United States General Accounting Office

GAO

Report to Congressional Committees

February 1993

BANK EXAMINATION QUALITY

FDIC Examinations Do Not Fully Assess Bank Safety and Soundness

148518

GAO

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

Comptroller General
of the United States

B-249414

February 16, 1993

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

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

This report presents the results of our review of bank examinations performed by the Federal Deposit Insurance Corporation (FDIC). Weaknesses in FDIC examinations of loan quality and internal controls, and inadequate quality control over examinations limited FDIC's ability to identify and address bank problems in their early stages. Reliance on unverified state examination results further diminished FDIC's ability to determine the significance and magnitude of bank problems. Improving the quality of FDIC examinations in these areas would aid in the prompt detection and correction of bank problems. Also, improved examinations are critical to the effectiveness of regulatory reforms recently enacted in the Federal Deposit Insurance Corporation Improvement Act of 1991.

We are sending copies of this report to the Secretary of the Treasury; Chairman of the Board of Directors, Federal Deposit Insurance Corporation; other federal banking and thrift regulatory agencies; and other interested parties. Copies will be made available to others on request.

This report was prepared under the direction of Robert W. Gramling, Director, Corporate Financial Audits, who may be reached on (202) 275-9406 if you or your offices have any questions. Major contributors are listed in appendix II.

Charles A. Bowsher

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Comptroller General
of the United States

Executive Summary

Purpose

Record numbers of bank failures during the last 10 years have depleted the Bank Insurance Fund. The Federal Deposit Insurance Corporation (FDIC) is the primary federal regulator for most insured banks, which it examines to identify and control risk. By identifying conditions that lead to problems early, FDIC can intervene and prevent such problems from becoming serious. GAO assessed the quality of FDIC's bank examinations by focusing on its consideration of loan quality, internal controls, work performed by state banking authorities, and quality control over examinations. The assessment included examinations for 11 open banks and 17 banks that failed without warning by FDIC.

Background

FDIC was the primary federal regulator for 7,606 banks as of December 31, 1991. During calendar year 1991, FDIC performed 4,089 safety and soundness examinations for these banks. FDIC uses the results of examinations to support informal actions to correct identified weaknesses that are a supervisory concern. Examinations are also the basis for formal administrative action against banks found to be operating under unsafe or unsound practices.

Loan quality review is one of the most important components of a bank examination because loans ordinarily involve the greatest risk of loss for banks. Review of a bank's internal controls is essential because they impact all bank operations, and unsound control practices contribute significantly to bank failures.

Results in Brief

FDIC's bank examinations did not ensure that examiners detected the full extent of serious safety and soundness weaknesses early enough for FDIC to take appropriate corrective action to prevent banks from failing and minimize losses to the Bank Insurance Fund. Examiners frequently did not obtain sufficient evidence to judge loan quality and the adequacy of allowances established by banks for loan losses. Information in the examiners' working papers about loans and borrowers was often missing, outdated, incomplete, or unverified. The examiners' limited review of internal controls was not sufficient to detect and correct in a timely manner control weaknesses that could lead to bank failure. These deficiencies were exacerbated by inadequate practices for controlling examination quality.

The effectiveness of FDIC's oversight of banks was further limited by its reliance on state examinations to extend intervals between FDIC examinations without assessing the quality of state examination work.

Principal Findings

Insufficient Evidence for Assessing Loan Quality and Adequacy of Loan Loss Reserves

FDIC guidance provided examiners considerable flexibility to tailor loan examination procedures to the bank examined. GAO found that examinations for 8 of 11 randomly selected open banks and 11 banks that failed without being identified by FDIC as problem banks contained insufficient evidence for detecting loan quality problems. GAO estimated that the most recent FDIC examination did not include sufficient evidence for detecting loan quality problems for at least 40 percent of the 7,691 banks that FDIC supervised as of September 30, 1990.

FDIC officials believed that examiners were adequately evaluating loans but were not documenting their work. However, for many of the banks GAO reviewed, evidence in the working papers showed that examiners often relied on outdated and incomplete data to assess loan quality and the adequacy of reserves for loan losses. For failed banks, the examiners' insufficient loan reviews contributed to FDIC's inability to provide an early warning of bank problems.

Insufficient Evidence of Internal Control Reviews

According to FDIC's Examination Manual, examiners were responsible for an overall assessment of banks' internal controls. However, the specific examination procedures to use were left to the examiners' discretion. Examinations for all open and failed banks GAO reviewed did not include evidence that comprehensive reviews of internal controls were performed. GAO estimated that this weakness extended to nearly all 7,691 banks supervised by FDIC as of September 30, 1990. Further, GAO found that most of the banks that failed without warning had weaknesses in internal controls, but examiners had not performed comprehensive evaluations of the controls that would have detected these weaknesses early.

State Examination Results Not Verified

FDIC relied on examinations performed by state banking authorities to extend the amount of time between its examinations but did not assess the quality of state examiners' work. FDIC had no requirement for such assessments. Reliance on state examination work without reviewing its quality does not provide FDIC with assurance that such work is sufficient to identify bank problems in a timely manner.

Effect of FDIC Improvement Act of 1991 on Bank Examinations

The FDIC Improvement Act of 1991 requires federal regulators to conduct annual on-site examinations of banks with total assets greater than $100 million but allows substituting state examinations in alternate years. The act provides that the regulators must determine whether state examinations meet the purpose of the improved examination requirements. Making this determination will require the regulators to assess the quality of state examinations.

Among other early warning provisions, the act requires management of banks with assets of $150 million or more to annually report on the condition of internal controls and for their external auditors to review and report on assertions made by bank management. FDIC can review and use this work in conducting its examinations; however, most FDIC-supervised banks are small and, therefore, not subject to the requirement. Achieving the same level of assurance for these smaller banks would entail FDIC performing internal control reviews as part of its examinations.

Quality Control Over Examinations Inadequate

FDIC's policies and practices for preparation and review of examination working papers, on-site supervision, and retention of examination working papers did not ensure that examiners' work was sufficient to identify bank problems early. FDIC officials rarely performed supervisory review of examination working papers. Examination working papers were not prepared in a manner to enable an independent reviewer to readily judge the adequacy of work performed by examiners nor retained long enough to facilitate a systematic review of examination quality.

Recommendations

GAO recommends that FDIC establish policies to (1) require examiners to obtain current and complete information for loan quality reviews, (2) use, to the extent possible, the work of auditors in reviewing internal controls after verifying the scope and quality of that work, and supplement that work as necessary to ensure an annual comprehensive assessment of significant internal controls, (3) require examiners to assess the work of state examiners when such work is used to extend examination intervals, and (4) improve quality control over its examinations.

Agency Comments

FDIC provided written comments on a draft of the report. These comments are presented and evaluated in chapters 2 through 5. In general, FDIC disagreed with GAO's conclusions and recommendations. FDIC stated that its examination approach was the most effective considering its current level of personnel resources. Also, FDIC, for the most part, concluded that existing policies and procedures were adequate and that little or no changes in its operating practices were needed.

FDIC lacked minimum essential examination requirements and allowed its examiners considerable flexibility in conducting safety and soundness examinations. GAO found that these policies were resulting in examination practices that failed to adequately review the condition of banks' internal controls and loan quality, and placed reliance on state examinations without reviewing working papers of state examiners to determine the quality of the examinations. FDIC also had insufficient supervisory review of its examiners' work to determine that examination conclusions were adequately supported, which is especially important when examinations are conducted by less experienced staff. Such examination practices have not protected the insurance fund. From 1985 through 1991, 610 FDIC-regulated banks failed, with assets totaling about $60 billion, at a cost of almost $12 billion to the insurance fund.

FDIC's reactive examination approach did not result in timely identification of control breakdowns that lead to problem loans and other poor quality assets and, therefore, did not effectively protect the Bank Insurance Fund and, ultimately, taxpayers from losses. GAO believes that FDIC needs to establish minimum essential examination requirements that result in proactive oversight of banking operations in determining bank safety and soundness.

Contents

Abbreviations

CAMEL	capital adequacy, asset quality, management performance earnings, and liquidity level
FDIC	Federal Deposit Insurance Corporation
FIRREA	Financial Institutions Reform, Recovery, and Enforcement Act of 1989
FRB	Federal Reserve Board
OCC	Office of the Comptroller of the Currency
OTS	Office of Thrift Supervision
SAIF	Savings Association Insurance Fund

Introduction

The Bank Insurance Fund administered by the Federal Deposit Insurance Corporation (FDIC) ended 1991 with a deficit balance of $7 billion due to record numbers of bank failures. From 1985 through 1991, 1,192 federally insured banks failed or received federal assistance. From 1988 through 1991 alone, 724 banks with total assets of over $160 billion failed, at an estimated cost to the fund of over $23.7 billion.

The purpose of our work was to determine whether FDIC bank examinations effectively anticipated and reported bank problems. Specifically, the report discusses how well FDIC examined the quality of bank loans and internal controls—both of which are leading indicators of a bank's safety and soundness. We discuss the effectiveness of the examination processes of the Federal Reserve Board (FRB), Office of the Comptroller of the Currency (OCC), and Office of Thrift Supervision (OTS) in separate reports.[1]

Background

The Federal Deposit Insurance Corporation Improvement Act of 1991 (Public Law 102-242) increased FDIC's borrowing authority for covering losses and working capital needs related to resolving troubled institutions. The act increased FDIC's authority to borrow funds from the Treasury on behalf of the Bank Insurance Fund and the Savings Association Insurance Fund to cover losses incurred in resolving troubled institutions to $30 billion. However, it requires FDIC to recover these funds through premium assessments charged to insured institutions. Also, FDIC may borrow funds for working capital, but the amount of its outstanding working capital borrowings is subject to a formula in the act that limits FDIC's total outstanding obligations. Working capital funds are to be repaid primarily from the management and disposition of failed financial institution assets.

The act is a critical step towards improving bank regulation because it provides for an early warning of safety and soundness problems to minimize losses to the fund. It includes supervisory reform provisions for insured institutions to help federal regulators identify problems early and take corrective action to prevent or minimize the cost of failure. Regulator on-site examinations of banks is a key provision in the act. Federal regulators must conduct annual on-site examinations of all federally insured financial institutions except for certain well-capitalized and

[1] Bank Examination Quality: FRB Examinations and Inspections Do Not Fully Assess Bank Safety and Soundness (GAO/AFMD-93-13), Bank Examination Quality: OCC Examinations Do Not Fully Assess Bank Safety and Soundness (GAO/AFMD-93-14), and Examination Quality: OTS Examinations Do Not Fully Assess Thrift Safety and Soundness (GAO/AFMD-93-11).

well-managed institutions with assets of less than $100 million, which must be examined every 18-months. In addition, insured institutions with assets of $150 million or more must receive annual independent financial statement audits. Among other requirements, these institutions must prepare reports on the effectiveness of their internal control structures, and external auditors must attest to management's assertions about internal controls. Further, the act requires the regulators to establish designated capital standards and noncapital safety and soundness requirements ("tripwires") to facilitate prompt regulatory action.

As stated in our April 1991 Bank Supervision report,[2] bank capital is typically a lagging, rather than a leading, indicator of bank problems and regulatory enforcement actions tended to focus on capital inadequacy, rather than on the underlying causes for capital deterioration. Our analysis showed that capital difficulties were most frequently caused by losses from bad loans or bank operations. We also reported that weaknesses in internal controls over bank operations contributed significantly to bank failure.[3]

FDIC administers the Bank Insurance Fund, which insures customer deposits in federally insured commercial banks, state chartered savings banks, and certain federal savings banks. As insurer of customer deposits, FDIC has regulatory authority over banks. It also has regulatory authority over thrift institutions as a result of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), which placed FDIC in charge of the newly created Savings Association Insurance Fund (SAIF). SAIF provides insurance for thrifts and replaces the previous insurance fund for thrifts administered by the Federal Savings and Loan Insurance Corporation. FDIC insured deposits in 12,392 banks and 2,210 thrifts as of December 31, 1991.

FDIC has federal supervisory authority over state-chartered banks that are not members of the Federal Reserve System (referred to as state nonmember banks) and conducts periodic examinations of these institutions. It has secondary or backup supervisory authority over national banks, state-chartered banks that are members of the Federal Reserve System, and thrifts. In its backup role, FDIC has authority to examine these institutions. However, it generally defers to OCC to supervise and examine national banks and FRB to supervise and examine

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

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

state-chartered banks that are members of the Federal Reserve System. Since the passage of FIRREA, both FDIC and OTS have examined thrifts.[4]

All four regulatory groups are members of the Federal Financial Institutions Examination Council, which was formed in 1979. The objective of the Council is to maintain uniform standards for the federal examination and supervision of federally insured depository institutions, bank holding companies, and savings and loan holding companies. In addition to the Council, regulatory agencies periodically form interagency working groups to address issues which impact all federally insured depository institutions.

