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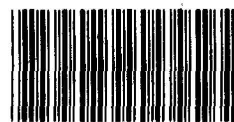
Report to Congressional Committees

February 1993

BANK EXAMINATION QUALITY

FRB Examinations and Inspections Do Not Fully Assess Bank Safety and Soundness



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Comptroller General
of the United States

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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
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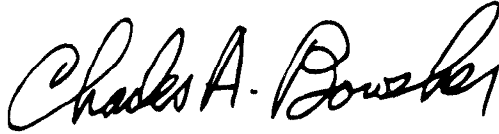
The Honorable Jim Leach
Ranking Minority Member
Committee on Banking, Finance and
Urban Affairs
House of Representatives

This report presents the results of our review of bank examinations and bank holding company inspections performed by the Federal Reserve Board (FRB). Weaknesses in FRB examinations of internal controls and loan loss reserves limit FRB's ability to fully assess the safety and soundness of banks. In addition, the bank holding company inspection process does not fully evaluate the risks posed by intercompany transactions between insured bank subsidiaries and nonbank affiliates or, in some cases, the risk from asset quality problems at those affiliates. Improving the quality of FRB examinations and inspections in these areas would aid the prompt detection and correction of bank problems and reduce the risks associated with holding company activities. Also, improved examinations and holding company inspections 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 Governors, Federal Reserve System; 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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Executive Summary

Purpose

Record numbers of bank failures during the last 10 years have depleted the Bank Insurance Fund. The Federal Reserve Board (FRB) is the primary regulator for all bank holding companies and for state-chartered banks that are members of the Federal Reserve System. Bank examinations and bank holding company inspections are FRB's primary means to identify weaknesses that may ultimately lead to failure. The purpose of GAO's review was to determine whether FRB examinations of banks and inspections of bank holding companies effectively evaluated the safety and soundness of institutions which are subject to FRB regulatory authority.

GAO assessed the quality of FRB bank examinations by evaluating examiners' reviews of loan quality, the loan loss reserve, and internal controls. GAO assessed the quality of bank holding company inspections by focusing on examiners' reviews of holding company and nonbank subsidiary activities which could adversely impact the insured bank subsidiaries. The assessment included examinations of 10 banks (6 randomly selected large banks with assets over $10 billion and 4 smaller banks) and 7 holding company inspections.

Background

Examinations provide the basis for FRB to assess bank safety and soundness by rating banks' capital adequacy, asset quality, management, earnings, and liquidity. Results of examinations also provide a basis for supervisory action and are the primary catalyst for bank closure.

Loan quality reviews and assessments of the adequacy of loss reserves are two of the most important components of a bank examination because loans comprise the majority of assets in most banks and involve the greatest risk of loss. In addition, the review of a bank's internal controls is essential because of their impact on all bank operations. The system of internal controls provides the framework for the accomplishment of management objectives, accurate financial reporting, and compliance with laws and regulations.

The primary purpose of the bank holding company inspection is to determine if the strength of the holding company is being maintained on an ongoing basis and to assess the consequences of transactions between the parent organization, the insured bank subsidiaries and nonbank affiliates. Nonbank subsidiaries may engage in a variety of activities unrelated to deposit taking and lending that pose considerable risk to the insured bank subsidiary.

Results in Brief

FRB examiners' reviews of bank internal control systems were not sufficient to promptly detect weaknesses that could negatively impact banks' financial condition. Not comprehensively assessing internal controls impeded examiners from effectively considering this critical factor in evaluating the overall safety and soundness of banks.

GAO generally found that examiners reviewed a sufficient amount of loans to be reasonably confident that bank management had identified all significant problem loans. However, FRB examiners lacked a reliable methodology to evaluate the adequacy of bank loan loss reserves. The examiners did not consider the specific risk from identified problem loans or the general risk conditions at individual banks such as the quality of loan portfolio management, adequacy of loan policies, current economic conditions, or the composition of the bank's loan portfolio. Consequently, loan loss reserves at FRB banks could be understated, thus masking the banks' true financial condition and the potential need for regulatory intervention. In addition, quality controls over loan review working papers, though generally sufficient, could be improved.

The lack of minimum inspection standards has resulted in a superficial approach to the bank holding company inspection process. FRB inspections did not evaluate the risks posed by intercompany transactions between insured bank subsidiaries and nonbank affiliates. In addition, the risk from asset quality problems at nonbank affiliates was not consistently evaluated. As a result, potentially harmful transactions which could lead to financial deterioration at the insured bank subsidiary may go undetected. As with the bank examinations, quality controls over the inspection working papers could be enhanced.

Principal Findings

Insufficient Reviews of Internal Controls

Effective internal controls serve as checks and balances against undesired actions and, as such, provide reasonable assurance that banks operate in a safe and sound manner. The lack of good internal controls puts the bank at risk of mismanagement, waste, fraud, and abuse.

For the 10 banks GAO reviewed, none of the examinations included systematic identification, testing, and evaluation of critical control procedures. Although some control testing was performed, it was not

comprehensive enough to provide a basis to conclude on the effectiveness of the systems of internal control. FRB's Examination Manual stated that examiners are to review, document, and test the bank's internal control system. However, FRB considered its Manual only as a reference guide for examiners and did not have minimum mandatory procedures for testing internal controls. In addition, some serious control weaknesses which were identified by examiners were not specifically considered in assessing bank safety and soundness. Based on these findings for the 6 large banks included in the sample, GAO estimated that insufficient internal control reviews were performed in the most recent examinations (at the time of our review) of at least 8 of the 12 large banks supervised by FRB as of September 30, 1990.

The Federal Deposit Insurance Corporation Improvement Act of 1991 requires management of insured depository institutions with assets of $150 million or more to annually assess and report on the condition of internal controls. Also, the institution's external auditors are required to review and report on management's assessment. These requirements are effective for institutions' fiscal years which begin after December 31, 1992. The institution's and auditor's reports can provide an efficient tool for examiners to use in assessing internal controls and planning the scope of their examinations.

Methodology to Assess Adequacy of Loan Loss Reserves Lacking

For examinations of five of the six large banks and all four small banks it reviewed, GAO found that examiners did not have a sufficient basis to assess the adequacy of bank loan loss reserves or reserving methods. GAO estimated these conditions existed for the most recent examination for at least 6 of the 12 large banks supervised by FRB as of September 30, 1990. Although maintenance of an adequate loan loss reserve is critical to bank safety and soundness and essential to early identification of deteriorating financial conditions, FRB examiners did not have a reliable approach for assessing the adequacy of such reserves.

While the FRB Manual identifies risk factors which should be considered in the determination of reserve adequacy, it does not provide a specific methodology for quantifying them. For lack of better guidance, examiners used standard percentages based on historical averages of banking industry losses to estimate required reserves on problem and performing loans. These averages are likely to be misleading when applied to an individual bank's loan portfolio and particularly when applied to specific problem loans. Differences in loan underwriting policies, loan

administration practices, portfolio composition and geographic dispersion, and specific collateral values cannot be appropriately considered using industry averages.

Holding Company Inspections Did Not Assess Risks to Insured Banks

In six of seven bank holding company inspections that it reviewed, GAO found that FRB examiners did not adequately assess the direct risks to the insured bank subsidiaries posed by intercompany transactions. The transactions included loans to nonbank affiliates, expenses allocated to the bank subsidiary, and assets transferred to the bank by nonbank subsidiaries. Examiners also did not evaluate the indirect risk to the banks posed by asset quality problems in two of the three inspections where there were large credit-extending nonbank subsidiaries.

The FRB inspection manual provides detailed guidance and procedures for review of intercompany transactions, but only limited guidance for the review of nonbank subsidiary asset quality. However, examiners are not required to follow these procedures, and there are no established minimum requirements for the inspection process.

