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BANK AND THRIFT REGULATION

Improvements Needed in Examination Quality and Regulatory Structure

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GAO/T-AFMD-93-2

Mr. Chairman and Members of the Committee:

We are pleased to be here today to discuss the results of our recently completed review of bank and thrift examinations and bank holding company inspections performed by the federal depository institution regulators. My statement summarizes the findings and recommendations included in our report being issued today, Bank and Thrift Regulation: Improvements Needed in Examination Quality and Regulatory Structure (GAO/AFMD-93-15). In addition, we are issuing today four companion reports--one for each of the regulatory agencies--which present our findings in more detail.[1]

The significant increase in bank and thrift failures since the 1980s is further evidence that the business of banking has become more risky. Unfortunately, as my testimony will discuss, regulatory oversight has not kept pace with this changing banking environment. Implementation of the fundamental safety and soundness reforms enacted in the Federal Deposit Insurance Corporation Improvement Act of 1991 and a more effective and efficient regulatory examination process and structure are essential for overseeing the banking and thrift industries without undue burden.

Our review of the examination process shows surprising weakness in this fundamental regulatory function, which many may have assumed to be an effective deterrent to unsafe and unsound banking. Further, our work shows that examination weaknesses are symptomatic of a regulatory structure that is not as effective and efficient as it should be in overseeing our depository institutions.

The reforms of the bank and thrift examination function which we are recommending today are integral to successful implementation of the FDIC Improvement Act and are needed to make the examination function effective and efficient for both the regulators and the industries. Our findings show that the regulators' approach to determining bank and thrift safety and soundness is too often playing catch-up due to limited scope examinations that result in a reactive rather than a proactive approach to examinations. A lack of minimum examination and inspection requirements is limiting the effectiveness of examiners as well as resulting in inefficiencies and inconsistencies among the regulators. When you put all this

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[1]Bank Examination Quality: FRB Examinations and Inspections Do No 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).

together with the performance of the overall regulatory system over the years, we are concerned that the regulatory system has not effectively and efficiently kept pace with the rapidly changing business of banking.

EXAMINATIONS AND INSPECTIONS 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. Our work disclosed that the examinations performed by the Federal Deposit Insurance Corporation (FDIC), the Federal Reserve Board (FRB), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS) during the period covered by our review failed to meet this basic objective.

Bank regulators assess the overall safety and soundness of a bank by rating five major areas: capital adequacy, asset quality, management, earnings, and liquidity. These areas are given a rating from 1 to 5, with 1 indicating the least degree of supervisory concern and 5 indicating the highest degree of concern. A composite rating is also assigned to each bank. OTS uses a similar rating system for thrifts.

Our work focused on 58 randomly selected bank and thrift regulatory examinations generally performed between 1989 and 1991. We selected 11 FDIC regulated banks, 6 FRB banks, 21 OCC banks, and 20 thrifts regulated by OTS. 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. 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.[2] We did a detailed review of the examination working papers, reports, and related information in order to assess the effectiveness and efficiency of the examiners' reviews of internal controls, loan quality, and loan loss reserves.

Assessing loan quality and determining the adequacy of loan loss reserves are two of the most important components of an examination because loans generally comprise the majority of bank and thrift assets and involve the greatest risk. Without proper assessment of loan quality and loan loss reserves, examiners have no reliable basis to understand the true financial condition of an institution.

Assessing the adequacy of internal controls is another important component of an examination, because the system of controls

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

provides the framework for achieving management objectives, protecting assets from loss, accurate financial reporting, and compliance with pertinent laws and regulations. Timely detection of inadequate controls, or breakdowns in controls, can provide an early warning of problems before they seriously erode asset quality and capital. If examiners do not assess internal controls, they lose the opportunity to proactively address problems before they worsen and to better protect the insurance funds and taxpayers from losses.

The weaknesses we found in the bank and thrift examinations in our sample were in the very areas that are critical to bank and thrift safety and soundness. These weaknesses includ d lack of comprehensive internal control assessments and insufficient review of loan quality and loan loss reserves. In addition, we noted an 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 and consistency of the examination process to determine an institution's safety and soundness.

Lack of Internal Control Reviews Impedes Early Detection of Problems

A strong system of internal controls is the single best deterrent to unsafe and unsound activities which could cause a bank or thrift to fail. In previous reports, we cited weak internal controls as contributing significantly to bank and thrift failures in 1987 through 1989.[3] Yet, we found only 1 examination out of the 58 we reviewed where a thorough review of internal controls was performed. We estimate that at least 94 percent of the bank and thrift examinations performed during the period covered by our review did not include an adequate assessment of internal controls. Therefore, examiners were limited in detecting the early warning signs of bank or thrift failure and often did not react until deterioration was already evident.

