United States General Accounting Office

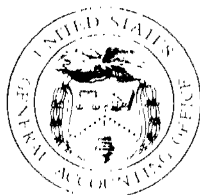
GAO

Report to the Congress

September 1990

BANK INSURANCE FUND

Additional Reserves and Reforms Needed to Strengthen the Fund



GAO/AFMD-90-100

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

Comptroller General
of the United States

B-114831

September 11, 1990

To the President of the Senate and the
Speaker of the House of Representatives

This report presents the results of our audit of the Bank Insurance Fund's financial statements for the years ended December 31, 1989 and 1988. The Bank Insurance Fund is the insurer of deposits for the banking industry.

The Bank Insurance Fund was formerly reported as the Federal Deposit Insurance Corporation (FDIC). Public Law 101-73, the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) created the Bank Insurance Fund as well as the Federal Savings and Loan Insurance Corporation Resolution Fund, which assumed most of the assets, debts, obligations, and other liabilities of the dissolved Federal Savings and Loan Insurance Corporation, and the Savings Association Insurance Fund, a new fund for savings and loan associations. FIRREA transferred the assets and liabilities of FDIC to the Bank Insurance Fund and expanded FDIC's operations to include the administration of the three funds. FIRREA requires that FDIC maintain each fund separately and that we audit them annually. We will report separately on the financial condition of these funds.

We found that the Fund is too thinly capitalized to deal with the potential for bank failures in the event of a recession. Such an event could exhaust the Fund and require a taxpayer bailout. Our report discusses the serious problems facing the banking industry, the Fund's ability to deal with the exposure it faces in the 1990s, and our recommendations for needed reforms to strengthen the Fund.

We are sending copies of this report to the Chairman of the Board of Directors, Federal Deposit Insurance Corporation; the Director of the Office of Management and Budget; the Secretary of the Treasury; the Chairman of the Board of Governors of the Federal Reserve System; the Comptroller of the Currency; and the Chairmen of the Senate Committee on Banking, Housing and Urban Affairs and the House Committee on Banking, Finance and Urban Affairs.

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 staff have any questions.

Charles A. Bowsher
Comptroller General
of the United States

Executive Summary

Purpose

This report presents GAO's opinion on the Bank Insurance Fund's December 31, 1989 and 1988 financial statements as required by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA). It includes other information and observations of importance to the Congress, the administration, and the taxpayers in considering the serious problems facing the banking industry and the Fund's ability to deal with the exposure it faces in the 1990s.

Background

The Bank Insurance Fund insures deposits in about 13,200 commercial and savings banks and is administered by the Federal Deposit Insurance Corporation (FDIC). Prior to 1989, the insurance entity reported as FDIC. It was renamed the Bank Insurance Fund by FIRREA. FDIC operations also 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 failed banks.

As the Fund's administrator, FDIC provides financial assistance to banks in danger of failing. For failed banks, FDIC is appointed receiver, pays the insured claims of the failed banks' depositors or banks acquiring those claims, and liquidates the remaining assets of failed banks not assumed by acquiring banks. The Fund's operations are funded through assessments from insured banks and certain other activities.

Results in Brief

Not since it was born in the Great Depression has the federal system of deposit insurance for commercial banks faced such a period of danger as it does today. The Bank Insurance Fund has resources to handle anticipated bank failures in 1990. However, a worst case scenario suggests that 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.

The leading cause of problems within the industry is the increasingly risky nature of its loan portfolio, especially the growing levels of nonperforming loans. Meanwhile, as of December 31, 1989, the ratio of the Fund balance to insured deposits stood at .7 percent, the lowest level ever. GAO's analysis shows that because of the likelihood of high levels of losses from future anticipated bank failures, the minimum Fund ratio of reserves to deposits of 1.25 percent, set by FIRREA, is not likely to be met by 1995. Even if this target could be met, Fund reserves may still prove inadequate to cover losses in the event of a recession.

The Bank Insurance Fund ended 1989 with a net loss of $852 million, reducing its balance to $13.2 billion. GAO identified a total of 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. The failure of these banks would result in an estimated cost to the Fund of between $4 billion and $6 billion.

GAO also identified a significant number of other banks that are at risk of failure within the next few years. A recession would exacerbate their problems and could lead to their failing, as well as the failure of other banks, threatening to deplete the Bank Insurance Fund.

GAO's analysis raises other concerns, including

- a potential liquidity problem for the Fund resulting from its $8 billion contingent liability for troubled assets held by acquirers of failed banks, some undetermined portions of which FDIC will be required to purchase in the future, and
- the inability of the supervisory and examination processes to provide the early warning system needed to deal with troubled banks, specifically (1) the inadequacy of regulator on-site examination coverage, (2) unrealistic asset appraisals resulting in overstated recoverable values, and (3) overly optimistic financial accounting and reporting by banks.

In GAO's opinion, the Fund's December 31, 1989 and 1988, financial statements are fairly presented in accordance with generally accepted accounting principles. The estimated costs of $4 billion to $6 billion from the banks GAO believes 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 costs are excluded from the Fund's financial statements. GAO believes these accounting principles may unduly delay recognizing losses that could substantially reduce the Fund balance.

GAO's Analysis

Financial Performance of Commercial Banks Is Declining

The performance of the commercial banking industry worsened in 1989 compared to 1988. The risks associated with the industry's loan portfolio and declines in certain regional economies have led to significant growth in nonperforming assets, particularly real estate loans in the Northeast. Also, large commercial banks are continuing to experience losses on their portfolios of loans to less developed countries. These negative trends, which have been increasing the risk to the Fund over the past few years, together with the potential for bank losses on loans involving highly leveraged transactions, could lead to bank failures in the 1990s and significant costs to the Bank Insurance Fund. (See chapter 2.)

Many Banks in Danger of Failing

While the number of banks on FDIC's problem list has declined from about 1,600 in 1987 to 1,100 in 1989, the number of problem institutions, along with the level of exposure they represent to the Fund, is still alarmingly high. GAO's financial analysis of the 200 problem banks with assets over $100 million at December 31, 1989, as well as the nation's 100 largest banks, disclosed 35 institutions in such severe financial condition that without some form of recapitalization, they are likely to fail or require regulatory assistance within the next year.

These 35 banks are located principally in the Northeast and Southwest and have assets totaling $45.1 billion. Based on loss rates FDIC has historically experienced on bank failures, GAO estimates that the failure of these banks would result in a total cost to the Fund of $4 billion to $6 billion. It is not possible to predict with certainty that each of these banks will fail in the near future. However, GAO believes it is highly likely that most of them will fail within a year.

GAO also identified a significant number of other banks that although less troubled than the 35, are also at risk to fail within the next few years, particularly if their regional economies continue to deteriorate. If many of these troubled banks were to fail, the Fund could be significantly impaired. A recession could exacerbate this problem and result in even more bank failures, which could deplete the Fund.

Separate Asset Pools Are a Liquidity Concern for the Fund

In assisting failed banks, FDIC enters into agreements with acquirers that in some cases require FDIC to later purchase the failed banks' troubled assets from the separate asset pools which the acquirers are allowed to establish. As of December 31, 1989, the Fund was contingently liable for about $8 billion of troubled assets that acquirers may pass back to FDIC. If such transactions are not carefully monitored, they may pose a liquidity problem for the Fund or overextend its resources.

In addition, unrealistically high appraisal values for these assets could mask losses that may be incurred when they are sold. FDIC guidelines require that assets held in separate asset pools be recorded and adjusted based on appraised values. GAO found indications that some recorded values for these assets had overstated recoverable values due to unrealistic assumptions used by the appraisers. (See chapter 4.)

Reliance on Bank Financial Reports May Hinder Early Warning of Problem Banks

Regulators' efforts to strengthen both on-site and off-site monitoring systems are hindered by unreliable information in the quarterly reports of financial condition that banks prepare for the regulators. GAO found instances where the banks' reports did not reflect their true financial condition; their accuracy seemed to be dependent on whether there had been a recent on-site examination by the bank regulators. GAO believes that the effectiveness of off-site monitoring as an early warning of potential bank problems may be limited by reliance on banks' reports. (See chapter 3.)

Fund Reserves Too Low

The Bank Insurance Fund ended 1989 with a net loss of $852 million, reducing the fund balance to $13.2 billion. The ratio of the Fund balance to insured deposits stood at .7 percent—the lowest level ever—of its reserves to insured deposits. FIRREA established assessment rates that FDIC may charge to increase the Fund's reserves and set a minimum 1.25 percent ratio of reserves to insured deposits to be achieved by 1995. It is unlikely that the Fund will reach this minimum ratio without using annual assessment rates higher than those currently authorized by FIRREA. (See chapter 4.)

Fund Reserve Level and Accounting Principles Need Further Study

GAO identified two issues for further study. First, Bank Insurance Fund reserves set at 1.25 percent of insured deposits may not be sufficient to carry the Bank Insurance Fund through a recession. The risk levels associated with the industry's loan portfolio have increased over the past

decade. Because levels of bank equity capital have not changed correspondingly, the increased portfolio risk is not cushioned by additional capital. Therefore, the traditional level of Bank Insurance Fund reserves may not be sufficient now. (See chapter 2.)

The level of deposit insurance reserves necessary to reasonably protect the taxpayer against losses from bank failures in a recession requires further study. It should be included in the deposit insurance reform study required by FIRREA. GAO recognizes that achieving a more adequate Fund balance solely through premium assessments may not be feasible. Therefore, the study should include other means of reducing the Fund's exposure, such as increasing capital levels in banks. (See chapter 4.)

Second, study is required to determine the extent to which the application of generally accepted accounting principles is hindering early warning of the financial condition of troubled banks. Because the principles allow management too much discretion, they may be unduly delaying the recognition of losses in the financial statements. Additionally, basing an estimate of loss on the traditional fair value concept may not be appropriate. The traditional concept determines values in a market where the seller is under no compulsion to sell and has time to negotiate a sale. Assets in troubled banks and nonperforming assets in any bank may have to be disposed of in a market when conditions may require that the assets be disposed of in the near future. Both of these concerns with the application of generally accepted accounting principles impact banks' capital, the accurate determination of which is critical if the government's interests as insurer are to be protected. GAO is raising these questions to encourage the accounting profession, regulators, and others to begin to further define the problems and develop the changes that may be needed to minimize losses to the Bank Insurance Fund. These issues and other accounting, reporting, auditing, and internal control issues facing the banking industry are discussed in this report. (See chapter 5 and appendix II.)

Recommendations

To address the concerns and uncertainties currently facing the Bank Insurance Fund, GAO is recommending that

- the Congress amend FIRREA to authorize the FDIC Chairman to raise the assessment rates beyond those currently provided so that the Fund can achieve the minimum reserve ratio of 1.25 percent designated in FIRREA by 1995;

- the Secretary of the Treasury determine in the Department's study of deposit insurance reform required by FIRREA (1) the reasonableness of the minimum and maximum reserve ratios designated by FIRREA, (2) a reserve ratio target that would protect taxpayers by maintaining the Fund in the event of a recession, (3) means in addition to premium assessments, such as increased capital levels in banks, that would reduce the Fund's potential liabilities;
- the Chairman of the Federal Deposit Insurance Corporation, the Chairman of the Board of Governors of the Federal Reserve System, and the Comptroller of the Currency perform on-site full scope examinations of problem banks and large banks on an annual basis; and
- the Chairman of the Federal Deposit Insurance Corporation (1) revise its appraisal guidelines for determining and recording the book value of assets owned or held in separate asset banks so they reflect more realistic values by taking into account both historical experience and current conditions and (2) monitor the use of separate asset pools to ensure the Bank Insurance Fund has cash resources to meet its commitments.

Agency Comments

The Federal Deposit Insurance Corporation and the Board of Governors of the Federal Reserve System generally concurred with GAO's findings and recommendations. In fact, FDIC's Board of Directors recently issued a proposal to implement additional assessment rate increases allowed by FIRREA in 1991 based on its revised projections of the Fund's 1990 operations and the impact of these operations on the Fund balance. GAO believes this increase is necessary in light of the Fund's current condition and outlook and commends FDIC's recent action.

The Office of the Comptroller of the Currency stated that the report was, for the most part, factually accurate. However, the Office questioned the recommendation for annual on-site, full scope examinations of problem banks and large banks. The Department of the Treasury did not specifically address GAO's recommendation on factors to include in its study on deposit insurance reform. Treasury stated that the report should be a useful contribution to a better understanding of the Bank Insurance Fund. (See chapters 2, 3, and 4 for agency comments and GAO's evaluation.)

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Abbreviations

CAEL	capital adequacy, asset quality, earnings, and liquidity
CAMEL	capital adequacy, asset quality, management, earnings, and liquidity
ECR	estimated cash recovery
FDIC	Federal Deposit Insurance Corporation
FIRREA	Financial Institutions Reform, Recovery, and Enforcement Act of 1989
FRB	Federal Reserve Board
FSLIC	Federal Savings and Loan Insurance Corporation
GAO	General Accounting Office
HLT	highly leveraged transaction
LDC	less developed countries
NCNB	North Carolina National Bank
OCC	Office of the Comptroller of the Currency
OREO	other real estate owned
RTC	Resolution Trust Corporation
SFAS	Statement of Financial Accounting Standards

Introduction

During the 1980s, banks failed at record rates. From 1934, the year the Federal Deposit Insurance Corporation (FDIC) was created, through 1979, a period of 46 years, 558 FDIC-insured banks failed. In the 10 years from 1980 through 1989, 1,085 FDIC-insured banks, including 630 in the last 3 years, failed or received assistance from FDIC. These failures and assistance transactions have had an adverse effect on the Bank Insurance Fund, which was formerly reported as FDIC. Our 1988 audit[1] reported that the insurance fund incurred its first net loss since its inception—$4.2 billion—in 1988. This loss reduced the insurance fund balance from $18.3 billion at the end of 1987 to $14.1 billion at the end of 1988. The ratio of the fund balance to insured deposits was reduced to what then was its lowest level ever—about .83 percent as of December 31, 1988.

The banking industry and the Bank Insurance Fund continue to be vulnerable to the exposures caused by persistent problems in real estate lending and loans to less developed countries and uncertainties associated with loans involving highly leveraged transactions. Furthermore, in 1989 industry earnings fell from the previous year's $24.8 billion to $16.3 billion, and the Fund reported a net loss for the second consecutive year. The Bank Insurance Fund's 1989 net loss was $852 million, reducing the fund balance to $13.2 billion. As a result of this loss and growth in the industry's insurable deposit base, the ratio of the Fund balance to insured deposits fell to a record low of .7 percent at December 31, 1989. Just 4 years earlier, the Fund reported an $18 billion balance and a 1.19 percent ratio of the Fund balance to insured deposits.

These adverse trends have fostered heightened concerns in both the Congress and the general public as to whether the banking industry will mirror the financial disaster in the savings and loan industry—and ultimately require a taxpayer bailout. While the conditions in the banking industry parallel some of those in the savings and loan industry, they are in many respects different. Some of the problems that contributed to the savings and loan debacle are not present in the banking industry. This report addresses the condition of the Bank Insurance Fund and the exposures it faces, but it does not attempt to compare these to the savings and loan industry. This report discusses FDIC's role as the insurer of banks and its responsibility for reporting on the condition of the Bank Insurance Fund.

[1] Financial Audit: Federal Deposit Insurance Corporation's 1988 and 1987 Financial Statements (GAO/AFMD-89-63, April 28, 1989).

The Federal Deposit Insurance Corporation

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. On August 9, 1989, with the enactment of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), FDIC was designated sole federal insurer of all banks and savings associations. As such, FDIC is responsible for reporting on the condition of the Bank Insurance Fund, the Savings Association Insurance Fund and the Federal Savings and Loan Insurance Corporation Resolution Fund. These three funds are accounted for and reported separately by FDIC. 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 Owners' Loan Act. The Savings Association Insurance Fund is the insurance fund for federally insured savings associations. The Federal Savings and Loan Insurance Corporation Resolution Fund is the fund established by FIRREA to manage the assets and liabilities related to transactions entered into before January 1, 1989, by the now defunct Federal Savings and Loan Insurance Corporation. We will report separately on the condition of the other funds.

FDIC is the insurer of all banks; however, it does not have primary regulatory responsibility for all banks. The Federal Reserve Board (FRB) 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 (OCC) 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.

FDIC's role as the insurer of banks is to protect depositors in the nation's banks, help maintain confidence in the banking system, and promote safe and sound banking practices. FDIC supervises approximately 7,500 state-chartered nonmember banks and insures deposits up to $100,000 in approximately 13,200 commercial and savings banks. In addition, FDIC supervises approximately 470 state-chartered savings banks. OCC supervises approximately 4,250 national banks, and FRB supervises approximately 1,050 state-chartered member banks.

As the insurer of bank deposits, FDIC has established financial programs for both failing and failed banks. Financial assistance to failing banks is

designed to rehabilitate an insured bank. Assistance may be granted directly to the bank or to a company that controls or will control it. Assistance may also be granted to facilitate the merger of a bank. When banks fail, FDIC is appointed receiver, directly pays insured claims to depositors or the acquiring bank, and liquidates the remaining assets and liabilities not assumed by the acquiring bank.

Although FDIC does not receive any appropriated funds to administer the Bank Insurance Fund, FDIC is subject to congressional oversight. The Bank Insurance Fund's operations are funded through assessments from insured banks and the Fund's internal operations, such as investments and recoveries from sales of assets acquired in assisting troubled institutions.

Objectives, Scope, and Methodology

The objectives of our audit were to (1) render an opinion on the presentation of the Bank Insurance Fund's financial statements in accordance with generally accepted accounting principles for the years ended December 31, 1989 and 1988, and (2) report on FDIC's internal control structure and on its compliance with applicable laws and regulations related to the Bank Insurance Fund. In addressing these objectives, we

- evaluated the financial condition of the banking industry and the adequacy of the Bank Insurance Fund to meet its current and near-term identifiable needs through 1990;
- analyzed financial information on the banking industry and on specific banks the regulators identified as troubled institutions to determine the potential near-term exposure to the Bank Insurance Fund;
- analyzed the impact existing assistance transactions could have on the Fund's cash position;
- reviewed the Fund's sources of revenue to determine its ability to handle the potential costs of additional failure and assistance transactions, as well as the potential for increased costs on existing transactions; and
- identified significant accounting and related reporting issues that we believe should be studied and resolved to ensure reliable financial reporting by banks.

The issues are derived in part from findings of our ongoing review of the adequacy of financial information that was available to the regulators for 39 banks that failed during 1988 and 1989.

Our work was performed at FDIC headquarters in Washington, D.C.; FDIC's New York regional office; and various FDIC receivership locations in Texas. We conducted our work between August 1989 and June 1990. Our audit was performed in accordance with generally accepted government auditing standards.

The Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Department of the Treasury provided official agency comments on a draft of this report.

Report Organization

Chapter 2 discusses the commercial banking industry's financial performance and major areas of concern related to the future condition of the industry. Chapter 3 analyzes the problem bank sector of the banking industry, including our concerns regarding the quality of call report data that banks reported. Chapter 4 assesses the adequacy of the Bank Insurance Fund's balance and liquidity position. Chapter 5 identifies accounting and reporting issues in the banking industry that require further study and resolution to ensure that banks report reliable financial information.

Appendix I contains our opinion on the 1989 and 1988 financial statements of the Bank Insurance Fund, our reports on FDIC's internal control structure and on its compliance with laws and regulations for the Bank Insurance Fund, and the Bank Insurance Fund's financial statements for the years ended December 31, 1989 and 1988. In accordance with auditing standards, our opinion includes an explanatory paragraph expressing our concern about the significant exposure of problem banks as discussed in chapter 3. Appendix II contains our March 7, 1990, letter to the Secretary of the Treasury, outlining our suggestions for consideration in Treasury's study of the federal deposit insurance system. Comments from FDIC, FRB, OCC, and Treasury are included in appendixes III, IV, V, and VI, respectively.

Increased Risks in Commercial Banking Industry Not Matched by Increases in Equity Capital

The performance of the commercial banking industry worsened in 1989 compared to 1988. The growth in nonperforming assets outpaced the growth in the industry's equity capital,[1] and industry earnings declined sharply from their 1988 level. The composition of the banking industry's assets has changed from commercial and industrial loans to a greater reliance on real estate loans. The banking industry's opportunities for lending to commercial applicants have been reduced significantly by international competition, corporations issuing debt directly in the market, and other nonbank sources making financing available to these applicants. Banks have become more actively involved in real estate lending to replace the opportunities lost to lend to these commercial borrowers.

The risks associated with the industry's loan portfolio and declines in certain regional economies have led to significant growth in the industry's nonperforming assets, particularly real estate loans. In addition, large commercial banks are continuing to experience losses on their portfolios of less developed countries (LDC) debt. The industry's exposure to highly leveraged transactions (HLTS) is also of concern. Regulators have not tracked total industry exposure on HLTS over time and thus comparable data from years prior to 1989 are not available. However, the FRB measured the HLT exposure of the 50 largest bank holding companies, for their bank and nonbank subsidiaries, as $126 billion as of year end 1989. Comparative data are not available for 1988. The impact of loans categorized as HLTS on the cost of future bank failures is unknown.

Commercial Banks' Performance in 1989

The commercial banking industry is continuing to show significant asset growth in real estate loans. The industry's equity capital, its cushion to absorb loan losses, is growing at a rate comparable to the overall growth in assets. However, the growth in real estate loans and industry nonperforming loans has greatly exceeded the growth in the industry's equity capital. Also, industry earnings declined sharply in 1989, as a significant number of large banks reported 1989 year-end losses.

According to FDIC, the commercial banking industry reported total assets of $3,299 billion at December 31, 1989. This is an increase of $168 billion (5.4 percent) over the $3,131 billion of total assets reported at year-end 1988. Real estate loans accounted for more than half of this growth, increasing $87 billion (12.8 percent) in 1989. Industry loss reserves

[1]Equity capital is defined as common equity and retained earnings.

totaled $53 billion at December 31, 1989, an increase of $6 billion (13.9 percent) from the $47 billion reported in 1988. Higher reserves for LDC and real estate loans accounted for this increase.

At year-end 1989, the industry reported $206 billion in equity capital. This is an increase of $9 billion (4.6 percent) from the $197 billion reported at year-end 1988. The industry's equity capital to assets ratio declined to 6.2 percent at December 31, 1989, from 6.3 percent for year-end 1988. This decline indicates that the rate of industry asset growth was slightly higher than that of its equity capital. Table 2.1 shows the growth of equity from 1985 through 1989.

Table 2.1: Banking Industry Equity Capital for 1985 Through 1989

Dollars in billions

Year-end	Total equity capital	Percentage of total assets	Percentage of total loans and leases
1985	$169	6.2	10.3
1986	182	6.2	10.3
1987	181	6.0	10.1
1988	197	6.3	10.2
1989	206	6.2	10.0

The Northeast and Southwest regions pose the greatest financial risk to the Bank Insurance Fund because their loan portfolios contain a higher level of problem real estate loans. At year-end, both regions reported equity capital to asset ratios of 5.6 percent, compared to ratios at year-end 1988 of 5.9 and 5.7 percent, respectively. The year-end 1989 ratios for these two regions were 10 percent below the industry's average of 6.2 percent. These negative trends are of concern because the high growth in real estate loans is accompanied by increasing default rates for these loans, while equity capital, the industry's cushion to absorb loan losses, is growing more slowly.

In 1989, the commercial banking industry reported earnings of $16.3 billion, a decline of $8.5 billion (34 percent) from the $24.8 billion reported in 1988. Commercial banking industry earnings for 1989 were about the same as in 1988 in each geographic region except for (1) the Northeast region, which reported an $11.7 billion decrease, and (2) the Southwest region, which reported a $1.6 billion increase. The decline in earnings reported by banks with more than $10 billion in assets largely accounts for the decrease in the Northeast. In 1989, this group of banks was comprised of 44 banks with collective assets of $1,252 billion as compared to 40 banks with assets of $1,162 billion in 1988. These banks reported

1989 earnings of only $1.3 billion, a decrease of 88 percent from 1988 earnings of $11.1 billion. For 1989, 25 percent of these large banks reported net losses, while only 5 percent reported net losses in 1988.

