Remarks by

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before the

National Auditing and Regulatory Compliance Conference
Bank Administration Institute
Chicago, Illinois

June 17, 1998

I'd like to begin this morning by sharing an interesting case that just came to my attention. The facts are these: on his own account, the CEO of a Washington D.C. national bank made a big unsecured loan -- amounting to nearly half the bank's total capital -- to a Baltimore firm in which he was the majority shareholder. Through after-hours doctoring of the books, he was able to hide the transaction from OCC examiners and the bank's own auditors. Although the bank's bylaws called for weekly board meetings to consider major loan applications, few meetings were actually held. When the board did assemble, the CEO announced that there was no business requiring its attention, and sent the members on their way. Meanwhile, the CEO was furtively extending new loans to the Baltimore firm as its old loans came due. In the end, both the firm and the bank came crashing down. The CEO, one Leonard Huyck, wound up doing time in federal prison.

The bank in question was the Merchants National Bank. If the name doesn't ring a bell, perhaps it's because Merchants National failed during a sleepy Washington D.C. summer -- the summer of 1866. Merchants was, in fact, the second national bank ever to fail.

The lesson of this story is as relevant for bankers and bank supervisors today as it was 132 years ago. A basic foundation of bank safety and soundness is a vigorously administered and thorough system of internal controls. And my message to you this morning is simple: I am concerned that the vigor and thoroughness of banks' internal controls are slipping. This is a trend that must be reversed. You have a crucial role to play in accomplishing that result.

Today, increasing numbers of the cases that come to the OCC's special supervision division -- the division that deals with problem banks -- wind up there as a result of fraud. Much of it is garden variety theft and embezzlement and loan and check fraud that would be instantly recognizable to any 19th century banker.

Now as then, most of these schemes to defraud are simple in concept. How simple they are to execute depends upon the bank's internal control mechanisms and procedures. Where controls are effective, fraud can be prevented or uprooted before it affects the bank's solvency. Where internal controls go awry, fraud can fester undetected -- with possibly disastrous -- and certainly expensive -- consequences for the bank.

For example, a bank that violated the fixed principle of internal controls that "no single person shall both authorize loans and control their disbursement" recently suffered a big loss when its president made "nominal" loans to nonexistent borrowers -- and used the cash in a bid to corner the bank's stock.

Or consider the bank that violated the fixed principle that "the board of directors shall exercise special vigilance in cases involving loans to insiders and affiliates." This bank recently suffered big losses when an unscrupulous officer originated an unsecured loan to an out-of-town jewelry store and used the proceeds to buy his wife lavish gifts.

A bank that violated the basic principle that "independent verification of all loan documentation shall be performed before a loan is issued" recently failed when an ambitious loan officer falsified borrowers' financial statements and collateral inspections. In this case, the fraud came to light as the result of the bank's adherence to another basic precept of internal controls: officers and employees in sensitive positions shall be away from their desks for at least two consecutive weeks each year.

In each of these cases, the failure to follow fundamental techniques for sound internal controls led to expensive mistakes that diminished bank capital and tarnished banking reputations even when the bank itself survived. In each of these cases, personal suffering and financial loss could have been avoided if only these simple, common sense procedures had been in place.

Evidence of weakening internal controls is not merely anecdotal. Late last year, in a study similar to BAI's own Audit Benchmarking Survey, the OCC's Central District here in Chicago found that the growth in audit capabilities in the banks they looked at was not keeping pace with the growth of the banks themselves. We found that turnover in the banks' auditing departments was increasing; so was the employee-to-auditor ratio. While these findings represented preliminary results based on a small sample and are open to various interpretations, they do give us additional reason to be concerned. Particularly as banks seek to grow even larger, their internal control capacities should be strengthened, not diminished, relative to the size and complexity of the resulting organizations.

To some degree, the slippage in internal controls might be attributed to the current health of the economy and the profitability of most banks. Some bankers in tight labor markets are reportedly finding it hard to recruit enough competent internal auditors to fill vacancies. Given the difficulty in hiring staff to guard against fraud, some bankers may have come to accept an understaffed, less robust internal control function and the fraud that attends it as just another incidental cost of doing what is these days a most profitable business. In good times, losses can be more readily absorbed, and in-house auditors often have a harder time getting the ear of senior management.

The decline in internal controls is also undoubtedly related to the competitive lending environment in which banks currently operate. As loan margins grow thinner, banks feel an increasing urgency to cut costs, and are most likely to economize in areas they perceive as having minimum impact on income. When this approach is directed to a bank's internal controls, it misguidedly sacrifices long-term strength and stability to short-term profits.