Each of the regulators' examination manuals discussed the importance of evaluating internal controls, but the manuals were viewed as guidance rather than as required procedures. Therefore, the determination of examination procedures to be performed to

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[3]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).

evaluate internal controls, as well as other examination areas, was left to the discretion of the examiners in the field. This high degree of discretion allowed by all the regulators resulted in less than adequate reviews of internal controls in almost all cases.

In order to understand the serious problem presented by the failure to assess internal controls, let me explain in a little more detail why internal controls are so important.

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 an insured depository institution at risk of mismanagement, waste, fraud, and abuse.

For example, the internal control structure over lending would be designed to ensure that the institution has safeguards in place to protect against imprudent lending activities which are not consistent with sound operating goals and objectives. Such a control structure may include policies and procedures such as the following:

-- Appropriate officers or committees approve all loans and credit lines (including all new loans, renewals, and extensions) in conformity with formal lending policies and authority limits.

-- Approvals are based on credit investigations and evaluations performed prior to extending the credit and, in the case of certain types of loans, periodically thereafter.

-- When loans or loan participations are purchased from other institutions, the worthiness and capability of the selling institution to properly underwrite and service the loans are evaluated. The underlying collateral and the underlying borrower's creditworthiness are also often evaluated.

-- An inventory of required loan documents, including evidence of collateral and of the recording of liens, when applicable, is monitored to ensure timely receipt and comparison to the appropriate customer file.

-- Pertinent loan information entered into the data processing system, such as loan type, loan amount, interest rate, maturity, amortization terms, and collateral, is independently tested to ensure accuracy.

-- Loan officers review outstanding loans and credit facilities periodically for collectibility and adequacy of collateral, based on detailed, timely credit investigations and evaluations.

It is important to note that a strong system of internal controls does not impede a bank or thrift from making "character" loans or

loans with a greater than normal amount of risk involved. On the contrary, strong controls would allow that these type loans be made, to the extent authorized by the institution's policies, but would manage the risk of such loans and provide the proper monitoring mechanisms to compensate for the additional risk. In other words, internal controls do not preclude institutions from taking risks--rather, they ensure that such risks are consciously entered into and analyzed in accordance with the institution's operating strategies and objectives.

We found that bank examiners did a limited review of some of the controls described above during their examinations, but systematic comprehensive reviews which would provide a basis to conclude if the controls were operating properly were not performed. We found that examiners, in the course of several of these limited reviews, identified internal control weaknesses, but they did not factor these weaknesses into the safety and soundness ratings of the institutions and did not require immediate corrective action. 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 practices; deficient policies, procedures, and systems; and inadequacies in the loan review process. Yet, examiners continued to give the institution a relatively favorable management rating (which encompasses internal controls) 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 comprehensive assessments 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 undue reliance on lagging indicators such as asset quality deterioration will likely continue and unnecessarily add to the losses of the insurance funds. We believe a separate safety and soundness rating factor for internal controls is essential to help achieve the needed focus on this critical area and have recommended this added rating factor to the regulators.

In addition, better coordination with the external auditors, who perform internal control work as part of their annual audits, is needed to efficiently address internal controls in the examination process. The FDIC Improvement Act includes provisions which can significantly aid examiners in these coordination efforts. The act requires that management of banks and thrifts with assets greater

than $150 million perform comprehensive assessments of the institutions' systems of internal control over financial reporting and report to federal regulators as to the effectiveness of such control systems. The institutions' external auditors are required to attest to managements' assertions in a separate report to regulators. These assessments can efficiently assist examiners in determining the adequacy of internal controls, since, as long as examiners review the scope and quality of work performed, they can rely on managements' and auditors' assessments.

Review of Loan Quality and Loss Reserves Was 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 estimate that at least 70 percent of the examinations performed during the period covered by our review were not sufficient in the review of loan quality and loss reserves. Deficiencies varied among the four regulators, including use of nonrepresentative samples in loan reviews, reliance on outdated and/or incomplete loan file information, and use of unsound methodologies for evaluating loan loss reserve adequacy. As with the review of internal controls, regulatory agencies lacked minimum, mandatory examination standards in these areas. Procedures to be performed and the level of documentation and supervisory review of those procedures was generally left to the field examiners' discretion. This high level of discretion, coupled with internal quality control problems which are discussed later, increased the risk of inconsistent and insufficient examination work.

For 31 of the 38 OCC and OTS institutions sampled which had been recently examined,[4] 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 portfolios. OCC examiners generally excluded more than 50 percent of the commercial loan portfolios from their review, and OTS generally left more than 80 percent of the loan portfolio unreviewed.