As of December 31, 1991, FDIC supervised 7,157 state-chartered, nonmember commercial banks and 449 state-chartered savings banks. During calendar year 1991, FDIC performed 4,089 safety and soundness examinations for these banks. These banks are predominantly small, with the vast majority (85 percent) having less than $150 million in assets. In our April 1991 failed banks report, we found that large bank failures caused significant losses to the Bank Insurance Fund, and that the total estimated cost of 161 smaller bank failures in 1989 was comparable to one large bank failure—about $2 billion. However, our concern about the impact small banks may have on the Bank Insurance Fund has increased because of the fund's current unfavorable financial condition.

Bank Supervision

FDIC's role is to protect depositors in the nation's banks and thrifts, help maintain confidence in the bank and thrift industries, and promote safe and sound banking practices. Bank supervision is a primary tool FDIC uses to fulfill this role. FDIC's Division of Supervision—through its headquarters in Washington, D.C., and eight regional offices—carries out this supervisory role through on-site examinations and off-site monitoring of banks between examinations.

Section 8 of the Federal Deposit Insurance Act gives FDIC formal administrative enforcement powers including authority to terminate insurance and to issue cease and desist actions for banks found to be operating under unsafe or unsound practices. FDIC may also impose civil money penalties against both banks and individuals for violations of certain statutes. In addition, FDIC uses informal Memorandums of Understanding for addressing and correcting identified weaknesses that

[4]Our report on the Office of Thrift Supervision's examination of thrifts, (GAO/AFMD-93-11), discusses the need to improve coordination between it and FDIC in examining thrifts.

are of supervisory concern, but which have not deteriorated to the point where they warrant formal administrative action. Formal and informal actions are based upon on-site examination results.

On-Site Examinations

The most comprehensive examination is the on-site full scope safety and soundness examination. The objective of on-site examinations is to identify problems early and control risk in banks. FDIC also conducts specialty examinations, such as electronic data processing, compliance, and trust examinations. Electronic data processing examinations serve to determine the validity and reliability of the records produced by banks' automated systems. For compliance examinations, examiners determine the bank's adherence to various consumer protection and civil rights laws and regulations. The objective of trust examinations is to determine whether the bank's trust operations have created contingent liabilities. These are limited scope examinations, which may be performed concurrently with safety and soundness examinations.

After completing a full scope examination, FDIC uses a uniform rating system to assign a numeric rating to reflect its assessment of the bank's financial condition, compliance with laws and regulations, and overall operating soundness. FDIC's rating of capital adequacy, asset quality, management performance, earnings, and liquidity is commonly referred to as the CAMEL rating. Although no arithmetic average of the CAMEL components is calculated, an overall composite rating is assigned that takes into account these and other subjective factors regarding the bank's overall financial condition, along with the safety and soundness of its operations. CAMEL component and composite ratings range from 1 to 5 with a 5 rating representing the most critically deficient level of performance and, thus, the highest degree of supervisory concern.

Prior to the FDIC Improvement Act, FDIC required full scope examinations at least every 24 months for banks with composite CAMEL ratings of 1 or 2 and every 12 months for banks with 3, 4, or 5 composite ratings. The annual examination requirement of the FDIC Improvement Act applies to all insured institutions except for certain well-capitalized and well-managed institutions with assets of less than $100 million. Such institutions are required to have examinations at least once during each 18-month period provided they were in outstanding condition when last examined and had not had a change in control during the preceding 12 months.

State banking authorities also conduct examinations of FDIC-supervised banks, and FDIC has extended the intervals between its examinations when banks have received state examinations. The FDIC Improvement Act allows examination requirements to be met by state examinations in alternating years if the federal regulator deems this appropriate.[5]

On-site examinations are performed by field office examiners assigned to each FDIC region. An examination is typically staffed with one or more commissioned examiners—one of whom is designated as the examiner-in-charge—and several noncommissioned assistant examiners and trainees. Commissioned examiners are considered qualified to plan and perform a bank examination and supervise the work of other examiners. To become commissioned, an examiner must complete a series of training courses, receive on-the-job training, and pass a written test. The commissioning process typically takes from 3 to 4 years.

Off-Site Monitoring

FDIC's off-site monitoring program tracks the financial condition and performance of banks between examinations using data submitted by banks in quarterly "call reports." These reports contain unaudited financial information and consist of a Report of Condition (balance sheet), Report of Income, and related supporting schedules. The schedules provide additional details relating to critical items such as cash, securities, loans, and equity. Call reports are required to be prepared in accordance with regulations promulgated by the banking regulators, which for the most part are consistent with generally accepted accounting principles.

Objective, Scope, and Methodology

Our objective was to evaluate FDIC's examination process to determine its effectiveness in judging bank safety and soundness, including providing an early warning of bank problems. Specifically, we determined whether

- FDIC's procedures and practices for performing bank examinations were appropriate and adequate, especially regarding loan quality and bank internal controls over operations, and
- examinations were adequately documented and FDIC provided sufficient supervision and oversight of work performed to ensure examination quality.

[5]Prior to the FDIC Improvement Act, the frequency of examinations could be extended to 48 months for 1- or 2-rated banks and 24 months for 3-rated banks provided the bank had received an interim state examination and the results were confirmed by FDIC off-site monitoring.

To accomplish our objective, we reviewed examinations of 11 open banks that had FDIC as their primary federal regulator. The 11 banks were selected randomly from the universe of 7,691 state-chartered nonmember banks and state-chartered savings banks FDIC regulated as of September 30, 1990.[6] Our sample allows us to project our results to the universe of the most recent full-scope examination for the banks regulated by FDIC at that time. Because of our limited sample size, our estimates fall within a relatively wide range, or confidence interval. We did not expand our sample in order to narrow the range because, for each projected finding, even the low end of the range indicates that the deficiencies we identified affected a significant segment of the examinations. Our projections are made at the 95-percent confidence level.

We also judgmentally selected 17 state-chartered nonmember banks that failed during 1988 and 1989 without having been identified by FDIC as troubled banks prior to failure to determine the cause of failure, and the reason the examination process was ineffective in identifying the severity of the problems in advance of failure.[7] The 17 failed banks were comparable in size to the randomly selected open banks. FDIC was able to provide working papers for only 11 of these failed banks; therefore, detailed review of examination work was limited to these 11 banks. For the 6 banks for which working papers were not available, we reviewed examination reports and correspondence files to the extent this information was available.

To assess FDIC's procedures and practices for performing examinations, we reviewed—for each open bank and failed bank—the most recent 3 years of documented FDIC examination activities to the extent this information was available. This included FDIC reports of examination, reports prepared by state banking authorities, correspondence files, and any other documented analyses identified by FDIC officials. In addition, we reviewed in detail the working papers supporting the most recent safety and soundness examination conducted by FDIC to assess the quantity and quality of the evidence that supported conclusions in FDIC reports. The examinations reviewed were all full-scope examinations. We reviewed FDIC examination work for each CAMEL factor; however, we focused on asset

[6]We randomly selected 13 open banks for review; however, one bank failed prior to review, and the examination working papers for another bank had been destroyed by FDIC. Therefore, our examination review included the remaining 11 banks for which examination working papers were still available.

[7]These banks either never appeared on the FDIC's problem bank list or were placed on the list only within one quarter prior to failure.

quality and internal controls because we have previously identified these as primary causes of bank failure.[8]

To assess FDIC's examination policies, we analyzed FDIC's Manual of Examination Policies, which provides guidance for assessing capital adequacy, asset quality, management (including internal controls over bank operations), earnings, and liquidity. We compared this guidance to the type and level of work documented in our sample examinations. We also considered other supplementary guidance including (1) FDIC's "Division of Supervision Revised Examination Program" memorandum and "Allowance for Loan and Lease Losses" memorandum to assess the examiner work on loans, and (2) FDIC's "Statement of Policy Providing Guidance On External Auditing Procedures For State Non-member Banks," and the American Institute of Certified Public Accountants auditing guidance to assess the examiners' work on internal controls.

To determine whether FDIC provided sufficient supervision and oversight of work performed to ensure examination quality and whether examination documentation was sufficient for supervision and oversight, we discussed FDIC practices with appropriate officials and reviewed pertinent documents.

Our work was performed at FDIC headquarters in Washington D.C., and at FDIC regional offices located in Atlanta, Chicago, Dallas, Kansas City, and Memphis between January 1991 and January 1992 in accordance with generally accepted government auditing standards. FDIC provided written comments on a draft of this report. These comments are presented and evaluated in chapters 2 through 5 and are included in appendix I.

[8]Failed Banks: Accounting and Auditing Reforms Urgently Needed (GAO/AFMD-91-43, April 22, 1991) and Bank Supervision: Prompt and Forceful Regulatory Actions Needed (GAO/GGD-91-69, April 15, 1991).

Insufficient Evidence in Examination Files for Detecting Loan Quality Problems

Our review of examination files for randomly selected banks showed that examinations frequently lacked sufficient evidence to judge loan quality and, therefore, detect problem loans early. FDIC guidance provided examiners considerable flexibility to tailor loan examination procedures to individual banks, and FDIC officials told us that examiners adequately evaluated loans even though they did not document their work. However, available evidence for the failed banks we reviewed indicated that insufficient loan quality reviews contributed to FDIC's inability to provide an early warning of bank problems.

Loan Quality Reviews Critical to Examinations

The review of a bank's loan portfolio and related allowance for loan losses is one of the most important components of a bank examination. Loans comprise a major portion of the assets of most banks and usually involve the greatest credit risk and potential loss for banks. Accordingly, conclusions reached by examiners regarding the condition of the bank largely depend upon their assessments of loan quality. Further, to increase profitability and liquidity, bank managers are developing new credit instruments and approaches to lending, which are resulting in more complex loans. Loan loss allowances, which in essence set aside a portion of bank capital for problem loans, are critically important because regulatory enforcement actions are often based on inadequate capital levels.

Loan quality reviews, based on information in bank files and discussions with management, require difficult judgments about the collectibility of individual loans. Current and relevant information helps bank management and examiners make judgments about loan collectibility. Such information is particularly important in evaluating loans for business and agricultural purposes because the collectibility of these loans depends largely on the borrower's ability to service debt from current successful operations. In many cases, cash flow and other financial information that is less than 1 year old is sufficient to enable bank management to manage the bank's loan portfolio on a safe and sound basis and enable examiners to accurately assess loan quality. However, high risk or problem loans may need to be assessed with more current information.

Examiners pass without criticism loans they conclude are good and adversely classify those they determine to be unsafe. Adverse classifications are expressions of the examiner's judgment about the risk that a particular loan will not be repaid. There are three levels of adverse classification: substandard, doubtful, and loss. Loans classified substandard are inadequately protected by the current net worth and paying capacity of the borrower or by the collateral pledged, if any. These loans are characterized by the distinct possibility that the bank will sustain some loss if deficiencies are not corrected. Loans classified doubtful have all the weaknesses as those classified substandard with the added characteristic that collection or liquidation in full is highly questionable and improbable. Loans classified loss are considered uncollectible and of very little value to the bank.

Evidence for Loan Quality Decisions Incomplete, Outdated, and Unverified

We found that 8 of the 11 randomly selected open bank examinations did not include sufficient evidence to support examiner conclusions about loan quality.[1] Information needed to assess loan quality was either missing, incomplete, outdated (over 1 year old), or unverified. Further, the bases for the examiners' conclusions about the collectibility and risk of individual loans could not be determined. Based on our sample results, we estimated these conditions existed for the most recent FDIC examination for at least 40 percent of the 7,691 banks that were supervised by FDIC as of September 30, 1990.[2] We also found similar deficiencies in examinations for all 11 banks we reviewed that failed without warning.

For the 8 open bank examinations, between 33 and 55 percent of the dollar value of examined loans lacked sufficient information to determine matters such as the borrower's payment history, ability and willingness to repay the bank, and the value of underlying collateral for loans—all of which are considered by FDIC guidance to be essential for loan quality analysis. Such information was either missing entirely or was outdated, incomplete, or insufficient for meaningful analysis. In most cases, examiners did not prepare written explanations for their conclusions about the collectibility and risk of individual loans, which made it impossible to determine the basis for their decisions to pass or classify loans. We found similar deficiencies for examinations of banks that failed without warning.

We found numerous examples of higher risk loans, such as business and agriculture loans, during our review of open bank examinations that illustrate insufficient information to determine the borrower's ability to

[1]Most of the loans reviewed were made for purposes other than single-family mortgages, which are relatively low-risk loans.

[2]The range of our confidence interval, at a 95 percent confidence level, is that these conditions existed for the most recent FDIC examination (at the time of our review) of between 40 percent and 94 percent of the 7,691 banks that were supervised by FDIC as of September 30, 1990.

repay the loan, use of outdated and incomplete information, and lack of adequate explanation for conclusions reached.