Quality Control Measures Could Be Improved

GAO found for both the bank examinations and holding company inspections it reviewed that working paper documentation, although generally adequate, could be enhanced in order to better facilitate supervisory review. In addition, supervisory review of the working papers was not always evident. Examiners lacked minimum mandatory procedures for working paper preparation and documentation of supervisory review. Improved documentation would allow for more efficient supervisory review, and documented supervisory review is an important quality control measure to ensure the working papers provide adequate support for examiner conclusions and that the reviewer concurs with these conclusions.

Recommendations

GAO recommends that FRB (1) ensure that comprehensive reviews of internal controls are performed by examiners, which include appropriate consideration of assessments of the internal control structure by bank management and its independent auditor required by the FDIC Improvement Act, (2) develop and implement a sound methodology for evaluating the adequacy of bank loan loss reserves and reserving methods, (3) require minimum mandatory procedures to assess the actual and potential risks of bank holding company activities to insured bank

subsidiaries, and (4) fully document procedures performed and supervisory review.

Agency Comments

FRB provided written comments on a draft of this report. These comments are presented and evaluated in chapters 2 through 4. FRB's comments focused on the report's findings and conclusions and did not specifically address all of GAO's recommendations. FRB stated that it intended to judiciously consider GAO's recommendations for enhancing its examinations and inspections going forward.

Although FRB recognized the importance of continually reviewing and strengthening its bank examination program, it did not concur with GAO's overall conclusion that its examinations did not fully assess bank safety and soundness. FRB stated its examination philosophy of annual full scope examinations with thorough asset quality reviews was sufficient to assess bank risk and has proven effective. GAO agrees that annual full scope examinations, including thorough asset quality reviews are critical to the overall success of the examination process. However, FRB's examination approach falls short in several areas, particularly internal controls and loan loss reserves, which are essential to a full assessment of bank safety and soundness.

FRB concurred with GAO on the importance of banks having effective internal control systems and the need for the examination process to verify the existence of such systems. However, FRB did not agree that examiners should be required to perform annual comprehensive assessments of internal controls as it feels the level of such work should be left to the examiners' discretion. GAO believes that annual systematic evaluations of internal controls are the most effective way to minimize bank failures, since such evaluations focus on identifying and correcting the root cause of asset quality problems before they lead to asset quality deterioration.

FRB only partially concurred with our recommendation to develop a more specific methodology to be used by examiners for assessing the adequacy of bank loan loss reserves. FRB stated that bank management is responsible for establishing and maintaining an adequate loan loss reserve, and that examiners should focus their efforts on identifying deficiencies in the bank's methodology. While we do not disagree that the ultimate responsibility for establishing and maintaining adequate loan loss reserves rests with bank management, FRB has responsibility for determining the

adequacy of the reserves in assessing bank safety and soundness. In order to do so, examiners need a reliable approach to evaluate the adequacy of management's methodology and resultant reserve balances.

FRB stated that GAO's findings with regard to bank holding company inspections did not accurately portray its general activities in reviewing intercompany transactions and nonbank subsidiary asset quality. GAO's sample included some of the largest bank holding companies in the United States and was comprised of inspections performed by four different Federal Reserve Banks. Therefore, GAO believes its findings clearly portray a significant problem regarding the adequacy of FRB's bank holding company inspection process in protecting insured bank subsidiaries from harmful affiliate activities.

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Abbreviations

BOPEC	bank subsidiaries, other (nonbank) subsidiaries, parent company, earnings, and capital
CAMEL	capital adequacy, asset quality, management, earnings, and liquidity
FDIC	Federal Deposit Insurance Corporation
FRB	Federal Reserve Board
OCC	Office of the Comptroller of the Currency
OTS	Office of Thrift Supervision

Introduction

The purpose of our work was to determine whether the Federal Reserve Board (FRB) examinations of banks and inspections of bank holding companies effectively evaluated the safety and soundness of institutions which are subject to FRB regulatory authority. Specifically, this report discusses how well FRB examiners assessed the quality of bank loans, the adequacy of loan loss reserves, and the effectiveness of bank internal controls. This report also discusses FRB's inspections of bank holding companies, focusing on how well the examiners evaluated the risks posed by holding company activities to their insured bank subsidiaries.

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 almost $24 billion.

In response to the nation's banking problems, the Congress passed the Federal Deposit Insurance Corporation Improvement Act of 1991 (Public Law 102-242). The act provided FDIC increased authority to borrow funds to cover both losses and working capital needs for 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.

This legislation also provided major reforms in the banking industry, including expanded regulatory powers, revised capital standards, a requirement for audited financial statements and internal control reporting requirements for larger institutions, and revised examination frequency requirements. These reforms are a positive step towards correcting the problems faced by the banking industry. The effectiveness of these reforms, to a large degree, hinges on the bank examination process, which is the primary activity through which regulators assess the safety and soundness of banks.

Background

Responsibility for regulating the nation's federally insured depository institutions is divided among four regulators. FRB has regulatory oversight responsibility for state-chartered banks that are members of the Federal Reserve System (state member banks) and bank holding companies. The Office of the Comptroller of the Currency (OCC) regulates all nationally chartered banks. The Federal Deposit Insurance Corporation (FDIC) regulates state-chartered banks that are not members of the Federal Reserve System. Thrifts and thrift holding companies are regulated by the Office of Thrift Supervision (OTS).

We discuss the effectiveness of the examination processes of FDIC, OCC, and OTS in separate reports.[1] The four regulatory agencies periodically form interagency working groups to address issues which impact all federally insured depository institutions.

Most banks are owned or controlled by a bank holding company. A bank holding company is a company that controls one or more banks. A company controls a bank if it owns, controls, or has the power to vote 25 percent or more of the voting stock of a bank, controls the election of a majority of the bank's directors, or exercises a controlling influence over the bank's management or policies. The largest bank in the holding company is typically referred to as the lead bank and often holds most of the company's assets. Although FRB is responsible for inspecting all bank holding companies, either OCC or FDIC would be responsible for regulating the lead bank if it is a nationally chartered bank or a state chartered bank that is not a member of the Federal Reserve System. A bank holding company structure allows the nonbank subsidiaries to engage in a variety of activities unrelated to the traditional deposit taking and lending functions. The nonbank subsidiaries of the holding company typically engage in activities such as mortgage origination, leasing, underwriting and sale of securities and commercial paper,[2] and electronic data processing. Under the Bank Holding Company Act of 1956, bank holding companies are required to register and file annual reports with FRB.

Supervision of state member banks and bank holding companies is designed to be a coordinated effort among the Federal Reserve Board of

[1]Bank Examination Quality: FDIC Examinations Do Not Fully Assess Bank Safety and Soundness (GAO/AFMD-93-12), Bank Examination Quality: OCC Examinations Do Not Fully Assess Bank Safety and Soundness (GAO/AFMD-93-14), and Thrift Examination Quality: OTS Examinations Do Not Fully Assess Thrift Safety and Soundness (GAO/AFMD-93-11).

[2]Commercial paper is a short-term, unsecured money market obligation used to finance current obligations. Bank-related paper accounts for about 25 percent of the commercial paper market and is an obligation of the bank holding company or the nonbank subsidiary, but not the bank itself.

Governors, located in Washington D.C., and the 12 Reserve Banks located throughout the United States. Examiners from the 12 Reserve Banks, operating under the authority of the Federal Reserve Act, conduct examinations of state member banks in order to evaluate their safety and soundness. They also inspect the parent holding company and nonbank subsidiaries to ensure that banking and commercial activities are appropriately separated as called for by the Bank Holding Company Act of 1956, the Bank Merger Act of 1960, and the Change in Bank Control Act of 1978. The Board of Governors reviews examination and inspection reports prepared by the Reserve Banks and conducts special studies of issues related to supervision. The Board of Governors also formulates regulations, oversees mergers and foreign banking activities, and monitors compliance with consumer regulations such as the Truth in Lending Act, the Fair Credit Billing Act, and the Equal Credit Opportunity Act. In addition, it monitors interim financial data received from bank management, which FRB refers to as off-site surveillance.

