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BANK AND THRIFT REGULATION

Improvements Needed in Examination Quality and Regulatory Structure

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The Honorable Donald W. Riegle, Jr.
Chairman
The Honorable Alfonse M. D'Amato
Ranking Minority Member
Committee on Banking, Housing, and
Urban Affairs
United States Senate

The Honorable Henry B. Gonzalez
Chairman
The Honorable Jim Leach
Ranking Minority Member
Committee on Banking, Finance and
Urban Affairs
House of Representatives

This report summarizes the results of our reviews of bank and thrift examinations performed by the Federal Deposit Insurance Corporation (FDIC), Federal Reserve Board (FRB), Office of the Comptroller of the Currency (OCC), and Office of Thrift Supervision (OTS). Our reviews focused on how well regulators assessed the quality of bank and thrift loan portfolios and related loan loss reserves, and the effectiveness of the institutions' internal control systems. This report also discusses how regulators should effectively and efficiently implement the requirements of the Federal Deposit Insurance Corporation Improvement Act of 1991 that affect these critical areas. In addition, the report discusses the evolution of the current regulatory structure for financial institutions since the Great Depression and its ability to meet the demands of today's more complex banking environment. Several matters for congressional consideration are presented in the report.

We are sending copies of this report to the Acting Chairman of the Board of Directors, Federal Deposit Insurance Corporation; the Chairman of the Board of Governors of the Federal Reserve System; the Acting Comptroller of the Currency; the Acting Director of the Office of Thrift Supervision; the Secretary of the Treasury; and the Director of the Office of Management and Budget.

This report was prepared under the direction of Robert W. Gramling, Director, Corporate Financial Audits, who may be reached on (202) 275-9406 if you or your offices have any questions. Major contributors are listed in appendix I.

Charles A. Bowsher
Comptroller General
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Executive Summary

Purpose

Record numbers of bank and thrift failures in the 1980s and continuing into the 1990s have depleted the bank and thrift insurance funds. The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) and the Federal Deposit Insurance Corporation Improvement Act of 1991 provided funding authority to resolve failed institutions and restore the insurance funds, and regulatory reforms to better manage the safety and soundness risks to the insurance funds and minimize losses.

Bank and thrift examinations are the primary means to identify weaknesses that may ultimately lead to institution failure. Effective examinations are key to the successful implementation of the reform legislation. GAO assessed the quality of the examinations by evaluating examiners' reviews of loan quality, loan loss reserves, and internal controls.

This report summarizes GAO's findings reported separately for each of the four regulators, discusses how the regulators can use reform requirements to enhance examinations, and identifies matters for congressional consideration critical to the success of the reform legislation. It also discusses the ability of the regulatory structure to meet the demands of the current complex banking and thrift environment.

Background

Four federal regulators—the Federal Deposit Insurance Corporation (FDIC), Federal Reserve Board (FRB), Office of the Comptroller of the Currency (OCC), and Office of Thrift Supervision (OTS) supervise and examine all federally insured banks and thrifts. FRB also regulates bank holding companies. As of December 31, 1991, there were 12,366 federally regulated commercial and savings banks with nearly \$3.7 trillion in assets and 2,187 thrifts with \$931 billion in assets. FRB regulated 6,441 bank holding companies.

Banking regulators assess overall bank safety and soundness by examining and rating five major areas: capital adequacy, asset quality, management, earnings, and liquidity. OTS uses a similar rating system.

Assessing loan quality and determining the adequacy of loss reserves are two of the most important components of an examination because loans comprise the majority of bank and thrift assets and involve the greatest risk. Internal controls provide the framework for achieving management objectives, accurate financial reporting, and compliance with laws and regulations.

FRB inspections of bank holding companies assess their financial condition and compliance with restrictions on transactions between the insured bank subsidiaries and nonbank affiliates. Nonbank subsidiaries may engage in a variety of activities unrelated to deposit taking and lending that can pose considerable risk to the insured bank subsidiary.

GAO randomly selected 58 banks and thrifts, including 11 FDIC regulated banks, 6 FRB banks, 21 OCC banks, and 20 thrifts from the universe of banks and thrifts as of September 30, 1990, to review the quality of the most recent examination. The sample included 20 banks with assets greater than $10 billion, 18 banks with assets less than $10 billion, and 20 thrifts of various size. The statistical nature of the sample allowed the results to be projected to the universe of most recent examinations (at the time of GAO's review) of all banks and thrifts. GAO judgmentally selected a number of other banks and 7 bank holding company inspections for review for which the results were not projectable.

Results in Brief

GAO's review of examinations for the 58 randomly selected banks and thrifts showed the examinations were too limited to fully identify and determine the extent of deficiencies affecting safety and soundness. These limitations impeded early warning of the seriousness of bank and thrift weaknesses and reduced the opportunity for taking timely corrective action and minimizing losses to the insurance funds. Similar weaknesses affected the quality of bank holding company inspections. Extensive flexibility given examiners and a lack of minimum requirements was a common problem affecting the quality of examinations and inspections.

The FDIC Improvement Act of 1991 provides a structure to strengthen corporate governance and facilitate early warning of safety and soundness problems—deficiencies that contributed significantly to the failure of banks and thrifts and the depletion of the insurance funds.

As measured by the unprecedented failures of banks and thrifts since 1980, the regulatory system has been far less effective in preventing and minimizing the number and cost of failures than in the preceding 50 years. The regulatory system must be improved to enable it to effectively function in the high-risk, complex financial industry of today. Successful implementation of the FDIC Improvement Act and improved examinations and accounting rules are vital to regulatory effectiveness and protection of the insurance funds.

GAO also identified many inconsistencies among the regulators that may hinder their efficiency and effectiveness. GAO believes that the regulatory structure that grew out of the Great Depression has not kept pace with today's highly competitive and complex banking world.

Principal Findings

Internal Controls Not Thoroughly Tested

GAO's 1989 and 1990 reports on failed banks and thrifts showed that weak internal controls contributed significantly to institution failure. GAO found that regulators thoroughly reviewed internal controls for only 1 of the 58 bank and thrift examinations it reviewed.

Each of the regulator's examination manuals discussed the importance of assessing internal controls, but the manuals were viewed as a reference guide only. The extent of internal control work was left to the examiners' discretion. GAO found that examiners reviewed some bank controls, but systematic comprehensive reviews of controls which would provide a basis to conclude on their adequacy were not performed.

Reviews of Loan Quality and Loss Reserves Not Adequate

GAO found that the reliability of 47 of the 58 examinations was undermined by weaknesses such as nonrepresentative loan samples, reliance on outdated or incomplete data, lack of a consistent methodology for assessing loan portfolio risks and the adequacy of loss reserves, and insufficient or inconsistent quality control over examinations. The regulators lacked minimum required examination standards, allowing examiners discretion in conducting the reviews.

For 31 of 38 OCC and OTS examinations, GAO found examiners did not review loan samples that were representative of the institutions' portfolios. OCC's reviews generally excluded more than 50 percent of the commercial loan portfolio and OTS's reviews excluded more than 80 percent of the loan portfolio from review. In addition, three OCC banks in GAO's sample had not been recently examined and, therefore, OCC lacked timely data to assess their loan quality. For 8 of 11 FDIC examinations, GAO found between 33 percent and 55 percent of the dollar value of loans reviewed lacked sufficient data to assess loan quality. In one case, cash flow data were 3 years old, and FDIC examiners did not verify collateral. In another, examiners did not analyze the borrower's ability to repay the debt. For 5 of 6 FRB examinations, GAO found that FRB's review of loan quality was generally adequate.

None of the regulators had a risk-based methodology to judge the adequacy of an institution's loan loss reserves. Examiners lacked a consistent framework to quantify loan portfolio risks such as real estate exposure, unfavorable economic conditions, and deficient loan policies. Methods for assessing loan loss reserves varied among the regulators and the lack of a generally accepted method made it difficult for the regulators to successfully challenge management's estimates when the examiners believed reserves were inadequate.

In nearly all FDIC examinations, and several OTS examinations, GAO found inadequate evidence of work performed and supervisory review, mostly in the loan area. Their examination manuals encouraged examiners to avoid excessive documentation, but provided little definitive guidance and did not require supervisory review of working papers. FRB and OCC examinations were generally adequately documented, although GAO found some inconsistencies, especially in documentation of supervisory review.

No Formal Program to Assess State Examinations

FDIC and FRB did not have a formal program to assess the quality of state examinations they relied on in lieu of their own examinations. FDIC extended its examination intervals by relying on state examinations for a number of the banks in GAO's sample. In its review of failed banks, GAO identified several cases where such reliance may have been inappropriate. FRB relied on some state examinations for small member banks. OCC examines only nationally chartered banks, and OTS did not rely on state examinations of state chartered thrifts. The FDIC Improvement Act allows regulators to place increased reliance on state examinations. Without a formal review program, however, regulators lack a sound basis to rely on state examinations.

OTS and FDIC Thrift Examinations Lacked Effective Coordination

In 20 thrift examinations reviewed, GAO found 13 were performed by OTS and FDIC within 6 months of each other. However, they worked together at only 5 of these thrifts. The regulators reached different safety and soundness ratings for 9 of the 20 examinations. In May 1992, the regulators agreed to better coordinate their examinations. It is too early to determine if the agreement has been successfully implemented.

FRB Bank Holding Company Inspections Leave Insured Banks Exposed

For six of seven inspections reviewed, GAO found FRB examiners did not thoroughly review intercompany transactions, such as loans from the bank to nonbank affiliates, fees charged by the holding company to the insured bank subsidiary, and assets transferred from nonbank subsidiaries to insured bank affiliates, to detect potential abuse of the insured bank. FRB lacked minimum inspection requirements, allowing examiners broad discretion in conducting inspections. Examiners inappropriately relied on management representations; assumed examiners of the insured bank would review the transactions, which GAO found did not always occur; or considered that harmful transactions would be evident and therefore did not specifically search for any. However, intercompany transactions such as below market interest rates and excessive service fees, which would not likely be evident unless a thorough review was performed, can drain a bank's capital and cash over an extended period.

FDIC Improvement Act Can Aid the Regulators

Previous GAO reports showed that breakdowns in internal controls contributed significantly to bank and thrift failures, weak regulatory oversight allowed safety and soundness problems to go uncorrected and drain bank capital, and audit committees of the largest banks lacked the independence and expertise to properly oversee bank operations. The act's reforms provide a structure to strengthen corporate governance and to facilitate early warning of safety and soundness problems.

Management and auditor reporting requirements along with mandatory independent audit committees provide the opportunity to strengthen institutions' internal controls and corporate governance. The regulators can use the results of managements' assessments and external auditors' reviews to improve the quality and efficiency of examinations.

The act requires the regulators to develop safety and soundness standards as a basis for timely correction of operational and managerial weaknesses, such as inadequate loan documentation or credit underwriting, before they lead to nonperforming loans and erosion of capital. The act also establishes capital standards and requires that regulators take prompt actions when standards are not met. These prompt regulatory requirements should lead to more timely regulatory decisions in assisting troubled institutions and minimizing losses to the insurance funds.

The regulators need reliable financial reports from bank and thrift management to effectively use the act's prompt regulatory requirements, which are based on reported capital. However, the reliability of financial reports will continue to be diminished unless flexible accounting rules for nonperforming loans, investment securities, and related party transactions that contribute to overstated capital levels are tightened. This is not likely to happen without congressional action given the reluctance of the Financial Accounting Standards Board and the regulators to appropriately change accounting rules.

Current Regulatory System Has Not Kept Pace With the Banking and Thrift Industries

As measured by the unprecedented failures of banks and thrifts since 1980, the regulatory system has been far less effective in preventing and minimizing the number and cost of failures than in the preceding 50 years since the Great Depression. From 1934 through 1979, a 46-year period, 558 banks failed at a cost to the insurance fund of about $141 million. From 1980 through 1991, a 12-year period, 1,382 banks failed or received assistance costing the insurance fund $35 billion. For the same 46-year period, 143 thrifts failed costing the insurance fund $306 million. For the following 12-year period, 1,073 thrifts failed costing $119 billion.

In addition to inflation and economic recession, increased risk-taking by banks and thrifts, deregulation, internal control weaknesses, violations of safety and soundness laws and regulations, and higher insured limits all contributed to the high cost of deposit insurance. GAO is concerned that the regulatory structure has not kept pace as the bank and thrift industries have become riskier and more competitive. In addition, new risks, such as the widespread use of highly complex financial derivative products by banks and thrifts, are continuously emerging and must be effectively dealt with by regulators.

Although GAO did not study the current regulatory structure in detail, it identified inconsistencies and overlap among the four regulators that undermine their effectiveness and efficiency. Such inconsistencies include differences in loan quality and loss reserve evaluations, bank and thrift rating systems, examination guidance and regulations, and fees charged institutions. Issues involving overlap or duplication of responsibilities include holding company inspections conducted by FRB while other regulators examine the insured bank subsidiaries, separate headquarters and regional office structures, two separate agencies for disposing of assets acquired from failed institutions, and separate central banking systems for banks and thrifts.

Recommendations

The following is a summary of the recommendations GAO made in its separate reports on the four regulators. To strengthen examinations, banking and thrift regulators should

- ensure annual comprehensive internal control reviews are performed, using, where appropriate, assessments conducted by bank/thrift management and their auditors,
- use sampling methodologies that provide representative coverage of an institution's loan portfolio,
- require examiners to obtain and document current and complete data for loan quality reviews,
- develop and implement a sound methodology to quantify risks in assessing the adequacy of loan loss reserves,
- require examiners to formally assess the quality of state examinations when relied on, and
- develop minimum mandatory inspection procedures for assessing the risks of bank holding company activities to insured bank subsidiaries.

Agency Comments

OTS and OCC generally agreed with GAO's recommendations, while FDIC generally disagreed. FRB stated that GAO's recommendations for the most part had merit and said it would carefully evaluate the findings and recommendations, but did not specify what action it may take. FDIC stated that GAO's recommendations were too prescriptive and would, in effect, turn its work into an audit. FDIC generally did not believe it needed to change its examination policies or procedures, and GAO is concerned that examination quality may not be uniformly improved or not improved at all in the case of FDIC. GAO believes the varying receptiveness of the regulators to the recommendations is yet another example supporting the need to reexamine the existing regulatory structure.

Matters for Congressional Consideration

Given the findings summarized in this report and the comments GAO received from the regulators, the House and Senate Banking Committees should

- urge the regulators to adopt GAO's recommendations as minimum mandatory examination standards to ensure consistent, effective annual full-scope examinations and inspections, and, absent adoption of such minimum standards by the regulators, the Congress should consider legislating such requirements;

- urge the Financial Accounting Standards Board and the regulators to adopt accounting rules for regulatory financial reports that reflect the fair value of nonperforming loans and investment securities, and the economic substance of related party transactions, and, absent the adoption of such accounting rules, the Congress should consider legislating these requirements; and
- in conjunction with the administration, consider appointing a panel of experts to assess the appropriateness of continuing with the present regulatory structure and to develop alternatives.

Contents

Abbreviations

AICPA	American Institute of Certified Public Accountants
BOPEC	bank subsidiaries, other nonbank subsidiaries, parent company, earnings, and capital adequacy
CAMEL	capital adequacy, asset quality, management, earnings, and liquidity
FDIC	Federal Deposit Insurance Corporation
FASB	Financial Accounting Standards Board
FIRREA	Financial Institutions Reform, Recovery, and Enforcement Act of 1989
FRB	Federal Reserve Board
FRS	Federal Reserve System
FSLIC	Federal Savings and Loan Insurance Corporation
GAAP	generally accepted accounting principles
MACRO	management, asset quality, capital, risk management, and operating results
OCC	Office of the Comptroller of the Currency
OTS	Office of Thrift Supervision
RAP	regulatory accounting principles
RTC	Resolution Trust Corporation
SAIF	Savings Association Insurance Fund

Introduction

This report summarizes the findings, conclusions, and recommendations included in our four separately issued reports[1] that assessed whether regulatory examinations effectively evaluated the safety and soundness of banks and thrifts. Specifically, the reports evaluated how well federal regulatory examiners assessed the quality of banks' and thrifts' loans, including assessing the adequacy of the related loan loss reserves and the effectiveness of the institutions' internal controls. The reports also discussed how regulators could effectively and efficiently use requirements in the Federal Deposit Insurance Corporation Improvement Act of 1991 that affect these areas. This report discusses the history of deposit insurance, including the growth of failed institutions, and whether the regulatory structure for supervision and examination of financial institutions has kept pace with the demands of today's complex banking environment.

