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Additional Reserves and Reforms are Needed to Strengthen the Bank Insurance Fund

Statement of
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Comptroller General of the United States

Before the
Committee on Banking, Housing, and Urban Affairs
United States Senate

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ADDITIONAL RESERVES AND REFORMS ARE NEEDED TO STRENGTHEN THE BANK INSURANCE FUND

TESTIMONY OF CHARLES A. BOWSHER
COMPTROLLER GENERAL OF THE UNITED STATES

BEFORE THE COMMITTEE ON BANKING,
HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

TUESDAY, 10:00 a.m., SEPTEMBER 11, 1990

Not since its birth during the Great Depression has the federal system of deposit insurance for commercial banks faced such a period of danger and uncertainty as it does today. Issues arising from our audit of the Bank Insurance Fund's 1989 financial statements, the report on which is being issued today, cause us both apprehension and concern for the safety and soundness of the Fund in the 1990s.

The Fund reported a loss of $852 million in 1989, its second consecutive loss, which reduced the Fund balance to $13.2 billion. The record level of bank failures that occurred during the last two years has reduced the Fund's ratio to insured deposits to only .7 percent at December 31, 1989, its lowest level in the Fund's history. FDIC now believes the Fund could suffer another loss as high as $2 billion in 1990, due to the high level of bank failures that is continuing in 1990.

The increasingly risky nature of the industry's loan portfolio is resulting in increasing loan performance difficulties which could severely impact the Fund. We have identified 35 large banks in such severe financial condition that without some form of recapitalization, they are likely to fail or require assistance within the next year. We estimate that these banks, if they fail, will cost the Fund between $4.4 billion and $6.3 billion. We also identified a significant number of other institutions that were experiencing severe negative performance trends.

The prospect for the Fund achieving the minimum reserve ratio of 1.25 percent by 1995 as designated by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) is not good. Neither FDIC's nor our projections of the Fund balance indicate that the Fund can achieve the desired minimum reserve ratio under the current assessment provisions in FIRREA. In fact, over the next few years, the Fund's low reserve level accompanied by a recession could lead to a level of bank failures that would exhaust the Fund and require taxpayer assistance.

Our audit raises other concerns, including

-- the low level of cash resources coupled with existing commitments to purchase problem assets from acquirers of

failed banks, which will limit FDIC's options for resolving future banks failures,

-- overstated appraised values for foreclosed real estate held by acquirers of failed banks that can be passed back to FDIC could lead to additional losses to the Fund,

-- accounting and reporting by banks, which is not providing regulators with an adequate early warning of financial problems and may reduce the effectiveness of off-site monitoring by regulators. Application of generally accepted accounting principles allow too much discretion on the part of bank management and may be unduly delaying the recognition of losses in the financial statements, and

-- serious internal control weaknesses that contributed to the failure of a number of banks in 1988 and 1989. We cited similar problems in banks and savings and loans in previous reports and made recommendations for improving their internal controls. Unfortunately, to the detriment of the insurance funds and the taxpayers these recommendations were not included in the Financial Institutions Reform, Recovery, and Enforcement Act of 1989. These improvements along with a number of other auditing and financial reporting reforms are critically needed to protect the deposit insurance funds.

The Bank Insurance Fund is too thinly capitalized in light of the exposures it faces. FDIC has recognized this and, within the constraints of FIRREA's assessment provisions is proposing to increase the 1991 assessment rates. We commend FDIC's timely actions, however, additional steps are needed to minimize the potential liabilities facing the Fund. We encourage the Congress, regulators, the accounting profession, and others to implement the recommendations in our report which we believe are needed to minimize losses to the Fund. We must do everything possible to ensure that the banking industry avoids the debacle that consumed the savings and loan industry and is now costing the nation's taxpayers hundreds of billions of dollars.

Mr. Chairman and Members of the Committee:

We are pleased to be here today to discuss the results of our audit of the Bank Insurance Fund's 1989 financial statements. The report on our 1989 audit[1] is being issued today, and it addresses in detail the issues we will discuss. The message is disturbing.

-- The Fund balance has decreased 28 percent over the last 2 years from $18.3 billion to $13.2 billion. The Fund lost $4.2 billion in 1988 and $852 million in 1989. FDIC now believes the Fund could suffer a third consecutive loss as high as $2 billion in 1990, due to the continuing high level of bank failures.