- In several instances examiners wrote "stale" next to loan information over 1 year old but provided no explanation about additional information obtained or alternative procedures performed, if any, which may have enabled the examiner to conclude about the current quality of the loan.
- One examination we reviewed included a linesheet[3] for a $489,986 loan that had been restructured. The loan consolidated several loans that had been classified by state bank examiners about 9 months prior to the FDIC examination. The state examination report stated that the financial statements for the borrower were self-prepared, highly "illiquid," did not "lend any support to the outstanding debt," and did not include annual income. FDIC examiners passed the consolidated loan, but their linesheet only included the scant statements "paying as agreed" and "collateral and CF [cash flow] sufficient." The FDIC working papers did not include current financial information for the borrower or analysis of his financial condition.
- Another examination included a linesheet for a commercial loan totaling $400,000. The linesheet did not indicate whether the borrower had been paying the loan in an orderly manner and did not include evidence that the borrower had sufficient earnings, cash flow, or liquid assets to service the debt. Further, the linesheet did not include information on the condition or value of the collateral for the loan. The loan was rated "special mention"[4] by the examiners with no further explanation.
- The working papers for an examination indicated that a commercial loan had been classified by FDIC during the previous examination, and that the bank had written off $95,000 of the loan balance as a loss. The linesheet for the current examination indicated that the current loan balance was $132,919, but that the borrower had no cash and his company showed a net loss during the previous year. Although collateral value should have been very important on this loan because of the borrower's apparent inability to service the debt, there was no evidence that examiners obtained recent valuations on the collateral. In addition, the loan had two guarantors; however, there was no evidence that the examiners obtained current financial information for either of them. The examiners passed this loan without written explanation.

[3]A linesheet is a working paper used by examiners to record information and their conclusions about the quality of specific loans.

[4]According to the FDIC Manual, special mention loans do not presently expose the bank to a sufficient degree of risk to warrant adverse classification but do possess credit deficiencies deserving management's close attention.

- A linesheet from an examination included prices for livestock and grain, which served as the source of repayment for a $186,400 farm loan. The prices on the linesheet were over 3 years old. There was no evidence that examiners verified that the collateral existed and was in good condition or attempted to obtain current livestock or crop prices from commodity exchanges or business publications. This loan was passed without explanation by the examiners.

The 17 banks that failed without warning had significant loan problems; however, FDIC's loan quality reviews provided little warning of impending bank failure. For the 11 failed banks for which we were able to obtain working papers, we identified the same types of loan quality review deficiencies as we found for open banks. The working papers did not include evidence that critical information about borrowers and loans had been obtained and analyzed. Financial and collateral information was often outdated, and the basis for the examiners' conclusions about individual loans was not documented. For 5 of the 11 failed banks, no evidence existed to support judgments made by examiners about loans.

In commenting on a draft of this report, FDIC said it rejected the notion that 17 banks failed without warning. FDIC stated that while some banks fail on short notice as a result of liquidity or a defalcation, most remain open for a considerable period of time after severe problems are identified. The 17 failed banks in our study all failed either within 3 months of inclusion on FDIC's problem bank list or without having been on the list at all.

Examiners Given Flexibility But Lacked Specific Guidance

Examiners were given much discretion in planning and conducting loan quality reviews, and they had to exercise sound judgment in evaluating the collectibility of individual loans. The FDIC Manual provided descriptions of various loans and the risks they entail, rather than detailed step-by-step procedures for performing loan quality reviews. The Manual stated that obtaining loan information was an important process and should be done carefully to ensure that loans are evaluated accurately and fairly. The Manual indicated that to properly analyze any loan, an examiner should acquire information about the borrower's financial condition, purpose and terms of the loan, and prospects for its orderly repayment. In addition, consideration should be given to the risk involved in the loan, the character and record of the borrower, and the nature and degree of collateral. Further, the Manual stated that examiners should carefully weigh information obtained about a loan and make a judgment as to credit quality based on its specific characteristics.

The FDIC Manual stated that failure to obtain and record pertinent information about loans can reflect unfavorably on examiners. The Manual also stated that assets should be listed by name and amount criticized, but written discussions should be limited to significant criticized assets contested by management, criticized insider loans, and special situations. Under certain circumstances, examiners were supposed to provide written discussions for all larger criticized assets and other assets of special mention. In addition, to streamline the loan review process, the Manual encouraged examiners not to document financial and collateral information for loans they pass without criticism. For such loans, the Manual stated that examiners should provide a summary comment indicating they have reviewed sufficient material to pass the loan. One FDIC official told us that some examiners have broadly interpreted this guidance to mean that they need only mark the working paper "P" when they determine that a loan should be passed without criticism.

FDIC guidance did not indicate what procedures, if any, examiners should perform or what additional information needed to be obtained to evaluate loan quality when critical financial or collateral information is outdated. According to the guidance, examiners were to ensure that bank management considered current conditions and information when analyzing loan quality for determining allowances for loan losses. Although one FDIC official told us that information over 1 year old was considered outdated, the Manual did not define outdated information.

FDIC Officials Believed Loan Evaluations Were Adequate

FDIC officials stated they were confident that examiners obtained sufficient information to assess loan quality from bank files or from management, even though this may not have been documented in the examination working papers. FDIC officials also stated that there were instances when examiners relied on outdated information because banks did not update loan files. An FDIC headquarters official told us that no specific law or FDIC policy requires banks to obtain and maintain current loan information on borrowers.[5] In such cases, examiners make judgments on loans based on the information available at the time of the examination. The officials told us this is not considered a significant concern because examiners are trained to make judgments and have developed considerable expertise.

Notwithstanding FDIC's opinion that its examiners are well trained and have considerable expertise, adequately documented evaluations of loan

[5]The FDIC Improvement Act requires FDIC and the other bank and thrift regulators to develop standards for safety and soundness, including loan documentation by December 1, 1993.

quality based on current and complete information are critically important if examinations are to function as an effective early warning tool for bank supervision.

Documented support for examiner conclusions about individual loans is important because of the large amount of flexibility that examiners have in planning and performing loan quality reviews, and the amount of judgment required to assess loan quality. Such support provides assurance that examiners are obtaining enough information and performing sufficient analyses to identify problem loans early. Support consisting of only a summary statement indicating that examiners have reviewed enough information to pass a loan does not provide assurance that enough information is obtained and sufficient analyses performed to identify problem loans as soon as possible.

When information about loans in bank files is outdated and incomplete, examiners must rely on the assertions of bank management to identify the current significance of problems. This can inhibit early detection of loan quality problems because management may not identify problems until after they become too serious to correct. To prevent serious problems in a bank, both bank management and examiners need to fully understand the conditions and circumstances of individual loans that may lead to problems. Current, complete, and accurate information is needed to develop this understanding and accurately judge loan quality.

Loan Coverage May Be Insufficient

For the 11 open banks in our sample, we found that examiners reviewed between 18 and 61 percent of the value of the banks' loans. This means that for these bank examinations, examiners did not review between 39 percent and 72 percent of the value of the banks' loan portfolios. Because we found substantive problems in the quality of loan reviews done by FDIC examiners, we did not assess whether loans selected for review provided a representative basis for examiners to judge the overall quality of the banks' loan portfolios. However, even if 100 percent of a bank's loan portfolio was reviewed, poor quality loan reviews, such as those found in our sample, could largely negate the benefit derived from reviewing this many loans.

According to the FDIC Manual, the cut-off point for loan review coverage should be sufficient for a thorough analysis of a representative portion of total loans. We believe loans reviewed must be representative of the bank's loan portfolio to provide a sufficient basis to make complete loan quality assessments. FDIC selected loans for review based on size, which may or may not have resulted in representative samples being reviewed.

Generally, the most efficient way to achieve a representative sample is to use statistical sampling techniques, which allow conclusions to be made about the entire loan portfolio from which the sample was drawn, while minimizing the number of loans which must be tested. Judgmental samples, like those done in the examinations we reviewed, are not representative of the unsampled portion of the loan portfolio and, therefore, may not provide a basis to conclude on the overall loan portfolio. A judgmental sample could be representative of the overall loan portfolio, if it included a sufficient amount of loans such that the risk of error in the unreviewed portion of the portfolio was not material. To achieve this result, however, a large number of loans would have to be reviewed.

According to an FDIC headquarters official, statistical sampling is generally not used to select loans for review. However, the official stated that statistical sampling is sometimes used by examiners to assess homogeneous groups of loans such as consumer loans. The official stated that loans are selected based on dollar value and the cut-off point for selection is based on the judgment of the examiner. While statistical sampling techniques usually would be a more efficient basis for loan review conclusions, use of these techniques does not preclude the use of judgmental samples.

Allowance for Loan Losses Not Adequately Supported

We found insufficient evidence for most of the examinations of open banks we reviewed to support assessments of the banks' allowances for loan losses as called for in the FDIC Manual. Several FDIC officials told us that examiners evaluated the loan loss allowances primarily by reviewing historical loss data but did not always document their work. Without such evidence, however, FDIC does not know examiners are ensuring that allowances established by banks adequately reflect the volume and severity of problem loans in their portfolios. In this regard, for the 11 of 17 banks that failed without warning for which working papers were available examiners' assessments of loan loss allowances did not adequately determine the effect problem loans had on bank capital early enough for FDIC to take effective corrective action.

The FDIC Manual stated that examiners must carefully assess the adequacy of the bank's allowance for loan losses to ensure that it covers all risk of loss in the bank's loan portfolio. According to the Manual, factors such as the volume and severity of problem loans, management policies and capabilities, asset quality trends, portfolio strategies, loan charge-off and collection policies, and local and general economic conditions should be considered to support the examiner's determination as to the appropriate level for the loan loss allowance. The Manual stated that the allowance should be sufficient to cover at least those loans determined to be uncollectible, some applicable percentage of other classified loans, and an estimate of potential losses on all other loans in the bank's portfolio.

For most of the 11 open bank examinations we reviewed, the examiners concluded that loan loss allowances were adequate or acceptable and the working papers included beginning and ending balances of the allowance account, write-offs and recoveries for previous periods, and industry averages. However, as mentioned earlier, we found that 8 of the 11 examinations in our sample did not include evidence necessary to assess loan quality, which is the major factor for assessing loan loss allowances. Further, only 5 of the 11 open bank examinations included evidence that examiners assessed the methodologies used by banks to set their current allowance amounts. In most cases, the examinations did not include evidence that examiners calculated an estimated requirement for the loan loss allowance based on the results of their loan examinations. In addition, we found little evidence that examiners considered factors called for in the Manual—such as asset quality trends, portfolio strategies, or the condition of general and local economies—in their analyses of the allowances.

For example, one examination report stated that the amount of the bank's classified loans had increased by 37 percent over the previous examination. The bank's allowance amount, however, remained unchanged from the previous period and was below the average amount for similar banks. The examiners did not explain in the report or the working papers their acceptance of the bank's determination not to increase its loan loss allowance when loan problems were increasing significantly.

In 1991, after the examinations we reviewed were performed, FDIC issued additional requirements for evaluating allowances for loan losses. According to a May 1991 policy memorandum, historical data are not sufficient to evaluate the quality of the loan portfolio and the adequacy of a bank's loan loss allowances. The memorandum stated that examiners should ensure that bank management considers current relevant data when evaluating loan collectibility. The memorandum did not define current nor explain what procedures examiners are to perform if bank management does not use current conditions and information to evaluate loan collectibility.

In June 1991, FDIC issued specific guidance for assessing and calculating bank loan loss allowances in accordance with the May 1991 policy statement. This guidance required examiners to include in the examination working papers a worksheet detailing the information considered in evaluating the bank's allowance, including the bank's loan loss history, reserve coverage of nonperforming loans, portfolio risk exposure, lending procedures, loan administration, level of problem loans, off-balance sheet items, and general economic conditions. The guidance further stated that the worksheet serves as documentation to support the level of allowance recommended by the examiner. Several FDIC officials told us that the current guidance should serve to make the examiners' evaluations of the allowance account more consistent from bank to bank.

Because all the examinations we reviewed were conducted prior to June 1991, we were not able to determine whether FDIC's expanded examination guidance for loan loss allowances is being followed. However, it is important to note that loan loss allowances cannot be evaluated without representatively reviewing the quality of the bank's loans. Thorough reviews of individual loans and the overall loan portfolio using current relevant data are critical to effective assessments of the bank's allowances for loan losses.

Conclusions

Because evidence obtained to judge loan quality and loan loss allowances was often missing, outdated, and incomplete, FDIC examiners were not in an optimal position to identify problems in their early stages. Use of outdated and incomplete information caused examiners to substantively rely on bank management to identify the significance of problems. This can inhibit early detection of loan quality problems because management may not identify problems until after they become too serious to correct. We believe this was evident in our review of banks that failed without warning. In addition, FDIC's guidance for loan review and documentation policy does not provide assurance that examiners are obtaining current, complete, and accurate data to assess individual loans. Finally, the effectiveness of FDIC's additional guidance for reviewing allowances for loan losses will be impaired unless its approach to assessing loan quality is improved.