In previous reports, we cited weak internal controls and poor loan quality as contributing significantly to the failure of banks and thrifts.[2] Loans are the largest single component of banks' and thrifts' assets and represent the greatest potential for loss. Internal controls are intended to protect against unsound practices and ensure accurate reporting of an institution's condition and performance. These include policies and procedures for safeguarding assets, such as loan underwriting and documentation, as well as other financial reporting controls.

The Bank Insurance Fund administered by the Federal Deposit Insurance Corporation (FDIC) ended 1991 with a deficit balance of $7 billion due to the record numbers of bank failures. From 1985 through 1991, 1,192 federally insured banks failed or received federal assistance. From 1988 through 1991 alone, 724 banks with total assets of over $160 billion failed or received assistance, at an estimated cost to the Fund of over $23.7 billion.

Also, the number of currently troubled thrifts demonstrates that the thrift industry's problems are not over. As of December 31, 1991, the Office of Thrift Supervision (OTS), the primary regulator for federally insured thrifts,

[1]Bank Examination Quality: FRB Examinations and Inspections Do Not Fully Assess Bank Safety and Soundness (GAO/AFMD-93-13), Bank Examination Quality: OCC Examinations Do Not Fully Assess Bank Safety and Soundness (GAO/AFMD-93-14), Bank Examination Quality: FDIC Examinations Do Not Fully Assess Bank Safety and Soundness (GAO/AFMD-93-12), and Thrift Examination Quality: OTS Examinations Do Not Fully Assess Thrift Safety and Soundness (GAO/AFMD-93-11).

[2]Failed Banks: Accounting and Auditing Reforms Urgently Needed (GAO/AFMD-91-43, April 22, 1991), Bank Failures: Independent Audits Needed to Strengthen Internal Control and Bank Management (GAO/AFMD-89-25, May 31, 1989), and Thrift Failures: Costly Failures Resulted From Regulatory Violations and Unsafe Practices (GAO/AFMD-89-62, June 16, 1989).

identified 170 troubled thrifts that may require assistance by September 30, 1993, and another 260 thrifts that are troubled but not likely to fail within the next 2 years. The Savings Association Insurance Fund (SAIF), which was created by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) to insure thrifts and is administered by FDIC, is scheduled to assume full resolution responsibilities for thrifts on October 1, 1993. SAIF's reported fund balance, its cushion to absorb losses from thrift failures, was about $195 million at September 30, 1992. If there is still a significant number of thrifts in need of resolution after September 30, 1993, SAIF could be insolvent when or shortly after it assumes its insurer responsibilities.

The weakened condition of the insurance funds underscores the need to ensure that bank and thrift examinations fully detect problems before they become severe and contribute to more financial institution failures and further losses to the insurance funds and, ultimately, the taxpayers.

Background

In response to the nation's banking problems, the Congress passed the FDIC Improvement Act of 1991. The act is a critical step towards improving bank and thrift regulation to provide an early warning of safety and soundness problems, minimize losses to the insurance funds, and rebuild the Bank Insurance Fund.

The act provided FDIC increased authority to borrow funds to cover both losses and working capital needs for resolving troubled institutions. The act increased FDIC's authority to borrow funds from Treasury on behalf of the Bank Insurance Fund and the Savings Association Insurance Fund to cover losses incurred in resolving troubled institutions to $30 billion. However, it requires FDIC to recover these funds through premium assessments charged to insured institutions. Also, FDIC may borrow funds for working capital, but the amount of its outstanding working capital borrowings is subject to a formula in the act that limits FDIC's total outstanding obligations. Working capital funds are to be repaid primarily from the management and disposition of failed financial institution assets.

The act also provided major regulatory reforms affecting the banking and thrift industries, including capital standards for prompt regulatory action and other expanded regulatory powers, annual audited financial statements and internal control reporting requirements for larger institutions, and requirements for annual full-scope examinations. These reforms are a positive step towards correcting the problems faced by the banking and thrift industries. The effectiveness of these reforms, to a large degree, depends on the quality of examinations, which is the primary tool by which regulators assess the safety and soundness of banks and thrifts.

Federal Regulatory Structure for Banks and Thrifts

Four federal regulators—FDIC, the Federal Reserve Board (FRB), the Office of the Comptroller of the Currency (OCC), and OTS—supervise and examine all federally insured banks and thrifts.

FDIC is an independent regulatory body and the primary regulator of state-chartered banks that are not members of the Federal Reserve System (FRS). It has secondary supervisory authority over national banks, state-chartered banks that are members of FRS, and thrifts. FDIC received secondary regulatory authority over thrift institutions as a result of FIRREA, which placed FDIC in charge of the newly created SAIF. FDIC is also responsible for administering the Bank Insurance Fund. The Fund insures federally insured commercial banks, state chartered savings banks, and certain federal savings banks. As of December 31, 1991, FDIC supervised approximately 7,157 state-chartered nonmember commercial banks and 449 state-chartered savings banks. These banks had total assets of $1.1 trillion. FDIC shares its regulatory responsibility with the respective state banking regulators.

FRB is also an independent regulatory body. FRB and its 12 Reserve Banks share responsibility with state banking regulators for supervising and examining the 982 state-chartered banks that were members of the Federal Reserve System as of December 31, 1991. These banks held a total of approximately $593 billion in assets as of December 31, 1991. In addition, FRB regulated 6,441 bank holding companies and their nonbank subsidiaries, whose assets totaled $3.3 trillion as of December 31, 1991. These holding companies controlled about 8,500 commercial banks and about 93 percent of the assets of all insured commercial banks in the United States.

OCC, an agency under the Department of the Treasury, supervises all national banks. As of December 31, 1991, OCC supervised 3,778 banks with total assets of approximately $2 trillion. OCC is responsible for regulating most large banks with assets over $10 billion.

OTS, also under the Department of the Treasury, serves as the primary regulator for thrifts and thrift holding companies. As of December 31, 1991, OTS supervised 2,187 thrifts with assets totaling $931 billion.

Regulatory Examinations

All regulators use on-site examinations as the primary means to assess bank and thrift safety and soundness. Full-scope examinations are the most comprehensive type of examination. Off-site monitoring of institutions is also conducted between examinations to assess financial performance and condition. FDIC, FRB, and OCC rate banks on capital adequacy, asset quality, management, earnings, and liquidity, referred to as the CAMEL rating. An overall composite CAMEL rating is also assigned based on these ratings and other factors. OTS uses the MACRO rating system, which is similar to the CAMEL rating system, to assess management, asset quality, capital, risk management, and operating results. Like the overall rating for banks, a composite MACRO rating is also assigned.

The purpose of the rating system is to identify institutions that exhibit financial, operating, and compliance weaknesses that may require supervisory attention. The CAMEL and MACRO ratings range from 1 to 5, with 1 indicating the least degree of supervisory concern and 5 indicating the highest degree of supervisory concern. A composite rating of 1 is assigned to institutions that are basically sound in every respect. Most findings at these institutions are minor and may be corrected in the normal course of business. Institutions assigned a composite rating of 5 exhibit an extremely high probability of failure. Without urgent and decisive corrective action, the volume and severity of weaknesses or unsafe and unsound conditions will likely result in the institution's failure.

When examiners analyze and rate bank and thrift capital, they focus on the volume of high risk and inferior assets, the institution's experience, management's abilities, earnings retention, and capital ratios compared to those of similar institutions. When analyzing asset quality, examiners concentrate primarily on the level, distribution, and severity of poor quality assets and the adequacy of the allowance for loan losses. Examiners also review the level of concentrations of loans in a specific industry, lending policies, and the adequacy of loan administration procedures. During the analysis and rating of management, examiners must consider all factors that relate to the safe and sound operation of the institution. Therefore, the examiners rate management on technical competence, compliance with regulations, ability to plan and respond to changing environments, and adequacy and compliance with internal policies.

Two of the five rating elements for banks and thrifts have different names but are substantively the same. Bank examiners' rating of earnings is similar to thrift examiners' assessment of operations. Evaluation of these areas focuses on earning trends, peer group comparisons, quality and composition of net income, and the ability to cover losses and provide capital. Bank examiners' rating of liquidity and thrift examiners' rating of risk management concentrate on the volatility of deposits, exposure to interest rate risk, and the availability of assets convertible to cash.

Bank Holding Company Inspections

FRB's inspection cycle for bank holding companies is based upon the size and complexity of the institution. Those with assets exceeding $10 billion are to receive a full-scope examination annually. Depending on the financial condition of the institution, one limited or targeted scope inspection may also be required each year. Smaller institutions are generally inspected every 1 to 3 years depending on the complexity of operations and financial condition.

Examiners rate five critical areas of the bank holding company—bank subsidiaries, other nonbank subsidiaries, parent company, earnings, and capital adequacy on a consolidated basis—which are referred to by the acronym BOPEC. Examiners use a five-point rating scale, similar to that used for banks and thrifts, and rate management separately using satisfactory, fair, or unsatisfactory.

Off-Site Surveillance

In addition to on-site monitoring efforts, each regulator maintains an off-site surveillance program to monitor the financial condition of banks, thrifts, and their related holding companies. Off-site monitoring assists in setting examination schedules and in determining the allocation of more examiner resources to the most critical institutions exhibiting weak or deteriorating financial conditions. Institutions that exhibit weak or declining conditions are to be examined more frequently than those without deficiencies. The off-site program relies on information received from institution management in required monthly, quarterly, and annual reports on the institutions' financial condition and performance.

Objectives, Scope, and Methodology

This report has two primary objectives: (1) to summarize the findings in our four companion reports on the quality of examinations and inspections conducted by bank and thrift regulators, and (2) to discuss the appropriateness of the current regulatory structure in the context of the history of deposit insurance and our findings related to examination and inspection practices.

Our overall objectives were to assess the effectiveness of (1) FDIC's, FRB's, OCC's, and OTS's examinations in evaluating the safety and soundness of commercial banks and thrifts, including providing an early warning of problems, and (2) FRB's bank holding company inspections in evaluating activities which may adversely impact the insured bank subsidiaries. Specifically, we determined whether examiners

- performed a comprehensive evaluation of banks' and thrifts' internal controls,
- conducted a thorough analysis of loan quality to determine the level and distribution of problem loans and the adequacy of loan loss reserves, and
- conducted a comprehensive evaluation of the risks posed by bank holding company operations and nonbank subsidiary activities upon the insured banks.

We also assessed whether documentation supporting examination and inspection conclusions and supervision of work was adequate to ensure examination and inspection quality, and whether FDIC and OTS coordinated their examinations of thrifts to maximize the effectiveness of supervision.

To accomplish our objectives, we made a random selection from the universe of banks and thrifts as of September 30, 1990. Selected were 11 FDIC regulated banks, 6 FRB banks, 21 OCC banks, and 20 thrifts. The random sample included 20 banks with assets greater than $10 billion, 18 banks with assets less than $10 billion, and 20 thrifts of various sizes. In addition, as part of our FRB review, we judgmentally selected 4 additional banks and 7 holding companies of lead bank subsidiaries with assets greater than $10 billion. We also reviewed 17 of 31 failed banks that we identified in a prior report that were not recognized as problem banks prior to failure.[3]

For the randomly selected banks and thrifts, the statistical nature of our sample allowed us to project our results to the applicable universe of examinations covered by our work. Because of our limited sample size, our estimates fall within a relatively wide range, or confidence interval. We did not expand our sample in order to narrow the range because, for each projected finding, even the low end of the range indicated that the deficiencies we identified affected a significant segment of bank and thrift examinations. Our projections are made at the 95 percent confidence level and are discussed in the separate reports issued on each regulator.

[3]Bank Insurance Fund: Additional Reserves and Reforms Needed to Strengthen the Fund (GAO/AFMD-90-100, September 11, 1990).

For each institution in our study, we reviewed in detail the working papers supporting the most recent safety and soundness examination or inspection conducted by the regulators to assess the quantity and quality of evidence that supported conclusions in examination and inspection reports. Examinations and inspections selected for detailed review were generally performed between 1989 and 1991.

To evaluate the adequacy of the examination and inspection work, we used the regulators' manuals, which provide guidance in the form of objectives and suggested procedures to be used in conducting examinations and inspections. We conducted interviews with the examiners-in-charge and other regulatory officials as necessary to clarify our understanding of certain examination and inspection procedures.

We summarized the major regulatory provisions of the FDIC Improvement Act, with emphasis on the supervisory and accounting reforms. We evaluated these reforms to determine what impact the provisions in the act would have on the examination problems found in our review. In addition, we summarized significant accounting issues discussed in our prior reports that impact regulatory effectiveness in identifying emerging problems in banks and thrifts.

In preparing this report, we also reviewed various reports and other documents analyzing the history of deposit insurance and the regulatory structure, including the number and timing of bank and thrift failures and the changing environment in which banks and thrifts operate.

Our work in assessing the quality of examinations and inspections was performed at the headquarters of each regulator in Washington, D.C., and at a number of their regional offices. We conducted our review between December 1990 and January 1992 in accordance with generally accepted government auditing standards. Each regulator was provided the opportunity to comment on our individual draft report on its examination program. Copies of their comments are included in our individual reports for each regulator and are summarized in chapter 2 of this report.

Examinations Were Too Limited to Fully Determine Bank and Thrift Safety and Soundness

The basic objective of bank and thrift regulatory examinations is to determine the safety and soundness of depository institutions and to identify and follow up on areas requiring corrective action. Based on our review of 58 randomly selected banks and thrifts, regulatory examinations performed by FDIC, FRB, OCC, and OTS were too limited to identify and determine the extent of deficiencies affecting safety and soundness. These limitations impede early warning of the seriousness of bank and thrift weaknesses and reduce the opportunity for timely corrective actions and minimizing losses to the insurance funds. In addition, our review of 7 judgmentally selected holding companies of some of the nation's largest banks disclosed that the holding company inspections performed by FRB were too limited to ensure that activities of the holding company and nonbank subsidiaries were not adversely affecting the safety and soundness of the insured bank subsidiaries.

The weaknesses we found in the bank and thrift examinations in our sample included lack of comprehensive internal control assessments, insufficient review of loan quality and loan loss reserves, overreliance on unverified data, and inconsistent or lack of quality controls over the examination process. These weaknesses were exhibited in varying degrees among the four depository institution regulators. A lack of minimum, mandatory examination standards in these areas was a common factor among the regulatory agencies that limited the reliability of the examination process to determine an institution's safety and soundness.

The bank holding company inspections we reviewed were too limited to fully evaluate the risks posed by intercompany transactions between insured bank subsidiaries and nonbank affiliates or, in some cases, the risk from asset quality problems at those affiliates. We found that examiners often performed only superficial procedures in these areas, which provided little basis to determine if activities harmful to the insured bank were occurring. Similar to the lack of requirements for bank and thrift examinations, FRB had no minimum mandatory standards for examiners to follow in performing bank holding company inspections.

Lack of Internal Control Reviews Impeded Early Detection of Problems

Our 1989 and 1991 reports on bank and thrift failures showed that weak internal controls were a common characteristic of failed banks and thrifts. Yet, we found that a thorough review of internal controls was performed in only 1 of the 58 randomly selected bank and thrift examinations we reviewed. We estimated, at a 95 percent confidence level, that at least 94 percent of the most recent bank and thrift examinations as of the date of our review did not include an adequate assessment of internal controls. Each of the regulator's examination manuals discussed the importance of assessing internal controls, but the manuals were viewed as reference guides only, and the determination of examination procedures to be performed was left to the discretion of the field examiners. Inadequate testing of controls in areas essential to safe and sound operation of banks and thrifts inhibits the early detection of problems that could lead to serious financial deterioration of the institution.

