

GAO

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High-Risk Series

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Bank Insurance Fund





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Comptroller General
of the United States

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The President of the Senate
The Speaker of the House of Representatives

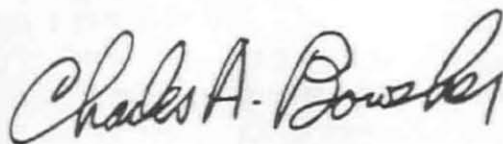
In January 1990, in the aftermath of scandals at the Departments of Defense and Housing and Urban Development, the General Accounting Office began a special effort to review and report on federal government program areas that we considered "high risk."

After consulting with congressional leaders, GAO sought, first, to identify areas that are especially vulnerable to waste, fraud, abuse, and mismanagement. We then began work to see whether we could find the fundamental causes of problems in these high-risk areas and recommend solutions to the Congress and executive branch administrators.

We identified 17 federal program areas as the focus of our project. These program areas were selected because they had weaknesses in internal controls (procedures necessary to guard against fraud and abuse) or in financial management systems (which are essential to promoting good management, preventing waste, and ensuring accountability). Correcting these problems is essential to safeguarding scarce resources and ensuring their efficient and effective use on behalf of the American taxpayer.

This report is one of the high-risk series reports, which summarize our findings and recommendations. It describes our concerns over the Bank Insurance Fund, focusing on the factors that contributed to the depletion of the Fund's reserves and discusses the need for effective implementation of the Federal Deposit Insurance Corporation Improvement Act of 1991 and improved accounting rules and bank examinations to shore up and maintain the well-being of the nation's system of deposit insurance. The desirability of the current regulatory structure also needs to be evaluated. Competitiveness issues confronting the banking industry must be resolved once the regulatory reforms are in place.

Copies of this report are being sent to the President-elect, the Democratic and Republican leadership of the Congress, congressional committee and subcommittee chairs and ranking minority members, the Director-designate of the Office of Management and Budget, and the Acting Chairman of the Federal Deposit Insurance Corporation.

A handwritten signature in black ink, reading "Charles A. Bowsher". The signature is written in a cursive, flowing style with a large initial "C".

Charles A. Bowsher

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Overview

The Federal Deposit Insurance Corporation (FDIC) was created in 1933 to provide deposit insurance to protect bank depositors. In addition, FDIC was authorized to make and enforce banking rules and to perform other supervisory duties as part of the insurer's role. Through the Bank Insurance Fund, FDIC insures deposits of up to \$100,000 in about 11,700 commercial banks and about 430 savings banks.

The Problem

The Fund's reserves are exhausted. In 1987, it reached \$18.3 billion—its highest level ever. But an upsurge in bank failures caused it to lose more than \$25 billion in 4 years. As of December 1991, it was \$7 billion in the red.

The Causes

In the 1980s, U.S. banks found their traditional customer base shrinking and the competition from other domestic and foreign financial services vendors on the rise. In response, banks turned to riskier lending activities—most notably, loans for commercial real estate ventures.

Weak internal controls, flawed corporate governance systems, and lax regulatory supervision put both the banks and the

insurance fund at risk, and further heightened the threat by making less likely any early warning of problems. Meanwhile, flexible accounting standards contributed to the problem by enabling weak institutions to hide the extent of their problems until their losses had grown.

In the second half of the 1980s, many of these institutions went broke: Between 1987 and 1991, 882 banks with assets totaling \$151 billion failed. By 1991, the Fund's reserves were depleted.

Even while costs to the Fund mounted, neither the Congress nor the administration received an early warning of the size of the problem from the federal budgetary system. Under the current cash-based method, costs to the deposit insurance system are already incurred by the time their impact on the budget is recognized.

GAO's
Suggestions for
Improvement

The Federal Deposit Insurance Corporation Improvement Act, enacted in December 1991, contains accounting, corporate governance, and regulatory reforms designed to correct weaknesses in the deposit insurance system. Among other measures, the act's early warning reforms

provide for the timely disclosure of internal control weaknesses and violations of laws and regulations. Its early intervention requirements are designed to ensure that regulators take prompt and appropriate actions to correct unsafe banking practices.