Recommendations

We recommend that the Chairman of the Federal Deposit Insurance Corporation take the following actions:

- Establish a policy for examinations that requires representative and adequate documented evidence to support conclusions reached by examiners on loan quality. The policy should require examiners to document the bases for their conclusions about individual loans regardless of whether the loans are passed or classified.
- Establish an examination policy for loan review to require examiners to assess higher risk loans, such as those for business and agricultural purposes, based on current, complete, and accurate information.
- Monitor examinations to ensure that examiners are following FDIC's June 1991 policy issued to supplement its May 1991 guidance for evaluating allowances for loan losses and documenting their work in accordance with the guidance.
- Coordinate the implementation of the loan quality review recommendations with the other federal depository institution regulatory agencies to achieve uniform requirements.

Agency Comments and Our Evaluation

In its comments on a draft of this report, FDIC generally disagreed with our conclusions. FDIC's response to our specific recommendations in this chapter indicates that FDIC is not willing to effectively address the problems we identified.

FDIC said that its approach to supervision and examination was effective in identifying bank problems early and that the changes we recommended were too structured and would be counterproductive absent a marked increase in examination staffing. FDIC further stated that its working paper documentation standards were sufficient and that its heavy reliance on examiner judgment, as opposed to greater documentation and supervisory review, has been proven successful repeatedly.

The number and cost of FDIC-regulated banks that failed from 1985 through 1991 shows that FDIC's approach to supervision and examination has not protected the insurance fund. For this 7-year period, 616 FDIC-regulated banks failed, with assets totaling over $65 billion, at a cost of $12.8 billion or 20 percent of the failed banks' assets, to the Bank Insurance Fund.

Although faltering economic conditions have been a factor in bank failures, FDIC's approach to bank examinations has also contributed to the losses incurred by the Bank Insurance Fund. FDIC's lack of minimum essential examination requirements and meaningful quality control over examinations leads to a lack of assurance that examinations are able to detect unsafe and unsound conditions promptly that may result in problem and failed banks. For example, we found that 8 of 11 randomly selected open bank examinations did not include sufficient evidence to support examiner conclusions about loan quality. Further, as discussed in chapter 3, none of the examinations we reviewed included evidence that comprehensive evaluations of internal controls were performed by examiners. Breakdowns in internal controls and poor quality loans are primary factors that contribute significantly to bank failure, as evidenced by our review of banks that failed in 1987, 1988, and 1989.[6] In addition, failure to identify some banks as "problem" institutions until shortly before their demise is additional evidence that FDIC's approach needs revision. The 17 failed banks in our study all failed either within 3 months of inclusion on FDIC's problem bank list or without having been on the list at all.

We continue to believe that FDIC examiners would be more effective in fully assessing bank safety and soundness if their work was guided by the minimum essential requirements we recommend. The regulatory reforms required by the FDIC Improvement Act of 1991 include annual full scope examinations. This requirement is an essential part of the regulatory reforms to identify bank safety and soundness problems in a timely manner and take prompt corrective action. We do not believe the flexible examination approach used by FDIC will effectively fulfill the act's requirements. We agree that costs and benefits should be considered in setting examination requirements. Bank failures have depleted the Bank Insurance Fund. Effective examination requirements are needed to minimize losses to the Bank Insurance Fund, which ultimately translate into costs to the banking industry through premium assessments or to the taxpayers if insurance funds are insufficient.

We recommended that FDIC establish a policy for examinations that requires representative and adequate documented evidence to support conclusions reached by examiners for both passed and classified loans. FDIC's response reiterated its current examination policies, which are not adequate. We do not believe that FDIC's current requirement for examiners to provide only summary comments indicating they have reviewed sufficient material to pass loans provides adequate documentation for loan quality review. Specific requirements are needed because the examiner's

[6]Failed Banks: Accounting and Auditing Reforms Urgently Needed (GAO/AFMD-91-43, April 22, 1991) and Bank Failures: Independent Audits Needed to Strengthen Internal Control and Bank Management (GAO/AFMD-89-25, May 31, 1989).

conclusion about the safety and soundness of the bank depends largely on conclusions that are reached about the bank's individual loans. The examiner's decision to pass a loan or classify it as substandard, doubtful, or loss is based on judgment after various factors and types of information related to collectibility are analyzed and weighed. Documentation not only facilitates the examiner's analysis and weighing of information about a loan, but enables reviewers to understand the basis for the examiner's judgment as well. Written comments to support examiner conclusions about decisions to either pass or classify a loan must address the collectibility and risk of the loan, including the borrower's payment history, ability and willingness to repay the bank, and the value of underlying collateral.

FDIC did not concur with our recommendation to establish an examination policy for loan review to require examiners to assess riskier loans, such as for business and agricultural purposes, based on current, complete, and accurate information. FDIC stated that it cannot ensure that examiners always have current information to judge loan quality and, to compensate for this deficiency, examiners discuss loans with bank management and make inspections. FDIC further stated that because bank management may be criticized and downgraded by examiners for documentation deficiencies, including outdated information, bank problems are identified early enough to avoid serious problems.

We believe that high risk loans, such as business and agricultural loans, need to be evaluated using current and complete information because the collectibility of such loans depends largely upon the profitability of borrowers. Current cash flow and other financial information are critical to both bank management's and the examiner's understanding of the borrower's ability to service debt and the conditions and circumstances that may lead to problems. Although it was not clear from FDIC's comments what inspections entail, we found no evidence in the examinations we reviewed that examiners went beyond the loan files and discussions with management to review loan quality. Further, for two open bank examinations we reviewed, the examiners identified significant loan file deficiencies but did not downgrade management. Several FDIC officials told us that loan file deficiencies alone would not necessarily cause examiners to downgrade management. Although bringing management's attention to loan file deficiencies is important for internal control purposes, it is not a substitute for loan review based on current and complete information.

FDIC stated its belief that its current practices already address our recommendation that it monitor examinations to ensure that examiners are following FDIC's additional guidance (June 1991 policy issued to supplement May 1991 guidance) for evaluating allowances for loan losses and documenting their work in accordance with the guidance. FDIC stated that examiners are required to document their analysis of reserves in the working papers and must forward the papers to the regional office whenever reserves are determined to be inadequate. In addition, FDIC stated that review of all examinations by the regional office is sufficient to ensure that reserves were adequately analyzed and that corrective action was taken where appropriate.

We believe that it is critically important for FDIC to monitor a representative number of examinations including supporting working papers to ensure that its policies for evaluating loan loss allowances are being followed. A representative review must include examinations that conclude allowances are adequate as well as those that determine they are not. Most of the open bank examinations we reviewed that had insufficient support included conclusions that loan loss allowances were adequate or acceptable. In comments on our recommendations in chapter 5, FDIC stated that future regional reviews will include random selections of examination reports with working papers. It is not clear whether this review will include the working papers for assessing the allowances. At the time of our field work, regional reviews of examinations were limited mainly to the examination reports. Further, during discussions of our findings in this report, FDIC officials told us that there are no plans for regional office reviews of examination working papers other than those involving real estate loan appraisals. In that case, monitoring examinations to ensure that examiners are following FDIC guidance would be difficult because the worksheet supporting the examiners' conclusions about loan loss allowances would not be included in the examination working papers related to real estate loan appraisals.

Examinations Lacked Evidence of Comprehensive Internal Control Review

In 1991 and 1989, we reported that internal control weaknesses contributed significantly to bank failure.[1] Similarly, we found from reviewing available regulatory documentation that most of the 17 banks that failed without warning by FDIC experienced internal control weaknesses that went uncorrected and eventually contributed to the banks' failure. However, none of the examination files for the open and failed banks we reviewed included evidence that comprehensive evaluations of internal controls were performed by examiners. FDIC guidance stated that examiners are responsible for the overall assessment of the bank's system of internal control. It suggested that the assessment can be accomplished by (1) an overall evaluation of the internal control system, (2) performance of standard examination procedures, and (3) review of external audit programs and reports. The guidance, however, did not clearly define requirements for examiners. As a result, there was no assurance that internal controls were adequately reviewed to identify bank problems early and, thus, protect the safety and soundness of banks and minimize losses to the Bank Insurance Fund from failed banks.

Internal Controls Are Important to Banks

Internal controls promote bank safety and soundness by preventing errors and irregularities from occurring, or by identifying them early enough for management to take corrective action before the bank's financial condition is significantly damaged. Internal controls comprise the bank's plan of organization and all methods and measures adopted by the bank to safeguard its assets, ensure the accuracy and reliability of accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies.

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

For banks supervised by FDIC, loan operations are of paramount importance because loans comprise a major portion of the banks' assets

[1] Failed Banks: Accounting and Auditing Reforms Urgently Needed (GAO/AFMD-91-43, April 22, 1991) and Bank Failures: Independent Audits Needed to Strengthen Internal Control and Bank Management (GAO/AFMD-89-25, May 31, 1989).

and involve significant risk. Internal controls for loans protect and facilitate an accurate accounting for a bank's assets from the time a loan is applied for by a prospective borrower to the time the borrower repays the loan. This covers the initial application process; loan authorization and disbursement; and loan servicing, accounting, and collection.

Loan policies and procedures help to prevent loans from being made that involve risks the bank is not properly equipped to handle—risks resulting from factors such as geographical location of the borrower, size and purpose of the loan, or industry involved. The policies and procedures require bank personnel to properly document loan information prior to approval and disbursement of funds so that loans are extended only to creditworthy applicants. They require personnel to maintain complete and current credit information on each borrower throughout the life of the loans so that bank management is made aware of any repayment problems as soon as they develop. Loan policies and procedures identify loans that warrant special attention by management and require management to take effective collection actions against borrowers who fail to make payments according to loan terms. Loan accounting controls help to ensure that interest income and accrued interest from loans are properly recorded in the bank's records, that customers' accounts are properly credited as payments are made, and that income is not accrued on nonperforming loans.

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

Periodic comprehensive evaluations of internal controls—including identification of significant controls and review of individual transactions and records to determine whether controls are functioning properly—help ensure that adequate systems are in place to enable banks to operate safely and soundly.

The FDIC Improvement Act of 1991 requires financial institutions having assets of $150 million or more to prepare reports on the effectiveness of their internal control structures. In addition, the act requires external auditors to attest to management's assertions about the effectiveness of internal controls. Examiners can enhance the efficiency of their work by using the available internal control reviews required by the act in planning and conducting their examinations. However, because the vast majority of insured state nonmember banks have assets of less than $150 million, they will be exempt from these internal control requirements. We believe it is important that examiners ensure that these smaller banks, even though less complex, receive the same comprehensive internal control evaluation as larger institutions. According to available information from FDIC, 998 or 84 percent, of the banks that failed from 1985 to 1992 had total assets of $100 million or less. These banks accounted for 24 percent of the total loss incurred by the Bank Insurance Fund during this period, and thus contributed substantively to its deficit at the end of 1991. However, for institutions with total assets greater than $150 million, FDIC examiners can enhance the efficiency of their work by using the available internal control reviews required by the act in planning and conducting their examinations and specifically reviewing internal controls.

No Evidence of Overall Evaluations of Internal Controls

FDIC guidance did not provide specific requirements for an overall evaluation of a bank's internal controls, and we did not find evidence that overall evaluations were performed by examiners. Although FDIC officials told us that examiners do enough work to assess internal controls for safety and soundness purposes, there was no evidence that examiners understood the banks' essential controls and identified all material deficiencies in bank operations. Examinations included little evidence that critical controls were identified and tested.

Manual Not Clear on Required Examination Procedures

The FDIC Manual included an extensive discussion of internal controls; however, it did not define what constitutes an overall evaluation of a bank's internal control system for examiners. The Manual stated that FDIC's "Internal Routine and Control Schedule," which is an internal control questionnaire, provided a framework for an overall evaluation of a bank's system of internal controls and should be prepared by the examiner and included in the examination working papers. This schedule, however, did not adequately address all critical controls over bank operations. For example, the only loan related questions on the schedule pertained to bank controls over collateral and liability ledgers. Controls for the initial loan application process, loan authorization and disbursement, and loan servicing and collection were not specifically addressed by the schedule.

The Manual also described standard internal control examination procedures for areas such as cash, securities, premises and equipment, income and expense accruals, and deposit accounts. For loans, the Manual stated that the examiner's evaluation of the loan portfolio involved an assessment of lending and collection policies. The Manual, however, did not clearly state the extent to which examiners are expected to perform the procedures or test individual transactions and records to determine whether bank policies are being followed and to identify the magnitude and cause of deficiencies. Rather, the Manual left this to the examiners' discretion.

Extent of Work and Support for Conclusions Not Documented

The examination working papers for all 11 of the randomly selected open banks did not include evidence that examiners obtained an overall understanding of the bank's internal controls. Based on these results, we estimated that this condition existed for the most recent FDIC examination of nearly all 7,691 banks that were supervised by FDIC as of September 30, 1990.[2] None of the examinations in our sample included documentation of the banks' internal operations and significant controls over those operations. Further, the internal control schedule required by FDIC's Manual was included in only two of the open bank examinations we reviewed. We found the same types of deficiencies involving the internal control assessment in examinations involving the 11 banks that failed without warning.