Internal Controls Are Essential to Safe and Sound Operations

A strong internal control system provides the framework for the accomplishment of management objectives, accurate financial reporting, and compliance with laws and regulations. Effective internal controls serve as checks and balances against undesired activities and, as such, provide reasonable assurance that banks and thrifts operate in a safe and sound manner. The lack of good internal controls puts insured depository institutions at risk of mismanagement, waste, fraud, and abuse.

Because of the importance of internal controls to safe and sound bank and thrift operations, annual comprehensive evaluations of controls are essential. The evaluation of a bank's or thrift's internal control system should include (1) an overall understanding of the major operating functions within the institution, such as lending and deposits, and an assessment of risks within those functions, (2) an assessment of the adequacy of the design of the control systems within each major operating function to determine if the systems are set up to effectively prevent undesirable activities, (3) specific identification of critical control procedures within the systems, such as loan approval requirements, (4) testing of critical control procedures to determine if they are operating as designed, and (5) evaluation of the results of the control tests to determine if the control systems are effectively operating to prevent undesirable activities. The review of an institution's policies and procedures, without the specific identification and testing of controls, does not provide an adequate basis for evaluation of the internal control system. Systematic tests of the control procedures are essential to obtain assurance that the policies and procedures are being carried out as intended.

Internal Controls Not Systematically Tested

We generally found that examiners did not systematically identify, test, and evaluate critical controls to determine if they were functioning and thus providing the appropriate checks and balances against undesired activities. Failure to comprehensively assess critical systems of internal controls could result in examiners not detecting significant control weaknesses in time to prevent or minimize the effects of mismanagement or imprudent banking practices.

All of the regulators, to some degree, stated that they relied on either external or internal auditors in the internal control area. However, we usually found no documentation of such reliance, nor was there any indication that the extent and quality of the work performed by the auditors had been evaluated as a basis for reliance. Without an understanding of the internal control work performed by the auditors (external or internal), examiners could not be sure that the critical control systems they wished to rely on in their examinations had been tested. Nor could they be sure that all serious safety and soundness deficiencies in these critical areas had been identified.

Each examination manual included an extensive discussion of the importance of internal control assessments. The manuals included internal control questionnaires as one of the primary tools to perform internal control assessments. OTS and FRB examiners used the questionnaires, to some degree, in most examinations we reviewed, while use by OCC and FDIC examiners was sporadic. The responses to the questionnaires used by FRB examiners were generally based on inquiry of bank personnel. In the case of OTS, thrift management actually filled out the questionnaires. Beyond the questionnaires, the manuals did not provide specific guidance with regard to testing of controls and factoring the control evaluations into the rest of the examination.

The examiners told us they viewed their manuals as a reference only, and, therefore, the internal control assessment guidance that was included was not considered mandatory. The extent of work to be performed was left to the discretion of the field examiners. In practice, we found some evidence that examiners reviewed some bank policies. However, we found little evidence that examiners tested the policies they reviewed to determine if effective control procedures existed to ensure compliance with those policies. For example, we noted sporadic testing of underwriting policies in the loan quality reviews, but the tests were not carried out in a systematic manner and, therefore, the results did not provide a reliable basis to evaluate the adequacy of controls in this area. In most cases, the results of these sporadic tests were not summarized, nor was there any indication in the examination working papers that conclusions on internal controls were drawn from the results of this work.

Several examiners told us that they performed some control testing, but did not always document their tests. However, without documentation of the control evaluations, particularly those of the highly complex systems of large banks, it is unlikely that examiners could effectively identify the controls and perform systematic tests of such controls to determine whether they were functioning as intended.

Impact of Control Weaknesses Was Not Determined by Examiners

Even when bank policies were criticized by examiners, there was no indication that examiners attempted to evaluate the impact of the policy weaknesses. For example, one FDIC examination report on a bank in our sample stated the bank's loan policy did not address guidelines for the review of the allowance for loan losses, parameters for placing a loan on the bank's "watch list" (listing of problem loans that require close monitoring by management), guidelines for not accruing interest income on delinquent loans, collection procedures against borrowers who do not make timely payments, and the lending authority of bank officers. In spite of these policy deficiencies, there was no indication that examiners determined whether unsafe and unsound practices existed and, if so, the financial impact of such practices.

In addition, in several cases where control weaknesses were apparent, examiners did not factor such weaknesses into the safety and soundness ratings of the institutions. There was no separate CAMEL (or MACRO) rating for internal controls. However, examiners were instructed to consider the condition of internal controls in their rating of management. Several OCC and FRB examiners told us, and our review confirmed, that their primary consideration in rating management was the profitability of the institution. Only when profitability declined did examiners downgrade the management rating and focus on control weaknesses in the examination reports.

For example, OCC examiners' 1988 and 1989 reports on one large bank in our sample expressed concerns about loan concentration in commercial real estate; liberal underwriting standards and practices; deficient policies, procedures, and systems; and inadequacies in the loan review process. Management was rated 2 until 1990, when these same control weaknesses were evidenced by such significant asset quality deterioration that OCC identified the bank as in imminent danger of failing.

Without a requirement for a comprehensive assessment of internal controls, the regulators have little assurance that examinations will detect all major control weaknesses in a timely manner. Early detection of internal control problems in critical areas provides examiners an opportunity to require bank management to correct the problems before significant permanent financial damage results. However, our review disclosed several instances where serious attempts by regulators to gain corrective action on control weaknesses did not occur until the financial damage had already been done. If the examination approach is not revised to include a significant focus on internal control evaluations, this situation is likely to continue and unnecessarily add to the losses of the insurance funds.

Implementation of FDIC Improvement Act Could Aid Examiners' Internal Control Assessments

As discussed in more detail in chapter 3, the FDIC Improvement Act requires that management of banks with assets greater than $150 million perform comprehensive assessments of the banks' systems of internal control over financial reporting and report to federal regulators as to the effectiveness of such control systems. The banks' external auditors are required to attest to managements' assertions in a separate report to regulators. These assessments can help examiners determine the adequacy of internal controls. However, in order to rely on such work, examiners will need to review not only the reports prepared by management and the external auditors, but also the supporting working papers to ensure that the scope and quality of the work performed by management and the external auditors is sufficient to assess the effectiveness of the internal control system.

Review of Loan Quality and Loss Reserves Not Sufficient to Determine Reliability of Reported Financial Condition

Evaluating loan quality and the related loan loss reserves is fundamental to assessing the financial condition of a bank or thrift. We found that 47 of the 58 randomly selected examinations we reviewed were deficient in this critical area. We estimated that at least 70 percent of the most recent bank and thrift examinations as of the date of our review were not sufficient in the review of loan quality and loss reserves.[1] Deficiencies varied among the four regulators, including use of nonrepresentative samples in loan reviews, reliance on outdated and/or incomplete loan file information, use of unsound methodologies for evaluating loan loss reserve adequacy, lack of documented evidence to support conclusions on problem loan classifications, and inconsistent documentation of supervisory review of examination working papers. Regulatory agencies lacked minimum, mandatory examination standards in these areas. The procedures to be

[1]The range of our estimate, at a 95 percent confidence level, is that these conditions existed for the most recent examinations (at the time of our review) of between 70 percent and 92 percent of banks and thrifts which existed as of September 30, 1990.

performed and the level of documentation and supervisory review of those procedures was generally left to the field examiners' discretion.

Representative Loan Samples Were Not Reviewed by OCC and OTS

For 31 of the 38 OCC and OTS institutions we sampled which had been recently examined,[2] examiners did not review loan samples which were representative of the portfolios and therefore had no valid basis to conclude on the condition of the loan portfolios. At the time of our review, OCC and OTS had no minimum loan coverage requirements. As with other areas of the examination, the scope of the loan quality review was left to the field examiners' discretion.

To be representative, a sample must be chosen in such a way that all items in the population have an opportunity to be selected. Generally, the most efficient way to achieve a representative sample is to use statistical sampling techniques, which allow conclusions to be made about the entire population from which the sample was drawn, while minimizing the number of items which must be tested. Assurance about the quality of loans could be achieved by selecting loans for review in a nonstatistical manner. However, this would require reviewing a significant number of loans in the portfolio to ensure that the portion not reviewed, if misstated, would not materially affect the institution since a sample selected in a nonstatistical manner would not allow conclusions to be drawn about the entire population but only the portion reviewed. Regardless of the type of sampling used, a significant amount of errors (disagreements with bank management's assessment of the loan quality) noted by examiners in their testing would require that the sample be expanded, and may require an expansive review of the loan portfolio to determine its true condition.

OTS and OCC used judgmental sampling techniques in almost all of the examinations we reviewed. Statistical sampling techniques were used in three OTS examinations and one OCC examination of a large bank. None of the OTS and only three of the OCC judgmental samples were representative and therefore provided a meaningful basis to judge the quality of the loan portfolios.

OCC's approach to loan quality review focused on the banks' loan risk rating systems, with particular emphasis on commercial loans since these generally pose the highest risk of loss for a commercial bank. Examiners rated selected loans using one or more of the following categories: "pass"

[2]In addition, three small OCC banks in our sample had not been recently examined and, therefore, OCC lacked timely data to assess their loan quality.

(no known credit problem), special mention (protected from loss but potentially weak), substandard (inadequately protected and weak), doubtful (inadequately protected and weak with high possibility of loss), or loss (considered uncollectible). They compared their ratings to the banks' ratings to determine the accuracy of the banks' risk rating systems.

OCC used a targeted examination approach, which tended to center on particular loan types identified as high risk, but often left other high risk loan types entirely unreviewed. The judgmental sampling techniques used by OCC generally left more than 50 percent of the commercial loan portfolio unreviewed. For 7 of the 14 large OCC bank examinations we reviewed, 68 percent to 78 percent of the commercial portfolio was not reviewed by examiners.

We also found that loan samples were not expanded at banks where OCC examiners found numerous differences between their ratings and bank managements' ratings of the loans they reviewed. For example, OCC examiners reviewed a judgmental sample of 49 percent of the commercial loan portfolio of one large bank, concentrating on large loans and those identified by bank management as problems. In the past, this bank had been criticized by OCC for liberal underwriting practices and an unreliable risk rating system. Examiners also found significant risk rating exceptions in the current examination—18 percent for commercial real estate loans and 14 percent for highly leveraged transactions. Despite this, the loan sample was not expanded to the remaining 51 percent of the commercial loan portfolio to determine its condition. An examiner for this bank told us that more loans could not be reviewed because of time and resource constraints.

Only 4 of the 7 small OCC banks in our sample had on-site examinations during 1990. Loan coverage in these 4 examinations ranged from 8 percent to 32 percent and was based on judgmental, targeted samples. One small OCC bank had not been examined since 1984; thus, we did not evaluate the adequacy of the samples for that examination as it did not provide a current basis for examiners to evaluate loan quality. The two other small OCC banks in our sample had only one on-site safety and soundness examination between 1987 and 1990—in 1987 at one bank, and in 1989 at the other bank. These examinations were limited in scope and were performed by less experienced examiners. Overall, insufficient work was performed at all seven of the small OCC banks to provide a current basis to assess the quality of the loan portfolios.

OTS examiners generally sampled less than 20 percent of the loan portfolio. Their samples were judgmentally selected in 17 of the 20 examinations we reviewed, and consisted of certain of the loans identified as problems by thrift management and other loans considered by OTS to be "high risk."[3] OTS's Regulatory Handbook recommended that examiners sample at least 40 percent to 60 percent of high-risk loans, yet 15 of the 20 examinations we reviewed did not achieve this minimum coverage rate. Examiners told us that the 40 percent criteria was only a recommendation and that they felt they had sufficient coverage to assess the riskiness of the thrifts' loans.

Failure to review representative loan samples and to expand loan reviews when problems were identified precluded OCC and OTS examiners from having reasonable assurance that the extent and severity of problem loans identified by bank management reflected the true condition of the loan portfolios.

FRB Loan Review Coverage Was Generally Sufficient

We generally found that the loan coverage obtained in FRB examinations we reviewed was sufficient for examiners to be reasonably confident that bank management had identified and appropriately classified significant problem loans. However, one of the six large bank examinations we selected was limited in scope and did not include a detailed review of the loan portfolio.[4] FRB examiners used statistical sampling techniques for selection of their detailed loan review samples in three of the five large bank full scope examinations. The other two examinations included judgmental loan samples, but a sufficient amount of loans were reviewed such that these judgmental samples were reasonably representative of the banks' portfolios.

FDIC Relied on Outdated, Unverified Loan File Information

FDIC examiners used judgmental sampling techniques in all 11 examinations we reviewed. Loan review coverage for these examinations ranged from 18 to 61 percent. We did not assess the sufficiency of coverage for each individual FDIC examination we reviewed because we found significant problems in the quality of FDIC examiners' loan reviews, which resulted in the amount of coverage obtained being irrelevant.

[3]OTS considers all loans other than mortgages on one-to-four family, owner-occupied residences, and loans for small dollar amounts, such as consumer loans, to be high risk.

[4]FRB officials told us that this bank was in strong financial condition and had a record of sound policies and procedures. Therefore, a decision was made during that examination cycle to perform a limited scope examination on this bank so that additional examiner resources could be devoted to certain large problem banks in that district.

For 8 of the 11 FDIC examinations we reviewed, between 33 percent and 55 percent of the dollar value of examined loans lacked sufficient information to assess the quality of the loans. The FDIC Manual indicated that to properly analyze any loan, an examiner should acquire information about the borrower's financial condition, purpose and terms of the loan, prospects for its orderly repayment, and the value of the underlying collateral. Such information was often either missing entirely or was outdated, incomplete, or insufficient for meaningful analysis in the FDIC examinations we reviewed.

For example, one examination linesheet[5] we reviewed included prices for livestock and grain, which served as the source for repayment for a $186,400 farm loan. The prices on the linesheet were over 3 years old. There was no evidence that examiners verified that the collateral existed and was in good condition or attempted to obtain current livestock or crop prices. This loan was "passed" without criticism and without any explanation by the examiners.

Another examination included a linesheet for a commercial loan totaling $400,000. The linesheet did not indicate whether the borrower had been making payments on the loan and did not include an analysis of the borrower's ability to repay the debt. The linesheet also did not include an analysis of the loan collateral to determine if it would be sufficient to cover the loan balance in the event of foreclosure. This loan was classified "special mention"[6] by the examiners with no further explanation.

Although FDIC's Manual instructed examiners to consider pertinent information to evaluate loans, it also encouraged examiners to streamline the loan review examination process, particularly for loans they passed without criticism. For these loans, the Manual stated that examiners should provide a summary comment indicating they reviewed sufficient material to pass the loan. One FDIC official told us that some examiners had broadly interpreted this guidance to mean that they needed only mark the working paper "P" when they determined that a loan should be passed without criticism.

[5]A linesheet is a working paper used by examiners to record information and their conclusions about the quality of specific loans.

[6]According to the FDIC Manual, special mention loans do not presently expose the bank to a sufficient degree of risk to warrant adverse classification but do possess credit deficiencies deserving management's close attention.

We believe that adequately documented evaluations of loan quality based on current and complete information are critically important if examinations are to function as an effective early warning tool for bank supervision. Such documentation is especially important because of the high degree of judgment required in loan quality evaluations.

Seventeen of the 31 banks we identified in a prior report[7] as never having been recognized as problem banks prior to failure were regulated by FDIC. FDIC's loan quality reviews for these banks provided little warning of their impending failures. For the 11 failed banks for which we were able to obtain FDIC examination working papers, we identified the same types of loan quality review deficiencies as described above for the open banks. Financial information about borrowers and loan collateral was often outdated or missing and the rationale for examiners' conclusions on loan quality was not documented. For 5 of the 11 failed banks, there was no evidence in the working papers to support FDIC examiners' loan quality judgments.

Examiners Lacked a Consistent, Reasonable Approach for Assessing Reserve Adequacy

An adequate reserve for estimated loan losses is critical to the safe and sound operation of a bank or thrift and essential for early identification of deteriorating financial conditions. The reserve must be sufficient to cover both specifically identified loss exposures as well as other inherent[8] exposures in the portfolio. Therefore, an adequate reserve hinges on (1) timely identification and analysis of loss exposures on nonperforming loans, and (2) analysis of exposure to losses on performing loans considering past trends and current conditions.