In addition to leaving substantial portions of the loan portfolio unreviewed we also found that OCC's loan samples were not expanded at banks where examiners found significant differences between their loan quality ratings and those of bank management. For example, at one large OCC bank, examiners tested 22 percent of the

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[4]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.

commercial loan amount. Sample selection for commercial real estate loans was judgmental, including bank-identified problem loans with a carrying value over $3 million and all other loans over $5 million. This bank's holding company had experienced rapid growth through numerous mergers and acquisitions in the 1980s, including a major merger which almost doubled the size of the bank during 1990. Examiners found a substantial portion of the loans they reviewed had underwriting weaknesses. In addition, OCC examiners disagreed with management's loan quality rating for 11 percent of the loans they reviewed, most of which were loans acquired in the 1990 merger. Examiners noted a lack of timeliness and accuracy in the ratings of the acquired loans. Even though these weaknesses were identified, examiners did not expand their review to determine the magnitude of such problems in the remaining 78 percent of the commercial loan portfolio, which included a substantial amount of loans acquired from other institutions.

Failure to review a representative sample of the loan portfolio and to expand that sample when problems are identified can result in bank failure before the extent and magnitude of its problems are determined by regulators. We found this to be the case in our review of the failed Bank of New England, where loan risk rating deficiencies were identified at the bank as far back as 1985.[5] However, OCC's coverage of the bank's loan portfolio between 1985 and 1989 was usually less than 30 percent, concentrating on large and bank-identified problem loans. During the 1989-1990 examination, OCC expanded its coverage to about 70 percent of the loan portfolio. OCC identified a substantial amount of loans with serious credit risks which had not been identified by bank management. OCC required the bank to increase its loan loss reserve by $1.4 billion, from $200 million to $1.6 billion. This loan loss provision had the effect of reducing the bank's equity capital to less than 2 percent of assets. The subsequent OCC examination report indicated that the bank was in imminent danger of failing. Bank of New England was taken over by FDIC in January 1991.

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.

We generally found that 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

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[5]Bank Supervision: OCC's Supervision of the Bank of New England Was Not Timely or Forceful (GAO/GGD-91-128, September 16, 1991).

detailed review of the loan portfolio. 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.

FDIC examiners used judgmental sampling techniques in all 11 examinations we reviewed, with loan coverage ranging from 18 percent to 61 percent of the dollar amount of the portfolios. 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 being irrelevant.

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[6] 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.

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.

The problems in reviewing loan quality also impact examiners' ability to evaluate the adequacy of the institutions' loan loss reserves. The majority of OCC, OTS, and FDIC examinations we reviewed did not provide a sufficient basis for examiners to determine the extent and severity of problem loans. As a result, examiners did not have a basis to assess the adequacy of loss

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

reserves on problem loans at these institutions. In addition, we found that examiners from all four regulatory agencies lacked 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.

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[7] 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. In practice, examiners used varying methods to evaluate reserve sufficiency, including set percentages of troubled loans or other rules of thumb, most of which failed to adequately assess the risks in the loan portfolios. Therefore, the examination process provided little assurance that institutions' reserves were adequate, and certainly no assurance that they were consistently evaluated.

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.[8] 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

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[7]Inherent losses exist when events or conditions have occurred which will ultimately result in specific loan losses, but which are not yet apparent as problems in individual loan quality.

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

significantly understated for the risks in the loan portfolio. Yet, examiners 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. Without a methodology to quantify the identified risks in the loan portfolio, examiners had no reasonable basis to determine the amount of the understated reserve or recommend specific improvements in the bank's methodology for estimating the reserve.

Regulators Lacked a Formal Program to Assess the Quality of State Examinations

FDIC and FRB sometimes relied on state examinations, but had not developed a formal program to review the quality of state examinations as a basis for relying on that work. 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 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 FDIC supervised banks that failed without warning, we found 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.

The following examples from the failed banks we reviewed illustrate instances where FDIC may have inappropriately relied on state examinations as a basis to delay its own examinations.

-- A state examination reported deterioration of the bank and improper intercompany transactions that were jeopardizing the bank safety and soundness. Nevertheless, the state rated the bank a "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 policy allowed for reliance 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 where FRB relied 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 examiners' work.

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. As OCC examines only nationally chartered banks, it did not rely on state examinations.

The FDIC Improvement Act of 1991 allows federal banking and thrift regulators to substitute state examinations for federal examinations on a limited basis if the federal regulator deems such action appropriate. However, lack of a formal review process could result in inappropriate reliance on state examinations and delay recognition of serious safety and soundness concerns.

LIMITED FRB HOLDING COMPANY INSPECTIONS LEFT INSURED BANK SUBSIDIARIES EXPOSED TO HARMFUL AFFILIATE ACTIVITIES

FRB inspections of bank holding companies assess their financial condition and compliance with restrictions on transactions between the insured bank subsidiary 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. Attachment I illustrates bank holding company intercompany transactions.

We judgmentally selected 7 bank holding companies of some of the nation's largest banks and reviewed inspections performed during 1990. These 7 holding companies had lead bank subsidiaries which accounted for 24 percent of the total assets of all banks with assets greater than $10 billion at the time of our sample selection. We performed a detailed review of the inspection working papers and reports in order to assess examiners' reviews of the impact of affiliate activities on insured bank subsidiaries. Our review disclosed that the bank holding company inspections 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 primary direct risk that holding company activities pose to bank subsidiaries is intercompany transactions with negative economic impact. However, 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. For example, examiners often did not review the terms of intercompany loans or the sufficiency of the related collateral, or test expense allocations to the insured bank subsidiary to determine the reasonableness of the fees or to determine if services were actually provided.