From 1986 to 1991, the number of state member banks and bank holding companies regulated by FRB increased by less than 1 percent from 7,358 to 7,423 institutions, while assets at these institutions increased 8 percent, from $3.6 trillion to $3.9 trillion. The operating budget for FRB's supervision of these institutions increased 45 percent, from $163 million to $237 million, and the number of FRB field examiners increased by 21 percent, from 914 to 1,109.

As of December 31, 1991, FRB regulated 982 state member banks, whose assets totaled $593 billion. These banks represented nearly 8 percent of the nation's insured commercial banks and accounted for about 16 percent of their assets. In addition, FRB regulated 6,441 bank holding companies and their nonbank subsidiaries, whose assets totaled $3.3 trillion as of December 31, 1991. These holding companies controlled about 8,500 commercial banks and approximately 93 percent of the assets of all insured commercial banks in the United States.

Bank Examinations

According to the Federal Reserve Board's Commercial Bank Examination Manual, the primary objectives of the bank examination process are to provide an objective evaluation of a bank's soundness and compliance with banking laws and regulations, permit the Federal Reserve to appraise the quality of management and directors, and identify those areas where corrective action is required to strengthen the bank's performance and enable it to comply with laws and regulations.

The primary tool used by FRB to fulfill its supervisory responsibilities over state member banks is the full scope safety and soundness examination. FRB requires a full scope examination annually for all state member banks. FRB shares supervisory responsibility for state member banks with state banking authorities through the Alternate Year Examination Program. Under this program, certain mutually agreed upon state member banks that are relatively free of supervisory concerns are examined in alternating years by the Reserve Bank or the state. This program was designed to foster greater cooperation and joint supervisory actions in order to reduce duplication of examinations and thereby conserve examination resources. In addition to annual full scope examinations, limited or targeted scope examinations[3] may be required depending upon the bank's size and financial condition.

The full scope examination focuses on five critical areas of bank operations and condition—capital adequacy, asset quality, management, earnings, and liquidity. These areas are commonly referred to by the acronym CAMEL. Each CAMEL element is rated on a five-point scale. Based on these ratings, the examiners determine a composite rating which reflects the overall condition of the institution. The purpose of the rating system is to identify institutions that exhibit financial, operating, and compliance weaknesses that may require supervisory attention. A composite rating of 1 is assigned to institutions that are basically sound in every respect. Most findings at these banks are minor and may be corrected in the normal course of business. Banks assigned a composite rating of 5 exhibit an extremely high probability of failure. Without urgent and decisive corrective action, the volume and severity of weaknesses or unsafe and unsound conditions will likely result in the institution's failure.

When examiners analyze and rate bank capital, they focus on the volume of higher risk and inferior assets, the bank's growth experience, management's abilities, earnings retention, and capital ratios compared to those of similar institutions. When analyzing asset quality, examiners concentrate primarily on the level, distribution, and severity of poor quality assets and the adequacy of the allowance for loan and lease losses. Examiners also review the level of concentrations of loans in a specific industry, lending policies, and the adequacy of credit administration procedures. During the analysis and rating of management, examiners must consider all factors that relate to the safe and sound operation of the bank. Therefore, the examiners rate management on technical

[3]Limited scope examinations focus on all areas of interest to FRB, but usually involve a less intensive assessment than a full scope examination. Targeted examinations focus intensively on one or two of the bank's activities.

competence; compliance with banking regulations; ability to plan and respond to changing environments; adequacy and compliance with internal policies; tendencies toward excessive loans to directors, officers, and employees; and the willingness to serve the needs of the community. The evaluation and rating of earnings focuses on earnings trends, peer group comparisons, quality and composition of net income, and the ability to cover losses and provide sufficient capital. Liquidity is the bank's ability to meet the demands of depositor withdrawals and borrowers' credit and cash needs. In analyzing liquidity, the examiners concentrate on the volatility of deposits, reliance on interest-sensitive funds, and the availability of assets convertible into cash.

Bank Holding Company Inspections

FRB's inspection cycle for bank holding companies is based upon the size and complexity of the institution. Those with assets exceeding $10 billion are to receive a full scope inspection annually. Depending upon the financial condition of the institution, one limited or targeted scope inspection may also be required each year. Smaller institutions are generally inspected every 1 to 3 years depending on the complexity of operations and financial condition.

According to the Federal Reserve Board's Bank Holding Company Supervision Manual, the objectives of the holding company inspection are to ascertain whether the strength of a bank holding company is being maintained and to determine the consequences of transactions between the parent holding company, its nonbanking subsidiaries, and the subsidiary banks. In order to accomplish these two objectives, the full scope inspection is designed to include a detailed review, on a consolidated and individual entity basis, of asset quality, earnings, capital adequacy, cash flow and liquidity, and the competency of management. Based on this review, examiners rate five critical areas of the bank holding company—bank subsidiaries, other (nonbank) subsidiaries, parent company, earnings, and capital adequacy on a consolidated basis—which are referred to by the acronym BOPEC. Examiners use a five-point rating scale, similar to that used in rating the state member banks, and also rate management satisfactory, fair, or unsatisfactory.

According to FRB's Bank Holding Company Supervision Manual, a holding company can adversely impact an insured bank subsidiary in two primary ways. The first is for the holding company or its nonbank subsidiaries to take excessive risk and subsequently fail, thus reducing consumer confidence and causing substantial withdrawals. The second way is

through inappropriate intercompany transactions that typically involve the purchase or sale of assets and services at nonmarket terms.

Off-Site Surveillance

In addition to on-site monitoring efforts, FRB maintains a systemwide off-site surveillance program to monitor the financial condition of state member banks and bank holding companies to assist in setting examination/inspection schedules, and to allocate more examiner resources to the most critical institutions exhibiting weak or deteriorating financial conditions. Institutions that exhibit weak or declining conditions are to be examined more frequently than those without deficiencies. The off-site program relies on information received from bank and holding company management in required quarterly Reports of Income and Condition to compute financial ratios related to key areas addressed during the on-site examinations and inspections. These ratios are analyzed by the Reserve Bank and the Board of Governors to identify emerging financial difficulties and the most appropriate supervisory response.

Objectives, Scope, and Methodology

Our overall objectives were to assess the effectiveness of FRB's (1) bank examination process in evaluating the safety and soundness of commercial banks and (2) bank holding company inspection process in evaluating activities which may adversely impact the insured bank subsidiaries. Specifically, we determined whether FRB examiners

- performed a comprehensive evaluation of bank internal controls;
- conducted a thorough analysis of bank management's loan classification system to determine the level and distribution of problem loans;
- evaluated the adequacy of the loan loss reserve and management's methodology for establishing the reserve; and
- conducted a comprehensive evaluation of the risks posed by bank holding company operations and nonbank subsidiary activities upon the insured bank.

To assess FRB's procedures for performing bank examinations, we selected a sample of 10 banks from the universe of 1,010 state member banks, as of September 30, 1990, that had FRB as their primary federal regulator and reviewed the most recent safety and soundness examinations. We randomly selected 6 of the 12 state member banks with total assets greater than $10 billion, and we judgmentally selected a sample of 4 banks with total assets less than $10 billion. Five of the six examinations of banks with assets exceeding $10 billion were full scope and one was limited

scope. The most recent examinations for the four banks with assets less than $10 billion were all full scope.

