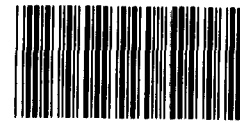


February 1993

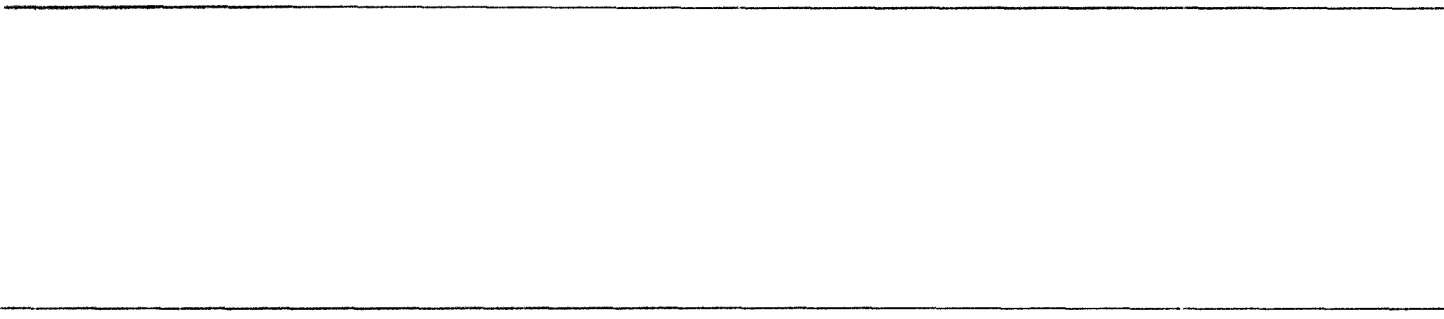
BANK EXAMINATION
QUALITY

OCC Examinations Do
Not Fully Assess Bank
Safety and Soundness



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United States
General Accounting Office
Washington, D.C. 20548

Comptroller General
of the United States

B-249589

February 16, 1993

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 presents the results of our review of bank examinations performed by the Office of the Comptroller of the Currency (OCC). Weaknesses in OCC examinations of loan quality and internal controls limited OCC's ability to fully assess banks' safety and soundness. Improving the quality of OCC examinations in these areas would aid the prompt detection and correction of problems which threaten bank safety and soundness. Improved examinations are critical to the effectiveness of the supervisory and prompt corrective action reforms recently enacted in the Federal Deposit Insurance Corporation Improvement Act of 1991.

We are sending copies of this report to the Secretary of the Treasury, the Comptroller of the Currency, other federal banking and thrift regulatory agencies, and other interested parties. Copies will be made available to others on request.

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 II.

Charles A. Bowsher
Comptroller General
of the United States

Executive Summary

Purpose

Record numbers of bank failures during the last 10 years have depleted the Bank Insurance Fund. The Office of the Comptroller of the Currency (OCC) is the primary federal regulator for nearly 3,800 nationally chartered banks with total assets of almost \$2 trillion. Bank examinations are the primary tool used by OCC to identify and control weaknesses that may lead to bank failures. GAO assessed the quality of OCC examinations by focusing on their coverage of bank internal controls and loan quality, including the reserve for loan losses. The assessment included examinations of 21 randomly selected banks, 14 of which had assets greater than \$10 billion.

Background

Based on the results of its examinations and other supervisory activities, OCC assigns ratings to banks for capital adequacy, asset quality, management, earnings, and liquidity. In addition, OCC assigns each national bank a composite rating for overall safety and soundness. Results of examinations also provide a basis for supervisory action and are a catalyst for bank closure.

A thorough knowledge of banks' internal controls is a necessary part of supervision and is of primary interest to examiners in evaluating the safety and soundness of bank operations. Pervasive internal control weaknesses can lead to serious deterioration of a bank's financial condition and, ultimately, to failure. Reviewing loan quality and the adequacy of loss reserves are also important components of bank examinations because loans ordinarily are a bank's single largest asset and represent the greatest potential for loss. Inadequate loan loss reserves are a common characteristic of banks which fail.

Results in Brief

OCC examiners did not comprehensively evaluate internal controls that were critical to the safe and sound operation of the banks they examined. Further, when control weaknesses were evident, examiners did not expand their reviews to determine the full extent of the weaknesses and their significance to the banks' financial condition.

OCC examinations did not provide a sufficient basis to assess the quality of the banks' total loan portfolio or the adequacy of the reserve for loan losses. Inadequate loan loss reserves are an unsafe and unsound banking practice and can mask the true financial condition of a bank and the possible need for regulatory intervention. In addition, quality controls over loan review working papers, though generally sufficient, could be improved.

Principal Findings

Critical Internal Controls Not Evaluated

OCC's Handbook stated that the foundation of the supervisory process is anticipatory supervision, requiring a thorough knowledge of the bank's policies, procedures, practices, and controls. Although the Handbook provided guidance for performing internal control assessments, OCC considered it to be only a reference document and allowed examiners discretion in determining the scope of an examination.

GAO found that examiners did not comprehensively review controls at 13 of the 14 large banks sampled or at 6 of the 7 small banks where examinations had been done at the time of GAO's sample. No on-site examination had been performed at the seventh small bank since 1984, and, therefore, OCC lacked current knowledge of the bank's internal controls. Based on these findings, GAO estimated that the lack of comprehensive review of internal controls existed for the most recent examinations of at least 72 percent of the large banks and at least 59 percent of the small banks supervised by OCC as of September 30, 1990. In addition, internal control weaknesses which were evident to examiners were not recognized as early warning signs of financial deterioration and were not specifically considered in assessing bank safety and soundness. Not performing adequate control testing constitutes a serious gap in the examination process.

The Federal Deposit Insurance Corporation Improvement Act of 1991 requires management of insured depository institutions with assets of \$150 million or more to annually assess and report on the condition of internal controls. The institutions' external auditors are required to review and report on management's assessment. These requirements are effective for institutions' fiscal years which begin after December 31, 1992. The institutions' and auditors' reports should provide an efficient tool for examiners to use in assessing internal controls and planning the scope of their examinations.

Insufficient Work Performed to Assess Loan Quality and Reserves

Determining loan quality is an important function of examinations because typically loans are banks' largest single asset and represent the greatest risk of loss.

GAO found that examinations for 10 of the 14 large banks and 6 of the 7 small banks did not include sufficient testing to determine the extent and severity of problem loans or the adequacy of the reserve for loan losses. As the seventh small bank had not received an on-site examination since 1984, examiners had no current basis for assessing loan quality and reserves. GAO estimated that insufficient testing of loans existed for at least 50 percent of large banks and 59 percent of small banks supervised by OCC as of September 30, 1990. Examiners assessed loan quality based on loan samples which excluded major segments of the banks' loan portfolios and thus were not representative of those portfolios. OCC had no minimum loan sampling criteria and in several cases told GAO that the level of loans reviewed during examinations was limited by examiner resource constraints.

As a result of the limited loan reviews, examiners did not have a sufficient basis to conclude that the full extent of problem loans and related losses had been identified. This limitation and the lack of a standard approach to evaluating a bank's overall loan loss reserve hindered the examiners' ability to assess the adequacy of the bank's loss reserves.

Adequate loan loss reserves are critical to bank safety and soundness and essential to early identification of deteriorating financial conditions. OCC's general guidance on risk factors that should be considered in establishing loan loss reserves, such as economic conditions and loan policies and procedures, did not provide a means for quantifying these risk factors. Lack of specific examination guidance for evaluating the adequacy of loan loss reserves, combined with the examiners' limited review of banks' loan portfolios, provides banks with the opportunity to delay recognition of losses in their loan portfolios and to mask the need for regulatory intervention.

GAO also found that documentation of loan review procedures performed by examiners, though generally sufficient, could be enhanced in order to better facilitate supervisory review. Supervisory review of examination working papers also was not always evident. OCC's Handbook included specific guidance regarding working paper documentation and review, but compliance was inconsistent because Handbook procedures were not mandatory. Improved documentation would allow for more efficient supervisory review. The review process is an important quality control measure to ensure that conclusions reached are properly supported.

Recommendations

GAO recommends that OCC establish policies to (1) ensure that annual comprehensive reviews of internal controls are performed by examiners, which include appropriate consideration of assessments of the internal control structure by bank management and its independent auditor required by the FDIC Improvement Act, (2) use appropriate sampling methodologies which provide representative coverage of the loan portfolio as a basis to determine loan quality, (3) develop and implement a specific methodology for evaluating the adequacy of bank loan loss reserves and reserve methodologies, and (4) require compliance with working paper documentation and supervisory review standards.

Agency Comments

OCC provided written comments on a draft of this report. These comments are presented and evaluated in chapters 2 and 3. OCC generally agreed with GAO's recommendations except for the need for a separate rating factor for internal controls. It also had reservations about GAO's recommendation regarding evaluation of loan loss reserves.

OCC agreed with GAO on the importance of assessing banks' internal control systems and planned several enhancements to examinations, including assessing internal controls at every multinational bank in 1993 and hiring more examiners. OCC believed that with its planned emphasis on internal controls assessment that a separate rating factor was not needed. GAO is encouraged by OCC's response, but believes that examinations of all banks should include an assessment of internal controls as a preventive measure for minimizing losses to the insurance fund. A separate rating factor for internal controls would help ensure that assessment of internal controls is emphasized during the examination.

OCC generally agreed with GAO that representative sampling methods should be used to assess loan quality and plans to assess the results of an ongoing pilot program to determine how representative sampling methods can complement OCC's current loan review program. OCC is concerned about the feasibility of developing a more specific methodology for assessing the adequacy of a bank's total loan loss reserves, but stated it is committed to continuing to improve its methods. GAO acknowledges the difficulty of the task, but such difficulties are compounded when hundreds of examiners are attempting to make judgments about the adequacy of banks' loan loss reserves without the benefit of a standard methodology.