Each of the regulators' examination manuals provided general guidance on risk factors that examiners should consider in evaluating reserve adequacy. However, none of the manuals or other regulatory guidance included a methodology or specific procedures to quantify the potential loss from these risk factors.

The majority of OCC, OTS, and FDIC examinations we reviewed did not provide a sufficient basis for examiners to assess the extent and severity of problem loans. As a result, examiners did not have a basis to assess the adequacy of loss reserves on problem loans at these institutions. In addition, we found that examiners from all four regulatory agencies lacked

[7]Failed Banks: Accounting and Auditing Reforms Urgently Needed (GAO/AFMD-91-43, April 22, 1991).

[8]Inherent losses exist when events or conditions have occurred which will ultimately result in loan losses, but which are not yet apparent in individual loans.

an adequate approach to assess overall reserve sufficiency, particularly in instances where there were indications that the reserve may not be sufficient, such as significant increases in delinquent loans and/or economic downturns affecting major lending areas of the bank.

For example, FRB examiners used a "rule of thumb" approach to assess the adequacy of loan loss reserves, which relied on estimated loss percentages derived from industry historical averages, with no adjustment for differences in loan policies, loan administration practices, portfolio composition, and economic conditions affecting the individual banks being examined. For one bank we reviewed, examiners applied the rule of thumb percentages to the loan portfolio (classified and nonclassified loans) and concluded that the reserve was adequate. However, other information in the examination report and examination working papers raised serious concern about the appropriateness of this conclusion. The report stated that noncurrent loans were inordinately high and total delinquencies and nonaccruals[9] excessive. One third of the total loan portfolio was real estate loans and the majority of these were construction and development loans and commercial real estate loans. Further, the report stated that 60 percent of these loans were in a geographic region suffering from overbuilding. Examiners had downgraded several of the bank's internal classifications on real estate loans and identified several real estate loans which they recommended be placed on nonaccrual status. Examiners also stated in the examination report that the bank's reserve was significantly below the average for banks of similar size. In spite of the concerns raised about loan concentrations in real estate, deteriorating trends in asset quality, and inadequacy in the bank's internal classification system, the examiners did not adjust their analysis of the reserve to reflect these additional risks of loss or require bank management to increase the reserve level.

FDIC examiners reviewed the activity (i.e., total charge-offs, provisions, and recoveries) in the loan loss allowance account of most open banks we reviewed, as well as industry averages, and concluded in almost all cases that the reserves were adequate or acceptable. However, examiners did not appear to consider the specific results of their loan quality reviews, asset quality trends, or current economic conditions in their analyses of reserve adequacy for the banks we reviewed.

[9]Nonaccruals are loans in which interest accruals have been suspended because full collection of principal is in doubt, or interest payments have not been made for a sustained period of time.

For example, one examination report stated that the amount of the bank's classified loans had increased by 37 percent over the previous examination. The bank's allowance amount, however, remained unchanged from the previous period and was below the average amount for similar banks. The examiners did not explain in the report or the working papers their acceptance of the bank's determination not to increase its loan loss allowance when deterioration in the loan portfolio was evident.

We also found that FDIC examiners assessed bank managements' loan loss reserve methodologies in less than half the examinations we reviewed. Without such an assessment, FDIC has no assurance that an adequate reserve will be maintained by a bank between examinations or that quarterly regulatory reports reasonably reflect the bank's true financial condition, particularly in times of economic downturns.

We found that OCC examiners consistently assessed bank managements' loan loss reserve methodologies. However, in cases where the methodologies were deemed inadequate, examiners did not have an adequate approach to estimate the required reserve. For example, at one bank we reviewed, OCC examiners concluded that the bank's methodology was not adequate because it did not include loss potential on the nonproblem portion of the loan portfolio. However, examiners did not estimate the amount of potential additional reserves which would be required, but rather only reported their concerns in the examination report and concluded that the reserve was "marginally adequate."

Regulators' assessments of loan loss reserves and methodologies are especially critical given the latitude in the recognition of losses on problem loans afforded by existing accounting rules, as discussed in our recent report.[10] In addition, little authoritative accounting guidance exists for recognition and measurement of inherent losses in the loan portfolio. These deficiencies in accounting rules result in little or no assurance that reserves established by bank or thrift management under current accounting rules are adequate. However, without a reasonable methodology of their own, examiners often lacked the ability to successfully challenge the reserves and reserving methods established by bank or thrift management. For example, at one large FRB bank, examination reports for 3 consecutive years stated that the reserve was significantly understated for the risks in the loan portfolio. Yet, examiners

[10] Depository Institutions: Flexible Accounting Rules Lead to Inflated Financial Reports (GAO/AFMD-92-52, June 1, 1992).

did not recommend that management develop and implement a methodology to ensure that the bank maintained a reasonable reserve for loan losses or require an increase in the current reserve.

Insufficient Documentation and Supervisory Review of Loan Review Work

We found serious quality control deficiencies in almost all the FDIC and several of the OTS examinations we reviewed. These deficiencies, including inadequate evidence of work performed and lack of supervisory review, were of particular concern because they occurred in the loan review area, which requires a significant amount of examiner judgment and generally represents the greatest risk of loss to the institution.

Examination manuals for both FDIC and OTS encouraged examiners to avoid excessive documentation, but provided little definitive guidance on the minimum level of documentation required to ensure that adequate evidence was obtained to support examiner conclusions. In addition, neither OTS's nor FDIC's policies required supervisors to document their review of examination working papers. In practice, we found little evidence that the work of assistant FDIC examiners had been reviewed. These assistants were not commissioned examiners and therefore close supervision and review of their work was essential, especially in the critical area of loan quality review. Without proper documentation, supervision, and review of examination work in high-risk areas, there is a high likelihood that errors in examiner judgment could go unchallenged and that incorrect conclusions could result.

In a September 1991 memorandum to its examination staff, OTS provided new examination guidance in response to concerns raised by us in this review and the Department of the Treasury's Inspector General during an audit of OTS's examination process.[11] OTS established new requirements which addressed some of the loan review weaknesses identified during our review of the 20 thrift examinations, particularly the need for better working paper documentation. However, OTS did not address how it will ensure that the new guidance is being effectively implemented, and OTS continued to provide examiners considerable discretion in the area of loan review.

FDIC acknowledged that it did not have a written policy for onsite review of examination working papers. FDIC officials told us that the signature of the examiner-in-charge on the report of examination served as evidence of review by experienced examiners.

[11] Office of Thrift Supervision's Examination Process (OIG-91-064, August 1991).

FRB and OCC loan review working papers were generally sufficient to provide documentation of work performed and conclusions reached. However, we found instances where improved documentation would allow for more efficient supervisory review. We also found that examination working papers lacked consistent evidence of supervisory review. The examination manuals for both OCC and FRB included specific guidance on working paper documentation and supervisory review. However, as these manuals were viewed as reference guides only, this guidance did not constitute mandatory standards.

OCC and FRB examiners told us they reviewed working papers but did not always initial them. However, we believe documentation of review is important to ensure that critical areas are not overlooked in the review process. In addition, the reviewer's initials or signature are written verification that the work has been checked for adequacy of evidence to support examination conclusions and that the reviewer concurs with such conclusions.

Regulators Lacked a Formal Program to Assess Quality of State Examinations

FDIC and FRB sometimes relied on state regulators but had not developed a formal program to review the quality of state examinations as a basis for relying on that work in conducting their examinations. Lack of a formal review process for state examinations could result in inappropriate reliance on those examinations and delay recognition of serious safety and soundness concerns. Without an assessment of state examiner qualifications, as well as periodic review of their actual working papers, federal regulators have no sound basis to rely on state examinations. FDIC extended its examination intervals for a number of the banks we reviewed due to state coverage.

At the time of our review, FDIC guidance allowed examination intervals of up to 48 months if interim state examinations were performed and off-site monitoring confirmed the state ratings. FDIC extended examination intervals for 6 of the 11 randomly selected open banks we reviewed because of interim state examinations. For two of these banks, FDIC exceeded its maximum examination interval requirement of 48 months when state examinations had been performed. In one case, 85 months elapsed between FDIC examinations. In our review of 17 banks that failed without warning, we found that 6 of the banks had not had an FDIC examination during the 48-month period prior to failure, but had received one or more interim state examinations during that time.

Neither the examination reports nor the working papers for the open and failed banks we reviewed included evidence that FDIC officials or examiners had assessed the work and findings of state examiners to determine if enough work had been done to effectively identify bank problems.

According to FDIC officials, although the quality of state examination reports varied from state to state, examiners did not review the work that supports findings and conclusions in the reports, and there was no FDIC requirement to do so. FDIC officials told us that reliance on state examination reports was typically based on the FDIC region's historical knowledge of the quality of each state's examination reports and the expertise of its personnel, which made it unnecessary and undesirable to verify state examination results on an individual basis. They told us that when examination report quality of a state was known by FDIC to be a problem, the state's reports were not used to extend intervals between FDIC examinations.

The following examples from the failed banks we reviewed illustrate instances where FDIC may have inappropriately relied on state examinations and delayed its own examinations.

- A state examination reported deterioration of the bank and improper intercompany transactions that were jeopardizing bank safety and soundness. Nevertheless, the state rated the bank "2" for both asset quality and management. Neither FDIC nor the state examined the bank until 31 months later, when FDIC rated the bank "5" in asset quality and "4" in management. The bank was closed 4 months later.
- In another case, FDIC changed the state's examination rating from "2" to "3" based on evidence contained in the state's examination report. The bank had not been examined by FDIC during the previous 37 months, and FDIC was aware that the state had a history of being too lenient with this bank with regard to asset classifications. Nevertheless, FDIC did not examine the bank for 16 months after changing the state's rating. The bank failed 2 months later.
- For another bank, FDIC did not perform an examination for a 40-month period between June 1984 and September 1987. During this time, the bank was examined by the state. During the 1987 examination, FDIC found that classified assets had increased from $158,000 (at the 1986 state examination) to $8 million. FDIC subsequently stated in a file memorandum that "it appears that financial information was downloaded, with the

[state] examination being nothing more than a cursory review to justify the [financial] ratios."

FRB also has relied on state examinations under its Alternate Year Examination Program. This program, in effect since 1981, allowed FRB to rely on alternate year state examinations of certain mutually agreed upon state member banks that were relatively free of supervisory concerns. Although we did not encounter any instances of inappropriate reliance on state examinations for the FRB banks in our sample, we noted that FRB did not have a formal program in place to review state bank examiners' work. FRB officials told us that FRB informally identified states which they felt were qualified and capable of performing adequate examinations based on experience gained from previous joint examinations. The FRB officials also indicated that states with inadequate resources and expertise were not relied on to perform alternate year examinations.

At the time of our review, it was OTS's policy to conduct annual examinations of all thrifts, and it did not rely on state examinations. In addition, as OCC examines only nationally chartered banks, it did not rely on state examinations.

The FDIC Improvement Act of 1991 allows federal banking regulators to substitute state examinations for federal examinations on a limited basis if the federal regulator deems such action appropriate. The act provides that federal examinations need only be conducted in alternate 12-month[12] periods if an examination has been performed by state banking authorities during the intervening 12-month period and the federal regulator determines that the state examination carries out the intended purpose of the act's requirements in this area.

OTS and FDIC Performed Duplicative Examinations With Conflicting Results

Both OTS and FDIC examined thrifts with the same objective of assessing the safety and soundness of the thrift industry. FIRREA empowered the Director of OTS, as the primary regulator of the thrift industry, to conduct examinations, prescribe regulations, and issue orders, as necessary to ensure the safe and sound operation of thrift institutions. The act also stipulated that FDIC, as the administrator of the newly created Savings Association Insurance Fund, could examine any institution applying for or covered by FDIC insurance.

[12]The applicable period is 18 months for certain well-capitalized and well-managed institutions with total assets of less than $100 million.

As shown in table 2.1, each regulator performed independent examinations and prepared separate reports of the 20 thrifts in our sample during a 12-month period. In 13 of 20 cases, thrifts were examined by OTS and FDIC within 6 months of each other. However, they worked together at only 5 of those thrifts.

Table 2.1: Months Between FDIC and OTS Examinations

	0-3 months	4-6 months	7-9 months	10-12 months
Number of thrifts	11	2	5	2

Improved coordination between the two regulators could have resulted in more efficient and effective use of their examination resources. We estimated that OTS and FDIC expended about $53 million and $16 million, respectively, for salaries and benefits related to "safety and soundness" examinations of thrifts in 1991.

While duplicating each other's examinations, OTS and FDIC sometimes arrived at conflicting conclusions. Composite ratings differed at 9 of the 20 thrifts we reviewed. This inconsistency between regulators confuses thrift management and undermines the credibility of the regulatory process.

Since both regulators use virtually the same rating system, composite ratings should be consistent. Each regulator's definition for the condition identified by the 1 to 5 rating was virtually the same as to the degree of safety and soundness it represented. However, FDIC and OTS disagreed on the composite rating on 5 of the 11 thrifts that they examined within 3 months of each other. (See table 2.2.)

Table 2.2: Differing Composite Ratings at Five Thrifts

Institution	OTS rating	FDIC rating
A	3	4
B	3	2
C	4	5
D	2	3
E	3	2

FDIC and OTS signed a joint memorandum on May 18, 1992, that required the two regulators to more effectively coordinate the examinations of thrifts. The provisions of this memorandum provided for improved coordination but allow FDIC and OTS to continue separate examinations. It is still too early to determine the effectiveness of the new procedures on reducing duplication of thrift examination efforts.

Limited FRB Holding Company Inspections Leave Insured Banks Exposed to Harmful Affiliate Activities

For six out of the seven bank holding company inspections we reviewed, the examiners did not adequately evaluate intercompany transactions that could threaten the safety and soundness of the insured bank subsidiaries. In addition, at two of the three bank holding companies where large credit-extending nonbank subsidiaries existed, the examiners did not conduct an independent analysis of asset quality. The FRB Bank Holding Company Supervision Manual did not establish minimum mandatory procedures to ensure these areas are thoroughly evaluated. As a result of these deficiencies, adverse intercompany transactions and asset quality problems at the nonbank subsidiaries, which could have damaging financial consequences to the insured bank subsidiaries, may not be detected.

Examiners Did Not Assess Risks From Intercompany Transactions

The primary direct risk that holding company activities pose to bank subsidiaries is intercompany transactions with negative economic impact. However, the examiners did not adequately assess the risks of intercompany transactions in six of the seven bank holding company inspections we reviewed. Specifically, the examiners' analyses of loans from banks to nonbank affiliates, fees charged by the holding company to the insured bank subsidiary, and assets transferred from nonbank subsidiaries to insured bank affiliates were not adequate to detect potential abuse of the insured bank.

One examiner told us that he did not focus on intercompany transactions during the inspection of a $27 billion holding company because he relied on the examiners of the lead bank to discover and inform him of any adverse intercompany transactions during their examination. However, during 1990, the regulator of this holding company's lead bank did not review insider and affiliate transactions. Two other examiners told us that transactions which may harm the insured bank would be large and therefore easily detected. However, this may not be the case with transactions such as below market rate loans and excessive service fees. Such transactions can drain banks of capital and cash over an extended period. The long-term negative impact upon the insured bank may be just as severe under these circumstances as that of a single large adverse transaction.

The FRB Manual included an extensive discussion of the risks posed by intercompany transactions, as well as specific procedures to evaluate these risks. However, FRB officials told us that the Manual was intended only to provide guidance for the examiners. FRB policy did not establish minimum or mandatory procedures designed to accomplish the inspection objectives and evaluate the risk to insured bank subsidiaries. The determination of the actual procedures to be performed was left to the discretion of the field examiners.

Examiners Relied on Management's Assessment of Nonbank Asset Quality

At two of the three bank holding companies where large, credit-extending nonbank subsidiaries existed, the examiners did not conduct an independent analysis of nonbank asset quality. Despite increasing trends in problem assets at these nonbank subsidiaries, the examiners' analysis of nonbank asset quality was limited to reviewing management's quarterly internal reports.