For the randomly selected banks, the statistical nature of our sample allowed us to project the results of our work to the most recent FRB examinations for the 12 banks with assets greater than $10 billion. 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. Since we used a judgmental sample to evaluate FRB's examination of banks with assets less than $10 billion, we did not project the findings of those evaluations.

For each of the 10 banks, we reviewed in detail the working papers supporting the most recent safety and soundness examination conducted by FRB to assess the quantity and quality of evidence that supported conclusions in FRB examination reports. Examinations selected for detailed review were performed between 1989 and 1991. We reviewed FRB examination working papers for each CAMEL factor; however, we focused on the examination of internal controls and asset quality, including the loan loss reserve, because we have identified deficiencies in these areas as primary causes of bank failure.[4] We also reviewed the three most recent safety and soundness examination reports for each of the 10 banks in order to identify trends in examination issues and the resolution of these areas. In addition, we reviewed correspondence files and any other pertinent analyses identified by FRB officials.

To assess FRB's examination of internal controls, we reviewed all examination areas for the 10 banks in our sample to determine if a comprehensive review was performed by the examiners. To assess FRB's examination of loan quality, we reviewed the scope of the examiners' asset quality review to determine if it was adequate to support their evaluation of the accuracy of bank management's internal classification system and conclude on the condition of the bank's loan portfolio. To assess the examiners' analysis of the loan loss reserve, we reviewed the methodology and procedures used by the examiners to determine the adequacy of the reserve and to evaluate management's procedures for determining the level of the reserve.

[4] 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).

To evaluate the adequacy of examination work, we used FRB's Commercial Bank Examination Manual, which provides guidance in the form of objectives and suggested procedures for assessing capital adequacy, asset quality, management (including internal controls over bank operations), earnings, and liquidity. We also considered the American Institute of Certified Public Accountants Statement on Auditing Standard number 55, Consideration of the Internal Control Structure in a Financial Statement Audit, in assessing the examiners' work on internal controls. We conducted interviews with the examiners-in-charge as necessary to clarify our understanding of certain examination procedures.

To assess FRB's holding company inspection process, we selected a judgmental sample of seven institutions from the universe of 49 bank holding companies whose lead banks had assets of greater than $10 billion. Of these seven bank holding companies, six lead banks were regulated by OCC, and one was regulated by FRB. We reviewed FRB work for all areas of the inspection, but examined intercompany transactions and nonbank asset quality in greater detail since these areas pose considerable risk to the insured bank subsidiary.

For each of the seven bank holding companies, we reviewed in detail the working papers supporting the most recent full scope inspection to assess the quantity and quality of the evidence that supported the conclusions in the inspection report. Holding company inspections selected for review were performed during 1990. We also reviewed the two previous bank holding company inspection reports in order to identify trends in inspection issues and the resolution of these areas.

To assess inspection work, we used FRB's Bank Holding Company Supervision Manual, which provides guidance in the form of inspection objectives and suggested procedures. To clarify our understanding of certain inspection procedures and objectives, we conducted interviews with the examiners-in-charge as necessary.

Our work was performed at the Federal Reserve Board of Governors in Washington, D.C., and at Reserve Banks located in Kansas City, New York, San Francisco, Dallas, Chicago, Boston, Minneapolis, and Richmond. We conducted our review between December 1990 and January 1992 in accordance with generally accepted government auditing standards. FRB provided written comments on a draft of this report. These comments are presented and evaluated in chapters 2 through 4 and are included in appendix I.

Comprehensive Reviews of Bank Internal Controls Not Performed

Examiners' reviews of the internal control systems for the 10 banks we reviewed were not sufficient to detect and correct unsafe and unsound banking practices. In addition, the failure to adequately assess internal controls impeded examiners from effectively considering this critical factor in evaluating the safety and soundness of the banks. We previously reported in 1989 and 1991 that internal control weaknesses contributed significantly to bank failures.[1] Inadequate testing of internal controls is a serious gap in the examination process and may allow banks to continue less than prudent banking practices.

FRB's Commercial Bank Examination Manual stated that examiners are to review, document, and test the control system as a basis for determining the overall adequacy of a bank's internal controls and for determining examination scope. However, FRB allowed examiners considerable discretion in determining what examination work to perform, and they viewed the Manual as guidance rather than required procedures. FRB had not established minimum mandatory internal control examination procedures. As a result, there was no assurance that internal controls were adequately reviewed to identify weaknesses early and obtain corrective action before the safety and soundness of banks was threatened.

Internal Controls Are Essential to the Safe and Sound Operation of a Bank

A strong internal control system provides the framework for the accomplishment of management objectives, accurate financial reporting, and compliance with laws and regulations. Effective internal controls serve as checks and balances against undesired actions and, as such, provide reasonable assurance that banks operate in a safe and sound manner. The lack of good internal controls puts the bank at risk of mismanagement, waste, fraud, and abuse.

In our Bank Failures reports, we stated that internal control weaknesses contributed significantly to bank failures in 1987, 1988, and 1989. In our review of 184 failed banks in 1987, we found that internal control weaknesses were a major contributor in their failure. Among the most significant of these weaknesses were inadequate or imprudent loan policies and procedures, weak loan administration, poor loan documentation, inadequate credit analysis, failure to establish adequate loan loss reserves, and inadequate supervision by the bank's board of directors. Furthermore, in reviewing 39 banks that failed in 1988 and 1989, we found that the same weaknesses were a major cause of bank failure. Of

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

the 39 banks, 33 had serious internal control problems which regulators cited as contributing significantly to their failure.

The system of internal control comprises 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. As such, internal controls impact all major operational areas of banks including loans, securities investments, property and equipment, customer deposits, capital, and revenue and expenses. Each of these areas is important to profitable operations. Further, each can contribute to rapid financial deterioration because of adverse economic conditions, improper management practices, fraud, or abuse.

For most banks, loan operations are of paramount importance because loans typically comprise most of the banks' assets and involve significant risk. Internal controls for loans protect and facilitate an accurate accounting of the banks' assets from the time a loan is applied for by a prospective borrower to the time the borrower repays the bank. This covers the application process; authorization and disbursement of funds; and servicing, accounting, and collection.

Controls over loans include the policies and procedures which provide assurance that loans are not made that involve risks the bank is not properly equipped to handle—risks resulting from factors such as geographic location of the borrower, size and purpose of the loan, or industry involved. They also help ensure that bank personnel properly document and analyze credit information on borrowers. This is important so that loans are extended only to creditworthy applicants and that complete and current credit information is maintained on borrowers. Such controls ensure timely notice to bank management of any borrower repayment problems. Controls over loan operations include procedures to identify loans that warrant special attention by management such that effective collection actions can be taken in a timely manner against borrowers who fail to make payments according to loan terms. Finally, controls include a sound methodology to estimate a reserve for loan losses which includes consideration of general and local economic conditions, delinquent and problem loans, and the extent to which renewals and extensions have been used to keep loans current.

Because of the importance of internal controls to safe and sound bank operations, annual comprehensive evaluations are needed to ensure that

effective controls are being maintained. Controls found to be effective in one year may not be effective the next year due to factors such as changes in bank operations or noncompliance with established procedures. An evaluation of a bank's internal control system should include (1) an overall understanding of the major operating functions within the bank, such as lending and deposits, and an assessment of risks within those functions, (2) an assessment of the adequacy of the design of the control systems within each major operating function to determine if the systems are set up to effectively prevent undesirable activities, (3) specific identification of critical control procedures within the systems, such as loan approval requirements, (4) testing of critical control procedures to determine if they are operating as designed, and (5) evaluation of the results of the control tests to determine if the control systems are effectively operating to prevent undesirable activities. The review of a bank's policies and procedures, without the specific identification and testing of controls, does not provide an adequate basis for evaluation of the bank's internal control system. Systematic tests of the control procedures are essential to obtain assurance that the policies and procedures are being carried out as intended.