-- Our review of the 200 largest problem banks and the nation's 100 largest banks showed 35 banks in such severe financial condition that without some form of recapitalization, they are likely to fail or require assistance within the next year. We estimate that these banks, if they fail, will cost the Fund between $4.4 billion and $6.3 billion.

-- We are concerned that the Fund's cash resources are too low to enable it to deal decisively with problem banks. The Fund faces potential cash shortages from its commitment to

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

purchase troubled assets from acquirers of failed institutions. As of December 31, 1989, the Fund had $13.7 billion in cash and investments but was contingently liable for about $8 billion of troubled assets that acquirers may pass back to FDIC. Our concern is the low level of cash resources coupled with existing commitments to purchase problem assets could limit FDIC's options for resolving future bank failures.

-- Another concern related to the Fund's commitment to purchase troubled assets from acquirers of failed institutions is that the estimated recoverable value of the assets may not be realized. Overstated appraisal values for foreclosed real estate held by the acquirers could lead to additional losses to the Fund. A sample of real estate with book values of $488 million showed an overstatement of about $76 million.

-- At year-end 1989, the ratio of the Fund balance to insured deposits reached its lowest point ever, .7 percent. The prospect for the Fund achieving the minimum reserve ratio of 1.25 percent by 1995 as designated by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) is not good. Further, there appears to be no empirical basis for the 1.25 percent minimum reserve ratio. We are concerned that even if the minimum reserve ratio

could be achieved, it would not be sufficient to protect the taxpayers in the event of a recession. Over the next few years, low levels of reserves coupled with a recession could lead to a level of bank failures that would exhaust the Fund and require taxpayer assistance.

-- Increased risks in the commercial banking industry are a major exposure to the Fund's outlook. In 1989 problem banks remained at an alarmingly high number, about 1,100 or 9 percent of the industry. Also, industry earnings declined $8.5 billion due to losses experienced by banks in the Northeast and large commercial banks as a result of loss provisions for real estate and less-developed country loans. In addition to these concerns, the 50 largest bank holding companies reported $126 billion of loans categorized as highly leveraged transactions. The performance of these risky loans and their ultimate effect on the financial condition of banks is unknown because of their relative newness. While the commercial banking industry's loan portfolio risks have increased, there has been relatively no change in the level of the industry's equity capital, its cushion to absorb losses on loans.

-- Regulators need a more timely early warning of troubled institutions to minimize losses to the insurance fund. The quarterly reports of financial condition that banks prepare

for the regulators do not always reflect their true financial condition, and this may reduce the effectiveness of off-site monitoring by regulators. We are concerned that accounting principles allow bank management too much discretion in recognizing and determining loss amounts as reported in financial statements.

-- Our ongoing review of a number of banks that failed in 1988 and 1989 showed that serious internal control weaknesses contributed to their failure. We previously reported this problem in 1989 for banks and savings and loans that failed in 1987 and made recommendations for improving internal controls. Unfortunately, to the detriment of the insurance funds and the taxpayers these recommendations were not included in the Financial Institutions Reform, Recovery, and Enforcement Act of 1989. These improvements along with a number of other auditing and financial reporting reforms are critically needed to protect the deposit insurance funds.

FDIC has recognized that the Bank Insurance Fund is too thinly capitalized in light of the exposures it faces and, within the constraints of FIRREA's assessment provisions, is proposing to increase the 1991 assessment rates. We commend FDIC's timely actions, however, additional steps are needed to minimize the potential liabilities facing the Fund. I would now like to provide

some of the details of the issues facing the Bank Insurance Fund along with my recommendations.

PROBLEM BANKS EXPOSE THE BANK INSURANCE FUND TO SIGNIFICANT RISKS

The Bank Insurance Fund enters the 1990s in a precarious position. Between 1980 and 1987, the ratio of the Fund balance to insured deposits averaged 1.17 percent. At December 31, 1989, however, the ratio of the Fund balance to insured deposits equaled .7 percent, the lowest this ratio has ever been in the history of the Fund. Clearly the past 2 years have seen a significant deterioration of the Fund at a time when its exposure to potential, significant losses is higher than ever. At December 31, 1989, FDIC identified 1,109 banks with assets of $235 billion as problem institutions. The number of problem banks continues to be high and poses a significant financial threat to the health of the Bank Insurance Fund.

