Remarks by
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Let me begin by acknowledging two important anniversaries: the ICBA's 70th as the voice of independent community banking in America and Ken Guenther's 20th anniversary as executive director. Congratulations to everyone -- especially to you, Ken, and to all your colleagues who've had a hand in the extraordinary record of success the ICBA has built over these many years. If I might be so presumptuous, I'd like to suggest to the ICBA leadership that an ideal anniversary present for Ken would be a new typewriter.

In recognition of these milestones, I bring you a concession. Those of you who are bracing for another OCC speech about increasing credit risk and deteriorating loan underwriting standards can relax. In the spirit of the occasion, I will not discuss those subjects with you this morning.

Please don't misunderstand. Things haven't suddenly turned rosy on the credit risk front. The competitive and earnings pressures affecting credit risk are not abating, and as long as these pressures continue to adversely affect the quality of credit risk selection and underwriting standards, we will continue to be concerned.

Judging by the numbers, 1999 was an outstanding year for the banking business. Virtually every aggregate measure of bank performance was up. And while bankers continue to face challenges, I think most bankers -- community bankers and megabankers alike -- would agree that the past few years have been a good time to be in the banking business.

The late Congressman Wright Patman, who chaired the House Banking Committee during the 1960s, used to say that if there were no bank failures, it meant that bankers weren't doing their job. While I can appreciate the thought underlying that statement -- that banks that are too risk averse may not be serving their communities properly -- I would be perfectly content in my present position to have a zero failure rate. In fact, for several years during the 1990s, we had no national banks fail.

Three national banks did fail in 1999, however. Two were small community banks. The third was a community bank with ambitions to be a player in the highly sophisticated securitization market. One could easily view these as isolated cases in an otherwise healthy bank universe.

Yet beneath the surface lie some troubling similarities -- similarities with a message for the banking system as a whole. Each of the three failed banks evidenced some weakness or combination of weaknesses in management and internal controls. In one case, improper record keeping and accounting and ineffective board oversight contributed to the bank's failure. In the second case, the bank largely lacked external audit or loan review systems, and so fell victim to fraud orchestrated by the bank's president. In the third case, there was apparent fraud on an even larger scale -- activity that our examiners brought to light only a few months after a national auditing firm gave the bank a completely clean audit opinion.

Quite apart from these three cases, we have been increasingly concerned about the quality of audit and internal control functions at many other banks, large and small. When Acting Comptroller Julie Williams addressed this subject in a speech less than two years ago, she called attention to the warning signs of a weakening control environment. She and other OCC officials since then have cited the rising number of cases of bank fraud -- fraud that might have been detected if sound audit and control procedures had been followed. We've noted with dismay cutbacks in the size, status, independence, and proficiency of many banks' internal audit departments. And we've identified -- and criticized -- the emerging subculture in bank management that, under pressure to maximize earnings, accepts a higher risk of operational losses stemming from weak internal controls in return for whatever quick savings might be realized by failing to make those controls more robust. Such an approach, we've argued, sacrifices long-term strength and stability to short-term profits, and jeopardizes bank safety and soundness.

It is essential that bankers keep firmly in mind -- and the three 1999 failures should serve as a reminder -- that a vigorous, independent control and audit program is essential to a bank's safety and soundness.

The OCC philosophy of internal controls is simple. We believe that effective internal control is the foundation of a bank's management of risk. When properly designed and consistently enforced, a good system of internal controls will help management to safeguard the bank's resources, to produce reliable financial reports, and to comply with laws and regulations. It will also reduce the possibility of significant errors and irregularities, and assist in their timely detection when they do occur.

Three basic rules guide our approach to internal control supervision. First, boards of directors and senior bank management cannot delegate their responsibilities for establishing and maintaining an effective system of internal control. Second, bankers and examiners must each verify the integrity of internal control systems. Finally, the OCC will perform an internal controls assessment during every regular on-site examination using minimum core assessment standards.

What core policies and procedures are we looking for? Let me offer some thoughts on that subject -- and some additional examples of what can occur when these policies and procedures are neglected.

The first element of an effective internal controls program is a **control environment** that provides the discipline and structure to bank activities. A positive control environment is one that reflects management's commitment to the importance of effective internal controls, and sets the tone for the control activities that are undertaken to carry out management directives. It's an environment that allows -- indeed, expects -- bank employees and others performing internal control functions to do so objectively, recognizing that evaluations must be candid and accurate if they're to be of genuine value to management.