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Abbreviations

BC	Banking Circular
CAMEL	capital adequacy, asset quality, management, earnings and liquidity
FDIC	Federal Deposit Insurance Corporation
FRB	Federal Reserve Board
OCC	Office of the Comptroller of the Currency
OTS	Office of Thrift Supervision

Introduction

The purpose of our review was to determine whether the examinations conducted by the Office of the Comptroller of the Currency (OCC) provided an adequate basis for assessing the safety and soundness of banks OCC supervised. Specifically, this report discusses how well OCC examiners assessed the effectiveness of bank internal controls, the quality of loans, and the adequacy of loan loss reserves.

The Bank Insurance Fund administered by the Federal Deposit Insurance Corporation (FDIC) ended 1991 with a deficit balance of \$7 billion due to 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, at an estimated cost to the fund of almost \$24 billion.

In response to the nation's banking problems, the Congress passed the Federal Deposit Insurance Corporation Improvement Act of 1991 (Public Law 102-242). 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 the 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.

This legislation also provided major reforms in the banking industry, including expanded regulatory powers, revised capital standards, a requirement for audited financial statements and internal control reporting requirements for larger institutions, and revised examination frequency requirements. These reforms are a positive step towards correcting the problems faced by the banking industry. The effectiveness of these reforms, to a large degree, hinges on the bank examination process, which is the primary vehicle by which regulators assess the safety and soundness of banks.

Background

The responsibility for regulating financial institutions is divided among four federal regulators. The Office of the Comptroller of the Currency

(OCC) is the primary regulator for nationally chartered banks. The Board of Governors of the Federal Reserve System (FRB) regulates state-chartered banks that are members of the Federal Reserve System and bank holding companies. FDIC (the insurer for all federally insured depository institutions) regulates state-chartered banks that are not members of the Federal Reserve System. The Office of Thrift Supervision (OTS) regulates savings and loan institutions and savings and loan holding companies.

We assessed examinations conducted by FDIC, FRB, and OTS in separate reports.¹ The four regulatory agencies periodically form interagency working groups to address issues which impact all federally insured depository institutions.

OCC, under the Department of the Treasury, is responsible for promoting and monitoring the soundness of the national banking system. As of December 31, 1991, OCC was the primary regulator for 3,778 nationally chartered banks with total assets of almost \$2 trillion. These banks represented nearly 31 percent of the nation's insured commercial banks and accounted for about 54 percent of their assets.

From 1987 to 1991, the number of national banks decreased by approximately 18 percent, while the total assets of the banks increased by approximately 12 percent. During this same time period, the overall condition of national banks deteriorated, as evidenced by the growing number of failed and problem banks, which peaked in 1990 but remained relatively high in 1991. Table 1.1 shows the number and total assets of banks supervised by OCC from 1987 to 1991, as well as the number of problem and failed national banks.

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

Table 1.1: Number, Assets, and Condition of Banks Supervised by OCC

Dollars in trillions

Year-end	Total banks	Total assets	Total problem and failed banks	Failed and problem banks as a percentage of total banks
1987	4,603	\$1.77	376	8.17
1988	4,333	1.85	412	9.51
1989	4,165	1.98	423	10.16
1990	3,968	1.98	468	11.80
1991	3,778	1.99	412	10.91

Supervisory Approach

The essential objectives of bank supervision are (1) to provide an objective evaluation of a bank's soundness, (2) to appraise the quality of bank management and directors, and (3) to identify and follow up in those areas where corrective action by management is required to strengthen the bank, improve the quality of its performance, and enable it to comply with applicable laws, rulings, and regulations. To achieve these objectives, OCC uses a combination of off-site monitoring activities and on-site examinations.

OCC uses a computerized supervisory monitoring system to track the financial condition of national banks. This system aids in (1) the early warning, identification, and monitoring of problem banks, (2) the determination of possible systemic problems within the banking industry, and (3) the estimation of resources needed to monitor and supervise banks. The system contains information for each bank on its current financial condition, compliance performance, previous examination results, and supervisory concerns.

Primary supervisory responsibility for each national bank rests with a portfolio manager. Using the supervisory monitoring system as a tool, the portfolio manager identifies risks specific to each bank supervised and develops annual supervisory strategies to address the risks. These strategies describe the overall supervisory objectives for the coming 12 months, along with plans for supervisory activities to accomplish those goals. OCC allocates its supervisory resources based on the identified risks, giving highest priority to large and problem banks.

Off-site activities generally consist of a review and analysis of bank-submitted data, including quarterly call reports.² These activities aid in the formulation of a supervisory strategy for the bank, including identifying and planning for on-site activities. The objectives of on-site activities are to: (1) test and reach (or reaffirm) conclusions about the reliability of banks' systems, controls, and reports, (2) investigate changes or anomalies disclosed by off-site monitoring and analysis, and (3) evaluate those aspects of banks' operations for which portfolio managers cannot rely on the banks' own systems and controls. These on-site activities are carried out in the form of the bank examination. The on-site bank examination allows for the use of objective, first-hand information as a basis for reaching conclusions about the condition and quality of the bank and its management.

At the time of our review, on-site examinations conducted by OCC generally were not full-scope because OCC placed a great amount of reliance on off-site monitoring. OCC examiners generally devoted their on-site efforts to those risks identified in the supervisory strategies. Thus, unless an area of bank operations was specifically identified as a risk in OCC's supervisory strategy, it was not likely a target for on-site examination.

Guidance on how an examination is to be performed is provided in examining circulars, bulletins, the Comptroller's Handbook for National Bank Examiners, and other handbooks relating to consumer, compliance, fiduciary activities, and electronic data processing examinations. This guidance emphasizes that examiners are to use experience and judgment in deciding on an examination scope and the procedures to be employed. OCC also issues annual operating plans that identify systemic supervisory concerns which should be incorporated into the supervisory strategies of each national bank.

OCC rates five critical areas of banking operations—capital adequacy, asset quality, management, earnings, and liquidity (commonly referred to by the acronym CAMEL)—using a five-point scale, with 1 as the best rating and 5 as the worst. Based on the overall condition of the institution, a composite CAMEL rating is also determined. A composite rating of 1 is assigned to institutions that are basically sound in every respect. Most findings at these banks are minor and may be corrected in the normal course of business. Banks assigned a composite rating of 5 exhibit an extremely high immediate probability of failure. Without urgent and decisive corrective

²Call reports are prepared by bank management and submitted to FDIC on a quarterly basis. Call reports consist of a balance sheet, income statement, and various supporting detailed analyses of balances and related activities.

action, 5-rated banks will likely fail and require some form of assistance from the Bank Insurance Fund. Banks with composite ratings of 3 exhibit financial, operational, or compliance weaknesses ranging from moderately severe to unsatisfactory. At least annually, OCC issues a report to each bank's board of directors, which states the composite CAMEL rating that reflects OCC's view of the bank's operations and condition.

Loan quality is a major focus of bank examinations because loans are generally a bank's largest asset and are the primary source of earnings and capital. Regulators review loan portfolios to ensure that bank management has identified loans with a higher than normal risk of default. Bank management is required to identify problem loans and establish reserve accounts for estimated losses in the event loans become uncollectible. If the banks' reserves are deemed insufficient, regulators may require banks to establish larger reserves for future losses.

Objective, Scope, and Methodology

The overall objective of our review was to assess the effectiveness of OCC's examination process for evaluating the safety and soundness of national banks. Specifically, we determined whether OCC examiners

- performed a comprehensive evaluation of banks' internal controls,
- conducted a thorough analysis of banks' loan classification systems to determine the level and distribution of problem loans, and
- evaluated the adequacy of the loan loss reserves and banks' methodologies for establishing their reserves.

We previously reported³ that regulatory enforcement actions tended to focus on capital inadequacy, which is typically a lagging, rather than a leading, indicator of bank problems, as opposed to focusing on the underlying causes for capital deterioration. Our analysis showed that capital difficulties were frequently caused by losses from bad loans. Our past work has also shown that the allowance for loan and lease losses was substantially understated for banks that failed and that weaknesses in internal controls over bank operations contributed significantly to bank failure.⁴ Therefore, we focused our work on the examiners' review of internal controls and loan quality, including the allowance for loan and lease losses.

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

⁴Failed Banks: Accounting and Auditing Reforms Urgently Needed (GAO/AFMD-91-43, April 22, 1991).

To select examinations for review, we obtained a listing of the 4,017 OCC-regulated banks as of September 30, 1990. We randomly selected 14 of the 35 banks with assets greater than \$10 billion (large banks) and 7 of the 3,982 banks with assets of less than \$10 billion (small banks). The statistical nature of our samples of large and small banks allowed us to project the results of our work to the relevant populations. 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 indicates that the deficiencies we identified affected a significant segment of the examinations. Our projections are made at the 95 percent confidence level.

We determined the supervisory history of the selected banks by reviewing information from OCC's supervisory monitoring system, OCC reports to the banks' boards of directors issued since 1987, call reports, external audit reports and management letters, and other information provided by OCC. We reviewed the examiners' working papers supporting OCC's most recent on-site safety and soundness examination (at the time of our review) for each bank.

To assess OCC's work addressing bank internal controls, we reviewed examination working papers and reports to determine if examiners identified key controls in all significant areas of bank operations; evaluated the effectiveness of those controls either by assessing work performed by the banks' auditors or by testing the controls themselves; and, where controls were either lacking or were ineffective, expanded the scope of their examinations to verify that affected bank data were properly recorded.

To assess OCC's work addressing loan quality, we concentrated on commercial loans because these generally represent the greatest risk to the banks. We reviewed examination working papers from the most recent OCC examination to determine if examiners' work supported their conclusion on the accuracy of the banks' loan risk rating systems and the overall condition of the banks' commercial loan portfolios.

