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THRIFT EXAMINATION QUALITY

OTS Examinations Do Not Fully Assess Thrift Safety and Soundness

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

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

This report presents the results of our review of examinations of savings and loan institutions (thrifts) performed by the Office of Thrift Supervision (OTS). Weaknesses in OTS examinations of loan quality and internal controls, and inadequate quality control over examinations limited OTS's ability to identify and address thrift problems in their early stages. Improving the quality of OTS examinations in these areas would aid in the prompt detection and correction of thrift problems. Also, improved examinations are critical to the effectiveness of regulatory reforms recently enacted in the Federal Deposit Insurance Corporation Improvement Act of 1991. Further, OTS and the Federal Deposit Insurance Corporation did not effectively coordinate their examinations resulting in duplicative work. These examinations sometimes arrived at different conclusions.

We are sending copies of this report to the Secretary of the Treasury, Director of the Office of Thrift Supervision, Director of the Office of Management and Budget, federal banking regulatory agencies, and other interested parties. Copies will be made available to others on request.

B-249101

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 III.

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Executive Summary

Purpose

The past decade has been marked by a massive rate of failure among U.S. savings and loan institutions (thrifts). Internal control weaknesses, including weak loan underwriting and administration, and noncompliance with laws and regulations contributed significantly to their failure. Examinations of thrift institutions by the Office of Thrift Supervision (OTS) is critical to ensuring the safety and soundness of thrifts. GAO assessed the quality of these examinations, focusing on OTS's reviews of loans and internal controls and the effectiveness of coordination between OTS and the Federal Deposit Insurance Corporation (FDIC). The assessment included examinations for a random sample of 20 thrifts.

Background

The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) created OTS within the Department of the Treasury as the primary regulator of the savings and loan industry. To discharge its regulatory responsibilities, OTS examines federally insured thrifts annually. Based on these examinations, OTS rates thrifts based on five critical areas: management, asset quality, capital, risk management, and operating results. Results of the examinations determine the extent of regulatory review, need for enforcement actions, decisions to close or liquidate thrifts, and approval of applications for mergers.

FIRREA also gave FDIC responsibility for administering the Savings Association Insurance Fund which replaced the insolvent Federal Savings and Loan Insurance Corporation. The act gave FDIC, as insurer, the authority to examine thrifts and to recommend or take independent enforcement actions.

As the largest single component of a thrift's assets, loans represent the greatest potential for loss. Therefore, reviewing loans is a critical factor in thrift examinations. In addition, reviewing a thrift's internal controls gives examiners an opportunity to identify unsound practices before they lead to serious consequences.

Results in Brief

GAO found that in examinations for 17 of 20 thrifts, OTS did not review enough loans to accurately assess the safety and soundness of individual thrifts. Examiners generally judgmentally selected loans for review and reviewed a small portion of the value of a thrift's total loan portfolio, in most cases less than 10 percent. The loans were not selected on a representative basis, and thus did not accurately represent the thrifts' portfolios. GAO estimated that nonrepresentative loan coverage existed in the most recent OTS examination for at least 64 percent of the 2,612 thrifts that OTS supervised as of the sample date. The examiners also lacked a consistent methodology for assessing the adequacy of the thrifts' allowances for losses on loans, thus increasing the risk to the insurance fund should a thrift fail.

GAO also found that in examinations for the 20 thrifts, OTS did not test internal controls adequately to detect problems that could lead to insolvency. OTS primarily relied on unverified information provided by the thrifts to determine the effectiveness of internal controls. In addition, OTS did not assess the quality or determine the extent of the external auditor's internal control work as a basis for relying on that work. GAO estimated that these deficiencies existed in the most recent examinations of nearly all of the 2,612 thrifts that OTS supervised as of the sample date.

OTS and FDIC did not effectively coordinate their examinations, resulting in duplicative work. These examinations sometimes arrived at differing conclusions, thereby undermining confidence in examination results.

Principal Findings

Insufficient Review of Loans and Loan Loss Reserves

OTS did not require examiners to review a specific amount of loans or select loans using a method that would result in reviewing a representative sample of a thrift's portfolio.

OTS guidance recommended that examiners review 40 to 60 percent of the total dollar value of high-risk loans—defined as other than small loans and mortgages on family-type residences. Only 5 of the 20 examinations GAO reviewed met this minimum recommended criteria.

In 17 of the 20 examinations, GAO found that examiners relied on thrift managers to identify problem loans for review. As a result, examiners could not have reasonable assurance that the loans that were not reviewed did not have significant problems.

OTS provided only general guidance to examiners for assessing the adequacy of loan loss reserves. GAO found that examiners used a wide variety of approaches to assess the adequacy of loan loss reserves of the 20 thrifts examined. The lack of a consistent examination methodology increased the risks of inconsistent thrift examinations and inadequate loan loss reserves.

Internal Controls Not Independently Assessed

OTS did not require its examiners to comprehensively review thrifts' internal controls or assess the work of auditors who may have reviewed internal controls as a basis for relying on that work.

Instead, examiners relied on thrifts' responses to questionnaires and on reviewing auditors' reports to identify internal control weaknesses. They did not independently test the accuracy of the thrifts' responses or review the working papers prepared by the external auditors. Although examiners performed limited control testing in conjunction with other examination work, primarily the review of loans, such work did not give examiners a comprehensive understanding of the strengths and weaknesses of a thrift's internal controls because of the limited loan coverage and nonrepresentative sampling. As a result, OTS could not be certain that controls were operating effectively to ensure sound practices.

The FDIC Improvement Act of 1991 requires management of thrifts with assets of $150 million or more to annually assess and report on the condition of internal controls. The thrift's external auditors are required to review and report on management's assessment. The results of these reviews will be useful to OTS in assessing internal controls and in planning the scope of its examinations.

Examinations Duplicated, Conclusions Inconsistent

OTS and FDIC used their examination resources inefficiently by examining the same thrifts for safety and soundness within similar periods. Less than 6 months elapsed between duplicate examinations at 13 of the 20 thrifts in GAO's sample. These efforts were usually not coordinated and officials of each agency said they could not rely on the other's work because they applied different standards.

In 5 cases, duplicate examinations were performed within 3 months or less and OTS and FDIC reached inconsistent conclusions regarding the thrifts' overall safety and soundness. OTS's rating was better than FDIC's for three thrifts and worse for two. In such circumstances, thrift managers had difficulty judging the urgency of corrective action.

In response to GAO's concerns, OTS and FDIC signed a joint memorandum that requires FDIC thrift examinations to be performed on a joint basis with OTS unless compelling reasons dictate otherwise.

Recommendations

GAO recommends that

- OTS require examiners to (1) review a minimum, representative sample of each thrift's loans, (2) develop and apply a consistent methodology to assess the adequacy of a thrift's reserves, (3) use, to the extent possible, the work of external auditors in reviewing internal controls after verifying the scope and quality of that work, and supplement that work as necessary to ensure an annual comprehensive assessment of significant internal controls, and (4) review internal controls of thrifts not subject to the FDIC Improvement Act, and
- OTS and FDIC monitor the implementation of their joint memorandum to ensure that thrift examinations are coordinated and that a common set of examination standards is used.

Agency Comments

OTS provided written comments on a draft of this report. These comments are presented and evaluated in chapters 2 through 4. OTS agreed with all of GAO's recommendations, except for the one regarding the review of internal controls in thrifts not subject to the FDIC Improvement Act. OTS stated that budgetary constraints coupled with its annual examination requirements preclude it from implementing the recommendation. Since internal control weaknesses are one of the common characteristics of failed thrifts, GAO believes that it is important that OTS adequately assess the internal controls of all thrifts including those with less than $150 million in assets that are not subject to the act's requirements.

FDIC provided comments on chapter 4, which are discussed in that chapter. FDIC agreed that inefficiencies existed between FDIC and OTS examination efforts initially, but stated that some inefficiencies were necessary to carry out the mandate of FIRREA. FDIC indicated that the two regulators have made considerable strides in resolving examination and supervision differences and in improving on the number of examinations conducted jointly.

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Abbreviations

CAMEL	capital, assets, management, earnings, and liquidity
FDIC	Federal Deposit Insurance Corporation
FRB	Federal Reserve Board
FSLIC	Federal Savings and Loan Insurance Corporation
FIRREA	Financial Institutions Reform, Recovery, and Enforcement Act
MACRO	management, asset quality, capital, risk management, and operations
OCC	Office of the Comptroller of the Currency
OTS	Office of Thrift Supervision
SAIF	Savings Association Insurance Fund

Introduction

This report evaluates whether the Office of Thrift Supervision's (OTS) examinations have effectively identified and anticipated safety and soundness problems in thrifts. In a previous report, we cited poor loan quality and weak internal controls as common characteristics of failed thrifts.[1] Loans are the largest single component of a thrift's assets and represent the greatest potential for loss. Therefore, the condition or riskiness of a thrift's loan portfolio is critical to its safety and soundness. Internal controls are the components of a thrift's operations that are intended to protect against unsound practices and ensure accurate reporting of the thrift's condition and performance. These include policies and procedures for safeguarding assets, loan underwriting and documentation, and financial reporting. This report focuses on OTS assessments of thrifts' loans and internal controls. In addition to the quality of examinations, this report evaluates the extent of coordination and reliance between OTS and the Federal Deposit Insurance Corporation (FDIC), which has also examined thrifts in conjunction with its authority to administer the Savings Association Insurance Fund (SAIF). We discuss the effectiveness of the examination processes of the Federal Deposit Insurance Corporation, Federal Reserve Board (FRB), and Office of the Comptroller of the Currency in separate reports.[2] Regulatory agencies periodically form interagency working groups to address issues which impact all federally insured depository institutions.