A hostile control environment, by contrast, is one in which management pays lip service to the concept of an independent control function, but acts in a way that compromises that principle. I'm thinking of one institution -- admittedly, an extreme case -- that wrote a model set of control procedures and then cancelled the internal auditors' stock options when the auditors had the audacity to challenge a management decision. Clearly, this was an institution whose heart was not in its own policies. But managers can create a hostile control environment by less overt means: by not listening to the auditors, or by not acting on their findings, or by not providing the audit function with adequate resources to do its job.

A truly independent internal audit function should, first and foremost, exist in an atmosphere that encourages speaking up without fear of retribution. To that end, the board of directors should be involved in such matters as fixing the compensation, reviewing the performance, and approving the budget of the internal auditor. The audit function should, moreover, have direct access to the audit committee of the board -- or, in cases where there is no audit committee, to the outside directors.

Bankers should ask themselves whether they're fostering an atmosphere in which people know that it's wrong not to identify and surface problems, and in which those involved in the process can be assured that no negative repercussions will be suffered if they do. That's certainly a question that OCC examiners will be asking when they assess an institution's internal controls.

The second element of an effective internal controls program is **risk assessment**. This refers to the identification and analysis of relevant risk, both internal and external, that can jeopardize a bank's operations or prevent it from achieving its objectives. Risk assessments help determine what risks exist, what their magnitude is, how they should be managed, and what types of controls are needed. It means understanding the business you're in -- or the business you're about to enter.

Too many banks, in their zeal for income growth and new markets, have ignored this basic precept. Several banks can speak with unhappy authority on this subject, after absorbing large losses in acquisitions of businesses that senior management did not understand.

The third element consists of **control activities,** including policies, procedures, and practices that help bank personnel carry out board and management directives. Control activities include reviews of operating performance, approvals, and authorizations for transactions and activities, segregation of duties, vacation requirements for officers and employees in sensitive positions, and the design and use of documents to ensure that transactions are properly recorded. Policies should ensure that bank officers who perform internal control functions as an adjunct to their operational duties not be put in a position of evaluating their own work. They should also ensure that duties other than the performance of control functions do not conflict with or compromise those functions.

When these policies and practices do not exist, it can cost banks dearly. Unreconciled accounts mount -- and so do losses. Fraud goes undetected until it's beyond the point of effective repair. The veteran employee entrusted with special access to the bank's records abuses the privilege. The bank that outsourced its construction loan disbursements to a title company winds up having its capital nearly wiped out as the result of the title company's failure to ensure that the work being funded was actually completed.

Such tales of woe have become an unfortunate commonplace in today's financial world.

The fourth element in an effective internal controls program covers **accounting, information, and communication systems.** These systems must capture and deliver pertinent and timely information that enables bank officers to carry out their responsibilities. Management must have the proper tools to effectively manage risk.

But we see an alarming increase in the number of "surprises"-- problems that don't come to light until they have already had a sizeable impact on the bank's financial condition. Recently, a number of banks have had to restate earnings as the result of inadequate attention to accounting controls.

Finally, effective internal review programs such as **self-assessment or monitoring** can provide oversight of a bank's control system performance. Self-assessment, in the form of periodic evaluations of a department's controls by a person responsible for that area, is one type of oversight mechanism. For community banks, a clear and focused internal audit program can be a key defense against fraud by providing independent assessments of a control system's quality and effectiveness.

This is the kind of review that bankers should be performing every day, and it's critical. Auditors, loan reviewers, and bank examiners can be a good backstop against risk. But nothing can replace front-line accountability.

The principles I've just outlined apply to banks across the board, and they apply to every phase of a bank's operations. In the loan production area, for example, all banks, regardless of size, should have an effective process for approving and monitoring loan policies and practices. They should have clear and consistent policies and procedures. They should have information systems that provide appropriate reporting to line management, senior management, and the board. And they should have a loan review function that provides independent evaluation of the risk and quality of the loan portfolio, to avoid the inherent conflict of interest that would arise if the person who made a loan is also charged with reviewing it.

In the compliance area, an effective internal control environment features a board and senior management active in approving and monitoring compliance policies and practices. It has a designated compliance officer or compliance committee, sound operational controls, and training appropriate to the institution's activities. It has policies and procedures that address all relevant compliance issues. And it includes an independent audit program that tests compliance with the various consumer protection laws and adherence to bank policies.