Overall, 1,474 banks (11.6 percent of the industry) reported net losses in 1989, compared to 1,863 banks (14.2 percent of the industry) reporting net losses in 1988. Thus, while fewer banks overall are reporting losses, a greater number of the large banks experienced losses. This is a concern because experience has shown that the failure of large banks cause significant impairment to the Fund balance. For example, the total cost to the Bank Insurance Fund of providing assistance to Continental Illinois National Bank and Trust Company of Chicago was over $1.1 billion. Additionally, the cost to the Fund arising from the failure of First RepublicBank Corporation, Dallas, is currently estimated to be $2.9 billion. Most recently, the closing of 20 MCorp subsidiary banks is expected to cost the Fund $2.7 billion. In contrast, the Fund has incurred estimated costs of $2.0 billion in 1989 on failure and assistance transactions for 161 banks with assets of less than $1 billion. The assets of these smaller institutions totaled $7.5 billion. Thus, the Fund appears better able to handle the costs associated with smaller bank failures.

Changes in Commercial Bank Loan Portfolios

The banking industry's business strategy has changed significantly over the past 5 years. Additional business sources were needed to compensate for revenue losses when traditional business sources, such as certain commercial and industrial borrowers, began obtaining financing outside of the commercial banking industry. As a result, the composition of the commercial banking industry's loan and lease portfolios has changed.[2]

Since 1985 the commercial banking industry has reported an increase of $408 billion (24.8 percent) in total loan and lease portfolios. Total industry loan and lease portfolios were $1,649 billion at December 31, 1985, and increased to $2,057 billion by December 31, 1989. Of the reported year-end 1989 loans and leases, $1,781 billion (86.6 percent) were real estate loans, commercial and industrial loans, and loans to individuals. In comparison, $1,325 billion (80.4 percent) of the reported year-end 1985 loans and leases were these types of loans. Thus, from 1985 to 1989, the overall loan concentrations remained in these three

[2] Commercial banks' loan and lease portfolios consist of (1) real estate loans, (2) commercial and industrial loans, (3) loans to individuals, (4) agriculture/farms loans, and (5) other loans and leases. Banks report loans and leases as a single line item to the regulators. Although the leases included in a bank's loans and lease portfolio are legally leases, they have virtually all the characteristics of loans.

loan categories. However, as illustrated in table 2.2, the mix within these loan categories changed significantly.

Table 2.2: Composition of Commercial Banking Loan and Lease Portfolios From 1985 Through 1989

Dollars in billions

	December 31,				
Loans and leases	**1985**	**1986**	**1987**	**1988**	**1989**
Real Estate	$438	$515	$600	$675	$762
Percent	26.6	29.1	33.5	34.9	37.0
Commercial/Industrial	578	601	590	600	618
Percent	35.0	33.9	32.9	31.1	30.1
Loans to individuals	309	336	351	378	401
Percent	18.7	18.9	19.6	19.6	19.5
Agriculture/Farms	36	31	29	30	31
Percent	2.2	1.8	1.6	1.6	1.5
Less developed countries	87	83	79	67	54
Percent	5.3	4.7	4.4	3.4	2.6
Other	201	207	142	181	192
Percent	12.2	11.6	8.0	9.4	9.3
Total Loans and Leases	**$1,649**	**$1,773**	**$1,792**	**$1,932**	**$2,057**

The changes in the industry's portfolio mix show that commercial banks are increasingly reliant on real estate lending. This is currently a serious concern because of the depressed real estate markets in various geographical sectors of this country. The changes in bank loan portfolios, together with these economic downturns, may increase the number of bank failures, which in turn would significantly affect the Bank Insurance Fund.

The remaining categories of the industry's loan portfolio consist of agriculture/farm loans, LDC loans, and other loans and leases. In total, these categories comprised $324 billion (19.6 percent) of the $1,649 billion total loans and leases reported at December 31, 1985, and $277 billion (13.4 percent) of the $2,057 billion total loans and leases reported at December 31, 1989. LDC loans totaled $54 billion (2.6 percent) of the year-end 1989 total loans and leases. Based on the amount of total loans outstanding, LDC loans would not appear to present a significant exposure to the banking industry. However, because of the high concentration of LDC loans in large banks and their high loss rate, they are a concern to the banking industry and the Bank Insurance Fund.

The industry data reported above are somewhat deficient because data on the level of HLTs included in the various loan and lease categories are not available for the full 5-year period from 1985 through 1989. Higher

levels of HLTs may increase the risk associated with the change in the banking industry's portfolio.

Problems in Real Estate

Significant concentrations in nonperforming real estate loans were largely responsible for the high level of bank failures in the late 1980s. Poor lending practices combined with a significant economic downturn in the Southwest region led to most of the bank failures there. Because of the cyclical nature of real estate markets and the recent history of significant bank failures due to high concentrations of nonperforming real estate loans, we are concerned about the significant growth in the banking industry's level of real estate loans, particularly in the Northeast. The significant growth in this region's nonperforming real estate loans is similar to that which occurred in the Southwest region in the 1980s.

Bank real estate loans are comprised of (1) construction and development loans, (2) loans secured by 1-4 family and multifamily residential properties, (3) loans secured by farmlands, and (4) loans secured by nonresidential, nonfarm properties. The different types of real estate loans have varying degrees of risk associated with them. Construction and development loans are considered the riskiest because of their more speculative nature. Banks with assets greater than $1 billion hold more construction and development loans than the smaller banks. This is true, in part, because construction and development loans are typically large loans and smaller banks are usually unable to fund significant levels of these loans due to their liquidity and capital restraints. Further, we have found that insolvent banks and banks that fail irrespective of size have a higher proportion of construction and development loans than banks with higher capital levels.

Commercial banks reported a total of $762 billion in outstanding real estate loans as of December 31, 1989. Of these loans, $22.2 billion (2.9 percent) were reported as either 90 days or more past due or in nonaccrual status. In comparison, at December 31, 1988, commercial banks reported noncurrent real estate loans of $16.0 billion (2.4 percent) of the $675 billion in real estate loans outstanding.

The Southwest region continued to report the highest ratio of noncurrent real estate loans to total real estate loans outstanding, but the ratio improved. In 1989, the southwest reported that $4.0 billion (7.7 percent) of the region's $51.3 billion total real estate loans outstanding were either 90 days or more past due or in nonaccrual status. In comparison,

this region reported in 1988 that $4.5 billion (8.2 percent) of its $54.2 billion total real estate loans outstanding were past due 90 days or more or in nonaccrual status.

The Northeast, Southeast, and Central regions reported increases in the ratio of noncurrent real estate loans to total real estate loans outstanding in 1989. The sharpest increase in the ratio of noncurrent real estate loans to total real estate loans outstanding between 1988 and 1989 occurred in the Northeast. That region reported noncurrent real estate loans of $9.9 billion (3.8 percent) of its $259.3 billion in outstanding real estate loans at December 31, 1989. In comparison, at December 31, 1988, this region reported noncurrent real estate loans of $4.4 billion (1.9 percent) of its $231.7 billion in outstanding real estate loans. Table 2.3 shows the changes in noncurrent real estate for each region for 1988 and 1989.

Table 2.3: Commercial Banks' Noncurrent Real Estate Loans for 1988 and 1989

Dollars in billions

Real estate loans	Northeast	Southeast	Central	Midwest	Southwest	West
1989	$259.3	$141.5	$117.1	$42.5	$51.3	$147.6
Percent noncurrent	3.8	1.8	1.4	1.6	7.7	2.3
1988	$231.7	$122.7	$103.7	$39.1	$54.2	$121.8
Percent noncurrent	1.9	1.4	1.2	1.6	8.2	3.0

The six New England states[3] in the Northeast region showed the most significant increase in noncurrent real estate loans in 1989. Noncurrent real estate loans represented 5.8 percent of the outstanding real estate loans for these six states, a sharp increase from the 1.7 percent reported in 1988.

LDC Problems Persist

Increased loss provisions for LDC debt continue to adversely affect the reported earnings of the commercial banking industry. FDIC reported that 5 of the 10 largest banks in the United States reported 1989 year-end losses due to increased loss provisions for LDC loans. Total U.S. commercial bank exposure to countries that FDIC, FRB, and OCC categorized as "troubled" foreign debtors was $54 billion as of December 31, 1989. This is a decrease of $14 billion (21 percent) from the $68 billion total reported at December 31, 1988, and a sharp decrease of $37 billion (41

[3]The six New England states are Massachusetts, Connecticut, Maine, Vermont, Rhode Island, and New Hampshire.

percent) from the $91 billion total reported at December 31, 1982, the beginning of the international debt crisis. This decrease can be attributed to several factors, including (1) banks becoming less involved in international lending or abandoning such lending entirely, (2) countries seeking lending from other external financing sources, and (3) banks charging off and increasing reserves on troubled foreign loans.

While total U.S. commercial bank exposure on troubled foreign loans has declined, the remaining exposure is heavily concentrated in a small number of the nation's largest banks. Of the $54 billion exposure reported at December 31, 1989, $43 billion (80 percent) is held by nine money center banks.[4] At December 31, 1982, these nine money center banks held $58 billion (64 percent) of the total U.S. LDC exposure. Thus, even though the nine money center banks' exposure to troubled foreign debtors decreased between 1982 and 1989, their exposure to these loans remained relatively high. Much of the overall decline in industry exposure to LDC loans was attributable to increased loss reserves. For example, in 1989, large commercial banks set aside a total of $10 billion for future losses on their foreign operations, which include LDC debt. Despite increased reserves, total LDC exposure could still have a significant impact on their operations.

FDIC, FRB, and OCC reported that as of December 31, 1989, the nine money center banks reported reserves on their LDC exposure ranging from 40 percent to 95 percent, with an average reserve level of 49 percent. At December 31, 1988, the nine money center banks had average LDC reserve levels of 36 percent.

The federal banking regulators believe that the U.S. commercial banking system could better absorb the impact of the debt servicing problems associated with developing country debt today than in 1982, when the international debt crisis began. In a joint report, the regulators state that (1) banks with LDC exposure have generally increased their capital levels, (2) the earnings of large multinational banks are more diversified than in the past, and (3) the banking industry's policies and procedures on international lending have been strengthened. Despite these improvements, federal banking regulators also report that both bank management and the regulatory bodies will need to continually monitor the

[4]The nine money center banks are Bank of America, Banker's Trust, Citibank, Chase Manhattan Bank, Chemical Bank, Continental Bank, First National Bank of Chicago, Manufacturer's Hanover, and Morgan Guaranty.

existing risk presented by the substantial exposure levels of the largest U.S. banks to LDC debt.

Last year, the administration unveiled a debt plan for highly indebted countries which called for banks to both forgive some existing LDC debt and to extend new loans to developing countries. The plan received some acceptance by commercial banks; however, only the Mexico restructuring has been completed to date. Furthermore, very little new money was offered, with most banks granting interest rate or principal concessions. Failure of the plan to provide for successful restructurings for other debtor countries could cause further losses to the banks as the developing countries continue to experience difficulty repaying their debt.

Uncertain Risks Associated With Highly Leveraged Transactions

In addition to the adverse impact of nonperforming real estate and LDC loans, there is a growing concern over the future performance of HLTS. Since HLTS are a type of transaction rather than a lending category, any loan type (for example, real estate or commercial and industrial) could result in an HLT. In October 1989, FDIC, FRB, and OCC agreed on a common definition of HLTS to be utilized by all examiner personnel. According to the three federal regulators, a bank or bank holding company is considered to be involved in a highly leveraged transaction when it extends credit to or invests in a business where the financing transaction involves the buyout, acquisition, or recapitalization of an existing business and significantly increases the company's ratio of total liabilities to total assets.

These loans experienced significant growth in the industry during the late 1980s with the advent of the junk bond market in the investment banking industry. Many of the junk bond offerings by investment bankers were part of an overall financing package that also included senior debt[5] loaned by commercial banks that qualified as HLTS. FDIC

[5] Senior debt typically collateralized with the first—most superior—lien against the assets of the borrower.

reported that if overall economic conditions deteriorate, loans to highly leveraged commercial borrowers could add to credit losses. Discussions with bank regulators revealed that although these loans have resulted in significant losses in the investment banking industry, HLTs in the commercial banking sector are generally better collateralized than they are in the investment banking industry.

The recent financial problems in the investment banking industry have raised concerns about bridge loans and junk bond exposures in the commercial banking industry. Bridge loans are defined as temporary financing by a lender until permanent financing can be obtained. Bridge loans similar to those which facilitate a securities offering in the investment banking industry are usually not made in commercial banks. Also, commercial banks have minimal exposure to losses on junk bonds. Unlike prior regulations for savings and loans, in most states commercial banks can only invest in investment grade[6] bonds. By definition, junk bonds are not investment grade and, therefore, commercial banks generally do not invest in them. Further, regulators consider any junk bonds in commercial banks as classified assets[7] for which loss reserves are usually required to be recorded.

Generally, when commercial banks issue bridge loans associated with securities offerings they are extremely short term. According to the regulators, commercial banks do not have significant amounts of outstanding bridge loans or loan commitments in connection with uncompleted securities offerings. Commercial banks usually provide bridge loan financing for construction projects, as opposed to uncompleted securities offerings, to facilitate financing for the time between the maturity of the construction loan and the point at which the borrower obtains permanent financing. Bridge loans in commercial banks have the same characteristics as permanently financed loans, except for the shorter term to maturity. These loans usually have the normal loan to value ratio of the respective loan type and are fully collateralized by the underlying asset. Investment banking industry bridge loans pose the risk that the investment banker who provides bridge financing will be unable to raise sufficient funds from the sale of the related securities to repay the bridge loan. Further, this financing is generally provided

[6]Investment grade means that the debt or equity security is rated in one of the four highest rating categories by at least one nationally recognized statistical rating organization.

[7]In general, classification of an asset indicates that the asset has been impaired and that loss reserves are necessary to accurately reflect the recoverable value of the asset. However, assets can sometimes be classified when insufficient loan file documentation makes it impossible to evaluate the asset quality based on the available data.

without recourse to the company issuing the securities. Thus, the exposure to bridge financing is significantly less in commercial banks than the investment banking industry.

In 7 of the 10 largest banks, HLT exposure was in excess of the banks' equity capital—ranging from 112 percent to 206 percent. Most outstanding HLT bank loans are in the form of secured, senior debt. Thus, the principal risk is that in the event of bankruptcy of the leveraged company, its assets (the underlying security for the loan) would be reduced in value to such an extent that senior debt holders would suffer loss. The significant market discounts on junk bonds associated with some of the senior debt held by banks suggest that there is little or no earnings margin to cover interest payments on the junk bonds. The recent bankruptcy filings of companies involved in junk bond offerings illustrate the risk that the senior debt portion of the original financing package may not be repaid. Historically, and especially as demonstrated in bank failures, the value of underlying assets for loans that default tends to be significantly reduced compared to the loan origination value. This phenomenon has resulted in significant losses to banks and the Bank Insurance Fund.

While some industry observers suggest that leveraged buyout transactions (which by their very nature are HLTs) strengthen the subject companies, others hold contrary views. Some industry observers have stated that in many instances management practices of companies that had junk bond offerings may have diminished both asset and business values. As a result of the required emphasis on debt service, management may be required to adopt cost cutting measures that reduce investments in the company's future economic viability. These policies and practices typically result in companies that are weaker than their financial statements purport them to be. If this view is correct, in bankruptcy there will be less protection for bank held senior debt. Also, unlike other loans, HLTs do not necessarily improve with seasoning. The borrowers are usually so highly leveraged that they are unable to reduce the principal amount outstanding substantially over the life of the loan and thus remain vulnerable to downturns in the industry and the economy generally for the life of the loan. These loans usually have large balloon payments with minimal principal reductions other than those tied to significant asset sales.

Conclusions

Overall, the condition of the banking industry deteriorated in 1989 as compared to 1988. The industry's increased level of nonperforming assets adversely affected the industry's earnings. Losses due to increased provisions for LDC loans severely hampered the earnings of large commercial banks in 1989 as compared with 1988. Moreover, the increasing levels of nonperforming real estate loans, particularly in the Northeast, and the uncertain impact of bank losses on loans involving HLTs raise serious concerns as the banking industry enters the 1990s.

The disturbing trend in nonperforming real estate loans in the Northeast region is reminiscent of problems experienced by many Southwest banks in the 1980s. Real estate loan performance problems in these banks ultimately led to the failure of many Southwest banks in the late 1980s and continue to hamper the recovery of others. Because these failures have had a significant impact on the Bank Insurance Fund in the past 3 years, we are concerned that the high levels of nonperforming real estate loans, coupled with the potential for bank losses on loans involving HLTs, could lead to bank failures in the 1990s and significant costs to the Bank Insurance Fund.

Agency Comments and Our Evaluation

OCC commented (see appendix V) that our conclusions about the condition of the banking industry are inaccurate because they are drawn, for the most part, from analyses of industry data covering only 2 years. OCC believes that this is an insufficient time span from which to draw substantive conclusions about industry trends and their impact on the Bank Insurance Fund.

Our focus on more recent events is appropriate in light of the banking industry's current environment. The purpose of our analysis of the banking industry is to highlight those indicators that present exposure to the industry and, ultimately, the Fund in both the short and the long term. Current data comparisons are more useful in identifying current industry problems that could affect the Fund than evaluating historical data that are 5 to 10 years old. In the last 2 years, a period of national economic growth, a record number of bank failures caused the Fund to suffer a net loss in both years and has resulted in the Fund balance declining dramatically from $18.3 billion to $13.2 billion (27.9 percent). Additionally, FDIC recently estimated that the Fund will lose $2 billion in 1990 and decline for the third consecutive year.

Problem Banks Expose the Bank Insurance Fund to Significant Risks

Continued problems in real estate loans have contributed to many bank failures over the past 2 years. Moreover, a significant number of banks are in such severe financial condition that without some form of capital infusion, they are also likely to fail in the near future.[1] In addition, other banks are vulnerable to future failure if their negative performance trends continue and their regional economies continue to deteriorate. If these banks were to fail, we estimate that the cost would materially impact the Bank Insurance Fund balance. Many uncertainties affect the continued existence of these banks and we cannot accurately predict their future viability. However, in their present financial condition they pose a significant exposure to the Fund.

Our estimates of the cost to the Fund in the event of these bank failures may be low because the estimates are based on FDIC's historical loss rates, which do not provide for changes in asset composition that have occurred over the past few years. Our estimated costs may also be low because the underlying financial data on which they are based come from bank call reports. Our limited review of examination reports for certain problem banks suggests that call report data may only be as reliable as the most recent bank examination. Examination policies regarding problem banks vary among the regulators. FDIC and FRB require annual on-site, full scope examinations of problem banks. OCC monitors call reports and other related data in deciding the frequency and scope of examinations of problem banks.

Problem Banks Declining but Still at High Level

The number of problem banks has declined from a year-end all time high of 1,575 at December 31, 1987, to 1,109 at December 31, 1989. While this has been a significant 30 percent drop, the number of problem banks continues at an alarming level, and they pose a significant, ongoing financial threat to the health of the Bank Insurance Fund.

FDIC produces a quarterly problem bank list which lists institutions with a uniform composite rating of 4 or 5. This composite rating is assigned to a bank after a regulatory examination. It is based on the examiner's combined ratings for each of the following factors: adequacy of capital, quality of assets, performance of bank management, level and composition of earnings, and level of liquidity—referred to as the CAMEL rating. The rating is based upon a scale of 1 through 5. A 1 represents the

[1] 31 U.S.C. 714(c) precludes us from disclosing the identity of a specific open bank.

highest rating and, consequently, the lowest level of supervisory concern; a 5 represents the most critically deficient level of performance and, therefore, the highest degree of supervisory concern.

A 4-rated bank exhibits serious financial weaknesses and potential unsafe and unsound conditions that if not effectively addressed, could impair the bank's future viability, pose a threat to the interests of the bank's depositors, and a potential for disbursement of funds by the Bank Insurance Fund. While the regulators do not consider a 4-rated bank's failure to be imminent, such a bank exhibits a higher than normal potential for failure. The regulators consider a 5-rated bank to have an extremely high immediate or near-term probability of failure. These institutions exhibit weaknesses or unsafe and unsound conditions that require urgent aid from stockholders or other public or private sources of financial assistance. In the absence of urgent and decisive corrective measures, 5-rated banks will likely fail and require some form of assistance from the Bank Insurance Fund.

As of December 31, 1989, 1,092 commercial banks (8.6 percent of the industry's 12,706 commercial banks) with assets totaling $187.8 billion (5.7 percent of the industry's $3.3 trillion in assets) were on the problem bank list. In certain instances, the Bank Insurance Fund is the insurer of savings banks. However, industry data reported by the regulators usually cover the commercial banking industry, which excludes savings banks insured by the Fund. There were 17 savings banks with assets totaling $47.6 billion included on the problem bank list as of December 31, 1989. Table 3.1 shows the distribution of problem banks on the list based on composite ratings for 3 years.

Table 3.1: Problem Banks for Calendar Years 1987 Through 1989

Dollars in billions

	As of December 31,					
	1989		1988		1987	
	Number	Assets	Number	Assets	Number	Assets
4-rated banks	895	$211.8	1,124	$317.4	1,339	$336.5
5-rated banks	214	23.6	282	34.8	236	21.9
Total Problem Banks	**1,109**	**$235.4**	**1,406**	**$352.2**	**1,575**	**$358.4**

The number of banks on the problem bank list has been significant over the past several years. At December 31, 1987, the problem bank list included 1,575 banks. Through December 31, 1989, 258 of these banks

actually failed and 21 were assisted. Of the remaining banks, 729 were deleted due to an improved financial condition or merger and 567 remained on the list at December 31, 1989. Thus, while a bank's presence on the problem bank list identifies it as an institution in severe financial condition, it does not conclusively indicate that the bank will fail. Conversely, as is discussed later, a bank's absence from the list is not assurance that the bank will not fail.

FDIC believes that as the number of problem banks continues to decline, the failure rate will also decline. While the number of banks on the problem bank list has declined since 1987, the number of problem institutions along with the level of exposure they represent to the Bank Insurance Fund is still alarmingly high and poses a significant risk to the Fund. The Southwest region's 610 problem banks continued to be the highest number by far, more than three times the 178 problem banks reported by the West, the second highest region. At year-end 1989, the Northeast region reported 20 problem banks as compared to 19 in 1988.

In 1989, 206 banks with assets of $29.2 billion failed, compared to 200 banks with assets of $36.5 billion that failed in 1988. Through the first quarter of 1990, the bank failure rate decreased from the 1989 rate. FDIC reported that 37 banks with assets totaling $2.0 billion had failed during the first quarter of 1990. By comparison, FDIC reported 63 bank failures (including 20 MCorp subsidiary banks), with assets totaling $18.6 billion, during the first quarter of 1989.

Certain Problem Banks Threaten the Fund's Soundness

We conducted a financial analysis of all the banks with assets in excess of $100 million on FDIC's problem bank list at December 31, 1989, using quarterly and annual financial information the banks reported in their quarterly call report and Securities and Exchange Commission submissions from December 1986 through December 1989. We analyzed banks with over $100 million in assets because we believe banks with lower asset levels can be resolved by the Bank Insurance Fund and not result in the fund balance declining from year to year unless a recession were to occur. As stated in chapter 2, the collective estimated cost of 161 smaller bank failures in 1989 was comparable to one large bank failure.

Our analysis included 171 of the problem banks with assets totaling $202 billion (85.8 percent of the total assets of banks on the December 31, 1989, problem bank list). Additionally, we reviewed financial information for the 100 largest U.S. commercial banks, 5 of which were included in the 171 from the problem bank list. Also, our review

included another 34 banks that we identified as problem banks based on other regulatory and public source information. In total, we reviewed the financial condition of 300 banks.

We reviewed each of the 300 banks' asset composition and performance, equity capital level, earnings performance, and liquidity level. We also compared these key financial indicators for each bank with the averages of all 300 banks and with the averages of the industry as a whole. We used this information to determine which banks were in such severe financial condition at December 31, 1989, that they were likely to fail in the near future without some form of recapitalization. We also used this information to determine which banks were experiencing significant downward trends in their performance as of December 31, 1989, such that a continued deterioration in their region's economies would result in the likelihood of their failure. We reviewed the condition of these banks through March 31, 1990, to see if conditions had changed significantly since December 31, 1989.

Our financial analysis of the 300 banks showed 35 institutions in such severe financial condition at December 31, 1989, that without some form of recapitalization, they are likely to fail or require regulatory assistance in the near future. These 35 banks are located principally in the Northeast and Southwest and have assets totaling $45.1 billion. While it is not possible to predict with certainty that all of these banks will fail, we believe it is highly likely that many, if not all, of them will fail. If all of these banks fail, we estimated a cost to the Fund ranging from $4.4 billion to $6.3 billion.

Of these banks, 26 with assets totaling $17.5 billion were listed on the December 31, 1989, problem bank list. These institutions represent 2.3 percent of the banks and 7.4 percent of the total assets of the banks on the problem bank list. The remaining 9 banks with assets totaling $27.6 billion were rated 2 to 5 by the regulators.

