to the public interest, independence, and the agency's mission can mitigate the risk of regulatory capture.[3]

- **Communicating the importance of risk management.** FDIC's ERM procedures state that the FDIC Chairman confirms the Corporate Risk Appetite Statement and is responsible for setting an expectation for division and office leaders to be risk-aware and engaged in the ERM process. Further, FDIC's risk appetite statement instructs employees to become familiar with the agency's position on risk and develop an understanding of how certain risks and opportunities may affect the agency's ability to accomplish its mission. According to officials, FDIC's Chairman communicated the agency's risk appetite statement to all FDIC employees and contractors in May 2019 by a corporate-wide email. Officials further stated that the risk appetite statement is posted on the agency's internal ERM webpage.

Conclusions

FDIC supervises the majority of banks in the United States, including some of the largest, and it is essential that its staff are not inappropriately influenced by the industry they are regulating. The agency has implemented several policies and practices that serve to mitigate regulatory capture by promoting transparency in decision-making, assigning lines of responsibility in the bank examination process, and implementing ethics policies and procedures designed to prevent conflicts of interest. FDIC has also identified regulatory capture as an enterprise-wide risk through its ERM process.

However, FDIC could strengthen efforts to address risks of regulatory capture, in several ways:

- FDIC's small-bank examination reports did not always document whether and how the examination addressed all of the high-risk areas that were in the scoping plan. Requiring such documentation would increase the transparency of the examination decision-making process.

[3]GAO-19-69.

- Some case managers did not consistently comply with FDIC's policy to document their assessment of how banks have addressed MRBAs. Instituting appropriate controls to ensure such compliance would help ensure transparency in decision-making.
- FDIC deletes some examination documentation after one examination cycle. Increasing the documentation retention period would facilitate officials' ability to investigate potentially improper actions by examiners that go back farther than one cycle.
- FDIC does not have a process for systematically collecting information on where departing examiners, including examiners-in-charge, enter into employment after leaving FDIC. Implementing such a process would improve FDIC's ability to assess whether an employee's independence may have been compromised by a future employment opportunity.

Recommendations for Executive Action

We are making the following four recommendations to the Federal Deposit Insurance Corporation:

The Division Director for Risk Management Supervision (RMS) should require case managers to document how high-risk areas in the scoping plan were considered by the examination team if they were not addressed in the examination report. (Recommendation 1)

The Division Director for RMS should implement policies to require that higher-level managers review case managers' documentation that describes whether banks have fully addressed MRBAs. (Recommendation 2)

The Division Director for RMS should revise examination documentation retention policies to increase the retention period beyond one examination cycle for banks with satisfactory or better composite ratings. (Recommendation 3)

The FDIC Chairman should direct RMS and the Legal Division Ethics Unit to develop a process for systematically requesting and collecting information on where departing examiners, including examiners-in-charge, enter into employment after leaving FDIC. (Recommendation 4)

Agency Comments and Our Evaluation

We provided a draft of this report to FDIC and OGE for review and comment. FDIC's RMS provided written comments, which we have reprinted in appendix II. RMS neither agreed nor disagreed with our four recommendations but described steps it would take or had taken in response to each recommendation. In addition, both RMS and OGE provided technical comments, which we incorporated as appropriate.

In its overall comment, RMS said FDIC takes the risk of regulatory capture seriously and highlighted actions the agency has taken to address regulatory capture risks. RMS cited several policies as mitigating capture risk at the agency and examiner levels. In particular, RMS said we did not include detail on the five agency-level mitigation strategies that FDIC cited. We discussed three of the five in our draft report (but added detail in one instance in response to FDIC's comment), and we revised our report to include one other mitigation strategy. We do not believe the fifth strategy is applicable for our work, as we explain below.

The following are agency-level mitigation strategies that RMS identified that we address in our report:

- **Insurer perspective.** We added detail to the background section of our report in response to RMS's comments, noting that FDIC's Division of Insurance and Research manages the Deposit Insurance Fund, which keeps the FDIC's insurance function separate from RMS.
- **Dual banking system.** RMS said we did not discuss how joint regulation of state nonmember banks by FDIC and state authorities makes regulatory capture more difficult. We addressed this issue in table 3 of our report, which notes that alternating examinations with state examiners increases the number of examiners who review the examination and is a mitigation strategy FDIC identified as part of its risk inventory.
- **Funding source.** RMS said we did not discuss how FDIC is not dependent on supervisory assessments or financially affected by institution charter changes because FDIC is funded by the Deposit Insurance Fund. We addressed this in table 1 of our report, which notes that threats to change the bank charter to a new regulator are a potential form of regulatory capture. We said that some banking regulators charge fees to cover the cost of bank

examinations and therefore a change in the bank charter would deprive the regulator of revenue. We noted, however, that FDIC does not charge fees for bank examinations. To clarify this point in response to RMS's comment, we added detail to table 1 explaining that FDIC does not charge bank fees because examination costs are funded by the agency's Deposit Insurance Fund.

- **Mission of stability and governance**. RMS said its mission statement and political-balance governance structure help mitigate against capture. In our report, one of FDIC's efforts intended to help promote the agency's commitment to the public interest that we identified was "promoting a mission and culture of public service." We cited FDIC's mission to maintain stability and public confidence in the nation's financial system. However, we determined that the specific example of governance at the board of directors level is not likely to help mitigate the risk of regulatory capture of the bank examination process, and therefore was outside the scope of our work. RMS's comments also noted that FDIC is charter neutral. We concluded that the benefits of mitigation on this topic were covered by the discussion of the examination funding source, as explained above.

We did not include one agency-level mitigation strategy identified by FDIC in our report. Specifically, RMS said FDIC's activities related to its role as a back-up supervisor for non-FDIC-supervised institutions serve as an additional control against regulatory capture. We concluded that this is not an activity that mitigates regulatory capture at FDIC. Although FDIC's back-up supervisor role may help mitigate regulatory capture for other banking regulators, we did not evaluate this role, as it was outside the scope of our work.

For the regulatory capture mitigation strategies RMS identified at the examiner level, our report identifies some of the policies RMS cited. As we explain in our report, we focused on mitigation strategies in bank examinations that can (1) reduce the potential benefits to industry of capturing the regulatory process, (2) block or reduce avenues of inducement, or (3) promote a culture of independence and public service. Our recommendations generally focused on potential improvements in the agency's internal controls that would help management verify that its policies designed to help mitigate the risk of regulatory capture are being implemented as intended.

In addressing our recommendations overall, RMS said some recommendations would undermine agency goals. Specifically, RMS expressed concern that implementing these recommendations would conflict with agency goals to empower staff, establish accountability for delegated authorities, and minimize regulatory burden by providing timely decision-making. We discuss these concerns below in the context of our first and second recommendations. For the third and fourth recommendations, RMS said pilot projects were planned that we believe respond to our recommendations.