The failure of hundreds of savings and loans during the 1980s led to the insolvency of the Federal Savings and Loan Insurance Corporation (FSLIC) and prompted the Congress to restructure the federal agencies that oversee these institutions. The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) abolished the Federal Home Loan Bank Board and created OTS as the primary regulator of the nation's thrift industry. FIRREA also gave FDIC the responsibility for administering the new thrift insurance fund. Although the oversight agencies changed, the primary oversight tool used to assess thrift safety and soundness remained the periodic on-site examination of each thrift.

Results of OTS examinations determine the supervisory treatment of thrifts, including the depth of future regulatory reviews, the need for regulatory enforcement actions, the approval of mergers and similar proposals, and

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

[2] Bank 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 Bank Examination Quality: OCC Examinations Do Not Fully Assess Bank Safety and Soundness (GAO/AFMD-93-14).

decisions to close and liquidate thrifts. Furthermore, examinations are to promptly identify dangerous conditions or unsound banking practices, so that regulators can take appropriate actions. Because examinations are so vital to the regulatory process, it is important that they be performed competently and reach accurate, well-supported conclusions.

Indications are that the thrift industry's troubles are not over. As of December 31, 1991, nearly 600 failed thrifts have been resolved since the passage of FIRREA. OTS has identified an additional 169 thrifts that may require assistance by September 30, 1993, and another 260 thrifts that are troubled but not likely to fail within the next 2 years. If there is still a significant number of thrifts in need of resolution after September 30, 1993, the date that the Savings Association Insurance Fund created by FIRREA assumes it full resolution responsibility, it could be insolvent almost immediately. The Fund's balance was about $195 million at September 30, 1992. The possibility of another insurance fund insolvency underscores the need to ensure that examinations detect problems before they become severe and contribute to thrift failures.

Regulatory Changes in the Thrift Industry

From the 1930s through the 1970s, the federal government closely regulated the thrift industry to ensure the availability of funds for home mortgages. In the 1930s, the Congress established the Federal Home Loan Bank Board as the industry's primary federal regulator and FSLIC as its insurer. Thrifts granted federal insurance had to comply with federal laws and regulations and to submit to federal examinations[3] to ensure their regulatory compliance and overall soundness. Prior to the 1960s, the thrift industry experienced dramatic growth and prosperity. Thrifts thrived in an environment with strong demands for mortgages, low and stable interest rates, and minimal competition from commercial banks.

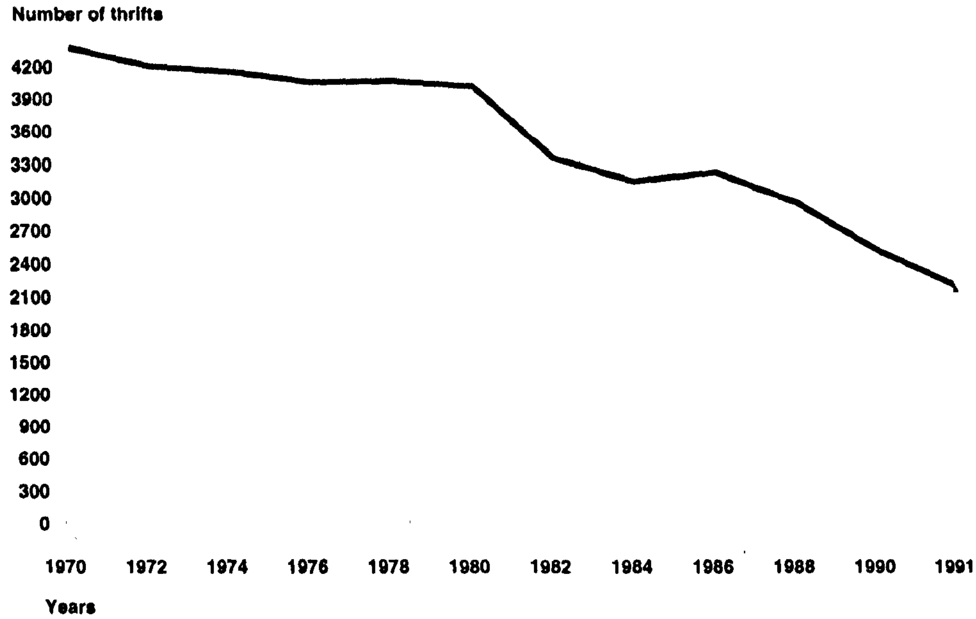
Interest rates and competition for deposits increased in the 1960s and intensified through the 1970s and 1980s. Competition from money market funds and commercial banks caused numerous customers to withdraw their deposits from thrifts. Increasing costs of funds and fixed rate long-term assets created interest rate mismatches that severely affected the thrift industry's net worth. In response to the changing environment, the Congress enacted a series of laws relaxing restrictions on thrifts to improve their competitive position. The two most significant laws were the Depository Institutions Deregulation and Monetary Control Act of 1980

[3]State-chartered thrifts also had to comply with applicable state regulations and to submit to state examinations.

and the Garn-St Germaine Depository Institutions Act of 1982. These laws phased out statutory interest rate limitations and expanded the scope of permissible investments. Thrifts were allowed to invest in commercial loans and increase their consumer and nonresidential real estate lending.

With deregulation, thrifts ventured into new, riskier strategies to attract deposits and generate higher profits. These risky activities, combined with interest rate mismatches, fraud, insider abuse, and management's lack of expertise in new investments, precipitated a series of thrift failures which dramatically affected the soundness of the thrift industry as problem institutions were merged with and/or acquired by other institutions. Although the number of thrifts declined from 4,365 in 1970 to 4,039 in 1979, figure 1.1 shows that a much more dramatic decline occurred during the 1980s. By 1991, the number of thrifts stood at 2,187. Despite the decline in the number of thrifts, the total assets of the thrift industry grew during the 1970s and 1980s. However, the thrift industry's total assets have declined during 1990 and 1991. As of December 31, 1991, consolidated assets of federally insured thrifts totaled about $931 billion.

Figure 1.1: Number of Thrifts From 1970-1991



Source: Data provided by OTS headquarters.

During the 1980s, thrift regulators struggled to keep pace with the changing laws and regulations and the weakening condition of the industry. Eventually, heavy losses from numerous thrift failures depleted the FSLIC's reserves to the point of insolvency. On August 8, 1989, its last day of operation, FSLIC reported a capital deficit of $87 billion—the largest ever reported by a public or private corporation.

Examinations Are the Cornerstone of Thrift Regulation

An office within the Department of the Treasury, OTS has authority to (1) grant thrifts federal charters, (2) establish regulations governing them, (3) examine and supervise them and their affiliates, and (4) enforce their compliance with federal laws and regulations. Five regional offices supervise and examine thrifts, while OTS headquarters develops national policy guidelines and monitors the thrift industry as a whole.

Annual on-site examinations are the primary means by which OTS assesses thrifts' financial health and compliance with laws and regulations. To guide the examination process, OTS has published the Thrift Activities Regulatory Handbook, setting forth examination objectives and recommended procedures. OTS also periodically reviews financial data submitted by thrifts to identify changes in their operations. This off-site monitoring process supplements on-site examinations and allows OTS to maintain oversight of thrifts between examinations.

OTS has adopted a policy of performing annual full-scope safety and soundness examinations of every thrift, in an effort to keep pace with the volatile condition of the thrift industry and the effects of changing laws and regulations. OTS advised us that it does not rely on state examinations in planning or conducting examinations. During its examinations, OTS reviews five critical areas of a thrift's operation, commonly referred to as the MACRO elements: (1) management (effectiveness of the thrift's board of directors, capability of executive management, soundness of internal controls), (2) asset quality (quality of loan approval process, level and severity of delinquent loans, adequacy of loan loss reserves), (3) capital adequacy (compliance with regulatory capital requirements, trends in capital levels), (4) risk management (exposure to fluctuations in interest rates, compliance with liquidity requirements), and (5) operating results (level and stability of earnings, future earnings prospects, dividend payouts).

The examiner's objective is to perform sufficient work to rate each MACRO element and determine a composite rating. The ratings range from 1 to 5, with 1 indicating the least degree of supervisory concern and 5 indicating the highest degree of supervisory concern. The MACRO ratings play a crucial role in OTS's supervision of thrifts. OTS uses MACRO ratings to determine the level of testing planned for on-site examinations, to initiate enforcement actions, to grant applications for such requests as mergers, and to close severely troubled thrifts. Furthermore, OTS uses the ratings to identify trends in particular institutions, as well as to assess the condition of the industry as a whole.

Examiners conclude the examination by issuing ratings for each MACRO element, an overall composite rating, and a report of examination. A copy of the report with the composite rating is provided to the thrift's management.

Objectives, Scope, and Methodology

Our specific objectives were to

- determine whether OTS's examination practices for review of loan quality and internal controls provided a reasonable basis to judge the thrift's financial condition and the safety and soundness of its operations,
- assess whether documentation supporting examination conclusions and supervision of work was adequate to ensure examination quality, and
- evaluate whether OTS and FDIC coordinated their examinations to maximize the effectiveness of supervision.