FDIC stated that the 7 banks rated 4 or 5 were not on the problem bank list because their last examination was too close to year-end to reflect their revised CAMEL rating in the year-end problem bank list. In addition, they stated that 3 of these 7 banks were operating under a recapitalization plan that the regulators believed was credible. The remaining 2 banks were rated 2 or 3. They were not examined in the last year and thus the CAMEL rating did not change.

The primary determinants we used in identifying the 35 banks likely to fail were the likelihood of their becoming equity insolvent based on the bank's earnings trend and the level of nonperforming assets. Generally, these banks were already insolvent based on equity capital or had minimal levels of equity capital, had excessive levels of problem assets (composed of nonperforming loans, delinquent loans, and other real estate owned/acquired through foreclosure), and had earnings trends that if continued would lead to their insolvency based on equity capital in the near future. Table 3.2 shows that financial indicators of the 35 banks' financial condition are dramatically worse than the industry averages and the averages of the 300 banks we reviewed.

Table 3.2: Key Banking Industry Financial Indicators as of December 31, 1989

Dollars in billions

		Equity capital		Problem assets		Net income (loss)	
	Total assets	**Amount**	**Percent[a]**	**Amount**	**Percent[a]**	**Amount**	**Percent[a]**
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

Our analyses of the 300 banks showed that a significant number of other banks were experiencing significant negative trends in certain key financial indicators at December 31, 1989. These trends include the rate of depletion of equity capital, negative earnings, the growth in problem assets, and low levels of bank liquidity. In addition, these banks are primarily located in the Northeast and Southwest—areas with depressed real estate markets. Given the banks' financial condition, they are likely to fail in the future if these economies continue to deteriorate.

Costs related to the 35 banks we believe are likely to fail in the near future without recapitalization and those banks we believe are likely to fail later if deteriorating economic conditions persist could significantly impair the Fund, which reported a balance of $13.2 billion as of December 31, 1989. In addition, there are several other large banks that could fail if the economy experiences a recession. Their financial condition was better than the banks we identified; however, their failure could result in depletion of the Fund.

Our estimates of $4.4 billion to $6.3 billion of costs to the Fund are based on loss rates FDIC has historically experienced on bank failures.

However, there are certain inherent limitations in using historical experience to predict future events. As a result of changes in the composition of assets in banks, such as those noted in chapter 2, FDIC's past loss rates might be inaccurate indicators of future loss rates. For example, very few of the bank failures have had concentrations of HLTs in their loan portfolios through 1989. HLTs are relatively new and do not yet have reliable historical loss rates which could be used to reasonably predict their potential impact on bank losses.

Quality of Bank Call Report Data Not Always Reliable

Another factor affecting the Fund's estimated exposure for future bank failures is the quality of some quarterly call report data the banks prepared for the regulators. The call report consists of a balance sheet, income statement, and various other financial information required by the governing bank regulations. These reports are not audited. Other than on-site examinations by the regulators, call reports and other information the banks prepare at the regulators request are the principal means by which regulators assess the financial condition of a bank. The regulators use this data for off-site monitoring of banks' financial condition and performance between on-site examinations in order to identify adverse trends in an individual bank or the industry, in the aggregate or regionally. The data 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.

We used the quarterly call reports to analyze the banks' financial condition. Although we did not review the overall quality of call reports, we have found examples in certain problem banks that suggest call report accuracy often depends on whether there has been a recent examination by the bank regulators.

We reviewed examination reports for 10 institutions in the Northeast which were rated 4 or 5. We found that the regulators reported that these institutions had understated the level of nonperforming loans in their call report submissions; thus, they had established inadequate levels of loss reserves and had overstated interest income and net income. In addition, our ongoing study on accounting and reporting issues in banking, where we reviewed examination reports prepared prior to the failure of 39 banks, found that the regulators cited inadequate reserves being reported in the call reports in 31 of the 39 banks. The level of these understatements and their impact on the institutions' financial condition varied. We found that some of the asset classifications the examiners recommended would change the reported financial

condition of the institutions. Thus, the information reported in call reports does not always reflect the true financial condition of an institution. Discussions with regulators revealed that they agree that the quality of call report information submitted by some banks, particularly problem institutions, is questionable.

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. In general, banks remain on the problem bank list for several quarters or years before they either fail, are merged or assisted, or their financial condition improves resulting in a composite CAMEL rating less than 4. However, of the 406 banks that failed in 1988 and 1989, 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 recent failure of the National Bank of Washington is another example of a bank that failed without appearing on the problem bank list. 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. While we did not review the examination and call reports for these institutions, we are concerned that the call reports apparently did not forewarn regulators about the conditions which caused these banks to fail.

Monitoring of Banks Varies Among the Regulators

Federal regulators attempt to ensure that all banks are examined on a routine basis. However, due to staffing limitations, greater reliance is being placed on off-site monitoring. The accuracy of call report data, particularly for troubled or near troubled (3-rated) banks where the effect of misstatement is more critical, is a concern for effective off-site monitoring. Another concern is the disparity in the frequency and scope of on-site examinations from regulator to regulator. Both FDIC and FRB rely more on on-site examinations, while OCC utilizes off-site monitoring with limited scope on-site examinations.

The goal of the Federal Reserve Board, which supervises and regulates state-chartered banks that are members of the Federal Reserve System and bank holding companies, is to examine state-chartered banks and inspect large and problem bank holding companies annually. OCC, which supervises and regulates national banks, places the responsibility for the scope and timing of examinations on field managers assigned to monitor specific banks. FDIC supervises and regulates insured state-

chartered banks that are not members of the Federal Reserve System. FDIC's goal is to conduct on-site examinations at least every 24 months for institutions considered healthy, and on-site examinations at least every 12 months for problem and near-problem institutions.

FDIC Monitoring

FDIC's Division of Supervision is responsible for conducting and planning bank examinations. It conducts full scope on-site examinations of problem banks for which FDIC has supervisory responsibility. These examinations, sometimes referred to as safety and soundness examinations, are often more limited in scope for banks with CAMEL ratings of less than 4. A full scope examination consists of a detailed review of the entire bank to determine its CAMEL rating. In conjunction with safety and soundness examinations, the Division of Supervision also conducts more specific examinations for (1) performance of fiduciary responsibilities, (2) adequacy of internal controls in electronic data processing, and (3) compliance with consumer protection and civil rights laws and regulations.

FDIC's Division of Supervision does not conduct on-site examinations based on fixed examination cycles. It believes that the use of such cycles results in some banks receiving too much supervision and others not enough. Instead, it places more emphasis on monitoring problems/risks within the banking industry and individual banks through off-site monitoring procedures. However, to ensure that banks are routinely examined, the Division of Supervision has an examination frequency policy that requires an on-site examination be conducted at least every 24 months for banks with a 1 or 2 CAMEL rating and every 12 months for banks with a 3, 4, or 5 CAMEL rating. The examination frequency policy is also flexible and counts many state examinations of banks rated 1, 2, and 3 the same as an FDIC examination. However, the frequency of examinations is not necessarily accelerated for banks on the problem bank list. Rather, the Division of Supervision assesses the risk associated with these banks on a case-by-case basis and decides on an appropriate response (for example, an examination within 6 months, a visit to the bank quarterly, or periodic phone calls to the bank).

In addition to the on-site examination process, FDIC has an off-site monitoring program known as the CAEL off-site review program. CAEL stands for capital, asset quality, earnings performance, and liquidity. Under the CAEL program, financial information submitted by the banks (call report data) is reviewed and compared to the examination data. The CAEL program is maintained in a computer database and updated as quarterly

call reports are submitted to FDIC. The program gives examiners on-line access to the latest supervisory data and financial information and helps them detect banks with deteriorating financial conditions. Thus, banks are examined on-site once every 12 or 24 months, and supervisory off-site review is performed on a quarterly basis.

FRB Monitoring

The FRB uses a computerized surveillance system to monitor the financial condition of all member banks. The surveillance system is divided into two parts, one for member banks and one for bank holding companies. The main objective of the system is to identify financial institutions that are not yet problems but exhibit deteriorating financial profiles. FRB reviews and updates the system quarterly to facilitate early warning and to detect emerging problems.

Data used in the surveillance system are obtained from the financial reports of the banks and bank holding companies. Using this data, the system computes six ratios for each institution and ranks it based on a comparison with its peers. The lowest ranked institutions (the bottom 5 percent through 10 percent) are segregated by district on an exception list. The responsible field analyst will perform an extensive evaluation of all the institutions identified on the exception list and, based on this evaluation, conclude as to whether they are potential emerging problems . The system also provides a detailed performance report for each institution.

Although FRB administers the program, its reserve banks have computer access to the data and the performance reports. Reserve bank analysts review the exception list to determine the validity of the initial evaluations and annotate the list with their final evaluation or surveillance notation. Generally, banks with a 3 CAMEL rating are put on a "watch" list (the "watch" list indicates that a bank's condition warrants concern but is manageable). Banks with a 4 CAMEL rating require special supervision (increased frequency of examination) and banks rated 5 are considered problem banks targeted for special attention (on-site supervision and constant contact with the bank). Bank holding companies are rated using the BOPEC rating system. BOPEC stands for bank subsidiaries, other subsidiaries, parent company, earnings-consolidated, and capital adequacy-consolidated. This system uses the same 1 to 5 rating categories as the CAMEL rating system. In addition, reserve banks prepare written analyses for all institutions with deteriorating financial profiles. FRB staff report the reserve bank's conclusions to FRB senior officials; any revisions are reported back to the reserve banks. The reserve banks

then take supervisory action, such as on-site supervision or close monitoring of the bank's condition.

In addition to the surveillance system described above, the stock prices for bank holding companies with over a $1 billion in consolidated assets are also monitored. Bank holding companies with a decline of 10 percent or more in their stock price relative to the industry are added to the exception list.

In addition to the surveillance system, the reserve banks examine state member banks in conjunction with state banking authorities and inspect large and problem bank holding companies at least once a year. However, certain banks require additional review. For example, multinational state member banks and all other banks with assets greater than $10 billion are subject to a full scope examination annually, in addition to limited scope or target examinations. Limited scope examinations review all areas of activity covered by a full scope examination, but less intensively. Also, banks with a 4 or 5 CAMEL rating must be examined twice a year, including one full scope examination, until their condition improves.

Between examinations, the reserve banks review all annual Securities and Exchange Commission filings and regulatory reports to aid in the early detection of banks with deteriorating conditions.

OCC Monitoring

Like FRB and FDIC, OCC also uses a computerized supervisory monitoring system to monitor the financial condition of national community banks, national regional banks, and multinational banks. Generally, on-site examinations at OCC are more limited in scope than those done by FDIC and FRB, and greater reliance is placed on an off-site monitoring system to aid in (1) the early warning, identification, and monitoring of problem banks, (2) the determination of possible systematic problems within the financial community, and (3) the estimation of resources needed to monitor/supervise problem banks.

OCC's field offices are primarily responsible for identifying problem banks. Portfolio managers from the field are assigned specific banks to review and monitor. OCC believes that this system enables the portfolio managers to remain in constant contact with their banks and thus become very familiar with the banks' operations.

Portfolio managers use the supervisory monitoring system as a primary tool to carry out their responsibilities. The supervisory monitoring system contains such information as the bank's most recent call report and CAMEL rating, other relevant off-site/on-site financial data such as financial statements, any enforcement actions against the bank, audit reports, risk profile, and supervisory strategy.

The portfolio manager writes the supervisory strategy, which includes critical data: how often the bank should be examined, supervisory actions needed based on the bank's condition and any significant changes in the bank's business strategies, the bank's capital level, and the percentage of classified assets.

OCC requires a manager to update the supervisory strategy at least once a year. For banks with a 4 or 5 CAMEL rating, the strategy should be updated quarterly or after each on-site review. For banks rated 4 or 5, district managers have more input into the supervisory strategies. Some districts with banks rated 4 or 5 include 3-rated banks in this review process. OCC's Special Supervision Division and Multinational Division look at all 5-rated banks. They review the bank's condition and supervisory strategy for adequacy and reasonableness.

The regulators stated that because of the large number of problem banks and the limited number of bank examiners, each of the three bank regulatory agencies has developed its own system of off-site monitoring. While these are useful tools in day-to-day surveillance, they may not be as effective as routine, on-site examinations because they rely on the integrity of quarterly call reports and other bank financial data. Without frequent full scope, on-site examinations, particularly for problem institutions and large institutions, the financial information provided by the banks through call reports could present an overly optimistic picture of their financial condition. We believe that full scope, on-site examinations are the most certain means for regulators to determine the true financial condition of banks.

Regulator Judgment Decides When Banks Fail

While analysis of a bank's financial condition and performance may show that it has little potential for viability, this does not mean the bank will actually fail. Depending on the type of institution, OCC or a state chartering authority has the express power to close an institution. A bank fails when its chartering authority declares it to be insolvent and closes the institution. A recent OCC regulation, effective November 21, 1989, defines insolvency as the point at which the institution has

exhausted its equity capital. However, state chartering authorities will close an institution when it has become insolvent on the basis of regulatory capital.[2]

FDIC, OCC, FRB, and state banking authorities for state-chartered banks determine together the options available for a distressed institution. The regulators consider their assessment of the institution's current financial condition and its primary causes. If they conclude that (1) the institution would be viable given some infusion of financial assistance and (2) such assistance would be more cost beneficial than closing the institution, they will attempt to provide assistance. For example, if an institution cannot meet its obligations as they come due and if the regulators conclude that the bank is otherwise a viable institution, FRB may authorize the bank to borrow funds from a Federal Reserve Bank to meet its liquidity needs. Since such borrowings are payable on demand, FRB could call them whenever the institution is no longer considered viable. Additionally, these borrowings are collateralized by bank assets which are equal to or in excess of 100 percent of FRB borrowings.

Granting this assistance implies the belief that it will enable the institution to return to viability. In some cases, however, FDIC may provide temporary assistance to an institution no longer considered viable to minimize the disruption of banking services in the bank's community and to bring about an orderly closing of the institution.

The regulators also consider other factors in determining whether a distressed institution is viable. They may request and evaluate business plans the institution submits to determine whether the institution has a realistic strategy to work itself out of its difficulties. In addition, if the bank is a subsidiary of a bank holding company, the holding company's ability to provide capital and/or other assistance to the distressed institution is considered. FRB will bring pressure to bear on those holding companies that are able to provide such assistance. However, a recent federal court decision related to the MCorp bank holding company in Texas could adversely affect FRB's ability to apply pressure to holding

[2]Regulatory insolvency refers to the point at which an institution has exhausted its regulatory capital. The major distinction between equity capital and regulatory capital is that the reserves for loan and lease losses are included in the determination of regulatory capital.

companies. The court ruled that FRB does not have authority to order a holding company to transfer its funds to its troubled subsidiary banks.[3]

The size of the institution and the effects closing it would have on the local economy and other parts of the nation's banking system are also considered in determining whether to close an insolvent institution. Thus, although we can use empirical data to identify banks that may fail, we cannot say with certainty that the chartering authorities will or should close these institutions until the institution is insolvent based on regulatory capital.

Discussion of GAO's Opinion on the Fund's 1989 Financial Statements

Appendix I includes the Bank Insurance Fund's 1989 and 1988 financial statements and our opinion on those statements. The Fund's 1989 financial statements do not reflect the $4.4 billion to $6.3 billion estimated cost associated with the 35 institutions we believe are likely to fail in the near future without some form of recapitalization. Under generally accepted accounting principles, an entity must accrue an estimated loss if it is probable that a liability has been incurred and the amount of the loss can be reasonably estimated. If both of the conditions are not met, disclosure of the loss contingency should be made if there is a reasonable possibility that a loss has occurred.

We believe that losses can be reasonably estimated using FDIC's historical loss experience in assisting failed institutions. However, we were not able to ascertain that it was probable that FDIC had incurred a loss from the 35 banks as of December 31, 1989, the date of its financial statements.

We applied several criteria in determining whether, in effect, the 35 banks had failed and FDIC had probably incurred a loss. The criteria reflect the conditions the regulators use in deciding bank assistance actions. First, we believe it is probable that the Bank Insurance Fund has incurred a liability if a bank is insolvent on the basis of regulatory

[3]MCorp, Civ. No. 89-2816 (5th Cir, May 15, 1990). In this case, FRB argued that MCorp's failure to provide capital to its subsidiary banks was an "unsafe and unsound practice" under 12 U.S.C. 1818, which FRB could act to restrain. The court concluded that FRB's determination was an unreasonable and impermissible interpretation of the statute since, among other things, the Congress had made no effort in any of the Bank Holding Company Act legislation to require holding companies to inject capital into subsidiary banks.

capital.[4] Second, we considered whether, as of December 31, 1989, any of the 35 banks were (1) equity insolvent based on generally accepted accounting principles or in severe enough financial condition that they would become insolvent in a year if not recapitalized, and (2) a current agreement or ongoing negotiations indicated that bank assistance from the Fund would be necessary. While the 35 institutions we identified were either equity insolvent or in severe enough financial condition as of December 31, 1989, that they were likely to become insolvent soon if they were not recapitalized, none of the institutions have agreements or were negotiating with the regulators to receive assistance from the Bank Insurance Fund. Consequently, these institutions did not meet the conditions for probable loss required by generally accepted accounting principles for recording a loss in the Fund's financial statements.

FDIC included a note to its financial statements disclosing the possibility that financial assistance to failing banks may be required and that this assistance could have a material impact on the condition of the Fund. FDIC's note did not mention that we had identified 35 banks that may fail in the near future. FDIC believes it is not possible to identify the timing of assistance. This position strengthens our concern that generally accepted accounting principles regarding loss contingencies may be unduly delaying loss recognition. The criteria for determining when a loss is probable allow too much subjective judgement that management can use to not recognize losses and still meet generally accepted accounting principles. Chapter 5 further discusses our concerns and suggestions.

Because of the significant impact these 35 institutions would have on the Fund if they failed in the near future, we have included an explanatory paragraph in our opinion on the Fund's 1989 financial statements to disclose our concerns and the effect of these potential failures on the Fund's financial statements. As of the date of our opinion, June 28, 1990, 9 had already failed. Based on March 31, 1990, call data we found that the remaining banks' financial conditions had not improved.

Conclusions

The Bank Insurance Fund faces significant costs in the near future due to the severely deficient financial condition of 35 problem banks. The Fund balance could be significantly reduced if these banks fail or

[4] At December 31, 1989, 5 of the 35 banks were insolvent on the basis of regulatory capital. These banks were subsequently closed in 1990 and their costs incurred in the Bank Insurance Fund's 1990 operations.

require assistance. The Fund faces additional loss contingencies later from other institutions whose current financial condition makes them susceptible to failure if their regional economies continue to deteriorate.

While we have estimated the potential exposure facing the Fund from these problem institutions, we cannot be certain that these banks will fail. The decision to close an institution ultimately rests with its chartering authority. Our estimates are also limited because of the questionable quality of the call report data the bank reported to the regulators and which we used in our analyses. Because the call report information does not always accurately state the financial condition of these institutions, the Bank Insurance Fund's potential loss exposure may actually be greater than we have estimated. Furthermore, inaccurate call reports may also keep banks in severe financial condition from appearing on FDIC's problem bank list. Because the regulators are increasingly relying on call report information in their off-site monitoring of banks to supplement on-site, full scope examinations, early warnings of potential bank failures and their impact on the Fund may not occur.

Recommendation

We recommend that the Chairman, Federal Deposit Insurance Corporation; the Chairman, Federal Reserve Board; and the Comptroller of the Currency annually perform on-site, full scope examinations of problem banks and large banks.

Agency Comments and Our Evaluation

In its written comments on a draft of our report, FRB agreed with our recommendation that regulators should perform annual on-site, full scope examinations of problem and large banks, stating that its current policies exceed this standard. FRB also concurred with our views regarding the importance of on-site examinations. (See appendix IV.)

FDIC commented that its recent goals have been to increase efforts in on-site as well as off-site monitoring. (See appendix III.) However, it does not intend its improved off-site monitoring to substitute for an effective on-site examination program.

OCC questioned our recommendation as well as the accuracy of our portrayal of its approach to bank supervision. (See appendix V.) OCC stated it utilizes both on-site and off-site examination techniques that use its resources efficiently while at the same time provide current information about the condition of each bank under OCC's supervisory authority. OCC believes its present approach to bank supervision allows its examiners

both flexibility and accountability in determining what types of supervisory activities to perform at the banks for which they are responsible and when these activities are to be performed.

Our work found that OCC does not perform annual full scope examinations on large and problem banks. Failure to perform full scope examinations increases the likelihood that a large bank could experience severe financial deterioration and not be identified in a timely manner. An example of this is the recent failure of the National Bank of Washington which, prior to its failure, had a CAMEL rating of less than 4, implying that it was not in danger of failing. Additionally, the failure to perform annual full scope examinations of problem banks increases the risk that any further deterioration of a problem bank's financial condition would not be reported. Thus, a bank that should be closed could remain open and ultimately result in increased costs to the Bank Insurance Fund due to the delay in closing the bank.

Our report is consistent with OCC's description of its supervision process. OCC's off-site monitoring system is similar to that of the other regulators. However, like FDIC and FRB, we believe that enhanced off-site monitoring of banks should complement vigorous on-site examinations, not replace them or reduce their scope, as we believe OCC's current supervisory approach has done.

While the scope of an examination would, and should, vary from bank to bank, a comprehensive, full scope examination is the most accurate means of assessing a bank's financial health. Annual full scope examinations of large and problem banks, complemented by off-site monitoring and resident examiners in large banks, would produce a supervisory system capable of identifying troubled banks and aiding in timely intervention by regulators.

OCC also commented that the report's estimates about the number of potential banks failures and their impact on the Bank Insurance Fund are based on limited and insufficient data. OCC stated that while loss rates experienced by FDIC on bank failures could increase, OCC's new closure policy should mitigate this increase. OCC also stated that the report does not estimate the extent to which inaccurate call report data have led to understating problem banks' financial conditions or additional costs to the Fund.

Our report acknowledges the limitations of the data used to identify the number of banks that are likely to fail within the next year. However,

experience to date in 1990 supports the process we used to identify these potential bank failures. As of August 15, 1990, more than one third of the 35 banks we identified as likely to fail had already failed. In addition to those that had already failed, FDIC acknowledged that another bank would require assistance. This report does not specifically identify the 35 banks, as we are statutorily prohibited from disclosing the names of any open banks to the public. However, we can disclose and have disclosed this information to the regulators.

Our report acknowledges OCC's policy of closing banks when they become equity insolvent. While this policy states OCC will consider closure at the point of equity insolvency, it does not affirmatively state that all equity insolvent banks will be closed. OCC could allow a bank that is equity insolvent to remain open under this policy, thus not reducing the cost of the eventual bank failure to the Fund. Also, as acknowledged in our report, we did not conduct a detailed review of the scope and quality of bank supervision practices, including the quality of bank call reports. However, our future plans include such a review and at that time we will be better able to correlate the impact of inaccurate call report and other bank prepared data on the timing of supervisory actions and, ultimately, on the Fund.

Reported Performance and Condition of the Bank Insurance Fund

The Bank Insurance Fund ended the year 1989 with a balance of $13.2 billion, as compared to $14.1 billion at year-end 1988, and reported a net loss in 1989 of $852 million. Loss reserves relating to 206 bank failures and one assistance transaction along with certain increases to existing loss reserves from prior years' bank failures contributed to the loss. At December 31, 1989, the ratio of the Fund balance to insured deposits equaled .7 percent, the lowest ever in the history of the Fund (down from .83 percent at year-end 1988). From 1980 through 1987, the ratio of the Fund balance to insured deposits averaged 1.17 percent. Thus, the past 2 years have seen sharp declines in the Fund's reserve ratio.

FIRREA authorizes FDIC to increase annual assessments each year beginning in 1990 to eventually achieve a minimum reserve ratio to insured deposits of 1.25 percent, or up to 1.5 percent if the FDIC determines that a significant risk of substantial future losses justifies a higher reserve ratio for a particular year. However, FIRREA also places various constraints on the amount and timing of the increases FDIC can impose. Because of these assessment constraints and the Fund's exposure to risks, our estimates show the Fund will not achieve the minimum reserve ratio by 1995. Further, we question whether the assessment authority under FIRREA is too restrictive to build a Fund balance that would protect the taxpayer in the event of a recession.