In addition, the act provides for the rebuilding of the depleted deposit insurance fund. The act increases FDIC's borrowing authority to cover losses incurred from resolving troubled institutions and requires FDIC to develop a recapitalization plan to increase the Fund's reserves to 1.25 percent of insured deposits within 15 years.

The provisions of the FDIC Improvement Act are largely in keeping with long-standing GAO recommendations. We believe, however, that the ultimate success of the act will depend on FDIC's use of its authority to rebuild the insurance fund and on the quality of the regulators' oversight efforts and the regulations they develop and issue to implement the new law. The current quality of examinations limits the regulators' ability to assess the safety and soundness of insured depository institutions. The merit of the regulatory structure also needs to be reviewed to provide for more efficient and effective regulation.

In addition, neither the Financial Accounting Standards Board nor the federal regulators have acted to effectively tighten flexible accounting rules. Therefore, we have asked the Congress to consider legislating certain regulatory accounting principles for nonperforming loans and more rigorous financial reporting to regulators. This would result in more accurate and useful financial reporting and enable regulators to better assess the condition of federally insured institutions.

To remedy the lagging disclosure of the cost of deposit insurance on the budget, we believe that some form of accrual-based budgeting should be adopted. This would give decisionmakers an earlier and better measure of the expected costs of deposit insurance.

Finally, numerous competitiveness issues—such as interstate branching and regulatory burden—must eventually be resolved in order to ensure the banking industry's long-term viability. We believe that the implementation of the FDIC Improvement Act will have a direct bearing on both the timing of further changes and the benefits that are likely to be realized from them. When the act's reforms have been effectively

implemented, other modernization issues can be addressed on their merits and at an acceptable risk to the safety and soundness of the banking system.

Banking Regulators and the Bank Insurance Fund

FDIC was created by the Banking Act of 1933 to stabilize or promote the stability of banks by providing deposit insurance to protect bank depositors. It was authorized to promulgate and enforce rules and regulations relating to the supervision of insured banks and to perform other regulatory and supervisory duties consistent with its responsibilities as insurer. Enactment of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 designated FDIC sole federal insurer of all banks and savings associations and administrator of the insurance funds. The act created a new insurance fund for thrifts—the Savings Association Insurance Fund—and retitled the insurance fund for banks the Bank Insurance Fund. In its insurance capacity for bank depositors, FDIC, through the Bank Insurance Fund, covers federally insured commercial banks, state chartered savings banks, and any federal savings bank chartered pursuant to section 5(o) of the Home Owner's Loan Act. Deposits are insured up to \$100,000 in about 11,700 commercial banks and about 430 savings banks.

However, FDIC does not have primary regulatory responsibility for all banks. The Board of Governors of the Federal Reserve

System examines state-chartered banks that are members of the Federal Reserve System and bank holding companies, while the Office of the Comptroller of the Currency examines national banks. FDIC's operations include examining state-chartered banks that are not members of the Federal Reserve System, conducting liquidation activities for insured banks that have failed, and providing and monitoring assistance to failing banks.

Federally insured depository institutions pay premiums, or assessments, for insurance coverage. The premiums paid by financial institutions insured by the Bank Insurance Fund are the primary sources for funding expenses incurred by the Fund in resolving failed institutions. From 1933, the year FDIC was created, through 1989, the assessment rate charged insured institutions never exceeded 8.3 basis points. Up until 1984, this was sufficient to provide the Fund with adequate revenues to fund insurance expenses. In fact, in some years FDIC was actually able to rebate a portion of these premiums back to the industry. In 1984, insurance expenses exceeded premiums, but the shortfall was funded through FDIC's other sources of revenue, primarily investment income. This additional income was used to supplement insufficient insurance premiums

during the next 3 years. However, in 1988, the rising level of bank failures and their increasing costs resulted in FDIC incurring insurance expenses that exceeded all its revenue sources, resulting in the first net loss sustained by FDIC in its history. Although legislation was enacted in 1990 to substantially increase FDIC's authority to raise assessment rates, which FDIC did, the rising tide of insurance losses continued to exceed the Fund's revenue sources. By December 31, 1991, these losses exhausted the Fund's reserves.