To assess OCC's work addressing the allowance for loan and lease losses, we determined if the examiners evaluated the banks' allowance methodologies in accordance with criteria outlined in Banking Circular 201, which is the primary OCC guidance for banks and examiners on establishment of loan loss reserves. In cases where examiners determined

that the banks' allowance methodologies were inadequate or that the banks' loan risk rating systems were inaccurate, we reviewed how the examiners concluded on the adequacy of the allowance amounts.

We also reviewed OCC's examination handbooks, annual operating plans, various banking circulars and bulletins, and other guidance to OCC examiners regarding the review of internal controls and loan quality. Further, we discussed examination activities with OCC examiners-in-charge, field office personnel involved in the examinations, district officials who supervised some examinations, and headquarters officials responsible for the large bank examinations.

Our work was performed at OCC headquarters in Washington, D.C., at OCC duty stations in Newark, N.J. and Boston, Mass., and at OCC sites at various banks throughout the country. We conducted our review between December 1990 and January 1992 in accordance with generally accepted government auditing standards. OCC provided written comments on a draft of this report. These comments are presented and evaluated in chapters 2 and 3 and are included in appendix I.

Evaluations of Critical Internal Controls Not Performed

Examiners did not perform sufficient procedures to evaluate critical internal controls for 20 of the 21 examinations we reviewed. OCC's Examination Handbook included a thorough discussion of the importance of assessing internal controls, both as a basis for determining examination scope and for identifying specific weaknesses and recommendations. However, OCC allowed examiners considerable discretion in determining what examination work to perform, and they viewed the Handbook as guidance rather than required procedures. In addition, OCC officials told us they did not have adequate resources to perform internal control assessments at all banks they examined. In light of our prior reports showing that internal control weaknesses are a major cause of bank failures, inadequate testing of controls in areas essential to the safe and sound operation of banks constitutes a serious gap in the examination process.

Strong Internal Controls Are Essential to Bank Safety and Soundness

Internal controls promote bank safety and soundness by preventing problems or irregularities from occurring, or by identifying them early enough for management to take corrective action. The system of internal control comprises the bank's plan of organization and all methods and measures adopted by the bank to safeguard its assets, ensure the accuracy and reliability of accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies.

Internal controls impact all major operational areas of banks including loans, securities investments, property and equipment, customer deposits, capital, and revenue and expenses. Each of these areas is critically important to profitable operations. Further, each can contribute to rapid financial deterioration because of adverse economic conditions, improper management practices, fraud, or abuse. A properly designed and functioning internal control system includes policies and procedures that cover all operational areas of the bank to protect it against adverse conditions and improprieties and ensure that it operates in a safe and sound manner.

Controls over loan operations are of paramount importance because loans typically comprise most of the banks' assets and involve significant risk. Internal controls for loans protect and facilitate an accurate accounting for the bank's assets from the time a loan is applied for by a prospective borrower to the time the borrower repays the bank. This covers the initial application process; loan authorization and disbursement; and loan servicing, accounting, and collection. Controls include the loan policies

and procedures which provide assurance that, among other things, loans are not made that involve risks the bank is not properly equipped to handle—risks resulting from factors such as geographical location of the borrower, size of the credit, purpose of the loan, or industry involved. These controls help ensure that (1) bank personnel properly document loan information prior to approval and disbursement of funds so that credits are extended only to creditworthy applicants, (2) complete and current credit information is maintained on each borrower throughout the life of the loans so that bank management is made aware of any repayment problems as soon as they develop, and (3) effective collection actions are taken in a timely manner against borrowers who fail to make payments according to loan terms.

Finally, controls over the allowance for loan losses provide assurance that charge-offs and recoveries of bad loans are properly authorized, and that the bank's computation of the allowance includes, among other things, consideration of general and local economic conditions, trends in loan growth, concentrations of loans, delinquent and other problem loans, and the extent to which renewals and extensions have been used to keep loans current.

Internal Controls Not Systematically Tested for Large Banks

Examiners did not systematically identify, test, and evaluate critical internal controls of 13 of the 14 large banks in our sample. Based on these findings, we estimate these review limitations existed for at least 72 percent of the most recent large bank examinations performed by OCC.¹ Failure to effectively evaluate the system of internal controls could result in examiners not recognizing unsafe or unsound practices before they lead to deterioration in the banks' financial condition.

OCC's Handbook stated that the foundation of the supervisory process is anticipatory supervision, requiring a thorough knowledge of the bank's policies, procedures, practices, and controls. Only when the examiner completely understands the bank's system can an assessment and evaluation be made of the effects of internal controls on the examination. Performing thorough reviews of controls at the beginning of the examination allows examiners to identify the areas with weak controls and therefore higher risk, as well as areas with strong controls and therefore lower risk. This allows examiners a basis to efficiently and effectively focus the examination. Only after an evaluation of internal

¹The range of our estimate, at a 95 percent confidence level, is that these review limitations existed for the most recent examinations (at the time of our review) for between 72 percent and 98 percent of the large banks supervised by OCC as of September 30, 1990.

controls has been performed is there reasonable basis to exclude major areas of a bank's operations from further examination procedures, and then only if the controls are found to be functioning effectively.

The Handbook provided guidance for performing internal control assessments, including sample internal control questionnaires for many areas of banking activity. OCC officials, however, told us the Handbook is used only as a reference, and examiners are allowed flexibility in deciding the examination scope and the procedures to be employed. They also said that internal controls are generally reviewed only in targeted examination areas and internal control questionnaires are not consistently used. Examination working papers showed no evidence that examiners systematically identified and tested critical controls in the areas they reviewed.

Working papers covering targeted examination areas often included copies of bank policies, procedures, internal audit reports, notes from discussions with bank management, management information systems reports, and organization charts. However, in 13 of the 14 large bank cases we reviewed, examiners did not document

- the critical control procedures which applied to all operating areas;
- whether those controls, if followed, were adequate to prevent undesirable activities;
- their conclusions on whether the controls in nontargeted areas were operating effectively; and
- how the results of their assessments affected the planned examination scope.

OCC officials told us that experienced examiners did not need to use the questionnaires to evaluate the adequacy of controls and that much of the control work they performed was not documented in the working papers. However, without documentation of the critical controls, the procedures performed to test those controls, and the results of the tests, OCC had no assurance that an effective evaluation of those controls had been made.

We found only one case where internal control reviews were performed in nontargeted examination areas. This is of particular concern since OCC's targeted examination approach excludes significant portions of the banks' operations. Without internal control assessments in these areas, there is a high likelihood that examiners would not discover serious control

problems until significant damage to the banks' financial condition resulted.

OCC officials told us they considered internal control assessments in the nontargeted areas more appropriate work for the banks' internal auditors, and that OCC did not have sufficient resources to perform comprehensive internal control assessments at all of the banks they supervised. We agree that efficiencies could be achieved in the examination process by using the internal control work of the auditors. Examiners, however, should only rely on internal control work performed by the banks' audit function after sufficient review and evaluation, and then only if the auditors are competent and independent and their audit programs adequate and effective.

Examiners at 7 of the 14 large banks we reviewed told us they relied to some extent on the bank's internal auditors to review controls in nontargeted examination areas. We found, however, no documentation of such reliance. In several cases, we did find an evaluation of internal audit qualifications, but examination working papers did not indicate the scope of the work the auditors performed or whether examiners reviewed the adequacy or effectiveness of such work. Without an understanding of the breadth and depth of the auditors' work, examiners cannot be assured that adequate procedures were performed by the auditors in the nontargeted examination areas.

For two banks where examiners relied on internal audit, we found that examiners had performed no evaluations of the internal audit unit since 1987. All of these banks experienced significant growth through mergers and acquisitions since OCC last assessed the audit unit. Such growth could significantly impact the effectiveness of the internal audit unit.

At one large bank in our sample, we believe examiners did sufficient work to evaluate the bank's internal control systems. Specifically, examiners reviewed the internal audit function, including the scope and adequacy of work performed, evaluated internal controls in all significant areas of bank operations, tested controls over loans, documented the reliance placed on the internal auditors for specific bank operating areas, and used the internal control questionnaires from their Examination Handbook to assess controls in nontargeted exam areas.

Limited Supervisory Attention Was Given to Small Banks

We found that on-site safety and soundness examinations at all of the seven smaller banks in our sample were too infrequent and limited in scope to assess the effectiveness of these banks' internal control systems. Based on these findings, we estimate these review limitations existed for at least 59 percent of small bank examinations performed by OCC.²

OCC concentrated its resources at large banks, and, therefore, in some cases, small banks did not receive supervisory attention until capital or other problems became severe. For example, one small bank in our sample had not had an on-site safety and soundness examination since 1984. The OCC portfolio manager recommended on-site visits to this bank because of concerns over management competency, lack of a problem loan identification system, and increases in past due loans from 1.47 percent of total loans at September 30, 1988 to 5.99 percent at August 31, 1990. These recommended examinations were not conducted as scheduled due to staffing constraints.

Two other small banks 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 very limited in scope, included little or no review of internal controls, and were performed by less experienced examiners.

OCC's examination scope at the other four small banks generally included some review of bank policies and procedures in targeted examination areas. However, no identification and testing of controls was performed to assess the bank's compliance with these policies and procedures. In addition, no review of internal controls was performed in the nontargeted examination areas of these banks.

Examiners we interviewed told us that more staff were needed to adequately assess small banks, and more experienced staff were needed at the large banks due to the growing complexity of banking. OCC officials agreed that, during the time frame covered by our review, their examinations of small banks were lacking due to their need to shift staffing to the growing number of large, problem banks. They noted that four of the seven smaller banks in our random sample were located in their Northeast and Southwest Districts, where they have the most large and problem banks and had difficulty retaining staff. Officials also said that providing training to their staff has been a problem because of

²The range of our estimate, at a 95 percent confidence level, is that these review limitations existed for the most recent examinations (at the time of our review) of between 59 percent and 100 percent of the small banks supervised by OCC as of September 30, 1990.

examination priorities, and training was deferred for 1990 and 1991. They believe it takes 4 to 6 years to fully train an inexperienced new hire.