The FRB Inspection Manual includes 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. As with the bank examinations we previously discussed, FRB policy did not establish minimum, mandatory procedures to accomplish inspection objectives. Determination of actual procedures to be performed was left to the discretion of the field examiners.

In addition to the direct risk posed by intercompany transactions, asset quality problems at nonbank subsidiaries pose an indirect risk to the insured bank subsidiary. Yet we found that 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. The FRB Manual provided no definitive guidance for reviewing the asset quality of nonbank subsidiaries. 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.

At one of these 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.

As a result of these inspection deficiencies, adverse intercompany transactions and asset quality problems at the nonbank subsidiaries, which could have damaging financial consequences to the insured bank subsidiaries, may go undetected by regulators. This concern is intensified by ambiguities in accounting rules for the treatment of intercompany transactions. These rules do not provide clear guidance for the treatment of such transactions when their economic substance is different from their legal form. Such ambiguities 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 provide little or no benefit to the bank. These inadequate accounting rules, along with deficiencies in the inspection process, raise 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.

EXAMINATION AND INSPECTION QUALITY CONTROLS WERE INCONSISTENT

We found quality control deficiencies in almost all of the FDIC and several of the OTS examinations we reviewed. These deficiencies, including inadequate evidence of work performed and lack of documented 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 documented supervisory 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--especially in an environment where examiners have discretion in selecting examination procedures.

FRB and OCC examination working papers, as well as FRB inspection 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 and inspection 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. The FRB Inspection Manual did not provide any guidance with regard to working paper preparation or supervisory review of working papers.

OTS AND FDIC PERFORMED DUPLICATIVE EXAMINATIONS WITH SOMETIMES CONFLICTING RESULTS

Both OTS and FDIC examined thrifts with the same objective of assessing the safety and soundness of the thrift industry. The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (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. FIRREA 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.

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

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. For 5 of these examinations, FDIC and OTS examined the thrifts within 3 months of each other. This inconsistency between regulators confuses thrift management and undermines the credibility of the regulatory process.

FDIC and OTS signed a joint memorandum on May 18, 1992, that requires the two regulators to more effectively coordinate the examinations of thrifts. The provisions of this memorandum provide 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.

INCONSISTENCIES IN EXAMINATION PRACTICES COULD RESULT IN INEQUITABLE TREATMENT OF BANKS BY REGULATORS

As is evident from the discussion thus far, we identified significant inconsistencies among the regulators in their examination policies and practices. These inconsistencies included differences 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 does the assessment--as was previously described for OTS and FDIC safety and soundness ratings of the same thrift institutions for virtually the same time periods.

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 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. OTS's approach was to focus on "high risk" loans. Its overall portfolio coverage was very limited and the documentation of 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 also varied among the federal regulators. Examination frequency was inconsistent for the small OCC banks in our sample. OTS

consistently performed annual on-site examinations. FDIC and FRB programs allowed for reliance on state examinations in alternate years for small banks.

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. 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 required adjustments to record adequate loan loss reserves among institutions. These timing differences could, in turn, result in disparities in supervisory action by one regulator versus another, as could differences in loan quality review scope and examination timetables discussed above.

In addition to potential inequities and undue regulatory burden in the treatment of banks and thrifts, we are also concerned that these differences among the regulators will hinder how well the regulators address problems we found in our review. 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.

Although we did not study the efficiency and effectiveness of the regulatory structure as a whole, we believe the examination problems and inconsistencies we found are symptomatic of the difficulty of efficiently and effectively regulating the banking and thrift industries with four separate federal 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 during 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 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, [illegible], 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.

The Banking Act of 1933 imposed restrictions on group banking organizations' activities, which later became known as bank holding companies. 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.

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 period, deregulation initiatives enabled banks to assume more risk in their portfolios and at the same time reduced bank regulators' supervisory controls over banks. Additionally, the Garn-St Germain Depository Institutions Act of 1982 eliminated the real estate loan-to-value restrictions for national banks. Also during this period, several states expanded the powers of banks and thrifts, which enabled them to engage in high-risk activities such as speculative real estate lending. The regulators' examination staffing levels were also reduced during the early 1980s, resulting in increased use of off-site monitoring of institutions.

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 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 at a cost to the insurance fund of $24 billion. From 1990 through 1991, 296 banks failed costing the insurance fund an additional $11.3 billion. See attachment II.

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 the U.S. Treasury of nearly $47.4 billion. From 1990 through 1991, an additional 547 insured thrifts failed costing an additional $71.6 billion. See attachment III.

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.