Examiners Did Not Systematically Test and Evaluate Controls

None of the 10 examinations we reviewed included systematic identification, testing, and evaluation of critical control procedures. Based on these results for the six large banks included in our sample, we estimated that these conditions existed for the most recent examinations of at least 8 of the 12 large banks supervised by FRB.[2] Without this type of assessment of internal controls, it is likely the examination would overlook a critical area of the bank's operations.

FRB's Commercial Bank Examination Manual stated that examiners should test for compliance with policies, practices, procedures, and internal controls, and it included internal control questionnaires for every major examination area. The Manual stated that the questionnaires were designed so that answers could be substantiated by inquiry to bank personnel, by observation, or by tests and that certain questions were so critical that substantiation by observation or testing should be done. In the large bank cases, examiners completed questionnaires for a few selected examination areas. However, the questionnaires did not show evidence that any responses, including those to questions designated as critical, were tested by examiners or otherwise verified.

[2]The range of our estimate, at a 95 percent confidence level, is that these conditions existed for the most recent examinations (at the time of our review) of between 66 percent and 100 percent of the 12 large banks that were supervised by FRB as of September 30, 1990.

Examiners stated that the questionnaires were generally completed based on inquiry of bank personnel or observation of bank operations. They also stated that they tested certain controls and that they were alert for noncompliance with policies and procedures while performing the examination. For example, they stated that their examination of loans included checks for compliance with loan policy and loan administration procedures. Examination working papers did not show evidence of actual testing, or even identification, of relevant control procedures. Examiners told us that it was not their practice to document their testing of compliance with policies and procedures. Their practice was to identify instances of noncompliance in the examination report. This approach may be adequate to detect noncompliance with some policies and procedures; however, we believe that a systematic and comprehensive evaluation of internal controls, such as that described previously, would require documentation of the nature, extent, and result of work performed to adequately assess risk and evaluate a bank's overall system of internal controls. Without a documented risk assessment including systematic identification and testing of critical controls, there is a high likelihood that significant control weaknesses will not be detected in time to prevent or minimize the effects of mismanagement or imprudent banking practices.

Examiners told us they relied on the internal audit function at large banks in lieu of performing their own comprehensive review of internal controls. Had examiners identified the critical controls and determined that the work performed by the auditors was sufficient to evaluate those controls, reliance on the work of the internal auditors may have been appropriate. However, we did not find evidence in any of the six large bank examinations that examiners had first obtained an understanding of the control system and identified critical controls that they were relying on internal auditors to review and test. In addition, there was no documented assessment of the results of the internal auditors' work and how those results impacted the examiners' overall evaluation of the bank's system of internal controls.

As with the large banks, the work performed by examiners at the four small banks was not sufficient to assess the adequacy of the banks' control systems and to determine the level of compliance with controls. At two of the four small banks, examiners completed questionnaires for the various examination areas. At the third bank, they completed a short list of questions and at the fourth, they did not document any review of internal controls. The questionnaires, when used, focused on the evaluation of a bank's policies, practices, and procedures. Although the source of

information used to complete the questionnaires generally was not documented, examiners stated that the questionnaires were completed with information obtained from bank personnel in interviews and from observation of bank operations during the on-site examinations. Examination procedures did not include identification of critical controls and systematic tests for compliance with those controls.

Control Weaknesses Not Reflected in Examination Conclusions

Identified control weaknesses were not reflected in examiners' conclusions regarding the adequacy of the internal control structure, nor were they considered in the determination of the safety and soundness ratings of the banks in our sample. According to FRB's Manual, the adequacy of the control system and compliance with that system is one of several factors that examiners should consider when rating bank management. However, examiners stated, and our review confirmed, that the bank's financial condition was the primary basis for rating management. For example, a 1987 examination report for one bank in our sample rated management as reasonably satisfactory even though the examination revealed inadequate accounting controls and procedures, noncompliance with the bank's loan policy, and many violations of laws and regulations. Management was downgraded to unsatisfactory in 1990 when asset quality and the bank's financial condition deteriorated.

In two of the four small banks, examiners concluded in the examination reports that the internal control system was adequate, but the same reports listed major control deficiencies. For example, at one bank, examiners cited a number of weaknesses and serious administrative problems in the examination reports for 3 consecutive years. These deficiencies included weak loan administration, inadequate reserve for loan losses, and numerous violations of laws and regulations. In the most recent examination, over half of the loans reviewed had some form of credit or collateral deficiency. The bank had a history of repeated violations of laws and regulations regarding extensions of credit to officers, directors, and shareholders of the bank. Examiners also reported misuse of bank assets for the personal use of officers' and directors' families. However, the examination report stated that the bank's internal controls related to accounting records and operating systems were adequate. Had examiners performed a comprehensive review and evaluation of the control systems they might have recognized the pervasive nature of the deficiencies and helped avert the subsequent asset quality deterioration which occurred at this bank.

FDIC Improvement Act of 1991 Can Strengthen Examinations

The FDIC Improvement Act of 1991 (Public Law 102-242) requires federally insured banks with assets of $150 million or more to annually report to the federal regulators on their financial condition and management for fiscal years beginning after December 31, 1992. The report is to include a statement of management's responsibilities for preparing financial statements, establishing and maintaining an adequate internal control structure, and complying with laws and regulations relating to safety and soundness which are designated by FDIC or the appropriate federal banking agency. The report also must include management's assessment of (1) the effectiveness of the institution's internal control structure and procedures and (2) the institution's compliance with the designated laws and regulations. Management's statement of responsibilities and assessments must be signed by the chief executive officer and the chief accounting or financial officer of the institution. In addition, the act requires the institution's external auditor to report separately on management's assertions. The management and auditor reporting requirements in the act are intended to (1) focus management's attention on its accountability for internal controls and compliance with laws and regulations and (2) improve the regulatory agencies' ability to detect unsafe and unsound conditions and support prompt regulatory action to ensure that deficiencies which may threaten an institution's solvency are corrected in a timely manner.

The scope of work required for external auditors to attest to bank managements' assertions regarding the effectiveness of internal controls and compliance with laws and regulations is greater than the internal control and compliance work required by generally accepted auditing standards for opining on the fair presentation of an institution's financial statements. Generally accepted auditing standards require the auditor to obtain a general understanding of the entity's internal control structure. However, only the controls that the auditor relies on in the course of the audit have to be thoroughly tested and evaluated. Regarding illegal acts, the auditor's responsibility is to detect and report misstatements resulting from illegal acts that have a direct and material effect on the financial statement amounts. Satisfying the requirements of the FDIC Improvement Act should result in the auditor obtaining a more thorough knowledge of the institution's controls and operations and providing an independent assessment of the credibility of management's report.

These new requirements should significantly enhance the likelihood that examiners will identify emerging problems in banks earlier. Also, by relying on the more thorough work now required of external auditors,

regulators should be able to concentrate their resources in other parts of the examination for those institutions covered by the act and obtain substantively better coverage of internal controls. However, obtaining the expected benefits will entail the regulator's review of management's assessment and the external auditor's internal control work—including working papers, policies, and procedures—to provide a basis for reliance. Under the act, the regulators have access to external auditors' working papers so they can review the quantity and quality of work conducted in these areas.

Institutions with less than $150 million of assets are not required to report under the act. It is therefore important that regulators assess what, if any, internal control work has been performed by bank management and the external auditors for these institutions and, if such work is not adequate, to independently test the effectiveness of internal controls and compliance with laws and regulations during their examinations. According to available information from the FDIC, 84 percent of the banks that failed from 1985 to 1992 had total assets of $100 million or less. These 998 banks accounted for 24 percent of the total loss incurred by the Bank Insurance Fund during this period, thus contributing substantially to its deficit at the end of 1991. Therefore, we believe it is important that these smaller banks, even though less complex, receive the same comprehensive internal control evaluation as the larger institutions.