Regulatory System Proves Ineffective as Industry's Risks Increased

For most of the period in which the system of federal deposit insurance has been in existence, banks faced limited competition for business. Entry was restricted, no interest was paid on demand deposits, and rates that could be paid on other deposits were controlled by Federal Reserve regulations. Particularly during the 1980s, however, many of these protections, which helped reduce risks to banks and thus protect the deposit insurance system, were eliminated or greatly diminished by changed regulations, advances in technology, and other factors. Large, blue-chip companies, which were traditionally the major customer base for banks, began to raise much of the money needed to finance their operations directly from financial markets, bypassing banks. Banks also faced increasing competition from finance companies and other non-banks, and foreign banks.

Facing increasing competition from other domestic and foreign industries with their traditional customer base shrinking, banks turned to alternative lending opportunities, such as loans to less-developed countries, loans to finance highly leveraged transactions, and loans for commercial real estate. These lending strategies carried greater risk of loss to both the insured

institution and the insurance fund. Further, banks were still restricted from engaging in interstate banking activities, effectively preventing them from diversifying the risks in their loan portfolios. This left many banks vulnerable to adverse regional economic and market conditions.

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

As the banking industry took on riskier lending strategies, bank internal controls and

corporate governance systems as well as bank regulatory supervision were not effective in minimizing these risks both to banks and to the insurance fund. Our studies of banks that failed between 1987 and 1989 found inadequate systems of internal controls including weaknesses in loan underwriting, loan documentation, asset classification and problem workout practices, and compliance with safety and soundness laws and regulations. Although bank management is responsible for maintaining an effective system of internal control, audit committees should also play a vital role in an effective system of corporate governance to oversee management's attention to internal controls. However, in response to our survey, many audit committee chairmen of the nation's largest banks advised us that committee members lacked the independence and expertise necessary to effectively perform their responsibilities.

Weakened regulatory supervision hindered regulators' ability to identify and resolve problem institutions in a timely manner. The reduction in examination staff during the early 1980s reduced the number and scope of on-site examinations and gave rise to increased use of off-site monitoring of

banks. Bank regulators also followed a philosophy of trying to work informally with troubled institutions to correct serious operational deficiencies and improve their health and viability. This sometimes resulted in delaying needed regulatory enforcement actions and increasing the ultimate cost of bank failures to the insurance fund. When enforcement actions were taken they tended to focus on capital inadequacy, rather than on a troubled institution's underlying problems, as the key indicator of unsafe and unsound banking practices, despite the fact that bank capital is typically a lagging indicator of serious bank problems.

Our soon to be issued reports on the quality of regulatory examinations also show that the limited nature of these examinations is not sufficient to fully assess the safety and soundness of bank operations and practices. Our review of bank and thrift examinations showed serious weaknesses in the examination process, including a lack of comprehensive internal control assessments by the examiners, insufficient loan quality and loan loss reserve reviews, over-reliance on unverified data, and weak or inconsistent quality controls over the examination process. A lack of minimum, mandatory examination standards in these areas was a

common factor for each of the regulatory agencies that limited the effectiveness of the examination process as an early warning of problems.

The adequacy of financial information reported by banks to the regulators is critical to the regulatory early warning process, especially for off-site monitoring. Deficiencies in existing accounting standards contributed to hindering the early warning process by allowing troubled institutions to delay timely reporting of loan impairment and to inaccurately minimize the extent of losses suffered by the institution from asset deterioration. Our review of 39 banks that failed in 1988 and 1989 showed that flexible accounting standards allowed problem banks to unduly delay recognizing losses in their loan portfolios and to overstate the value of real estate acquired through foreclosure, thus overstating their capital. The magnitude of FDIC's adjustments to the loss reserves of these banks at the time of their failure showed that \$7.3 billion in reported bank capital did not exist. Flexible accounting rules are also used by banks to recognize gains while deferring losses on debt investment securities and to not recognize the economic substance of related party transactions when materially

different than their legal form. Such latitude contributes to banks reporting inflated capital levels and further clouds the regulators' ability to accurately assess the true financial condition of insured institutions.