To address the above objectives, we randomly selected a sample of 20 thrifts from the universe of 2,612 federally insured solvent thrifts as of September 30, 1990. We then selected the most recent full-scope safety and soundness examination for these 20 thrifts as of June 30, 1991. Our sample allows us to project our results to the universe of the most recent full-scope examination for the 2,612 thrifts. Our estimates are at the 95 percent confidence level. 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.

To determine whether OTS examination practices for reviewing loan quality and internal controls provided a reasonable basis for judging the safety and soundness of thrifts, we reviewed the examination procedures contained in OTS's Thrift Activities Regulatory Handbook. In addition, we obtained and reviewed the working papers supporting the 20 examinations in our sample to determine if the work performed by examiners supported their conclusions reached about thrifts' loan quality and internal controls. The examinations we reviewed were conducted by OTS between August 1989 and June 1991.

We also analyzed OTS's examination working papers to assess its quality control practices. Specifically, we looked at the adequacy of the documentation of the scope of the work performed, the methodology used by the examiners in their assessments, and the supervisory review of the work performed and conclusions reached by the examiners. To obtain additional information on the work performed, we interviewed the OTS examiners-in-charge for all 20 examinations.

To determine the level of coordination between OTS and FDIC regulators, we reviewed the examination reports issued by both regulators for the thrifts in our sample. We analyzed OTS working papers to ascertain how its examiners used the work performed by FDIC. We also discussed coordination with the examiners-in-charge, as well as with FDIC and other OTS officials.

Our work was performed at OTS headquarters in Washington, D.C., and at OTS regional offices located in Chicago, Dallas, and San Francisco. We conducted our review between December 1990 and January 1992 in accordance with generally accepted government auditing standards. We obtained agency comments from OTS on a draft of this report and from FDIC on a draft of chapter 4. OTS's and FDIC's comments are included as appendixes I and II, respectively.

Examination Practices Inhibited Early Detection of Loan Quality Problems

Quality loan reviews are critical to reaching accurate assessments of thrift safety and soundness and to detecting loan problems before they result in losses. However, OTS examination guidance provided considerable discretion to the examiners in determining the scope and documentation of the loan reviews performed during examinations. For the 20 thrifts in our sample, the examiners frequently (1) reviewed less than 10 percent of the thrift's total loan value and (2) selected loans for review in a manner that did not ensure an accurate, comprehensive assessment of the thrift's overall loan portfolio condition. In addition, almost half of the examinations did not have evidence that supervisors reviewed the loan evaluations. Without assurance that examiners review a minimum representative sample of loans and that loan evaluations are accurate, OTS cannot reliably gauge the adequacy of the loan loss reserve nor the overall safety and soundness of thrifts or the risk that they pose to the insurance fund.

Examiner Assessments of the Loan Portfolio Were Inadequate

The examiner's ability to assess the safety and soundness of a thrift's current operations and future viability is largely dependent on performing sufficient reviews of loans. Risky and uncollectible loans are a leading cause of thrift failure. In our June 1989 report on thrift failures, we found that unsafe loan underwriting and lending practices contributed significantly to the downfall of 24 of the 26 failed thrifts we reviewed.

Despite the importance of assessing loan quality in judging safety and soundness, OTS did not require its examiners to review a representative portion of the thrift's portfolio. For the examinations in our sample, examiners left significant portions of the thrifts' loans untested and typically did not review a representative sample of loans. As a result, examiners did not have a sufficient basis to accurately assess the condition and riskiness of the overall loan portfolio.

Representative Samples Are Essential for Assessing Loan Quality

In order to draw a valid conclusion about the quality of a thrift's loan portfolio, a representative sample of loans 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.

Assurance about the quality of loans could be achieved by selecting loans for review in a nonstatistical manner. However, this would require reviewing a significant dollar amount of the loan portfolio to ensure that the portion not reviewed, if misstated, would not materially affect the institution. However, a sample selected in a nonstatistical manner would not allow conclusions to be drawn about the entire population but only the portion reviewed.

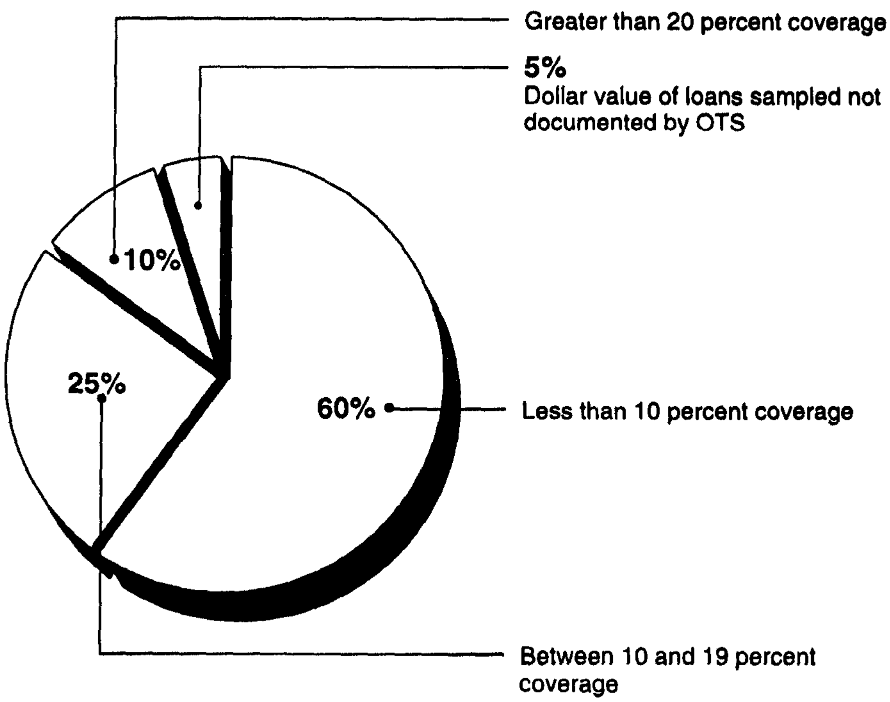
In evaluating a thrift's loan portfolio using a statistical or nonstatistical sample, a significant number of errors noted by examiners in their testing would require that the sample be expanded. If significant errors were still noted, then examiners would be required to perform a significantly larger review of the loan portfolio to determine its true condition.

Examiners Did Not Assess Large Segments of the Loan Portfolio

OTS's Regulatory Handbook stated that the objective in sampling loans is to provide examiners with sufficient information to draw reliable conclusions about the condition of the loan portfolio and the associated risk to a thrift's viability. However, the basis for the examiners' conclusions was questionable since most of the examinations in our sample were not representative of the thrifts' portfolios and covered less than 10 percent of the thrifts' total loan dollar value. (See figure 2.1.) Based on our sample, we estimate that examiners reviewed less than 10 percent of thrifts' total loan dollar value during the most recent full-scope examination for at least 38 percent of the 2,612 thrifts.[1]

[1]The range of our estimate, at a 95 percent confidence level, is that these conditions existed for the most recent OTS examination at between 38 percent and 79 percent for the 2,612 thrifts that were supervised by OTS as of September 30, 1990.

Figure 2.1: Examination Coverage of Total Loans at Sampled Thrifts



OTS's guidance provided significant discretion to the examiners regarding the level of loan sampling. Although OTS's Regulatory Handbook was intended to promote standardization of the examination process, examiners are not required to perform its procedures. For example, it recommended that examiners sample at least 40 to 60 percent of the dollar value of the thrift's high-risk loans.[2] However, 15 of the 20 examinations in our sample did not achieve this recommended minimum coverage rate. OTS examiners said that the 40-percent criteria was only a recommended criteria and that they felt that they had sufficient coverage to assess the riskiness of the thrift's loans.

OTS Could Not Project Results of Loan Reviews

Examiners still might have accurately assessed thrifts' loan portfolios, had they selected loans on a statistical sampling basis to compensate for low rates of coverage. This would have provided the examiners with a basis for

[2]OTS considers all loans other than mortgages on one- to four-family, owner-occupied residences, and loans for small dollar amounts, such as consumer loans, to be high risk. For example, mortgages on commercial real estate and multi-family residences, as well as insider loans and multiple loans to one borrower, are considered to be high-risk loans.

determining if additional sampling was needed to determine the causes and financial impact of any deficiencies noted during the loan review. The OTS Handbook did not require examiners to use representative sampling or any specific sampling methodology. For 17 of the examinations in our sample, OTS judgmentally selected loans they considered riskiest to the thrift. These included problem or classified loans[3] identified by the thrift and other loans considered to be "high risk." We estimated that examiners judgmentally selected loans in a manner that resulted in nonrepresentative loan coverage during the most recent full-scope examination for at least 64 percent of the 2,612 thrifts.[4]

OTS's practice of selecting problem and high-risk loans for review on a judgmental basis, rather than sampling a thrift's entire portfolio, does not permit regulators to anticipate emerging problems in the overall portfolio. The examiners cannot have reasonable assurance that the portion of loans not reviewed contain no fundamental weaknesses that could result in substantial losses to the thrift.