For example, at one of the two institutions, nonbank assets totaled 20 percent of total consolidated assets. The examiner-in-charge told us they had been relying solely upon management data to evaluate nonbank asset quality for several years, despite known problems at several nonbank subsidiaries. These problems included increasing mortgage delinquencies, significant interest rate risk, continued net losses, high levels of classified loans and an inadequate reserve for loan and lease losses. One of the nonbank subsidiaries at this institution, whose assets totaled 13 percent of total consolidated assets, had never been examined by FRB. However, when OCC reviewed this nonbank subsidiary because it was being transferred to the lead bank, OCC noted significant increases in problem loans and credit losses directly attributable to underwriting deficiencies.

The FRB Manual provided no definitive guidance for reviewing asset quality of nonbank subsidiaries. It stated that the examiner should concentrate on appraising the quality of assets held by the nonbank subsidiaries since asset problems at these entities could lead to financial problems at the banks. However, the Manual did not establish criteria for when asset quality reviews are necessary. The Manual had no guidelines to assist the examiner during the planning phases of the inspection to establish materiality limits or assess the potential impact of poor asset quality on the nonbank subsidiaries. This lack of adequate guidance, combined with FRB's view that examiners are not required to follow the Manual, led to inconsistent and inadequate practices in reviewing nonbank asset quality.

Accounting Guidance for Related Party Transactions Is Ambiguous

We have previously reported that the authoritative accounting guidance for the treatment of related party transactions is not clear when their economic substance is different from their legal form.[13] The ambiguities in these accounting rules may allow bank holding companies to record income and require bank subsidiaries to record expenses for transactions which have the appropriate legal form, such as written service contracts and sales agreements, but in reality have provided little or no benefit to the bank. Further, the ambiguity in the accounting rules raises the probability that intercompany transactions that place a drain on the insured bank's capital, but which have no real economic substance, may go unchallenged by auditors and regulators.

Supervisory Review and Quality of Working Papers Was Inconsistent

Although the examiners' working papers generally provided adequate evidence of the work performed, we found instances where the documentation was incomplete. Working papers often lacked an indication of information sources, the purpose of procedures performed, and the conclusions reached on specific procedures or analyses. In addition, documented supervisory review of the working papers was sporadic. The FRB Manual did not provide any guidance on working paper preparation or how supervisors should review working papers. Four of the seven examiners-in-charge acknowledged that working paper documentation could be improved. These lead examiners also told us that they reviewed the working papers, although they did not always document their review. Adequate working paper documentation allows an objective reviewer to understand the work performed and the conclusions drawn from that work. In addition, consistently documented supervisory review is an important quality control measure to ensure that risks to the insured bank subsidiary are properly identified and that the reviewer agrees with the conclusions presented in the inspection report.

Conclusions

The examination process for banks and thrifts has fundamental flaws which impede the achievement of the basic examination objective—to determine the safety and soundness of depository institutions and to identify and follow up on areas requiring corrective action. Likewise, the limited bank holding company inspection process impedes the achievement of the basic inspection objective—to ensure that the activities of the holding company and nonbank subsidiaries are not adversely affecting the safety and soundness of the insured bank

[13] Federal Asset Disposition Association: No Economic Basis for Reported Fee Income Under 1988 Letter Agreement (GAO/AFMD-91-15, July 29, 1991).

subsidiaries. The examination and inspection processes are the cornerstone of bank and thrift supervision, and, therefore, the deficiencies which our review disclosed must be corrected in order to maintain a solid supervisory structure.

Although certain of the problems we found can be corrected through better coordination and communication among regulatory agencies, most require a change in the basic examination or inspection approach and, in some cases, expansion of the review scope and procedures. We believe these changes are essential to ensure the best possible use of the examination and inspection functions as preventive tools to guard against unsafe and unsound insured depository institution activities.

Recommendations

The following is a summary of recommendations presented in our four individual reports to federal banking and thrift regulatory agencies.

Federal bank and thrift regulatory agencies should establish examination policies, as applicable, to

- perform annual comprehensive internal control reviews as part of the examination of all banks and thrifts, using, where appropriate, the internal control assessments of the institution's management and its independent auditors;
- require that the condition of a bank's or thrift's system of internal controls be added to the CAMEL/MACRO rating as a separate critical component of the rating;
- use appropriate sampling methodologies which are representative of the loan portfolio as a basis to determine loan quality;
- obtain and document current and complete information for loan quality reviews;
- develop and implement a sound methodology for evaluating the adequacy of loan loss reserves and reserving methods;
- require complete documentation and thorough supervisory review of all examination and inspection procedures;
- formally assess the work of state examiners when such work is used to extend examination intervals;
- monitor the implementation of the joint May 1992 OTS/FDIC memorandum to ensure (1) effective coordination of thrift examinations by these regulators and (2) that common standards are used as a basis for reaching examination conclusions; and

- require minimum mandatory procedures to assess the actual and potential risks of bank holding company activities to insured bank subsidiaries.

Summary of Agency Comments and Our Evaluation

Each of the four federal depository institution regulators commented on the individual reports on their respective agencies' examination process. The responses to our recommendations varied among the regulators, ranging from almost complete agreement to complete disagreement. Many of the findings and recommendations presented in the individual reports were similar. The differences in the responses to our conclusions and recommendations further highlight the lack of a uniform regulatory philosophy among the agencies. The following is a summary of the comments from each agency.

Office of Thrift Supervision

OTS agreed with our recommendations with one exception. They did not agree that comprehensive internal control reviews should be a requirement for examinations of thrifts with assets of less than $150 million. They stated that budgetary constraints coupled with OTS's annual examination requirement preclude it from implementing this recommendation. Since internal control weaknesses are one of the common characteristics of failed thrifts, we believe that assessing internal controls of all thrifts, including those with assets of less than $150 million, is important to a regulatory process with the goal of minimizing thrift failures and losses to the insurance fund.

In commenting on many of the recommendations, OTS cited initiatives that it had undertaken or that were planned. If effectively implemented, these initiatives should strengthen OTS's ability to identify and address loan quality problems and internal control weaknesses in time to prevent irreversible deterioration of a thrift's financial condition. In addition, OTS plans to coordinate more effectively with FDIC to eliminate unnecessary duplication of examination efforts. This should result in a more efficient and consistent approach to the examination process by the two regulators.

Office of the Comptroller of the Currency

OCC generally agreed with our recommendations, except for the need for a separate rating factor for internal controls. They concurred with us on the importance of assessing banks' internal control systems and planned several enhancements to the examination process, including specific steps to ensure a thorough evaluation of internal controls at every multinational bank in 1993. OCC stated that it does not believe a separate CAMEL rating factor is necessary for internal controls in light of its planned changes which will give sufficient emphasis to this area of the examination. We are encouraged by OCC's response, but believe a separate rating factor is needed to help ensure that a comprehensive evaluation of internal control adequacy is performed by examiners and duly considered in assessing the safety and soundness of national banks. In addition, we believe that such an assessment should be performed annually for all banks as an effective measure against bank failure and losses to the insurance fund.

OCC agreed with us that representative sampling methods should be used to assess loan quality and has tested a statistical sampling model in order to determine how statistical sampling can best complement OCC's traditional judgmental sampling approach. We encourage OCC to move forward with this program as quickly as possible to ensure that adequate loan review coverage is obtained on all upcoming examinations.

OCC is concerned about the feasibility of developing a more specific methodology for assessing the adequacy of bank loan loss reserves, but stated it is committed to improving its methods in this area. While we acknowledge the difficulty of developing an effective approach to this highly judgmental area, we would emphasize that a standard framework is needed to help ensure that such judgments are made by examiners in a consistent and reasonable manner.

Federal Reserve Board

FRB's comments did not specifically address all of our recommendations, but it stated it intends to judiciously consider such recommendations for enhancing its examination and inspection programs. Although FRB recognized the importance of continually reviewing and strengthening its bank examination program, it did not concur with our overall conclusion that FRB examinations did not fully assess bank safety and soundness. FRB believes its examination philosophy of annual full-scope examinations with thorough asset quality reviews is sufficient to assess bank risk and has proven effective. We agree that annual full-scope examinations, including thorough asset quality reviews, are critical to the overall success of the examination process. However, FRB's examination approach needs to be enhanced in several areas, particularly the evaluation of internal controls and loan loss reserves, in order to fully assess banks' risks.

FRB concurred with us on the importance of banks having effective internal control systems and the need for the examination process to verify the existence of such systems. However, FRB did not agree that examiners should be required to perform annual comprehensive assessments of internal controls as they feel the level of such work should be left to the examiners' discretion. We believe internal control reviews are essential to achieving preventive regulation, and therefore minimum mandatory procedures for internal control reviews should be required on all examinations.

FRB only partially concurred with our recommendation to develop a more specific methodology to be used by examiners to assess loan loss reserve adequacy. FRB stated that its longstanding policy has been that establishment of reserves is bank management's responsibility, with the internal and external auditors having responsibility for attesting to management's determination. While we do not disagree that bank management should be responsible for establishment of adequate loss reserves, and that auditors have attestation responsibilities, examiners also have a responsibility to assess reserve adequacy in order to effectively evaluate a bank's safety and soundness.

FRB stated that our findings with regard to bank holding company inspections did not accurately portray FRB's general activities in reviewing intercompany transactions and nonbank subsidiary asset quality. The holding companies in our sample, while not randomly selected, held approximately 24 percent of the assets of insured banks with assets over $10 billion at the time of our selection. Therefore, we believe our findings indicate a significant problem regarding the adequacy of FRB's bank holding company inspection process.

Federal Deposit Insurance Corporation

In general, FDIC disagreed with our conclusions and recommendations. FDIC believes that its examination approach is effective, particularly considering the limited level of personnel resources. For the most part, FDIC concluded that its existing examination policies and procedures were adequate and that little or no changes were needed.

Our review showed that FDIC's examination approach lacked many essential requirements necessary for conducting effective safety and soundness examinations of banks. We found that FDIC's examination policies and practices did not result in adequate reviews of the condition of banks' loan portfolios and the effectiveness of their systems of internal control. In addition, FDIC relied on state examinations in lieu of performing its own examinations without determining the sufficiency of the state examiners' work. Quality control over preparation, review, and retention of FDIC examination working papers was seriously lacking.

FDIC's examination practices have not effectively minimized bank failures or losses to the Bank Insurance Fund. From 1985 through 1991, 610 FDIC-regulated banks with assets totaling about $60 billion failed at a cost of almost $12 billion to the insurance fund. We believe this record indicates that FDIC should be making every effort to strive towards an improved examination approach. The recommendations we made to FDIC are designed to result in an examination approach which identifies and corrects unsafe and unsound banking practices before they result in irreparable financial conditions. Such a proactive examination approach would promote a more safe and sound banking system and provide better protection to the Bank Insurance Fund.

Matter for Congressional Consideration

The inconsistent and, in several cases, unresponsive comments which we received from the four federal regulatory agencies raised concern that the overall quality of examinations will not be improved in the critical areas where we identified deficiencies and that nonuniform regulation will continue. Without meaningful change in the examination and inspection processes, bank and thrift regulatory systems will continue to be focused on reacting to situations which have already deteriorated, often beyond repair. This reactive regulatory approach is likely to hinder the effective implementation of the FDIC Improvement Act.

The act generally requires annual full-scope examinations as a key component of regulatory reform but does not define the term. The House and Senate Banking Committees should urge the regulators to adopt our recommendations as minimum standards for full-scope annual examinations to provide a consistent and preventive approach to bank and thrift supervision to help minimize losses to the depository institution insurance funds. Absent adoption of such minimum standards by the regulators, the Congress should consider legislating such requirements.

FDIC Improvement Act Requirements Can Greatly Aid Examination and Supervision

The FDIC Improvement Act reforms provide a structure to strengthen corporate governance and to facilitate early warning of safety and soundness problems. These reforms address deficiencies that significantly contributed to the failure of banks and thrifts and the depletion of the insurance funds. The internal control, compliance, audit committee, and exchange of reports and information requirements provide the opportunity to improve both the quality and efficiency of examinations. In addition, requirements for prompt regulatory action are intended to lead to more timely regulatory decisions in assisting troubled institutions and minimizing losses to the insurance funds and taxpayers. The act provides the opportunity to improve the efficiency and effectiveness of regulatory oversight and to strengthen flexible accounting rules, but it must be fully implemented with meaningful regulations to achieve these objectives. The effectiveness of the act's capital standards intended to minimize losses to the insurance funds will be diminished unless accounting rules that contribute to inflated reporting of capital levels are tightened.

Corporate Governance Requirements Can Enhance Management Accountability and Improve Examinations

An effective corporate governance function is a first line of defense to ensure an institution's safety and soundness. How well an institution's Board of Directors and management fulfill this responsibility, as well as the effectiveness of its audit committee, greatly affect the soundness of policy and operating decisions and the identification and correction of unsound operations in a timely manner.

Our reports on bank and thrift failures[1] showed that the corporate governance system upon which successful regulation depends is seriously flawed. The failed institutions had serious internal control problems, including violations of laws and regulations, which regulators cited as contributing significantly to their failure. Had these problems been corrected, the institutions might not have failed or their failure could have been less expensive to the insurance funds. Our report[2] on the audit committees of the nation's largest banks (assets of $10 billion or more) showed that their committees lacked the independence and expertise that we believe are necessary to properly oversee bank operations. Of the 40 audit committee chairpersons responding to our questionnaire, 25 reported their membership included large customers of the bank, 19

[1]Failed Banks: Accounting and Auditing Reforms Urgently Needed (GAO/AFMD-91-43, April 22, 1991), Bank Failures: Independent Audits Needed to Strengthen Internal Control and Bank Management (GAO/AFMD-89-25, May 31, 1989), and Thrift Failures: Costly Failures Resulted From Regulatory Violations and Unsafe Practices (GAO/AFMD-89-62, June 16, 1989).

[2]Audit Committees: Legislation Needed to Strengthen Bank Oversight (GAO/AFMD-92-19, October 21, 1991).

reported their members had little or no expertise in banking, and 13 reported their members had no expertise in law and never met independently with the bank's legal counsel.

The FDIC Improvement Act requires federally insured banks and thrifts with assets of $150 million or more to annually report to the federal regulators on their financial condition and management for fiscal years beginning after December 31, 1992. The report is to include a statement of management's responsibilities for preparing financial statements, establishing and maintaining an adequate internal control structure for financial reporting, and complying with laws and regulations relating to safety and soundness which are designated by FDIC or the appropriate federal banking agency. The report also must include management's assessment of (1) the effectiveness of the institution's internal control structure for financial reporting and (2) the institution's compliance with the designated laws and regulations. Management's statement of responsibilities and assessments must be signed by the chief executive officer and the chief accounting or financial officer of the institution. In addition, the act requires the institution's external auditor to report separately on management's assertions.

The act also requires the applicable institutions to have an independent audit committee entirely made up of outside directors who are independent of institution management. For large institutions, the act provides that audit committees shall include members with banking or related financial management expertise and not include any large customers of the institution and have access to the committee's own outside counsel.

These new requirements should significantly enhance the likelihood that examiners will identify emerging problems in banks and thrifts earlier. The regulators need to fully utilize the assessments and other information that will be available through these requirements to improve the quality and efficiency of examinations. By relying on the work now required of management and its external auditors, where appropriate, the regulators will be able to obtain substantively better coverage of internal controls. For example, the required assessments of internal controls are intended to include controls related to loan quality and the adequacy of loan loss reserves, which are critical areas of bank and thrift operations.

However, to obtain the expected benefits, the regulators will need to (1) establish effective working relationships with institution management and its audit committee and auditors and (2) review management's assessment of internal controls and the auditor's review of that work to provide a basis for reliance. Under the act, the regulators have access to external auditors' working papers so they can review the scope and quality of work conducted in these areas. In addition, the act provides for the exchange of auditor and examination reports to facilitate efficient and effective conduct of these functions. The act provides that the independent audit committee's duties shall include reviewing with management and the auditor the basis for management's report on internal controls and compliance, and the auditor's report on management's assessments and the entity's financial statements. Effective fulfillment of these responsibilities by all parties will not only aid institution management, but should provide valuable insight for the regulators in planning and conducting examinations.