Severity of Internal Control Weaknesses Not Recognized by Examiners

Although examiners did not perform comprehensive reviews of banks' internal controls, in several cases their limited reviews in targeted areas identified serious control problems in bank operations. However, examiners did not expand their reviews to determine the magnitude of these weaknesses, nor did they appear to consider the problems in their determination of the banks' safety and soundness ratings.

Examiners are directed to consider internal controls, operating procedures and all lending, investment, and operating policies in determining their rating for bank management. We found several cases, however, where serious internal control problems were cited in examiners' reports to bank management for several years, but OCC's rating of bank management did not reflect such problems until serious asset deterioration was evident. Several examiners told us that they determined the management rating based primarily on the financial performance of the banks.

For example, at one large bank in our sample, OCC's 1987 reports to bank management noted problems with the inaccurate identification of credit risk, lack of independence of the internal audit unit, and ineffective management information systems. The 1988 reports highlighted operational problems, including the lack of timely risk reviews for commercial real estate, and found a frequent pattern of operational lapses and high incidence of policy and procedural breaches pointing to an inattentiveness to control discipline. Up to this point, OCC had rated bank management as "2" (satisfactory). The 1989 report cited the previous serious management problems and noted a complete failure in the control environment, including internal audit and risk review. OCC characterized the condition as "appalling." This assessment was made in conjunction with examiners' identification of significant deterioration in asset quality. At this point, OCC's rating of bank management went to "3" (unsatisfactory) and then to "4" (poor) several months later.

In October 1989, OCC and the bank entered into a formal agreement, which, among other things, called for a complete review of the bank's internal controls. This review, conducted by the bank's external auditors, identified over 7,000 internal control weaknesses, of which they classified about 500 as significant.

For another large bank in our sample, the examiners' reports in 1988 and 1989 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 internal control weaknesses were evidenced by such significant asset quality deterioration that OCC identified the bank as in imminent danger of failing.

In our 1991 review of the failed Bank of New England,³ we found that internal control problems including inadequate loan review, concentration in commercial real estate, and aggressive underwriting were evident in OCC's reports to bank management as far back as 1985. OCC continued to rate the bank's management "2" until 1989 (when the rating was changed to "3"), even though these deficiencies had been consistently noted. In addition, OCC did not expand its review in these problem areas in its examinations from 1985 to 1989 in order to identify the magnitude of the weaknesses. In 1990, OCC identified the bank as in imminent danger of failing. The bank was declared insolvent in January 1991. The estimated cost of this failure to the Bank Insurance Fund is over \$1 billion.

Had examiners been performing comprehensive internal control reviews at these banks, they should have recognized the breadth and depth of the weaknesses in time to direct bank management to take corrective action and avoid irreversible financial deterioration. However, not only did their failure to perform comprehensive internal control assessments preclude them from identifying all control problems, but those they did identify were not given serious consideration in rating the banks' safety and soundness.

New Law Can Strengthen OCC Internal Control Reviews

The FDIC Improvement Act of 1991 (Public Law 102-242) requires federally insured banks 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, 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 and procedures

³Bank Supervision: OCC's Supervision of the Bank of New England Was Not Timely or Forceful (GAO/GGD-91-128, September 16, 1991).

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 management and auditor reporting requirements in the act are intended to (1) focus management's attention on its accountability for internal controls and compliance with laws and regulations and (2) improve the regulatory agencies' ability to detect unsafe and unsound conditions and support prompt regulatory action to ensure that deficiencies which may threaten an institution's solvency are corrected in a timely manner.

The scope of work required for external auditors to attest to bank management's assertions regarding the effectiveness of internal controls and compliance with laws and regulations is greater than the internal control and compliance work required by generally accepted auditing standards for opining on the fair presentation of an institution's financial statements. Generally accepted auditing standards require the auditor to obtain a general understanding of the entity's internal control structure. However, only the controls that the auditor relies on during the course of the audit have to be thoroughly tested and evaluated. Regarding illegal acts, the auditor's responsibility is to detect and report misstatements resulting from such acts that have a direct and material effect on the financial statement amounts. Satisfying the requirements of the FDIC Improvement Act should result in the auditor obtaining a more thorough knowledge of the institution's controls and operations and providing an independent assessment of the credibility of management's report.

These new requirements should significantly enhance the likelihood that examiners will identify emerging problems in banks earlier. Also, by relying on the more thorough work now required of external auditors, regulators should be able to concentrate their resources in other parts of the examination for those institutions covered by the act and obtain substantively better coverage of internal controls. However, to obtain the expected benefits, the regulators will need to review management's assessment and the external auditor's internal control work, including working papers, policies, and procedures, 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.

Institutions with less than \$150 million of assets are not required to report under the act. For those, the regulators will need to assess what, if any, internal control work has been performed by bank management and the external auditors, and may have to independently test the effectiveness of internal controls and compliance with laws and regulations during their examinations.

We believe it is important that these smaller banks even though less complex, receive the same comprehensive internal control evaluation as larger institutions. 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, and thus contributed substantively to its deficit at the end of 1991.

Conclusions

OCC's failure to perform systematic identification, testing, and evaluation of key controls significantly increased the possibility that serious control weaknesses were not detected by examiners before they resulted in permanent damage to the bank's financial condition. In addition, examiners' failure to recognize the pervasive nature of control weaknesses they did identify deterred them from requiring corrective action for the deficiencies and from appropriately considering the weaknesses in the safety and soundness rating of the bank. Further, the CAMEL rating does not include a separate factor for internal controls and examiners did not focus on this area in determining the ratings of the banks.

Additional internal control reporting requirements for bank management and the external auditors included in the FDIC Improvement Act can significantly enhance examiners ability to verify the adequacy of internal control systems for banks with assets of \$150 million or more. These requirements will allow examiners to make the most efficient use of their resources by using internal control work performed by management and the auditors, providing they evaluate and document the scope and quality of the work performed. However, the act does not require annual reports from banks with assets of less than \$150 million. While the control systems of these smaller banks may be less complex, they are still critical to safe and sound operations and therefore require thorough reviews by examiners as part of each annual examination.

Recommendations

We recommend that the Comptroller of the Currency take the following actions:

- Develop comprehensive internal control review procedures for all major aspects of bank operations to be used during OCC's annual on-site examinations. The procedures should identify any major risk areas in each bank's operations, identify the related significant internal controls, and require testing to assess the effective operation of the internal controls.
- Require examiners to rely on the assessments required by the Federal Deposit Insurance Corporation Improvement Act of 1991 to the extent possible, and supplement these assessments as necessary to ensure a comprehensive assessment of internal controls. As a basis for reliance, direct the examiners to use the internal control review procedures as guidance in reviewing the quality of management's and the external auditor's internal control assessments required by the act.
- Require examiners to conduct independent comprehensive reviews of internal controls of banks with assets of less than \$150 million.
- Require that the condition of a bank's system of internal controls be added to the CAMEL rating as a separate critical area for rating to highlight the significance of internal controls to a bank's viability.
- Coordinate the implementation of the internal control recommendations with the other federal depository institution regulatory agencies to achieve uniform requirements.

Agency Comments and Our Evaluation

In its comments on a draft of this report, OCC concurred with the importance of assessing the quality of a bank's internal control systems, but only partially agreed with our finding that its examiners did not systematically test critical internal controls. It said that documentation weaknesses made it difficult for us to determine the full extent of internal control testing by OCC examiners. OCC also stated that experienced examiners can "condense" internal control review procedures with "little loss of effectiveness." As discussed in this chapter, we believe a comprehensive assessment of internal controls must include systematic identification, testing, and evaluation of critical internal controls. We found little or no evidence of such systematic internal control assessments in the OCC examinations we reviewed. We do not believe it is possible to make an effective assessment of internal controls without documenting the identified controls, the tests performed on those controls, and an analysis of the results of those tests, particularly in the cases of the large banks with highly complex systems.

OCC also stated that it has taken several steps, including hiring additional examiners, to ensure proper assessments of control systems since we performed our examination reviews. It stated that under its 1992 supervision operating plan, management appraisal procedures, including procedures to assess internal controls, were to be conducted during examinations of all banks with over \$1 billion in assets. Its 1993 operating plan includes a program to assess the adequacy of internal controls in every multinational bank. We are encouraged by OCC's recognition of the importance of strengthening its work in this area. However, we are concerned that OCC has limited its current plan for internal control assessments to multinational banks only. We believe that an annual full scope examination, which is required by the FDIC Improvement Act of 1991 for banks with assets of \$100 million or more, should include an assessment of internal controls. Such a "preventive" regulatory approach applied to all banks will aid in reducing the number of future problem banks.

OCC agreed with our recommendation to use, to the extent possible, the internal control assessments to be performed by bank management and their external auditors under the FDIC Improvement Act, and to supplement these assessments as necessary to ensure a comprehensive review of bank control systems. It stated that it is developing procedures to incorporate the external auditors' work into the examination process, including a methodology to test and evaluate that work.

OCC did not agree that a separate CAMEL rating factor specifically relating to the examiners' assessment of internal controls should be added to the existing rating structure. It stated that the rating assigned to management should clearly reflect the quality of the bank's internal controls. In addition, OCC stated that the changes it has made to strengthen internal control reviews by examiners are sufficient and that the added step of a separate rating factor is not necessary. We believe the addition of a separate internal control rating factor will help ensure that examiners appropriately focus on the condition of the internal control structure as a major component of bank safety and soundness.

Loan Quality and Loan Loss Reserves Not Adequately Assessed

Examinations of 17 of the 21 banks we selected did not provide a sufficient basis for assessing the quality of the banks' loans. OCC had no minimum loan coverage requirements to ensure representative reviews of loan portfolios during examinations. In addition, examiners told us that staffing constraints limited their ability to perform thorough loan reviews. Lack of adequate testing of loans increases the possibility that all of a bank's problem loans are not being identified and losses adequately reserved for in a timely manner. Examiners also did not have a quantitative risk-based approach to evaluate the overall adequacy of the bank's reserve for loan losses. Without a sound assessment of loan quality and loan loss reserve adequacy, examiners cannot gain a true understanding of the bank's financial condition.