In response to our first recommendation that case managers document how high-risk areas in the scoping plan were considered by the examination team if not addressed in the examination report, RMS said it would make a policy change to require examiners to obtain written concurrence from their manager for material changes in planned examination procedures before the examination ended. Managers who review the proposed changes would be required to provide documentation of their concurrence to case managers. Case managers would be expected to ensure that these changes are documented in the confidential section of the examination report.

Although this policy change likely would improve management's control over changes to scoping plans, it does not address our finding that small-bank examination reports did not always document whether and how the examination addressed all of the high-risk areas that were in the scoping plan. If case managers documented that examination procedures for areas not discussed in the examination report were assessed and that examiners' conclusions about these areas were well supported, RMS management would have better assurance that case managers were monitoring examination teams' procedures and conclusions for all planned aspects of the examination. As RMS noted in its comments, the agency conducts internal reviews of examinations to determine whether the procedures performed support examination findings and align with the examination plan. However, these reviews consider only a sample of examinations and occur less frequently than annually for each regional office. Further, when these reviews identify concerns about completed examinations, having consistent documentation from case managers about whether examination procedures aligned with the examination planning—including documentation of scoping changes—would better allow management to assess whether or the extent to which a lack of case manager oversight was part of the cause of the identified problems.

Regarding the general concerns about our recommendations conflicting with agency goals for staff empowerment, staff accountability, and timely decision-making, we note that FDIC policy already requires case managers to perform the review that we are discussing. We found that case managers' review of examination reports is an important control established by FDIC. Having layers of review that involve individuals with differing perspectives—such as case managers—can limit the effect any one individual can have on an examination. Requiring that case managers provide a brief statement explaining the results of this analysis would not seem to conflict with agency goals for staff empowerment or accountability or add a meaningful delay in finalizing the examination report. We maintain that implementing our recommendation would improve RMS's controls around case managers' monitoring of examination teams' work.

In response to our second recommendation for higher-level managers to review case managers' documentation that describes whether banks have fully addressed MRBAs, RMS described two new actions. First, RMS said in June 2020 it conducted a training session for all case managers that included the importance of following RMS policy for evaluating and documenting institutions' responses to MRBAs. Second, RMS said it will expand the size of review samples during the next round of its regional reviews for the purpose of confirming that there is not a systematic problem with case managers' adherence to RMS policy. RMS did not specify whether its expanded review samples would be large enough to generalize results to all examinations within a region.

RMS said its prior reviews had not indicated a systemic problem with case manager adherence to RMS policy related to the evaluation and documentation of MRBA resolution. RMS observed that our analysis was not generalizable to MRBA documentation across FDIC. RMS also said its planned actions were responsive to our findings, particularly in light of its conclusions about the low residual risk of regulatory capture at FDIC.

The additional training and expansion of the size of examination review samples that RMS described are practices that likely would help provide additional controls around the documentation of assessing banks' progress toward addressing MRBAs. However, we do not believe these steps would be sufficient to address our recommendation. FDIC uses the MRBA tracking process to help identify when banks' corrective actions are not sufficient to address supervisory concerns. When banks do not address the supervisory concern, they are subject to increased monitoring and could be subject to additional supervisory action. Thus,

inaccurate or incomplete information about MRBAs' status may inhibit FDIC in determining when increased monitoring or additional supervisory action could be appropriate. Adding appropriate controls—such as supervisory review—to monitor case manager compliance with this documentation policy could help ensure that FDIC achieves its goal of transparency in determining whether banks have addressed MRBAs.

Our report identified having layers of review and documentation of consequential decisions as elements that could help mitigate capture risk. Having a review policy would provide better assurance that case managers have not been captured, for example, by prematurely closing MRBAs as completed to avoid conflicts with banks resistant to implementing MRBAs. We noted in our report that channels of capture can be nonfinancial and can include actions taken by a capturing party to make adversarial situations difficult for regulatory staff. We do not believe FDIC's general concerns about our recommendations impairing staff empowerment and timely decision-making outweigh the substantial potential benefits from adding a layer of review. Further, we believe it would enhance staff accountability. We therefore maintain that our recommendation is appropriate and should be addressed.

In response to our third recommendation to revise examination document retention policies for banks with satisfactory or better composite ratings, RMS said it would implement a pilot project to extend the retention of workpapers beyond one examination cycle for these banks. RMS said it plans to evaluate the results of the pilot and assess its effectiveness. These actions, if fully implemented, would address our recommendation.

In response to our fourth recommendation to collect post-employment information for departing examiners, RMS said it would implement a process with the Legal Division Ethics Unit to request information from departing examiners about whether and where they will enter into employment upon leaving FDIC. RMS said that this action will be implemented as part of a 3-year pilot project, and that RMS and the Legal Division Ethics Unit will evaluate the results at the end of the 3-year period and assess the pilot program's effectiveness. If these actions are fully implemented, we believe they would address our recommendation.

We are sending copies of this report to the appropriate congressional committees, the Federal Deposit Insurance Corporation, the Office of Government Ethics, and other interested parties. In addition, the report will be available at no charge on the GAO website at http://www.gao.gov.

If you or your staff have any questions about this report, please contact me at (202) 512-8678 or clementsm@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made major contributions to this report are listed in appendix III.

Michael E. Clements
Director, Financial Markets and Community Investment

Appendix I: Objectives, Scope and Methodology

This report examines the extent to which the Federal Deposit Insurance Corporation (FDIC) (1) has policies that encourage transparency and accountability in the bank examination process and has implemented those policies to achieve their intended outcomes; (2) has policies to minimize the risk of conflicts of interest that could threaten the independence of bank examination staff and has implemented those policies to achieve their intended outcomes; and (3) has developed an agency-wide focus to address the risks of regulatory capture and compromised independence. For the purposes of this report, we define regulatory capture as a condition that exists when a regulator acts in service of private interests, such as the interests of the regulated industry, at the expense of the public interest due to actions taken by the interested parties.

To aid our assessment of FDIC's response to the risk of regulatory capture, we relied on our previously developed framework, which was based on theoretical economic literature, on preventing collusion, including regulatory capture, through well-designed contracts.[1] That effort resulted in three objectives of control activities that help reduce the risk of regulatory capture. The objectives are (1) reduce the potential benefits to industry of capturing the regulatory process; (2) block or reduce avenues of inducement; and (3) promote a culture that values independence and public service. For this report, we expanded on this previously developed framework by reviewing relevant academic literature on nonfinancial inducements for potential regulatory capture and the potential role of intermediaries in inducing regulatory capture.

To assess the extent to which FDIC has policies that encourage transparency and accountability in the bank examination process and has implemented those policies to achieve their intended outcomes, we analyzed FDIC policies for the bank examination process, reviewed bank examination documentation for 10 banks to assess implementation of the examination policies, and interviewed FDIC examination staff both at the

[1]The framework development is discussed in app. I of GAO, *Large Bank Supervision: OCC Could Better Address Risk of Regulatory Capture*, GAO-19-69 (Washington, D.C.: Jan. 24, 2019).

examiner and management levels. Our review of FDIC policies included written procedures for conducting bank safety and soundness examinations and for case manager review of examination planning and results.