The federal budgetary system also did not forewarn the administration and the Congress of the rising costs associated with the nation's deposit insurance system. Under the current cash-based budgeting treatment for deposit insurance, the costs for this program have already been incurred by the time the program's budgetary impact is disclosed. We believe that some form of accrual-based budgeting should be adopted to better measure the expected costs of deposit insurance before these costs are incurred. Such a budgetary system would give the administration and congressional leaders earlier warning of rising insurance costs, and would better assist them in policy decision-making. However, the administration's proposed accrual budgeting for deposit insurance introduced in the fiscal year 1993 budget went beyond tested accrual accounting conventions and was questionable because of the uncertain assumptions and poor data that underlie the calculations.

The weaknesses in the regulatory early warning system and the budgetary treatment for deposit insurance hindered the regulators, the administration, and the Congress from recognizing earlier on the increasingly significant exposure to insurance losses facing the Bank Insurance Fund. These factors contributed significantly to the precipitous decline and depletion of an insurance fund that, just 5 years ago, reached the highest level in its history.

Successful Implementation of the FDIC Improvement Act Is Critical for the Industry and the Insurance Fund

The FDIC Improvement Act of 1991, enacted December 19, 1991, provides for accounting, corporate governance, and regulatory reforms that help address the serious weaknesses in the nation's system of deposit insurance that contributed to the depletion of the Bank Insurance Fund. Successful implementation of these reforms is critical to facilitating early warning of safety and soundness problems and minimizing losses to the Fund.

The act's early warning reforms, which include provisions for timely disclosure of internal control weaknesses and violations of laws and regulations, address the flawed corporate governance system. The act requires insured financial institutions with assets of \$150 million or more to submit annual reports to the regulators containing (1) a statement of management's responsibility for the institution's financial statements, internal controls, and compliance with safety and soundness laws and regulations designated by the regulators, (2) audited financial statements, (3) management's assessment of the effectiveness of the institution's internal controls, and (4) management's assessment of the institution's compliance with designated laws and regulations.

The institution's external auditors are required to report separately on management's assertions on internal controls and compliance with laws and regulations. The institution's external auditor is also required to meet certain qualifications, such as having received a peer review that meets guidelines acceptable to the FDIC, and the regulators have the authority to remove, suspend, or bar the external auditor upon showing of due cause. Additionally, the act contains a number of requirements to improve communication among the insured institution, its external auditor, and the regulators.

The corporate governance system is also strengthened by the act's independent audit committee requirements. Institutions with assets of \$150 million or more must establish audit committees made up entirely of outside directors who are independent from the management of the institution. Among its duties, the audit committee is responsible for reviewing with management and its external auditor the basis for financial reports, the auditor's opinion, management's assessment of the institution's internal controls and compliance with laws and regulations, and the external auditor's report on management's assertions on internal

controls and compliance. Audit committees for large institutions are required to include members with banking or related financial management expertise and exclude large customers of the institution. The committee must also have access to outside counsel independent from the institution.

The corporate governance reforms are effective for institutions whose fiscal years begin after December 31, 1992. The regulators have published proposed regulations to implement these reforms. We have advised FDIC that the draft regulations need considerable modifications to be effective. If these changes are not made, the benefits expected from the act's internal control and other corporate governance requirements are not likely to be realized.

The act's regulatory reforms include requirements for annual full-scope examinations for generally all institutions and for the establishment of a system of capital and noncapital "tripwires" to provide for early regulatory intervention to minimize losses to the insurance fund. The intent of the act's requirement for annual full-scope examinations is to ensure that the regulators have a sound basis for reaching conclusions about the safety and soundness of a bank's

operations. The act's early intervention requirements are designed to ensure that appropriate action is taken to promptly correct unsafe and unsound banking practices.