The FDIC Improvement Act was enacted to try to control these risks. But there are additional real and potential problems which were not addressed by the act, including the bank examination quality issues and inefficiencies in the regulatory structure set forth in this testimony and related reports. In recent months, interest rate spreads have dramatically increased bank and thrift 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. Currently, bank supervision is weak and the efficiency of the regulatory structure is questionable. Also, 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.

CONCLUSIONS AND MATTERS FOR CONGRESSIONAL CONSIDERATION

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 activities of the holding company and nonbank subsidiaries are not adversely affecting the safety and soundness of the insured bank 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.

A summary of our recommendations to the regulators and matters for congressional consideration to correct the deficiencies we identified are included as attachment IV. Each of the four federal depository institutions regulators commented on our 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, even though 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, and raise concern that the overall quality and consistency of examinations and inspections will not be improved in the critical areas where we identified deficiencies. 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 House and Senate Banking Committees should urge the regulators to adopt our recommendations as minimum standards to provide a consistent and proactive approach to bank and thrift supervision to help minimize losses to the depository institution insurance funds. Absent adoption of such minimum standards by regulators, the Congress should consider legislating such requirements.

Weaknesses in the examination and inspection processes are further increased by flexible accounting rules in the areas of loan loss reserves for problem loans and related party transactions. We also have continuing concerns regarding accounting rules for investment securities, both current and proposed, which allow many such securities to be carried at cost even though the related market values may be significantly lower. To date, neither the Financial Accounting Standards Board (FASB)[9] nor the regulators have taken adequate action to address the accounting weaknesses in these

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[9]FASB is the accounting rule setting body that promulgates accounting principles, commonly known as generally accepted accounting principles, for private sector financial reporting.

areas. Although FASB has made some recent progress on its loan impairment project, we are not optimistic that the revised accounting rules in this area will be sufficiently definitive in requiring fair value accounting for nonperforming loans.

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[10] and investment securities and (2) the economic substance of related party transactions when materially different from 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.

In addition to addressing problems with examinations and accounting, we believe the effectiveness and efficiency of the entire regulatory structure should be critically analyzed. The current regulatory structure has evolved over more than 60 years as a patchwork of regulators and regulations, which has added unnecessarily to the burden on banks and the taxpayers. In addition, given the less effective performance of the regulatory system since the 1980s, we question the ability of the current regulatory structure to effectively function in today's complex banking and thrift environment. We believe the House and Senate Banking Committees, in conjunction with the administration, should assess the appropriateness of continuing with the present regulatory structure and develop viable alternatives to that structure.

In closing, I would like to spend a few minutes discussing the importance of following through on the fundamental safety and soundness reforms of the FDIC Improvement Act of 1991. We recognize that there may well be some unnecessary and overly burdensome regulations in effect and have a separate effort under way addressing that issue. Preliminary findings are expected this spring. However, regulations which are critical to protection of the safety and soundness of the banking and thrift industry should be vigorously defended.

The combination of higher risk banking and thrift industries and a weak regulatory system 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 better