Annual full scope examinations at banks with assets greater than $100 million are required by the act. The act allows these examinations to be conducted by state banking regulators in alternate 12 month periods, if the appropriate federal banking agency determines that the examination of the insured depository institution conducted by the state during such an intervening 12 month period was equivalent to a full-scope, on-site examination. Since 1981, FRB has relied on alternate year state examinations of certain mutually agreed upon state member banks that were relatively free of supervisory concerns under the Alternate Year Examination Program. However, in discussions with FRB officials, we noted that they did not have a formal program in place to review the state bank examiners' work. However, they told us that FRB informally identified states which they felt were qualified and capable of performing adequate examinations based on experience gained from previous joint examinations. The FRB officials also indicated that states with inadequate resources and expertise were not relied upon to perform alternate year examinations. The act also allows for certain well capitalized and well

managed banks with assets less than $100 million to be examined on an 18-month cycle.

Conclusions

FRB's failure to perform systematic identification, testing, and evaluation of key controls significantly increased the possibility that serious control weaknesses may not have been detected by examiners in time to avert permanent damage to banks' financial condition. In addition, examiners' failure to recognize the pervasive nature of control weaknesses they did identify deterred them from requiring corrective action and from appropriately considering the weaknesses in the safety and soundness rating of the bank. Further, the CAMEL rating did not include a separate factor for internal controls and examiners did not focus on this area in determining the banks' ratings.

Additional internal control reporting requirements for bank management and the external auditors included in the FDIC Improvement Act can significantly enhance examiners' ability to assess the adequacy of internal control systems for banks with assets of $150 million or more. These requirements will allow examiners to use their resources more effectively by using the internal control work performed by management and the auditors, providing the examiners evaluate and document the scope and quality of the work performed. The act does not require internal control reports from banks with assets less than $150 million. However, as these banks cumulatively represent significant exposure to the Bank Insurance Fund, it is essential that regulators perform comprehensive internal control reviews of these banks during their examinations.

Reliance on state examinations in alternate years can be an effective means of utilizing available examiner resources. However, the lack of a formal program to evaluate the effectiveness of states' examination programs could lead FRB to inappropriately rely on certain state examinations to assess safety and soundness of state member banks.

Recommendations

We recommend that the Chairman of the Federal Reserve Board of Governors take the following actions:

- Develop comprehensive internal control review procedures for all major aspects of bank operations to be used during FRB'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 review of internal controls. As a basis for reliance, direct the examiners to use the internal control review procedures as guidance in reviewing the quality of management's and the external auditor's internal control assessments required by the act.
- Require examiners to conduct independent comprehensive reviews of internal controls of 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.
- Develop a formal program to evaluate examinations performed by state banking regulators to be relied on under the Alternate Year Examination Program.
- Coordinate the implementation of the internal control and use of state examinations recommendations with the other federal depository institution regulatory agencies to achieve uniform requirements.

Agency Comments and Our Evaluation

In commenting on a draft of this report, FRB recognized the importance of continually reviewing and strengthening its examination program and stated that it would carefully evaluate our findings and consider the recommendations presented.

FRB's response did not specifically address our recommendations, but rather commented on our findings and conclusions. FRB did not concur with our overall conclusion that its examinations did not fully assess bank safety and soundness. It stated that its examination philosophy of annual full scope examinations combined with a thorough asset quality review was sufficient to determine the true risk profile of a bank. In 1990, we recognized the importance of annual full scope examinations and recommended to the Congress that this approach be taken by all bank regulatory agencies.[3] However, in order to help minimize losses to the Bank Insurance Fund, we believe FRB's annual full scope examinations should be enhanced to more fully assess bank risks.

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

FRB concurred that an effective system of internal controls is important and should be verified during the examination process. However, FRB did not concur with our conclusion that internal control work performed by FRB examiners was inadequate. FRB stated that it is more efficient to allow examiners discretion to establish the scope of an examination and that experienced examiners have sufficient training and experience to make the correct decisions regarding the appropriate scope of the internal control review. FRB also stated that asset quality problems are the overriding cause of bank failures, and examination resources are most effectively used by thoroughly evaluating credit quality and the bank's system of classifying its loans. When examiners identify deficiencies in loan documentation, poor policies, imprudent lending terms, and inaccurate internal classifications, FRB stated the examiners are expected to perform a more comprehensive review of the internal control system.

FRB's approach to internal control review is largely reactive rather than proactive and is likely to identify weaknesses only when troubled loans or other asset deterioration has occurred. We believe that an annual systematic evaluation of internal controls would be an effective use of examiner resources, since this review would identify the root cause of asset quality problems before they lead to asset quality deterioration. This type of preventive regulation, in our opinion, is the most effective means to reduce losses to the Bank Insurance Fund.

FRB concurred that the FDIC Improvement Act will enable examiners to review management reports to assist them in identifying emerging internal control weaknesses. However, we believe that FRB needs to establish comprehensive minimum standards to judge the adequacy of the internal control assessments prepared by management and the independent public accountants as a basis to rely on that work.

FRB did not fully agree with our findings that identified control weaknesses were not reflected in examiners' conclusions regarding the adequacy of internal controls, and that the weaknesses were not considered in the determination of the safety and soundness ratings of the banks in our sample. They stated that examiners criticize the internal control systems in various sections of their examination reports and that working papers include the corrective actions taken by management. The adequacy of the control system and compliance with that system is one of the factors that examiners are to consider when rating bank management. However, for the banks in our sample, examiners primarily rated management on the financial performance of the bank—not the adequacy of the internal

control systems. In our view, specific consideration of the bank's internal control system and a separate rating for the adequacy of those controls would effectively highlight their importance.

FRB Lacked Reliable Methodology to Assess Adequacy of Loan Loss Reserves

The majority of a bank's assets are generally in the form of loans, which also usually pose the greatest credit risk to the bank. Banks cushion themselves from this credit risk through a reserve for loan losses. Maintenance of an adequate loan loss reserve is essential to safe and sound banking practice and is a key factor in determining a bank's financial condition. FRB's Manual provided a general discussion of risk factors to consider in evaluating reserve adequacy, but did not provide a specific methodology to quantify these factors. Examiners generally reviewed a sufficient amount of loans to be reasonably confident that management identified all significant problem loans. However, for five of the six large bank examinations we reviewed, and all four of the small bank examinations, examiners did not have a sufficient basis to assess the adequacy of bank loan loss reserves or reserving methods. Consequently, examiners did not have reasonable assurance that the financial information used to rate the safety and soundness of banks during examinations and to monitor banks between examinations accurately reflected the banks' true financial condition and operating results.

Adequate Loan Loss Reserves Are Critical to Bank Safety and Soundness

An adequate reserve for estimated loan losses is critical to the safe and sound operation of a bank and essential for early identification of deteriorating financial conditions. Regulators require all banks with assets of $10 million or more to estimate and maintain a reserve for expected loan losses based on an evaluation of the collectibility of the loan portfolio. The reserve must be adequate to cover both specifically identified loss exposures as well as other inherent[1] exposures in the portfolio. Therefore, an adequate reserve hinges on (1) timely identification and analysis of loss exposures on nonperforming loans, and (2) analysis of exposure to losses in performing loans considering past trends and current conditions.

According to FRB's Commercial Bank Examination Manual, examiners should evaluate management's estimate of losses existing in the bank's loan portfolio, as well as the procedures used in making that estimate. This evaluation provides examiners with the basis for determining the adequacy of a bank's loan loss reserve and, as stated in the Manual, should consider the following:

- evaluation of lending policies, practices, and internal controls;

[1]Inherent losses exist when events or conditions have occurred which will ultimately result in loan losses, but which are not yet apparent in individual loans.