Our review of bank examination documentation consisted of examinations from two large banks and eight small banks in FDIC's Atlanta and New York regions. We selected these two regions because they are among the regions containing the most large banks where FDIC is the primary federal regulator.[2] We defined large banks as those with $10 billion or more in assets, which are subject to continuous examination procedures under FDIC policy. Small banks, which have less than $10 billion in assets, are subject to point-in-time examinations that occur at periodic intervals. Examination documentation for the two large banks reflected results from the 2018 examination cycle. Examinations for the eight small banks had examination starting dates between August 2016 and February 2019. The examination documentation we reviewed included, among other things, scoping plans, reports of examination, and written conclusions by case managers about banks' progress in addressing Matters Requiring Board Attention, which is a type of supervisory recommendation issued by FDIC as part of the examination process. We assessed the bank examination documentation against FDIC policy requirements for conducting bank examinations and federal internal control standards and evaluated, for example, the completeness of documentation and whether examinations documented high-risk areas identified during the examination planning process

The banks we reviewed were a judgmental sample, and the results of our analysis of documentation from these bank examinations are not generalizable to all FDIC bank examinations. We selected our sample of small banks to evaluate the transparency of examiner documents using a variety of metrics, including asset size, prior overall examination rating and Management component rating, and proportion of commercial real estate lending relative to assets.[3] This latter metric was selected because high concentrations of commercial real-estate lending are a factor we

[2]Because we report on bank examination results, we are not providing a full set of selection factors for our sample of banks to avoid identification of the banks selected. Details of bank examination reports are confidential under FDIC regulation.

[3]To examine documentation for banks with a variety of asset sizes, we selected three banks with less than $1 billion in assets, four banks between $1 billion and $3 billion, and one bank between $3 billion and $10 billion.

previously identified as posing a risk to bank soundness.[4] This measure is captured in the Reports of Condition and Income that FDIC-insured institutions provide to federal banking regulators. We established that these data were reliable for our purposes of selecting a nongeneralizable sample of bank examination documentation to analyze. We established reliability by reviewing the controls that FDIC has in place to help assure the accuracy and completeness of information collected for the Reports of Condition and Income.

We also interviewed FDIC headquarters officials and a nongeneralizable sample of regional office examination staff in FDIC's Atlanta, New York, and San Francisco regions. We selected the New York and San Francisco regions because they had the greatest number of banks that were examined under FDIC's continuous examination process for banks with greater than $10 billion in assets. We selected the Atlanta region because we also planned to analyze documentation for bank examinations in that region, and interviewing Atlanta region staff would provide us with the opportunity to ask about any documentation practices specific to that region.

In total, we spoke with 44 regional office examiners and managers. This consisted of individual interviews with eight assistant regional directors, eight case managers, and 13 examiners (including examiners-in-charge) who examined banks where FDIC was the primary federal regulator. In addition, we conducted three group interviews with large bank examiners—who were not examiners-in-charge—for banks where FDIC was the primary federal regulator. These three group interviews consisted of a total of 15 examiners. Staff in each job category were selected at random from a list of staff from the selected locations provided to us by FDIC. In some cases, individuals were unavailable or declined to participate, and we then selected another person using the same random-sampling methodology. Because the sample was nongeneralizable, the views of the staff we spoke with are not generalizable to all FDIC regional office staff. Our interviews focused on the following topics: relationships with supervised banks, team dynamics during the examination process, and conflicts of interest and other threats to independence.

To examine the extent to which FDIC has policies to mitigate potential conflicts of interest that could threaten the independence of bank

[4]See GAO, *Financial Institutions: Causes and Consequences of Recent Bank Failures,* GAO-13-71 (Washington, D.C.: Jan. 3, 2013.)

examination staff and implemented those policies to achieve their intended outcomes, we identified and reviewed federal statutes and regulations related to conflicts of interest for government employees, as well as FDIC supplemental standards for ethical conduct; FDIC employee requirements for submitting financial disclosure forms; procedures for managers to brief departing employees on post-employment restrictions; and procedures for reviewing workpapers of departing examiners. We also analyzed all 26 conflict-of-interest waivers issued by FDIC from January 2017 to May 2019 to determine whether issuance of waivers was consistent with FDIC policy.

In addition, we reviewed whether FDIC maintained documentation demonstrating that the agency implemented its post-employment briefing process for departing senior examiners in accordance with its policy. To do this, we identified senior examiners who left FDIC between January 2017—when FDIC instituted a new documentation process—and June 2019 using lists of former bank examination employees provided by the Division of Administration and staffing rosters provided by the Division of Risk Management Supervision (RMS). We then reviewed documentation from past post-employment briefings provided by the Ethics Unit to assess whether FDIC maintained documentation showing that each of the individuals we identified as senior examiners had received the required post-employment briefing. We assessed this information against FDIC policy requirements. We determined these FDIC data were reliable for our purpose of evaluating FDIC's implementation of post-employment briefings for senior examiners, including by analyzing the results for possible outlier results and missing information. In addition, we compared FDIC's workpaper review procedures to the workpaper review procedures of two other federal banking regulators (the Federal Reserve Bank of New York and the Office of the Comptroller of the Currency) that we reviewed in prior work.[5] Lastly, we interviewed ethics officials and RMS staff to discuss the design and implementation of ethics policies and procedures.

To evaluate the extent to which FDIC has developed an agency-wide focus to address the risks of regulatory capture and compromised independence, we reviewed documentation provided by FDIC's Risk Management and Internal Controls branch (RMIC) and RMS on how FDIC manages the risks posed by the banks they regulate. For example, we reviewed FDIC's risk appetite statement, risk inventory, and operating

[5]See GAO-19-69 and GAO, *Large Bank Supervision: Improved Implementation of Federal Reserve Policies Could Help Mitigate Threats to Independence*, GAO-18-118 (Washington, D.C.: Nov. 6, 2017).

procedures for risk management. We assessed these documents against Office of Management and Budget guidance on risk management, as well as federal internal control standards. We also reviewed bank examiner training, performance management, and strategic planning documentation related to regulatory independence and procedures for communicating with bank staff. For example, we reviewed annual reports, strategic plans, training modules, and performance management guidelines. We also interviewed officials from RMIC and RMS to discuss the design and implementation of FDIC's enterprise risk management framework.

We conducted this performance audit from April 2016 to September 2020 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Appendix II: Comments from the Federal Deposit Insurance Corporation

Federal Deposit Insurance Corporation
550 17th Street NW, Washington, D.C. 20429-9990
Division of Risk Management Supervision

August 19, 2020

Michael Clements
Director
Financial Markets and Community Investment Team
United States Government Accountability Office
Washington, D.C. 20548

Dear Mr. Clements:

Thank you for the opportunity to comment on the U.S. Government Accountability Office's (GAO's) draft audit report titled, *Bank Supervision: FDIC Could Better Address Regulatory Capture Risks (Report)*.