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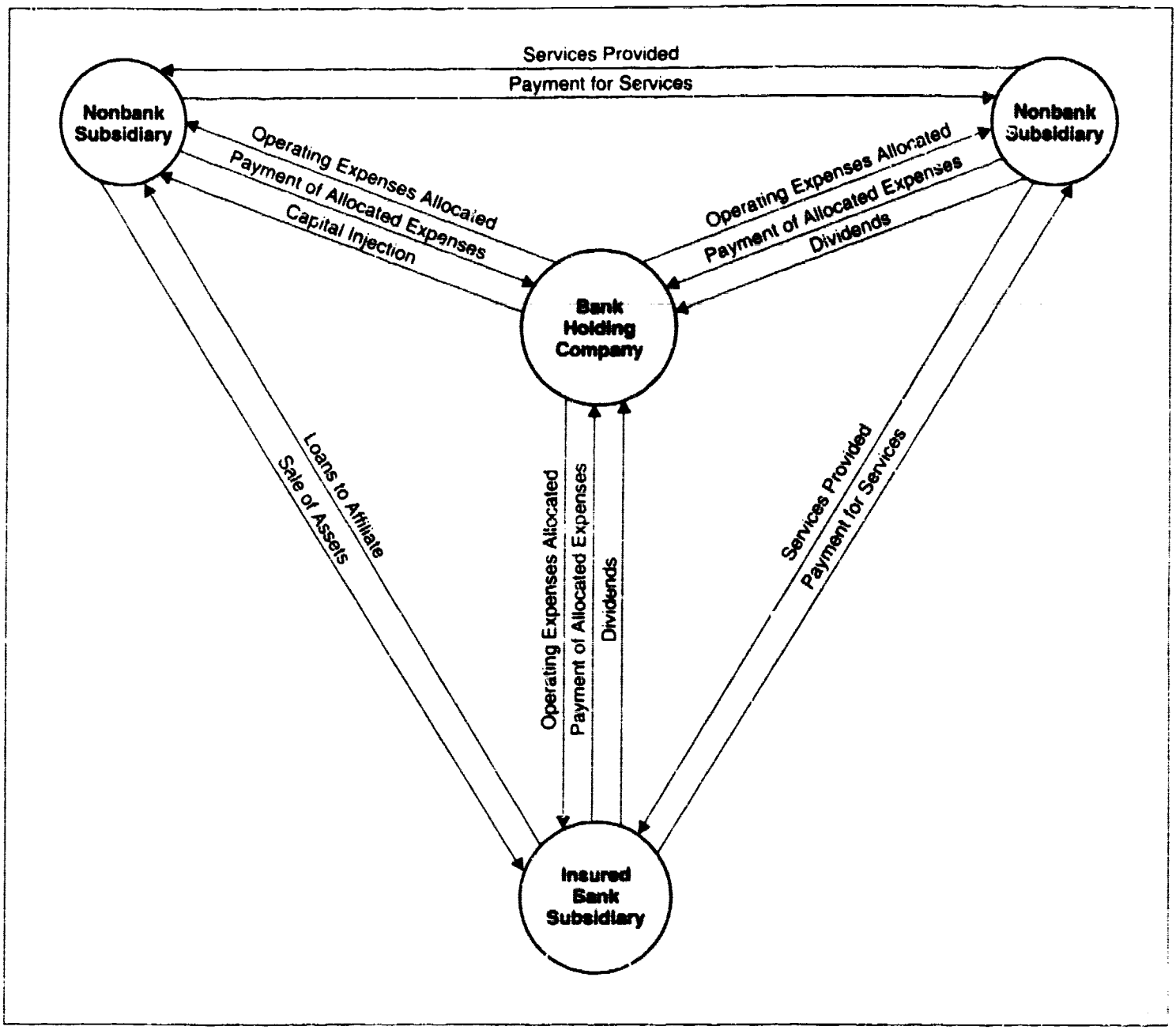
[10]Accounting rules for nonperforming loans were identified as a matter for congressional consideration in our June 1992 report, Depository Institutions: Flexible Accounting Rules Lead to Inflated Financial Reports (GAO/AFMD-92-52).

information on the condition and activities of insured depository institutions. The act also requires that the regulators develop standards by which to better judge unsafe and unsound conditions and provides mechanisms to correct such conditions in a timely manner. These reforms are critically linked to provide an early warning of safety and soundness problems and minimize future losses to the insurance funds. These reforms will not be overly burdensome to well-managed institutions and, in the long run, will be beneficial to these institutions as the industry as a whole becomes stronger. A healthy banking and thrift industry is the best support for long-term growth and prosperity of our economy, and should not be sacrificed for potential short-term rewards. Altering these reforms surely sets the stage for a repeat performance of past mistakes and their consequences.