- loans classified in the current examination, including those on management's list of loans deemed less than fully collectible;
- current delinquency trends;
- excessive loan renewals and extensions;
- listings of past-due loans, loans on which interest is not being collected in accordance with loan terms, and loans whose terms have been modified;
- bank officers' and employees' assertions regarding loan collectibility;
- general or local economic conditions that might have a bearing upon the collectibility of loans; and
- all available and comparable outside information regarding banks of similar loan portfolio size, composition, and quality.

The Manual also stated that examiners should consider management's determination of known probable losses during their review of specific loans. This review, combined with consideration of the above factors for performing loans will enable the examiner to conclude on the overall adequacy of the loan loss reserve.

Misstatement of the loan loss reserve affects capital, asset quality, and earnings—three of the five CAMEL components that examiners use to rate the safety and soundness of banks at the end of on-site examinations. It also hampers the examiners' ability to identify deteriorating financial conditions that may require supervisory action between on-site examinations. Examiners use unaudited quarterly bank financial reports (call reports) to monitor banks between on-site examinations. If bank procedures are not adequate to reliably estimate loan losses, then examiners have no assurance that management's reported financial information reasonably reflects the bank's condition and operating results.

Our 1991 report on 39 banks that failed in 1988 and 1989 stated that bank call reports did not provide regulators with advance warning of the extensive deterioration in the banks' financial condition. The asset valuations FDIC prepared after the banks failed showed that loss reserves were understated by billions of dollars. Deficiencies in accounting rules, along with weak internal controls, allowed bank management to delay the recognition of losses which masked the need for early regulatory intervention that could have minimized losses to the Bank Insurance Fund. Existing accounting rules provide a significant amount of latitude in the recognition and measurement of losses on individual problem loans.[2] In addition, little authoritative accounting guidance exists for recognition and

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

measurement of inherent losses in the loan portfolio. These deficiencies in accounting rules make the examiners' evaluation of loan loss reserve adequacy even more critical.

Examiners' Evaluation of Reserve Adequacy Not Based on Risk Analysis

Examiners did not have a sufficient basis to evaluate the adequacy of the loan loss reserve in five of the six large bank examinations we reviewed. We estimated this to be the case for at least 6 of the most recent large bank examinations performed by FRB examiners as of our sample date.[3] One of these five examinations was limited in scope and did not include a detailed review of the loan portfolio.[4] The other four were full scope examinations but did not sufficiently consider the risks in the loan portfolio in evaluating the adequacy of the loss reserve.

Although the Examination Manual specifically identifies risk factors that examiners should consider in evaluating adequacy of loss reserves, it does not provide a methodology or specific procedures to quantify the risk of loss from these factors for nonclassified loans, nor does it provide detailed guidance for determination of loss estimates on individual problem loans. In practice, examiners used standard percentages based on average historical losses—referred to as the "rule of thumb" method—which did not consider loss exposure on individual problem loans, current economic conditions, loan portfolio characteristics, or other risk factors outlined in the Manual. Use of standard percentages derived from historical averages is likely to be misleading when applied to an individual bank, since differences in loan portfolio characteristics, as well as current financial conditions, are not considered.

Rule of Thumb Approach Hinges on Loan Classifications

Examiners are supposed to perform detailed loan file reviews, including analysis of borrowers' repayment ability, evaluation of collateral sufficiency, and discussions with loan officers, in order to ensure that management had identified all significant problem loans and appropriately categorized them in accordance with FRB's standard loan classifications. These loan classification categories are described in table 3.1.

[3]The range of our estimate, at a 95 percent confidence level, is that these conditions existed for the most recent examinations (at the time of our review) of between 49 percent and 95 percent of the 12 large banks supervised by FRB as of September 30, 1990.

[4]FRB officials told us that this bank was in strong financial condition and had a record of sound policies and procedures. Therefore, a decision was made during that examination cycle to perform a limited scope examination on this bank so that additional examiner resources could be devoted to certain large problem banks in that district.

Table 3.1: Loan Classifications Used by FRB

Classification	Description
Specially mentioned	Currently protected loans with potential weaknesses, which may, if not corrected, inadequately protect the bank at some future date.
Substandard	Loans inadequately protected by the current sound worth and repayment ability of the obligor or by the pledged collateral, if any.
Doubtful	Loans which have all the weaknesses inherent in an asset classified as substandard and whose collection or liquidation is highly questionable.
Loss	Loans considered uncollectible and of such little value that their continuance as active assets of the bank is not warranted. (Loss classification does not mean that an asset has absolutely no recovery or salvage value.)

We generally found that examiners reviewed a sufficient amount of loans in sufficient detail to be reasonably confident that management had identified and appropriately classified significant problem loans. Loan coverage ranged from 51 percent to 88 percent of the portfolio value for the five large banks we reviewed which received a full scope examination, and 49 percent to 88 percent for the four smaller banks, and was generally representative of the major segments of the portfolio. For example, at one large bank, examiners reviewed all loans above $10 million, all highly leveraged transactions,[5] all loans for which the bank had discontinued accrual of interest (nonaccrual status), and all other loans rated specially mentioned or worse by the bank. This review covered 51 percent of the bank's loan portfolio value. At three banks, examiners selected statistical samples of larger dollar value loans for review, which enabled examiners to have a sound basis for concluding on the appropriateness of loan classifications, without requiring inordinate sample sizes. At the other banks, examiners did not use statistical sampling, but selected sufficient judgmental samples that were reasonably representative of the banks' loan portfolios.

The purpose of the loan classifications is to identify loans which require special attention and analysis due to concerns about the potential for default. The severity of the classification depends upon the likelihood of default and probability that the bank will incur some loss, but does not directly relate to the amount of expected loss. We found, however, that in four of the five full scope large bank examinations, examiners applied the "rule of thumb" standard percentages to the loan classification categories

[5]A highly leveraged transaction is a financing transaction which involves the buyout, acquisition, or recapitalization of an existing business and results in a high liabilities-to-assets leverage ratio for the borrower.

to estimate the reserve for problem loans. Reserve estimates for the rest of the portfolio were also determined by examiners using a rule of thumb approach, and consisted of applying a flat standard percentage to the nonclassified loan balance. For the banks we reviewed, the rule of thumb percentages applied to the problem loan classification categories and the nonclassified loans were

- substandard: 10, 15, or 20 percent reserve (varied by FRB district);
- doubtful: 50 percent reserve;
- loss: 100 percent write-off; and
- nonclassified: 1/2 percent or 1 percent reserve (varied by district).

In addition to the categories above, the examiners in one district allocated a reserve of 5 percent to specially mentioned loans for the three banks we reviewed in that district. Examiners from the other FRB districts in our sample did not allocate reserves for the specially mentioned category, but included these loans in the nonclassified category for reserve analysis purposes. For the 10 banks we reviewed, 84 percent of classified loans fell in the substandard and specially mentioned categories.

Examiners also used a rule of thumb approach in two of the four small bank cases. In the two remaining cases, examiners used a flat percentage of total loans to assess the adequacy of the loss reserve. In one of these two cases, examiners estimated the reserve adequacy as 1 percent of total loans. In the other, they used 1.2 percent of total loans. Written agreements between the regulator and the banks' boards of directors specified these percentages as a minimum reserve level. However, the basis for these percentages was not shown in the examination working papers or reports.