The reports of examination and the examination working papers for our sample banks contained either no information or very limited information about internal control procedures performed by examiners. For example, we noted that technical exception listings for bank credit files were included for seven of the open bank examinations. These listings, however, only identified the extent to which information about borrowers was missing from credit files. We also noted in reviewing securities that for six of the open banks, only safekeeping receipts for securities were reviewed by examiners. Most of the reports of examination included only scant statements about the adequacy of the banks' policies for loans and investments, and the extent to which required vacation policies for bank employees were being followed. There was little evidence that procedures were performed on individual transactions and records to determine compliance with the policies.

Further, deficiencies in bank policies that were mentioned in examination reports were not accompanied by discussions of their magnitude, cause,

[2]The range of our confidence interval, at a 95 percent confidence level, is that these conditions existed for the most recent FDIC examination of between 72 percent and 100 percent of the 7,691 banks that were supervised by FDIC as of September 30, 1990.

or impact on the scope of the examination. One report of examination for an open bank stated that the loan policy did not address guidelines for the review of the allowance for loan losses, parameters for placing a loan on the bank's "watch list" (listing of problem loans that require close monitoring by management), guidelines for not accruing interest income on delinquent loans, collection procedures against borrowers who do not make timely payments, and the lending authority of bank officers. However, it was not clear whether only the bank's written policies were deficient or whether actual practices of bank personnel were deficient. There was no evidence that examiners tested individual transactions and records to determine the extent and cause of the deficiencies, and there was no explanation as to how the deficiencies affected the number of individual loans they reviewed. We found that only about 18 percent of the loan portfolio (including only 1.5 percent of the commercial and industrial loan portfolio) was reviewed by the examiners—a small amount of loans given the policy deficiencies mentioned in the report.

A report of examination for another open bank stated that internal controls had been "subject to significant comment" in a previous examination report prepared by the state banking authority. The report further stated that a thorough review of the area revealed that the exceptions had been addressed. However, neither the report nor the working papers disclosed whether the state or FDIC conducted the thorough review, the specific weaknesses reported by the state, or what FDIC examiners did to assess the current status of internal controls. Although the report identified one inadequate appraisal, neither it nor the working papers stated the number of records tested or included evidence that enough testing had been done to determine the magnitude and cause of the problem.

According to FDIC officials, examiners performed internal control procedures during examinations, but did not always document their work. Several officials stated that controls over loans were evaluated by examiners when they evaluated individual loans. However, we found little support for this assertion as the linesheets for loan reviews did not typically include internal control related information, such as whether loan disbursements and renewals, collection efforts for delinquent loans, and accounting for loans were proper and in accordance with bank policies. To adequately determine the magnitude and significance of internal control problems, it is critically important for examiners to document their work and clearly identify the number of records and transactions reviewed, and the number of deficiencies identified.

Several FDIC officials told us that heavy workloads and limited resources have precluded examiners from performing more comprehensive internal control reviews and preparing related documentation. These officials stated that since the passage of FIRREA in 1989, significant personnel resources were assigned to examinations of savings institutions regulated by the Office of Thrift Supervision.

Inadequate performance of comprehensive evaluations of internal controls over bank operations inhibited FDIC from identifying the magnitude of problems prior to bank failure. Most of the 17 banks that failed without warning by FDIC had serious internal control deficiencies. Available evidence indicated that comprehensive evaluations of internal controls were not performed by examiners prior to failure.

Little Evidence That Examiners Reviewed Auditors' Work

As part of the overall assessment of internal controls, the FDIC Manual required examiners to determine whether the bank has an adequate external audit program. The Manual stated that banks that have annual financial statement audits generally have satisfactory programs. For banks that have work performed by auditors that is more limited than a financial statement audit, examiners were required to determine whether the auditors are qualified and independent of the bank, and whether the procedures they perform are adequate for the risk level of the bank. The Manual included audit procedures for areas such as cash, investments, loans, the allowance for loan losses, and customer deposits.

In addition, in January 1990, FDIC issued its "Statement of Policy Providing Guidance on External Auditing Procedures for State Nonmember Banks." The statement required examiners to review the risks in the bank's operations and comment negatively if sufficient auditing procedures were not performed by external auditors as often as necessary to ensure the safe and sound operation of the bank under examination. The statement also stated that if a bank chooses to have an audit of its financial statements performed by an independent public accountant, the audit will generally satisfy the objectives of the statement.

The external auditing procedures included in the January 1990 statement were more specific and comprehensive than those included in the Manual and more adequately addressed the major high risk operational areas of banks. The statement included a comprehensive listing of internal control procedures for loans, the allowance for loan losses, security investments, insider transactions, and general accounting and administrative controls.

It included procedures for policy review as well as procedures for testing specific transactions to ensure that bank policies were being adhered to. The statement suggested that auditors use sampling where testing is required or where determinations must be made. It also stated that the sampling method and extent of testing (including the minimum sample sizes) should be disclosed by the auditor in the audit report. The statement, however, did not explain how examiners are to assess the work performed by external auditors or address the extent examiners should perform the auditing procedures when they are not performed by auditors.

Of the 28 open and failed banks we reviewed, 8 had independent financial statement audits within 24 months prior to examination. Most of the other banks had received directors' examinations or other limited reviews.[3] We found no evidence that examiners determined whether the external auditor was qualified and independent of the bank, and in only one case was there evidence that the examiner reviewed the auditor's work to determine whether the procedures performed were sufficient for the bank.

We identified two cases from open banks where the external auditor's independence was questionable and should have been thoroughly reviewed by the examiners. One case involved a bank that had received an external directors' examination by a firm whose president was a major stockholder of the bank. The other case involved a troubled bank, which state examiners believed was being managed by the auditors who had performed annual financial statement audits for the bank. Neither case included evidence that FDIC examiners reviewed the relationships and concluded as to whether independence was compromised.

According to FDIC officials, examiners conducted reviews to determine whether external auditors were independent of the bank, and they reviewed reports to determine what auditors covered but did not always document this work. Officials from one regional office stated that examiners assumed that larger, nationally recognized accounting firms were independent absent proof to the contrary. They explained, however, that examiners should still review financial arrangements to determine whether auditors were independent of the bank. FDIC officials in another regional office stated that they assumed examiners performed many of the

[3]Directors' examinations are limited bank reviews performed by external auditors that do not typically incorporate financial statements or determine the collectibility of loans, adequacy of collateral, and reasonableness of loan loss allowances. Further, these examinations do not necessarily include reviews of a bank's internal control structure similar to reviews associated with financial statement audits. Limited reviews usually entail agreed upon procedures performed by the external auditor and, therefore, are less comprehensive than financial statement audits.

procedures included in the policy statement when they assessed loans and securities but did not always document their work.

For the six failed banks that had received independent audits, there was no evidence suggesting that examiners reviewed the work of the auditors to determine whether it included comprehensive evaluations of internal controls. Similarly, there was no evidence of such a review for the four failed banks that had received more limited reviews. Internal control deficiencies contributed to the failure of each of these banks. One bank we reviewed failed because of fraudulent lending practices on the part of the bank's vice president. In 1983, FDIC had reported that the individual had an inordinate amount of authority to make loans and book loan restructurings and renewals directly into the bank's accounting system. Subsequent examination reports stated that the examiners had reviewed limited-review reports prepared by the bank's external auditor in 1985 and 1986, and that these reports stated that no material weaknesses were identified by the auditors. There was no evidence that the examiners communicated with the auditors or reviewed the auditors' work to determine whether enough was done to adequately assess bank policies and practices.

Conclusions

FDIC's ability to identify problems in a timely manner and take corrective action is compromised if examiners do not comprehensively evaluate internal controls over bank operations or ensure that such evaluations are adequately performed by independent auditors. FDIC's guidance did not adequately set forth requirements for examiners to conduct overall evaluations of internal controls including review of internal control work performed by external auditors. Further, the guidance did not include requirements for examiners to systematically test individual records and transactions to determine compliance with bank policies and the magnitude and cause of deficiencies that were identified. For banks that are not subject to the internal control review requirements of the FDIC Improvement Act, it is particularly important for examiners to either evaluate internal controls or determine whether internal controls are sufficiently evaluated by internal or external auditors so that such work can be relied on.

Recommendations

We recommend that the Chairman of the Federal Deposit Insurance Corporation take the following actions:

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

Agency Comments and Our Evaluation

FDIC disagreed with our recommendation to develop comprehensive internal control review procedures, including identification of controls and testing to be used during on-site examinations. FDIC stated that comprehensive procedures are already in place and that an examination is not designed to test controls in the manner of an audit but rather to identify excessive risk or weaknesses and determine their causes. FDIC stated that examiners perform pre-examination risk assessments to identify deficiencies and potential problem areas in internal controls and bank policies. FDIC further stated that the highest risk of loss to financial institutions results from lending and investment decisions and policies and controls in these areas are discussed in the report of examination and receive the bulk of analytical attention. It stated that the examiners' review of loans will reveal the loans' collectibility; conformance to bank policies for application, servicing, and collection; and conformance to laws and regulations.

To identify excessive risk or weakness in a bank, examiners must understand the magnitude and cause of problems. Such understanding is obtained by systematically identifying and testing specific controls. Although the FDIC Manual included an extensive discussion of internal controls, it did not clearly state what examiners have to do to complete an overall evaluation of internal controls and the extent to which examiners are to analyze individual transactions and records. Comprehensive review of internal controls facilitates proactive regulatory oversight to identify problems in a timely manner. Reviewing nonperforming loans as a primary approach to internal controls leads to reactive regulatory oversight that is not timely as control weaknesses have already contributed to nonperforming loans. Because most FDIC supervised banks will not be required to have auditors attest to the effectiveness of their internal controls due to the $150 million threshold established by the FDIC Improvement Act of 1991, examination requirements in this area are critical to ensure that all FDIC banks receive comprehensive internal control evaluations.

FDIC did not concur with the recommendation to require examiners to conduct independent comprehensive reviews of internal controls of banks with assets less than $150 million. It stated that costs would outweigh anticipated benefits. FDIC stated that banks with assets under $150 million are generally subject to some form of yearly external audit or directors' examination and that examiners review the external auditors' reports, using the guidance for external auditors to plan their own work. When reports are not available, the examination scope is adjusted.

As stated in our report, we previously reported that internal control weaknesses contributed significantly to bank failure. Further, according to information from FDIC, most of the banks that failed from 1985 to 1992 had total assets of $100 million or less and accounted for 24 percent of the total loss incurred by the Bank Insurance Fund during the period. Because problem banks are often small and collectively their failure significantly affects the Bank Insurance Fund, we believe that it is important for banks with assets less the $150 million to receive the same comprehensive internal control evaluation as larger institutions. FDIC cannot reliably assume that external audits or directors' examinations comprehensively evaluate internal controls. In fact, neither of these reviews routinely provide such coverage of internal controls.

We found little evidence in the working papers to support the FDIC assertion that examiners performed pre-examination assessments designed to identify potential problem areas in internal controls. For two open bank examinations in which we found documented evidence of this assessment, there was only cursory reference to potential areas of weakness in internal controls. We also found that deficiencies in bank policies that were mentioned in examination reports were not accompanied by discussions of their magnitude, cause, or impact on the bank's condition or on the scope of the examination. Further, we found little support on loan linesheets or other working papers that examiners ensured that controls over areas such as loan disbursements and renewals, collection efforts for delinquent loans, and accounting for loans were in place and functioning properly.

Regarding the recommendation to require examiners to rely on the assessments required by the Federal Deposit Insurance Corporation Improvement Act of 1991 to the extent possible, and supplement these assessments as necessary, FDIC stated that its existing guidance on external auditing procedures will be used to judge the adequacy of work performed by external auditors. FDIC stated that although it is satisfied with its existing internal control policies, it intends to review and revise the existing internal control checklist to ensure that it includes all key internal control procedures. FDIC further stated that the revised checklist will be included in the regional office review process. However, other than stating that the procedures in the guidance form the basis for preparing a standardized checklist for each examination, FDIC did not comment on whether it would require its examiners to supplement the work of external auditors when the work is deemed inadequate.

The standardized checklist can help examiners determine whether work performed by auditors is sufficient to identify problems early and control risk if it addresses all significant bank controls. A checklist, however, cannot be the sole basis for evaluating internal controls particularly when the work of auditors is judged to be inadequate. The checklist must be supported by evidence that control design has been reviewed and actual operation of controls tested.

Other than stating that examiners prepare standardized checklists based on the information in the guidance for external auditors, FDIC did not provide specific comments regarding the recommendation to establish documentation requirements for the examiners' assessments of work performed by auditors and procedures examiners perform to enable FDIC to assess the adequacy of internal control evaluations.