FDIC recently issued final regulations covering the implementation of the act's capital tripwire provisions. Under these regulations, which are effective December 19, 1992, bank regulators are required to take specified actions when an institution's capital falls below certain levels. Such actions include restricting the payment of dividend and management fees, restricting asset growth, and prohibiting acquisitions, branch openings, and new business ventures. The actions taken by the regulators become more restrictive as the institution's capital declines. The regulations also require that the regulators take prompt action to resolve a problem institution before its capital is depleted, thereby minimizing losses to the insurance fund. Closure of a troubled institution can occur when a bank's tangible equity falls to 2 percent or less of its total assets.

The noncapital tripwires include safety and soundness standards relating to internal controls, loan documentation, credit

underwriting, interest rate exposure, and asset growth. They are intended to facilitate timely correction of deficiencies before losses occur and capital is eroded. These standards must be developed by the regulators and are to be effective no later than December 1, 1993.

The act establishes objectives for accounting principles applicable to reports filed with the regulators by depository institutions. These objectives essentially require that the application of the accounting principles result in financial statements and reports of condition that accurately reflect the capital of such institutions, and facilitate effective supervision and prompt corrective action to resolve troubled institutions at the least cost to the insurance funds. The regulators are required to review all accounting principles used by insured institutions in developing reports filed with the regulators by December 19, 1992, to ensure they meet the objectives of reliable financial reporting established by the act. If the regulators determine that application of any accounting principle will not meet the act's objectives, the regulators have the authority to prescribe accounting principles which satisfy these objectives.

In June 1992, we presented a detailed analysis of the applicable accounting rules for recognizing and measuring losses from nonperforming loans. The analysis indicated deficiencies in existing accounting rules that contribute to unreliable financial reports of insured institutions. The Financial Accounting Standards Board (FASB) and the regulators reviewed our report, but neither appears likely to take corrective action. There still appears to be a reluctance to value nonperforming loans at values that reflect fair value conditions, although we believe this would provide the best measure of an institution's eventual recovery on such loans. Until these deficiencies in existing accounting standards are corrected, we remain concerned that nonperforming loans will not be valued consistently on a fair value basis, and that, as a result, asset values and capital will continue to be overstated. Similarly, flexible accounting rules for investment securities and related party transactions are a continuing problem contributing to banks reporting overstated capital.

Deposit insurance has proven to provide an incentive for inappropriate risk taking at the expense of the insurance fund and, ultimately, the taxpayer. To address the

problem of excessive risk taking on the part of federally insured institutions, the FDIC Improvement Act places limitations on institution levels of brokered deposits, which have been used in the past as a funding source for high-risk growth. The act also requires that the regulators develop and issue revised risk-based capital standards that consider interest-rate risk, concentrations of credit risk, risks associated with nontraditional banking activities, and risks associated with multifamily mortgage lending. Regulations implementing these revised standards are required by June 1993. The act also requires that FDIC replace its premium assessment rate system, wherein all institutions were assessed at the same rate, with a risk-based premium system by January 1994. FDIC is implementing a transitional risk-based premium system effective January 1, 1993, whereby institutions posing a higher risk of failure and cost to the insurance fund, as measured in part by capital thresholds, will be charged higher premiums than those institutions considered well or adequately capitalized.

Legislation was proposed in 1992 that, if enacted, would have delayed, deleted, or modified the accounting, corporate

governance, and regulatory reforms required by the FDIC Improvement Act. The most comprehensive of these were the "Credit Availability and Regulatory Relief Act of 1992" and H.R. 5433, the "Comprehensive Community Bank Burden Reduction Act of 1992." The stated purpose of the proposed legislation was to reduce the regulatory burden on depository institutions. Although we believe reducing regulatory burden has merit, these proposals were misguided. We remain concerned that such harmful proposals will be attempted in 1993 and, if enacted, would place the insurance funds at serious risk.