Examiners' Loan Quality Reviews Focused on Banks' Risk Rating Systems

According to OCC's Examination Handbook, examination procedures should be designed to analyze the quality of the bank's loan rating processes. The loan rating process is a primary control used by banks to identify problem loans, and is a major factor in determining the bank's loan loss reserve. Therefore, determination of the reliability of this process is a key objective of the examination.

To evaluate a bank's loan rating process, examiners analyzed the bank's documentation for a sample of individual loans to determine the reliability of the bank's loan risk ratings. The risk rating systems generally focused on commercial loans, because they pose the highest risk in a bank's portfolio. Commercial loans included working capital advances, plant and equipment financing, commercial real estate loans, agricultural loans, and loans to individuals for business purposes. Examiners rated the selected loans using one or more of the following categories: "pass" (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 bank's ratings to determine the accuracy of the bank's risk rating system.

Examiners reviewed Shared National Credits¹ at all the large banks. They also targeted commercial real estate loans during examinations because OCC was concerned about these loans throughout the banking system. OCC's examination approach relied on examiner judgment to determine

¹Shared National Credits are commercial loans in original amounts of \$20 million or more which are (1) shared at inception by two or more banks under formal agreement or (2) sold in part to one or more banks with the purchasing bank(s) assuming a prorated share of credit risk.

what, if any, additional loan portfolios to review, and what sampling techniques to use.

Insufficient Testing of Risk Rating Systems at Large Banks

OCC examinations at 10 of the 14 large banks we reviewed did not provide a sufficient basis for concluding on the reliability of the banks' loan risk rating systems and judging the condition of the loan portfolios. Loan samples reviewed to test bank risk rating systems were not representative of the portfolio and examiners did not expand their samples when discrepancies were found which indicated the rating systems may be unreliable. Based on these results, we estimated that at least 50 percent of the most recent OCC large bank examinations did not provide a sufficient basis to evaluate the loan portfolio.²

Representative Samples Are Essential for Assessing Loan Risk Rating Systems

In order to draw a valid conclusion about the quality of a bank's loan risk rating process, a representative sample of loans rated by management should be analyzed by examiners. To be representative, the 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.

In evaluating a bank's risk rating system using a statistical sample, a significant number of errors noted by examiners in their testing would require that the sample be expanded. If significant errors were still noted, then examiners would not be able to rely on the bank's risk rating system and would be required to perform their own expansive review of the loan portfolio to determine its true condition.

Judgmental samples, by their very nature, are not representative of the unsampled portion of the population, and therefore do not provide a basis to conclude on that portion of the population. However, a judgmental sample could be representative of the overall loan portfolio, if it included a sufficient amount of loans such that the risk of error in the unreviewed portion of the portfolio was immaterial. However, to achieve this result using judgmental sampling requires a very large dollar amount of loans to

²The 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 50 percent and 87 percent of the 35 large banks supervised by OCC as of September 30, 1990.

be reviewed. In addition, where errors were found, an even larger sample is required to provide a basis to conclude on the condition of the portfolio.

**OCC Samples Were Not
 Representative of the Loan
 Portfolio**

OCC had no criteria establishing a minimum acceptable sampling level for loans. The Handbook suggested the use of statistical sampling to determine whether the bank's internal loan review process adequately identified problem loans. The Handbook also stated that judgmental samples have an inherent and unavoidable risk that the examined portion of the portfolio may not reflect the condition of the unexamined portion. That risk increases as the sample size decreases. OCC policy, however, did not require that examiners use statistical sampling. Examiners used judgmental sampling in 13 of the 14 large bank cases we reviewed. In 10 of these 13, the samples were not sufficient to assess the banks' risk rating systems.

Table 3.1 shows OCC's commercial loan review examination coverage for the 14 large banks in our sample. Our calculations are based on loan funds currently disbursed, versus committed to be disbursed at some future date, unless otherwise indicated.

**Table 3.1: Commercial Loan
 Examination Coverage**

Bank number	Percent of commercial loans tested by examiners	Percent of commercial loans to total loans
1	22	45
2	26	40
3	27	61
4	28	55
5	30 ^b	44
6	31	45
7	32	64
8	42 ^{a,b}	62
9	45	59
10	49 ^b	51
11	60	77
12	68 ^b	53
13	69	77
14	90	43

^aAs discussed later in this chapter, statistical sampling techniques were used by examiners for bank 8.

^bIncludes amounts committed to be disbursed at a future date.

We generally found that examination working papers included sufficient information to support examiners' assessments of individual loans selected for review. However, most examinations we reviewed did not include a representative sample of individual loans to provide a sound basis for conclusions about the banks' risk rating systems or the portfolios as a whole.

We do not believe that the examinations of the first seven banks in table 3.1, which judgmentally covered 22 percent to 32 percent of the commercial portfolio, adequately tested the banks' risk rating systems, nor did they provide a sufficient basis for assessing the quality of the commercial loan portfolio. These examinations left 68 to 78 percent of the commercial loan portfolio untested, even though these portfolios made up 40 to 64 percent of the entire loan balance and represented the highest credit risk.

For example, at bank 7, examinations between 1987 and 1990 targeted only Shared National Credits and commercial real estate loans to determine loan quality. In the 1987 through 1989 examinations, examiners identified many commercial real estate loans which deviated from the bank's established underwriting criteria and reported numerous exceptions to the bank's internal risk ratings. The 1989 examination report to the bank's holding company covering its subsidiary national banks—including the bank we reviewed—reported 41 loans which examiners believed should have been more severely rated by bank management (downgraded), or 33 percent of the 126 commercial real estate loans reviewed. The report stated that the overall level of risk in the commercial real estate portfolio could not be determined because bank credit files lacked current financial information and analysis on many borrowers and guarantors. For the 1990 examination, examiners tested 32 percent of the bank's commercial loan amount. Examiners concluded that the bank's risk rating accuracy had improved from the previous year, but noted that 10 of the credits reviewed had been downgraded by bank management after the bank was given a list of loans which would be in OCC's sample. The examiner wrote, "I don't know if their system just happened to detect these changes in 7/90, or if the bank was giving extra attention to the loans we would be reviewing." Even with this concern over possible manipulation of the sample loans, examiners did not expand their review at this bank.

At bank 1, examiners tested 22 percent of the 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 credits over \$5 million. This bank's holding company 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 205 credits reviewed had underwriting weaknesses. In addition, OCC downgraded 22 loans (11 percent), most of which were acquired in the 1990 merger. Examiners noted a lack of timeliness and accuracy in the risk 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.

For the seven remaining large bank examinations, where 42 to 90 percent of commercial loans were reviewed, we considered the following additional factors for determining the overall adequacy of loan coverage:

- past loan problems identified,
- loan classes covered and sampling techniques used,
- noncommercial loan coverage, and
- loan rating exception occurrence rates.

For banks 11, 12, and 13, we concluded the loan examination coverage was sufficient, as the samples did not leave major portions of the portfolio unexamined and did not result in high levels of loan rating exceptions.

At bank 14, we concluded the examination scope was not sufficient to assess loan quality, even though examiners tested 90 percent of commercial loans, because they had not reviewed any portion of the noncommercial loans at this bank since 1987. In 1990, these loans represented 57 percent of the bank's total loans.

In the case of banks 9 and 10, examiners did not expand their examination scope even though significant problems were identified in the commercial loans they reviewed, which accounted for 45 percent and 49 percent of their respective portfolios. At bank 9, past problems identified by OCC included a heavy concentration in real estate construction and land development loans, liberal underwriting practices, significant concerns about the accuracy of the bank's loan rating system, and an unacceptable methodology for calculating the loan loss allowance. Even though the supervisory strategy for the 1990 examination recommended a coverage of

60 percent to 70 percent, the actual commercial loan coverage at this bank was only 45 percent. In addition, the sample reviewed was judgmental and concentrated on large and bank-identified problem loans.

The examiner-in-charge told us further coverage was not possible due to staffing constraints. Due to the large number of credit risk exceptions OCC identified (12 percent of commercial loans and 25 percent of commercial real estate), examiners concluded that the number of discrepancies indicated severe weaknesses in management's ability to properly risk rate commercial loans. The examiner-in-charge told us that he felt he had done sufficient work to justify giving the bank OCC's worst rating, although the report to the bank noted "...Of further concern is the segment of the portfolio not reviewed at this presence."

We believe that OCC should have expanded the scope of this examination to determine if all problem credits had been identified and as a basis for determining if more severe supervisory actions were necessary at that time. Examiners and headquarters officials told us they did not believe their job was to determine the extent and magnitude of bank problems; their job was to report identified problems to the banks and to see that those problems were addressed by bank management.

At bank 10, past problems identified by OCC included liberal underwriting practices and an unreliable risk rating system. For the 1990 examination, examiners judgmentally reviewed 49 percent of commercial loans, concentrating on large and bank-identified problem loans. Examiners found significant exceptions with the bank's risk ratings for commercial real estate (18 percent exception rate) and highly leveraged transactions³ (14 percent exception rate), yet did not expand their work to determine the overall condition of the commercial portfolio. An examiner at this bank told us that reviewing more loans was not possible due to time and resource constraints.

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 the regulators. In our review of the failed Bank of New England, we found that loan risk rating deficiencies were identified at the bank as far back as

³A highly leveraged transaction is a financing transaction which involves the buyout, acquisition, or recapitalization of an existing business and results in a high liabilities-to-assets leverage ratio for the borrower.

1985.⁴ 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. They 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.