As part of our financial audit, we analyzed the financial condition and performance of 300 banks. These included banks with assets in excess of $100 million on FDIC's December 31, 1989, problem bank list, the 100 largest commercial banks in the United States, and other institutions that we identified as problem banks based on regulatory and public source information. Our analysis

focused on large banks because experience has shown that large bank failures cause the most significant impairment of the Fund.

Based on our analysis, we identified 35 banks that were in such severe financial condition at December 31, 1989, that without some form of recapitalization they are likely to fail or require regulatory assistance within the next year. These banks are located principally in the Northeast and Southwest and had assets totaling $45.1 billion at year-end 1989. Generally, these 35 banks had regulatory capital comprised primarily or only of loss reserves, were insolvent based on equity capital[2] or had minimal levels of equity capital, had excessive and increasing levels of problem assets, and had negative earning trends that, if continued, would result in their failure. Using FDIC's historical loss rates, we estimate that the cost to the Fund for the failure of all 35 banks would be between $4.4 billion and $6.3 billion. Because the FDIC historical loss rates do not reflect the major changes in the composition and quality of the industry's loan portfolio, our cost estimates could be significantly understated. The following table shows key financial indicators for the 35 troubled banks compared to other banks in our sample and the industry.

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[2]The major distinction between equity capital and regulatory capital is that reserves for loan and lease losses are included in regulatory capital.

Key Banking Industry Financial Indicators as of December 31, 1989

	Total Assets	Equity Capital Amount	Equity Capital Percent[a]	Problem Assets Amount	Problem Assets Percent[a]	Net Income (Loss) Amount	Net Income (Loss) Percent[a]
	(dollars in billions)						
Problem banks (35)	$ 45.1	$ .6	1.4	$ 4.0	8.8	$ (1.6)	(3.5)
Total sampled banks (300)	1,999.9	100.1	5.0	79.1	4.0	1.7	.1
Total commercial banks (12,706)	3,299.0	206.0	6.2	113.8	3.4	16.3	.5

[a]Percentage of total assets

As of August 13, 1990, 15 of the 35 banks had failed.

In addition to these 35 banks, we identified a significant number of other large banks that were experiencing severe negative performance trends as of December 31, 1989. While their financial condition was not as severe as that of the 35 banks, these other banks are at risk to fail within the next few years, particularly if their regional economies continue to deteriorate. These banks are also located principally in the Northeast and Southwest. If both these banks and the 35 other banks were to fail, the Fund could be severely impaired. A recession could exacerbate this problem, causing failure of other large banks beyond those we have identified, exhausting the Fund, and resulting in a taxpayer bailout.

SEPARATE ASSET POOLS ARE A POTENTIAL CASH PROBLEM

In addition to the exposures that could severely impact the Fund's equity condition, a number of existing failure and assistance transactions pose a potential future drain on the Fund's cash resources. In the last few years, FDIC has entered into agreements with the acquirers of failed institutions which under certain limits require FDIC to purchase from the acquirers an undetermined portion of the failed banks' remaining troubled assets that are maintained and reported as separate asset pools by the acquiring banks. At December 31, 1989, the Fund's potential cash exposure for assets held in separate asset pools was about $8.0 billion. We believe that FDIC needs to ensure that these transactions are carefully monitored to avoid cash availability problems for the Fund and to prevent overextending the Fund's cash resources.

A related concern is that unrealistically high appraised values could mask losses that the Fund may incur when assets held in separate asset pools are sold. These assets are recorded and adjusted based on appraised values, in accordance with FDIC guidelines. If appraisals are based on unrealistic assumptions, the assets' appraised and recorded value may not reflect what FDIC could recover at their disposition. During our review of the largest of the three separate asset pools, we estimated that the

book balances of $488 million for the other real estate owned that was acquired through foreclosure were overstated by about $76 million. We believe the FDIC should revise its guidelines for recorded values of assets held in separate asset pools. The underlying assumptions used by appraisers in valuing assets should be reviewed and recorded values adjusted when appraiser assumptions are not based on the assets' historical experience and current conditions.