As discussed in the report, it is critically important for examiners to document their internal control work to ensure that the magnitude and significance of internal control problems are accurately identified. Examiners can use the work of external auditors to improve examination efficiency either to satisfy the examiners' internal control assessment or to reduce the effort necessary depending on the scope and quality of the external auditors' work. Adequate assessments and documentation on the external auditor's qualifications, independence, and work quality can help (1) avoid misunderstandings about the extent to which the work should be relied upon and (2) ensure that each bank receives an adequate internal control evaluation.

In response to our recommendations that the CAMEL rating system be modified to include a separate factor for internal controls, FDIC stated that, since internal controls were included in their assessment of the management factor in the CAMEL rating system, no changes were needed.

We believe a separate CAMEL factor would emphasize the importance of internal control assessments and help ensure that this important examination element is not overlooked or inappropriately minimized. As stated earlier, we found little to no evidence that comprehensive internal control reviews were done by FDIC in the examinations in our sample and, therefore, FDIC did not have a sufficient basis to assess management on this critical factor.

FDIC Relied on Unverified State Examination Results

FDIC relied on examinations performed by state banking authorities to extend the amount of time between its own examinations. However, FDIC did not determine whether state examination results were accurate and valid. Reliance on unverified information to schedule and conduct examinations can prevent FDIC from identifying bank problems in a timely manner.

Work Performed by State Examiners Not Assessed

The FDIC Improvement Act of 1991 allows federal banking regulators to substitute state examinations for federal examinations on a limited basis if the federal regulator deems such action appropriate. The act provides that federal examinations need only be conducted in alternate 12-month periods[1] if an examination has been performed by state banking authorities during the intervening 12-month period and the federal regulator determines that the state examination carries out the purpose of requiring a full-scope, on-site examination. Prior to the act, FDIC guidance allowed examination intervals of up to 48 months if interim state examinations were performed and off-site monitoring confirmed the state ratings.

FDIC extended examination intervals for 6 of the 11 randomly selected open banks we reviewed because of interim state examinations. For two of these banks, FDIC exceeded its maximum examination interval requirement of 48 months when state examinations had been performed. In one case, 85 months elapsed between FDIC examinations. In our review of 17 banks that failed without warning, we found that 6 of the banks had not had an FDIC examination during the 48-month period prior to failure, but had received one or more interim state examinations during that time. Neither the examination reports nor the working papers for the open and failed banks we reviewed included evidence that FDIC officials or examiners had assessed the work and findings of state examiners to determine if enough work had been done to effectively identify bank problems.

According to FDIC officials, although the quality of state examination reports varied from state to state, examiners did not review the work that supports findings and conclusions in the reports, and there is no FDIC requirement to do so. The officials told us that reliance on state examination reports is typically based on the FDIC region's historical knowledge of the quality of each state's examination reports and the expertise of its personnel, which made it unnecessary and undesirable to

[1]The applicable period is 18 months for certain well-capitalized and well-managed institutions with total assets of less than $100 million.

verify state examination results on an individual basis. They told us that when examination report quality of a state was known by FDIC to be a problem, the state's reports were not used to extend intervals between FDIC examinations.

The following examples from the failed banks we reviewed illustrate instances where FDIC inappropriately relied on state examinations and delayed its own exams.

- A state examination reported deterioration of the bank and improper intercompany transactions that were jeopardizing bank safety and soundness. Nevertheless, the state rated the bank "2" for both asset quality and management. Neither FDIC nor the state examined the bank until 31 months later, when FDIC rated the bank "5" in asset quality and "4" in management. The bank was closed 4 months later.
- In another case, FDIC changed the state's examination rating from "2" to "3" based on evidence contained in the state's examination report. The bank had not been examined by FDIC during the previous 37 months, and FDIC was aware that the state had a history of being too lenient with this bank with regard to asset classifications. Nevertheless, FDIC waited another 16 months after changing the state's rating to conduct its own examination. The bank failed 2 months later.
- For another bank, FDIC did not perform an examination for a 40-month period between June 1984 and September 1987. During this time, the bank was examined by the state. During the 1987 examination, FDIC found that classified assets had increased from $158,000 (at the 1986 state examination) to $8 million. FDIC subsequently stated in a file memorandum that "it appears that financial information was downloaded, with the [state] examination being nothing more than a cursory review to justify the [financial] ratios."

Government auditing standards state that when auditors rely on the work of other auditors to avoid duplicating audit efforts, they should consider whether to (1) conduct additional tests and procedures such as reviewing the audit procedures followed and results of the audit conducted by the other auditors, (2) review the audit programs of the other auditors, and/or (3) review the working papers, including the other auditors' understanding and assessment of internal controls, tests of compliance, and conclusions reached. The standards further state that auditors may review the documentary evidence in the other auditors' working papers or make supplemental tests of the work conducted. While FDIC examiners are not subject to these standards in conducting their work, this type of preliminary assessment is necessary to determine whether work performed by state examiners is sufficient to address the risk levels of the bank and to develop an adequate basis for relying on such work to extend intervals between examinations. Also, such review and testing requires substantively less time than if FDIC conducted the examination itself. It would also provide objective evidence on the quality of work performed by the state examiner, as opposed to reliance on FDIC's historical perceptions.

Conclusions

Reliance on unverified results presented in state examination reports to schedule and conduct examinations can preclude early identification of bank problems. Under provisions of the FDIC Improvement Act of 1991, FDIC will be allowed to continue to substitute state examinations for its own examinations on a limited basis if it deems such action appropriate. However, to determine whether state examinations should be used to extend examination intervals requires an understanding of the procedures and methods applied by state examiners in assessing bank safety and soundness. We found no evidence that FDIC examiners performed procedures necessary to develop such an understanding.

Recommendations

We recommend that the Chairman of the Federal Deposit Insurance Corporation take the following actions:

- Establish a policy that requires examiners to assess the work of state examiners and determine if it can be relied on to extend the time between FDIC examinations. The assessment can be accomplished by reviewing state examination working papers or by performing limited work at the bank to verify findings presented in the state reports.
- Coordinate the implementation of the use of state examinations with the other federal depository institution regulatory agencies to achieve uniform requirements.

Agency Comments and Our Evaluation

FDIC stated that it sees merit in the recommendation to establish a policy that requires examiners to assess the work of state examiners and determine if it can be relied on to extend the time between FDIC examinations. It stated that while participating in more state examinations would not be practical because of personnel constraints, it plans to give serious consideration to including a review of state examination working papers in its Regional Office Review Program. FDIC stated that its review of state examination reports is valuable in its supervision of state nonmember banks, but that if its review shows that a state report findings are not adequately supported, the report is not used to extend examination intervals. Further, FDIC stated that state examinations will not be used to extend examination intervals for institutions whose composite CAMEL rating is 3 or higher.

As discussed in the report, reliance on unverified results of state examinations to schedule and conduct examinations can prevent timely identification of bank problems. Before FDIC relies on the work of state examiners to extend its own examination intervals, it must obtain an understanding of what work was performed by state examiners and whether the work was sufficient to address the risk levels of the bank. We believe that a review of state examination working papers for banks with composite CAMEL ratings of 1 or 2 is particularly important to determine whether that work supports a favorable rating, thus potentially justifying an extension of FDIC's examination interval. FDIC needs to ensure that the state examiners' work is reliable to ensure that problems are discovered as early as possible.

Insufficient Quality Control Over Examinations Hindered FDIC's Ability to Anticipate Bank Problems

FDIC's policies and practices for controlling examination quality were not adequate. Policies and practices for review of examination working papers, on-site supervision, and retention and documentation of examination work were not sufficient to ensure the adequacy of the examiners' work to identify bank problems. As a result, insufficient examination work may not be identified by supervisory officials and bank problems may go unidentified and contribute to bank failure.

Examination Review Limited Mainly to Reports

Reviews of examinations performed by FDIC supervisory officials were limited mainly to the examination reports and rarely included the examination working papers. Examination reports, however, often did not include the support for decisions made by examiners about the critical areas of loan quality and internal controls. As a result, much of the work and reasoning behind examiners' conclusions for these areas were not reviewed by supervisory officials.

Upon completion of examination work, examiners submit a report of examination to an FDIC field office supervisor, who reviews the report and submits it to an FDIC regional office for review. The report of examination is reviewed by a regional review examiner to determine whether problems identified are material, and if the report is complete, numerically accurate, and written with proper tone. Subsequent to this review, an assistant regional director also reviews the report and any comments made by the review examiner. FDIC officials told us that working papers generally are not reviewed by field office supervisors and regional officials unless FDIC takes enforcement action against a bank.

The report of examination typically includes examiner comments and conclusions for the five CAMEL areas, financial statements and analyses based on call report data, and other information provided by bank officers. The financial information is used primarily to compute ratios and trends, particularly for assessments of capital adequacy, earnings, and liquidity. These ratios and trends show how the bank has performed over time and how it compares to banks of similar size. Information from bank officers includes the extent and composition of credit extensions, loan commitments, litigation, and off-balance sheet activity. The report, however, does not include adequate support for examiner decisions about two of the most critical components of the examination—loan quality review and review of internal controls.

The reports for the open and failed banks we reviewed provided little basis to evaluate the competence and sufficiency of the evidence used by examiners to make loan assessments. They typically included written discussions for only some of the larger adversely classified loans and sometimes did not clearly explain why examiners concluded that the loans were substandard rather than doubtful. No explanations were provided in the reports for decisions made by examiners to pass loans without criticism. We found that reports for the open banks included written discussions for only a small percentage of total loans reviewed by the examiners. Of 11 reports for open banks, 6 included written discussions for less than 10 percent of the dollar value of loans examined, while 1 included written discussions for 25 percent of the dollar value examined. The remaining 5 reports did not include any written discussions for specific loans.

Further, as discussed in chapter 3, the reports we reviewed typically included only scant statements about the adequacy of the bank's loan and investment policies. The reports contained little information about the magnitude and cause of problems that were mentioned or that explained what was done by examiners to evaluate internal controls. As a result, the reports provided little basis to judge the examiners' work.

One open bank we reviewed illustrates the importance of periodic supervisory review of examination working papers. The bank was given a composite rating of "2" by FDIC as a result of an examination it conducted in December 1987. The state banking authority, however, assigned the bank a composite rating of "4" as a result of an examination performed in November 1988. We found that the state examiners adversely classified about $10 million in loans based on circumstances that existed at the time of the 1987 FDIC examination; however, the loans had not been classified by FDIC. Because these loans were passed by the examiners, they were not discussed in the examination report. Therefore, analyses performed on these loans, if any, were not subject to supervisory review by field office supervisors or regional office officials. Had FDIC officials reviewed the working papers subsequent to the 1987 examination, they might have determined that insufficient assessments had been performed for these loans and required examiners to do more work.

According to FDIC officials, FDIC did not have written policies for systematic review of examination reports and working papers by supervisory officials in the regions. The officials stated that FDIC relied predominantly on the training and expertise of its examiners to ensure examination quality, rather than on formal review policies.

In November 1991, FDIC began requiring regional offices to perform a random review of examination working papers for real estate loan appraisals. The purpose of the review was to determine whether examiners are ensuring that the appraisals are based on valid techniques and assumptions. However, according to FDIC officials, the review did not have to include an assessment of the examiners' determinations regarding loan classifications. Further, the officials stated that there were no plans to review examination working papers other than those involving real estate loan appraisals.

Systematic supervisory reviews of working papers by regional officials are essential to quality control of examinations because examiners have broad discretion and must exercise considerable judgment in planning the examination, gathering and analyzing data, and drawing conclusions about bank safety and soundness. Such reviews help ensure that examiners are consistently exercising sound judgment and obtaining enough information to identify bank problems early enough to take corrective action.

Insufficient Evidence of On-Site Review of Examinations

Less experienced examiners charged a substantial number of hours to the examinations we reviewed; however, there was little evidence in the examination working papers that senior examiners reviewed their work. According to FDIC officials, FDIC did not have a written policy for on-site review of examination working papers, but the signature of the examiner-in-charge on the report of examination serves as evidence of review by experienced examiners. FDIC cannot be assured that work performed by less experienced examiners is adequate without documented on-site review by experienced examiners of specific work performed.

We found that the examination working papers for the open and failed banks usually did not include signatures of either preparers or reviewers. For some of the most critical examination work—individual loan evaluations—we rarely found evidence on loan linesheets or other working papers that assessments for individual loans had been reviewed by the examiner-in-charge or other senior examiner.

According to FDIC data for the first and third quarters of 1991, assistant examiners and examiner trainees charged the majority of hours to safety and soundness examinations. These examiners are not commissioned (and are not qualified) to conduct bank examinations on their own, but they assist the examiner-in-charge in performing various parts of the examination.