While the 1.25 percent minimum reserve ratio designated by FIRREA is comparable to the average reserve ratio of 1.17 percent for the period from 1980 through 1987, we question whether it is sufficient considering the existing and future exposures the Fund faces. We believe the Fund is faced with greater risks today than ever before. We are not aware of any study that was done to determine the basis of the minimum and maximum reserve ratios prescribed by FIRREA. The uncertainties related to the sizeable HLT exposure, the growth in real estate lending, the persistent LDC debt problem, along with insufficient growth in the industry's equity capital compared to the growth in nonperforming loans cause us to believe the current $13.2 billion fund balance is too thinly capitalized. The riskier nature of the industry's loan portfolio coupled with a recession could deplete the Fund balance, resulting in costs to the taxpayer.

FIRREA Authorizes Assessment Increases to Reach Minimum Reserve Ratio

FIRREA provides for FDIC to charge incrementally increasing annual assessment rates to insured commercial banks beginning in 1990. The statutorily prescribed rate of .083 percent of a bank's adjusted average deposit liability for 1989 increases to .12 percent for 1990 and .15 percent for 1991 and beyond. FDIC charged the prescribed rates authorized for 1989 and 1990. FIRREA also authorizes FDIC to increase these prescribed rates under certain circumstances, but limits all authorized increases to .075 percent of insured deposits in any given year, and the assessment rate itself cannot exceed .325 percent of insured deposits. The circumstances under which FDIC may increase the rates are tied to the Fund's reserve ratio.

Under FIRREA, for each year beginning in 1989, the Fund's designated minimum reserve ratio to insured deposits is to be 1.25 percent. It may, however, be at a higher level not to exceed 1.50 percent if FDIC's board of directors determines on a yearly basis that a significant risk of substantial future losses to the Fund justifies a higher ratio. From 1989 until the earlier of January 1, 1995, or January 1 of the year in which FDIC first expects the Fund to attain the designated reserve ratio, FDIC may increase the statutorily prescribed rate only if the Fund's reserve ratio is not increasing on a calendar year basis. Thereafter, FDIC may also increase the assessment rate if it determines that the Fund reserve ratio is expected to be less than the designated reserve ratio.

FDIC Projections of Attaining the Minimum Reserve Ratio May Be Overly Optimistic

FDIC has developed two projections of the Fund balance and its ratio to insured deposits for each year from 1990 through 2000. Table 4.1 presents FDIC's projections through 1995. Scenario 1 uses FDIC's most optimistic estimate of failure and assistance expenses. Scenario 2 uses a more conservative estimate of these costs. Both projections use optimistic projections of income earned from investments. They use the beginning-of-the-year balance of investment principal, when on average this balance has declined over the last 5 years. We believe FDIC's estimates of costs associated with failure and assistance transactions in scenario 1 are unrealistic in light of the institutions we believe are likely to fail in the near future or later. Also, FDIC assumed annual growth of 6.9 percent in both the assessable deposit base and insured deposits. The actual insured deposit growth rate has averaged 5.6 percent over the last 5 years. The assessment rates prescribed under FIRREA of .12 percent for 1990 and .15 percent thereafter were applied to the assessable base to derive the assessment revenues.

Table 4.1: FDIC Projections of the Bank Insurance Fund Reserve Ratio for 1990 Through 1995

Dollars in billions

Scenario 1	1990	1991	1992	1993	1994	1995
Insured deposits	$2,002.2	$2,140.3	$2,288.0	$2,445.1	$2,614.7	$2,795.1
Assessable base	2,418.1	2,584.9	2,763.3	2,953.9	3,157.8	3,375.7
Assessments	2.9	3.9	4.1	4.4	4.7	5.1
Failure and assistance expenses	2.3	2.3	2.3	2.3	2.3	2.3
Net income	1.6	2.7	3.2	3.8	4.4	5.2
Fund balance	14.8	17.5	20.7	24.5	28.9	34.1
Ratio of fund balance to insured deposits (percent)	0.74	0.82	0.91	1.00	1.11	1.22
Scenario 2						
Insured deposits	$2,002.2	$2,140.3	$2,288.0	$2,445.1	$2,614.7	$2,795.1
Assessable base	2,418.1	2,584.9	2,763.3	2,953.9	3,157.8	3,375.7
Assessments	2.9	3.9	4.1	4.4	4.7	5.1
Failure and assistance expenses	3.8	3.8	3.8	3.8	3.8	3.8
Net income	0.1	1.1	1.4	1.8	2.3	2.8
Fund balance	13.3	14.4	15.8	17.6	19.9	22.7
Ratio of fund balance to insured deposits (percent)	0.66	0.67	0.69	0.72	0.76	0.81

FDIC's most optimistic scenario projects that by 1995 the Fund balance will come close to but will not achieve the minimum reserve ratio designated by FIRREA. Under scenario 2, the 1995 reserve ratio would be far below that designated minimum ratio. Under scenario 1, the Fund would exceed the 1.25 percent minimum reserve ratio in 1996. Under scenario 2, FDIC projects that the Fund would achieve the minimum reserve ratio of 1.25 percent by the year 2000.

GAO Projections of Attaining the Minimum Reserve Ratio

The following tables present our projections of the Fund's balance and its ratio to insured deposits for each year between 1990 and 1995 under three scenarios. Based on these projections, we do not believe that it is likely the ratio will reach the 1.25 percent minimum reserve ratio designated by FIRREA by 1995.

We present three scenarios using FDIC's projections of annual growth in insured deposits and the assessable base. We used FDIC's projections for determining assessment income and insured deposit growth because we believe the positive impact from higher assessments is largely offset by a higher insured deposit base in computing the Fund's reserve ratio.

Also, we applied FIRREA's assessment rates to each year's assessable base. Growth in all other revenue sources and expenses, other than the differing losses associated with failure and assistance transactions for each scenario, is based on their average growth between 1985 and 1989.

Table 4.2: GAO Projection of the Bank Insurance Fund Reserve Ratio for 1990 Through 1995 - Scenario 1

Dollars in billions

	1990	1991	1992	1993	1994	1995
Insured deposits	$2,002.2	$2,140.3	$2,288.0	$2,445.1	$2,614.7	$2,795.1
Assessable base	2,418.1	2,584.9	2,763.3	2,953.9	3,157.8	3,375.7
Assessments	2.9	3.9	4.1	4.4	4.7	5.1
Failure and assistance expenses	2.5	2.5	2.5	2.5	2.5	2.5
Net income	1.7	2.6	2.8	3.0	3.2	3.5
Fund balance	14.9	17.5	20.3	23.3	26.5	30.0
Ratio of fund balance to insured deposits (percent)	0.74	0.82	0.89	0.95	1.01	1.07

Table 4.2 presents an optimistic picture for the Fund. The assessment rate applied to the assessable base equaled .12 percent for 1990 and .15 percent for 1991 through 1995. This scenario also assumes that losses associated with failure and assistance transactions remain at the average levels between 1985 and 1987, when the Fund incurred no losses from the failure of a large institution. While the Fund's balance and its ratio to insured deposits increases from 1989 to 1990 and each year subsequently under this scenario, by 1995 the ratio is still below the minimum reserve ratio designated by FIRREA.

Table 4.3: GAO Projection of the Bank Insurance Fund Reserve Ratio for 1990 Through 1995 - Scenario 2

Dollars in billions

	1990	1991	1992	1993	1994	1995
Insured deposits	$2,002.2	$2,140.3	$2,288.0	$2,445.1	$2,614.7	$2,795.1
Assessable base	2,418.1	2,584.9	2,763.3	2,953.9	3,157.8	3,375.7
Assessments	2.9	5.0	4.1	4.4	4.7	5.1
Failure and assistance expenses	5.2	2.5	2.5	2.5	2.5	2.5
Net income (loss)	(1.0)	3.7	2.8	3.0	3.2	3.5
Fund balance	12.2	15.9	18.7	21.7	24.9	28.4
Ratio of fund balance to insured deposits (percent)	0.61	0.74	0.82	0.89	0.95	1.02

Under scenario 2 (table 4.3) we include loss estimates for the larger banks from the 35 institutions which we have identified as likely to fail in the near future. This significantly decreases the 1990 Fund balance and its ratio to insured deposits. Because the ratio of the Fund balance to insured deposits declines in 1990 compared to 1989, our projections assume FDIC will utilize the authority granted by FIRREA and will increase the 1991 assessment rate by .075 percent over the rate charged in 1990, the maximum allowable increase. In 1991, therefore, we assumed the assessment rate applied to the assessable base to be .195 percent. Because the Fund's ratio to insured deposits is projected to increase in each of the following years, we assumed the assessment rates for 1992 through 1995 would revert back to the statutorily prescribed rate of .15 percent. Under this scenario, the Fund's balance and reserve ratio will increase each year after 1990 but will remain thinly capitalized and well below the 1.25 percent minimum reserve ratio.

Table 4.4: GAO Projection of the Bank Insurance Fund Reserve Ratio for 1990 Through 1995 - Scenario 3

Dollars in billions

	1990	1991	1992	1993	1994	1995
Insured deposits	$2,002.2	$2,140.3	$2,288.0	$2,445.1	$2,614.7	$2,795.1
Assessable base	2,418.1	2,584.9	2,763.3	2,953.9	3,157.8	3,375.7
Assessments	2.9	5.0	4.1	4.4	4.7	5.1
Failure and assistance expenses	5.8	4.2	4.2	4.2	4.2	4.2
Net income (loss)	(1.6)	2.0	1.1	1.3	1.6	1.8
Fund balance	11.6	13.6	14.7	16.0	17.6	19.4
Ratio of fund balance to insured deposits (percent)	0.58	0.63	0.64	0.65	0.67	0.69

Under scenario 3 (table 4.4), we included the failure of both the larger of the 35 banks we identified as likely to fail in the near future and other large institutions which could fail if negative economic and financial trends persist. For the latter, we applied our estimated midpoint cost associated with these failures evenly over the 5-year period from 1991 through 1995. For the institutions we identified as likely to fail in the near future, we assumed the cost to be the midpoint of our loss range. Under this scenario, the Fund's ratio to insured deposits declines in 1990 compared to 1989. Consequently, our projections assume FDIC will increase the 1991 assessment rate by .075 percent over the rate charged in 1990, thereby charging a rate of .195 percent. Because the Fund's ratio to insured deposits is projected to increase in each of the following years, we assumed rates for 1992 through 1995 would revert back to the

statutorily prescribed rate of .15 percent. While the Fund balance and its ratio to insured deposits increase each year after 1990, the Fund would remain thinly capitalized through 1995 and would fail to achieve the 1.25 percent minimum reserve ratio under this scenario.

Our projections illustrate significant contingent losses facing the Fund in the 1990s. The significance of these projections is that they raise serious doubts about the Fund's ability to achieve the minimum reserve ratio of 1.25 percent by 1995 under the current assessment provisions of FIRREA.

Furthermore, our scenarios do not consider other factors which may expose the Fund to even greater risks. A recession or a severe decline in the Northeast economy similar to what occurred in the Southwest could result in the failure of many banks not included in our estimates and costs that would deplete the Fund. Also, the banking industry's increased dependence on riskier assets could result in additional losses and bank failures. For example, if these conditions resulted in the failure of two or three large money center banks, those failures would have a disproportionately large impact on the Fund. Additionally, the questionable quality of call report information may have resulted in our actually understating the Fund's exposure in the near future. Some banks which appear healthy based on call report information may actually have a deteriorating financial condition.

Because of these concerns, we believe the Fund balance needs to be built up to a level likely to withstand the cost of bank failures in 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, it may not be feasible to achieve adequate protection for the Fund and ultimately the taxpayer solely through assessment premiums.

FIRREA requires that the Department of the Treasury study deposit insurance reform. We believe such a study should assess the banks' ability to pay higher premiums and estimate at what point such higher premiums may become counterproductive. Treasury's study should also consider other means of reducing the Fund's exposure, such as requiring banks to maintain higher capital levels, and other options to further protect the Fund and ultimately the taxpayers.

Separate Asset Pools Present Liquidity and Asset Valuation Exposures to the Fund

With the failure of First RepublicBank Corporation in 1988, FDIC introduced the separate asset bank concept. The failure of other large banks in Texas have also resulted in the creation of other separate asset banks. In many respects, this concept is similar to the noncash transactions the Federal Savings and Loan Insurance Corporation entered into in the latter days of its existence due to the decline in its cash resources. These transactions require lower cash outlays upfront with the expectation that the disposition of acquired assets will generate cash sufficient to meet future needs. Further, if such cash outlays were made, they would be large enough to significantly impair the Fund's cash position. Because separate asset pools significantly leverage the Fund's assets through future exposure, they raise the concern that the Fund may become overextended beyond its ability to pay.

The separate asset bank concept allows the bank acquiring a failed institution to create and establish on its books a separate asset pool for all failed bank nonperforming assets. The Fund is obligated to (1) pay interest costs on the book value of the pool assets at the acquiring bank's cost of funds rate less income received on the separate asset pool's assets, (2) pay all expenses incurred in managing and liquidating the assets, (3) fund writedowns to market incurred on assets which can be transferred to the separate asset pool account during a specified period of time, (4) fund losses on the disposition of pool assets, and (5) purchase the remaining pool assets at the final settlement date when the separate asset pool is removed from the acquiring bank's books based on the terms of the assistance agreement.

FDIC considers all of the above factors when determining the ultimate cost of a transaction. At December 31, 1989, the Bank Insurance Fund's exposure for separate asset bank assets was approximately $8.0 billion. The three separate asset pools that in substance existed at December 31, 1989, resulted in an estimated interest cost to the Fund of $1.6 billion. This cost would have been avoided if the pool assets had been paid for in cash. However, had cash outlays for these pool assets been made at December 31, 1989, cash and cash equivalents and investments in U.S. Treasury obligations held by the Bank Insurance Fund would have decreased, and net receivables from bank assistance and failures would have increased, by $8.0 billion. Such cash outlays would have significantly impacted the Fund's liquidity position. This in turn could have impacted its ability to handle future bank failures due to insufficient cash resources or required Treasury borrowings.

Further, the terms of the bank assistance agreements related to these three separate asset pools allow the acquiring bank to transfer loans that were originally acquired into the separate asset bank if they become nonperforming after the consummation date. Generally, the dollar amount of loans that can be transferred for the first 12 months after consummation is limited only by the failed bank's total loans at the consummation date. However, from months 13 through 24 after the consummation date, the acquiring bank can continue to transfer loans to the separate asset bank up to an amount specified in the assistance agreement. For example, in 1989, North Carolina National Bank (NCNB), the acquirer of the failed First RepublicBank Corporation in Texas, transferred $1.1 billion from the $8.7 billion of loans that could have been transferred in the first year. This resulted in $163 million in cash payments associated with the losses resulting from the writedown to market value on the assets transferred. In addition, NCNB can put up to $750 million in the separate asset bank during 1990, the second year. These transfers further increase the Fund's potential liquidity exposure from separate asset banks.

The Fund is also exposed to the risk of further deterioration in the value of the assets in the separate asset bank. The book values of these assets are often based primarily on appraisals. Our review of certain assets in the separate asset bank created from the failure of First RepublicBank Corporation identified instances where the recoverable values determined and recorded were overstated due to (1) the appraiser's unrealistic assumptions and (2) FDIC guidelines that base recorded values on the most recent appraisal.

We reviewed the estimated cash recovery (ECR) value for all separate asset pool loans with a book value greater than $10 million and all other real estate owned (OREO)[1] valued at more than $2 million. The estimated cash recovery is the basis for the book value of assets in the separate asset bank. If an ECR is less than the current book value of an asset, the book value would be reduced by a valuation reserve to equal the ECR. Also, if the ECR value is greater than the book value, the book value can be increased up to the asset's original value when it was transferred into the separate asset bank.

Our review of ECRs for loans identified recoverable values comparable to those determined by the acquiring bank. However, we disagreed with 67

[1]Other real estate owned consists of properties that are acquired either directly from a failed bank, as a result of a foreclosure of a loan, or as part of a settlement with a borrower.

of the 133 ECRs for OREO assets analyzed due to the unrealistic assumptions used in determining these assets' appraised and recorded values. We estimated that 133 OREO assets with book balances of $488 million were overstated by about $76 million. While we disagreed with the valuations, they appear to have been made in compliance with FDIC guidelines.

The ECR prepared on a shopping center was one example of overstatement of the recorded value due to unrealistic appraisal assumptions. The former bank acquired this OREO property on August 5, 1986. From August 5, 1986, through September 30, 1989 (the date of the ECR), this shopping center had approximately 10-percent occupancy at below market rentals. However, the appraisal value assumed incremental increases in occupancy of 5 percent every 6 months at market rent rates. These estimates were used to compute 10 years of cash flow to determine the appraised value. The practice of estimating increases in occupancy and rental rates is acceptable in the appraisal industry. However, based on the historical experience of this property (that is, 10-percent occupancy over 3 years and below market rents) and the absence of any documented reason to expect improvement, these assumptions appear unreasonable, especially considering the property's separate asset pool status and the need for values that can be used for current transactions. We estimated that this property was overvalued by 30 percent. Based on a subsequent appraisal, the acquiring bank personnel revised the ECR for this property to an amount comparable to our estimate. Two appraisers will often assess the same property quite differently because they use differing assumptions in the appraisal process. This occurred in cases where the acquiring bank personnel reordered appraisals because the original appraisal was deemed unreasonable.

Appraisal quality has a significant impact on the accuracy of valuations for OREO and, on a larger scale, significant financial implications to the banking industry. Appraisals based on unrealistic assumptions could result in a bank making loans in excess of the loan collateral's realistic value. Further, loss reserves could be understated if they are based on unrealistically high appraisal values for the underlying assets. This could cause a bank's financial condition to be misstated.

A recent policy advocated by the Resolution Trust Corporation (RTC) Oversight Board could also affect the Bank Insurance Fund's exposure to separate asset pools. This policy allows RTC to sell property for amounts ranging from 85 percent to 70 percent of appraised value. In

addition, certain assets can be sold to the highest bidder regardless of the appraisal. While this policy will probably result in quicker asset sales by RTC, it may also affect the market value for assets in the Bank Insurance Fund separate asset pools. Additionally, this policy could have serious implications for commercial banks either holding real estate or involved in real estate lending.

Conclusions

As discussed in chapters 2 and 3, we are concerned that the Fund is vulnerable to a number of factors. A number of troubled banks already exist that we believe are likely to fail in the near future, whose costs would significantly reduce the Bank Insurance Fund. A continued economic downturn in the Northeast and Southwest could significantly raise the cost of these and existing failures to the Fund and could result in additional banks failing, with their costs being borne by the Bank Insurance Fund. The current downward trends in the real estate sector pose a threat to the health and stability of the Northeast banks and to the recovery of banks in the Southwest. Also, the performance of LDC loans continues to plague the profitability of large banks, and future losses associated with these loans could occur. In addition, uncertainties exist with regard to the effect loans involving HLTs, were they to begin to experience performance difficulties, would have on the commercial banking industry and on the Fund. The Fund also faces uncertain exposures from FDIC policy changes regarding sales of acquired assets and the ultimate financial impact of separate asset banks upon termination of the assistance agreements.

Because of the exposures it currently faces, the Bank Insurance Fund balance is too thinly capitalized. Further, the assessment increases and minimum reserve ratio designated by FIRREA will be insufficient in the event of a recession that results in significant bank failures. While the Fund has sufficient resources to handle the exposure it faces from the institutions we believe are likely to fail in the near future or later, other uncertainties facing the Fund could further reduce or deplete the Fund balance. The Fund's reserves need to be increased to ensure that, on a short-term and long-term basis, a recession will not deplete the Fund and result in costs to the taxpayer.

FIRREA increased the annual assessment rate for 1990 and requires another increase in 1991. However, the potential exposure the Fund faces in 1990 could result in significant costs which would consume the increased assessment revenue, significantly impair its cash resources, and reduce the Fund's reserve ratio to insured deposits from its year-

end 1989 level. Given the statutory restrictions on FDIC's authority to increase assessments and the outlook for the Fund, it is unlikely that the minimum reserve ratio designated by FIRREA of Fund balance to insured deposits of 1.25 percent will be achieved by 1995.

Recommendations

We recommend that the Congress amend FIRREA to give the Chairman of the Federal Deposit Insurance Corporation the authority to raise rates beyond those provided in FIRREA so that the Fund achieves the minimum reserve ratio of 1.25 percent designated in FIRREA by 1995.

We recommend that the Secretary of the Treasury ensure that the Department's study of deposit insurance reform (required by FIRREA) determine (1) the reasonableness of the minimum and maximum reserve ratios designated by FIRREA in light of the banking industry's present condition and the exposure to the Fund, (2) a reserve ratio target that would protect taxpayers by maintaining the Fund in the event of recession, and (3) means in addition to premium assessments, such as increased capital levels in banks, that would reduce the Fund's potential liabilities. The results of this study should be reported to the Congress in a timely manner.

We recommend that the Chairman of the Federal Deposit Insurance Corporation (1) revise FDIC guidelines for recorded values of assets held in separate asset pools to include a critical review of the appraisers' underlying assumptions in valuing assets acquired from failed banks or assets maintained in separate asset banks and adjust recorded values, if necessary, to reflect these assets' realistic values in light of their historical experience and current conditions, and (2) monitor the use of separate asset pools to ensure the Bank Insurance Fund has cash resources to meet its commitments.

Agency Comments and Our Evaluation

In their written comments, neither the Department of the Treasury nor OCC, a component of Treasury, specifically addressed our recommendation regarding the need for Treasury's study of deposit insurance reform to include steps to maintain the Fund's soundness in the event of a recession. (See appendixes V and VI.)

FRB recognized, however, the need for Treasury's study, and for the Congress, to consider all possible steps for maintaining the strength of the deposit insurance system and for protecting the taxpayers' interest. (See

appendix IV.) FRB specifically mentioned the need to consider adjustments to deposit insurance rates and their impact on institutions' profitability as well as the capital adequacy of institutions. We believe FRB's comments reflect the intent of our recommendations.

OCC commented that because we project that the Fund balance will rise, our later statement that the Fund could be depleted is contradictory and makes this comment appear alarmist. OCC stated that it is difficult to estimate the impact of a recession on the number of bank failures and that the report does not present data (1) to support its assertions that the changing composition of bank loan portfolios may raise the cost of bank failures or (2) to assess the impact of a recession on the number of bank failures.

We believe that the deterioration of the Fund's balance during 1988 and 1989, years of perceived national economic growth, support our concerns about the Fund's ability to withstand a recession. The broader conceptual issue of our report is that the Fund balance should attain and be maintained at a level that would protect taxpayers from incurring costs due to bank failures. A recession is an economic event that could reasonably occur, and we believe the Fund should be adequately capitalized to withstand such an event. When an economic downturn occurred in the Southwest, almost every major bank failed. If this occurs in the Northeast, a region that currently is exhibiting signs of economic deterioration similar to those present in the Southwest in the early 1980s, many of its large banks could fail. We believe the Fund should be capitalized to withstand the failure of several large banks in that region. Our projections of Fund balance growth are based on foreseeable conditions as of the date of our report and assume a stable economy. However, as stated throughout the report, we believe that known exposures and recent economic indicators present sufficient cause to be concerned about the Fund's low level and, ultimately, its solvency.

FDIC recognized that the Fund is undercapitalized and on August 14, 1990, announced its proposal that the assessment rate for 1991 be increased by the maximum amount allowable under FIRREA. If this proposal is implemented, the Fund would receive $1.1 billion more in assessment income than it would have under the statutorily prescribed rate of .15 percent. FDIC's actions follow recent statements made by its Chairman that the Fund could incur significant losses resulting from bank failures in 1990 and reflects FDIC's concerns that the Fund is undercapitalized. We concur with FDIC's proposed action and stress the need for the Fund to be increased and maintained at a level that will

allow it to deal with the costs of future bank failures and protect taxpayers from incurring these costs.

FDIC observed that appraisals of assets held in separate asset pools are redone periodically and that sales values are compared to appraisals to determine if any adjustments are necessary. (See appendix III.) FDIC also stated that appraisers working in its environment had little motivation to overstate values. Our findings show, however, that in accepting appraisals, appraisers and bank management often assume optimistic recoveries for other real estate owned. We continue to believe that FDIC needs to tighten its appraisal guidelines to ensure realistic values in light of historical experience and current conditions.

Accounting and Reporting Issues Facing the Banking Industry

Our limited review of call reports and examination reports for certain problem banks showed that call reports, when compared to examination reports, are not always serving as an accurate early warning to regulators of an institution's deteriorating financial position. This problem takes on greater significance when the known exposure to the Fund is significant enough to impair the Fund balance and the prospects for achieving the minimum reserve ratio designated by FIRREA by 1995 are limited.