Bank 8 was the only examination in our sample where examiners used statistical sampling techniques to test the commercial loan portfolio. The examiners used judgmental samples to test significant classified and other selected commercial loans, then tested a statistical sample of nonclassified commercial loans not covered in any of its judgmental samples to provide assurance that all of the bank's problem loans had been identified. Their actual testing covered 42 percent of commercial loans held by the bank, but the use of statistical sampling techniques allowed examiners to draw a conclusion about the entire loan population from which their sample was selected. Examiners also reviewed certain of the bank's noncommercial portfolios, following up on a more extensive review performed the previous year. We believe the scope for this examination was generally sufficient to assess loan quality.

OCC's 1991 operating plan recommended that examiner loan reviews include at least 30 percent of banks' commercial loan portfolios and that examinations include reviews of retail, consumer, and residential mortgage portfolios. We do not believe this coverage recommendation is a sufficient standard. Without a change in policy to require representative sampling of commercial loans, including expansion of samples when errors are found, our concern over the adequacy of OCC examinations to assess the true condition of banks' loan portfolios remains.

As discussed in chapter 2, we found that safety and soundness examinations for the seven small banks in our sample either had not been recently performed, or were limited in scope. The total loan review coverage at the four banks which were examined during 1990 ranged from 9 percent to 32 percent of the total portfolio and the samples were

⁴Bank Supervision: OCC's Supervision of the Bank of New England Was Not Timely or Forceful (GAO/GGD-91-128, September 16, 1991).

judgmentally selected. Overall, insufficient work was performed at all of the seven small banks to provide a current basis to assess the quality of the loan portfolio.

Inadequate Basis to Assess Loan Loss Reserves

An adequate reserve for estimated loan losses is critical to the safe and sound operation of a bank and essential for early identification of deteriorating financial conditions. Misstatement of the loan loss reserve affects capital and earnings—two of the five CAMEL components that examiners use to rate the safety and soundness of banks at the end of on-site examinations.

An inadequate reserve also affects the examiners' ability to identify deteriorating financial conditions that may require supervisory action between on-site examinations. Examiners use unaudited and unexamined quarterly bank financial reports to monitor banks between on-site examinations. If bank management does not have appropriate procedures to estimate a loan loss reserve, then examiners have no assurance that management's reported financial information reasonably reflects the bank's true condition and operating results. Understated loan loss reserves disguise financial deterioration and limit the effectiveness of OCC's off-site monitoring system.

In our 1991 report on 39 banks that failed in 1988 and 1989, we found that the early warning system provided by bank call reports did not provide regulators with advance warning of the true magnitude of the deterioration in the banks' financial condition. Deficiencies in accounting rules were a major factor which allowed bank management to unduly delay the recognition of losses and mask the need for early regulatory intervention that could have minimized losses to the Bank Insurance Fund. Existing accounting rules provide a significant amount of latitude in the recognition and measurement of losses on individual problem credits.⁵ In addition, little authoritative accounting guidance exists for recognition and measurement of inherent losses in the loan portfolio. These deficiencies in accounting rules make the examiners' evaluation of loan loss reserve adequacy even more critical, since there is no assurance that reserves established by management under current accounting rules are adequate.

As previously noted, examinations for 10 of the 14 large banks and all seven small banks did not include sufficient testing to conclude that bank

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

management had identified the extent and severity of problem loans. As a result, examiners did not have a basis for assessing the adequacy of these banks' reserves for estimated losses on problem loans. Based on these findings, we estimated that these review limitations existed for at least 50 percent of the large banks and 59 percent of the small banks regulated by OCC.⁶ In addition, for 10 out of 14 large bank examinations we reviewed, and three of the four small banks examined in 1990, examiners noted that the banks' methodologies for establishing overall reserves (for both problem and nonproblem loans) were either unacceptable or needed improvement. In these cases, we found that examiners had no quantitative approach to evaluate overall reserve adequacy which sufficiently considered the risk of loss in the banks' portfolios.

Bank management is responsible for establishing a reasonable methodology for estimating the amount of expected losses in the loan portfolio. The reserve must be adequate to cover both specifically identified loss exposures and inherent loss exposures.⁷ Therefore, an adequate reserve hinges on (1) timely identification and analysis of problem loans (accomplished through the bank's risk rating system) and (2) an analysis of inherent risk in nonproblem loans which considers past trends, current conditions, and the future outlook for all major loan categories.

According to the examiner's Handbook, examiners are responsible for determining that bank management has documented a reasonable methodology for estimating an appropriate loan loss allowance. OCC's Banking Circular (BC) 201, issued in 1985, provides a general framework for banks to develop, and examiners to assess, reserve methodologies. According to BC 201, these methodologies should consider:

- estimated future loss on all significant loans (in order to determine the amount of reserves to be allocated);
- known deterioration in concentrations of credit, certain classes of loans, or pledged collateral;
- risk in international lending including problem transfer risk;
- historical loss experience based on volume and types of loans;

⁶The range of our estimate of a 95 percent confidence level, is that these conditions existed for the most recent examinations (at the time of our review) of between 50 percent and 89 percent of the large banks and between 59 percent and 100 percent of the small banks supervised by OCC as of September 30, 1990.

⁷Inherent losses exist when events or conditions have occurred which will ultimately result in loan losses, but which have not yet surfaced in the form of specific problem credits.

- results of independent loan portfolio quality reviews directed by management;
- trends in portfolio volume, maturity, and composition;
- off-balance sheet credit risk;
- volume and trends in delinquencies and non-accruals;
- lending policies and procedures including those for charge-off, collection and recovery;
- national and local economic conditions and downturns in specific industries; and
- experience, ability, and depth of lending management and staff.

BC 201, while providing sound general guidance, did not provide specific guidance with regard to quantification of the above factors. Therefore, banks and examiners used varying approaches for development and evaluation of loan loss reserve methodologies.

BC 201 was revised subsequent to the performance of our field work. The revisions included added discussions on segmentation of the loan portfolio, consideration of estimated losses on significant classified loans, and consideration of estimated losses on pools of similar loans in the loan loss allowance analysis. We used the provisions of the 1985 version for purposes of our analysis because this version was in effect during the time of our review. In addition, we do not believe the revised BC 201 will significantly impact the loan loss reserve methodologies of banks and review by examiners since it still does not provide specific procedures for quantification of the risk factors.

For the 14 large banks we reviewed, examiners concluded that only four banks had adequate reserve methodologies; four banks had “improving” methodologies compared to prior reviews, but still needed better documentation and analysis to support underlying assumptions; and six banks had unacceptable methodologies. For the four small banks which were examined in 1990, one bank had a satisfactory reserve methodology, and three banks had methodologies that did not comply with BC 201. For the two small banks last examined in 1987 and 1989, one had an adequate methodology and one had an “improved” methodology which needed further enhancements. We did not perform a detailed review of the working papers of the small banks that had not been examined since 1984 because it was evident that examiners had no current basis for assessing loan quality and reserves.

Examiners assessed the banks' reserve methodologies based on a comparison of such methodologies to BC 201. In cases where the methodology was not considered adequate, examiners lacked an approach to estimate the reserve that included quantification of the BC 201 risk factors. For example, at one bank we reviewed, examiners concluded that the bank's methodology did not comply with BC 201 because it did not include loss potential in the nonproblem portion of the loan portfolio. However, examiners did not estimate the amount of potential additional reserves which would be required, but rather reported their concerns in the examination report and concluded that the reserve was "marginally adequate."

In two other cases, bank management did not accept OCC's conclusion that its reserves were inadequate. At one of these banks, bank management disagreed with OCC's conclusion that reserves were inadequate because OCC used trend averages, rather than a range of high and low estimates, to estimate the required reserves. The bank argued that OCC had previously criticized the bank's reserve methodology because it used averages, rather than ranges, to estimate reserves. At the other bank, examiners extrapolated the results from their loan review sample to the entire commercial real estate portfolio and concluded that this reserve was inadequate. Bank management argued (and we agree) that extrapolation is not valid for nonrepresentative judgmental samples because of the inherent sampling risk. If examiners had used a reasonable quantitative approach in their reserve analyses, they may have been able to better justify their conclusion and convince management to increase the reserves.

Examiners used a reserve methodology which considered the types of risk elements outlined in BC 201 in one FRB examination we reviewed. For that examination of a large bank, examiners used a computer model⁸ that assessed specific and inherent risk. This model included three primary components—specifically allocated reserves, unallocated reserves, and consumer reserves. Specific reserve allocation was based on a comprehensive, detailed review and determination of the loss exposure for each problem loan reviewed. Unallocated reserves were determined from an analysis of loan quality trends, current and expected market conditions, and the bank's loan administration and underwriting standards. To estimate consumer loan reserves, the model incorporated average charge-off data for the different types of consumer credit, such as

⁸We did not review the programming aspects of the model in detail, but it appeared to include the appropriate components to assess the adequacy of the bank's reserve.

credit card and installment loans. We believe this type of model could be effectively used by OCC examiners to quantify their analysis of loan portfolio risk exposures outlined in BC 201. Without such an approach, examiners do not have a solid basis for requiring bank management to increase their reserves.

OCC officials agreed that examiners did not have specific guidance for determining the adequacy of the allowance. They said they usually did not have problems getting bank management to supplement reserves when the examiners determined that the reserves were understated. They also said the only way to really determine if the allowance is adequate, when the bank's methodology is not adequate or when the bank's internal loan risk ratings are not reliable, is to review a large percentage of loans. They said they did not have enough resources for such expanded loan coverage.

Examination Quality Controls Were Inconsistent

Although loan review examination working papers were generally sufficient to provide documentation of the work performed and conclusions reached, we found instances where improved documentation would allow more efficient supervisory review. We also found that working papers lacked consistent evidence of supervisory review. OCC's Examination Handbook included specific guidance on working paper documentation and supervisory review. However, as stated previously, the Handbook was used as a reference guide only and did not constitute mandatory standards.