Institutions with less than $150 million of assets are not subject to the act's internal control requirements. For those, the regulators will need to assess what, if any, internal control work has been performed by institution management and its auditors, and may have to independently test the effectiveness of internal controls and compliance with laws and regulations during their examinations. The failure of an individual small financial institution does not present a significant risk to the insurance funds. However, over time their collective impact is costly. According to available information from FDIC, 84 percent of the banks that failed from 1985 to 1991 had total assets of $100 million or less. These 998 banks accounted for 24 percent of the total loss incurred by the Bank Insurance Fund during this period, thus contributing substantially to its deficit at the end of 1991.

Prompt Regulatory Requirements Can Enhance Timely Corrective Actions and Minimize Insurance Fund Losses

Our report on bank supervision[3] showed that prompt and forceful regulatory actions were needed to ensure that banks operate in a safe and sound manner and thereby preserve the health of both the banking industry and the insurance fund. We studied regulators' actions to enforce safe and sound banking practices by analyzing 72 banks from the universe of banks that as of January 1, 1988, were identified by regulators as having difficulty meeting the required minimum capital standards. In about half of the sampled cases, we found that due to weak regulatory oversight, bank capital levels were not improved and the underlying causes of bank capital

[3]Bank Supervision: Prompt and Forceful Regulatory Actions Needed (GAO/GGD-91-69, April 15, 1991).

problems were not corrected. Similarly, our 1989 thrift failures[4] report on 26 thrifts which failed between January 1, 1985, and September 30, 1987, revealed that these thrifts had critical problems over extended periods of time. Management at these thrifts was often unresponsive to the concerns of regulators and violated written agreements or enforcement actions. These thrifts represented over 50 percent of the estimated losses to the insurance fund for thrifts that failed during the 21-month period ended September 30, 1987.

The FDIC Improvement Act provisions for prompt regulatory action require the regulators to establish standards for safety and soundness and provide for specific regulatory actions if standards are not met. The act requires FDIC to develop standards to aid the regulators in overseeing banks and thrifts. The standards cover financial institution operational and managerial areas such as loan documentation, credit underwriting, and asset growth; asset quality, earnings, and stock valuation standards such as maximum ratio of classified assets to capital, and minimum earnings sufficient to absorb losses without impairing capital; and compensation standards to prohibit employment contracts or other arrangements that would provide excessive compensation, fees, or benefits, or possibly lead to material financial loss to the institution. Failure to correct noncompliance with the established standards within timeframes set by the act can lead to restrictions such as limitations on institution growth and requirements to increase the institution's ratio of tangible equity to assets until the noncompliances are corrected. FDIC is required to develop the standards and implementing regulations by December 1, 1993.

The FDIC Improvement Act also required the regulators to establish certain capital requirements for categories named in the act to be effective not later than December 19, 1992, to facilitate regulatory actions to protect the insurance funds. The categories included well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized. The act established restrictions for undercapitalized institutions such as limiting growth and requiring regulatory approval for acquisitions, branching, and new lines of business. The act establishes additional restrictions for significantly undercapitalized institutions and undercapitalized institutions that fail to submit and implement capital restoration plans. Further, the act sets certain time limits for appointment of a receiver if other actions fail to restore the capital of an institution that is critically undercapitalized.

[4]Thrift Failures: Costly Failures Resulted From Regulatory Violations and Unsafe Practices (GAO/AFMD-89-62, June 16, 1989).

The safety and soundness standards should aid management in fulfilling its responsibilities to operate the institution in a safe and sound manner and help the regulators take consistent and timely corrective actions when deficient operations are identified. These standards should also help to preserve an institution's capital. Safety and soundness weaknesses, such as poor loan underwriting and documentation practices that fail to assess or maintain timely and reliable data on the borrower's ability to repay, eventually can lead to nonperforming loans resulting in losses that erode capital. Similarly, the capital standards are intended to preserve capital and, when capital has been eroded, to ensure a minimum level of capital exists to guard against losses to the insurance funds. The quality of examinations is critical to ensure safety and soundness standards are being met as breakdowns in these controls, such as loan underwriting and documentation, lead to nonperforming loans and other poor quality assets. Further, the reliability of reported capital is critical to the effective functioning of the capital standards to protect the insurance funds from losses.

Flexible Accounting Rules Are Contributing to Inflated Financial Reports and Capital Levels

In our 1991 failed banks report on 39 banks which failed in 1988 and 1989, we concluded that the accounting rules used to recognize and measure loan losses were a major factor in bank management not reporting $7.3 billion in deteriorated asset values on financial reports. The deficiencies in accounting rules allowed bank management to unduly delay the recognition of losses in its financial reports to regulators and thus mask the need for early regulatory intervention that could have minimized losses to the Bank Insurance Fund. Our report also recognized that accounting for debt securities is based on management's ability and intent to hold or sell the investments. Management's intent and the assessment of ability to hold are subjective and often cannot be verified until an investment is disposed of or an institution fails. Such flexibility can result in management recognizing gains and deferring loss recognition—a practice that results in inflated capital. Finally, our report showed that accounting rules for related party transactions should be enhanced to state how the economic substance of such transactions should be recognized in financial reports when it is materially different than the legal form of the transaction. As discussed in chapter 2, within a holding company structure, the flexibility of the accounting rules can result in the earnings and capital of insured institutions being diverted.

In a recently issued report,[5] we identified the specific problems with accounting rules for loan losses and described the status of the Financial Accounting Standards Board[6] (FASB) proposed standard related to these issues. In commenting to FASB on the proposed standard, we expressed concern that the standard, as drafted, would not result in full recognition of losses on nonperforming loans because fair market value concepts were not required to be used in deriving these loss estimates. Because of FASB's reluctance at that time to fully embrace fair market value concepts, we recommended government action to set specific new accounting rules for recognizing losses from nonperforming loans. Our recommendations were addressed to the federal depository institution regulators. In commenting on a draft of our report, the regulators generally agreed in concept with the accounting principles we recommended. However, they said either that the accounting rules should be addressed by FASB or that the regulators' practices or ongoing efforts to clarify evaluation of troubled loans would satisfy our concerns. The regulators referred to their November 1991 Interagency Policy Statement as an example of their most recent effort to clarify evaluation of troubled loans. However, this policy statement emphasized that the market in today's economic environment may not be representative of fair values and discouraged the use of current transaction data in valuing troubled loans. Therefore, we do not believe the regulators' policy statement adequately addressed the concern that many nonperforming loans are not being valued on a current fair market value basis and that asset values and capital are being overstated.

The potential magnitude of unrecognized losses on nonperforming loans was recently demonstrated in a January 18, 1993, article in The Wall Street Journal. This article reported recent write-downs of problem real estate loans by some of the nation's largest banks of 40 percent to 60 percent of the face value of those loans. These write-downs, which in one case reportedly amounted to as much as $1 billion, were taken in anticipation of selling the problem loans, which indicates that the loans were not previously recorded at amounts reflective of their fair market values.

FASB recently met to discuss its position on its draft standard on accounting for impaired loans and is considering several changes which would result in a somewhat more realistic measure of losses from

[5] Depository Institutions: Flexible Accounting Rules Lead to Inflated Financial Reports (GAO/AFMD-92-52, June 1, 1992).

[6] FASB is the accounting rule setting body that promulgates accounting principles, commonly known as generally accepted accounting principles, for private sector financial reporting. Financial reports required by bank and thrift regulations are for the most part consistent with these accounting principles.

impaired loans. We are encouraged by this progress and hope for more. However, substantive revision of the standard, as we have recommended, may delay the FASB rulemaking process such that the effective date of the new standard would be after 1994. Therefore, we remain concerned, both with the effective date and whether the final standard, when ultimately adopted, will be sufficiently definitive in requiring fair value accounting for nonperforming loans.

We are also concerned about flexible accounting rules for investment securities, which represent a significant asset for most banks and thrifts. On September 9, 1992, FASB issued for public comment a proposed accounting rule change for investments in debt securities and equity securities that have readily determinable fair values. Although the proposed changes provide more restrictive conditions for carrying investment securities at amortized cost, the accounting continues to be based on management's intent and ability to hold the securities to maturity. Investment securities held for current resale would be classified as trading securities and reported at fair value with unrealized gains or losses reported in the results of operations. Securities not classified as either held to maturity or trading securities would also be reported at fair value, but unrealized gains or losses would be recorded directly against equity.

We believe these proposed classification categories will be subject to flexibility for the same reasons that the existing classifications based on intent and ability to hold investments to maturity have failed to result in satisfactory accounting for debt investment securities. Management will be prone to include most marketable securities in the "hold to maturity" category and auditors will have a difficult time determining whether the category is being misused. This will likely result in continuing abusive management practices to recognize gains and defer recognition of losses—known as "gains trading" or "cherry picking." For these reasons, we believe that investment securities should be accounted for at fair value.

Regarding related party transactions, FASB advised us that it believes the accounting rules are sufficient to ensure fair financial reporting. It cited certain parts of existing accounting rules and the American Institute of Certified Public Accountants (AICPA) Code of Professional Conduct to support its position. We believe that such indirect guidance is insufficient to ensure that related party transactions are accounted for based on economic substance when materially different than their legal form. The AICPA advised us that it is important to distinguish between business purpose and the "arms-length" nature of transactions. Because of the relationship of parties, their affiliate statements (such as parent and subsidiary) may not reflect a true "arms-length" condition. Although we do not disagree with the AICPA, financial statements need to reflect the true business purpose or substance of transactions, not withstanding whether they are not conducted at "arms-length."

Given the current accounting rules and auditing standards for related party transactions, it is likely that auditors will detect only the most egregious transactions and require appropriate accounting or issue a qualified audit report. These rules provide little incentive for an auditor to go beyond the apparent legal form of such transactions and consider economic substance in opining on financial statements. In such circumstances, there is a high risk that misleading disclosures of such transactions in financial statements may not be identified by the auditor. Regarding financial institutions, the risk of loss to the insurance funds resulting from the failure of large holding companies and their insured subsidiaries is such that additional standard setting is needed to ensure fair reporting of related party transactions.

The Congress recognized some of our concerns about bank financial reporting in enacting the FDIC Improvement Act. The act provided that accounting principles applicable to reports or statements required to be filed with federal banking agencies by insured depository institutions should:

- result in financial statements and reports of condition that accurately reflect the capital of such institutions;
- facilitate effective supervision of the institutions; and
- facilitate prompt corrective action to resolve the institutions at the least cost to the insurance funds.

The act required the banking and thrift regulators to review the accounting principles used by depository institutions with respect to regulatory reporting and modify any such principles which are not consistent with generally accepted accounting principles or which fail to comply with the objectives stated above. Any modifications in accounting principles were to be no less stringent than generally accepted accounting principles. The act also required that regulators issue guidance regarding reporting of off-balance sheet items and disclosure of the market value of assets and liabilities. These accounting reforms were to be completed by December 19, 1992, but had not been fully implemented by regulators as of year-end 1992. However, based on the regulators' response to our previous recommendations on loan loss accounting, the lack of specific requirements in the act to address our aforementioned concerns, and FASB's reluctance to take definitive action to address these problems, we believe further prompting of the regulators to take action will be needed.

Generally, we do not advocate the use of regulatory accounting principles (RAP) established by regulators that differ from generally accepted accounting principles (GAAP) established by FASB. However, the failure of FASB to take definitive steps to tighten flexible accounting rules makes regulatory action necessary. The use of RAP in these instances would strengthen accounting in these critical areas and should not be confused with previous uses of RAP that weakened accounting for thrifts. Also, these revised accounting rules should only apply to reports filed with the regulators.

Proposed Changes to the FDIC Improvement Act Would Negate the Reforms

Legislation was proposed in late 1992 that would have delayed, deleted, or modified the supervisory, corporate governance, prompt corrective action, and accounting reforms required by the FDIC Improvement Act. The most comprehensive of these proposals was the former administration's "Credit Availability and Regulatory Relief Act of 1992" and H.R. 5433, the "Comprehensive Community Bank Burden Reduction Act of 1992." The stated purpose of the proposed legislation was to reduce the regulatory burden on depository institutions. Similar proposals may be introduced in 1993. We recognize that there may be some unnecessary and overly burdensome regulations in effect and have a separate effort underway to study the overall issue of regulatory burden. However, regulations which are critical to protection of the safety and soundness of the banking and thrift industry should be vigorously defended.

The need for the FDIC Improvement Act's accountability and supervisory reforms remains critical, as evidenced by the bankruptcy of the former insurance fund for thrifts (the Federal Savings and Loan Insurance Corporation), the insolvency of the Bank Insurance Fund, the near insolvency of the Saving Association Insurance Fund, and the continuing high level of troubled banks and thrifts and their possible failure. As discussed in chapter 4 of this report, the combination of a higher risk banking and thrift industry and a less effective regulatory structure exposes the insurance funds, and taxpayers, to further losses. The FDIC Improvement Act, properly implemented, goes a long way towards reducing this exposure. The act provides the regulators with the tools necessary to obtain more and better information on the condition and activities of insured depository institutions, clear standards by which to judge unsafe and unsound conditions, and the incentives to correct unsafe and unsound conditions in a timely manner. These reforms are critically linked to provide an early warning of safety and soundness problems and minimize losses to the insurance funds. These reforms will not be burdensome on well-managed institutions. Altering these reforms surely sets the stage for a repeat performance of past mistakes and their consequences.

Conclusions

The early warning and prompt corrective action requirements of the FDIC Improvement Act provide the foundation to restore the flawed corporate governance that was evident in the failure of banks and thrifts and to improve institution accountability. These are vital reforms because the basic responsibility for the safety and soundness of depository institutions rests with institution management. Fully utilizing these reforms would help regulators improve the effectiveness and efficiency of supervision and examination functions. The effectiveness of the reforms will be severely limited if the quality of examinations and effectiveness of supervisory actions are not improved. Further, efficient use of the various assessments required of institution management, auditors, and audit committees provides an excellent opportunity for the regulators to minimize the cost of regulation to the institutions.

The perhaps temporarily improving condition of banks in recent months should not be the basis for relaxing the critical safety and soundness reform provisions which were enacted by the Congress—either by repeal of those provisions or by implementing weak regulations. The conditions that caused the steep losses as depicted in the figures in chapter 4 are still with us. We need to pursue full implementation of the reforms, and at the same time consider other reforms which now seem appropriate—like strengthening the bank examination process. If the Congress accedes to those who wish to weaken those reforms, significant taxpayer exposure to losses will continue.

Flexible accounting rules are a continuing problem that can greatly limit the effectiveness of the capital standards in preserving institution capital to guard against losses to the insurance funds from failed institutions. Based on the limited progress that FASB has made in addressing these issues and the lack of action of the regulators in responding to the recommendations in our flexible accounting rules report, we are not encouraged that appropriate corrective actions will be forthcoming.

Matter for Congressional Consideration

The Senate and House Banking Committees should urge the regulators to adopt accounting rules for regulatory financial reports that will reflect (1) the fair value of nonperforming loans[7] and investment securities and (2) the economic substance of related party transactions when materially different than their legal form. The committees may also wish to urge FASB to adopt such accounting rules. Absent the adoption of such accounting rules by either the regulators or FASB, the Congress should consider legislating such requirements for financial reports prepared by banks and thrifts for their respective regulators.

[7]Our June 1992 Flexible Accounting Rules report identified the accounting rules for nonperforming loans as a matter for congressional consideration.

Regulatory System Has Been Less Effective Since 1980 in Minimizing Insurance Losses

The history of deposit insurance shows that depositors have been protected, but the cost, especially to taxpayers, during the last decade has risen dramatically. A number of factors besides inflation and economic recession have contributed to the higher cost of deposit insurance. These include increased risk-taking by banks and thrifts coupled with internal control weaknesses, violations of safety and soundness laws and regulations, higher insured limits, and an environment of deregulation. As measured by the unprecedented failures of banks and thrifts and dramatically increasing loss rates, the regulatory system has been far less effective since 1980 in preventing and minimizing the number and cost of failures than in the preceding 50 years. Absent real regulatory reform, it is very likely that these high loss rates will continue.