OUTLOOK FOR THE BANK INSURANCE FUND

The outlook for the Bank Insurance Fund is dependent on its ability to maintain a sufficient level of capital to cope with the exposures it faces. FIRREA provides for FDIC to charge incrementally increasing annual assessment rates to insured commercial banks beginning in 1990. FIRREA also authorizes FDIC to increase these prescribed rates if the ratio of the Fund's balance to insured deposits is expected to decline, but limits annual increases and stipulates an assessment rate ceiling. FDIC recently proposed to increase the annual assessment rate to .195 percent for 1991, the maximum increase allowable, because it expects a loss in 1990 which will reduce the Fund balance and its ratio to insured deposits.

We commend FDIC's actions. We believe, however, that the proposed rate increase will not be sufficient to restore the Fund's capital position to a level adequate for it to deal with large bank failures that could occur in a recession. Both our projections of the Fund's ratio to insured deposits and those of FDIC illustrate that it is unlikely that the Fund will achieve the designated reserve ratio of 1.25 percent by 1995 under the current constraints of FIRREA, even in a non-recessionary environment.

Ratio of the Fund Balance to Insured Deposits (Percent)

	1989 (Actual)	1990	1991	1992	1993	1994	1995
FDIC - Scenario 1	0.70	0.74	0.82	0.91	1.00	1.11	1.22
FDIC - Scenario 2	0.70	0.66	0.67	0.69	0.72	0.76	0.81
GAO - Scenario 1	0.70	0.74	0.82	0.89	0.95	1.01	1.07
GAO - Scenario 2	0.70	0.61	0.74	0.82	0.89	0.95	1.02
GAO - Scenario 3	0.70	0.58	0.63	0.64	0.65	0.67	0.69

The key distinction between the five scenarios is the assumptions regarding the level of bank failures and their cost to the Fund. Under FDIC's first scenario, failure and assistance expenses are assumed to equal the average actual costs incurred by the Fund over the last ten-years. Under FDIC's second scenario, these costs are estimated based on actual costs for the last five years, the time period where the Fund incurred the majority of its costs. The FDIC scenarios do not reflect the recent statements made by the Chairman that the Fund could incur a net loss for 1990

and do not reflect FDIC's recent proposal to increase the 1991 assessment rate. FDIC has not revised its projections to account for the estimated loss in 1990 and the proposed assessment rate increase for 1991.

Our projections assume differing levels of bank failure and assistance expenses in increasingly more severity based on banks that we believe will fail soon and over the next few years if their negative financial trends persists. Additionally, under all three of our scenarios, we applied the maximum allowable assessment rates to derive assessment income. Despite this, none of our projections indicate that the Fund has the ability to achieve the minimum reserve ratio of 1.25 percent by 1995 under the current assessment provisions of FIRREA.

Our projections illustrate significant potential losses facing the Fund in the 1990s. I should also note that both our projections and those of FDIC assume a stable economy. A recession or a severe decline in the Northeast economy similar to what occurred in the Southwest could result in additional large banks failing beyond those included in our estimates. Also, the banking industry's increased dependence on riskier assets could result in additional losses and bank failures. For example, based on FDIC's historical loss rates, a $13 billion Fund balance could be eliminated by the costs related to the failure of one or more large money center banks with total assets of $130 billion. While

I am not saying that any money center banks are currently in danger of failing, this example demonstrates the vulnerability of the Fund at its current level of reserves.

We did not identify any study done to set the minimum (1.25) and maximum (1.50) reserve ratios prescribed by FIRREA. For this reason, and because of our concerns about the potential exposure facing the Bank Insurance Fund, we believe the Secretary of the Treasury's study of deposit insurance reform required by FIRREA needs to examine the reasonableness of these minimum and maximum reserve ratios. We believe this study needs to propose a reserve ratio target that regulators believe would protect taxpayers in the event of a recession.

We recognize the concern that raising assessments to build a more adequately capitalized Fund could significantly impact the profitability and competitiveness of banks. Also, achieving adequate protection for the Fund and ultimately the taxpayer solely through assessment premiums may not be feasible. Therefore, as part of the deposit insurance reform study, we believe the Department of Treasury should assess banks' ability to pay higher premiums and estimate at what point such higher premiums may become counter productive in their benefit to the Fund. Treasury's study should also consider other means for reducing the Fund's exposure such as bank capital levels required to be maintained and other

options that would further protect the Fund and ultimately the taxpayers.