For the open banks we reviewed, we found that noncommissioned examiners charged a substantial number of hours to the examinations, including loan quality review and review of internal controls. One examination report showed that 93 percent of the hours for loan review were charged by assistant examiners and trainees. Another report stated that 65 percent of the hours for loan review were charged by such less experienced examiners. Although the examination reports for these banks showed that the senior examiner charged hours to the examination, it was impossible to determine from the working papers whether these hours consisted of examination work performed or review of work performed by the less experienced examiners. Further, we noted that several examinations indicated that reviews of external audit reports, a critical component of internal control review, were performed entirely by less experienced examiners.

We also found that for five of the open bank examinations, an assistant examiner performed the duties of the examiner-in-charge. The only evidence of supervisory review consisted of statements in the examination report that the examiner-in-charge agreed with the report findings. One report stated that the examiner-in-charge "generally concurred with the findings of the assistant examiner" (who conducted the examination) without further explanation.

Documented on-site review of working papers by the senior examiner is essential to ensuring examination quality because less experienced examiners charge substantial hours to critical parts of examinations, which demand expertise and the exercise of sound judgment.

Retention and Documentation Policies Inadequate for Quality Control

FDIC's retention and documentation policies for examinations were inadequate for quality control. Examination working papers were not retained long enough to facilitate a systematic review, and the working papers were not prepared in a manner that enabled independent reviewers to clearly judge the competency and sufficiency of work performed by examiners.

FDIC could not provide us the examination working papers for the most recent examination for one of the open banks and six of the failed banks we reviewed. Further, for three of the failed banks, FDIC could not find the most recent examination report prior to failure. Therefore, an assessment of the examiners' work for these examinations was impossible. According to FDIC policy for retention of working papers, documentation with no long term supervisory importance may be destroyed when it is 1 year old. Reports of examination, however, must be retained for a period of 10 years. We assume that the working papers for the six failed banks had been destroyed because they were over 1 year old. According to FDIC officials, working papers for the one open bank were destroyed after the bank merged with another.

We found that working papers that were made available to us often did not include sufficient evidence for examination work or enable us to determine what procedures examiners performed. As previously discussed in chapters 2 and 3, sufficient evidence was not in the working papers to support loan quality review and comprehensive evaluations of internal controls. In addition, examination working papers generally did not indicate why work was performed or what was accomplished, or include specific conclusions reached by examiners. Further, it was often difficult to determine whether documents included in the working papers had been prepared by bank personnel or FDIC examiners.

Documentation of examination work and adequate retention of examination working papers are essential to quality control over examinations. Documentation enables supervisors to readily determine whether examiners did enough work and did it correctly to adequately judge bank safety and soundness. Retention of working papers is important because it enables supervisors to periodically select enough examinations to review to judge examination quality for a given time period.

Conclusions

Although FDIC relies on the training and expertise of its examiners to ensure examination quality, quality control over examinations must include three essential components: adequate documentation of examination work and retention of working papers, evidence of on-site supervision of examination work, and independent periodic review of working papers by higher level supervisory officials. These components are essential because examiners have broad discretion and must exercise considerable judgment in planning the examination, gathering and analyzing data, and drawing conclusions about bank safety and soundness. Further, a substantial number of hours were charged to examinations by less experienced examiners.

Recommendations

We recommend that the Chairman of the Federal Deposit Insurance Corporation take the following actions:

- Establish documentation policies for examiners that are sufficient to enable reviewers who did not perform the work to readily determine whether enough work was done and done correctly to support examiner judgments on bank safety and soundness.
- Require commissioned examiners to perform and document on-site reviews of all work performed by less experienced examiners.
- Establish a policy for periodic regional reviews of examinations by appropriate officials to ensure that reports are adequately supported by examiners' work. The working papers prepared by the examiners should be reviewed to determine whether adequate work was done to assess the safety and soundness of the bank.
- Establish policies for examination working paper retention that will facilitate the regional reviews of examination work. The retention policies should be sufficient for FDIC to periodically select sample examinations and review the working papers to judge the quality of examinations for a given time period.
- Coordinate implementation of the quality control recommendations with the other federal depository regulatory agencies to achieve uniform requirements.

Agency Comments and Our Evaluation

Regarding the recommendation to establish a policy for periodic reviews of examination working papers by appropriate officials, FDIC stated that future regional reviews of examinations will include a review of a sample of examination reports and working papers. FDIC did not comment directly on the recommendation to establish sufficient documentation policies for examiners to enable reviewers who did not perform the work to readily determine that enough work was done to support examiner judgments. However, FDIC's general comments, which are evaluated in chapter 2, express FDIC's belief that its documentation policies are adequate.

As discussed in the report, we found that examination working papers did not include sufficient evidence to determine what procedures examiners performed. Further, sufficient evidence was not in the working papers to support two of the most critical components of an examination—loan quality review and the evaluation of internal controls. Sound documentation policies are essential to effective regional reviews of examinations because reviewers must be able to readily determine from the working papers whether examiners analyzed enough information and exercised sound judgment in assessing the bank's condition, particularly the quality of its loans and effectiveness of its internal controls.

FDIC did not concur with the recommendation to require commissioned examiners to perform and document on-site reviews of all work performed by less experienced examiners. FDIC stated that its requirement for the examiner-in-charge to sign the examination report is sufficient for quality control purposes.

We believe that because expertise and sound judgment are critical to examinations, the actual work performed by noncommissioned examiners to support their conclusions regarding safety and soundness as evidenced in the working papers should be closely monitored by commissioned examiners. In our opinion, the signature of the examiner-in-charge on the examination report does not provide assurance that adequate monitoring is being performed on detailed work performed by noncommissioned examiners for critical areas such as loan quality and internal controls.

Regarding our recommendation on working paper retention policies, FDIC stated that it will review and revise as necessary retention instructions for examinations so that working papers will be retained at least until the subsequent FDIC examination. Although we believe that a review of the prior examination is essential for effective examination planning, our concern is that examination working papers be retained long enough for FDIC to complete a systematic review of working papers to ensure examination quality. The retention period should coincide with the review cycle that FDIC intends to incorporate into its regional review process mentioned above, rather than the dates of subsequent examinations.

Comments From the Federal Deposit Insurance Corporation

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

FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, DC 20429

OFFICE OF THE CHAIRMAN

November 12, 1992

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

Dear Mr. Chapin:

RE: Bank Examination Quality - Federal Deposit Insurance Corporation Examinations are Insufficient to Fully Detect Unsound Operations Early
Draft Report

See comment 1.

In short, we strongly disagree with the conclusions made in this report. We do agree and have long held the conviction that early identification of bank problems is essential, and that is a primary function of our examination and off-site monitoring activities. There is, however, a marked and distinct difference between the philosophy of an audit and that of an examination. A highly structured approach may well be appropriate for an audit, but those same procedures if employed in an examination would be counterproductive absent a marked increase in examination staffing. Those procedures would be at the expense of the scope and depth of examination coverage in areas that truly pose risk to the bank and the insurance fund. Some criticisms in your draft report are documentation and procedure related and somewhat at odds with our philosophy that examinations are best guided by policies, not detailed procedures. The report suggests a rigid examination approach with detailed procedures and full documentation every step of the way, somewhat akin to that used by CPA firms in the conduct of external audits which, in their case, may have a great deal more to do with client billing and firm liability than efficiency and effectiveness. The accountant's "by the book" approach presumably has had questionable results, given the public criticism and large number of lawsuits directed at accountants.

FDIC's supervision program is built around a belief that the most effective way to quantify risk to the insurance fund presented by any financial institution is through use of onsite examinations. Given a limited number of personnel resources, one way to increase the number of examinations is to retain sound analytical procedures, but limit the amount of unnecessary documentation. This is the underlying rationale behind FDIC'S examination program as described in the DOS Manual Of Examination Policies. Adoption of the approach advocated by the draft report would require a significant staff increase of perhaps 100 percent.

See comment 1.

Such an increase would be of dubious benefit unless it was accompanied by rigid loan and investment prohibitions or restrictions. Such further restrictions on banking would hurt the industry as well as the economy and still would not keep banks from failing during periods of asset value erosion, such as we have recently experienced.

FDIC policy provides for flexibility in scope of examinations based on a comprehensive, written pre-examination risk assessment, as well as on the emerging risk profile developed during the examination. Our program emphasizes the need for a maximum amount of analysis and minimal, but sufficient, documentation.

Once examiner analysis indicates that an individual investment, funding activity, policy or procedure presents an acceptable level of risk, further transcription of bank records to document that decision is not required. While there is no question that complete transcription of all information would facilitate a subsequent review of examiner judgment, it would substantially reduce the amount of examiner time available for the analysis of other areas, and examination of other banks. The proof of the quality of an examination is not the documented workpapers -- it is what is disclosed at the next exam as a result of the passage of time.

Although stressing maximum analytical effort and relying heavily on proven examiner judgment, FDIC policy does emphasize the importance of adequate and essential documentation. As stated, FDIC policy requires that the starting point of any examination is a written, pre-examination risk analysis that preliminarily sets the scope of the examination. This written document results from the review of all available offsite monitoring tools, prior examinations and current file information. The risk analysis, prepared by an examiner-in-charge and reviewed by a Field Office Supervisor, basically determines the initial scope of the examination. If the pre-examination risk analysis indicates an acceptable level of risk - generally potential composite "1" or "2", - a less extensive examination will be pursued. If the risk assessment is verified by analysis conducted during the examination, the limited scope will be adhered to. In general, limited scope reviews result in less documentation.

Existing FDIC examination policies and procedures are designed to result in an examination report that contains supportable findings accurately portraying risk to the insurance fund and detailing needed remedial measures. Given that fact, it follows that examination reports will display quantitative data relative to bank condition, both good and bad, but will concentrate primarily on supporting findings relative to negative conditions that might adversely affect the insurance fund. An FDIC report of examination "stands on its own". What is not included in FDIC

See comment 1.

reports is data supporting decisions regarding balance sheet items or policies that were viewed by the examiner as presenting little, if any, risk to the insurance fund. The soundness of FDIC examination reports and our ability to rely on examiner judgement has been successfully proven in numerous administrative hearings. More importantly, existing procedures have proven to be effective in dealing with most problem situations. Historically, most banks on the FDIC problem list have been strenghtened without any loss to the FDIC insurance fund. In short, FDIC policies and procedures have proven to be effective in identifying problems and recommending solutions in a timely manner thereby minimizing cost to the insurance fund. More structured documentation of analytical findings would not necessarily result in a decreased number of failures and could in fact increase our exposure as time and effort would be drawn from examination scope in areas posing real risks.

Finally, we reject the notion that your assessment included 17 banks that failed "without warning". While some banks fail on short notice as a result of liquidity or a defalcation, most banks remain open for a considerable period of time after severe problems are identified.

The following responses are provided for each recommendation contained in the draft report.

See comment 1.

RECOMMENDATIONS - CHAPTER 2

Recommendation - Establish a policy for examinations that requires representative and adequate documented evidence to support conclusions reached by examiners on loan quality. The policy should require examiners to document the bases for their conclusions about individual loans regardless of whether the loans are passed or classified.

Response - Criticism contained in the GAO draft report centers on two major areas: (1) The lack in some cases of written examination report comments describing criticized loans, and (2) insufficient documentation noted on line sheets relative to "pass" loans. FDIC policy provides that the only time criticized loans can be listed in a report without supporting narrative comments are: (1) When the examination will result in assigning an overall composite rating of "1" or "2", and even then loan criticism contested by management, criticized insider loans and other unique situations will be supported by detailed written loan comments; (2) in institutions rated "4" or "5" or deteriorating "3", written loan comments are always required unless no new formal or informal administrative action is contemplated and the criticized credits were supported by narrative comments at a previous review.

While we believe that existing FDIC policies and procedures are the most effective means for accomplishing timely problem identification, we recognize that exceptions to existing policies as noted in the GAO Draft Report indicate a need to emphasize adherence to those policies. For that reason, we intend to implement the following:

> Prepare a written communication to all examiners emphasizing the requirement to include written comments on line sheets indicating why loans were passed, or reasons for adverse classification in cases where adversely classified assets are listed in a report of examination without supporting narrative comments.

See comment 1.

Recommendation - Establish an examination policy for loan review to require examiners to assess business and agricultural loans based on current, complete, and accurate information.
Response - The DOS Manual of Examination Policies already requires examiners to identify documentation deficiencies in loan files, such as lacking current, complete, and accurate information, and to furnish a list of exceptions to bank management during the examination in order to expedite correction of the deficiencies. As a practical matter there is no way to assure that examiners always have current information on which to judge loan quality. Examinations might simply drag on for an unduly long period waiting for missing information which the bank has neglected to obtain and may require significant time to generate, such as new financial statements or collateral appraisals. To compensate, in part, for shortcomings in documentation, examiners discuss loans with bankers in order to better understand an inadequately documented loan, sometimes they make inspections, and in critical situations they might wait for documentation deficiencies to be resolved. The scope and timing of subsequent examinations takes into account documentation deficiencies at prior examinations, and procedures are in place to visit banks which have significant problems. When warranted, bank management will be criticized and downgraded for documentation deficiencies. The matter may well become part of a formal or informal corrective program. Such criticism of management is a component of identifying bank problems early enough to obtain corrective action and avoid serious problems.