For example, one thrift in our sample had a history of asset quality problems noted by OTS, FDIC, and state regulators. The thrift had an increasing level of delinquent mortgages on single-family dwellings. Loans of this type made up about two-thirds of the thrift's assets, so widespread problems with their quality could easily result in the thrift's failure. Yet the examiners did not select a representative sample of mortgages for single-family dwellings. Instead, they restricted their review to problem loans identified by the thrift, which accounted for about 14 percent of the thrift's total loan value. As a result, the examiners did not have a sufficient basis to gauge the future loss potential of the large portion of loans not reviewed.

MACRO Ratings Were Upgraded Despite Questionable Loan Coverage

Notwithstanding their incomplete assessments of loan quality, OTS examiners continued to reach judgments on thrifts' overall safety and soundness. While asset quality is only one area reviewed by the examiners, it affects all aspects of the thrift's operations and performance. The condition of the loan portfolio is critical to accurately rating the thrift's

[3]Problem loans are loans in which the payments are 30 days or more delinquent or previously classified loans. Classified loans are considered by the regulators or the thrift to be inadequately protected by the collateral, if any, or paying capacity of the borrower. The three categories (substandard, doubtful, and loss) of classified loans represent increasingly higher estimated potential for loan losses.

[4]The range of our estimate, at a 95 percent confidence level, is that these conditions existed for the most recent OTS examination at between 64 percent and 97 percent of the 2,612 thrifts that were supervised by OTS as of September 30, 1990.

performance in such elements as operations and capital and is an indicator of thrift management's competence. Yet, despite questionable coverage of loans, OTS improved one or more MACRO element ratings in 13 of the 20 examinations.

In one examination, OTS did not sample any loans for review. Instead, the examiners reviewed the thrift's listings of delinquent loans and multiple loans to one borrower, looking for adverse trends. Without any review of independently selected loans, OTS raised the thrift's asset quality rating from a 2 to a 1, the highest possible rating. The OTS examiner-in-charge said that the thrift's asset quality rating was raised because they found no indications of any asset quality problems and there had been little new lending activity since the last OTS examination. In effect, the examiners relied on the thrift to accurately report the condition of its loan portfolio.

In another examination, OTS reviewed only 14 percent of the thrift's nonresidential mortgage loans. This segment of the loan portfolio represented over one-fifth of the thrift's total assets and consisted primarily of church and commercial real estate loans, which are considered by OTS to be high-risk loans. OTS limited review of this portfolio to newly originated loans and thrift-identified problem loans. Significant problems in the $18 million of nonresidential loans not tested could have adversely affected the thrift's $3.5 million in capital. Despite the limited coverage, OTS improved the thrift's capital, asset quality, and management MACRO ratings.

Limited Loan Review and Inconsistent Approach Impaired Loan Loss Reserve Assessment

OTS examiners did not employ a consistent methodology in assessing the adequacy of the allowance for loan losses in the 20 thrifts in our sample. In addition, the low level of loans reviewed in these examinations made it virtually impossible for OTS to reliably assess the adequacy of the related loan loss reserve.

OTS examiners are responsible for determining whether thrifts have fulfilled their responsibility for establishing reliable estimates of the loss exposure of their loan portfolios. However, OTS provided only general guidance to examiners regarding how they are to evaluate the thrift's process for maintaining an adequate allowance for loan losses. This resulted in the examiners taking widely varying approaches to assessing the loss allowances at the 20 thrifts in our sample. For example, the examiners at one thrift simply updated its loan loss reserves to reflect additional classifications made during the examination. At another thrift, the examiners used the average of four different calculations to estimate the required reserve level. The lack of a standard methodology for the examiners to assess loan loss reserves can result in inconsistent examinations of thrifts and increased risk of inadequate loan loss reserves. OTS officials acknowledged the need for a more consistent methodology and stated that they were working closely with FDIC to develop a more consistent methodology that was acceptable to both regulators.

Loan Review Lacked Quality Control

OTS lacked sufficient control over the quality of loan reviews to ensure that the work performed was competent and comprehensive. Government and generally accepted auditing standards require that a system of quality control include, at a minimum, adequate documentation of examination work and evidence of on-site supervision to provide assurance of the quality of work. However, OTS's loan review working papers frequently (1) were not sufficiently detailed to enable independent reviewers to clearly judge the competency and sufficiency of the work performed and (2) lacked consistent evidence of supervisory review.

OTS's Regulatory Handbook provided only broad guidance to its examiners regarding the nature and level of detail needed to support examination work and did not require supervisors to document their review of the work performed by subordinate staff. The Regulatory Handbook stated that working papers should be sufficiently detailed to enable the regulator to make a proper analysis and reach a sound decision. According to the Handbook, examination working papers should describe the scope, document the procedures performed, and support the conclusions reached for each area of review. However, except for recommending documentation of loan sampling methodology, the Handbook only provided examples of information that may be included in the working papers. The Handbook specifically encouraged the examiners to avoid excess documentation and to use their judgment regarding the sufficiency of documentation.

OTS's Handbook recommended that examiners document their criteria for selecting loans to review and the percentage of high-risk assets sampled. However, of the 20 examinations we reviewed, 16 did not include adequate documentation of the sampling methodology in the supporting working papers. When we interviewed OTS examiners, they could not recall the specific criteria they used to select loans and could provide only a general description of their loan selection methodology. Only 5 of the 20 examinations in our sample had documentation identifying the universe of high-risk loans and their corresponding coverage of the high-risk loan portfolio.

Examiners did not provide sufficient information to justify their classification decisions in 7 of the examinations in our sample. For example, the working papers for an examination of a thrift with $1.2 million in self-classified loans contained sufficient information to support the examiner's review of the loan files for only two classified loans with a total value of $86,000. The examiner prepared the documentation to support his downgrading of the two loans from substandard to doubtful. For the remaining $1.1 million in classified loans, there was no evidence that the examiners had reviewed the loan files to determine the likelihood of repayment or reviewed the underlying collateral to assess the thrift's loss exposure.

In addition, examination working papers for the 20 examinations did not contain consistent evidence of supervisory review. OTS's examination guidance did not require that the examiner-in-charge review and sign off on the work performed by assistant examiners. On nine examinations, there was no evidence that supervisors reviewed and concurred with loan reviews. Given that review and classification of loans entails a large measure of judgment, the lack of supervisory review raises questions about the consistency and accuracy of examiners' classifications.

OTS Efforts to Address Loan Examination Weaknesses

OTS issued a memorandum to its examination staff in September 1991 to address concerns raised by us in this review and the Department of the Treasury's Inspector General during an audit of OTS's examination process.[5] The memorandum addressed some of the loan review weaknesses identified during our review of the 20 thrift examinations, particularly the need for better working paper documentation. However, the memorandum did not address how OTS will ensure that the new guidance is being effectively implemented and continues to provide examiners considerable discretion in the area of loan review.

The memorandum modified loan sampling guidance to require examiners to use statistical sampling techniques in reviewing the reliability of a thrift's internal loan review and classification system. If the examiners find the internal loan reviews to be acceptable, they may use the loans reviewed internally to meet the suggested minimum sampling coverage, which was lowered from 40 percent to 30 percent of high-risk loans.

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

However, the memorandum did not require the examiners to statistically sample those loans not reviewed and classified by the thrift. Instead, examiners are to use judgmental, nonrepresentative sampling if they find the internal loan reviews unreliable, or if additional sampling is required to meet the recommended minimum coverage level. Thus, large portions of the thrift's total loans could remain untested.

The September 1991 memorandum also established OTS's asset review documentation requirements and emphasized the need for examiners to comply with the requirements. The memorandum stated that working papers must describe criteria used to select samples, initial and supplemental sampling techniques, and the high-risk assets included in judgmental sampling. It stated that documentation should be sufficient to allow a reviewer to identify the assets reviewed, understand the rationale for the selection of the assets, and determine the percentage of assets reviewed for each portfolio and the overall coverage of high-risk assets. The memorandum also stressed the need for examiners to record enough information to clearly identify any loans reviewed and the basis for classification. The memorandum also required for the first time that the examiners-in-charge document their working paper review by initialing either each examination program or the listing of programs and supporting working papers.

OTS also published proposed revisions to its examination guidelines in the September 1, 1992, Federal Register. The proposed guidance provides specific percentage ranges for examiners to use in estimating the reserves necessary for classified assets. The guidance also provided general factors for the examiners to consider in determining the appropriate loss reserve levels. We believe that the proposed guidance was an important first step, but it did not address the application of specific factors to be considered in determining the appropriate loss reserve levels.

Conclusions

OTS's approach to assessing the quality of loans did not provide assurance that examiners performed sufficient work to assess the condition of loans and the extent and magnitude of loan problems. Examiners did not review a representative sample of loans and thus could not estimate the results of their review for the loan portfolio. Since examiners reviewed only a small portion of the thrift's total loans, the absence of a representative sample raises concerns about OTS's ability to reliably assess a thrift's safety and soundness. Further, OTS lacked a consistent methodology for assessing the adequacy of loan loss reserves which increases the risk to the insurance fund that thrifts may have inadequate reserves for loan losses.

The sufficiency and quality of the loan examination work we reviewed and the accuracy of examiners' conclusions are uncertain because (1) examiners did not document the performance of critical loan review procedures and (2) supervisors frequently did not document their review of working papers. This approach does not ensure consistency among examinations and may allow loan quality problems to go undetected until they are too pervasive to avoid failure of the thrift institution. OTS's September 1991 instructions addressed these documentation problems and were a good first step. However, they continued to provide too much discretion and lacked definitive requirements to ensure improvement of quality control over examinations.