While the studies of deposit insurance reform are being completed, we believe that FIRREA should be amended to give FDIC authority to raise rates beyond those provided in FIRREA. FDIC should use this authority to achieve the minimum reserve ratio of 1.25 percent designated in FIRREA by 1995.

COMMERCIAL BANKING INDUSTRY CONDITIONS THAT COULD LEAD TO MORE BANK FAILURES

The commercial banking industry's performance in 1989 and outlook add to our concerns for the safety of the Bank Insurance Fund. Industry earnings declined $8.5 billion from their 1988 level of $24.8 billion, to $16.3 billion. The large decline in earnings in 1989 is attributable to banks in the Northeast and the large commercial banks with assets in excess of $10 billion.

Real estate lending, which has increased significantly as a percentage of total industry lending activity, has experienced increasing loan performance difficulties. The Northeast in particular has experienced significant growth in nonperforming real estate loans. While total outstanding real estate loans in the Northeast increased 12 percent, from $232 billion in 1988 to $259 billion in 1989, the level of these loans that were nonperforming

increased from $4 billion in 1988 to $10 billion in 1989. This trend in the Northeast is reminiscent of the growth in noncurrent real estate loans in the Southwest during the early 1980s that eventually led to the high level of bank failures in that region from the late 1980s to the present. These failures caused the dramatic deterioration of the Fund over the last 2 years.

I am also concerned about the impact LDC loan difficulties are continuing to have on the industry. The level of U.S. commercial bank exposure on troubled foreign loans has declined from $91 billion in 1982, the beginning of the international debt crisis, to $54 billion at year-end 1989. The remaining exposure, however, is heavily concentrated in nine money center banks. These banks held $43 billion (80 percent) of the nation's troubled foreign loans at December 31, 1989. These banks currently have reserves averaging 49 percent of their foreign loan exposure. We are concerned that continued high LDC losses could make some of these banks more susceptible to failure.

The industry also faces growing risks from its increasing levels of loans considered highly leveraged transactions (HLTs). During the 1980s, HLT loans experienced significant growth with the advent of the junk bond market in the investment banking industry. The high debt to equity ratio typically present in companies involved in HLTs reduces the banks' likelihood of recovering in the event of default. The commercial banking industry's exposure on

HLTs is generally in the form of secured, senior debt, with minimal junk bond exposure. The impact of loans categorized as HLTs on the cost of future bank failures is unknown. However, recent bankruptcy filings of companies involved in junk bond offerings demonstrate that there is a risk that the secured, senior debt portion of the original financing package may not be fully repaid. This could result in losses for commercial banks because the related loan collateral value may be significantly less than the outstanding loan balance remaining to be repaid.

RELIANCE ON BANK FINANCIAL REPORTS MAY HINDER EARLY WARNING OF PROBLEM BANKS

Another factor affecting the Fund's estimated exposure for future bank failures is the quality of quarterly call reports the banks prepare for the regulators. These reports, which are unaudited, are used by the bank regulators in their off-site monitoring of banks' financial condition and performance between on-site examinations. The reports are also used in helping to decide the frequency and timing of on-site bank examinations and generally in planning the scope of an on-site examination.

Although we did not review the overall quality of call reports, we have found examples in reviewing certain problem banks that suggest call report accuracy often depends on whether there

has been a recent examination by the bank regulators. Generally, we found that the regulators reported that these institutions had understated the level of nonperforming loans in their call report submissions, and thus had established inadequate levels of loss reserves and had overstated interest income and net income.

Another indicator of the problems with the quality of call report data is the timing of bank failures in relation to when and if the bank appeared on FDIC's problem bank list. Because a bank's financial condition does not deteriorate overnight, the regulatory supervision process should detect an emerging problem bank prior to its imminent failure. Of the 406 banks that failed in the last 2 years, however, we found that 22 failed without ever appearing on the problem bank list and that 9 failed after appearing on the list for only one quarter. The absence or limited presence of these banks on the problem bank list suggests that the regulators had not thought them to be in danger of failing until the bank examiners, in conducting on-site examinations, found them to be in such severely deteriorated financial condition that they were immediately closed.