Public officials and others have also acknowledged that 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. A principal concern raised is whether financial data currently being prepared in accordance with generally accepted accounting principles are adequate for this purpose. The general presumption of those that advocate the use of some form of market value accounting in financial reporting is that write-downs from historical cost to market value under generally accepted accounting principles have failed to provide an effective early warning system. In that respect, two principal problems with generally accepted accounting principles are (1) that they may unduly delay application of fair market value to problem assets and thus defer the resultant loss recognition and (2) the stated definition of fair market value presumes that the seller is not compelled to sell, which is not typically the case for a troubled bank. In general, call report data are accounted for and reported in accordance with generally accepted accounting principles because the banking regulations that apply to the preparation of such data are based, to a large extent, on these principles.

In response to these concerns and the problems with call reports we have identified, we are currently reviewing whether a change in the criteria for write-downs from historical cost to market value or some form of market value accounting would have provided more reliable information on the decline in asset values for banks that failed. While our study is focused on bank accounting and reporting, these issues also impact accounting and reporting by the Bank Insurance Fund. As discussed in chapter 3, the criteria for determining whether and when to record a loss from bank failures, i.e., probable occurrence of a bank failure, are conceptually the same as those used in determining whether and when fair market value accounting should be applied—the probability of whether a loan is collectible from the borrower. In addition, our review of 39 banks that failed in 1988 or 1989 also indicates that serious

internal control weaknesses existed that contributed significantly to their failure.

This chapter presents some of the issues that our work has identified. Our work has not progressed far enough to frame recommendations; however, we believe that early disclosure of the problems we are finding will help the Financial Accounting Standards Board,[1] the regulators, and others to better define the problems and make the changes that are needed to minimize losses to the Bank Insurance Fund.

Banks' Reported Financial Condition Before Failure Dramatically Different Than After Failure

For our ongoing study of bank accounting and reporting issues, we selected a sample of 39 banks which failed in 1988 or 1989 and reviewed their most recent call reports and audited financial statements, the regulator's examination reports and asset valuation reports at the time of failure, and other relevant financial information. These banks were selected for review based on asset size and geographical location and accounted for about 90 percent of the total assets of the 406 banks that failed in those 2 years. Our objective was to determine if the banks' financial condition was adequately communicated by the reports of management and, if not, to evaluate the merits of some change in accounting principles as a possible solution to this problem.

Although our review of the financial reports is not complete, our findings tend to confirm the results of our limited review of call reports for certain problem banks as discussed in chapter 3. Generally, we found that the values reported in call reports for reserves for loan losses and for OREO losses were significantly less than the values reported by the regulators as a result of examinations or other reviews conducted about the time the bank failed. When financial statements were available that were audited by an independent public accounting firm, we found that they generally agreed with the call reports. Therefore, the audited financial statements also reported reserve values for loan losses and OREO losses that significantly overstated asset values compared to the values established by the regulators. Our findings indicate that call reports and audited financial statements are of limited use to the regulators for assessing the true financial condition of banks and for triggering timely intervention.

[1] The Financial Accounting Standards Board is the body that sets generally accepted accounting principles.

Our work suggests several possible reasons why bank management and its auditors are reporting values for loan losses and OREO reserves that are significantly different than the values established by the regulators.

- The criteria which must be satisfied before problem assets are written down from cost to fair value[2] under generally accepted accounting principles unduly delay the recognition of loss. Also, the somewhat subjective nature of these criteria gives bank management and auditors too much latitude in applying the intent of the accounting principles.
- Regulators more conservatively apply the provisions of generally accepted accounting principles for both the timing and determination of write-down to fair market value.
- Bank credit functions, related information systems, and other elements of bank internal controls are insufficient to identify the facts needed to determine the timing of when an asset should be written down from cost to fair market value.
- Bank management is not always motivated to reflect known losses from write-downs to fair market value at a time when it is struggling to preserve the institution and its control over it, and oversight by a bank's board of directors may not be sufficient to prevent misstatements of asset values.

Financial Reporting Issues for Further Study

Under generally accepted accounting principles, the basis of accounting for a bank's portfolio is cost, except where loss is probable and measurable. For banks, as well as for most other types of entities including the Bank Insurance Fund, losses are recognized only when it is probable that they will be incurred and the amount can be reasonably estimated. Further, specific rules relating to the timing of recognition and the definition of fair value may tend to defer loss recognition and limit the amount of loss taken.

There are two basic questions relating to the application of the principle of loss recognition which we are studying as part of our ongoing work.

- Is the requirement for the recognition of loss unduly delaying banks' reporting of losses on loans in adverse situations where an early warning of loss is needed?

[2]Financial Accounting Standards Board Statement (SFAS) No. 15 defines fair value as "the amount that the debtor could reasonably expect to receive in a current sale between a willing buyer and a willing seller, that is other than a forced or liquidation sale."

- Is basing the estimate of any loss on a traditional fair value concept—a seller is under no compulsion to sell and has time to negotiate a sale—appropriate when the adequacy of a bank's capital can be critical?

If it is found that current accounting rules result in delayed loss recognition and recognition of insufficient losses, then the government's interest as insurer should lead to a change in these rules.

We are also considering the role of bank directors in the determination of the amount of bank capital. An argument can be made that directors of institutions with government deposit insurance should be required to assume, in addition to their existing responsibilities to stockholders and others, fiduciary responsibility to protect the government's interest. Under this theory, the directors could be charged with the responsibility to make a reasonable investigation of the representations of bank management as to asset values. The Investment Company Act of 1940 required that directors establish fair values for the portfolios of investment companies. Depending on company type, the stock of such companies sell at net asset value or a function of net asset value. Therefore, net asset value, a capital concept used by investment companies, is critical in that situation. Because of the potential for management conflict of interest, the directors were given the responsibility for determining fair values. In the case of banks, this type of responsibility is consistent with existing directors' responsibilities because an accurate determination of bank capital is fundamental to effective bank management. The accurate determination of bank capital is critical if the government's interest as insurer is to be protected. This is especially true in light of bank capital levels in relation to the increased portfolio risk and the limited protection provided by the Bank Insurance Fund, as discussed in chapters 2 through 4.

Internal Control Weaknesses Continue

We previously reported that serious internal control weaknesses cited by federal regulators contributed significantly to virtually all of the 184 insured banks which failed in 1987.[3] Our findings from reviewing examination reports of our sample of 39 banks which failed in 1988 or 1989 also indicate serious internal control weaknesses 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

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

of the bank, but also to establishing and maintaining an effective internal control structure. We also previously 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]

The recommendations in our May and June 1989 reports have not been adopted. Our recommendations to the Congress included that, as a condition for deposit insurance,

- insured commercial banks be required to undergo an annual independent financial audit, as is currently required of federally insured savings and loans;
- federally insured banks and savings and loans be required to issue management reports on their internal controls and compliance with laws and regulations; and
- auditors of federally insured commercial banks and savings and loans be required, as part of their audit, to report on the adequacy of management's assertions with regard to the institution's internal controls and compliance with laws and regulations.

The regulators did not adopt our recommendations for reasons of cost and their belief that sufficient guidance already exists on management's responsibilities. We do not agree with the regulators' views and find that these same internal control weaknesses contributed significantly to bank failures in 1988 and 1989 as they did in 1987.

We believe that our proposed management and auditing reporting requirements are needed. In our forthcoming report on bank accounting and reporting issues, we will discuss the specific internal control weaknesses that regulators found in the 39 failed institutions we reviewed.

In addition, we believe that other reforms may be needed. We provided additional suggestions on enhancing the quality of management, audit, and financial reporting for federally insured financial institutions in our March 7, 1990, letter to the Secretary of the Treasury in connection with Treasury's study of deposit insurance reform as required by FIRREA. We also suggested a number of reforms that would (1) result in increased communication between regulators and an institution's independent

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

auditor and (2) require the independent auditor to recognize a responsibility to the public when auditing a federally insured institution. A copy of our letter to Treasury including our detailed suggestions is included in appendix II.

Reports on the Financial Statements of the Bank Insurance Fund for the Years Ended December 31, 1989 and 1988

Opinion Letter

GAO

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

Comptroller General
of the United States

B-114831

To the Board of Directors
Federal Deposit Insurance Corporation

We have audited the accompanying statements of financial position of the Bank Insurance Fund as of December 31, 1989 and 1988, and the related statements of income and fund balance and statements of cash flow for the years then ended. These financial statements are the responsibility of the Federal Deposit Insurance Corporation's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Bank Insurance Fund as of December 31, 1989 and 1988, and the results of its operations and its cash flows for the years then ended, in conformity with generally accepted accounting principles.

As stated in note 7, the accompanying financial statements include an estimated loss of $3.8 billion for those banks which the regulatory process has identified as being distressed and where ongoing negotiations and/or current agreement terms indicate that bank assistance will be necessary. Also, as stated in note 13, the Federal Deposit

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Insurance Corporation is monitoring the financial condition of certain large banks, predominately located in the Northeast, that are experiencing the effects of softening real estate markets and weakening state economies. Depending on the extent of the economic downturn, these banks may require financial assistance, which could have a material impact on the Bank Insurance Fund.

We have identified 35 banks with total assets of $45.1 billion that we believe are troubled[1] for which an estimated loss has not been recorded because no negotiations for assistance have occurred and the regulators consider them to be viable institutions. Generally, the regulators have implemented supervisory agreements for these banks and have allowed them to operate under recapitalization plans devised by the banks that do not include regulatory assistance. Due to the subjective judgments made by the chartering authorities--the state or the Comptroller of the Currency in the case of national banks--in determining whether and when to fail a bank, we were unable to determine whether or not these banks will fail. However, if these banks fail, we estimate that the Fund balance would have decreased, and the Fund's liabilities for estimated bank assistance would have increased, by amounts ranging from $4.4 billion to $6.3 billion as of December 31, 1989. Our estimate is based on the Fund's historical loss experience for failed bank transactions.

As disclosed in footnote 1 in the accompanying financial statements, enactment of Public Law 101-73, the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) on August 9, 1989, resulted in a change in reporting entity. The Bank Insurance Fund was previously reported as the Federal Deposit Insurance Corporation (FDIC) from inception through December 31, 1988. The effect of this change in reporting entity is immaterial to the financial statements as reported herein and no restatement of the prior year's amounts was necessary.

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[1]Our definition of a troubled bank is one that has negative equity or a minimal level of equity capital based on generally accepted accounting principles and that we believe is probable to fail in the near future unless it receives additional capital. The regulators believe that such institutions are viable and would not be conducting ongoing negotiations for assistance.

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The following comments provide supplementary information on the financial condition of the banking industry, the exposure to the Fund as a result of problem banks, concerns over the quality of financial information reported by banks, the performance and condition of the Bank Insurance Fund, and accounting and reporting issues facing the banking industry.

COMMERCIAL BANKING INDUSTRY'S FINANCIAL CONDITION

The performance of the commercial banking industry deteriorated in 1989 compared to 1988. Growth in real estate loans and nonperforming assets outpaced the growth in the industry's equity capital. This was particularly prominent in the Northeast region, where the equity capital to asset ratio declined in 1989 and was significantly lower than the industry's average. Industry earnings declined 34 percent to $16.3 billion in 1989 from their 1988 levels of $24.8 billion, primarily due to the poor earnings performance of large banks and banks in the Northeast region. The earnings performance of these banks declined due to the increasing level of nonperforming real estate loans and losses recognized by large banks on loans to lesser developed countries.

Real estate loans and leases totaled $762 billion (37 percent of total loans) at December 31, 1989, compared to $438 billion (27 percent) at December 31, 1985. Nonperforming real estate loans increased from $16 billion in 1988 to $22 billion in 1989.

The 50 largest bank holding companies reported that their bank and nonbank subsidiaries collectively had $126 billion in loans categorized as highly leveraged transactions at December 31, 1989. Because of their relative newness, the performance of loans categorized as highly leveraged transactions, as well as their impact on future bank failures, is uncertain.

The overall growth in nonperforming loans suggests that the industry faces a higher level of risk than it has historically. The level of nonperforming real estate loans, coupled with the potential for bank losses on loans categorized as highly leveraged transactions, could lead to additional bank failures in the 1990s, with the costs of these failures being incurred by the Bank Insurance Fund.

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About $43 billion of the $54 billion in troubled loans to lesser developed countries are held by nine large banks. The banks' average reserve level for these troubled loans was about 49 percent at December 31, 1989. These banks do not appear to be in danger of failing. However, additional losses from loans to lesser developed countries, combined with significant losses from other portfolio concentrations such as highly leveraged transactions or real estate loans, could make some of these banks more vulnerable to failure.

PROBLEM BANKS POSE SIGNIFICANT EXPOSURE TO THE BANK INSURANCE FUND

While the number of banks considered to be problem institutions by the regulators has declined from 1,406 in 1988 to 1,109 in 1989, we believe that a number of troubled institutions are in danger of failing, the costs of which would significantly impact the Bank Insurance Fund. We identified 35 institutions in such severe financial condition at December 31, 1989, that, without some form of recapitalization, they will likely fail in the near future. If all of these banks fail, we estimate that they would cost the Bank Insurance Fund between $4.4 billion and $6.3 billion. We also identified other banks which could fail later if their financial condition and regional economies continue to deteriorate. If these banks fail, we estimate their cost could significantly impact the Bank Insurance Fund. In addition, there are several other large banks that could fail if the economy experiences a recession. Their failure could result in depletion of the Fund.

Our loss estimates are based on FDIC's historical loss rates on bank failures, which may not reflect the increasing amounts of real estate loans and highly leveraged transactions in bank portfolios.

CALL REPORT QUALITY IS A CONCERN AS REGULATORS PLACE GREATER RELIANCE ON OFF-SITE MONITORING

We did not review the overall quality of call reports. In reviewing examination reports for 10 problem banks, we found indications that call report accuracy may depend on whether the regulators have recently examined the troubled institution. Generally, the call reports understated loan loss reserves and overstated net income when compared to

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the examiners' reports. Also, we found that of the 406 banks that failed in 1988 or 1989, 22 never appeared on the problem bank list, and 9 failed after appearing on the list only one quarter prior to failing. While we did not compare the call and examination reports for these banks, we are concerned that the call reports apparently did not provide adequate warning to regulators about the conditions which caused these banks to fail.

As the regulators are increasingly relying on off-site monitoring systems in their supervision of banks, the accuracy of call reports, which are an integral part of the off-site monitoring process, becomes more critical. We believe that the quality of call report data may prevent the off-site monitoring process from being a more effective early warning system of potential bank failures.

THE FUND'S RESERVES WILL NOT LIKELY REACH MINIMUM DESIGNATED LEVELS BY 1995

The Bank Insurance Fund ended 1989 with a net loss of $852 million, which reduced the Fund balance to $13.2 billion. Losses relating to 206 bank failures and one assistance transaction in 1989, along with increases in existing estimated losses for previous failures, contributed to the Fund's net loss. At December 31, 1989, the ratio of the Fund balance to insured deposits equaled .7 percent, its lowest level ever.

FIRREA provides for FDIC to charge incrementally increasing annual assessment rates to increase the Fund's reserves. However, the rate increases are tied, in part, to whether the ratio of the Fund balance to insured deposits annually increases and reaches the minimum reserve ratio of 1.25 percent designated in FIRREA by 1995. FDIC projections of Fund growth shows under one scenario, that the Fund balance will almost achieve the designated minimum reserve ratio of 1.25 percent in 1995. However, we believe that FDIC's assumptions in this scenario are overly optimistic and that it is likely that the Bank Insurance Fund will fall far short of the minimum reserve ratio by 1995 without using annual assessment rates higher than those allowed by FIRREA.

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SEPARATE ASSET POOLS COULD SIGNIFICANTLY REDUCE THE FUND'S CASH RESERVES

In addition to its exposure from problem institutions, the Fund faces exposure from existing failure and assistance transactions due to the potential cash payment requirements that could significantly reduce the Fund's cash position. As a result of large bank failures, FDIC has used the separate asset bank concept as a cash management method. This concept allows FDIC to defer paying for the bad assets of a failed bank to a later date, rather than making payment when the assistance agreement is consummated with the acquiring bank. At December 31, 1989, the Bank Insurance Fund had an $8 billion exposure for separate asset bank assets that it will have to pay for at a future settlement date if the assets are not disposed of by then. If large banks continue to fail and more separate asset banks are created, this type of noncash transaction will need to be carefully monitored to ensure that it does not result in an accumulation of payment deferrals that are greater than the Bank Insurance Fund's future cash resources.

Another exposure from existing assistance transactions also results from overvaluation of assets acquired from failed banks or assets maintained in separate asset banks by other acquirers that can be returned to FDIC. We found a number of instances where unrealistic assumptions were used by appraisers in valuing these assets. Reliance by FDIC on appraised values for these assets could result in FDIC establishing insufficient levels of valuation allowances and lead to higher levels of losses on the sales of these assets than expected.

ACCOUNTING AND REPORTING ISSUES FACING THE BANKING INDUSTRY

We are currently reviewing the financial reports of 39 banks that failed in 1988 or 1989 and which account for about 90 percent of the assets of banks that failed in those years.

This ongoing study has not progressed far enough to make recommendations; however, early disclosure of the problems found serve to help the accounting profession, regulators, and others to better define the problems and make the

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necessary changes that are needed to minimize losses to the Bank Insurance Fund.

Findings from our study of 39 failed banks suggest that the use of generally accepted accounting principles to value the assets of troubled banks results in overstated asset values compared to the values established by the regulators in the event the bank were to fail and FDIC would be called upon to dispose of the assets. The criteria under generally accepted accounting principles that is applied by bank management and its independent auditors in valuing the assets of problem banks may result in unduly delaying the recognition of losses. Consequently, the use of generally accepted accounting principles in reporting financial data by bank management could be preventing timely recognition of a troubled bank by the regulators. The lack of an early warning, which would permit regulators to intervene promptly with a troubled bank, exposes the Bank Insurance Fund to additional losses.

Our review of the regulators' examination reports for the 39 banks that failed in 1989 or 1988 also indicates that serious internal control weaknesses existed that contributed significantly to their failure--a problem we previously found and reported on for banks that failed in 1987.[2]

In our previous report, we recommended that all federally insured depository institutions be required to issue management reports on their internal controls and compliance with laws and regulations and undergo annual independent financial audits. We also recommended that auditors be required, as part of their financial audits, to report on management's assertions with regard to the institution's internal controls and compliance with laws and regulations. These steps would increase management's awareness of the importance of internal controls and would help establish accountability. These recommendations have not been adopted.

In addition to requiring that management assess and report on internal controls, we believe that other issues must also be considered, such as increasing or better defining

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

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directors' responsibilities either by statute or regulation.

We also believe that improved reporting by auditors and the sharing of regulator's reports with auditors would result in improved communication between the regulators and independent auditors and would enhance their effectiveness in carrying out their respective responsibilities.

We are continuing to review these accounting and auditing and related issues.

CONCLUSIONS

The level of deposit insurance reserves necessary to reasonably ensure that no cost to the taxpayer will occur as a result of bank failures likely to occur in a recession requires further study. The risk levels associated with the industry's loan portfolio have increased over the past decade. Levels of bank equity capital have not changed appreciably so that the increased portfolio risk is not cushioned by additional capital. Bank Insurance Fund reserves set a 1.25 percent of insured deposits may not be sufficient to accumulate a reserve that will carry the Bank Insurance Fund through a recession.

We believe the level of deposit insurance reserves necessary to meet the Fund's liabilities in the event of a recession should be addressed as part of the deposit insurance reform study required by FIRREA. In addition to considering premium increases to protect the financial integrity of the Fund, other means of reducing the Fund's exposure should be considered.

In conjunction with this report we have issued a report that extensively discusses the concerns cited in this opinion on the Bank Insurance Fund. Our report, Bank Insurance Fund: Additional Reserves and Reforms Needed to Strengthen the Fund (GAO/AFMD-90-100, September 11, 1990), recommends that the Congress enact legislation to provide additional reserves that are needed in the Bank Insurance Fund due to the more risky environment of the banking industry and the many financial exposures it faces. We also recommend other reforms that are needed to strengthen bank supervision.

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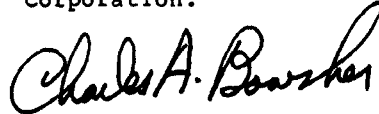
In addition to this report on our examination of the Bank Insurance Fund's 1989 and 1988 financial statements, we are also reporting on our study and evaluation of FDIC's internal control structure and compliance with laws and regulations. Also, during our examination, we identified matters that do not affect the fair presentation of the financial statements, but nonetheless warrant management's attention. We are reporting them separately to the Corporation.



Charles A. Bowsher
Comptroller General
of the United States

June 28, 1990

Report on Internal Control Structure

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

Comptroller General
of the United States

B-114831

To the Board of Directors
Federal Deposit Insurance Corporation

We have audited the financial statements of the Bank Insurance Fund for the years ended December 31, 1989 and 1988, and have issued our opinion thereon. This report pertains only to our study and evaluation of the Federal Deposit Insurance Corporation's internal control structure as it relates to the Bank Insurance Fund for the year ended December 31, 1989. The report on our study and evaluation of the Corporation's internal control structure for the year ended December 31, 1988, is presented in GAO/AFMD-89-63, dated April 28, 1989.

We conducted our audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

In planning and performing our audit of the financial statements of the Bank Insurance Fund for the year ended December 31, 1989, we considered its internal control structure in order to determine our auditing procedures for the purposes of expressing our opinion on the financial statements and not to provide assurance on the internal control structure.

The Corporation's management is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's

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authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles. Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the internal control structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

For purposes of this report, we have classified the Corporation's significant internal control structure policies and procedures into the following categories:

-- treasury, consisting of policies and procedures over cash disbursements, cash receipts, and investment activities, and

-- assistance to problem banks, consisting of policies and procedures over FDIC's supervision and liquidation activities for failed or assisted banks.

For all of the internal control structure categories listed above, we obtained an understanding of the design of the relevant policies and procedures and whether they have been placed in operation, and we assessed control risk. We performed limited tests of control procedures for all the categories listed above, except that we found it more efficient to rely solely on substantive audit tests for investment and cash receipt activities. For all categories, we performed audit tests to substantiate account balances associated with each control category. Such tests can also serve to identify weaknesses in the internal control structure.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the specific internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters

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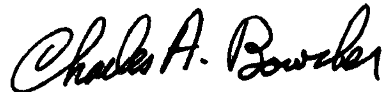
involving the internal control structure and its operation that we consider to be material weaknesses as defined above.

However, we noted certain matters involving the internal control structure and its operations that do not affect the fair presentation of the Bank Insurance Fund's financial statements, but which nevertheless warrant management's attention. We are reporting these other matters separately to the Corporation's management.



Charles A. Bowsher
Comptroller General
of the United States

June 28, 1990

Report on Compliance With Laws and Regulations

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

Comptroller General
of the United States

B-114831

To the Board of Directors
Federal Deposit Insurance Corporation

We have audited the financial statements of the Bank Insurance Fund for the years ended December 31, 1989 and 1988, and have issued our opinion thereon. This report pertains only to our review of the Federal Deposit Insurance Corporation's compliance with laws and regulations as they relate to the Bank Insurance Fund for the year ended December 31, 1989. Our report on the Corporation's compliance with laws and regulations for the year ended December 31, 1988, is presented in GAO/AFMD-89-63, dated April 28, 1989.

We conducted our audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

The Corporation's management is responsible for compliance with laws and regulations applicable to the Bank Insurance Fund. As part of obtaining reasonable assurance as to whether the financial statements were free of material misstatements, we selected and tested transactions and records to determine the Corporation's compliance with certain provisions of the Federal Deposit Insurance Act, as amended (12 U.S.C. 1811 et. seq.), which, if not complied with, could have a material effect on the Bank Insurance Fund's financial statements. However, it should be noted that our objective was not to provide an opinion on the overall compliance with such provisions.

Because of the limited purpose for which our tests of compliance were made, the laws and regulations tested did not cover all legal requirements with which the Corporation has to comply.

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The results of our tests indicate that, with respect to the items tested, the Corporation complied, in all material respects, with those provisions of laws and regulations that could have a material effect on the Fund's financial statements. With respect to transactions not tested, nothing came to our attention that caused us to believe that the Corporation had not complied, in all material respects, with those provisions.