The FDIC takes the risk of regulatory capture seriously as demonstrated by the significant measures it takes to ensure that agency and individual examiner actions are free of private interests and are consistent with our mission to maintain stability and public confidence in the nation's financial system. GAO defines regulatory capture as a condition that exists when a regulator acts in service of private interests, such as the interests of the regulated industry, at the expense of the public interest due to actions taken by the interested parties. Regulatory capture may occur at the agency level or at an individual examiner level, the latter being the primary focus GAO's report. The FDIC has a number of effective controls in place that mitigate the risk of either agency- or examiner-level regulatory capture from occurring.

Like other risks facing our agency, we have evaluated the risk of regulatory capture through our Enterprise Risk Management (ERM) program. ERM provides a structured and consistent means to identify and assess risks to achieving agency goals and objectives and make informed decisions on how to respond to risks. The FDIC views regulatory capture as a risk that could harm the FDIC's reputation. Accordingly, the FDIC's Risk Appetite Statement notes that the FDIC has a low appetite for risks to agency credibility and risks that could threaten its independence. The FDIC has also included regulatory capture in our ERM risk inventory. The risk description states "[i]f RMS [Division of Risk Management Supervision] examiners are not sufficiently independent of banks that they examine, then they may not provide an objective assessment of risks or fully identify safety and soundness issues."

Under our ERM program, FDIC divisions and offices identify risk responses, such as mitigating controls, which reduce identified risks to a level consistent with our risk appetite. During the audit, we communicated to GAO that we have a number of controls in place to address the risk of regulatory capture both at the agency- and examiner-level, as follows:

1

Agency-level mitigations

Insurer perspective – Our role as insurer provides an additional perspective and incentive for guarding against regulatory capture. The FDIC operates the federal deposit insurance system that since 1933 has contributed to the health and stability of the banking industry by assuring depositors their insured funds are safe. As the deposit insurer and receiver for failed banks, the FDIC is concerned about the safety and soundness of the banking industry and individual institutions. The FDIC's Division of Insurance and Research operates independently from the supervision divisions, providing an additional perspective on supervisory results.

Back-up supervisor role – The FDIC has a back-up supervisor role for non FDIC-supervised institutions. In this capacity, the FDIC regularly meets and coordinates with other federal banking agencies to discuss the supervision of individual institutions and general supervisory matters. This coordination of supervisory activities and discussion among the federal regulators serves as an additional control against regulatory capture.

Dual banking system – The joint regulation of state nonmember banks by the FDIC and state authorities makes regulatory capture more difficult. The FDIC and the states conduct alternating or joint examinations on financial institutions depending upon an institution's size, complexity, and condition. This involvement of another regulatory entity in the supervision of a given institution, and collaboration between the FDIC and the state authorities relative to the supervision, serves as an additional protection against regulatory capture of an individual examiner.

Mission of stability and governance – The FDIC has clarity and singularity in its mission, to maintain stability and public confidence in the financial system. We are governed by a five-member Board of Directors, of which no more than three can be members of a single political party, and are charter-neutral, unlike financial regulators that issue charters or grant membership to the Federal Reserve System.

Funding source – The FDIC is funded by the Deposit Insurance Fund (DIF). The Corporation is not dependent on supervisory assessments or financially affected by institution charter changes.

During the audit we requested the GAO acknowledge these important agency-level mitigations that inherently mitigate the risk of agency-level regulatory capture, but GAO's report did not acknowledge them.

Examiner-level mitigations

Examiner training – FDIC has a robust examiner training program that helps to ensure consistency and competency of examination activities. The process for commissioning examiners involves an intensive training process over a multi-year timespan. This process includes on-the-job training with experienced safety and soundness and compliance examiners, successful evaluations from various schools within the program, successful evaluations from senior examiners and successful completion of a technical evaluation. Prospective examiners must satisfy each of these requirements to receive their commission. This process usually takes

three to four years, and is designed to ensure that all examiners are trained and competent in a wide range of important areas of contemporary banking from capital calculations to consumer protection rules to information technology controls.

Examination policies – RMS has extensive, detailed examination policies and job aids that help to ensure examination consistency and rigor.

Examination team – Examiners work as a cohesive team and collaborate on examination activities making it more difficult for a single examiner to affect the scope or rigor of an examination.

Examiner-in-charge rotation – Dedicated examiners assigned to serve as the examiner-in-charge (EIC) of large institutions supervised under a continuous examination program (generally institutions with total assets over $10 billion), sign a 5-year agreement and must move to a different position after that period. Examiners assigned to serve as the EIC for institutions with total assets less than $10 billion may not serve in that capacity for more than two consecutive FDIC examinations, even if those examinations are separated by an alternating state examination.

Report of Examination reviews – Each report of examination goes through at least one level of review by a case manager, who is trained to conduct those reviews and ensure that reports of examination are consistent with FDIC policy. The case manager is independent from the field office and located in a regional office. Case managers also review intervening state reports of examination. In the case of more complex or troubled institutions, a report of examination (ROE) goes through additional levels of review by an assistant regional director (ARD), deputy regional director or regional director (collectively, regional management). In the case of problem banks (those rated CAMELS 4 or 5) and large banks (those with total assets greater than $10 billion) an additional review is completed by RMS headquarters staff.[1] Large bank target review letters are reviewed by a case manager, regional management, and RMS headquarters staff before issuance.

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Response to GAO Recommendations

As shown above, the FDIC has preventive, detective, and compensating controls that help to significantly reduce the risk of agency- and examiner-level regulatory capture. Because of these many mitigations, neither GAO nor FDIC identified any evidence of regulatory capture during the review. A number of the FDIC's existing controls are similar to those presented in GAO's report as being effective controls that make it more difficult for regulatory capture to occur, reduce avenues of inducement, and promote a culture of independence and public service.

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As a result of its effective mitigating controls, the FDIC has determined that the residual risk level of regulatory capture occurring is low. Further, as previously noted, neither GAO nor FDIC identified any evidence of regulatory capture during the four-year review. Therefore, the costs of additional controls, both in terms of dollars or effectiveness, must be balanced against the benefits of any limited, marginal gains in residual risk reduction. GAO made four recommendations in its draft report. We have carefully considered each recommendation in light of our assessment of regulatory capture risk and the mitigating controls that we have in place. Our response to each recommendation follows.

Recommendation 1:

The Division Director for Risk Management Supervision (RMS) should require case managers to document how high-risk areas in the scoping plan were considered by the examination team if they were not addressed in the examination report.