Recommendations

We recommend that the Director of the Office of Thrift Supervision take the following actions:

- Revise OTS examination guidance to (1) require that examiners utilize 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 and expand their loan review as appropriate based on the sample results and (2) provide examiners with a standard methodology to evaluate the adequacy of a thrift's overall loan loss reserve. Development and implementation of this guidance should be coordinated with the other federal depository institution regulatory agencies to achieve uniform requirements.
- Monitor examiners' compliance with loan sampling, documentation, and supervisory review requirements and ensure sufficient work is done to assess the condition of thrifts' loan portfolio and the extent and magnitude of loan problems.

Agency Comments and Our Evaluation

OTS agreed with all of our recommendations. OTS plans to test alternative approaches to loan sampling, including representative sampling. OTS will use its test results to evaluate changes needed to current loan sampling guidance. OTS's use of representative sampling would provide examiners with greater assurance on the condition of that portion of the loan portfolio not extensively tested. This in turn should lead to more accurate assessments about the thrift's overall safety and soundness.

OTS agreed that additional guidance was needed on the evaluation of loan loss reserves. OTS believes that the revisions to the examination guidelines it proposed on September 1, 1992, will serve that purpose. We believe that guidance is a good start, but more guidance is needed in the application of specific factors in determining loan loss reserves.

OTS commented that it plans to review examiners' compliance with loan sampling, documentation, and supervisory review requirements during its fiscal year 1993 Federal Managers' Financial Integrity Act program. We believe that such reviews are important and need to be conducted on a periodic basis. The reviews should provide assurance that examiners are performing sufficient work to assess the condition of thrifts' loan portfolio and to determine the extent and magnitude of loan problems.

Coverage of Internal Controls Insufficient for Early Detection of Weaknesses

Weak or nonexistent internal controls are among the primary characteristics contributing to thrift failures. However, OTS's approach to assessing internal controls did not provide assurance that weaknesses in a thrift's internal controls will be detected in their early stages, before they became severe and contribute to the thrift's failure. OTS did not require its examiners to comprehensively review internal controls. Instead, OTS's principal approach to assessing internal controls was to review (1) questionnaires completed by thrift management and (2) management letters and audit reports completed by external auditors. OTS did not verify the accuracy of thrift management's representations about internal controls or review the external auditor's work in this area as a basis for relying on it.

Comprehensive Internal Control Reviews Can Help Avert Thrift Failures

Our June 1989 report found that one of the main differences between solvent and failed thrifts was the presence or absence of effective internal controls. We concluded that internal control deficiencies were more of a factor in thrift failures than adverse economic conditions. OTS considers its evaluation of internal controls as part of its assessment of management in its MACRO rating system. As a result of being included in this broad category, internal controls have been deemphasized in examinations and their importance obscured.

Internal controls comprise a thrift's plan of organization, policies, procedures, and records. Internal controls safeguard assets; ensure accurate and reliable data; foster compliance with policies, laws, and regulations; and promote management efficiency. Internal controls should help prevent, detect, and facilitate early correction of errors and irregularities in all aspects of thrift operations. Examples of effective internal controls include personnel qualified in their area of responsibilities, segregation of duties, authorization of transactions and activities to ensure reliable financial records, controls over access to assets and important documents, and periodic comparison of records with actual assets and liabilities and resolution of any discrepancies.

Internal control reviews include (1) interviewing and observing thrift personnel to assess their competence and commitment in adhering to prescribed internal controls, (2) cataloging all major thrift operations and related key internal controls to identify potential risk areas, and (3) selecting a representative sample of transactions, preferably statistically chosen, from each major thrift operation to evaluate compliance with key internal controls and to identify pervasive problems and the appropriate level of further testing needed to quantify them.

Typically the most significant aspect of a thrift's business is its lending operation. We believe that a comprehensive review of controls done as part of an examination in this area would usually involve the following procedures:

- Interviewing and observing thrift senior management (including the board of directors), loan officers, loan servicing staff, and accounting staff to evaluate their competence to function in their designated area of responsibility and their commitment to prescribed policies. This procedure could identify weak direction, dictatorial senior management, incompetent personnel, intimidated subordinate employees, and other attributes that would significantly raise the likelihood for circumvention of key internal controls.
- Reviewing and documenting lending policies and procedures to identify key internal controls that ensure the thrift is operated safely and soundly. This review should include all aspects of the lending process, from loan solicitation through disbursement and recording.
- Testing a representatively selected sample of new and old loans which should include a sample of high-risk loans to determine the extent of compliance with key internal controls over the granting, servicing, and recording of loans. This loan control testing will identify problems and their root causes, indicate the extent of problems, and provide a basis for the level and focus of additional testing needed to quantify the impact of problems. Also, the results of testing will determine the appropriate supervisory action needed to correct the problems.

OTS Did Not Perform Comprehensive Reviews of Internal Controls

Although OTS guidance stated that examiners are expected to review internal controls during their examinations, it did not require specific testing of internal controls. Instead, the examiners were given considerable discretion over the extent of internal control reviews. For one of the examinations in our sample, there was no evidence that examiners reviewed the thrift's internal controls. For the remaining 19 examinations, examiners reviewed information provided by the thrifts and/or the external auditors to determine the presence or absence of specific controls and identify control weaknesses. The examiners said they tested selected aspects of the internal control environment, such as the thrift's compliance with its loan underwriting standards, during their review of loans.

However, the inadequate loan coverage discussed in chapter 2 precluded OTS from using the loan review results to satisfactorily assess the overall internal control environment. As a result, we believe that OTS's review of internal controls was deficient on all 20 examinations. We estimated that OTS did not adequately review internal controls for nearly all 2,612 thrifts covered by our work during the most recent full-scope examination.[1]

The OTS Regulatory Handbook stated that examiners should review and evaluate the adequacy and effectiveness of internal controls as the first steps of an examination. According to the Handbook, the objectives were (1) to determine whether existing controls afford reasonable assurance that the accounts and records are accurate and reliable, operations are properly authorized, and assets are adequately safeguarded, and (2) to identify weaknesses that require correction or further testing during the examination.

The examination procedures provided broad guidance on the assessment of internal controls but did not require a specific level of testing. For example, one examination procedure stated that the examiner should "verify that all policies are being properly enforced." However, the Handbook did not explain how the verification should be performed, what areas need to be emphasized, or what level of testing is required in making this assessment.

When beginning an examination, OTS required that thrifts complete an internal control questionnaire. The questionnaires contained a checklist and were tailored to produce information about the operation of controls in cash, lending, credit quality, internal audit, electronic data processing, and thrift management. OTS examiners verified thrift management questionnaire responses for 3 of the 20 thrifts in our sample. However, the examiners did not test the accuracy of the thrifts' questionnaire responses used in 17 of the 20 examinations to identify the presence and effectiveness of critical internal controls. Without independent verification of the thrifts' responses, examiners cannot rely on the questionnaires to make the determination that critical controls are actually in place and effective.

OTS examiners did not review the quality of work performed by the external auditor to determine what, if any, reliance could be placed on the external auditor's assessment of internal controls. External auditors are

[1]The range of our estimate, at a 95 percent confidence level, is that these conditions existed for the most recent OTS examination of between 83 percent and 100 percent of the 2,612 thrifts that were supervised by OTS as of September 30, 1990.

required to assess internal controls during the annual financial statement audits that are mandatory for each thrift. On 18 examinations, examiners complied with OTS examination guidance that recommended that examiners review the external auditor's reports to check for any material internal control weaknesses. However, despite having the authority to review the external auditor's work, examiners stated they did not review the external auditor's underlying working papers. As a result, OTS could not effectively rely on the work performed by the external auditors since it lacked assurance of the extent and quality of work performed by the auditors in assessing internal control weaknesses.

Although examiners looked for compliance with internal controls during the review of other areas, notably loan review, the scope of their work was not sufficient to assess the overall system of internal controls. For example, examiners assessed a thrift's compliance with its loan underwriting procedures—the steps thrifts perform before approving a loan which assess and document the borrower's ability to repay the loan. However, this assessment was not reliable because it was based on loans, as discussed in chapter 2, that were not representative of all loans.

FDIC Improvement Act of 1991 Can Strengthen Internal Control Assessments

The FDIC Improvement Act of 1991 (Public Law 102-242) requires federally insured thrifts and banks with assets of $150 million or more to annually report to the federal and state 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 the FDIC or the appropriate federal banking regulator. The report also must include management's assessment of (1) the effectiveness of the institution's internal control structure and procedures 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 attest and 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 thrift and bank managements' 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 and considering the possibility of illegal acts. 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 in 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 illegal 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 thrifts and 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' review of management's assessment and the external auditor's internal control work, including working papers, policies, and procedures, will be crucial to provide a basis for reliance. Institutions with fewer than $150 million of assets, are not required to report under the act. For those, the regulators' work can be expanded to include an independent review of the effectiveness of internal controls and compliance with laws and regulations. OTS requires all thrifts to obtain an annual audit of their financial statements. As previously discussed, the external auditor's scope of work will include some level of internal control review which OTS can use as appropriate in assessing the condition of a thrift's internal controls.