Charles A. Bowsher
Comptroller General
of the United States

June 28, 1990

Statements of Financial Position

FEDERAL DEPOSIT INSURANCE CORPORATION
BANK INSURANCE FUND
STATEMENTS OF FINANCIAL POSITION
(In thousands)

	December 31	
	1989	1988
Assets		
Cash and cash equivalents (Note 3)	$ 4,813,914	$ 2,928,010
Investment in U. S. Treasury obligations, net (Note 4)	8,925,360	13,292,644
Accrued interest receivable on investments and other assets	279,333	652,119
Net receivables from bank assistance and failures (Note 5)	5,498,127	5,813,873
Property and buildings (Note 6)	97,673	77,534
	$ 19,614,407	**$ 22,764,180**
Liabilities and the Fund Balance		
Accounts payable, accrued liabilities and other	49,701	64,763
Liabilities for estimated bank assistance (Note 7)	3,820,297	3,877,376
Liabilities incurred from bank assistance and failures (Note 8)	2,412,685	4,651,388
Estimated losses from litigation	122,201	109,523
Total Liabilities	**6,404,884**	**8,703,050**
Fund Balance	13,209,523	14,061,130
	$ 19,614,407	**$ 22,764,180**

See accompanying notes

Statements of Income and the Fund Balance

FEDERAL DEPOSIT INSURANCE CORPORATION
BANK INSURANCE FUND
STATEMENTS OF INCOME AND THE FUND BALANCE
(In thousands)

	For the Year Ended December 31	
	1989	**1988**
Revenue		
Assessments earned (Note 9)	$ 1,885,029	$ 1,773,011
Interest on U. S. Treasury obligations	1,371,962	1,396,402
Other revenue	237,637	178,245
Total Revenue	**3,494,628**	**3,347,658**
Expenses and Losses		
Administrative operating expenses	213,855	223,911
Merger assistance losses and expenses	235,314	1,023,926
Provision for insurance losses (Note 5)	3,811,290	6,298,266
Nonrecoverable insurance expenses	85,776	42,267
Total Expenses and Losses	**4,346,235**	**7,588,370**
Net Income (Loss)	**(851,607)**	**(4,240,712)**
Fund Balance - January 1	**14,061,130**	**18,301,842**
Fund Balance - December 31	**$ 13,209,523**	**$ 14,061,130**

See accompanying notes

Statements of Cash Flows

FEDERAL DEPOSIT INSURANCE CORPORATION
BANK INSURANCE FUND
STATEMENTS OF CASH FLOWS
(In thousands)

	For the Year Ended December 31	
Cash Flows From Operating Activities:	**1989**	**1988**
Cash inflows from:		
Assessments earned	$ 1,885,029	$ 1,773,011
Interest on U. S. Treasury obligations	1,446,156	1,492,126
Recoveries from bank assistance and failures	4,285,312	4,451,660
Increase (decrease) in accounts payable, accrued liabilities and other	(15,064)	60,999
Cash outflows for:		
Administrative operating expenses	214,294	226,245
Disbursements for bank assistance and failures	6,637,407	6,639,154
Increase (decrease) in accrued interest receivable on investments and other assets	(372,786)	204,951
Net Cash Provided by Operating Activities	**1,122,518**	**707,446**
Cash Flows From Investing Activities:		
Cash inflows from:		
Maturity and sale of U. S. Treasury obligations	6,092,095	3,390,000
Cash outflows for:		
Purchase of U. S. Treasury obligations	1,773,967	1,985,938
Property and buildings	21,527	5,483
Net Cash Provided by Investing Activities	**4,296,601**	**1,398,579**
Cash Flows From Financing Activities:		
Cash outflows for:		
Payments of liabilities incurred from bank assistance and failures	3,533,215	502,957
Cash Used by Financing Activities	**3,533,215**	**502,957**
Net Increase in Cash and Cash Equivalents	**1,885,904**	**1,603,068**
Cash and Cash Equivalents - January 1	**2,928,010**	**1,324,942**
Cash and Cash Equivalents - December 31	**$ 4,813,914**	**$ 2,928,010**

See accompanying notes

Notes to Bank Insurance Fund (BIF) Financial Statements

DECEMBER 31, 1989 and 1988

1. Impact of FIRREA Legislation:

The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) became public law on August 9, 1989. The primary purpose of the legislation was to reform, recapitalize, and consolidate the federal deposit insurance system so as to restore the public's confidence in the savings and loan industry and to ensure a safe and stable system of affordable housing finance through major regulatory reforms, strengthened capital standards and safeguards for the disposal of recoverable assets. FIRREA abolished the Federal Savings and Loan Insurance Corporation (FSLIC) and the Federal Home Loan Bank Board (FHLBB). Their functions were transferred, in a prescribed manner, to the Federal Deposit Insurance Corporation (FDIC), the Office of Thrift Supervision, the Federal Housing Finance Board, and the Resolution Trust Corporation (RTC).

Under FIRREA, the FDIC became the administrator of two separate and distinct insurance funds: the Bank Insurance Fund (BIF; formerly the Deposit Insurance Fund) which insures the deposits of all BIF-member banks, and the Savings Association Insurance Fund (SAIF) which insures the deposits of all SAIF-member savings associations (formerly a function of the FSLIC). Both insurance funds are maintained separately to carry out their respective legislative mandates, with no commingling of assets or liabilities. The FSLIC Resolution Fund (FRF), a third separate fund under FDIC management, and the RTC replaced the FSLIC in case resolution activities. The FRF will complete the resolution of all thrifts that failed or were assisted before January 1, 1989; the RTC will resolve all troubled thrift cases that occur from January 1, 1989 through August 8, 1992, after which the SAIF will begin resolving cases.

These financial statements pertain to the financial position, results of operations, and cash flows of the Bank Insurance Fund only.

2. Summary of Significant Accounting Policies:

General. These statements do not include accountability for assets and liabilities of closed insured banks for which the BIF acts as receiver or liquidating agent. Periodic and final accountability reports of the BIF activities as receiver or liquidating agent are furnished to courts, supervisory authorities, and others as required.

U. S. Treasury Obligations. Securities are shown at amortized cost, which is the purchase price of securities less the amortized premium or plus the accreted discount. Such amortizations and accretions are computed on a daily basis from the date of acquisition to the date of maturity. Interest is also calculated on a daily basis and recorded monthly using the constant-yield method.

Allowance for Loss on Receivables From Bank Assistance and Failures. The BIF records as a receivable the funds advanced for assisting and closing banks and establishes an estimated allowance for loss. The allowance for loss represents the difference between the funds advanced and the expected repayment, based on the estimated cash recoveries from the assets of the assisted or failed bank, net of all liquidation costs, and also from dividends received from, and sales of, equity instruments acquired in assistance agreements (the proceeds of which are deferred pending final settlement of the assistance transaction).

Litigation Losses. The BIF establishes an estimate for potential loss from litigation against the BIF in its corporate and receivership capacity. The FDIC Legal Division recommends these estimated losses on a case-by-case basis.

Depreciation. The cost of furniture, fixtures, and equipment is expensed at time of acquisition. This policy is a departure from generally accepted accounting principles; however, the financial impact is not material to the BIF financial statements. The Washington Office Buildings are depreciated on a straight-line basis over a 50-year estimated life. The San Francisco Condominium Offices are depreciated on a straight-line basis over a 35-year estimated life.

Merger Assistance Losses and Expenses. The costs incurred by the BIF which resulted from either providing assistance to open insured banks or merging of insured banks are recorded as merger assistance losses. These costs, which are not liquidation-related, are specified in the terms of the agreements and have no potential for recovery by the BIF.

Nonrecoverable Insurance Expenses. Nonrecoverable insurance expenses are incurred by the BIF as a result of: (1) paying insured depositors in closed bank payoff activity; (2) administering and liquidating assets purchased in a corporate capacity; (3) bid-package preparation for assistance transactions; and, (4) bridge bank operations.

Reclassifications. Reclassifications have been made in the 1988 Financial Statements to conform to the presentation used in 1989.

3. Cash and Cash Equivalents:

The BIF considers cash equivalents to be short-term, highly liquid investments with original maturities of three months or less. This includes the purchase of one-day Special Treasury Certificates (in thousands):

	December 31	
	1989	1988
Cash	$ 77,443	$ 12,644
Cash Equivalents	4,736,471	2,915,366
	$ 4,813,914	**$ 2,928,010**

4. U. S. Treasury Obligations:

All cash received by the BIF not used to defray operating expenses or for outlays related to assistance to banks and liquidation activities or invested in short-term highly liquid investments is invested in U. S. Treasury obligations. The BIF investment portfolio consists of the following (in thousands):

DECEMBER 31, 1989

Maturity	Description	Yield to Maturity at Market	Book Value	Market Value	Face Value
Less than one year	U.S.T. Bills, Notes & Bonds	8.16	$ 1,812,004	$ 1,824,807	$ 1,800,000
1-3 years	U.S.T. Notes & Bonds	7.99	5,446,301	5,414,175	5,300,000
3-5 years	U.S.T. Notes & Bonds	7.97	1,667,055	1,669,277	1,700,000
			$ 8,925,360	**$ 8,908,259**	**$ 8,800,000**

DECEMBER 31, 1988

Maturity	Description	Yield To Maturity at Market	Book Value	Market Value	Face Value
Less than one year	U.S.T. Bills, Notes & Bonds	9.07	$ 4,289,304	$ 4,302,784	$ 4,280,000
1-3 years	U.S.T. Notes & Bonds	9.21	5,004,351	4,935,705	4,900,000
3-5 years	U.S.T. Notes & Bonds	9.21	3,998,989	3,809,137	3,900,000
			$13,292,644	**$13,047,626**	**$13,080,000**

The unamortized premium, net of unaccreted discount, for 1989 and 1988 was $125,360,000 and $212,644,000, respectively. The amortized premium expense, net of accreted discount income, for 1989 and 1988 was $49,157,000 and $95,724,000, respectively.

5. Net Receivables from Bank Assistance and Failures (in thousands):

	December 31	
	1989	1988
Receivables from Bank Assistance:		
Open banks	$ 1,640,443	$ 1,301,753
Facilitate deposit assumptions	36,000	36,000
Facilitate merger agreements	134,398	350,648
Accrued interest receivable	14,366	8,257
Allowance for losses	(1,153,122)	(1,110,328)
Deferred settlements	(5,198)	-0-
	666,887	**586,330**
Bridge Bank Receivable:		
Capitalization	1,950,000	1,008,241
Accrued interest receivable	93,582	8,866
Allowance for losses	(1,750,000)	-0-
	293,582	**1,017,107**
Continental Bank (CINB) Assistance:		
Loans and related assets	2,018,692	2,153,189
Dividend receivable	-0-	12,797
Preferred stock/common stock	73,436	515,436
Allowance for losses	(1,057,727)	(1,280,110)
Deferred settlement	(284,217)	(159,090)
	750,184	**1,242,222**
Receivables from Bank Failures:		
Insured Depositor Payoff	4,952,026	3,207,323
Depositors' claims unpaid	79,055	32,841
Purchase and Assumption transactions	9,347,867	8,456,417
Corporate Purchase transactions	523,239	500,999
Allowance for losses	(11,114,713)	(9,229,366)
	3,787,474	**2,968,214**
	$ 5,498,127	**$ 5,813,873**

1989
ANALYSIS OF CHANGES IN ALLOWANCE FOR LOSSES
(In thousands)

	Beginning Balance	Provision For Loss	Transfers And Adjustments	Ending Balance
Open bank assistance	$ 1,110,328	$ 42,794	$ -0-	$ 1,153,122
CINB	1,439,200	(222,383)	(159,090)	1,057,727
Bridge Bank	-0-	-0-	1,750,000	1,750,000
Closed Bank:				
Insured Depositor Payoff	2,006,406	1,172,612	(12,959)	3,166,059
Purchase and Assumption	6,925,445	877,658	(77,138)	7,725,965
Corporate Purchases	297,515	(74,826)	-0-	222,689
Total Closed Bank	**9,229,366**	**1,975,444**	**(90,097)**	**11,114,713**
Liabilities for estimated bank assistance	3,877,376	2,002,757	(2,059,836)	3,820,297
Estimated losses from Corporation litigation	109,523	12,678	-0-	122,201
Total Allowance for Losses	**$15,765,793**	**$3,811,290**	**$ (559,023)**	**$19,018,060**

1988
ANALYSIS OF CHANGES IN ALLOWANCE FOR LOSSES
(In thousands)

	Beginning Balance	Provision For Loss	Transfers And Adjustments	Ending Balance
Open bank assistance	$ 115,105	$ 53,271	$ 941,952	$ 1,110,328
CINB	1,640,852	(201,652)	-0-	1,439,200
Closed Bank:				
Insured Depositor Payoff	1,634,862	423,578	(52,034)	2,006,406
Purchase and Assumption	5,072,785	1,966,368	(113,708)	6,925,445
Corporate Purchases	120,690	179,825	(3,000)	297,515
Total Closed Bank	**6,828,337**	**2,569,771**	**(168,742)**	**9,229,366**
Liabilities for estimated bank assistance	1,236,952	3,877,376	(1,236,952)	3,877,376
Estimated losses from Corporation litigation	600	(500)	109,423	109,523
Total Allowance for Losses	**$ 9,821,846**	**$6,298,266**	**$ (354,319)**	**$15,765,793**

The BIF liabilities for estimated bank assistance include amounts transferred to other line items, adjustments for cash outlays, and deferred settlements.

First RepublicBank/NCNB Texas National (Bridge Bank):

During 1989, the FDIC sold its shares of stock in NCNB Texas National Bank to NCNB Corporation for $1.1 billion, resulting in a gain of approximately $270 million.

Termination and final asset pool settlement is scheduled to occur on the fifth anniversary (November 22, 1993) of the agreement. At the time of termination, the FDIC must (a) purchase remaining unliquidated assets at fair market value; (b) settle with NCNB for the current settlement account balance arising from administering the Separate Asset Pool; and (c) settle with NCNB for deferred settlement account balances arising from gains and losses on disposition of assets as well as charge-offs and write-ups of pool assets.

The Separate Asset Pool balance on December 31, 1989 was $4.7 billion. Total estimated cost for the length of the entire Assistance Agreement is projected to be $2.9 billion.

MCorp/BancOne (Bridge Bank):

On March 28, 1989, twenty of the twenty-five MCorp subsidiary banks were declared insolvent by their chartering authorities and subsequently closed, with the FDIC appointed receiver. The FDIC organized a new Deposit Insurance Bridge Bank, N.A., Dallas, Texas, chartered by the Comptroller of the Currency (OCC) to purchase all assets and assume deposits and certain non-deposit liabilities from the failed institutions.

On July 5, 1989, the FDIC, BancOne Corporation, BancOne Texas Corporation, and BancOne Texas, N.A. entered into a financial assistance agreement designed to capitalize and stabilize the new bridge bank. The final approval on January 1, 1990 of the principal terms of BIF outlays and costs for the merger assistance included:

(a) The BIF will purchase 3,375,000 shares of Class B non-voting Convertible Common Stock and 1,250,000 shares of Class C non-voting Common Stock of BancOne Texas, N.A. in exchange for a note payable in the amount of $416.3 million due on or before the day on which the FDIC no longer owns any shares of such stock.

(b) The BIF funded negative equity of the Bridge Bank (including Bridge Bank operating losses) during its tenure of operation (March 29, 1989 to December 31, 1989), as well as mark-to-market for assets and liabilities as of the date of BancOne's acquisition, January 1, 1990. During January 1990, total funding of $2.6 billion was paid by (i) assumption of FRB indebtedness including principal and interest totalling $1.519 billion and forgiveness of a $300 million subordinated note advanced to the Bridge Bank, and (ii) a non-negotiable promissory note to BancOne Texas in the amount of $737 million due on or before March 1, 1995.

(c) By terms of the assistance agreement, the BIF and BancOne Texas, N.A. transferred to a Separate Asset Pool $2.5 billion of troubled assets and owned real estate of the insolvent MCorp banks. BancOne retains the right to transfer additional troubled loans to the Separate Asset Pool during its first two years of operations. Administration and funding costs of the Separate Asset Pool are to be borne by the BIF during its five year tenure.

Final settlement on the Separate Asset Pool will occur no later than January 1, 1995. At such time, the BIF will settle with BancOne Texas, N.A. for the current settlement account balance arising from the administration of the separate asset pool and for the deferred settlement account balance arising from gains and losses on the disposition of assets as well as charge-offs and write-ups of pool assets. In addition, the BIF will purchase the remaining unliquidated assets of the pool at fair market value. The total estimated cost to the BIF is $2.7 billion.

Texas American Bancshares/Texas American (Bridge Bank):

On July 20, 1989, the twenty-four subsidiary banks of Texas American Bancshares, Inc. were declared insolvent by their chartering authorities and subsequently closed, with the FDIC appointed receiver. Pursuant to the authority granted in 12 U.S.C. 1821, the FDIC organized a new national "bridge bank" called Texas American Bridge Bank, N.A., Fort Worth, Texas, to purchase all assets and assume deposits and certain non-deposit liabilities from the failed institutions.

Also on July 20, 1989, the FDIC Board of Directors approved the acquisition of Texas American Bridge Bank by Deposit Guaranty Bank, Dallas, Texas. An Interim Management Agreement was executed for the operation of the bridge bank pending completion of the assistance agreement. The financial assistance agreement was consummated on January 31, 1990, principal terms of which included: (a) the BIF funded negative equity of the Bridge Bank (renamed Team Bank) including the Bridge Bank operating losses incurred during its tenure of opera-

tion July 20, 1989 through January 31, 1990, as well as mark-to-market of certain assets and liabilities as of the date of Deposit Guaranty acquisition January 31, 1990; and (b) the FDIC and Deposit Guaranty Bank transferred approximately $772 million of troubled assets and owned real estate of the insolvent Texas American institutions to a Separate Asset Pool for liquidation. Administration and funding costs of the Separate Asset Pool are to be borne by the BIF. Total estimated cost to the BIF is approximately $900 million.

CINB Assistance:

The CINB assistance agreement, entered into on September 26, 1984, between the FDIC, the Federal Reserve Board, the Comptroller of the Currency, and a group of major U. S. banks terminated when it reached its prescribed valuation date on September 26, 1989. The Bank Insurance Fund (BIF) made the final payment for the indebtedness assumed of $2.2 billion on September 26, 1989.

During the term of the agreement, collection proceeds totaled $2.6 billion. Application of the proceeds were to administrative costs and interest expense totaling $176 million and $1.1 billion, respectively, and $1.3 billion in principal payments owing under the FRB agreement. The BIF estimated allowance for loss as of December 31, 1989 was $1.0 billion, which represents the difference between the amount funded and the amount BIF estimates as recoverable from the remaining assets and future proceeds from the sale of equity instruments which will be deferred until final disposition of the remaining assets.

Under the terms of the agreement, on the valuation date, the BIF exercised its option to acquire from Continental Illinois Holding Corporation (CIHC) the 10,080,809 remaining shares of Continental Bank Corporation (CBC) common stock. For every $20 of loss the BIF incurred, the BIF was entitled to acquire one share of CBC common stock at an exercise price of $0.00001 per share.

During 1989, the BIF sold all its shares (12.838 million) of the Continental Bank Corporation (CBC) Adjustable Rate Preferred Stock, Class A, valued at $280 million, for $273 million. Also, 7.2 million shares of CBC Junior Perpetual Convertible Preference Stock, valued at $162 million, was sold for $217 million. Cash dividends received for the year ended December 31, 1989 on the Junior Perpetual Convertible Preference Stock and the Adjustable Rate Preferred Stock, Class A were $11.4 million and $25.8 million, respectively. The gain on sale and the cash dividends received are being deferred until final disposition has been made of the remaining assets.

In addition, the BIF has remaining 3.264 million shares of the Junior Perpetual Convertible Preference Stock, which has a fair market value as of December 31, 1989 of $81 million. Also, the BIF retains the 10,080,809 shares of CBC common stock resulting from the exercise of the option, that as of December 31, 1989 has a fair market value of $199 million.

Net Worth Certificate Program:

The net worth certificate program was established at the FDIC by authorization of the Garn-St Germain Depository Institutions Act of 1982. Under this program, the BIF would purchase a qualified institution's net worth certificate and, in a non-cash exchange, the BIF would issue its non-negotiable promissory note of equal value. The total assistance outstanding to qualified institutions as of December 31, 1989 and 1988, is $258,539,000 and $321,897,000, respectively. As of December 31, 1989 and 1988, the financial statements excluded $258,539,000 and $321,897,000, respectively, of net worth certificates, for which no losses are expected. The original authority to issue net worth certificates expired October 13, 1986. The Competitive Equality Banking Act of 1987 reinstated the net worth certificate program through October 13, 1991.

6. Property and Buildings (in thousands):

	December 31	
	1989	**1988**
Land	$ 31,930	$ 31,850
Office buildings	77,643	56,197
Accumulated depreciation	(11,900)	(10,513)
	$ 97,673	**$ 77,534**

The BIF 1776 F Street property note payable of $5,939,000 was paid in full as of December 31, 1989.

A portion of depreciation expense is allocated to the failed banks as liquidation expense. In both 1989 and 1988, the amount of depreciation expense allocated to the failed banks was $496,000.

7. Liabilities for Estimated Bank Assistance:

The BIF records an estimated loss for its future or potential assistance to those banks which the regulatory process has identified as being distressed and where ongoing negotiations and/or current agreement terms indicate that BIF assistance will be necessary. The BIF outstanding liabilities for this estimated bank assistance as of December 31, 1989 and 1988, are $3,820,297,000 and $3,877,376,000, respectively.

The BIF has included in the December 31, 1989 Liabilities for Estimated Bank Assistance $535,963,000 of realized proceeds from the sale of equity instruments and other such transactions associated with the assisted institution. BIF defers recognition of such proceeds pending final termination of the assistance agreement. Such proceeds are available to fund future assistance costs and have been considered in determining the estimated loss to the BIF for future assistance.

8. Liabilities Incurred from Bank Assistance and Failures (in thousands):

	December 31	
	1989	**1988**
Funds held in trust	$ 489	$ 233,278
Depositors' claims unpaid	79,055	32,841
Notes indebtedness	798,982	998,818
Guaranty assistance	6,660	14,539
Federal indebtedness	1,450,000	3,316,178
Accrued interest/other liabilities	77,499	55,734
	$ 2,412,685	**$ 4,651,388**

Maturities of these liabilities for each of the next five years and thereafter are (in thousands):

1990	1991	1992	1993	1994	1995/Thereafter
$ 1,808,614	$ 206,311	$ 199,558	$ 103,919	$ 5,741	$ 88,542

9. Assessments:

The Federal Deposit Insurance (FDI) Act, as amended by FIRREA, directs that the FDIC set assessment rates for the Bank Insurance Fund members annually in accordance with the legislatively mandated rates against a member's average assessment base.

The FDI Act also provides for an assessment credit to BIF members when the Board of Directors determines that the BIF reserve ratio is expected to exceed the designated reserve ratio in the succeeding year, after taking into account expected expenses and revenues. The FDI Act defines the BIF designated reserve ratio as (i) 1.25 percent of estimated insured deposits; or (ii) a higher percentage, not to exceed 1.50 percent, as determined by the Board of Directors to cover expected risks of future losses.

The assessment rate is 0.12 percent for calendar year 1990. Based on the present projected status of the BIF, and anticipated expenses and revenue for the next year, the reserve ratio is not expected to exceed the designated reserve ratio. Therefore, insured members will not receive an assessment credit in 1990.

10. Pension Plan and Accrued Annual Leave:

The FDIC eligible employees assigned to the Bank Insurance Fund are covered by the Civil Service Retirement and Disability Fund. Matching employer contributions provided by the BIF for all eligible employees were approximately $13,786,000 and $13,404,000 for the years ending December 31, 1989 and 1988, respectively.

Although the BIF contributes a portion of pension benefits for eligible employees and makes the necessary payroll withholdings from them, the BIF does not account for the assets of the Civil Service Retirement and Disability Fund and does not have actuarial data with respect to accumulated plan benefits or the unfunded liability relative to its eligible employees. These amounts are reported by the U. S. Office of Personnel Management (OPM) for the Civil Service Retirement and Disability Fund and are not allocated to the individual employers. OPM also accounts for all health and life insurance programs for retired BIF eligible employees.

The BIF liability to employees for accrued annual leave is approximately $18,430,000 and $14,698,000 at December 31, 1989 and 1988, respectively.

11. Commitments:

The BIF lease agreement commitments for office space are $150,921,000 for future years. The agreements contain escalation clauses resulting in adjustments, usually on an annual basis. During 1989 and 1988, lease space expense was $29,390,000 and $34,038,000, respectively.

Leased space fees for future years are as follows (in thousands):

1990	1991	1992	1993	1994	1995/Thereafter
$ 31,835	$ 25,223	$ 18,363	$ 14,540	$ 11,758	$ 49,202

12. Entrance and Exit Fee Revenue:

In accordance with FIRREA provisions, the BIF will receive both entrance and exit fees for conversion and transfer transactions between the BIF and the SAIF. Interim regulations describing the fee calculations have been approved by the FDIC Board of Directors, however, revisions are anticipated with final approval expected in the coming year.