RMS Response:

Adjusting the planned scope of an examination in response to ongoing examination findings is a fundamental component of FDIC's forward-looking, risk-based approach to financial institution supervision.[3] Based on the risk presented by the institution, examiners are expected to perform an appropriate level of transaction testing to verify: the adequacy of and adherence to internal policies, procedures, and limits; the accuracy and completeness of management reports and financial reports; the adequacy and reliability of internal control systems; the effectiveness of the bank's risk management processes and practices; and compliance with laws and regulations. Examiners have the flexibility, subject to appropriate concurrence, to adjust the examination scope at any point during the examination based on findings to date. This flexibility ensures that examiner resources are used in the most efficient and cost-effective manner and that institution regulatory burden is minimized.

Examiners are expected to document their findings through a combination of brief summaries, source documents, report comments, and other workpapers that clearly describe financial conditions, management practices, and examination conclusions. Documentation is expected to generally describe: key audit/risk-scoping decisions, source documents reviewed, and general examination procedures performed.[4] In both instances that GAO cites as not addressing "high-risk" elements in the examination scoping plans in the examination report, the examiners followed RMS policy and appropriately documented their findings in the examination workpapers. Notwithstanding, RMS intends to update its procedures regarding the documentation of changes to examination scope set forth in examination planning documents.[5]

Under RMS policy, examiners are not required or expected to comment in the ROE on areas covered in the examination plan that do not give rise to criticism or concern. The ROE includes exception-based reporting on examination findings, while examiner workpapers document examiners' evaluation of the CAMELS components, including the results of the procedures performed, based on the examination plan.

RMS internal control processes include periodic review of examination workpapers on a sample basis as part of regional internal control review programs. These reviews evaluate consistency with RMS policy, including that the procedures performed supported examination findings and aligned with the examination plan, unless documented as a material deviation.

[3] See Section 20.1 of the RMS Manual of Examination Policies.
[4] See Section 1.1 of the RMS Manual of Examination Policies.
[5] Section 21.1 of the RMS Manual of Examination Policies sets forth expectations for the development and documentation of examination plans for institutions examined on a point-in-time basis (examination planning memo instructions). Internal RMS instructions set forth expectations for the development of annual supervisory plans for institutions examined on a continuous basis (supervisory plan instructions).

Examiners are required to document a material deviation from planned examination procedures in the confidential sections of ROEs for point-in-time examinations and in a targeted review worksheet[6] for continuous examinations. Review procedures also differ, based on whether the examination is conducted on a point-in-time or continuous basis. For point-in-time examinations, examiners discuss material changes in scope with their supervisor and the case manager. The case manager is required to ensure that the examiner documented the material changes from the planned examination scope in the confidential section of the ROE. For continuous examinations, examiners are currently required to update an internal worksheet after completion of each targeted review to identify any variances in hours, skillset or scope outlined in the Supervisory Plan. Examiners also use the worksheet to document the addition of new reviews or to delete reviews not completed. Examiners discuss all such changes with regional and headquarters staff.

RMS intends to change the existing policy by requiring examiners to obtain written (or electronic) concurrence from their manager[7] for a material change in planned examination procedures, and for the examiner's manager to provide a copy of the concurrence to the case manager. In situations in which the case manager receives such a concurrence, the case manager will ensure, as part of their ROE review, that the examiner has documented the material changes discussed in the concurrence document in the confidential section of the ROE.

Recommendation 2:

The Division Director for RMS should implement policies to require that higher-level managers review case managers' documentation that describes whether banks have fully addressed MRBAs.

RMS Response:

RMS agrees with GAO's finding that Matters Requiring Board Attention (MRBAs) for one ROE were prematurely closed out based on planned rather than completed action and MRBAs in another ROE were appropriately closed out based on completed and documented[8] action, but the actions were not sufficiently described in the MRBA tracking system. These findings did not identify any evidence of regulatory capture, but rather instances of staff not following RMS policy. In response to those findings, RMS regional management counseled the two case managers who did not follow RMS policy and conducted a training session for all case managers in June that included the importance of following RMS policy in evaluating and documenting institutions' actions to respond to MRBAs.

[6] Prior to the implementation of current Large Bank Supervision Procedures, issued January 13, 2017, the December 10, 2012 Large Bank Supervision Procedures required the examiner-in-charge to document any material changes to the supervisory plan during the annual examination cycle in a memorandum to the Associate Director in charge of large bank oversight before implementation.

[7] The appropriate manager will be the supervisory examiner or field supervisor for point-in-time examinations and the Assistant Regional Director for continuous examinations.

[8] The actions taken to close out the MRBA, which related to examinations conducted between August 2016 and October 2017, were fully described and documented in the FDIC's official system of record for supervision matters.

RMS reviews the regions' compliance with RMS and FDIC policy through regularly scheduled regional reviews, and each region conducts its own reviews between RMS reviews. None of these reviews has indicated a systemic problem with case manager adherence to RMS policy in general or specific to the evaluation and documentation of MRBA resolution. Moreover, none of these regular reviews has identified evidence of regulatory capture. Further, GAO described its sampling results as non-generalizable based on the small sample size. Therefore, RMS believes that the action taken is responsive to the findings, particularly given the low residual risk of regulatory capture at FDIC. Notwithstanding, RMS will expand the size of review samples during the next round of regional reviews to confirm that the existing finding remains true and existing controls are appropriate.

Recommendation 3:

The Division Director for RMS should revise examination documentation retention policies to increase the retention period beyond one examination cycle for banks with satisfactory or better composite ratings.

RMS Response:

Current RMS policy provides that the retention of workpapers beyond one examination should generally be confined to those banks with existing or pending administrative actions, special documents relating to past insider abuse, documents that are the subject of previous criminal referral letters, or other such sensitive documents.[9] Examination information may contain non-public customer information as defined in Section 501(b) of the Gramm Leach-Bliley Act. Therefore, examiners must carefully safeguard information and follow established procedures for accessing, transporting, storing, and disposing of electronic and paper information. Although RMS discourages the retention of workpapers beyond one examination cycle, major schedules and other pertinent workpapers can be retained if deemed useful. Additionally, if a bank's composite rating is 3 or worse, RMS policy provides that most workpapers should be maintained until the bank returns to a satisfactory condition.

As noted before, the FDIC is not the sole supervisor for state-chartered banks that are not members of the Federal Reserve. Supervisory responsibility is shared with the relevant state banking authority. This shared responsibility for supervising state-chartered banks provides an important control against regulatory capture. When examinations are conducted on an alternating basis, examiners from the state authority review the workpapers from the prior FDIC examination as part of their pre-examination planning process. Should any evidence of regulatory capture be evident in the examination workpapers, the state authority examiners would identify the problem and report their findings to the FDIC. When examinations are conducted on a joint basis, examiners from both the state authority and the FDIC review the workpapers from the prior joint examination as part of their pre-examination planning process. Again, should any evidence of regulatory capture be evident in the examination workpapers, the state and FDIC examiners would identify the problem, and report their findings to RMS management.