The bankruptcy of the former insurance fund for thrifts (the Federal Savings and Loan Insurance Corporation), the insolvency of the Bank Insurance Fund, the near insolvency of the Savings Association Insurance Fund, and the continuing high level of troubled banks and thrifts and their possible failures are further evidence of the need for the FDIC Improvement Act's accountability and supervisory reforms. The act provides the regulators with the tools necessary to obtain more accurate information on the condition and activities of insured depository institutions and clear standards by which to judge unsafe and

unsound conditions, and the institutions with incentives to correct unsafe and unsound conditions in a timely manner. These reforms are critically linked to provide an early warning of safety and soundness problems and minimize losses to the insurance funds. These reforms should not be burdensome on well managed institutions. Weakening these reforms sets the stage for a repeat performance of the mistakes of the past and their costly consequences.

Many Uncertainties Affect the Future Outlook for the Bank Insurance Fund

While successful implementation of the FDIC Improvement Act's accounting, corporate governance, and regulatory reforms is critical to restoring to an acceptable level management accountability and regulatory oversight, the depleted Bank Insurance Fund must be rebuilt. The act increases FDIC's borrowing authority from the Department of the Treasury from \$5 billion to \$30 billion to cover losses incurred from resolving troubled institutions. FDIC is also required to develop and implement a recapitalization plan for the Bank Insurance Fund to increase the Fund's reserves to a designated ratio of 1.25 percent of insured deposits over a maximum of 15 years. FDIC's borrowings from the Treasury are to be repaid by the industry and would be considered in recapitalization plans for the Fund. Although statutory requirements exist to rebuild the Fund, the Fund's outlook is uncertain.

As of June 30, 1992, the regulators identified 1,044 banks with assets totaling \$567 billion as problem institutions. However, the Fund's ultimate exposure to losses from troubled institutions is difficult to predict over the long term with any level of precision. FDIC's recently approved recapitalization plan for the Fund includes estimates of the total assets of expected bank failures projected

over 15 years. These estimates indicate that FDIC expects banks with assets totaling \$233 billion to fail between 1992 and 1995, at an estimated cost to the Fund of approximately \$40 billion. Over \$16 billion of these costs were recognized in the Fund's 1991 financial statements. Under FDIC's estimates, the level of failed bank assets and the cost of bank failures to the Fund decline significantly after 1995.

In April 1992, the Congressional Budget Office testified that it and other government and private entities estimated that the Fund faced costs of between \$15 billion and \$72 billion over the next 4 years from resolving problem banks. More recently, a private study concluded that the Fund could incur costs of between \$31 billion and \$95 billion by closing or assisting banks the study determined were insolvent at December 31, 1991 after applying discounts to mark the banks' assets to market value.

The range of these estimates, as well as their various underlying assumptions, is indicative of the difficulty of reliably estimating future bank failures and their cost to the Fund. We are currently reviewing the adequacy of the Fund's reserve levels as part of our audit of

the Fund's December 31, 1992, financial statements.

The recent low interest rate environment has enabled banks to recognize profits from the favorable interest spreads. Additionally, banks have been able to realize gains through the sales of securities, further generating short-term profits. While this may affect an institution's profit picture, it does not eliminate the losses embedded in the institution's asset portfolio. If interest rates begin to rise and banks have not adequately provided for loan portfolio losses, the number of bank failures could begin to rise. Poor economic and market conditions could also adversely affect amounts FDIC expects the Bank Insurance Fund will recover from the disposition of failed institution assets, resulting in higher than anticipated losses to the Fund.

Regarding interest rates, the drop in interest rates coupled with an ample supply of funds has led banks to increase their investments in securities. FDIC recently testified that many banks have funded long-term investment securities, such as Treasury bonds, with shorter-term deposits. As of June 30, 1992, over 1,200 banks had invested at least 20 percent of their assets in

investment securities with maturities of 5 or more years. These banks hold more than 9 percent of the industry's assets. A rise in interest rates generally would devalue these portfolios of debt securities. If short-term rates rise faster than long-term rates, net interest margins will be detrimentally affected. Such conditions could result in the failure of marginally capitalized banks and add to insurance fund losses.