The Handbook stated that working papers as a whole should support the information and conclusions contained in the report of examination, and should be prepared in a manner designed to facilitate an objective review. Specifically, the Handbook stated that each section of working papers should include documentation of the scope of work performed and conclusions drawn from that work. In addition, the Handbook indicated that each individual working paper should include

- the bank name, examination and work performance dates, and a schedule index number;
- the name and title of the person, or description of records, that provided the information needed to complete the schedule;
- a statement of title or purpose of the specific schedule or analysis; and
- initials of the preparer and the examiner designated to perform the review function.

We found that the working papers for the examinations we reviewed did not always comply with the above documentation requirements, which resulted in some difficulty in assessing the work that had been performed. We also found that supervisory review of the working papers was not consistently evident. Examiners told us they reviewed the working papers but did not always initial them. However, we believe the documentation of review is important to ensure that critical areas are not overlooked in the review process. In addition, the review process is an important quality control measure and the reviewer's initials or signature are written verification that the working papers have been checked for adequacy of evidence to support the examination conclusions and that the reviewer concurs with such conclusions.

Conclusions

Examiners' use of nonrepresentative sampling techniques precluded them from having reasonable assurance that all significant problem loans had been identified and properly reserved for. Use of statistical sampling techniques would allow for representative loan portfolio coverage, without requiring inordinate sample sizes. In some cases, use of statistical sampling may allow examiners to review less loans than they did in several of the examinations we reviewed, thus allowing efficiencies to be achieved in the utilization of examiner resources. In addition, lack of an adequate approach to evaluating overall reserve adequacy further limits examiners' ability to identify reserve deficiencies or to have a supportable basis for requiring additional reserves. Failure to maintain adequate loan loss reserves is an unsafe and unsound banking practice, yet the lack of sufficient guidance (both regulatory and accounting) provides banks with an opportunity to delay recognition of serious erosion in their loan portfolios and to mask the need for regulatory intervention.

OCC examiners' failure to consistently document their supervisory review weakens quality control over the examination process, as does incomplete working paper documentation. Examination quality control is important to ensure that conclusions reached are properly supported and have been challenged by an objective reviewer. This is particularly important in the loan quality review and other areas which require a high degree of examiner judgment.

Recommendations

We recommend that the Comptroller of the Currency require examiners to

- use and appropriately document sampling methodologies which provide a representative view of the loan portfolio as a basis to determine loan quality and the adequacy of the reserve for loan losses,
- expand their testing of individual loans to ensure proper identification of problem loans and related specific reserves where the loan risk rating or other loan administration systems are found to be unreliable,
- develop a quantitative risk-based approach to evaluate the adequacy of a bank's overall loan loss reserve which considers loss exposure from individual problem credits as well as inherent loss exposures in the remainder of the portfolio, which are outlined in Banking Circular 201, and
- fully document all examination working papers and indicate supervisory review and concurrence by initialling or signing each working paper.

We also recommend that the Comptroller of the Currency coordinate implementation of the examination loan quality and examination quality control recommendations with the other federal depository institution regulatory agencies to achieve uniform requirements.

Agency Comments and Our Evaluation

OCC generally agreed with our recommendation that representative sampling methods be used to assess loan quality. Although it continued to believe that its existing judgmental sampling methods can provide an adequate assessment of a bank's loan portfolio, it recognized the merits of using statistical sampling techniques, in conjunction with judgmental sampling of high risk loans, to provide a more reliable basis to assess loan quality. OCC has been testing a statistical model in several regional and community bank examinations since June 1992. It planned to assess the results of this pilot program to determine how statistical sampling can best complement OCC's traditional judgmental sampling techniques. We believe statistical sampling, used in conjunction with judgmental sampling of high risk loans, can provide an efficient and effective approach to the review of loan quality.

OCC agreed with our recommendation that expansion of loan review work is needed when loan risk rating or other loan administration systems are found to be unreliable, and agreed to work with its examiners to that end. It recognized that such expanded testing is needed to help determine the full extent of loan problems and the adequacy of related reserves. However, it did not state how this recommendation would be

implemented. We believe specific policies should be developed to address this important issue.

OCC agreed with our recommendation to develop a quantitative risk-based approach to be used by examiners to evaluate the adequacy of banks' loan loss reserves. However, OCC expressed concern that previous efforts have not been successful and that quantitative analysis has limitations. OCC stated that such analysis is useful to assess reserve adequacy for homogenous pools of loans such as credit card loans. However, it did not believe quantitative analysis is as reliable for assessing reserves for less homogeneous loans, such as commercial real estate. For these loans, OCC stated that examiners need flexibility to consider the loans' specific risks and characteristics. The risks and characteristics of loans cited by OCC to be assessed are similar to those included in its BC 201 examination guidance. As we discussed in this chapter, although BC 201 provides sound general guidance as to the types of loan portfolio risks which should be considered by examiners (and banks) in assessing loan loss reserve adequacy, it does not provide specific guidance for quantification of these risks. We believe these risk factors can be quantified to provide a reasonable basis to assess loan loss reserve adequacy.

OCC stated it has worked closely with the other federal depository institution regulators for the past 2 years to develop additional, more specific guidance for banks and examiners on loan loss reserves, and is committed to continuing this effort. However, it also indicated that efforts to develop a quantitative framework for assessing loan loss reserves have not been successful to date. We understand the difficulties in developing a viable approach to this highly judgmental area. However, such difficulties are compounded in the field where hundreds of examiners are attempting to make judgments regarding loan loss reserve adequacy without the benefit of a common framework on which to build their analyses.

OCC agreed that it could and should improve its working paper documentation and supervisory review programs and has issued additional guidance to examiners. However, OCC continues to lack minimum required documentation standards which are needed to effectively ensure consistent examinations and the quality of the examinations.

Comments From the Office of the Comptroller of the Currency

Note: GAO comments supplementing those in the report text appear at the end of this appendix.



Comptroller of the Currency
Administrator of National Banks

Washington, D.C. 20219

November 4, 1992

The Honorable Charles A. Bowsher
Comptroller General of the United States
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Bowsher:

Thank you for the opportunity to provide comments on your report on the Office of the Comptroller of the Currency's (OCC) examination of banks, dated September 1992. This letter is in response to the recommendations made in that report.

GAO auditors looked at three aspects of OCC examinations: OCC reviews of bank internal controls, bank loan portfolios, and the adequacy of loan loss reserves. GAO reviewed examinations of 14 national banks with assets of more than \$10 billion (out of a total population of 36 large banks) and 7 small national banks (out of a total population of 4100 small banks) as of yearend 1990. The examinations were conducted by the OCC from March 1987 through December 1990.

The auditors concluded that OCC examiners did not perform comprehensive evaluations of some critical controls. GAO also concluded that loan quality and loan loss reserves had not been adequately assessed in the sample examinations.

The OCC recognizes the validity of several of GAO's criticisms and recommendations. Over the past two years, we have taken a number of actions to address those deficiencies. This letter details those actions.

Unfortunately, the tone of the draft report -- including the frequent references to bank failure and losses to the deposit insurance fund -- detracts from its value as an objective review of examination policies and practices. The report strongly implies that, because of the policies and practices criticized by GAO, national banks have serious problems that could lead to failure. This conclusion cannot be supported by the work conducted in the audit. GAO reviewed OCC examination policies and practices in specific examinations -- not the underlying condition of the banks themselves.

See comment 1.

See comment 2.

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The GAO also criticizes the scope of OCC examinations. However, it is important to note that during the time frame of the audit, the OCC deliberately targeted its examination efforts on bank real estate loan portfolios. Therefore, many of the examinations in the GAO sample were not full scope and did not reflect standard examination processes and procedures. Economic conditions and the failure of record numbers of banks led us to conclude that the condition of the real estate sector posed a significant risk to the safety and soundness of the banking system at that time. We worked diligently during that period to uncover and control the numerous problems related to real estate lending. Once we were satisfied that real estate problems had been identified and were being addressed, we redirected our examination resources and efforts to broader areas of safety and soundness.

See comment 3.

GAO recommendations relate to four areas: internal controls, loan sampling, loan loss reserves, and working paper documentation and review. As I noted earlier, we basically agree with many of the recommendations but have reservations about others, including the one on the allowance for loan and lease losses. Since 1990, we have been working to improve our efforts in all four areas. In this letter, we describe those efforts as well as the additional actions we will take in response to your recommendations.

I. EVALUATION OF CRITICAL INTERNAL CONTROLS

See comment 4.

The OCC concurs with the GAO on the importance of assessing the quality of a bank's internal control systems, both for determining the scope of an examination, and in alerting examiners to existing and possible future problems. As your report notes, the Comptroller's Handbook for National Bank Examiners includes comprehensive review procedures for examiners to use in determining the effectiveness of all principal aspects of a bank's internal control systems.

These procedures are particularly useful for less experienced examiners to use as a checklist in assessing the quality of bank control systems. The OCC believes that experienced examiners can condense these review procedures with little loss of effectiveness, because they have identified more efficient methods to assess internal controls. In every case, however, examiners are expected to document their work in testing control systems to provide support for their conclusions.

The OCC recognizes the weaknesses in documentation of examinations that made it difficult to determine the full extent to which examiners tested internal controls. Since 1990, we have strengthened our documentation standards. (See discussion in Section IV. - Work Paper Documentation and Review.)

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In addition, since the 1990 examinations that were the subject of the GAO audit, we have taken several steps to ensure that control systems are properly assessed. We are also in the process of expanding our examiner work force to ensure that we have adequate resources to test internal controls. Our 1993 operating plan includes a program to assess the internal controls in every multinational banking company. Details of these OCC initiatives -- past, present and future -- are provided below:

- o In 1991, the OCC revised its enforcement policy to clarify the circumstances under which enforcement actions are taken. The revised policy specifically provides that enforcement actions may be taken on banks (including 1- and 2-rated institutions) with significant weaknesses in internal controls. Thus, even where asset problems have not surfaced, enforcement actions are encouraged as a preventive measure where systems and controls are inadequate.
- o As outlined in the OCC's 1992 Supervision Operating Plan, the OCC is conducting management appraisal procedures, including procedures to assess internal controls, in all banks over \$1 billion in assets.
- o In 1993, the OCC will require examination teams in every multinational banking company to assess the adequacy of internal controls. In carrying out this task, our examiners will:
 - assess the degree of importance the board and management place on developing and maintaining comprehensive internal controls for each major operational area;
 - include a sufficient amount of testing to assess whether control mechanisms are operational and routinely challenged by internal audit and/or other routine processes;
 - provide for a detailed review of any internal controls or systems deemed to be weak or nonexistent to assess the degree of exposure, if any, and to ensure that management and the board take adequate corrective action;
 - produce a written examination report that summarizes the work performed and the examiners' conclusions; and,
 - communicate, through meetings, our findings and recommendations to the board of directors of each bank that is reviewed.