In addition to weaknesses in examination and inspection quality discussed in chapter 2, we identified many inconsistencies and duplication of effort among the four regulators that hinder their efficiency and effectiveness. These inconsistencies are also likely to affect how well the regulators correct the examination problems we identified in chapter 2. The weaknesses we found in the quality of examinations and inspections could also hinder the effectiveness of the FDIC Improvement Act as discussed in chapter 3. We believe these problems and inconsistencies are symptomatic of the difficulty of efficiently and effectively regulating the banking and thrift industries with four separate regulators. The current regulatory structure has evolved over decades of legislative efforts to address specific problems, resulting in a fragmented system that may no longer be capable of handling the complexities of today's banking and thrift industries.

Development of Deposit Insurance and the Current Regulatory Structure

Deposit insurance was created following the Great Depression in an effort to protect depositors and restore confidence in the American banking system. While federal regulation of banks and the Federal Reserve System predate this period, the bank regulatory structure as we know it today, for the most part, was formed in response to this financial crisis. The regulatory system worked well the first 50 years, but was unable to stem the massive losses to the insurance funds in the 1980s.

Origin of Deposit Insurance and the Regulatory Structure

Historically, both the states and the federal government claimed and exercised the right to charter banks.[1] The dual chartering system was formalized in 1864 by the National Bank Act, which established a system

[1]The history of deposit insurance presented in this section is based largely on the Federal Deposit Insurance Corporation's 1987 publication, Mandate for Change—Restructuring the Banking Industry.

for national banks to exist along with state-chartered banks. The act established OCC with the authority to charter and supervise national banks.

Prior to 1913, the responsibility of maintaining reserves and liquidity was left to the individual banks. On occasion, banks collectively suspended the convertibility of deposits into currency or specie on demand in order to halt the spread of failures during bank panics. Following the 1907 bank panic, banks lobbied for the creation of a bankers' bank to serve as a lender of last resort. In 1913, the Congress passed the Federal Reserve Act, creating the Federal Reserve System—which comprises 12 regional reserve banks, coordinated by a Board of Governors in Washington, D.C., to serve as the nation's central bank. The Federal Reserve System was expected to ensure that solvent but temporarily illiquid banks could obtain funds and therefore survive a banking crisis. Its overall function was to foster a flow of credit and money that would facilitate orderly economic growth, a stable dollar, and long-run balance in our international payments. National banks were required to join the Federal Reserve System, but state-chartered bank membership was optional. State-chartered banks that joined the system were regulated by the Federal Reserve Board, while OCC retained regulation of national banks.

Early Federal Reserve policy did not succeed in preventing massive bank failures. With the Great Depression came the beginning of modern regulated banking. By and large, commercial banks, particularly those with affiliates engaged in marketing securities, were held accountable for the economic events of the times: the stock market crash, the collapse of the banking system (with 15,000 bank failures during the 1920s and early 1930s) and the Great Depression itself. Abuses of the operations of commercial banks' security affiliates were cited as the primary cause of these events.

The reforms enacted by the Congress in the early 1930s were an attempt to ensure the safety and stability of the banking system. Bank products, prices, and geographic restrictions were established. Competition within the banking system also was restricted through the establishment of interest-rate ceilings and deposit insurance. The original insurance limit was $2,500 per insured account. Separation of commercial and investment banking was achieved through various sections of The Banking Act of 1933, which collectively are known as the Glass-Steagall Act, 1933. The Banking Act of 1933 also created the Federal Deposit Insurance Corporation to ensure safety for individual depositors and stability for the banking system. FDIC administered the deposit insurance fund and regulated state-chartered banks that did not join the Federal Reserve System.

At that time, the Congress also created a system of regulation, insurance, and central banks for savings and loan associations. The Federal Home Loan Bank Act of 1932 created the Federal Home Loan Bank Board as an independent federal regulatory agency. The Bank Board, as mandated by the Home Owners' Loan Act of 1933, supervised all federally chartered thrift institutions. In conjunction with state agencies, it also regulated state-chartered thrifts that were insured by the Federal Savings and Loan Insurance Corporation (FSLIC), a government insurance agency created by the National Housing Act of 1934. The Bank Board oversaw the operations of the 12 Federal Home Loan Banks (established by the 1932 act) and FSLIC.

In 1934, when deposit insurance was extended to thrifts, the original limit of $2,500 was increased to $5,000. The limit has been raised six times since then. The current $100,000 limit was set in the Depository Institutions Deregulation and Monetary Control Act of 1980.

The Banking Act of 1933 imposed restrictions on group banking organizations' activities, which later became known as bank holding companies. Bank holding companies were prohibited from voting their stock in member banks unless they agreed to be examined by the Federal Reserve Board, to establish a reserve fund, and to cease engaging in underwriting and dealing in securities. The Banking Act of 1933 left open a number of avenues through which bank holding companies could avoid regulation and continue to expand and to acquire additional nonbank affiliates. Concerns over expansion by bank holding companies in the late 1940s led to the eventual passage of the Bank Holding Company Act of 1956. The act imposed limitations on the expansion of multibank holding companies by requiring Federal Reserve Board approval for new acquisitions, and by the "Douglas Amendment," which restricted interstate bank acquisitions by holding companies. The act also restricted the permissible activities of multibank holding companies.

Changes in Regulation and Banking Operations Increased Risks

Deregulation in the 1980s provided expanded powers for financial institutions and resulted in greater risk-taking in their operations, while regulatory oversight was reduced. Banks and thrifts were empowered with broader lending opportunities and given freedom to set interest rates to attract deposits. These changes enabled them to be more competitive with each other as well as with emerging nonbank competitors such as mutual funds. At the same time, regulators were given more flexibility in their approach to examining institutions during a time of major operational changes in the bank and thrift industries.

The Depository Institutions Deregulation and Monetary Control Act of 1980 increased deposit insurance coverage from $40,000 to $100,000. During this same period, deregulation initiatives enabled banks to assume more risk in their portfolios and at the same time reduced bank regulators' supervisory controls over banks. For example, the 1980 act decreased the number of annual examinations statutorily required for national banks from two to zero. Additionally, the Garn-St Germain Depository Institutions Act of 1982 eliminated the real estate loan-to-value restrictions for national banks. The regulators' examination staffing levels were also reduced during the early 1980s, resulting in increased use of off-site monitoring of banks.

The failure of hundreds of saving and loans during the 1980s led to the insolvency of FSLIC and prompted the Congress to restructure the Federal Home Loan Bank System. The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) created OTS as the primary regulator of the nation's thrift industry. FDIC was given responsibility for administering a new insurance fund for thrifts—the Savings Association Insurance Fund. The Federal Home Loan Bank Board was abolished and the Federal Home Finance Board was created to oversee the Federal Home Loan Banks. The FSLIC Resolution Fund was created to resolve the obligations of FSLIC and received most of FSLIC's remaining assets, and the Resolution Trust Corporation was created to resolve failed thrifts. Currently, the new insurance fund will assume full responsibility for resolving failed thrifts beginning October 1, 1993, and the Resolution Trust Corporation will terminate in December 1996 with remaining assets and obligations taken over by the FSLIC Resolution Fund.

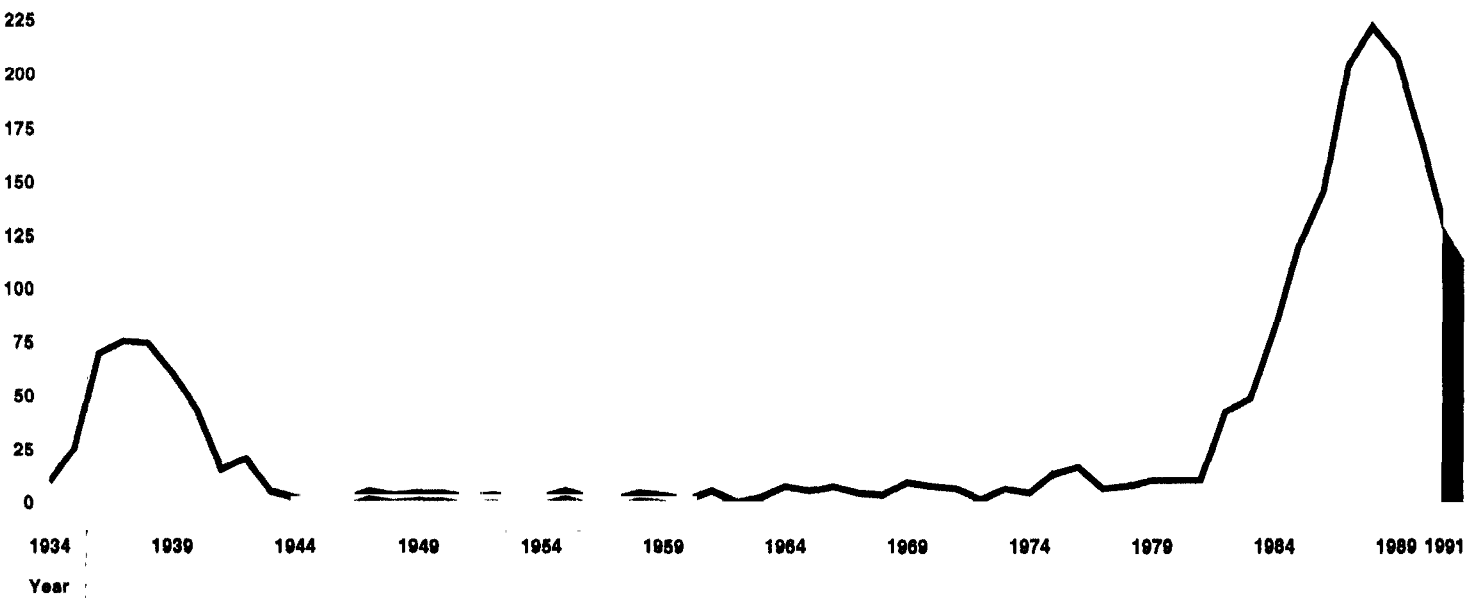
Fifty Years of Strong Performance Overshadowed by the Last 10 Years

Without question, the deposit insurance program has been successful in instilling public confidence in the banking system. This has been particularly evident in the last 2 decades. Despite the energy price shocks and inflation of the 1970s, recessions, stock market drops, regional dislocations, and well-publicized problems in the thrift and banking industries that have occurred over the past decade, most people have not had to worry about whether their money was safe.

Further, as measured by the number of insured depository institution failures and loss claims paid by bank and thrift deposit insurance funds from the 1930s through the 1970s, the statutory restrictions, supervision, and regulatory policies and practices were sufficient to control the level of risk assumed by the insured institutions. However, the number of institutions that failed and the amount of losses paid by the insurance funds to protect depositors increased dramatically in the 1980s and have continued at historically high levels.

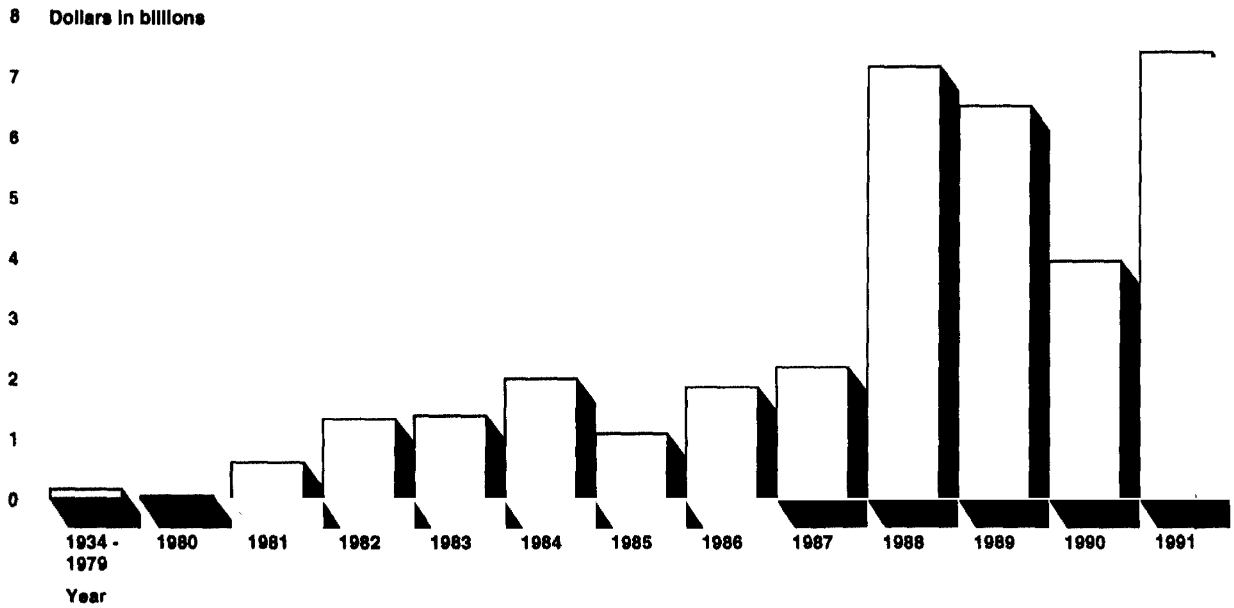
For example, from 1934 through 1979, a 46-year period, 558 banks failed at a cost to the insurance fund of $141.3 million. From 1980 through 1989, a 10-year period, 1,086 banks failed or received assistance at a cost to the insurance fund of $24 billion. From 1990 through 1991, 296 banks failed or received assistance costing the insurance fund an additional $11.3 billion. (See figures 4.1 and 4.2.)

Figure 4.1: Number of Resolved FDIC Insured Banks



Source: The Federal Deposit Insurance Corporation 1991 Annual Report.

Figure 4.2: Net Losses in Resolving FDIC Insured Banks

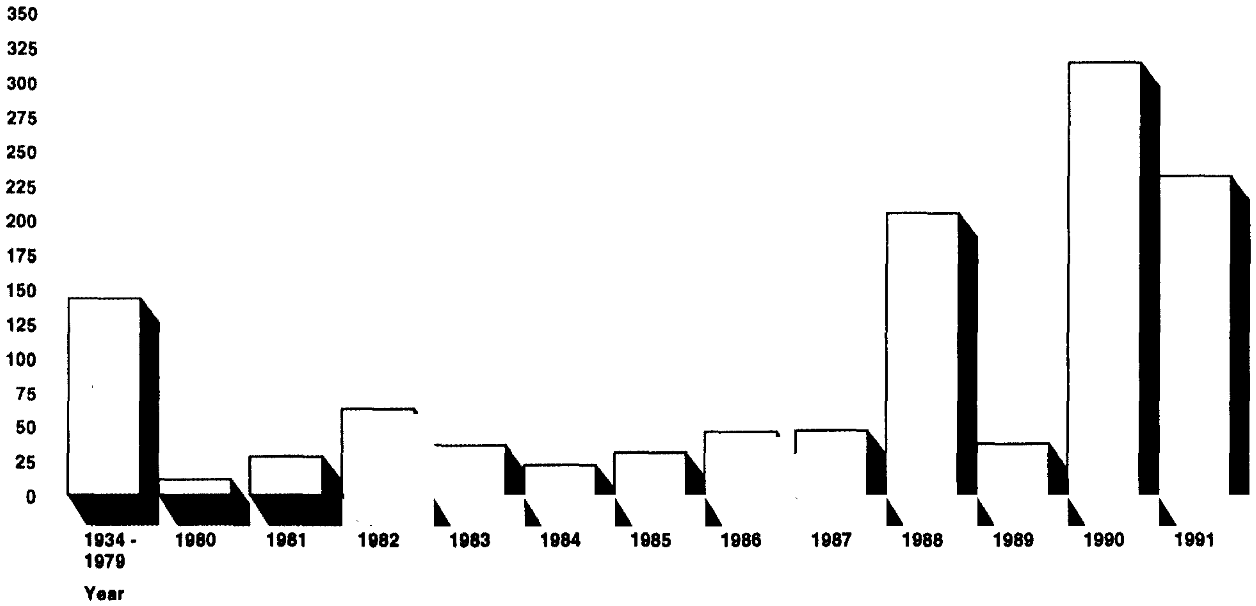


Source: The Federal Deposit Insurance Corporation 1991 Annual Report.