The apparent degradation of internal controls systems come at a particularly critical time for the banking business -- a time of rising risk in many phases of the industry. Many banks face intensified competition from domestic and foreign-based providers for what was once their core lending business, competition that has taken a toll in underwriting standards and loan terms. Technological challenges -- such as those associated with the millennium change and electronic commerce -- pose risks all their own. The information that banks have accumulated about their customers has great value -- not only for the banks but for others as well. There is an increasing risk that unauthorized persons will look for ways -- legal and illegal -- to access bank customers' private account information. And, of course, the wave of announced massive bank consolidations in recent weeks alone has created a new element of uncertainty -- and new challenges -- for the affected banks.

In the face of such industry change, it stands to reason that banks would be strengthening their internal controls instead of cutting them back. It stands to reason that banks would be adding experts in this area -- in-house or contract -- to their staffs. It stands to reason that banks would be upgrading their monitoring systems to make them more effective and more resistant to tampering and intrusion. A few banks are doing all of those things. But not enough. This failure reflects structural and management weaknesses that could have serious safety and soundness implications for some banks.

This is obviously an important concern for us. To further our supervisory efforts and attention to internal controls, we will release the new "Comptroller's Handbook for Internal Control" next month. This publication caps the OCC's emphasis on internal controls -- an emphasis that now permeates our whole approach to bank supervision for large banks and community banks alike. Indeed, our newly-revised Large and Community Bank Examination procedures integrate the review and testing of internal controls into all OCC examinations.

The OCC's regimen calls for examiners to review each bank's internal controls during every 12 or 18 month supervisory cycle. What will they be looking for? We recognize that no one form of control system is right for all banks. Community banks can implement controls in a less formal, less structured manner than larger banks and still have an effective control mechanism. Many of these smaller banks necessarily rely on outside consultants to perform "internal" audit functions and still are able to get the job done properly.

But we do believe that there are common critical components in internal control systems for all banks, and we embrace the five identified by COSO, the Committee of Sponsoring Organizations of the Treadway Commission. The list includes: Control Environment; Risk Assessment; Control Activities; Accounting, Information, and Communication Systems; and Self-Assessment.

Each of these elements is important, but the first -- control environment -- really represents the foundation for all the others. It provides the basic discipline and structure vital to an effective control system. It reflects the level of management's commitment and awareness of the importance of internal controls, and sets the tone for the control activities that are undertaken to carry out management directives. Included among these control activities are the bank's procedures for approving and authorizing transactions and reviewing operating performance; the checks and balances that limit employees' access to assets and records, and the design and use of documents.

Risk assessment is the identification and analysis of relevant risk, both internal and external, that can prevent the bank from reaching its objectives or can jeopardize its operations. The assessment helps determine which risks exist, how they should be managed, and what types of controls are needed.

The fourth element in an effective internal control program deals with accounting, information, and communication systems. These systems must not only capture information and generate necessary reports, but also enable all bank personnel to understand their roles in the overall control system, how their activities relate to others, and their accountability for the activities they conduct. And, finally, the self-assessment function consists of periodically measuring -- and testing -- the effectiveness of controls.

In assessing the bank's overall arrangements for internal controls, OCC examiners will look first at its written procedures. Written procedures are required for controls relating to insider transactions, Bank Secrecy Act, real estate lending, asset management, financial derivatives, interbank liabilities, and retail nondeposit investments.

But good processes are not enough. Impressive though they might appear on paper, internal controls are of little value unless they are thoroughly understood and strictly adhered to. That responsibility falls squarely on bankers. Our examiners will determine how well that responsibility has been met. To make that determination, we will be drilling down and doing more testing and verifying of actual transactions. Where the bank's risk profile is higher, we will be doing proportionately more of that kind of in-depth testing. Where warranted, we will be reviewing reconciliations and transaction orginations, internal audit working papers, and external audit reports. And we will bring any deficiencies to the attention of senior management.

But as much as we can do as regulators to help build a banking system that is truly safe and sound, responsibility for the development, implementation, and testing of internal controls rests first and foremost with managers and bank board members. This responsibility, as we say in the internal controls handbook, is "not diminished through delegation, outsourcing, or similar arrangements." This is crucial. Senior bank managers and board members -- not their subordinates or their contractors -- are responsible for ensuring that the internal control system is operating as intended and that it is modified, as appropriate, to adapt to changing conditions.

Bank managers and directors should be insisting that their own auditors constantly probe and test the effectiveness of the bank's internal controls. And they should welcome a vigorous internal control function that will prevent problems before they hatch -- or catch them before they undermine the bank's assets and earnings and its good name.

As long as all parties -- bank managers, board members, bank supervisors, and internal and external auditors -- play their respective roles in a vigorous and thorough fashion, the banking industry will have the foundation it needs to successfully transit a time of change and challenge -- and to prepare it for the new challenges that lie ahead.