The future condition of the thrift industry and its insurer, the Savings Association Insurance Fund (SAIF), could also affect the adequacy of the funding provided by the FDIC Improvement Act to cover the Bank Insurance Fund's needs. The \$30 billion in Treasury borrowing authority provided to FDIC is to cover the needs of both funds. While SAIF currently has some resolution responsibility, it will assume sole responsibility for resolving all federally insured thrifts from the Resolution Trust Corporation in October 1993. If SAIF assumes full resolution responsibility with a backlog of troubled thrifts, its available funding sources may prove insufficient to meet its resolution needs. If this occurs, FDIC may be forced to use some of the \$30 billion in Treasury borrowing authority to cover SAIF's

losses, thus reducing the amount of funding available to the Bank Insurance Fund.

FDIC recently increased assessments charged to insured institutions and will implement a transitional risk-based premium system in January 1993, 1 year ahead of the date mandated by the FDIC Improvement Act. Under this risk-based premium system, weaker, riskier institutions will pay more for insurance coverage. Such a system provides for a more equitable sharing of the burden within the industry, as well-run institutions will pay less for insurance coverage. It provides an incentive for poorly-run institutions to improve their operations. Assessment rates will range from 23 cents to 31 cents per \$100 of domestic deposits, with an average assessment rate of 25.4 cents charged to insured banks. The average assessment rate represents an increase of 10 percent over the current flat rate of 23 cents per \$100 of domestic deposits charged to all federally insured banks. However, at the time the proposal was released for public comment, FDIC estimated that, under its most likely scenario, the Fund would have only a 60 percent probability of attaining the designated reserve ratio over the maximum 15-year statutory period.

Competitiveness Issues Confronting the Banking Industry Must Also Be Resolved

The reforms contained in the FDIC Improvement Act are important to reduce the costs of deposit insurance—costs for taxpayers and for the healthy banks whose premiums pay for the losses of failed banks. When implemented, these reforms will lay the groundwork for consideration of additional reforms likely to appear soon on the incoming administration's and the Congress' agenda. These additional reforms, intended to modernize the banking system, include expanding the allowable business lines of banking organizations and removing federal restrictions on interstate banking and branching. At a minimum, interstate banking offers the opportunity for more efficient banking and should be considered.

Without question, the nation's economy needs a healthy, competitive banking system, and changes in the federal laws pertaining to powers and interstate banking may prove to be essential. However, modernization efforts pose potentially large, down side risks that cannot be ignored. The FDIC Improvement Act's management and supervisory reforms are a crucial element in the modernization of the banking system precisely because they address the conditions that are needed for operating a banking system safely in today's competitive,

fast changing financial markets. To operate safely, a bank that offers more products and serves wider areas must have up-to-date management systems for controlling risks and preparing accurate financial statements. Additionally, bank regulators must have the ability to know the financial condition of a bank, detect problems, and take action before a bank's capital is exhausted and the deposit insurance funds must take a loss.

When the FDIC Improvement Act's reforms are in place, other modernization issues can be addressed on their merits at an acceptable risk to the safety and soundness of the system. Thus, effective implementation of the act has a direct bearing on both the timing of further changes and the benefits that are likely to be realized.

Conclusions and Action Needed

The Congress has been very responsive to our recommendations to rebuild the Bank Insurance Fund and to put safeguards in place to improve regulation and minimize losses to the Fund. FDIC has the statutory authority to take steps to rebuild the Fund and has been given statutory power to implement reforms to minimize risks and losses to the Fund. The ultimate success of the FDIC Improvement Act will depend on FDIC's use of its authority to rebuild the Fund and the quality of the regulations developed and issued to implement the act. Proposed regulations to implement the act's internal control and other corporate governance provisions need considerable enhancement. It is critical that the incoming administration and the Congress strongly encourage the regulators to effectively implement the act.