This represents a 795 percent increase in the average number of resolutions per year in the 1980s as compared to the 1934-1979 period, and an additional 36 percent increase in the early 1990s. Bank failures in the 1980s also represented a 78,176 percent increase in the average amount of annual losses to the insurance fund as compared to the 1934-1979 period and an additional 136 percent increase for the early 1990s as compared to the 1980s.

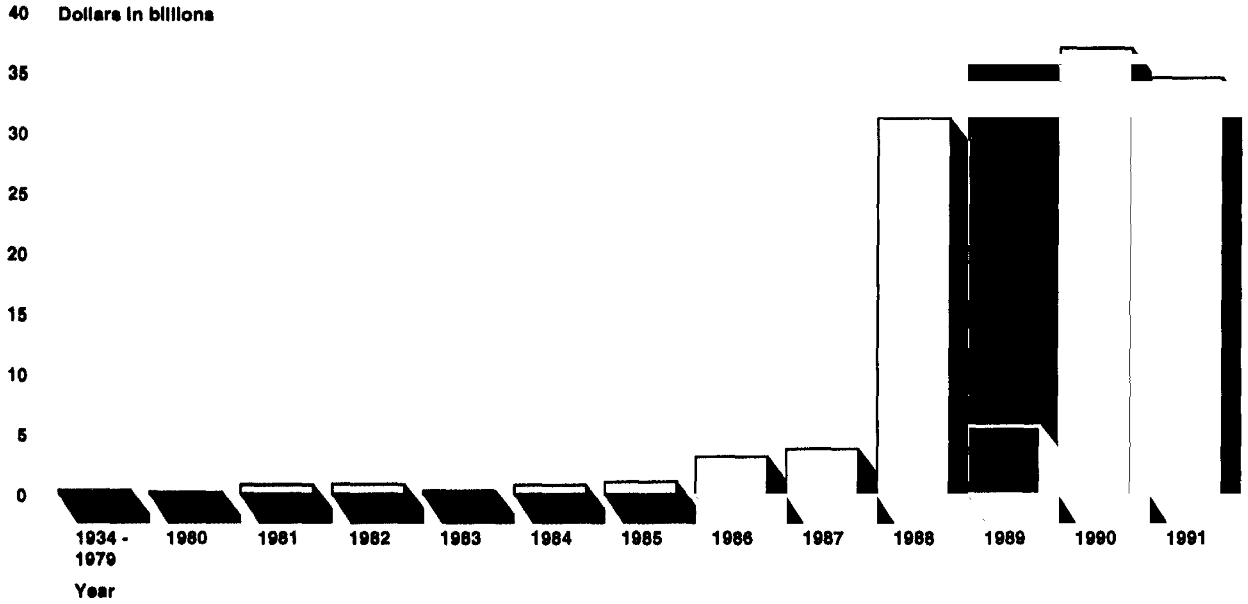
Also, for thrifts, for the same 46-year period, 143 FSLIC-insured depository institutions failed at a cost to the insurance fund of $306.1 million. From 1980 through 1989, a 10-year period, 526 insured institutions failed at a cost to the insurance fund and U.S. Treasury of nearly $47.4 billion. From 1990 through 1991, an additional 547 insured thrifts failed costing an additional $71.6 billion, as shown in figures 4.3 and 4.4.

Figure 4.3: Number of Failed Thrifts



Source: Data submitted by the Office of Thrift Supervision.

Figure 4.4: Net Losses in Resolving Failed Thrifts



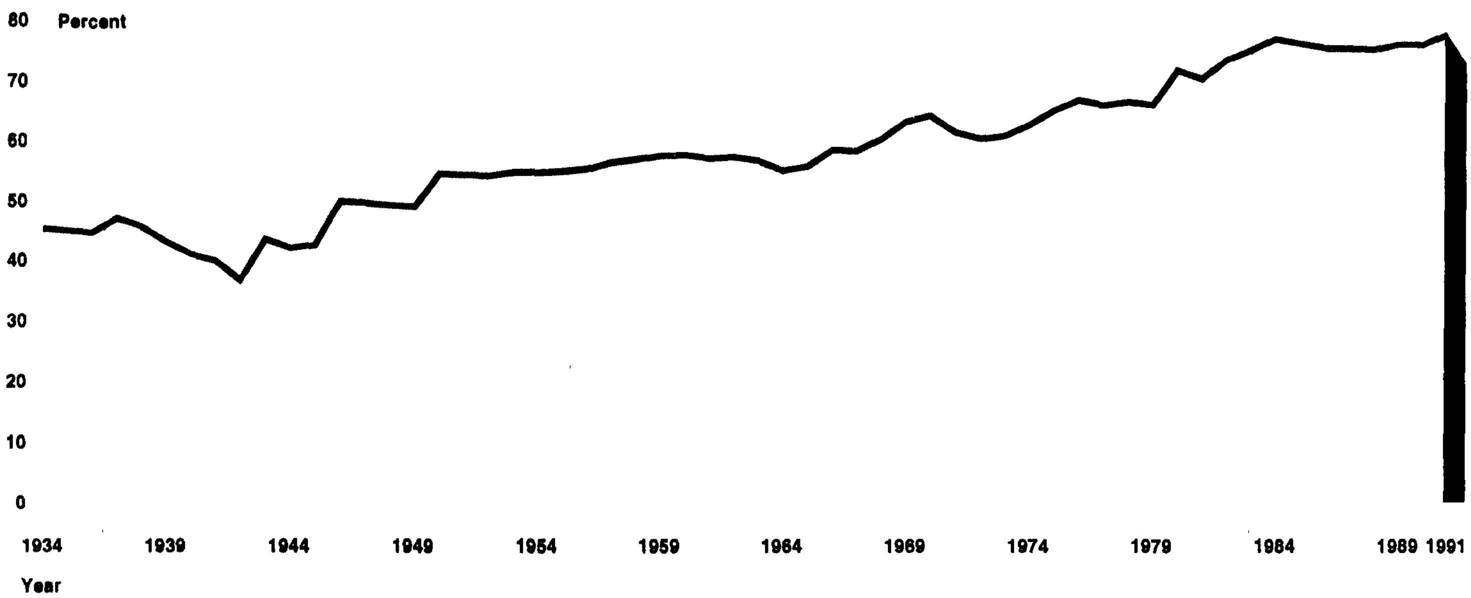
Source: Data submitted by the Office of Thrift Supervision.

This represents an increase of nearly 1,600 percent in the average number of failed saving institutions per year in the 1980s as compared to the 1934-1979 period, and an additional 420 percent increase in the early 1990s as compared to the 1980s. The failure rate of the 1980s also represents a 71,125 percent increase in the average annual insurance fund losses compared to the 1934-1979 period and an additional 656 percent increase in the early 1990s as compared to the 1980s.

The dramatic increase in bank and thrift failures and losses incurred in resolving the failed institutions since the 1970s vividly illustrate the significant change in the risks to the deposit insurance system and to the taxpayer. They also show the inability of the regulatory system to stem the tide of extraordinary failures and losses.

Some of the increase in losses due to bank and thrift failures resulted from the increases in deposit insurance coverage. As shown in figure 4.5, the deposit insurance safety net expanded from 45 percent of all deposits insured in 1934 to nearly 78 percent in 1991.

Figure 4.5: Insured Deposits as a Percent of All Deposits at FDIC Insured Banks



Source: The Federal Deposit Insurance Corporation 1991 Annual Report.

Another difference between the bank failures of the 1980s and preceding years is the losses incurred as a percentage of failed bank deposits. Losses arising from failed bank closures incurred by the insurance fund as a percent of their deposits averaged 2.3 percent from 1934 through 1979, increased to 12.3 percent from 1980 through 1989, and increased to 15.8 percent for 1990 and 1991. The 1980s total loss experience as a percent of total deposits in resolving failed banks was 435 percent greater than the 1934 through 1979 loss experience.

Average losses as a percent of deposits at failed thrifts exceeded 45 percent of deposits in 1989 through 1991. Similar data for prior years were not available from OTS.

While the increasing deposit insurance safety net contributed to the significant increase in losses as a percent of failed bank deposits from 1980 through 1991 as compared with 1934 through 1979, it does not fully account for the magnitude of these losses. Other major contributing factors include increased risk-taking by banks, internal control breakdowns, examination and accounting weaknesses, and deregulation. Our work has shown that the regulators lacked minimum essential examination requirements and that their approach to conducting examinations did not include comprehensive reviews of internal controls to proactively identify weaknesses. Examinations were also hindered by flexible accounting rules that can be used to hide losses and overstate bank capital. The FDIC Improvement Act requires reforms which will result in more timely identification of conditions affecting bank and thrift safety and soundness and trigger early intervention to minimize losses to the insurance funds. Improved examination quality and tightened accounting rules are needed to effectively implement the act's early warning reforms.

It is evident from the dramatic increase in failure and loss rates that the banking industry and the regulatory environment have changed. It is also apparent from the earlier history of the industry that recessions and inflation are not necessarily the fundamental drivers of the increased risk now faced by taxpayers. The FDIC Improvement Act was enacted to try to control this risk. But there are additional real and potential problems which were not addressed by the act, including the bank examination quality issues set forth in this report.

In recent months, the favorable, but inevitably short-lived, interest rate spreads have dramatically increased bank profitability. This, plus indications of an improved economy, has buoyed confidence in the stability of the banking system. However, the fundamentals have not changed. Banking is a riskier business than before, and at present, bank supervision is weaker. It remains to be seen how the banking industry will weather the continuing real estate glut and to what extent other new ventures by bankers, like participation in the derivatives market, will cause further stress.

Examination Policies and Practices of Regulatory Agencies Were Not Consistent

Although we did not study the efficiency and effectiveness of the regulatory structure as a whole, we identified inconsistencies among the regulators in their policies and practices that may hinder how well the regulators address the problems we found in our review. These differences among the regulatory agencies were evident in examination scope, frequency, documentation, and assessment of critical areas, such as loan loss reserves. Such differences could result in disparate conclusions regarding the safety and soundness of an institution, depending on which regulator did the assessment. Examples of such disparities between OTS and FDIC safety and soundness ratings of the same thrift institutions for virtually the same time periods are described in chapter 2 of this report.

Inconsistencies in examination scope were especially evident in loan quality reviews. The loan quality reviews performed by OCC on large banks in our sample were "targeted" and generally were not representative of the total loan portfolio. OCC's loan review work, though limited, was reasonably well documented. FDIC's stated philosophy, on the other hand, was to limit documentation. We found that FDIC's loan review work generally lacked sufficient information to assess the quality of the loans. FDIC examiners did not follow up on outdated or missing loan file information but rather relied on discussions with management to complete their loan analysis in many cases. OTS's approach was to focus on "high risk" loans. Its overall portfolio coverage was very limited and the documentation of the loan reviews was inconsistent. FRB was the only one of the four regulatory agencies whose examinations included sufficient loan coverage and evidence to provide a basis to conclude on the quality of the loan portfolio. FRB appeared to have devoted substantially more resources to its examinations of the large institutions we reviewed than did OCC.

Examination practices for smaller depository institutions varied among the federal regulators. Examination frequency was inconsistent for the small OCC banks in our sample. FDIC, FRB, and OTS generally performed annual on-site examinations. However, FDIC and FRB programs allowed for reliance on state examinations in alternate years for small banks. Neither FDIC nor FRB had a formal program in place to assess the quality of these state examinations, which, based on discussions with FDIC and FRB officials, can vary considerably.

Regulators' perceptions of their responsibility for assessing the adequacy of loan loss reserves varied greatly. These divergent perceptions were apparent in the inconsistencies in the examinations we reviewed and are discussed in detail in chapter 2. Some regulatory officials told us they believe that bank management is responsible for determination of reserve adequacy and that it is not the examiner's role to estimate an adequate reserve amount, even if the examiner does not believe management has fulfilled its responsibility. Officials at other regulatory agencies have stated policies which instruct examiners to calculate a prudent level of reserves if management's policies and procedures are deemed inadequate. These differing viewpoints could result in significant differences in the timing of recognition of adequate loan loss reserves among institutions. These timing differences could, in turn, result in a delay in the takeover of an institution by one regulator versus another, as could the differences in loan quality review scope discussed above.

Supervision of Bank Holding Companies Was Inefficient

As discussed in chapter 1, FRB is the regulator of the nation's bank holding companies and their nonbank subsidiaries. In most cases where the bank holding company includes a large bank subsidiary, that large bank is regulated by OCC. This was the situation in six of the seven holding company inspections we reviewed. We found that although OCC focused its primary efforts on the examination of the bank and the FRB inspection centered on the holding company operations, supervisory overlap occurred between the two regulators.

The OCC Reports of Supervisory Activity for these banks were addressed to the bank holding company, contained a summary of holding company activities, and examined the large bank along functional lines that may extend beyond the bank's boundaries into other entities controlled by the holding company. In these large institutions, bank operations are likely to overlap with those of the holding company since functions such as internal audit, interest rate risk management, and capital funding activities are often centralized at the holding company level. Therefore, as part of the bank examination, it is necessary for OCC examiners to review these types of activities for the overall company, as well as to familiarize themselves with the holding company structure and how it impacts the bank. Under the current supervisory structure, this type of work is a necessary duplication of the work performed by the FRB examiners in connection with the holding company inspections.

As discussed in chapter 2, we found that the FRB inspection process for the bank holding companies we reviewed did not adequately assess intercompany transactions or, in some cases, nonbank subsidiary asset quality. Assessment of these areas is important to ensure that insured bank subsidiaries are not being harmed by direct or indirect adverse intercompany activities. We believe these types of activities could be addressed most efficiently and effectively during the examination of the bank, as could the overlapping areas described above.

Examples of Other Inconsistencies and/or Inefficiencies

The following are other examples of inconsistencies and/or inefficiencies we noted in the current regulatory structure.

- A CAMEL rating is used for banks versus a MACRO rating for thrifts, even though their operations are similar.
- Each of the four regulatory agencies developed and used different regulatory manuals to provide their examiners guidance on how to conduct on-site examinations of financial institutions.
- The four regulators have separate headquarters and regional office regulatory structures.
- In addition to annual premiums for deposit insurance, OCC and OTS assess institutions they regulate a fee to fund their operations, while FRB and FDIC do not.
- Differences in regulatory philosophies result in significant time and effort required to coordinate development and implementation of new regulations.
- Both FDIC and the Resolution Trust Corporation (RTC) have responsibility for managing and disposing of failed institution assets and compete with each other.

Conclusions

The regulatory system that evolved from the Great Depression has been far less effective since the 1980s in minimizing losses to the insurance funds. Although banking in general has become more complex and risky, the regulatory system, as altered in the 1980s, has not effectively responded to these changes. Taxpayer funds remain in jeopardy until the reforms of the FDIC Improvement Act are fully implemented, the bank examination process is strengthened and other emerging problems are dealt with.

The regulatory structure has evolved over more than 60 years and has developed inefficiencies that reduce the effectiveness of the regulators and add unnecessarily to the cost of regulation. We believe that the ability of the current regulatory structure to effectively function in today's complex banking and thrift environment is an issue that needs to be considered.

Restructuring the regulatory system to deal with the operating inefficiencies that have developed over time involves a number of complex issues, as illustrated by the following questions.

- What is the most efficient and effective regulatory structure (e.g., single regulator, separate large and small bank regulators, single regulator but separate holding company regulator)?
- How would a single regulator of banks affect the Federal Reserve Board's ability to achieve its other responsibilities (e.g., monetary policy)?
- Should the regulatory and insurance functions be separate or combined under a single organizational structure?
- Should all banks be subject to a common set of regulations? (For example, should large banks be examined using standards that are different than those for small banks?)
- Should banks and thrifts be assessed uniformly for deposit insurance and examinations, and should deposits be insured by a single insurance fund?
- Are both the Federal Reserve Bank System and the Federal Home Loan Bank System needed to provide financing and other services to financial institutions?

Matter for Congressional Consideration

Given the increasing complexities of the banking and thrift industries and the less effective performance of the regulatory system since the 1980s, the House and Senate Banking Committees, in conjunction with the administration, should consider appointing a panel of experts to assess the appropriateness of continuing with the present structure and alternatives. We suggest the panel include representatives from a cross section of the banking and thrift industries, academia and other interested public institutions, and current and former regulatory officials.

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