The Fund's potential exposure from large banks and known problem banks is so great that accurate, up-to-date information on their financial condition is essential. Additionally, the accuracy of call report data, particularly for troubled or near troubled banks where the effect of misstatement is more critical, is a

concern for effective off-site monitoring. Therefore, we believe that the Chairman of the Federal Deposit Insurance Corporation, the Chairman of the Federal Reserve Board, and the Comptroller of the Currency should ensure that annual full scope, on-site examinations of all large banks and known problem banks are performed. We are currently reviewing the regulators' enforcement of bank capital standards. Further, because of our concerns, we plan to review the regulators' entire examination and supervision program beginning this fall.

ACCOUNTING AND AUDITING REFORMS NEEDED TO PROVIDE EARLY WARNING OF TROUBLED DEPOSITORY INSTITUTIONS

Regulators need more timely and reliable data on the financial condition of depository institutions to more effectively work with management to restore the health of troubled institutions and to minimize losses to the insurance fund. There is a concern that financial data prepared in accordance with generally accepted accounting principles are inadequate for this purpose. Call report data are accounted for and reported in accordance with generally accepted accounting principles. Banking regulations require that call reports be prepared on that basis.

Generally accepted accounting principles call for a writedown from cost to market value and recognition of a loss when an asset

value has been diminished. But, there are major problems with the timing of the recognition of loss and the determination of the amount of the writedown.

-- The requirement that a loss be "probable" before it is recognized. "Probable" is frequently interpreted in practice as "virtually certain." The "probable" requirement unduly delays the writedown of problem assets to fair market value and thus defers recognizing the loss in the financial statements.

-- The definition of fair market value used in determining the amount of the loss to be recognized. The definition assumes that the asset can be held until market conditions are good and that the seller has a good bargaining position. This frequently results in higher fair market values than are justifiable in the circumstances.

These generally accepted concepts for recognition of loss and the determination of fair market value frequently result in sudden dramatic losses when banks get into trouble and the regulators require loss recognition on a realistic basis. These losses could have been reflected earlier in bank call reports under more stringent accounting rules and thus provided a more timely early warning of bank failures. We are currently reviewing whether limited changes in present cost based generally accepted

accounting principles would be sufficient, or whether some form of market value accounting is necessary to provide more reliable call report data.

Our present view is that generally accepted accounting principles pertaining to the probability of collection of a troubled loan allow bank management too much leeway to defer the recognition of losses in financial statements. In our current work on bank failures we found a number of examples where examiners identified loans where collection was doubtful and in hindsight bank management should have recorded reserves to writedown the loans and recognize the losses. These loans were carried at historical cost because, based on bank management's judgment, the potential losses on these loans did not meet the accounting criteria of "probable" that would have required writedowns to fair value.

Similarly, our present view is that generally accepted accounting principles relating to fair market value do not sufficiently recognize the need for banks to realize collateral values in a short period of time. The traditional fair market value concept establishes values in a hypothetical market where the seller is under no compulsion to sell and has time to negotiate a sale. Assets in troubled banks and separate asset banks, or even nonperforming assets in any bank, may have to be and are often

disposed of in a market when conditions require that the assets be disposed of within a short time frame.

Conceptually, accounting for bank failures and the related loss recognition has some of the same inherent weaknesses as accounting for loan losses. The Bank Insurance Fund's December 31, 1989, financial statements are fairly presented in accordance with generally accepted accounting principles. However, the estimated costs of $4 billion to $6 billion from the banks we believe are likely to fail in the near future unless recapitalized do not meet the degree of certainty for loss recognition established by accounting principles. Accordingly, these estimated losses are not recognized in the Fund's financial statements.

The Financial Accounting Standards Board is currently studying certain market value accounting and disclosure issues for financial institutions. We encourage the Board to address market value based accounting for financial institutions. Based on our ongoing study of these issues our preliminary view is that market value based accounting or, in the alternative, comprehensive market value disclosure, is preferable to present accounting and disclosure standards for financial institutions.