The BIF has elected not to record the entrance and exit fee revenues which had been calculated using the interim regulations until the regulations have been finalized. Approximately $2.4 million in revenues had been calculated for conversion and transfer transactions consummated as of December 31, 1989.

13. Contingencies:

The FDIC and bank chartering authorities are directing additional resources to the monitoring of the financial condition of certain large banks predominately located in the Northeast region. These institutions are experiencing the effects of softening real estate markets and weakening state economies and may, in time, require financial assistance from the BIF. At this time, however, the FDIC cannot reasonably estimate the timing of such assistance or the expected cost to the BIF. Depending on the extent of the continued downturn in the condition of these segments of the economy in the Northeast, the financial assistance required could have a material impact on the condition of the Bank Insurance Fund itself.

14. Supplementary Information Relating to the Statements of Cash Flows (in thousands):

Reconciliation of net income (loss) to net cash provided by operating activities:

	For the year ended December 31	
	1989	1988
Net Income (Loss)	$ (851,607)	$(4,240,712)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Amortization of U. S. Treasury obligations	49,156	95,724
Interest on funds held in escrow	25,037	-0-
Building depreciation	1,387	891
Provision for insurance losses	3,811,290	6,298,266
Accrual of assets and liabilities from bank assistance and failures	(127,425)	12,934
Loss incurred for debt assumption	-0-	1,000,000
Loss incurred for forgiveness of note receivable	-0-	131,759
Net cash disbursed for bank assistance and failures not impacting income	(2,143,042)	(2,447,464)
Increase (decrease) in accounts payable, accrued liabilities and other	(15,064)	60,999
(Increase) decrease in accrued interest receivable on investments and other assets	372,786	(204,951)
Net cash provided by operating activities	**$ 1,122,518**	**$ 707,446**

Schedule of non-cash transactions incurred from bank assistance and failures:

	For the year ended December 31	
	1989	1988
Increase (decrease) in net receivable from bank assistance and failures:		
Preferred stock	$ (320,000)	$ 970,000
Notes receivable	1,770,000	2,100
Notes in lieu of cash	-0-	18,673
Depositors' claims unpaid	46,213	14,124
Transfer of allowance for loss	(1,950,000)	(941,952)
Total Increase (Decrease)	**(453,787)**	**62,945**
Decrease (increase) in liabilities incurred from bank assistance and failures:		
Notes payable	(1,450,000)	(990,773)
Pending claims of depositors	(46,213)	(14,124)
Liabilities for estimated assistance transfer	1,950,000	941,952
Total Decrease (Increase)	**453,787**	**(62,945)**
	$ -0-	$ -0-

GAO's March 7, 1990, Letter to the Secretary of the Treasury

Comptroller General
of the United States

Washington, D.C. 20548

March 7, 1990

The Honorable Nicholas F. Brady
The Secretary of the Treasury

Dear Mr. Secretary:

This letter responds to the notice published in the Federal Register on December 6, 1989, in which you requested comments on the topics being addressed by the Department of the Treasury's study of the federal deposit insurance system. We are only commenting on the issues identified under the topic of auditing and on-site examination as they relate to banks and savings associations.

Under this topic, you requested comments on whether a closer relationship between the auditors and regulators of depository institutions would benefit the deposit insurance system. You also asked for comments on the feasibility of adopting regulations that are the same as, or similar to, the audit provisions of England's Banking Act of 1987. Overall, we support establishing a closer relationship between auditors and regulators and implementing regulations similar to many of the audit provisions in the Banking Act. We also believe that other improvements are needed to better ensure the safety and soundness of insured depository institutions.

The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) also requires us to study and report on deposit insurance issues and to conduct a comprehensive study of the credit union system. Our studies are currently in process.

Other work that we plan to complete this year will also address some of the other issues you raised. At the request of the Subcommittee on Financial Institutions Supervision, Regulation and Insurance, House Committee on Banking, Finance and Urban Affairs, we are currently reviewing the condition of the Bank Insurance Fund and the banking industry. In addition, due to our concerns that current accounting requirements may not meet the regulators' needs, we recently started a study of bank accounting practices. Our purpose is to determine whether market value accounting would provide more useful disclosure of the true financial condition of banks.

GAO SUPPORTS MORE COMPREHENSIVE AUDITING AND REPORTING REQUIREMENTS

As you are aware, GAO has long been an advocate of and continues to strongly support audit and management reporting requirements. We believe that the management of all insured banks and savings associations should be required to issue reports assessing the effectiveness of their internal control structures and their compliance with laws and regulations related to safety and soundness. Further, all insured banks and savings associations should be required to undergo annual financial audits. Also, the role of auditors should be expanded to have them review and report on management's assertions contained in their report on internal controls and compliance. Our opinion on the need for management reporting and audit requirements is driven by three fundamental beliefs.

First, the federal government, as insurer of deposits, has a significant contingent liability to honor those deposits in the event of default. It therefore needs adequate mechanisms to protect its interests. FIRREA included many needed reforms, including strengthened capital requirements, limits on the activities of insured institutions, and strengthened supervision and enforcement. However, these reforms are not meaningful unless we ensure that institutions maintain strong internal controls, adhere to laws and regulations, and properly report their financial condition. Requiring management and audit reports would help fill a void in our current supervisory and examination structure. These requirements would also provide the federal government with a strong tool to help protect its interests.

Second, management of banks and savings associations have a fiduciary responsibility to operate their institutions in a safe and sound manner and protect the interests of their depositors. However, our work on the causes of savings association and bank failures showed that these failures were caused in large part by internal control weaknesses and noncompliance with laws and regulations directly within the control of management. This failure by management to fulfill its fiduciary responsibility for operating the institutions in a safe and sound manner occurred even though guidance, regulations, and directives were in place regarding their responsibilities. Requiring management to report to the regulators and deposit insurer on their responsibilities for establishing and maintaining an effective internal control structure, including controls for compliance with laws and regulations, and on the effectiveness of their internal controls would help ensure that controls are being maintained.

Third, we believe that the accounting profession has a responsibility to protect the government's and the taxpayers' interests when accepting an audit engagement of an insured depository institution. As such, the profession should take a proactive role in assisting institutions and the regulators to identify, prevent, and correct problems in financial reporting and internal controls. Regulators have come to increasingly rely on "off-site" monitoring using reported financial information. Therefore, it is imperative that this information be accurate and reliable. The accounting profession is in a unique position to help ensure the accuracy of this financial information. Further, expanding the role of auditors to require them to report on management's assertions on internal controls and compliance with laws and regulations is in keeping with our belief that the accounting profession has to assume greater responsibility than it currently has when accepting an audit engagement of an insured institution.[1] It would also help ensure the validity and reliability of the management report.

You have asked for comments on three specific proposals:

-- Requiring auditors to report audit results to the regulators,

-- Requiring regulators to share reports on an institution with its auditors, and

-- Requiring auditors to participate in conferences between the regulator and the institution.

In general, we support the general concepts of these three proposals. However, the full benefit of establishing a closer relationship between depository institution auditors and regulators will not be achieved unless all institutions are required to issue a management report as we have proposed on their internal controls and compliance with laws and regulations, and to undergo an annual financial audit. Consequently, in addition to establishing requirements that would allow a closer relationship between auditors and regulators, auditing and management reporting

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[1]The accounting profession also has to assume greater responsibility when accepting an audit engagement of any public company. Our opinion on the need for management reports and an expanded role for auditors applies to public companies as well as insured banks and savings associations.

requirements for banks and savings associations should be implemented.

We have previously supported and continue to support requiring the results of any audit to be reported to the regulators. Such a requirement is already in place for savings associations and should be implemented for all insured depository institutions. We also believe that regulators' reports on institutions should be shared with the auditor. Although section 931(a) of FIRREA requires an institution to share audit and examination reports with its auditor, we would, with exceptions to cover sensitive situations, support regulations to specifically require regulators to share information with the auditor.

We generally support the concept of auditor participation in meetings between regulators and insured institutions. Such participation would help auditors better fulfill their audit responsibilities. It may also provide the regulator with additional perspective on issues being addressed. However, the responsibility should be on the regulator or the institution to request that the auditor attend meetings. Also, auditor participation in conferences should be balanced with appropriate protection for the auditor from liability for disclosing information which might otherwise contravene any duties to the client. Our detailed comments on the three issues are provided in Enclosure I.

Under the same topic, you also asked about specific provisions in England's Banking Act of 1987. We would support regulations similar to many of the specific sections in that act on which you asked for comment. We have previously supported many of the concepts raised in those sections, such as required audits of entities applying for federal deposit insurance coverage and direct notification by the auditor to the regulator if the auditor is removed or replaced, resigns, or does not seek reappointment.

Nonetheless, we have various concerns with adopting requirements and authorities similar to those contained in some of the Banking Act's provisions. For example, the institution's auditor of record should be appointed by the institution rather than the regulator. Also, any additional auditor responsibility to directly report information to the regulators should be balanced with appropriate protection from liability for the auditor.

In some cases, we have no comments on specific provisions of England's Banking Act other than to note that there currently are similar federal laws and regulations. Our

detailed comments on each of the sections in the Banking Act are provided in Enclosure II.

OTHER RELEVANT ISSUES

Management reporting and audit requirements should go a long way toward preventing internal control weaknesses and noncompliance with laws and regulations. However, this belief is predicated on the quality of both management's assessment of internal controls and compliance with laws and regulations and the auditor's work, and on the auditor's independence. Our prior work on audit quality showed that certain steps should be taken to improve auditing and financial reporting. Many steps, such as revising and improving auditing standards, have already been taken. Some remain to be accomplished. In particular, two items should be considered as a means to ensure the quality and reliability of management and auditor reports.

First, insured depository institutions should be required to establish audit committees made up of outside directors. These directors should be independent in fact and appearance. As the Treadway Commission noted in its October 1987 report, audit committees can play an important role in preventing and detecting fraudulent financial reporting and overseeing internal controls. The audit committee should be responsible for appointing and reviewing the work of the auditor. As such, it would enhance auditor independence by serving as a buffer between management and the auditor.

The audit committee should include at least one attorney familiar with laws and regulations affecting insured institutions. Requiring an attorney to serve on the committee would provide a legal perspective on the application of laws and regulations and the relevant policies and procedures to achieve compliance.

Second, serious consideration should be given to requiring mandatory peer reviews for all auditors of insured depository institutions. Peer reviews serve as the cornerstone of the accounting profession's quality assurance program. They help ensure that auditors maintain high quality operations and adhere to professional standards. Although the American Institute of Certified Public Accountants (AICPA) has implemented a mandatory peer review program for its members in public practice, not all accounting firms are members of the AICPA. We have previously recommended that the Securities and Exchange Commission (SEC) require all firms practicing before it to undergo periodic peer reviews. The federal government is

exposed to potentially tremendous losses from its deposit insurance program. Therefore, every step possible, including mandatory peer reviews of accounting firms doing audits of insured institutions, should be taken to protect its interests.

In addition to steps to ensure the quality of management and auditor reports and the independence of the auditors, two other issues should be considered as a means to enhance financial reporting. First, insured banks and savings associations should be required to provide more disclosure in their annual reports on the risks and uncertainties facing them that are relevant to assessing their financial condition.

Currently, the SEC requires management of public companies to include in their annual reports a section often entitled "Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A)." The Office of Thrift Supervision (OTS) also requires a savings association applying to convert from mutual to stock form to include an MD&A section in its request. In the MD&A section, the SEC and OTS require management to discuss known material events and uncertainties which would be relevant to an assessment of the entity's financial condition, results of operations, and future prospects.

Requiring all insured banks and savings associations to provide more information on risks and uncertainties in annual reports would help regulators, the deposit insurer, depositors, and other financial statement users make better judgments on the areas of operations that deserve additional supervisory focus and on the continued viability of the institution.

Second, auditing and on-site examination requirements should be augmented for money center banks and other large banks and savings associations that, if they fail, would cause a significant loss to the insurance funds. Options that could be considered include:

-- allowing the regulator to appoint an auditor to conduct a joint audit of the institution with the auditor appointed by the institution,

-- requiring that the quarterly financial information submitted to the regulators by such institutions be reviewed by auditors using procedures established by the regulators in consultation with the accounting profession, and

-- requiring more frequent, on-site regulatory examinations of larger institutions.

CONCLUSION

American taxpayers are having to pay billions of dollars to resolve the savings and loan crisis. I believe that we owe it to them to take whatever steps are necessary to prevent another crisis of this magnitude. Positive action to identify and correct internal control weaknesses, noncompliance with laws and regulations, and fraudulent financial reporting is crucial. Enacting requirements similar to England's requirements for auditor and management reports and communications between the regulator and the auditor would be an important step in the right direction. As we have stated, consideration should also be given to establishing other requirements to enhance the quality of management, auditor, and financial reporting.

Sincerely yours,

Charles A. Bowsher
Comptroller General
of the United States

Enclosures - 2

ENCLOSURE I ENCLOSURE I

GAO Comments on Establishing a Closer Relationship Between Regulators and Financial Institution Auditors

This responds to the Department of the Treasury request for comments on whether a closer relationship between depository institution auditors and regulators would benefit the deposit insurance system. As requested, we have addressed the following issues: (1) should the independent auditors and accountants of a federally insured depository institution be required to report the results of any audit of the institution to the appropriate regulator(s); (2) should the appropriate regulator(s) be required to share reports on a depository institution with the institution's independent auditors and accountants; and (3) should the independent auditors and accountants of a federally insured depository institution be required to participate in conferences between the regulator and the depository institution.

In summary, we would support authorizations and requirements for federally insured banks and savings associations similar to those reflected by the three issues raised, and which are contained in many of the provisions of England's Banking Act.

England's Banking Act of 1987 contains requirements applicable to English banks and their auditors and accountants which address some of the three issues presented above. As a preliminary observation, we note that England's Banking Act of 1987 builds on the provisions of the Companies Act of 1985 requiring financial audits and reports by banks and other public companies.[1] Unlike in England, banks in the United States are under no general statutory or regulatory requirement to have annual independent audits. However, some banks are subject to audit as part of the Federal Reserve bank holding company regulations, Securities and Exchange Commission requirements, or state chartering laws. In addition, under a Federal Deposit Insurance Corporation (FDIC) policy statement, applicants for deposit insurance coverage will be required to obtain an independent annual audit for at least the first 3 years after FDIC grants deposit coverage. Federally insured savings associations are required to be audited annually by regulation, rather than by statute.

Some of the auditing and reporting requirements of England's Banking Act address issues related to improving financial management and disclosure that GAO has been concerned about over the years. For example, we supported efforts to include language

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[1]The Companies Act of 1985 is largely a consolidation of prior acts that predate 1985. In addition, audit and reporting requirements for "building societies," the equivalent to our savings associations, are contained in England's Building Societies Act of 1986.

in the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) that would have required institutions to issue reports on the effectiveness of their internal controls and compliance with laws and regulations, and to undergo an annual financial audit. As part of this audit, we proposed that the auditor issue a report to the Federal Deposit Insurance Corporation on management's assertions contained in its report. Also, in recent studies, we have recommended annual independent audit and reporting requirements and direct notification to regulators by terminated auditors. We also supported a general requirement that, under certain circumstances, auditors report information outside of the audited companies.

Issue I - Should Independent Auditors and Accountants of a Federally Insured Depository Institution be Required to Report the Results of Any Audit of the Institution to the Appropriate Regulators

United Kingdom legislation requires management to submit to the regulator audit reports on a bank's internal control system. Section 235 of England's Companies Act of 1985 requires bank directors to report on the development of the bank's business. Schedule 3 of England's Banking Act of 1987 requires banks to maintain accounting records and internal controls. The Bank of England, the principal regulator of banks in the United Kingdom, in interpreting these provisions, requires the auditors to report to the directors or senior management on the bank's internal control system. In addition, sections 236 and 237 of the Companies Act require annual audits and reports on banks' accounting records and financial statements, including assertions made in the directors' report concerning such accounts.

We support requirements applicable to all federally insured banks and savings associations for annual audits and reports. Such a requirement is already in place for savings associations. Office of Thrift Supervision (OTS) regulations require that an independent auditor's report on the institution's financial statements and an audit report on any material weaknesses in internal controls be filed annually by the institution with the regulator. Also, as noted above, we had supported as part of FIRREA a proposal for auditing and reporting requirements for all federally insured banks and savings associations. The proposal we supported would have required institutions' management to report on their internal control structures, including controls to ensure compliance with laws and regulations related to safety and soundness. It also would have required annual audit reports on institutions' financial statements by independent auditors, including reports on the assertions in the management reports.

ENCLOSURE I ENCLOSURE I

In our recent studies of the factors causing banks and savings association failures, we found that serious internal control weaknesses contributed significantly to the failures of those institutions.[2] In our reports, we recognized that management is responsible for maintaining adequate internal control systems, and that management reports and auditor reviews are needed to provide reasonable assurance that the controls are being maintained. To address the serious internal control weaknesses, we recommended that Congress, as a condition for federal deposit insurance, require each insured bank and thrift to (1) prepare annual management reports describing management's responsibilities for preparing financial statements and for establishing and maintaining an effective internal control structure, including controls to ensure compliance with laws and regulations, and (2) obtain an annual independent audit of its financial statements. The auditor would be required to issue an opinion on the institution's financial statements and a report on management's assertions regarding the effectiveness of the institution's internal control structure and compliance with laws and regulations.

Issue II - Should the Appropriate Regulators be Required to Share Reports on a Depository Institution with the Institution's Independent Auditors and Accountants

Section 83 of England's Banking Act of 1987 authorizes the Bank of England to disclose information to a bank's auditor or reporting accountant if it would assist the Bank of England in the discharge of its functions under the act or otherwise would be in the interest of depositors.

We support the concept of requiring regulators, except in limited circumstances, to share reports with an insured institution's auditors and accountants. Such report sharing would help ensure that high quality audits, which are in the regulators' best interests, are performed on insured institutions. Requiring federal regulators to bring matters to the attention of a depository institution's auditor is especially important when the regulator believes a matter is so important that the auditor's knowledge of it could significantly affect the form of the audit or the way in which the auditor's responsibilities are carried out. We note that OTS currently has regulations which authorize it to provide a savings association's independent auditor with access to

[2] Bank Failures: Independent Audits Needed to Strengthen Internal Control and Bank Management (GAO/AFMD-89-25, May 1989); Thrift Failures: Costly Failures Resulted From Regulatory Violations and Unsafe Practices (GAO/AFMD-89-62, June 1989).

the institution's examination reports if the auditor agrees in writing not to disclose the examination report or any portion thereof. In addition, section 931(a) of FIRREA requires federally insured financial institutions to provide their auditor with copies of the institutions' most recent reports of condition and examination, and certain information on supervisory actions concerning the institutions.

However, we do not believe the requirements of section 931(a) of FIRREA are sufficient because that provision relies on the institution to provide the auditor with reports and information. We believe the regulator should be required to notify the auditor of the existence of pertinent regulatory reports, and respond to the auditor's request for such reports. However, there should be exceptions to any general requirement for report sharing by regulators to cover sensitive situations such as those involving litigation and ongoing actions or investigations. In such cases, the regulator should notify the auditor that the reports are not available and explain why they are not available.

Issue III - Should Independent Auditors and Accountants of Federally Insured Depository Institutions be Required to Participate in Conferences Between the Regulator and the Depository Institution

While England's Banking Act does not expressly authorize or require auditors to participate in meetings between the Bank of England and banks, section 47 of the act authorizes auditors to communicate information to the Bank in good faith on a matter which they become aware of in their capacity as auditors, and which is relevant to any function of the Bank under the act without being regarded as having contravened any duty to which they may be subject whether or not the communication was in response to the Bank's request. Audit Guideline 307, which was issued by the Bank, indicates that section 47 of the act permits auditors to communicate with the Bank at meetings. (See Enclosure II for our comments on the section 47 authorization for auditors to communicate in good faith to the Bank.)

We generally support the concept of auditor participation in meetings between regulators and insured depository institutions. Such meetings are an appropriate means of exchanging information between the regulator, the institution, and auditor. Specifically, they would provide an opportunity for the auditor to discuss the affairs of the institution, including the opportunity for the auditor to explain any accounting issues which may be of concern to the regulator, and to hear the regulator's concerns directly. However, auditor participation in meetings or conferences should

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only occur when it is requested by the institution or the regulator.

While we support auditor participation at conferences with regulators and depository institutions, we are concerned that any such participation be balanced with appropriate protection for the auditor. In this regard, we note that section 47 of England's Banking Act insulates the United Kingdom auditor from any liability for disclosure of information which might otherwise contravene any duties to the client. There is no such protection for U.S. auditors. (See discussion in Enclosure II, Item F.) Any provision for auditor participation in meetings should also provide a corresponding limit on auditor liability for any potential disclosures by the auditor at such meetings which could place the auditor in breach of any duties owed to its client.

ENCLOSURE II ENCLOSURE II

GAO Comments on
Significant Provisions of
England's Banking Act of 1987

In addition to requesting comments on the three issues addressed in Enclosure I, the Department of the Treasury also requested comments on the feasibility of adopting regulations that are the same as, or similar to, the audit provisions of England's Banking Act of 1987, which affect the Bank of England's relationship with auditors and reporting accountants. You specifically mention sections 8, 39, 41, 45, 46, 47, 82, 83, 85, and 94 of that act. This enclosure responds to your request to the extent that comments on those provisions have not been provided in Enclosure I.

We have examined the cited provisions of the Banking Act of 1987 and would support federal regulations containing requirements and authorities similar to those contained in the following provisions.

-- Section 8(5), requiring auditor reports in connection with an application to do business;

-- Section 39(1)(b) and (2), authorizing the regulator to require a bank to provide supplemental audit reports and to prescribe the form and content of audit reports;

-- Section 41, authorizing the regulator to appoint investigators and imposing a duty on auditors to provide such investigators with requested information;

-- Section 45, requiring audited accounts and audit reports to be open to public inspection;

-- Section 46, requiring direct notice regarding a change of auditor; and

-- Section 47, authorizing an auditor to communicate to the Bank of England certain information or opinions notwithstanding any duty to the auditor's client.

Except in certain circumstances, we do not support federal regulations similar to the requirement in section 39(2) that reporting accountants be nominated or approved by the regulator. In addition, other than to note that there are similar authorities and requirements in U.S. law, we have no comments on section 82, placing general restrictions on disclosure of confidential information by any person receiving such information; sections 83 and 85, providing exceptions to restrictions on disclosure of confidential information; and section 94, imposing criminal

penalties for providing false or misleading information to regulators.

A. Reports Required in Connection with Application to Do Business

Section 8(5) of England's Banking Act of 1987 authorizes the Bank of England to require an auditor's report on information provided to the Bank in connection with an application to do business.

We support federal regulations which would have a similar effect with regard to institutions applying for federal deposit insurance. We believe that it is necessary for institutions applying for federal deposit insurance to be subject to the same auditing and reporting requirements as institutions already insured. Imposing such requirements on applicants would help ensure that their operations and financial affairs are being conducted in such a way that the interests of depositors will be protected and that they ultimately would not pose a risk to the insurance funds. Proposals which we previously supported (see Enclosure I) required annual financial audits of institutions applying for federal deposit insurance.

B. Power to Obtain Supplemental Reports; Appointment of Reporting Accountant; Form and Content of Reports

Section 39(1)(b) of England's Banking Act requires a bank to provide the Bank of England with a report by an accountant on information which the Bank has required or could require for the performance of its functions under the act. We support regulations similar to this requirement. If federal regulators need supplemental information from an insured financial institution, they should have the flexibility to require that such information be reported on by an auditor or accountant.

Section 39(2) of the Banking Act requires that an accountant reporting under section 39(1)(b) of the act be a person nominated by the Bank of England. We recognize that U.S. regulators already have the authority to employ auditors and accountants to assist them in the examination and inspection of insured institutions. In general, we would not support a requirement which would result in the regulator approving an institution's auditor of record. Nomination and approval of reporting accountants by a federal regulator is generally unnecessary as long as an accountant meets professional standards established by the accounting profession and state regulatory authorities. Further, requiring institutions to establish an audit committee, which would appoint and review the work of the auditor, is a more appropriate means to ensure auditor independence.

ENCLOSURE II   ENCLOSURE II

Nonetheless, auditing and on-site examination requirements should be augmented for banks and savings associations that, if they fail, would cause a significant loss to the insurance funds. One option to augment current requirements would be to allow regulators to appoint auditors to conduct joint audits of such institutions with auditors appointed by the institutions.