Regarding this recommendation, we do not believe that policy modification or additional guidance to examiners is necessary.

See comment 1.

Recommendation - Monitor examinations to ensure that examiners are following FDIC's additional guidance for evaluating allowances for loan losses and documenting their work in accordance with the guidance.
Response - As your Draft Report notes, examiners are required to document their analysis of reserves in the work papers. Examiners are required to forward such work papers to the regional office whenever reserves are determined to be inadequate. This procedure combined with the regional office

review of all examinations is believed sufficient to assure that DOS management can be reasonably comfortable that reserves were adequately analyzed and corrective action taken where appropriate.

See comment 2.

Recommendation - Coordinate the implementation of the loan quality review recommendations with other depository institution regulatory agencies to achieve uniform requirements.
Response - No criticism regarding interagency coordination is included in the draft report. The FDIC and other regulators have a long record of coordinating matters relating to asset quality reviews, and continued cooperation is anticipated.

RECOMMENDATIONS - CHAPTER 3

See comment 3.

Recommendation - Develop comprehensive internal control review procedures for all major aspects of bank operations to be used during FDIC's annual on-site examinations. The procedure should identify any major areas in each bank's operations, identify the related significant internal controls, and require testing to assess effective operation of the internal controls.
Response - FDIC has comprehensive internal control review procedures already in place. Even prior to the start of an onsite review, a pre-examination risk assessment is conducted to identify potential problem areas and deficiencies in controls and policies. In addition, the FDIC's basic examination program covers, we believe, most of the internal control reviews suggested. The process is, however, done on a component basis rather than as a control system review. For example, examiners are required to describe policies and practices regarding loans, investments, and interest rate risk on core pages in the examination report. In addition, on the core page titled Administration, Supervision, and Control, the examiner must comment on the extent to which recommendations by regulators and auditors are reviewed and implemented, and on management's knowledge, adherence, and willingness to comply with laws, regulations, etc. In addition, examiners complete work papers on internal controls not covered by other examination functions. The highest risk of loss to financial institutions results from lending and investment decisions. Inadequate policies and controls in these areas present the greatest threat to the insurance fund. It is precisely these areas, regardless of bank size, that receive the bulk of FDIC analytical attention. FDIC policies and procedures are designed to assess the extent of risk to the insurance fund resulting from institution-established policies and controls. If FDIC examiners find that outstanding loans or investments reflect inordinate levels of risk, then policies or controls are analyzed to ascertain the deficiencies that resulted in the unacceptable conditions. In many cases, instances of control deficiencies such as inadequate or outdated credit file documentation are listed on technical exception pages that are included in the examination report and serve as support for examiner criticism and corrective follow-up.

Significant deficiencies regarding other responsibilities of managements or boards of directors are addressed in the examiner's comments and conclusions. Testing does not take place in the manner of an audit; instead, the examination function is designed to identify excessive risk or weakness in each significant risk area in the bank, and when any is identified, to determine its cause. This traditional examination process, we believe, better suits regulatory needs than does a step-by-step audit test since examiners are able to both estimate the bank's true financial condition and identify the managerial or control weaknesses causing or allowing the problems to develop. For example, traditional examiner review of a loan will reveal its likely collectibility, its conformance to bank policy (including application, servicing and collection processes), the appropriateness of the bank policy, and its standing with regard to conformance with law and regulation. The FDIC continues to see no reason to create documentation in support of a conclusion not to make an adverse comment. Any adverse comment is fully discussed in the report of examination.

See comment 3.

Recommendation - Require examiners to rely on the assessments required by FDICIA to the extent possible, and supplement these assessments as necessary to ensure a comprehensive assessment of internal controls. As a basis for reliance, direct the examiners to use the internal review procedures developed as guidance in reviewing the quality of management's and the external auditor's internal assessments required by the FDICIA.

See comment 3.

Recommendation - Establish documentation requirements for the examiners' assessments of work performed by auditors and procedures examiners perform to enable FDIC to assess the adequacy of internal control evaluations.
Response - Corporation examiners are guided by FDIC's Statement of Policy Providing Guidance on External Auditing Procedures for State Nonmember Banks. The standards detailed in this policy statement provide a basis against which FDIC examiners can judge the adequacy of both internal and external audit programs. We will use these standards in assessing the adequacy of work performed by auditors in accordance with requirements of the Federal Deposit Insurance Corporation Improvement Act of 1991. In addition, audit procedures described in the Statement of Policy form the basis for a standardized checklist prepared as a workpaper by FDIC examiners at all Tier I and II examinations. When Section 112 of FDICIA is fully implemented, FDIC expects to make the fullest use possible of the results. It is much too early to judge that possibility for reports not due until 1994 at best and then only for the largest institutions.

See comment 3.

Recommendation - Require examiners to conduct independent comprehensive reviews of internal controls of banks with assets less than $150 million.
Response - While not necessarily mandated by federal or state

See comment 3.

statute the vast majority of banks, including those with assets of less than 150 million, are subject to some form of yearly outside audit or directors examination. These audits and examinations are subject to FDIC review in accordance with policies described above. FDIC intends to maintain in place its policy statements strongly encouraging all banks to have an annual audit of financial statements by an independent public accountant. Where material internal control problems are identified, we plan to require, by formal enforcement action or an informal corrective plan, audits by independent public accountants. As previously stated, existing policy requires certain pre-examination activities designed to appropriately determine the examination scope. Included therein would be reviews of external audit reports; if none are available, the examination scope would be adjusted accordingly. Proposed examination scopes are required to be in writing and would always include a comment on management. Further, the Congress has specifically set a $150 million floor on the size of institutions that must have internal control reviews by external auditors. The FDIC sees no reason to extend the scope of that exception with a back-door FDIC examination procedure, particularly given lack of risk-reward benfits to be gained.

Although we are satisfied that our existing policies relative to assessing effectiveness of internal controls are sufficient to identity weaknesses that may contribute to unacceptable levels of risk to the insurance fund, the GAO draft report has noted instances indicative of deviations from existing FDIC procedures. In order to remedy these deficiencies and update existing policies to encompass the requirements of the Federal Deposit Insurance Corporation Improvement Act of 1991, we intend to implement the following policy and procedural changes:

1. We will review and revise as necessary the existing workpaper checklist to insure that it include all key procedures appropriate to internal control assessment.

2. Periodic review of this workpaper will be included in the regional audit process described in subsequent remarks.

See comment 3.

<u>Recommendation</u> - Require that the bank's system of internal controls be added to the CAMEL rating as a separate critical area for rating to highlight the significance of internal control review to a bank's viability.
<u>Response</u> - We believe FDIC already satisfies GAO's recommendation in that internal controls, as that term is used by GAO, are the primary components of what FDIC considers in evaluating and assigning a performance rating to management. That is, we believe the definition of the management component of the CAMEL rating encompasses everything GAO calls internal control. The

See comment 2.

component rating is assigned in relation to management's technical competence; leadership and administrative ability, compliance with banking regulation and statutes; ability to plan and respond to changing circumstances; adequacy of and compliance with internal policies; and depth and succession. Further, assessment of management takes into account any undue concentration of credits or investments, the nature and volume of special mention classifications, and the adequacy of lending policies and procedures. We see no need to alter existing rating components.

See comment 2.

Recommendation - Coordinate the implementation of the internal control recommendations with the other federal depository institution regulatory agencies to achieve uniform requirements.
Response - We believe other regulators operate in substantially the same manner as FDIC with respect to internal controls and that they respond to the requirements of proper supervisory practice in substantially the same manner. In summary, the FDIC rejects the GAO's persistent emphasis on internal controls. An examination is not an audit; nevertheless, we believe we already give adequate attention to this matter and continue to believe we can rely on a review of the results and not just the policies.

See comment 4.

RECOMMENDATIONS - CHAPTER 4
Recommendation - Establish a policy that requires examiners to assess the work of state examiners and determine if it can be relied on to extend the time between FDIC examinations. The assessment can be accomplished by reviewing state working papers or by performing limited work at the bank to verify findings presented in the state reports.
Response - FDIC has found review of state examination report findings to be valuable in our supervisory efforts relative to State Nonmember banks. State examination reports are subject to the same regional office review process as is accorded FDIC reports. As you are aware, the Federal Deposit Insurance Corporation Improvement Act of 1991 makes provision for FDIC to continue to utilize state examinations to extend the FDIC examination interval, but only in select cases. State reviews will not be used to extend examination intervals for institutions rated composite "3", "4" or "5" by FDIC.

In general, we have found that State examinations accurately depict institution condition. Of the 2,108 situations where state examination conducted in 1991 or 1992 have received subsequent FDIC examination, 1,569 (74%) were accorded the same composite rating at the subsequent FDIC review as was assigned based on the state examination; 239 (11%) were accorded a better rating at the subsequent FDIC examination, and only 300 (14%) were accorded a more severe rating by FDIC. In the latter case, a more severe rating does not necessarily reflect a flaw in analysis that led to the prior rating, but may simply reflect deterioration in condition. It is also important to note that

See comment 4.

state examinations are subject to intensive reviews, that ratings assigned are FDIC ratings based on FDIC assessment of state findings, and that not all state examinations are accepted to extend examination intervals. If FDIC review shows a state report lacking in supportable findings, that examination report is not used to extend examination intervals. In such cases we see no reason to spend valuable time reviewing state workpapers or going back into the bank to test their findings.

State examination reports are not the sole source of information available to FDIC personnel when considering whether to extend examination intervals. FDIC has developed and utilizes several offsite based monitoring systems to assist in the supervisory process. The most sophisticated of these is CAEL, a system designed to interpret trends as depicted by quarterly call report data. CAEL has been found to be a highly accurate predictor of deterioration. When reviewing state or FDIC examination reports, the composite rating is always compared to the most recent CAEL rating and discrepancies are investigated.

While joining at more state examinations could add appreciably to personnel requirements and thus be impractical, we see merit in GAOs recommendation suggesting FDIC review of state work. We plan to give serious consideration to the merits and possibilities of extending the Regional Office Review Program described below to include state examination work papers.

<u>Recommendation</u> - Coordinate the implementation of the use of state examinations with the other federal depository institution regulatory agencies to achieve uniform requirements.

See comment 2.

<u>Response</u> - Little potential for significantly differing approaches exists; therefore, we see no value to this recommendation.

<u>RECOMMENDATIONS - CHAPTER 5</u>

<u>Recommendation</u> - Establish documentation policies for examiners that are sufficient to enable reviewers who did not perform the work to readily determine that enough work was done and done correctly to support examiner judgements on bank safety and soundness.

See comment 5.

<u>Recommendation</u> - Establish a policy for periodic reviews of examinations by appropriate officials to ensure that reports are adequately supported by examiners' work. The working papers prepared by the examiners should be reviewed to determine whether adequate work was done to assess safety and soundness of the bank.

See comment 5.

<u>Response</u> - Washington office staff periodically review regional office operations. Going forward, such regional reviews will include a review of random examination reports with work papers to determine their sufficiency in determining the safety and soundness of the bank. In addition, we plan to establish a

See comment 5.

formalized review process at the regional level. This new procedure will involve regional personnel periodically reviewing a sample of workpapers and line sheets to insure compliance with existing FDIC policies.

Recommendation - Require commissioned examiners to perform and document on-site reviews of all work performed by less experienced examiners.
Response - Every report of examination requires the signature of an examiner-in-charge who is responsible for all work performed during the examination. We have found this sufficient to ensure quality control, even when significant examination functions are handled by assistant examiners.

See comment 5.

Recommendation - Establish policies for examination working paper retention that will facilitate the regional reviews of examination work. The retention policies should be sufficient for FDIC to periodically select sample examinations and review the working papers to judge the quality of examinations for a given period of time.
Response - Instructions to Regions will be reviewed and, if necessary, revised to ensure that work papers are retained untilat least the subsequent FDIC examination.

See comment 5.

Recommendation - Coordinate implementation of the quality control recommendations with the other federal depository institution regulatory agencies to achieve uniform requirements.
Response - No problems have existed to date regarding record retention, and none are anticipated

Sincerely,

Andrew C. Hove

Andrew C. Hove
Acting Chairman

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

GAO Comments

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

2. We recommended that FDIC coordinate implementation of our recommendations (chapters 2 through 5) with the other banking and thrift regulators. However, FDIC did not agree with most of our recommendations. Other regulators were more responsive to our recommendations and indicated they would coordinate their implementation efforts. We believe that coordination is important to better ensure efficient and effective regulations. Our review disclosed that examination practices varied among the banking and thrift regulators. This issue is discussed in our summary report on the banking and thrift examination, Bank and Thrift Regulation: Examination Quality and Inefficient Regulatory Structure Hinder Effectiveness (GAO/AFMD-93-15).

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

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

5. See the "Agency Comments and Our Evaluation" section in chapter 5.

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