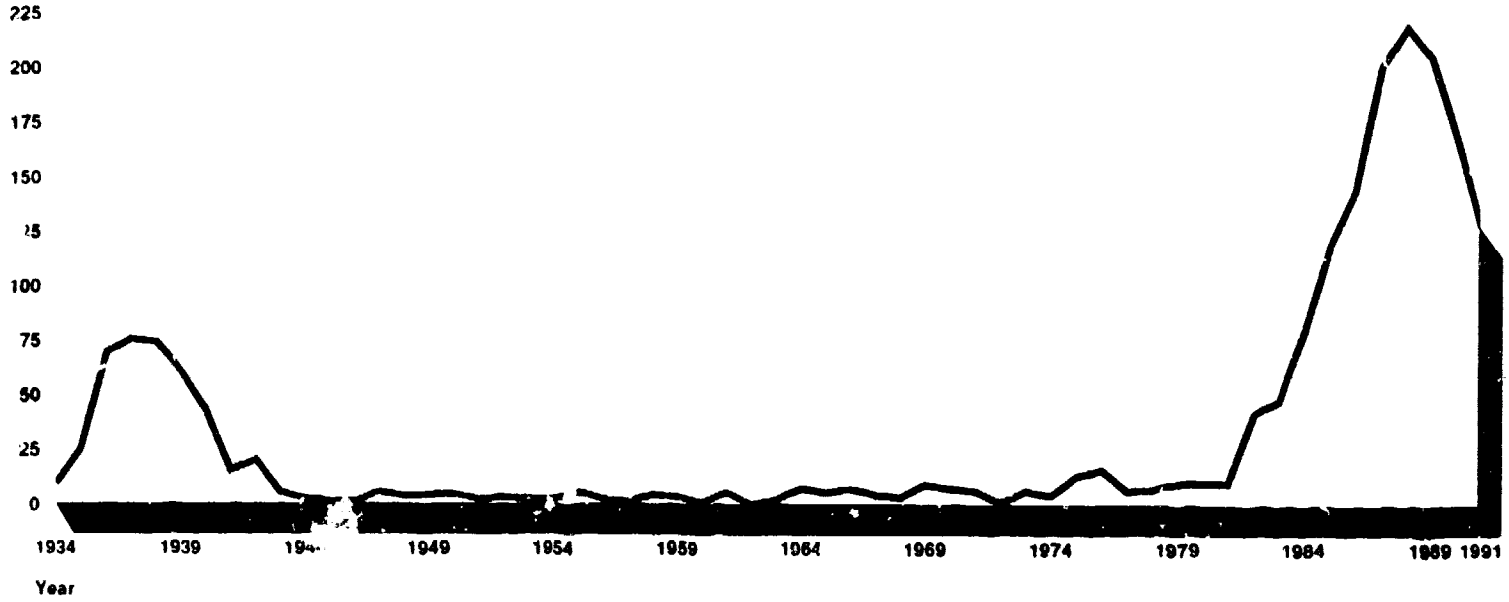
ATTACHMENT I

BANK HOLDING COMPANY
INTERCOMPANY TRANSACTIONS



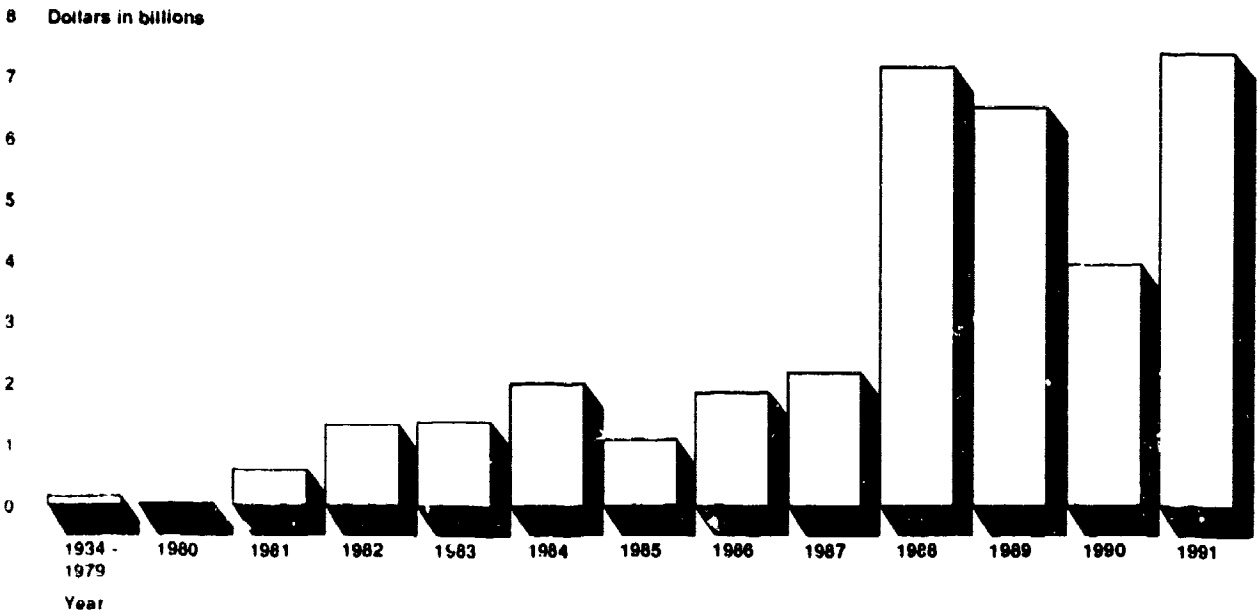
ATTACHMENT II

NUMBER OF RESOLVED FDIC INSURED BANKS



SOURCE: The Federal Deposit Insurance Corporation 1991 Annual Report

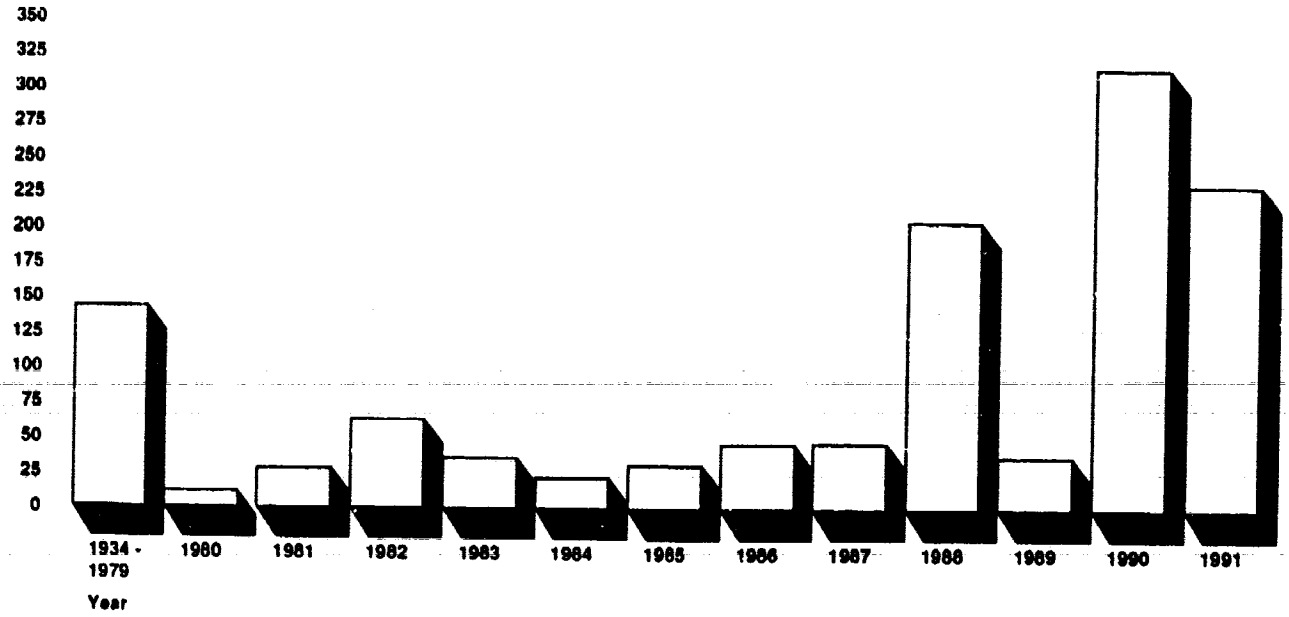
NET LOSSES IN RESOLVING INSURED BANKS



SOURCE The Federal Deposit Insurance Corporation 1991 Annual Report

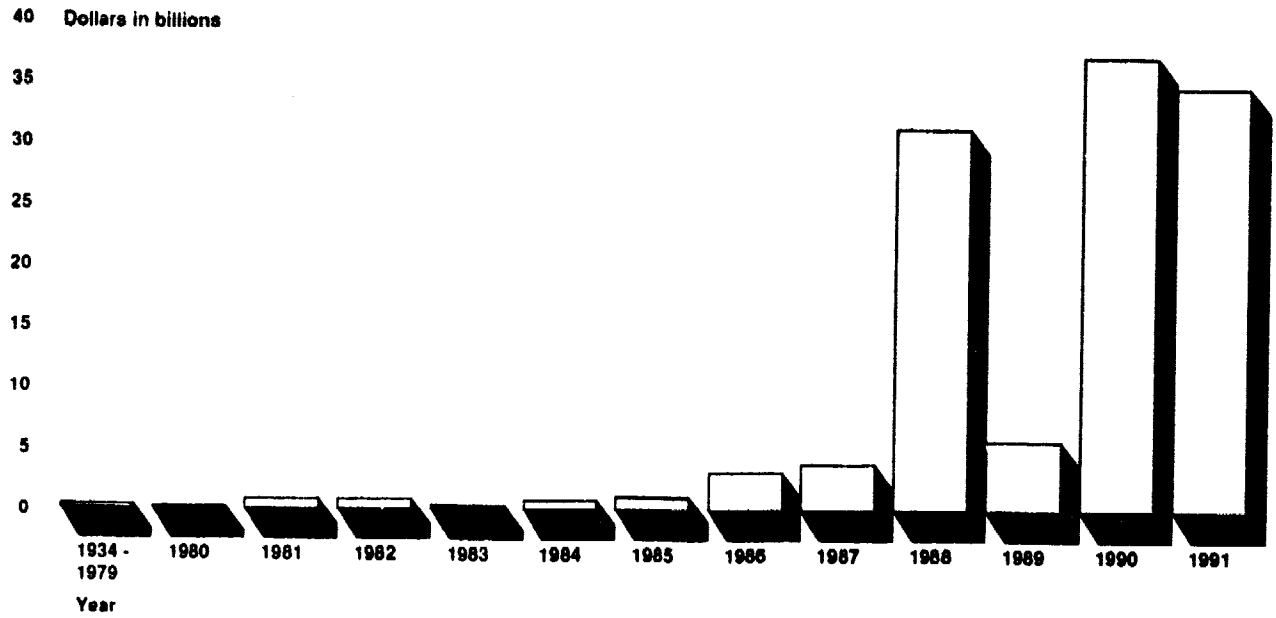
ATTACHMENT III

NUMBER OF FAILED THRIFTS



SOURCE: Data Submitted by the Office of Thrift Supervision

NET LOSSES IN RESOLVING FAILED THRIFTS



SOURCE: Data Submitted by the Office of Thrift Supervision

ATTACHMENT IV

RECOMMENDATIONS AND MATTERS FOR CONGRESSIONAL CONSIDERATION REGARDING BANK AND THRIFT REGULATION

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.

ATTACHMENT IV

The following is a summary of matters for congressional consideration presented in our summary report to the House and Senate Banking Committees.

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 to develop alternatives.