Section 39(2) of the Banking Act also authorizes the Bank of England to prescribe through notices (regulations) the form and content of audit reports. We support regulations similar to this requirement. The proposal which we previously supported was similar in that it would have authorized the Federal Deposit Insurance Corporation (FDIC), in consultation with the Comptroller General, to determine the form and content of audit and management reports. This aspect of our proposal was linked to specific criteria for management reports and auditing standards. The proposal required that FDIC, in consultation with the Comptroller General, prescribe specific criteria for management reports. It also required the use of generally accepted auditing standards (GAAS) for financial statement audits, and that FDIC prescribe attestation standards for application to management assertions made in management reports.

Criteria for management reports and auditing standards for financial statement audits are essential ingredients to accurate financial reporting. Thus, we support regulations imposing such requirements.

C. Investigations

Sections 41(1) and (5) of the Banking Act authorize the Bank of England to appoint persons to investigate banks and impose a duty on auditors providing reports under sections 8(5) and 39(1)(b) of the act to disclose such information as requested to the investigators.

We recognize the benefit of such a requirement. The duty imposed on auditors would require them to produce all documents relating to the financial institution which are in their custody or control, including the auditor's own working papers.

However, we have serious concerns regarding the impact of such a requirement on the auditor/client relationship. As we noted in Enclosure I, section 47 of the Banking Act provides the English auditor who discloses certain client information with protection from liability for such disclosures. It should be made clear that any auditor reporting or disclosing information under a duty similar to that imposed by section 41(5) of the Banking Act and

with similar protection from liability would be beneficial to any investigative process because such protection would enhance auditor cooperation without fear of breaching any duty to the auditor's client.

D. Audited Accounts and Reports Open to Public Inspection

Section 45 of England's Banking Act requires a bank to make available for public inspection its most recent audited accounts at United Kingdom offices where it holds itself out as accepting deposits.

We support such a requirement. The proposal which we previously supported required copies of audit reports filed with regulators to be made available for public inspection by regulators, unless restricted by law or regulation.

E. Notice Regarding Change of Auditors

Section 46 of England's Banking Act requires that the Bank of England must be notified by (1) a bank, if an auditor is removed or replaced, and (2) the auditor, if the auditor resigns, does not seek reappointment, or decides to make qualifications to the bank's accounts.

There are no statutory notification requirements in U.S. law. However, some insured financial institutions are subject to notification requirements as part of the regulatory process under Securities and Exchange Commission (SEC) and Office of Thrift Supervision (OTS) regulations. Both SEC and OTS require indirect notification from the audited institution, rather than direct notification from the auditor. Under SEC regulations, the institution must report the change of auditor to the SEC, and provide a letter to the SEC from the former auditor stating whether the auditor is in agreement with the reasons for the change. OTS regulations provide a similar procedure for savings and loan associations, except for an additional requirement that the auditor must discuss the reasons for the termination or change with the regulator, after notification of the change by the thrift. Under a recent American Institute of Certified Public Accountants (AICPA) rule, accounting firms which are members of the SEC practice section must notify the SEC directly if the auditor resigns, does not seek reappointment, or is dismissed.

The AICPA's direct notification rule does not apply to all auditors who may be engaged to audit an insured institution. Therefore, we support a direct notification requirement similar to that in section 46 of England's Banking Act.

ENCLOSURE II ENCLOSURE II

F. Communication by Auditor with Regulator

As we noted in Enclosure I, section 47 of England's Banking Act authorizes auditors to communicate information to the Bank of England in good faith on a matter which they become aware of in their capacity as auditors, and which is relevant to any function of the Bank under the act without being regarded as having contravened any duty to which they may be subject whether or not the communication was in response to the Bank's request.

There is no similar provision in U.S. law. We support a similar provision with limits on auditor liability because it could help protect the interests of depositors of the institution when there is an adverse occurrence or change of circumstances involving the institution. In our recent study of the implementation of changes to improve auditing and financial reporting of public companies, we supported a general requirement that, under certain circumstances, accountants report information, particularly on fraud, outside the audited company.[1] We noted that the extent to which such reporting should be required has not been resolved, and that there is no consensus on this issue among the public accounting profession and others who are concerned with audit quality and the accuracy and reliability of financial disclosures. Nevertheless, we concluded that such reporting is necessary and appropriate in certain circumstances.

While we support the concept, we note that the institution should continue to be the regulator's primary source of information, an arrangement which preserves the auditor/client relationship, and insulates the auditor from liability for breach of any duties owed to the institution. The responsibility to provide the regulator with information should be placed on the auditor only when the institution fails to report the information or the auditor no longer has confidence in the institution's directors or senior management. In such situations, the auditor should first attempt to report the information through the institution's audit committee. If the audit committee is unavailable or does not act promptly, then the auditor should be authorized to report directly to the regulator without being subject to liability for breach of any duty owed the institution.

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1 CPA Audit Quality: Status of Actions Taken to Improve Auditing and Financial Reporting of Public Companies (GAO/AFMD-89-38, March 1989).

ENCLOSURE II

G. Restricted Information; Disclosure of Information

Section 82 of England's Banking Act places general restrictions on disclosure by any person of confidential information obtained under or for purposes of, the act. Section 83 of the act provides exceptions for regulatory disclosure by permitting the Bank of England to disclose confidential information (1) for the purpose of assisting it to discharge its functions under the act, (2) if seeking advice from a qualified person, or (3) if disclosure to an auditor would assist the Bank to discharge its functions under the act or is otherwise in the interests of depositors. Section 85 of the act provides additional exceptions to the general restrictions on disclosure imposed by section 82.

We have no comments other than to note that various federal laws currently place general restrictions on the disclosure of confidential information contained in audit and examination reports of insured financial institutions, and also provide exceptions to the general restrictions placed on the disclosure and use of such information.

H. Civil and Criminal Penalties for Providing False or Misleading Information

Section 94 of England's Banking Act makes it a criminal offense to knowingly or recklessly provide the Bank of England, or an investigator appointed by the Bank under section 41 of the act, with materially false information in purported compliance with the act or in connection with an application to do business. Section 94 also makes it a criminal offense to fail to disclose relevant information to the Bank when it is known that withholding the information was materially significant to the exercise of the Bank's functions.

We have no comments other than to note that Title IX of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 provides civil and criminal penalties that go far beyond the scheme provided in section 94 of the Banking Act. Specifically, subtitle A of Title IX increased the civil money penalties banking agencies may impose for violation of the banking laws, expands the conduct warranting the imposition of such penalties, and significantly strengthens the banking agencies' enforcement powers. Subtitle E imposed civil penalties on financial institutions or officials who act knowingly or with reckless disregard in violating laws, regulations, or orders. Subtitle F increased criminal penalties for certain financial institution offenses and provides for civil and criminal forfeiture procedures for any property obtained in actions or transactions constituting financial institution offenses. In addition, it is a felony under the federal criminal code to knowingly and willfully provide false statements to the federal government.

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

August 14, 1990

Dear Mr. Bowsher:

We have reviewed the draft report to Congress on the Bank Insurance Fund and I would like to compliment your staff on its highly professional product. We appreciate the time and effort Mr. Donald Chapin and his staff put into hearing our views and incorporating clarifying comments regarding FDIC operations.

See comment 1.

There are three areas in the report where further clarification may be needed. First, regarding FDIC operations, the draft report states that "regulators are increasingly relying on off-site monitoring systems to supervise banks." This is true, but to more accurately state it, the report should identify that FDIC's improved off-site monitoring has not been a substitute for an effective on-site examination program. Our goal has been to increase efforts in both regards. In 1988, we adopted a revised policy on priority and frequency of examinations which calls for examining more banks more often. This policy supported by increased staff, greater staff experience and improved efficiencies has resulted in increased on-site examination performance by the FDIC.

See comment 2.

Secondly, the report highlights a potential liquidity problem that might occur for the Fund as a result of $8 billion of troubled assets held by acquirers of the three major asset pool transactions. FDIC staff discussed with GAO that a number of measures have been taken to reduce FDIC exposure to liquidity problems arising from these arrangements. The assets are under contract with specified termination procedures, including notice periods and in some cases a provision for funding. Also, care should be taken in the report to make clear that the "contingent liability" issue relates to liquidity, not unrealized losses. The GAO auditors agreed to make clear that FDIC may be required to purchase only "some undetermined portion" of these assets.

See comment 3.

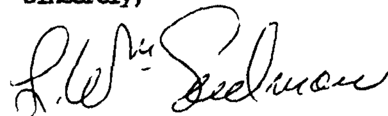
The last issue deals with the appraisal processes used by contractors to evaluate the recoverable value of assets held in the separate asset pools. The GAO report states that there were "unrealistic assumptions used by appraisers" in arriving at recoverable values. We have discussed with the auditors that appraisers are independent contractors working

within industry guidelines and practices. There would appear to be little motivation on the part of appraisers working in our environment to overstate values. Pool appraisals are re-done periodically and sales values compared on an on-going basis to appraisals to determine if any adjustments to the process are necessary.

Thank you for the opportunity to comment on the report.

With best wishes.

Sincerely,



L. William Seidman
Chairman

The Honorable Charles A. Bowsher
Comptroller General
U.S. General Accounting Office
441 G Street, N.W., Room 6114
Washington, DC 20548

The following are GAO's comments on the Federal Deposit Insurance Corporation's letter dated August 14, 1990.

GAO Comments

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

2. Discussion of separate asset pools in chapter 4 was modified to reflect FDIC's comment.

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

Comments From the Board of Governors of the Federal Reserve System

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

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ADDRESS OFFICIAL CORRESPONDENCE
TO THE BOARD

August 15, 1990

Mr. Donald H. Chapin
Assistant Comptroller General
Accounting and Financial
Management Division
U.S. General Accounting Office
Washington, D.C. 20648

Dear Mr. Chapin:

This letter outlines the views of the Board of Governors of the Federal Reserve System on the recommendations contained in the GAO draft report entitled "Bank Insurance Fund: Additional Reserves and Reforms Needed to Strengthen the Fund."

The draft report presents the results of the GAO's audit of the Bank Insurance Fund's financial statements for the years ended December 31, 1989 and 1988. It is the GAO's opinion that the Fund's financial statements are fairly presented in accordance with generally accepted accounting principles.

As part of the analysis relating to its audit opinion, the GAO estimates that losses of $4 billion to $6 billion could be incurred on banks the GAO believes are likely to fail in the near future unless these banks are recapitalized. The draft report acknowledges that these estimated losses do not meet the degree of certainty for loss recognition under generally accepted accounting principles. For this reason, these GAO-estimated losses are not included in the Fund's financial statements. However, the GAO believes the accounting principles applicable to the FDIC should be modified so that, in the GAO's view, the recognition of losses that could reduce the Fund balance is not unduly delayed.

The Board is not in a position to comment on the results of the GAO's audit or on the analysis, judgments, and assumptions employed by the GAO to arrive at its estimates of potential future losses to the Fund. However, in addition to these matters, the report also contains several recommendations regarding ways to strengthen the Fund or reduce the exposure of U.S. taxpayers. The Board's views on these recommendations are set forth below.

- 2 -

First, the GAO recommends that Congress amend FIRREA to authorize the FDIC Chairman to raise the deposit insurance assessment rates beyond those already provided in this statute. In addition, the GAO believes the FDIC Chairman should use this authority to achieve the minimum reserve ratio of 1.25 percent designated in FIRREA by 1995.

See comment 1.

As the GAO is aware, the Department of the Treasury, in conjunction with a number of other government agencies, including the depository institution regulatory agencies, is studying a broad range of possible reforms for addressing and strengthening the Federal deposit insurance system. In conjunction with this study, and separately, the agencies and the Congress will no doubt wish to consider all possible steps for maintaining the strength of our deposit insurance system and for protecting the interests of taxpayers. As part of this broad public policy review, it is reasonable to consider all feasible options, including appropriate adjustments to deposit insurance rates. Of course, the potential impact on the profitability of insured depository institutions and the need for appropriate phase-in arrangements to avoid disruptions are both important considerations in assessing the feasibility and efficacy of higher deposit insurance premiums.

See comment 1.

The GAO also recommends that the Treasury study address other means to protect taxpayers in addition to premium assessments and their impact on banks. FIRREA mandates that the agencies study a number of specific topics concerning the operation of the Federal deposit insurance system. As noted above, it seems entirely appropriate to give consideration to a wide range of feasible options for safeguarding the interests of taxpayers. In this regard, the Treasury has agreed to add to the interagency study a section on capital adequacy and its critical importance in protecting the Fund and limiting the risks to U.S. taxpayers. The Board believes that the recently-adopted risk based capital framework and strong minimum capital ratios can strengthen the incentives of bank owners to manage risks prudently and provide an appropriate buffer between the mistakes of bank managers and the deposit insurance fund. In addition to capital, it is the Board's understanding that the Treasury study will address the importance of on-site examinations and prompt corrective action in safeguarding the deposit insurance system.

See comment 2.

The GAO report also addresses the central role of on-site examinations. In particular, the report recommends that the Federal bank regulatory agencies perform on-site full scope examinations of problem banks and large banks on an annual basis. We agree with the thrust of this recommendation and would carry it further. For example, the Federal Reserve's examination frequency guidelines currently require on-site full scope examinations of all state member banks at least annually, with more frequent examinations for problem banks and large banks.

- 3 -

For small, nonproblem institutions, the Federal Reserve will accept, on an alternate year basis, examinations conducted by state authorities; however, for all large and problem banks, an annual examination by the Federal Reserve is required. The Federal Reserve's support for annual on-site supervisory examinations was reiterated in recent testimony delivered by Chairman Greenspan before the Senate Banking Committee on July 12, 1990. The Board believes that off-premise monitoring and surveillance, while helpful, cannot substitute for an on-site supervisory evaluation of bank assets and operating controls.

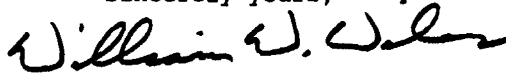
See comment 1.

Finally, the GAO makes two recommendations regarding the operation of separate asset banks set up by the FDIC to manage problem assets in connection with federally assisted merger or acquisition transactions. One recommendation calls for revising the appraisal guidelines used in connection with the disposal of the assets of these banks to reflect more realistic values. The other calls for enhanced monitoring of the use of separate asset pools. The GAO believes this is necessary to ensure that the Fund has the resources to meet its commitments to purchase the assets that could be put back to the FDIC by the acquiring bank in a federally assisted transaction.

Since these recommendations relate to the operation of the FDIC and its liquidation activities, it is difficult for the Board to comment on the specific details of the recommendations at this time. However, as a matter of policy, accurate appraisals and close monitoring of asset values are obviously important elements of any plan to dispose of assets in a way that protects the Fund and the position of U.S. taxpayers.

The Board appreciates the opportunity to respond to the draft GAO report.

Sincerely yours,



William W. Wiles
Secretary of the Board

The following are GAO's comments on the Board of Governors of the Federal Reserve System's letter dated August 15, 1990.

GAO Comments

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

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

Comments From the Office of the Comptroller of the Currency

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

Comptroller of the Currency
Administrator of National Banks

Washington, D.C. 20219

August 9, 1990

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

Dear Mr. Chapin:

As you requested, we have reviewed your draft report titled "Bank Insurance Fund: Additional Reserves and Reforms Needed to Strengthen the Fund" and are pleased to have this opportunity to comment on it. We found the report to be, for the most part, factually accurate, but we have three general concerns with it. First, we believe that the report does not accurately portray the OCC's approach to bank supervision. Second, the report draws inaccurate conclusions about the condition of the banking system and the Bank Insurance Fund. Third, estimates about the number of bank failures and their impact on the Bank Insurance Fund (Fund) are based on limited and insufficient data.

The Supervision of National Banks

See comment 1.

The primary function of bank supervisors is to ensure a safe and stable banking system. At the OCC, we accomplish this by assessing the level of risk in each individual bank, the role that risk may play in the stability of the overall national banking system, and actions that bank management has taken to identify and control those risks. Every national bank is supervised on an ongoing basis by an examiner assigned to monitor the bank. The OCC examiner designs a strategy for supervising each bank, based on analysis of comprehensive data gathered from bank visits, call reports, specialized bank-generated reports, regular contact with bank management, and the bank's supervisory history. The supervisory strategy is updated annually and allocates a level and type of supervision commensurate with the risks that are identified and the bank's systems that are in place to control those risks. The focus of the supervisory strategy for an individual bank is continuously modified as needed to address any significant changes in the bank's condition or the financial environment in which the bank operates.

As part of this ongoing supervision, we maintain a computer-based data file on each national bank. The data base includes the results of examinations and other analyses of the bank's

operations, statistical data on the bank's performance and condition, summaries of communications with a bank's management and board of directors, and information about the progress the bank has made in addressing identified problems. This data base provides a current, comprehensive overview of the condition of the individual bank and is an important means by which the OCC conducts its ongoing supervision.

The OCC's supervisory approach, which utilizes both on-site and off-site supervisory capabilities, promotes an efficient use of our resources to provide us with current information about the condition of each individual bank. We are able to monitor the condition of stable banks and focus our examination resources on the banks and bank activities that represent the greatest risk to the national banking system. Our continuous supervision is designed to identify emerging problems in individual banks and the banking system and to reassign resources as needed.

Before the OCC developed its current method of bank supervision, we operated on a calendar-driven examination schedule that provided for periodic on-site examination of every national bank based on asset size and/or CAMEL rating. Those examinations took several forms, but, for the most part, an examination meant that when the schedule indicated that a bank was due for an examination, a group of examiners went into a bank and completed a set of defined procedures. Unfortunately, this approach provided only a snapshot of the bank's condition; there was little ongoing analysis of a bank's condition between examinations, except for those banks already known to be experiencing significant problems.

This method was adequate when the business of banking was simpler and the economy was more stable, but with the sometimes dramatic changes in bank condition that have occurred in the past decade, it has become more difficult to detect risks through periodic examinations. Thus, our approach to bank supervision has evolved. The important change can be summarized as follows: examiners have more flexibility and accountability in determining what activities to perform at their banks, and when to perform them.

It is not uncommon for this approach to bank supervision to be misunderstood. In fact, it is not as different from the approaches of other supervisors as many think. The OCC devises a supervisory strategy for each national bank annually. National banks receive reports from examiners at least once a year. Examiners are in regular contact with bank management. We give the highest priority to large banks and to problem banks. In fact, in our multinational banks, we have "resident" examiners who continuously supervise the institutions. We have recently decided to significantly increase the staffs of those examiners. Likewise, many of our regional banks have dedicated examiners who supervise those banks on a fulltime basis.

Thus we are somewhat perplexed by the recommendation that full-scope examinations should be performed annually in large banks and problem banks. Without knowing what is meant by "full-scope," it is not easy to respond. In our largest banks, the resident

examiners develop and carry out those bank's supervisory strategies. If a particular area, activity, or process is not examined in any given 12-month period, it would be a result of an informed decision to target resources elsewhere in the institution. Regarding problem banks, the approach is generally the same. While examiners are not necessarily in residence, they perform annual on-site examinations that they complement with frequent off-site analyses. Again, without knowing what is meant by "full-scope," it would seem that our continuous supervision, at a minimum, fulfills the expectations of the recommendation for annual on-site examinations.

<u>Condition of the Banking System and the Bank Insurance Fund</u>

In the two years ending December 31, 1989, 406 FDIC-insured banks failed and more than 1,100 remained on the FDIC's list of problem banks. The number of failures and their cost to the FDIC were the highest in the history of the Fund and resulted in a decline in the fund balance, both in absolute terms and relative to insured deposits.

See comment 2.

Those developments, recent increases in past due and nonaccrual real estate loans, and the potential for future losses on loans to finance highly leveraged transactions or loans to developing countries have understandably given rise to concerns over the condition of the banking system and the health of the Bank Insurance Fund. Unfortunately, we do not believe that the GAO audit is sufficiently rigorous to assess those concerns. For the most part, data cover only two years, 1988 and 1989, an insufficient span of time from which to draw substantive conclusions about industry trends. Most comparisons, moreover, involve aggregate data, which offer a static and limited perspective about the future viability of individual banks. A more reliable assessment would be based on evaluations of banks of different sizes and in different locations and would cover a longer period of time.

See comment 2.

The assessment of the health of the Bank Insurance Fund is also incomplete and, to a certain extent, misleading. Absent is an evaluation of the financial characteristics of failed banks during the years immediately preceding their failure, or some comparable statistical method of specifying criteria to be used for projections of future bank failures. Also missing is a recognition that the OCC has taken steps to close banks earlier than in the past. Under current OCC practice, a bank can be declared insolvent as soon as it has depleted its equity capital; by closing banks when equity is depleted, the exposure of the Fund to losses will be reduced whenever reserves are available to absorb some of the failure costs.

<u>Bank Failures and the Bank Insurance Fund</u>

See comment 1.

The report's outlook on the condition of the banking system forms the basis for the GAO's estimate of the number of institutions with assets of more than $100 million that are highly likely to fail or require regulatory assistance in the near future. Insufficient

detail about the selection criteria was provided to evaluate the reliability of the assertion that "it is highly likely that many, if not all, of [those banks] will fail."

After estimating the number of banks that are likely to fail in the near future, the report attempts to make the case that many more banks may actually be at risk and the Fund could become insolvent because the FDIC's loss rates might increase above historical rates in the future; call report data are unreliable and may understate the losses to which the fund could be exposed, and a national recession or severe regional economic downturns could cause the failure of banks that were not in the GAO's estimates.

See comment 3.

It is difficult to estimate the risk that such developments or deficiencies pose to the Fund, however, without supporting analysis or confirming data. While FDIC loss rates could increase in the future, the OCC's new closure rule should dampen the effect. With respect to inaccurate call report data, moreover, the report does not estimate the extent to which problems had been understated in the past, whether those reporting inaccuracies had delayed supervisory actions, and the costs, if any, to the Bank Insurance Fund that resulted from call report inaccuracies.

See comment 3.

Similarly, it is difficult to estimate the impact of a recession on the number of bank failures, or even to distinguish among recessions of differing severity. No data are presented to support assertions that the changing composition of bank loan portfolios may raise the cost of bank failures, to demonstrate the relative effectiveness of on-site and off-site examinations, or to assess the impact of a recession on the number of bank failures.

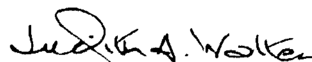
See comment 3.

GAO's projections imply that the Fund's balance would rise from $13.2 billion at the end of 1989 to $27.7 billion in 1995. Given that projection, assertions that the Bank Insurance Fund could be depleted seem alarmist. Care should be taken not to exaggerate the situation and adversely impact the ability of the bank regulators and the Fund to deal with problem banks in an orderly way. By the same token, we are concerned that the reference to an explicit number of banks likely to fail may draw market attention to the identification of those institutions. The risk is that GAO's prediction becomes a self-fulfilling prophecy.

See comment 4.

Thank you for the opportunity to comment. Provided separately, for your consideration, is a page by page listing of suggestions to clarify specific GAO statements contained in the draft report.

Sincerely,



Judith A. Walter
Senior Deputy Comptroller for Administration

The following are GAO's comments on the Office of the Comptroller of the Currency's letter dated August 9, 1990.

GAO Comments

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

2. See "Agency Comments and Our Evaluation" sections in chapters 2 and 3.

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

4. The page by page listing of suggestions is not included in this report at the request of OCC.

Comments From the Department of the Treasury

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

UNDER SECRETARY

DEPARTMENT OF THE TREASURY
WASHINGTON

August 13, 1990

Dear Mr. Chapin:

See comment 1.

My staff and I have reviewed your draft report on the Bank Insurance Fund. The Office of the Comptroller of the Currency here in the Treasury Department is sending you its own very detailed comments. I direct your attention to them.

See comment 2.

You have studied bank regulatory practices and made some assumptions about the number of troubled institutions and the likely cost to the Bank Insurance Fund of addressing their problems. We have some apprehension about the level of specificity in the report regarding problem institutions. For example, it does not seem crucial to your analysis to mention 35 problem institutions and their potential dollar losses. It could be detrimental to specific banks, if readers were to become that interested in so small a number of institutions and their adverse financial condition.

See comment 3.

In general, we applaud the effort your staff has devoted to preparing this report. We do not necessarily agree with their conclusions, but the report should be a useful contribution to a better understanding of the Bank Insurance Fund.

If I can be of further assistance as you complete the report do not hesitate to contact me.

Sincerely,

Robert R. Glauber
Under Secretary for Finance

Mr. Donald H. Chaplin
Assistant Comptroller General
General Accounting Office
Washington, DC 20548

The following are GAO's comments on the Department of the Treasury's letter dated August 13, 1990.

GAO Comments

1. The Office of the Comptroller of the Currency's comments are addressed in appendix V.

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

3. No change to report needed.

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