I know that your responsibilities for compliance are burdensome, and that full compliance with every law and regulation is challenging, no matter how good your compliance program might be. But the burden of compliance may be insignificant compared to the risks and losses that can result if compliance is not carried out properly. An effective internal control program that keeps an eye on compliance is cheap insurance against such loss. Unfortunately, too many banks today are choosing to run that risk without the protection that internal controls can provide.

The time has come, therefore, to reconcentrate our supervisory focus on internal controls and audit, and the OCC is doing just that. Where effective policies and procedures, and the will to enforce them, strike us as lacking, we will bring our concerns to the attention of management and the board, and make clear their responsibilities in this area.

Large banks may have more to lose in dollar terms when internal controls slip. But community banks' smaller margins for error make them no less vulnerable to such slippage. Many community banks have enjoyed impressive growth recently, and that's a tribute both to the skill and vision of their managers and to the rapid development of the financial marketplace. But for all organizations, growth brings challenge. It brings staff turnover, and, occasionally, the need to throw newcomers into the breach before they've been fully trained. Rapid growth can overwhelm both information systems designed to process a much smaller numbers of transactions, and managers accustomed to a narrower span of responsibility and control.

In other words, control procedures that might have been perfectly adequate to a bank at one stage in its development may no longer be sufficient once that institution has evolved into a larger, more complex operation.

The federal bank regulatory agencies recently adopted a common policy relating to outside audit that recognizes this fact. The FFIEC's interagency policy statement affirms that examination procedures should be geared to the differing needs and risk characteristics of the bank population. In keeping with this policy, our examiners have the discretion to tailor procedures to each individual bank. For example, while we strongly believe that all community banks should have the benefits of an external audit -- and we fully appreciate the costs involved

-- we recognize that there are a number of means to that end, ranging from full financial statement audits by independent public accountants to directors' examinations performed by other independent parties.

Right now, we are reemphasizing the minimum core objectives for internal controls and audit in our community bank examination procedures. These objectives require examiners to evaluate the quality of board oversight of the bank's audit programs; the adequacy of audit policies, procedures, and programs; the competence and independence of the internal audit staff; and the effectiveness of outsourced internal audit arrangements, if applicable.

For internal controls, our minimum objectives require examiners to evaluate each of the five control elements I discussed earlier: the control environment; internal risk assessments; control activities; accounting, information, and communications systems; and the bank's self-assessment and monitoring capabilities.

For external audit, the objectives require an assessment of the adequacy, independence, and reliability of the auditor's work. And in all three instances, examiners are required to include their conclusions about the bank's performance in this area in the report of examination and in their summary discussions with bank management.

But our emphasis continues to be on results rather than process, and on matching requirements to the size and complexity of each bank. So we rely on the examiners' judgments in determining what steps need to be taken to meet those objectives. Examiners on the scene determine what documents need to be gathered and analyzed, what discussions need to be initiated, and what kind of validations need to be performed to draw reliable conclusions. For example, if questions arise about the internal or external auditors' competence or independence, or if longstanding audit exceptions exist, examiners will probe more deeply to determine the cause of these weaknesses -- including conducting verification procedures, if necessary. If their evaluations point to concerns, our examiners are expected to make recommendations for corrective action.

But communication is most effective when it goes both ways. We want to hear from you. Banker input is critical in improving all phases of our examinations, to make them more useful and less burdensome. In fact, an effective program of internal controls is probably the best way I know to preserve the proper balance between bank managers and supervisors, enabling both of us to do what each does best.

One veteran banker used to diagram his conception of the appropriate system of checks and balances for banks by drawing three concentric circles. The innermost circle represented bank management, the second the audit or other control function, and the outermost circle, the bank supervisor.

I think that framework offers a reasonable approximation of what our respective roles should be. Proper internal controls and an effective audit function must be management's first line of defense against the unpleasant surprises that can cause severe, even irreparable damage. A strong and effective internal controls program will help ensure a bank's success -- and help its managers get a good night's sleep.

Finally, as for the supervisor's role, I would say this: that while supervisory <u>oversight</u> is critical, supervisory <u>intervention</u> should always be the last resort. We bring a useful outside perspective to your business. But if we find weaknesses in your audit or control environment or have the ability to catch a problem before you do, then you may have an issue requiring your board's attention.

Let me leave you with this challenge: to do whatever it takes to make sure that your bank has effective internal controls and audit in place. If they are, your shareholders will be better off, and we as supervisors can step back and let you do the job you were hired to do, as you'd prefer to do it, without undue interference. That's <u>our</u> goal, and it should be yours, too.