[9] See Section 1.1 of the RMS Manual of Examination Policies.

Notwithstanding the protections provided by the current examination workpaper retention policies, in response to GAO's recommendation, RMS will conduct a pilot process to maintain workpapers for a period encompassing three years for banks examined under a continuous examination process or three examinations for banks examined under a point-in-time examination process as an additional mitigation against the risk of regulatory capture of an EIC. At the end of the pilot period, RMS will evaluate the results of the pilot and assess its effectiveness.

As noted earlier, to mitigate the risk of regulatory capture of an EIC, should an examiner leave the FDIC to work for an institution that they recently examined as EIC, RMS policy requires the examiner's supervisor to review the examiner's work products and document the review in a memorandum to the Regional Director. Other risk mitigations, including rotating EICs, alternating or conducting joint examinations with state authorities, and requiring reviews of ROEs by independent case managers who are trained to perform that responsibility, minimize the risk that a single examiner could compromise examination findings over multiple examinations.

GAO Recommendation 4:

The FDIC Chairman should direct RMS and the Legal Division Ethics Unit to develop a process for systematically requesting and collecting information on where departing examiners, including examiners-in-charge, enter into employment after leaving FDIC.

FDIC Response:

GAO acknowledges in this report that strategies for blocking or reducing industry's ability to offer regulators inducements—such as future employment opportunities—in exchange for preferential treatment, "are generally difficult to implement and may be too narrow in scope to adequately protect the agency from capture." FDIC agrees with GAO that other policies may be a more effective means for reducing avenues of inducement and has established such policies including:

- prohibiting employees from holding a direct financial interest in a regulated entity and requiring recusals for those who are exposed to the conflict of interest (regulatory violation);
- monitoring employees' financial holdings through disclosure requirements (statutory violation); and
- instituting cooling-off periods for specified periods of time, which bar certain employees from employment at regulated entities and representation before their former agencies (statutory violation).

GAO's report identifies the above three examples as measures that could be effective in reducing avenues of inducement of regulatory capture, and these processes are already in place at FDIC. Nonetheless, GAO also recommends that FDIC adopt a process for systematically requesting and collecting information on where departing examiners, including examiners-in-charge, enter into employment after leaving FDIC.

Departing FDIC employees, whether leaving examiner positions or not, are not legally obligated to identify their future employer. However, examiners leaving FDIC for employment with a financial institution have certain obligations, violations of which may be punishable as criminal or civil violations as noted above, to share that information with the FDIC. FDIC examiners receive ethics training annually throughout their careers. Ethics training emphasizes the examiner's obligation to recuse from examining an institution with whom they are seeking post FDIC employment.

Further, as previously mentioned, FDIC follows workpaper review procedures when the departing examiner served as EIC for the institution. Should an examiner accept employment with an insured institution, the examiner's manager would have been on notice regarding the possible post FDIC employment at the time the examiner recused and be in a position to determine whether or not a work paper review was warranted.

The FDIC has in the past, systematically collected information from employees resigning from the Corporation to accept employment in the private sector. Departing employees were required to report information regarding their prospective private sector employer, the nature of its business or activities, the position to be occupied by the employee, the dates of negotiation for the employment, and the employee's official involvement, if any, with the prospective employer. However, the Corporation learned from experience that enforcement of the reporting requirement was difficult, the information obtained had little value and that the administrative burden of this particular information collection outweighed its benefits.

Notwithstanding, RMS and the Legal Division Ethics Unit will establish, on a pilot basis (for a period of three years), a process to request information from departing examiners about whether and where they will enter into employment upon leaving FDIC. Once completed, RMS and the Legal Division Ethics Unit will evaluate the results of this three-year pilot and assess its effectiveness.

We appreciate the GAO's review of regulatory capture, and the opportunity to comment. If you have any questions, please contact Megan Patzwall at 703-562-6378 or mpatzwall@fdic.gov.

Sincerely,

DOREEN EBERLEY

Digitally signed by DOREEN EBERLEY
Date: 2020.08.19 18:28:23 -04'00'

Doreen R. Eberley
Director

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Appendix III: GAO Contact and Acknowledgments

GAO Contact

Michael Clements, (202) 512-8678 or clementsm@gao.gov

Staff Acknowledgments

In addition to the contact named above, Stefanie Jonkman (Assistant Director); Steve Robblee (Analyst in Charge); Abigail Brown; Aaron A. Colsher; John Forrester; Anar N. Jessani; Marc Molino; Kirsten Noethen; Aku Pappoe; Christine Ramos; Bryan Sakakeeny; Jennifer Schwartz; and Farrah Stone made key contributions to this report.

Appendix IV: Accessible Data

Agency Comment Letter

Accessible Text for Appendix II Comments from the Federal Deposit Insurance Corporation

Page 1

August 19, 2020

Michael Clements Director

Financial Markets and Community Investment Team

United States Government Accountability Office

Washington, D.C. 20548

Dear Mr. Clements:

Thank you for the opportunity to comment on the U.S. Government Accountability Office's (GAO's) draft audit report titled, Bank Supervision: FDIC Could Better Address Regulatory Capture Risks (Report).

The FDIC takes the risk of regulatory capture seriously as demonstrated by the significant measures it takes to ensure that agency and individual examiner actions are free of private interests and are consistent with our mission to maintain stability and public confidence in the nation's financial system. GAO defines regulatory capture as a condition that exists when a regulator acts in service of private interests, such as the interests of the regulated industry, at the expense of the public interest due to actions taken by the interested parties. Regulatory capture may occur at the agency level or at an individual examiner level, the latter being the primary focus GAO’s report. The FDIC has a number of effective controls in place that mitigate the risk of either agency- or examiner-level regulatory capture from occurring.

Like other risks facing our agency, we have evaluated the risk of regulatory capture through our Enterprise Risk Management (ERM)

program. ERM provides a structured and consistent means to identify and assess risks to achieving agency goals and objectives and make informed decisions on how to respond to risks. The FDIC views regulatory capture as a risk that could harm the FDIC's reputation. Accordingly, the FDIC's Risk Appetite Statement notes that the FDIC has a low appetite for risks to agency credibility and risks that could threaten its independence. The FDIC has also included regulatory capture in our ERM risk inventory. The risk description states "[i]f RMS [Division of Risk Management Supervision] examiners are not sufficiently independent of banks that they examine, then they may not provide an objective assessment of risks or fully identify safety and soundness issues."

Under our ERM program, FDIC divisions and offices identify risk responses, such as mitigating controls, which reduce identified risks to a level consistent with our risk appetite. During the audit, we communicated to GAO that we have a number of controls in place to address the risk of regulatory capture both at the agency- and examiner-level, as follows:

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Agency-level mitigations

Insurer perspective – Our role as insurer provides an additional perspective and incentive for guarding against regulatory capture. The FDIC operates the federal deposit insurance system that since 1933 has contributed to the health and stability of the banking industry by assuring depositors their insured funds are safe. As the deposit insurer and receiver for failed banks, the FDIC is concerned about the safety and soundness of the banking industry and individual institutions. The FDIC's Division of Insurance and Research operates independently from the supervision divisions, providing an additional perspective on supervisory results.