We will continue to monitor the development and issuance of implementing regulations. However, because neither FASB nor the regulators appear willing to address the serious deficiencies in existing accounting standards for nonperforming loans, we have suggested that the Congress consider legislating regulatory accounting principles for nonperforming loans and financial reporting to the regulators. Generally, we do not advocate the use of

accounting principles that differ from generally accepted accounting principles. However, the use of more stringent accounting rules in the area of loan loss accounting and investment securities such as those we have advocated would result in more accurate and useful financial reporting and aid the regulators in better assessing the true condition of federally insured institutions. Also, the expanded use of complex financial derivatives and off-balance sheet risks by the banking industry poses considerable exposure to the insurance fund while reliable financial reporting of these activities is likely to lag. We have undertaken studies of these issues.

While the FDIC Improvement Act requires annual full-scope examinations of insured institutions, our soon to be issued reports on the quality of bank examinations show the need for substantial improvements to fully assess bank safety and soundness. If the regulators do not adequately address our recommendations to correct the serious weaknesses, the Congress may wish to enact legislation to mandate such improvements. Although we did not study the efficiency and effectiveness of the regulatory structure, we identified many inconsistencies among the regulators in their operations and practices

that may hinder how well the regulators address the problems we found in our review. The incoming administration and the Congress may wish to review the existing financial institutions' regulatory structure and consider alternatives to eliminate regulator inconsistencies and strengthen the efficiency and effectiveness of the regulatory structure.

On a related issue, regulatory burden and its effect on bank operations, costs, and competitiveness continues to surface as banking becomes more complex and competitive both domestically and internationally. We have undertaken a review of the regulatory burden facing the banking industry to determine both its extent and areas in which it might be reduced without damaging the achievement of the safety and soundness and consumer protection objectives of the FDIC Improvement Act.

With regard to our concerns about the usefulness of the budgetary process as an early warning of rising deposit insurance costs, we view improving budgeting for these activities as a longer-term project that should be given high priority by the Congress and the incoming administration.

Accrual-based budgeting for deposit insurance, as well as similar programs, has merit and, if properly developed, could provide useful information on emerging issues to foster proactive versus reactive policy decisions. As with the successful implementation of credit reform, we expect such a project will take several years to develop reliable historical data and estimation techniques.

The competitiveness issues confronting the banking industry need to be resolved to foster the industry's long-term viability. Successful implementation of the accounting, corporate governance, and regulatory reforms is critical to ensuring that modernization reforms are balanced with safety and soundness.

Related GAO Products

Financial Audit: Bank Insurance Fund's 1991 and 1990 Financial Statements
(GAO/AFMD-92-73, June 30, 1992).

Condition of the Bank Insurance Fund: Outlook Affected by Economic, Accounting, and Regulatory Issues (GAO/T-AFMD-92-10, June 9, 1992).

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

Accrual Budgeting (GAO/AFMD-92-49R, Feb. 28, 1992).

Bank Supervision: Observations on the National Bank Examiners' Conference
(GAO/T-GGD-92-10, Jan. 3, 1992).

Comprehensive Deposit Insurance Reform and Taxpayer Protection Act of 1991: Observations on Accounting Reforms and Funding for the Bank Insurance Fund
(GAO/T-AFMD-92-3, Dec. 11, 1991).

Financial Audit: Bank Insurance Fund's 1990 and 1989 Financial Statements
(GAO/AFMD-92-24, Nov. 12, 1991).

Bank Powers: Bank Holding Company
Subsidiaries' Market Activities Update
(GAO/GGD-91-131, Sept. 20, 1991).

OCC Supervision of the Bank of New
England (GAO/T-GGD-91-66, Sept. 19, 1991).

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

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Needs of the Bank Insurance Fund and the
Resolution Trust Corporation (GAO/AFMD-91-90,
Aug. 22, 1991).

Credit Unions: Reforms for Ensuring Future
Soundness (GAO/GGD-91-85, July 10, 1991).

Expanded Powers for Banking Organizations
(GAO/T-GGD-91-52, July 10, 1991).

Resolving Large Bank Failures
(GAO/T-GGD-91-27, May 9, 1991).

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