The FDIC Improvement Act also requires annual full scope examinations of thrifts with assets greater than $100 million. The act allows these examinations to be conducted by state thrift regulators in alternate

12-month periods, if the federal thrift regulator determines that the examination of the thrift conducted by the state during such an intervening 12-month period was equivalent to a full-scope, on-site examination. OTS's current policy is to conduct annual examinations of all thrifts and it does not rely on state examinations. If OTS decides to alter its practice and rely on state examinations, a program to review the state thrift examiners' work would provide OTS an appropriate basis for reliance on that work.

Conclusions

Effective supervision and examination is intended to provide an early warning system to identify and correct internal control weaknesses before they lead to further deterioration in the condition of thrifts. However, for all 20 thrifts included in our review, OTS did not ensure that either the examiners or the external auditors performed comprehensive reviews of internal controls. Complete reviews of internal controls would allow OTS to exercise this type of anticipatory approach to regulation. For thrifts with assets of $150 million or more, the FDIC Improvement Act requires more thorough reviews of internal controls by thrift management and external auditors. Thrift examiners can leverage their limited resources by relying on the work of external auditors once they have reviewed and tested such work to ensure its adequacy. It is also important that OTS review the adequacy of internal controls of smaller thrifts during its examinations.

Recommendations

We recommend that the Director of the Office of Thrift Supervision take the following actions:

- Develop comprehensive internal control review procedures for all major aspects of thrift operations to be used during OTS's annual on-site examinations. The procedures should identify any major risk areas in each thrift's operations, and the related significant internal controls, and require a level of testing that would provide a basis for assessing the effective operation of the internal controls.
- Require thrift 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 developed internal control review procedures to review the quality of management's and the external auditor's internal control assessments.

- Establish procedures examiners should perform to enable OTS to assess the adequacy of internal control evaluations and documentation requirements for the examiners' assessments of work performed by auditors.
- Require examiners to conduct independent comprehensive reviews of internal controls of the thrifts with assets of less than $150 million.
- Require that the condition of a thrift's system of internal controls be added to the MACRO rating as a separate critical area for rating to highlight the significance of an internal control review to a thrift'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

OTS agreed with all of our recommendations in this chapter except for the recommendation to perform comprehensive internal control reviews for thrifts with assets of less than $150 million. OTS stated that it recognized the need to test the adequacy of internal controls during thrift examinations and that it plans to revise its current examination guidance to emphasize periodic testing of internal controls. OTS cited budgetary constraints coupled with the annual examination requirement as precluding it from performing comprehensive internal control reviews of thrifts with assets less that $150 million.

We believe examiners should test internal controls during each annual full-scope examination to allow OTS to identify and correct internal control weaknesses before they result in deterioration of a thrift's financial condition. The need to identify and correct internal control weaknesses is no less acute for thrifts with less than $150 million in assets. Since internal control weaknesses are a common characteristic of failed thrifts, it is important that examiners assess the internal controls of all thrifts including those with less than $150 million in assets.

OTS has issued preliminary guidance to its examination staff on the use of external audits. OTS plans to further develop the guidance with the issuance of regulations on internal control evaluation and reporting requirements for external audits mandated by the FDIC Improvement Act. The preliminary guidance contained specific procedures and documentation requirements regarding the review of external audit products. However, the examination procedures contained in the preliminary guidance did not make the review of the external auditor's working papers mandatory. We believe that examiners cannot rely on the work performed by the external auditors without a review of the external auditor's working papers. Without an understanding of the scope and quality of work performed by the external auditors as evidenced by the working papers, OTS cannot determine the extent of reliance that can be placed on the external auditor's work.

OTS agreed that its rating system should be revised to highlight the importance of internal controls in thrifts' safety and soundness. It plans to add a sub-component for internal controls to the management element. In addition, OTS plans to work with the other federal regulators to achieve uniform requirements on the review and assessment of internal controls during examinations.

Regulatory Resources Were Used Inefficiently

Although both OTS and FDIC have the authority to examine thrifts, they had not effectively coordinated their efforts. Consequently, they conducted examinations of the same thrifts within similar periods. Prior to the passage of FIRREA in 1989, FDIC had no involvement with the thrift industry. FDIC performed its own examinations of thrifts during 1990 to obtain first-hand knowledge of their financial condition. However, FDIC continued to perform independent thrift examinations during 1991 and 1992, duplicating OTS's efforts. This overlap came at a time when deteriorating conditions in financial institutions were imposing an unprecedented work load on regulators. Moreover, in some instances, OTS and FDIC reached conflicting conclusions regarding the strength of the same institutions. Such disagreements send confusing signals to thrift management and undermine the credibility of the regulatory process.

OTS and FDIC Performed Duplicative Examinations

OTS and FDIC examinations had the same objective: to assess the safety and soundness of the thrift industry. FIRREA empowered the Director of OTS, as the primary regulator of the thrift industry, to conduct examinations, prescribe regulations, and issue orders, as necessary to ensure the safe and sound operation of savings institutions. The act also stipulated that FDIC, as the administrator of the newly created insurance fund, could examine any institution applying for or covered by FDIC insurance and recommend or take independent enforcement action.

As shown in table 4.1, each regulator performed independent examinations and prepared separate reports of the 20 thrifts in our sample during a 12-month period. In 13 of 20 cases, thrifts were examined by OTS and FDIC within 6 months of each other. However, they worked together at only 5 of those thrifts.

Table 4.1: Months Between FDIC and OTS Examinations

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

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

Conflicting Assessments Damage Credibility of Regulatory Process

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

Both regulators review and rate the same basic areas of a thrift's operations. FDIC reviews and generates ratings for five areas that are commonly referred to as the CAMEL elements: (1) capital adequacy, (2) asset quality, (3) management, (4) earnings, and (5) liquidity. In comparison to OTS's MACRO rating system, the capital, asset quality, and management elements are the same. While FDIC refers to one element as earnings, OTS refers to the same area as operating results. OTS's risk management element is similar to FDIC's liquidity element, but reflects thrifts' traditional concentration in fixed-rate residential mortgages that exposes them to greater interest rate risks. Both regulators use a five-point scale to rate the thrift's performance in each area.

Since both regulators use virtually the same rating system, composite ratings should be consistent. Each regulator's definition for the condition identified by the 1 to 5 rating was virtually the same as to the degree of safety and soundness it represented. However, FDIC and OTS disagreed on the composite rating on 5 of the 11 thrifts that they examined within 3 months of each other. (See table 4.2.)

Table 4.2: Differing Composite Ratings at Five Thrifts

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

For example, FDIC's composite rating for institution A was a rating of 4, while OTS examined the thrift 3 weeks later and rated it a 3. This was attributable to differences in the examiners' judgments of management performance, asset quality, and operating results (earnings), even though these factors had not changed discernibly over the intervening 3 weeks. For institution B, the composite rating difference appeared to be due to the regulators' different standards for capital requirements.

Differences in composite ratings send conflicting messages to thrift management regarding a thrift's condition. The director of one thrift expressed his concern over the inconsistency between regulators during a meeting with FDIC and OTS examiners. FDIC had rated this thrift a 5, while OTS rated it a 4. With its composite rating of 5, FDIC indicated that the institution had an extremely high, immediate, or near-term probability of failure and required urgent aid. OTS, with its composite rating of 4, indicated that a potential for failure was present, but not imminent if prompt action was taken to satisfactorily resolve serious problems or unsafe and unsound conditions.

OTS and FDIC Did Not Effectively Coordinate Examination Efforts

The duplicative examinations performed by OTS and FDIC and the conflicting results showed a lack of coordination and reliance between the two regulators. According to FDIC officials, examination coordination between FDIC and OTS has improved since January 1991. FDIC and OTS signed a joint memorandum on May 18, 1992, that required the two regulators to more effectively coordinate the examinations of thrifts. The memorandum was effective immediately. The provisions of this memorandum provided for improved coordination but allowed for both FDIC and OTS to continue separate examinations which can result in duplicative efforts. It is still too early to determine the effectiveness of the new procedures on reducing duplication of thrift examination efforts.

Because thrift regulation was new to FDIC, FDIC headquarters directed its regional offices to examine all thrifts by the end of 1990 to have its own assessment of the condition of the industry. FDIC officials stated that differences in time frames and the number of institutions to be examined during the year made it impossible to coordinate this examination work. In January 1991, FDIC headquarters instructed the FDIC regional offices to coordinate with OTS and other regulators. FDIC then changed its 1991 examination schedule to vary the intervening period based on FDIC composite ratings. According to FDIC and OTS officials, this resulted in improved examination coordination, particularly for large thrifts. However, FDIC officials told us that because of differences in examination schedules and the availability of examiners it was impossible for FDIC to perform all its thrift examinations jointly with OTS. With the scarcity of regulatory resources to examine thrifts, the inability to coordinate examination schedules is a questionable reason for duplicating examinations.

FDIC and OTS officials also noted that they could not rely on each other's examinations until differences between the two regulators' standards are resolved. For example, FDIC required higher than the minimum levels of capital for thrifts determined to be risky, such as those with composite ratings of 3, 4, or 5. OTS stated that they likely would not require a thrift to maintain capital in excess of the minimum capital requirement. Other items on which FDIC and OTS differed include criteria for classifying assets and estimating allowances for loan losses. FDIC and OTS officials told us that they are trying to resolve their major assessment differences and rely more on each other's work.