To ensure that we conduct this evaluation in a consistent manner, a working group has been formed to develop uniform and comprehensive procedures.

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- o The OCC hired 549 examiners between January 1991 and June 1992. We plan to hire an additional 300 examiners in 1993. Some of these new examiners have previous credit experience; as a result, they require less training than new examiners hired directly from college. These 800 new examiners will make it possible for the OCC to do a more complete review of all aspects of bank operations, including testing of internal controls.

As your report notes, the FDIC Improvement Act of 1991 (FDICIA) requires banks with assets of \$150 million or more to report annually on their financial condition and management for fiscal years beginning after December 31, 1992. FDICIA also requires that bank auditors report on management's assessments of internal controls. The auditors will use specific procedures to assess those controls.

OCC examiners will use these assessments, to the extent possible, and supplement them as necessary to ensure a comprehensive review of bank control systems. We are developing procedures to incorporate the work of external auditors into the examination process, which will include methodology to test and evaluate the results of the auditors' review.

Finally, the GAO recommends that an assessment of internal controls be added as a separate component of the CAMEL rating. Under current procedures, the final CAMEL rating assigned to a bank is based in part on the examiner's assessment of control systems for each functional area (i.e., capital adequacy, asset quality, management supervision, earnings, and liquidity). In particular, the rating assigned to management's supervision of the bank should clearly reflect the quality of the bank's internal controls.

In light of the changes the OCC has already made to strengthen both its review of internal controls and the documentation of its review, as well as new procedures for review of internal controls by outside auditors under FDICIA, we do not believe it is necessary to add Internal Controls as a separate CAMEL component.

II. LOAN SAMPLING TECHNIQUES

As your report notes, the OCC generally uses judgmental sampling techniques to select loans for review. The OCC uses judgment at two critical points in the loan review process. First, OCC senior management and examiners use their judgment to select areas of the loan portfolio for special attention. For example, in 1990 we focused extra attention on bank real estate loan portfolios because of the deterioration in many commercial real estate markets. Second, examiners use their judgment to determine which loans they will actually review. This "judgmental sampling" is consistent with our objective to review those loans that pose the greatest risk to the institution. In selecting loans, OCC examiners focus on problem loans, large credits, and other areas identified in the pre-examination as possible trouble spots.

See comment 5.

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We believe that our use of judgmental sampling to select loans for review can provide an adequate assessment of the bank's loan portfolio and loan loss reserve. Short of testing the entire portfolio, judgmental sampling takes advantage of the examiner's experience and knowledge of banking problems. However, we fully recognize the merits of statistical sampling. Used in combination, statistical and judgmental sampling techniques could provide a more sound basis upon which to assess loan quality. Judgmental sampling techniques would effectively focus on known risk areas, while statistical sampling would be more appropriate in assessing non-targeted lending operations.

Since June 1992, we have piloted a statistical sampling model in several regional and community banks in our Midwestern District. Using the results of this pilot program, a working group will be formed to determine how statistical sampling can best complement our current sampling procedures and enhance the quality and effectiveness of our examination process.

As GAO recommended, we will also work with examiners to ensure that they expand the scope of their work when discrepancies are identified in the bank's risk ratings and other systems. Expanding the scope of review will help to determine the full extent of the problems and ensure proper identification of problem loans and related reserves.

III. RESERVE FOR LOAN AND LEASE LOSSES

The OCC is responsible for determining that bank management has documented a reasonable methodology for estimating loan loss reserves and for providing an appropriate allowance for loan and lease losses. We share the GAO's concern that banks recognize loan losses in a timely manner and make adequate provisions for potential losses.

Estimating loan loss reserves and making provisions for an appropriate allowance must inevitably involve a considerable degree of judgment. But, the OCC recognizes that there may be some merit to using quantitative analyses to assist examiners in assessing the adequacy of loan loss reserves for some parts of a bank's portfolio. Banks themselves use many different models, averages, and ranges as a basis for determining the appropriate amount of their reserves. Depending on the unique circumstances of individual banks, OCC examiners have approved the use of these techniques.

In addition, OCC examiners themselves perform quantitative analyses for homogeneous pools of loans, such as credit card loans. This is appropriate for homogeneous pools because the characteristics of the pools, such as loss rates, remain relatively constant over a period of time.

See comment 5.

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For that reason, banks and examiners can use historical loss experience as a reasonable starting point in determining loan loss reserve adequacy for homogeneous pools of loans. However, historical loss rates must be evaluated and adjusted as necessary to incorporate the effect of current trends and conditions on loss recognition. The adjustments should reflect an overall estimate of the extent to which the expected rate of loss on a pool of loans in the current portfolio will differ from historical loss experience on the same kinds of loans. It is important to note that these adjustments are highly subjective estimates; a bank that uses this method to determine its loan loss reserve must revise these estimates each quarter.

Quantitative analyses, however, have proved to be considerably less reliable in determining appropriate reserves for the less homogenous parts of a bank's loan portfolio, such as commercial credits. In assessing loan loss reserve adequacy, examiners need flexibility to consider specific risks and characteristics associated with the commercial loan portfolio of an individual bank -- e.g., the bank's loan underwriting policies, loan administration practices, history of managing problem credits, geographic diversity of loans, and current economic conditions in the bank's market.

For the past two years, the OCC has worked closely with the other federal depository institution regulators in a coordinated effort to develop additional, more specific guidance to banks and examiners.

As part of this process, we have reviewed several kinds of quantitative analyses and formulas, including some developed by other agencies. None has proved to be successful. Nonetheless, we are committed to continuing this effort to achieve greater consistency and specificity in the assessment of loan loss reserves by the regulators.

In addition to this interagency effort, the OCC has issued several documents to provide more information on determining loan loss reserves to bankers and examiners:

- o The November 7, 1991, interagency statement on commercial real estate loans details additional factors that banks and examiners should consider in assessing the adequacy of the loan loss reserve as real estate loans become increasingly dependent on collateral for repayment.
- o As the GAO report noted, the OCC revised Banking Circular 201 (BC-201) earlier this year to provide clearer guidance to banks on timely identification and recognition of inherent loan losses. Although the circular does not define a single allowance methodology that must be used by all banks, it provides an analytical framework and greater detail on the factors a bank should take into consideration in determining its loan loss allowance.

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- o Based on the revised banking circular and our work with the other federal regulators, we are revising the Comptroller's Handbook for National Banks, as well as our training, to provide more specific guidance to examiners on assessing loan loss reserves. We have also sent to examiners a series of specific questions and answers on how to apply the revised circular.

IV. WORKING PAPER DOCUMENTATION AND REVIEW

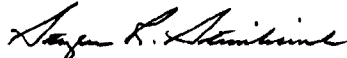
The detailed nature of working paper documentation is such that oversights can and do occur, and we agree there is room for improvement in this area. It is important to note, however, that the absence of a perfect audit trail does not mean that the work was not performed or reviewed.

We are continually working with our examiners to improve working paper documentation and review programs.

- o In November 1991, OCC issued Examining Circular 258, entitled "OCC Supervision Policy," which includes direction to examiners on documentation. It explains the three primary locations for examination documentation: the computer-based Supervisory Monitoring System (SMS), working papers, and reports of examination. While each serves a different purpose, all three work together to provide a complete trail of documentation of examiner activities. EC-258 further states that "the amount of documentation needed to support decisions and conclusions should reflect the problems and complexity of the institutions, and the nature and extent of the OCC's supervisory concerns."
- o The OCC is issuing standardized loan line sheets that will provide a consistent format for examiners to follow in documenting their analyses of individual loans. These line sheets will be used on a nationwide basis.

In summary, we appreciate the opportunity to comment on your draft report. We believe we have made significant improvements in our supervisory process since 1990, and we are committed to continuing these efforts. We will work with the other regulators to the extent possible to implement actions that are responsive to your recommendations.

Sincerely,



Stephen R. Steinbrink
Acting Comptroller of the Currency

See comment 5.

The following are GAO's comments on the Office of the Comptroller of the Currency's letter dated November 4, 1992.

GAO Comments

1. The examinations in our sample were randomly selected from listings of small and large banks regulated by OCC as of September 30, 1990. The examinations we reviewed were the most recently completed examinations at the time of our review, which was performed between December 1990 and January 1992. The statistical nature of our samples of large and small banks allows us to project the results of our work to the relevant populations.
2. The references to bank failures and losses to the deposit insurance fund which OCC appears most concerned about are presented in chapter 1 as background information. This information is factual in nature and serves to highlight the importance of an effective regulatory examination function as a primary means to deal with the problems faced by the banking industry. Our criticisms of OCC's examination policies and practices were not meant to imply that weaknesses in the examination process cause banks' problems, but rather that these weaknesses may preclude regulators from identifying problems before they result in irreversible damage to a bank's financial condition.
3. While it is true that many of the OCC examinations we reviewed included "targeted" reviews of real estate loan portfolios, such a targeted examination approach has been consistently used by OCC for some time. As is described in chapter 1, OCC places a high degree of reliance on off-site monitoring to identify risk areas which are then the targeted focus of the on-site examination.
4. See the "Agency Comments and Our Evaluation" section in chapter 2.
5. See the "Agency Comments and Our Evaluation" section in chapter 3.

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