In the interim, it is important that certain limited changes be made to existing generally accepted accounting principles for nonperforming loans and other real estate owned acquired through

foreclosure. The accounting profession should promptly consider amending accounting rules to require

-- recording losses when occurrence of loss is likely (more than a 50 percent chance) rather than "probable" as required under existing rules, and

-- valuing the underlying collateral on the assumption that near term disposition of the asset will be required.

We believe this interim step is needed to improve the early warning system and thereby help protect the Bank Insurance Fund.

I would now like to talk about auditing reforms that are needed to provide regulators an early warning of troubled banks. Before FIRREA was enacted, we reported that serious internal control weaknesses cited by federal regulators contributed significantly to virtually all of the 184 banks which failed in 1987.[3] We also reported that regulator's examination reports and related data showed numerous and sometimes blatant violations of laws and regulations at 26 failed savings and loans that we reviewed to determine the cause of their failure.[4] We recommended then that FIRREA include requirements for insured institutions to

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[3]Bank Failures: Independent Audits Needed to Strengthen Internal Control and Bank Management (GAO/AFMD-89-25, May 31, 1989).

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

undergo annual financial audits and issue management reports on the effectiveness of internal controls and their compliance with safety and soundness laws and regulations. To provide assurance on the validity of the management reports, we also recommended that, as part of the annual audit, auditors be required to review and report on management's assertions contained in its reports. Unfortunately, these recommendations were not adopted by Congress in FIRREA.

Weak internal controls are a serious problem in financial institutions which have recently failed and have contributed significantly to those failures. In studying the accounting and reporting issues I just discussed, we reviewed examination reports of 39 banks which failed in 1988 and 1989. Those reports showed that serious internal control weaknesses existed in many of the institutions. Bank management and the boards of directors have a responsibility to operate their institutions in a safe and sound manner. Safety and soundness relates not only to overseeing the day-to-day operations of the bank, but also to establishing and maintaining an effective internal control structure. The accounting profession and, of course, government regulators also play a significant role in ensuring corporate accountability. We need to ensure that these major players work well and that they work together.

I believe that when Congress revisits FIRREA, there should be amendments to include and strengthen the management and auditing reporting requirements we previously recommended. Also, these reporting requirements should be buttressed with other auditing reforms to provide regulators more timely and reliable information on the health of financial institutions. These additional auditing reforms include

- -- Strengthening auditing procedures to require auditors to assess the risks and uncertainties affecting the institution's ability to continue as a going concern over the next year.

- -- Strengthening the auditor's responsibility for detecting illegal acts and to ensure that these illegal acts are reported to the regulators when management has not dealt with the problem.

- -- Requiring the regulators to share with the auditors their knowledge of potential illegal acts by institutions. Exceptions should be made for situations involving litigation and ongoing investigations.

- -- Requiring insured depository institutions to have independent audit committees, which should include at least

one attorney to help assure their institutions comply with laws and regulations.

Finally, I would add that the stakes are just too high for the regulators to be monitoring the condition of institutions using unaudited call reports, especially when the quality of those reports for problem institutions is suspect. We believe those reports should be reviewed by auditors for known problem institutions and those large institutions that, if they fail, would cause a significant loss to the insurance funds.

Our March 7, 1990, response to the Treasury's request for comments on issues under its study of the deposit insurance system and my August 2, 1990, testimony before the House Subcommittee on Telecommunications and Finance[5] contain a detailed discussion of my recommendations. I would request that copies of that letter and testimony be included in the hearing record.

CONCLUSIONS

All of the concerns we have discussed today paint a troubled picture for the future of the banking industry and the Bank Insurance Fund. They are all serious concerns. We have presented

[5] Prevention, Detection, and Reporting of Financial Irregularities, Statement of Charles A. Bowsher, Comptroller General of the United States, before the Subcommittee on Telecommunications and Finance, House Committee on Energy and Commerce (GAO/T-AFMD-90-27, August 2, 1990).

our concerns to encourage the Congress, regulators, the accounting profession, and others to implement the changes needed to minimize losses to the Bank Insurance Fund. We must do everything possible to ensure that the banking industry avoids the debacle that consumed the savings and loan industry and is now costing the nation's taxpayers hundreds of billions of dollars.

Mr. Chairman, this concludes my prepared statement. I would be pleased to answer any questions you or the members of this Committee may have at this time.