In response to our concerns, the Director of OTS and the Chairman of FDIC signed a joint memorandum on May 18, 1992, that directed the FDIC and OTS Regional Directors to more efficiently discharge their responsibilities. The objectives of the new guidelines and procedures established by the memorandum were to (1) clarify the roles of OTS and FDIC, (2) establish communication responsibilities among FDIC, OTS, and thrifts, (3) define examination and reporting roles and responsibilities of the two regulators, (4) establish a resolution process for material differences in examination findings and proposed corrective actions, and (5) promote the most efficient use of FDIC and OTS resources. The memorandum required FDIC thrift examinations to be performed on a joint basis with OTS unless compelling reasons dictate otherwise. Only the OTS report is to be issued to the thrift unless the FDIC Board of Directors authorizes its own independent enforcement action. The memorandum also established OTS regulations, policies, and directives as the basis for reaching examination conclusions.

Conclusions

By performing duplicate examinations and reporting conflicting results, OTS and FDIC wasted scarce resources and undermined the credibility of the examination process. At a time when financial problems at thrifts and banks have depleted the insurance funds and are causing heavy examiner workloads, regulatory agencies can ill afford such inefficiency. While FDIC and OTS have taken steps to coordinate their work, the effectiveness of those steps cannot be immediately determined.

Recommendation

We recommend that the Director of the Office of Thrift Supervision and the Chairman of the Federal Deposit Insurance Corporation monitor the implementation of their May 18, 1992, joint memorandum to ensure (1) effective coordination of their examinations of thrifts and (2) that a common set of standards is being used as a basis for reaching examination conclusions.

Agency Comments and Our Evaluation

OTS agreed with our recommendations. OTS plans to measure the effectiveness of its efforts to coordinate OTS and FDIC examinations of thrifts during 1993. OTS stated that it was in the process of establishing a working group with FDIC to evaluate conformance with the standards contained in the joint memorandum. According to OTS, the working group will also conduct periodic assessments of OTS and FDIC composite examination ratings of thrifts. The assessments will be used to determine if additional guidance is needed to ensure that OTS and FDIC examination conclusions are based a common set of standards.

In its comments on a draft of this chapter, FDIC agreed that inefficiencies existed between FDIC and OTS examination efforts initially, but stated that some inefficiencies were necessary to carry out the mandate of FIRREA. FDIC pointed out that there was a strong congressional and public mandate for resolution of thrift industry losses and a growing public concern about the cost to the taxpayers to cover thrift losses. FDIC cited a number of reasons why it was necessary for it to perform independent examinations of all thrifts during 1990. Specifically, FDIC cited differences between OTS and FDIC in (1) the analysis of commercial credit risk, (2) classification of problem assets, and (3) the required levels of regulatory capital. In addition, FDIC said that its staff were acquainted with analyzing commercial loans, but needed training regarding differences with thrift industry practices. Moreover, FDIC stated that its examiners found OTS's examination procedures differed significantly from FDIC's in practice. While we recognize that FDIC has the authority to conduct thrift examinations to protect the insurance fund, we believe that the resolution of differences between FDIC and OTS and the education of both regulators' personnel could have been more efficiently accomplished with more effective coordination.

FDIC stated that the two regulators have made considerable strides in resolving examination and supervision differences. FDIC stated that the regulators have been able to improve the number of examinations conducted jointly from 34 percent in 1990 to 69 percent in 1992. FDIC cited the agreement entered into by both regulators on May 18, 1992, as a mutual recognition that it was not good public policy to send institutions mixed signals as to condition or needed corrective action.

Comments From the Office of Thrift Supervision

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

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John F. Downey
Deputy Director
Regional Operations

October 27, 1992

Donald H. Chapin
Assistant Comptroller General
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Chapin:

This is in response to your letter of September 8, 1992, regarding the Office of Thrift Supervision Examination Quality Report (GAO/AFMD-92-58). We appreciate the opportunity to comment on the proposed report. Overall, we found your findings and recommendations helpful. We have restated the GAO recommendations, our comments and proposed response follow.

See comment 1.

Recommendation 1
Revise OTS examination guidance to require that examiners utilize 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 and expand their loan review as appropriate based on the sample results.

OTS Comment: Our loan sampling approach has been refined over the past several years, most recently with our mid-year examination update memo (September 27, 1991) to field staff. This memo was in direct response to the Treasury Inspector General's Examination Audit.

We agree that loan review should include a representative sample of a thrift's portfolio, consistent with our risk focused examination approach. We intend to evaluate the September 27, 1991 changes and continue to consider other methodologies, software, and training issues. This evaluation will determine whether or not we should make further changes to our current sampling approach. We will develop a pilot to test alternative approaches.

See comment 1.

Recommendation 2
Revise OTS examination guidance to provide examiners with a consistent methodology to evaluate the adequacy of a thrift's overall loan loss reserves. Development and implementation of

this guidance should be coordinated with the other Federal depository institution regulatory agencies to achieve uniform requirements.

OTS Comment: OTS recently published a proposed rule for comment (REF: Federal Register Vol. 57, No. 170, Tuesday 9/1/92, p. 39736, OTS-92-294). This proposal will be responsive to the GAO recommendation when implemented. Also, we are participating in the interagency working group to develop uniform standards.

<u>Recommendation 3</u>
Monitor examiners' compliance with loan sampling, documentation, and supervisory review requirements and ensure sufficient work is done to assess the condition of thrifts' loan portfolio and the extent and magnitude of loan problems.

See comment 1.

OTS Comment: We have included this as an assessable unit in Regional Operations' 1993 FMFIA program and will conduct at least one review of this area in FY 1993.

<u>Recommendation 4</u>
Develop comprehensive internal control review procedures for all major aspects of thrift operations to be used during OTS' annual on-site examinations. The procedures should identify the related significant internal controls, and require a level of testing that would provide a basis for assessing the effective operation of the internal controls.

See comment 2.

OTS Comment: OTS recognizes the need for testing the adequacy of internal controls. With this in mind, we will recast our current guidance to examiners to emphasize periodic testing of internal controls.

<u>Recommendation 5</u>
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 developed as guidance in reviewing the quality of management's and external auditors' internal control assessments required by the act.

See comment 2.

OTS Comment: When this program becomes effective, our examiners will rely on external auditors' assessments to help identify supervisory concerns.

See comment 2.

Recommendation 6
Establish documentation requirements for the examiners' assessments of work performed by auditors and procedures examiners perform to enable OTS to assess the adequacy of internal control evaluations.

OTS Comment: On September 11, 1992 we issued preliminary guidance on the use of external audits in safety and soundness examinations. The guidance identifies regulatory monitoring and examination procedures that will help examiners use external audits to supplement supervision and examination of savings associations. This guidance will be further developed with the issuance of rules mandated by Section 112 of FDICIA. We also plan to emphasize testing procedures to supplement review of internal controls when necessary. (See number 4.)

See comment 2.

Recommendation 7
Require examiners to conduct independent comprehensive reviews of internal controls of the thrifts with assets of less than $150 million.

OTS Comment: We disagree with recommendation. Our responses to recommendations 4, 5 and 6 are adequate. OTS budgetary constraints coupled with the current annual examination requirement preclude us from pursuing this recommendation.

See comment 2.

Recommendation 8
Require that the condition of a thrift's system of internal controls be added to the MACRO rating as a separate critical area for rating to highlight the significance of an internal control review to a thrift's viability.

OTS Comment: This suggestion has merit. We will add a sub-component for internal controls to our Management MACRO factor. Additionally, we will consider this recommendation in our efforts to convert our current examination rating system from MACRO to CAMEL.

See comment 2.

Recommendation 9
Coordinate the implementation of the internal control recommendations with the other Federal depository institution regulatory agencies to achieve uniform requirements.

OTS Comment: To the extent this is possible, we will work with the other agencies and develop joint approaches.

See comment 3.

Recommendation 10
We recommend that the Director of OTS and the Chairman of FDIC monitor the implementation of their May 18, 1992, joint memorandum to ensure effective coordination of their examinations of thrifts.

OTS Comment: We plan to measure the effectiveness of our efforts to coordinate OTS/FDIC examinations of thrifts through an FMFIA internal review during 1993. The Deputy Director for Regional Operations is in the process of establishing a working group with FDIC counterparts. This working group will evaluate conformance to the standards.

Recommendation 11
We recommend that the Director of OTS and the Chairman of FDIC monitor the implementation of their May 18, 1992, joint memorandum to ensure that a common set of standards are being used as a basis for reaching examination conclusions.

See comment 3.

OTS Comment: We plan to conduct periodic assessments of composite examination ratings in order to determine if additional guidance is necessary.

Sincerely,

John F. Downey

John F. Downey
Deputy Director
for Regional Operations

The following are GAO's comments on the Office of Thrift Supervision's letter dated October 27, 1992.

GAO Comments

1. See the "Agency Comments and Our Evaluation" section in chapter 2.

2. See the "Agency Comments and Our Evaluation" section in chapter 3.

3. See the "Agency Comments and Our Evaluation" section in chapter 4.

Comments From the Federal Deposit Insurance Corporation

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

FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, DC 20429

OFFICE OF THE CHAIRMAN

November 12, 1992

Mr. Donald H. Chapin
Assistant Comptroller General
U. S. General Accounting Office
Washington, D. C. 20548

Dear Mr. Chapin:

Subject: Chapter 4 of OTS GAO Draft Report - Regulatory Resources are Used Inefficiently

See comment 1.