Back-up supervisor role – The FDIC has a back-up supervisor role for non FDIC-supervised institutions. In this capacity, the FDIC regularly meets and coordinates with other federal banking agencies to discuss the supervision of individual institutions and general supervisory matters. This coordination of supervisory activities and discussion among the federal regulators serves as an additional control against regulatory capture.

Dual banking system – The joint regulation of state nonmember banks by the FDIC and state authorities makes regulatory capture more difficult. The FDIC and the states conduct alternating or joint examinations on

financial institutions depending upon an institution's size, complexity, and condition. This involvement of another regulatory entity in the supervision of a given institution, and collaboration between the FDIC and the state authorities relative to the supervision, serves as an additional protection against regulatory capture of an individual examiner.

Mission of stability and governance – The FDIC has clarity and singularity in its mission, to maintain stability and public confidence in the financial system. We are governed by a five- member Board of Directors, of which no more than three can be members of a single political party, and are charter-neutral, unlike financial regulators that issue charters or grant membership to the Federal Reserve System.

Funding source – The FDIC is funded by the Deposit Insurance Fund (DIF). The Corporation is not dependent on supervisory assessments or financially affected by institution charter changes.

During the audit we requested the GAO acknowledge these important agency-level mitigations that inherently mitigate the risk of agency-level regulatory capture, but GAO's report did not acknowledge them.

Examiner-level mitigations

Examiner training – FDIC has a robust examiner training program that helps to ensure consistency and competency of examination activities. The process for commissioning examiners involves an intensive training process over a multi-year timespan. This process includes on-the-job training with experienced safety and soundness and compliance examiners, successful evaluations from various schools within the program, successful evaluations from senior examiners and successful completion of a technical evaluation. Prospective examiners must satisfy each of these requirements to receive their commission. This process usually takes

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three to four years, and is designed to ensure that all examiners are trained and competent in a wide range of important areas of contemporary banking from capital calculations to consumer protection rules to information technology controls.

Examination policies – RMS has extensive, detailed examination policies and job aids that help to ensure examination consistency and rigor.

Examination team – Examiners work as a cohesive team and collaborate on examination activities making it more difficult for a single examiner to affect the scope or rigor of an examination.

Examiner-in-charge rotation – Dedicated examiners assigned to serve as the examiner-in-charge (EIC) of large institutions supervised under a continuous examination program (generally institutions with total assets over $10 billion), sign a 5-year agreement and must move to a different position after that period. Examiners assigned to serve as the EIC for institutions with total assets less than $10 billion may not serve in that capacity for more than two consecutive FDIC examinations, even if those examinations are separated by an alternating state examination.

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Adjusting the planned scope of an examination in response to ongoing examination findings is a fundamental component of FDIC's forward-looking, risk-based approach to financial institution supervision.[3] Based on the risk presented by the institution, examiners are expected to perform an appropriate level of transaction testing to verify: the adequacy of and adherence to internal policies, procedures, and limits; the accuracy and completeness of management reports and financial reports; the adequacy and reliability of internal control systems; the effectiveness of the bank's risk management processes and practices; and compliance with laws and regulations.

Examiners have the flexibility, subject to appropriate concurrence, to adjust the examination scope at any point during the examination based on findings to date. This flexibility ensures that examiner resources are used in the most efficient and cost-effective manner and that institution regulatory burden is minimized. Examiners are expected to document their findings through a combination of brief summaries, source documents, report comments, and other workpapers that clearly describe financial conditions, management practices, and examination conclusions. Documentation is expected to generally describe: key audit/risk-scoping decisions, source documents reviewed, and general examination procedures performed.[4] In both instances that GAO cites as not addressing "high- risk" elements in the examination scoping plans in the examination report, the examiners followed RMS policy and appropriately documented their findings in the examination workpapers. Notwithstanding, RMS intends to update its procedures regarding the documentation of changes to examination scope set forth in examination planning documents.[5]

Under RMS policy, examiners are not required or expected to comment in the ROE on areas covered in the examination plan that do not give rise to criticism or concern. The ROE includes exception-based reporting on examination findings, while examiner workpapers document examiners' evaluation of the CAMELS components, including the results of the procedures performed, based on the examination plan.

RMS internal control processes include periodic review of examination workpapers on a sample basis as part of regional internal control review programs. These reviews evaluate consistency with RMS policy, including that the procedures performed supported examination findings and aligned with the examination plan, unless documented as a material deviation.

[3] See Section 20.1 of the RMS Manual of Examination Policies.

[4] See Section 1.1 of the RMS Manual of Examination Policies.

[5] Section 21.1 of the RMS Manual of Examination Policies sets forth expectations for the development and documentation of examination plans for institutions examined on a point-in-time basis (examination planning memo instructions). Internal RMS instructions set forth expectations for the development of annual supervisory plans for institutions examined on a continuous basis (supervisory plan instructions).

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Examiners are required to document a material deviation from planned examination procedures in the confidential sections of ROEs for point-in-time examinations and in a targeted review worksheet[6] for continuous examinations. Review procedures also differ, based on whether the examination is conducted on a point-in-time or continuous basis. For point-in-time examinations, examiners discuss material changes in scope with their supervisor and the case manager. The case manager is required to ensure that the examiner documented the material changes from the planned examination scope in the confidential section of the ROE. For continuous examinations, examiners are currently required to update an internal worksheet after completion of each targeted review to identify any variances in hours, skillset or scope outlined in the Supervisory Plan. Examiners also use the worksheet to document the addition of new reviews or to delete reviews not completed. Examiners discuss all such changes with regional and headquarters staff.

RMS intends to change the existing policy by requiring examiners to obtain written (or electronic) concurrence from their manager[7] for a material change in planned examination procedures, and for the examiner's manager to provide a copy of the concurrence to the case manager. In situations in which the case manager receives such a concurrence, the case manager will ensure, as part of their ROE review, that the examiner has documented the material changes discussed in the concurrence document in the confidential section of the ROE.

Recommendation 2:

The Division Director for RMS should implement policies to require that higher-level managers review case managers' documentation that describes whether banks have fully addressed MRBAs.

RMS Response:

RMS agrees with GAO's finding that Matters Requiring Board Attention (MRBAs) for one ROE were prematurely closed out based on planned rather than completed action and MRBAs in another ROE were appropriately closed out based on completed and documented[8] action, but the actions were not sufficiently described in the MRBA tracking system. These findings did not identify any evidence of regulatory capture, but rather instances of staff not following RMS policy. In response to those findings, RMS regional management counseled the two case managers who did not follow RMS policy and conducted a training session for all case managers in June that included the importance of following RMS policy in evaluating and documenting institutions' actions to respond to MRBAs.