These comments address subject report which this office did not receive until October 26, 1992.

In deriving the conclusions of this section of the report, equitable consideration must be accorded the conditions which existed at the time the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA") was enacted. Those conditions included a massive volume of costly thrift insolvencies which occurred during the oversight of the thrift industry by the Office of Thrift Supervision's predecessor, the Federal Home Loan Bank Board, and which contributed to the insolvency of the Federal Savings and Loan Insurance Corporation. There existed a strong Congressional and public mandate for resolution of thrift industry losses, and a growing public concern over the existing levels of budgetary deficit and fears that undisclosed thrift industry losses would further burden the taxpayers. Under those circumstances and conditions, the FDIC was called upon by Congress to shoulder an additional responsibility which by its very nature would involve a certain degree of redundancy and duplicative efforts.

Given those circumstances, and others discussed later, the FDIC determination to conduct a thorough and comprehensive analysis of the then existing risk exposure was totally appropriate and in the best public interest. To have done otherwise would have ignored the will of Congress. We concur with the need for efficiency and economy of operation in government organizations, but the circumstances which existed during the time period you discuss more than justify the approach taken by the FDIC.

At the onset Corporation personnel were well acquainted with examination procedures and regulatory procedures utilized for commercial banking institutions, but a certain amount of time expended involved training of Corporation personnel regarding the differences in S&L industry practices; the regulatory scheme; and the supervisory philosophies, practices, and techniques employed by the OTS. Our examiners found that many OTS examination procedures, which initially appeared to coincide with those of the federal banking agencies, differed significantly in practice. Some of the duplication of examiner efforts during the early stages was necessary in order that an independent analysis of industry risk could be obtained.

An initial review of examination reports by the Federal Home Loan Bank Board and OTS often provided our staff with limited information to support asset classifications assigned and in many cases were devoid of classification summaries or sufficient information to allow an adequate independent evaluation of loss exposure existing within such credits. Although our approaches to classification and assignment of overall ratings have come closer, we continue to have certain differences which we are attempting to resolve between our agency and OTS.

Now on pp. 36-37.

As an example, on report pages 54 through 56 it is suggested that the CAMEL rating utilized by federal banking regulatory agencies, and the MACRO rating definition utilized by OTS are the same. This is not totally correct. For example, we list below the definition of a Composite "4" institution according to OTS guidelines and FDIC:

OTS (As provided within the Office of Thrift Supervision's Regulatory Handbook page 071.3):

> Composite "4" - "Institutions in this group generally have an inadequate level of capital, or a combination of other conditions that are poor. Major and serious problems or unsafe and unsound conditions may exist which are not being satisfactorily resolved by the institution. Unless prompt action is taken to correct these conditions, they could reasonably develop into a situation that will impair future viability. A potential for failure is present but is not imminent. Institutions in this category require close supervisory attention and financial surveillance. Institutions with a positive net worth but that do not meet regulatory required minimum capital requirements would normally be assigned this rating. Profitable institutions that meet regulatory capital requirements, but have negative generally accepted accounting principles (GAAP) capital, may also be assigned this rating".

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Uniform Financial Institutions Rating System (CAMEL) (As provided within the FDIC Statements of Policy, pages 5079 - 5080.01):

> Composite "4" - "Institutions in this group have an immoderate volume of serious financial weaknesses or a combination of other conditions that are unsatisfactory. Major and serious problems or unsafe and unsound conditions may exist which are not being satisfactorily addressed or resolved. Unless effective action is taken to correct these conditions, they could reasonably develop into a situation that could impair future viability, constitute a threat to the interests of depositors and/or pose a potential for disbursement of funds by the insuring agency. A higher potential for failure is present but is not yet imminent or pronounced. Institutions in this category require close supervisory attention and financial surveillance and a definitive plan for corrective action."

You correctly pointed to various other differences in the composition of the individual component ratings within your comments, and as noted above there could be considerable difference in assignment of composite ratings due to the definitions utilized for composite CAMEL and MACRO ratings. For example, using the above definition, an institution could be GAAP insolvent and still rated composite "4" under the OTS MACRO designation. Increased consistency by the OTS in examination approaches and techniques utilized by the federal banking agencies would eliminate a significant portion of the differences between OTS and FDIC examinations.

Many other early differences between FDIC and OTS examination approaches continue to diminish. Obviously resolution of those differences, and an analysis of which approach was more correct, involved the expenditure of considerable examiner and staff personnel time and efforts. It was apparent that the volume and severity of loan and other asset classifications varied considerably between the FDIC and OTS, with OTS findings almost without exception being less severe.

This degree of divergent findings was quite different than the experience the FDIC has had in its concurrent and/or joint examinations with the other federal banking agencies and state authorities. Of course the FDIC has had almost 60 years of experience in dealing with State regulators and approximately 10 or so years with the Federal Reserve and Comptroller of the Currency examination personnel. This extended time period has allowed considerable interchange of professional ideas and techniques which the FDIC and OTS have only recently begun developing. As OTS

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and FDIC supervisory policies and practices have moved closer together, we have an increased sense of confidence that the Corporation's direct supervisory role can be reduced and that we can assume more of the back-up supervisory approach embodied in the May 19, 1992 agreement between the FDIC and OTS.

Although OTS examination personnel had developed considerable experience in classifying and reviewing housing related credits, it was often found that FDIC personnel had greater experience in analyzing repayment prospects and credit risk contained within larger commercial venture credits. This initial difference was often due to the limited sampling universe utilized by OTS personnel and their historical reliance upon repayment history and delinquency as the overriding basis for classification.

The utilization of comparable properties for appraisal purposes, projected absorption rates and discounted present values based upon income generation was only beginning to gain acceptance in thrift institutions at the start of the Corporation's thrift supervisory role, with many older appraisals made by insiders or other individuals with limited and suspect appraisal abilities. Rather than utilizing a somewhat liberal and inexact approach, FDIC classifications were made on a basis consistent with the federal banking agencies. Differences in classification totals and severity may have also been due to those instances where OTS confined their review to delinquencies, internal classifications and loans made between examinations. Quite obviously, a determination of the appropriate examination treatment occasionally required additional time for resolution.

Now on p. 38.

On page 58, it was stated that OTS "...likely would not require a thrift to maintain capital in excess of the minimum capital requirement." The resolution of this matter continues to be of great concern to the FDIC and has required considerable discussion and resolution efforts. As do State authorities and other federal banking agencies, FDIC has consistently believed it appropriate for financial institutions to maintain capital at levels necessary to absorb loss exposure which could occur in the case of excessive interest rate risk, excessive asset portfolio risk, or other other factors which may affect an institution's future viability. We contend that a regulatory approach which requires only minimum capitalization for such institutions is an inappropriate regulatory approach. We would further argue that the FDIC's approach has proven consistent with modern risk-based capital requirements and the mandates of Congress provided within the Federal Deposit Insurance Corporation Improvement Act of 1991.

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From the onset, the FDIC has exerted considerable effort to coordinate examinations concurrently with OTS, has advised OTS of plans to examine thrifts, and for the sake of regulatory solidarity has attempted to the degree possible to coordinate examinations to coincide with OTS timing and staffing requirements. Our records indicate FDIC examinations were conducted on concurrent/joint basis 34% of the time 1990. The ratio increased to 56% in 1991 and to 69% through June 30, 1992. Obviously at the initial phase of this process, the OTS had already conducted a number of examinations of these institutions and declined to participate in planned FDIC examinations. As further evidence that FDIC has attempted to act in an effective and efficient manner in conducting its analysis of risk exposure contained within the thrift industry, we would point to your comment that FDIC expended approximately $16 million compared to the $53 million expended by the OTS for thrift related safety and soundness examinations during 1991.

Based upon our objective that all thrift institutions be examined by the FDIC during 1990, we occasionally did have some examinations which may have occurred sooner than the FDIC would have conducted following a State authority or other federal agency examination. The FDIC attempted to minimize man-hours expended by Corporation personnel in this examination process by prioritizing examinations to those which appeared to exhibit the greatest potential for deterioration and/or potential for failure. In addition, the FDIC in nearly all instances has limited its reviews to determining the level of insurance risk and potential viability which existed. We were not involved in specialty examinations which would entail review of compliance with consumer laws and regulations, trust activities and/or data processing activities.

The FDIC and OTS have made considerable strides in resolving examination and supervisory differences. We agree that some inefficiencies did exist during the initial phases of this process, but we continue to think that was necessary if the FDIC was to properly carry out the mandate of FIRREA. We mutually agreed that it was not good public policy to send institutions mixed signals as to condition or needed corrective measures and as a result entered into an agreement on May 19, 1992.

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The agreement is designed to improve the overall supervision of the thrift industry and further enhance the efficiency of our supervisory efforts. Therefore, while we do not embrace the logic and arguments leading up to your conclusions, we do agree with the recommendations provided in the report and will continue to make appropriate efforts to incorporate the spirit of such recommendations in our future supervisory actions.

Sincerely,

Andrew C. Hove

Andrew C. Hove
Acting Chairman

The following are GAO's comments on the Federal Deposit Insurance Corporation's letter dated November 12, 1992.

GAO Comments

1. See the "Agency Comments and Our Evaluation" section in chapter 4.

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