[6] Prior to the implementation of current Large Bank Supervision Procedures, issued January 13, 2017, the December 10, 2012 Large Bank Supervision Procedures required the examiner-in-charge to document any material changes to the supervisory plan during the annual examination cycle in a memorandum to the Associate Director in charge of large bank oversight before implementation.

[7] The appropriate manager will be the supervisory examiner or field supervisor for point-in-time examinations and the Assistant Regional Director for continuous examinations.

[8] The actions taken to close out the MRBA, which related to examinations conducted between August 2016 and October 2017, were fully described and documented in the FDIC's official system of record for supervision matters.

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RMS reviews the regions' compliance with RMS and FDIC policy through regularly scheduled regional reviews, and each region conducts its own reviews between RMS reviews. None of these reviews has indicated a systemic problem with case manager adherence to RMS policy in general or specific to the evaluation and documentation of MRBA resolution. Moreover, none of these regular reviews has identified evidence of regulatory capture. Further, GAO described its sampling results as non-generalizable based on the small sample size. Therefore, RMS believes that the action taken is responsive to the findings, particularly given the low residual risk of regulatory capture at FDIC. Notwithstanding, RMS will expand the size of review samples during the next round of regional reviews to confirm that the existing finding remains true and existing controls are appropriate.

Recommendation 3:

The Division Director for RMS should revise examination documentation retention policies to increase the retention period beyond one examination cycle for banks with satisfactory or better composite ratings.

RMS Response:

Current RMS policy provides that the retention of workpapers beyond one examination should generally be confined to those banks with existing or pending administrative actions, special documents relating to past insider abuse, documents that are the subject of previous criminal referral letters, or other such sensitive documents.[9] Examination information may contain non- public customer information as defined in Section 501(b) of the Gramm Leach-Bliley Act. Therefore, examiners must carefully safeguard information and follow established procedures for accessing, transporting, storing, and disposing of electronic and paper information. Although RMS discourages the retention of workpapers beyond one examination cycle, major schedules and other pertinent workpapers can be retained if deemed useful. Additionally, if a bank's composite rating is 3 or worse, RMS policy provides that most workpapers should be maintained until the bank returns to a satisfactory condition.

As noted before, the FDIC is not the sole supervisor for state-chartered banks that are not members of the Federal Reserve. Supervisory responsibility is shared with the relevant state banking authority. This shared responsibility for supervising state-chartered banks provides an important control against regulatory capture. When examinations are conducted on an alternating basis, examiners from the state authority review the workpapers from the prior FDIC examination as part of their pre-examination planning process. Should any evidence of regulatory capture be evident in the examination workpapers, the state authority examiners would identify the problem and report their findings to the FDIC. When examinations are conducted on a joint basis, examiners from both the state authority and the FDIC review the workpapers from the prior joint examination as part of their pre-examination planning process. Again, should any evidence of regulatory capture be evident in the examination workpapers, the state and FDIC examiners would identify the problem, and report their findings to RMS management.

[9] See Section 1.1 of the RMS Manual of Examination Policies.

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Notwithstanding the protections provided by the current examination workpaper retention policies, in response to GAO's recommendation, RMS will conduct a pilot process to maintain workpapers for a period encompassing three years for banks examined under a continuous examination process or three examinations for banks examined under a

point-in-time examination process as an additional mitigation against the risk of regulatory capture of an EIC. At the end of the pilot period, RMS will evaluate the results of the pilot and assess its effectiveness.

As noted earlier, to mitigate the risk of regulatory capture of an EIC, should an examiner leave the FDIC to work for an institution that they recently examined as EIC, RMS policy requires the examiner's supervisor to review the examiner's work products and document the review in a memorandum to the Regional Director. Other risk mitigations, including rotating EICs, alternating or conducting joint examinations with state authorities, and requiring reviews of ROEs by independent case managers who are trained to perform that responsibility, minimize the risk that a single examiner could compromise examination findings over multiple examinations.

GAO Recommendation 4:

The FDIC Chairman should direct RMS and the Legal Division Ethics Unit to develop a process for systematically requesting and collecting information on where departing examiners, including examiners-in-charge, enter into employment after leaving FDIC.

FDIC Response:

GAO acknowledges in this report that strategies for blocking or reducing industry's ability to offer regulators inducements—such as future employment opportunities—in exchange for preferential treatment, "are generally difficult to implement and may be too narrow in scope to adequately protect the agency from capture." FDIC agrees with GAO that other policies may be a more effective means for reducing avenues of inducement and has established such policies including:

- prohibiting employees from holding a direct financial interest in a regulated entity and requiring recusals for those who are exposed to the conflict of interest (regulatory violation);

- monitoring employees' financial holdings through disclosure requirements (statutory violation); and

- instituting cooling-off periods for specified periods of time, which bar certain employees from employment at regulated entities and representation before their former agencies (statutory violation).

GAO's report identifies the above three examples as measures that could be effective in reducing avenues of inducement of regulatory capture, and these processes are already in place at FDIC. Nonetheless, GAO also recommends that FDIC adopt a process for systematically requesting and collecting information on where departing examiners, including examiners-in-charge, enter into employment after leaving FDIC.

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Departing FDIC employees, whether leaving examiner positions or not, are not legally obligated to identify their future employer. However, examiners leaving FDIC for employment with a financial institution have certain obligations, violations of which may be punishable as criminal or civil violations as noted above, to share that information with the FDIC. FDIC examiners receive ethics training annually throughout their careers. Ethics training emphasizes the examiner's obligation to recuse from examining an institution with whom they are seeking post FDIC employment.

Further, as previously mentioned, FDIC follows workpaper review procedures when the departing examiner served as EIC for the institution. Should an examiner accept employment with an insured institution, the examiner's manager would have been on notice regarding the possible post FDIC employment at the time the examiner recused and be in a position to determine whether or not a work paper review was warranted.

The FDIC has in the past, systematically collected information from employees resigning from the Corporation to accept employment in the private sector. Departing employees were required to report information regarding their prospective private sector employer, the nature of its business or activities, the position to be occupied by the employee, the dates of negotiation for the employment, and the employee's official involvement, if any, with the prospective employer. However, the Corporation learned from experience that enforcement of the reporting requirement was difficult, the information obtained had little value and that the administrative burden of this particular information collection outweighed its benefits.

Notwithstanding, RMS and the Legal Division Ethics Unit will establish, on a pilot basis (for a period of three years), a process to request information from departing examiners about whether and where they will enter into employment upon leaving FDIC. Once completed, RMS and the Legal

Division Ethics Unit will evaluate the results of this three-year pilot and assess its effectiveness.

We appreciate the GAO's review of regulatory capture, and the opportunity to comment. If you have any questions, please contact Megan Patzwall at 703-562-6378 or mpatzwall@fdic.gov.

Sincerely,

Doreen R. Eberley

Director

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