Historical Averages May Not Reflect Current Risk

Examiners told us that the standard percentages used for both classified and nonclassified loan reserve estimates were based on an analysis of historical losses during the 1980s, and, therefore, they felt the use of the rule of thumb was justified. We did not perform a detailed review of this analysis and were therefore unable to conclude on the propriety of the methods used to derive the historical information. Nevertheless, we believe that the use of average historical losses is likely to be misleading when applied to an individual bank's portfolio, especially in the economic climate that currently exists. Differences in loan policies, loan administration practices, portfolio composition, and economic conditions in the geographic sectors in which a bank operates cannot be

appropriately considered using industry averages. Of particular concern is the volatility of the commercial real estate market in various parts of the country, which has led to significant fluctuations in loan collateral values. The use of historical averages does not adequately provide for these types of fluctuations.

Our concerns about examiners' use of historical averages for assessing loan loss reserve adequacy are illustrated by results at one large bank. Examiners applied the rule of thumb percentages to the loan classification categories and the remaining unclassified loans and concluded that the reserve was adequate. However, other information in the report and examination working papers raised serious concern about the appropriateness of this conclusion. The examination report stated that noncurrent loans were inordinately high and total delinquencies and nonaccruals excessive. One-third of the total loan portfolio was real estate loans and the majority of these were construction and development loans and commercial real estate loans—those that have proven to be the highest risk for loss. Further, the report stated that 60 percent of these loans were in a geographic region suffering from overbuilding. Examiners had downgraded several of the bank's internal classifications on real estate loans and identified several real estate loans which they recommended be placed on nonaccrual status. Examiners also stated in the examination report that the bank's reserve was significantly below the average for banks of similar size. In spite of the concerns raised about loan concentrations in real estate, deteriorating trends in asset quality, and inadequacy in the bank's internal classification system, the examiners did not adjust their analysis of the reserve to reflect these additional risks of loss or require bank management to increase the reserve level.

Examiners used a reserve methodology which considered risk elements outlined in the Manual in only one examination we reviewed. For that examination of a large bank, examiners used a computer model[6] that assessed specific and inherent risk. This model included three primary components—specifically allocated reserves, unallocated reserves, and consumer reserves. Specific reserve allocation was based on a comprehensive, detailed review and determination of the loss exposure for each problem loan reviewed. Unallocated reserves were determined from an analysis of loan quality trends, current and expected market conditions, and the bank's loan administration and underwriting standards. To estimate consumer loan reserves, the model incorporated

[6]We did not review the programming aspects of the model in detail, but it appeared to include the appropriate components to assess the adequacy of the bank's reserve.

average charge-off data for the different types of consumer credit, such as credit card and installment loans. The reserve amount calculated by the model was then compared to the bank's reserve amount to conclude on its adequacy.

Examiners Had No Sound Basis for Challenging Management's Reserving Methods

In three of the five full scope large bank examinations we reviewed, examiners raised concerns about the adequacy of the loan loss reserve based on application of the rule of thumb procedures and the risks which they identified in the loan portfolios. However, because they did not have a methodology to quantify the identified risks, examiners had no basis to determine the amount of the understated reserve or recommend specific improvements in the banks' methodology for estimating the reserve. For example, at one large bank, examination reports for 3 consecutive years stated that the reserve was significantly understated for the risks in the loan portfolio, yet examiners did not recommend that management develop and implement a methodology to ensure that the bank estimated a reasonable reserve for loan losses, or require an increase in the current reserve.

Another large bank used set percentages based on its own internal analysis of historical losses, but its percentages were lower than those used by examiners. In the examination report, examiners expressed concern that the percentages used by the bank were not adequate and that the bank had not allocated any reserve for losses in the nonclassified portion of the loan portfolio. The examination report also stated that the bank had (1) a concentration in less-developed country loans, which were vulnerable to an unfavorable economic climate, (2) a high level of classified assets that were increasing, (3) a large highly leveraged transaction exposure, and (4) concentrations in real estate, including office buildings, hotels, and mixed use and retail projects, which had performed poorly in the cyclical downturn. However, examiners did not propose an adjustment to the reserve to reflect estimated losses from these additional risks, and they did not require bank management to develop and implement a reserve methodology to address these risks on an ongoing basis. Examiners had reported recurring concerns with the adequacy of the loss reserve and the bank's methodology for estimating the reserve since their 1988 examination. If examiners had used a sound methodology which quantified the risk of loss in the bank's loan portfolio, they would have had a stronger basis to challenge management's estimates and to require an increase in the bank's reserve level and revision of its reserve methodology.

In the case of the four small bank examinations we reviewed, we found that examiners used either the rule of thumb or a flat percentage of total loans outstanding to assess the adequacy of the banks' loan loss reserves. As with the large banks, the examiners had no sound basis to challenge managements' procedures and reserve estimates.

Examination Quality Controls Were Inconsistent

Although loan review examination working papers were generally sufficient to provide documentation of the work performed and conclusions reached, we found instances where improved documentation would allow for more efficient supervisory review. We also found that working papers lacked consistent evidence of supervisory review. FRB's Examination Manual included specific guidance on working paper documentation and supervisory review. However, as stated previously, the Manual was used as a reference guide only and did not constitute mandatory standards.

The Manual stated that working papers as a whole should support the information and conclusions contained in the report of examination, and should be prepared in a manner designed to facilitate an objective review. Specifically, the Manual stated that each section of working papers should include documentation of the scope of work performed and conclusions drawn from that work. In addition, the Manual indicated that each individual working paper should include

- the bank name, examination and work performance dates, and a schedule index number;
- the name and title of the person, or description of records, that provided the information needed to complete the schedule;
- a statement of title or purpose of the specific schedule or analysis; and
- initials of the preparer and the examiner designated to perform the review function.

We found that the working papers for the examinations we reviewed did not always comply with the above documentation requirements, which resulted in some difficulty in assessing the work that had been performed. We also found that supervisory review of the working papers was not consistently evident. We believe the documentation of review is important to ensure that critical areas are not overlooked in the review process. In addition, the review process is an important quality control measure and the reviewer's initials or signature are written verification that the working papers have been checked for adequacy of evidence to support the

examination conclusions and that the reviewer concurs with such conclusions.

Conclusions

FRB's lack of a reserve methodology which included procedures to quantify the risk of loss in individual bank loan portfolios precluded examiners from effectively assessing reserve adequacy and the financial condition of banks. In addition, lack of a sound reserve methodology diminished examiners' ability to require bank management to maintain sufficient reserves. The lack of an adequate methodology to estimate and evaluate reserves, along with flexible loan loss accounting rules, resulted in the potential for banks to delay recognition of serious erosion in their loan portfolios and to mask the need for regulatory intervention.

FRB examiners' failure to consistently document their supervisory review weakens quality control over the examination process, as does incomplete working paper documentation. Examination quality control is important to ensure that conclusions reached are properly supported and have been confirmed by an objective reviewer. This is particularly important in the loan quality review and other areas which require a high degree of examiner judgment.

Recommendations

We recommend that the Chairman of the Federal Reserve Board of Governors take the following actions:

- Develop a more specific methodology to be used by examiners for assessing loan loss reserve adequacy on a consistent and meaningful basis. This methodology should include direct consideration of the loss exposure from individual problem loans, as well as a framework for quantification of the risk factors outlined in the Examination Manual for the remainder of the portfolio.
- Require bank management to develop and implement a sound methodology for maintenance of an adequate loan loss reserve that is based on the methodology used by examiners for assessing loan loss reserve adequacy.
- Require examiners to take prompt corrective action when bank management fails to maintain an adequate loan loss reserve.
- Fully document all examination working papers and indicate supervisory review and concurrence by initialling or signing each working paper.

- Coordinate implementation of the above recommendations with the other federal financial institution regulatory agencies to achieve uniform requirements.

Agency Comments and Our Evaluation

FRB partially concurred with our recommendation to develop a more specific methodology to be used by examiners for assessing the adequacy of bank loan loss reserves. FRB stated that bank management is responsible for establishing and maintaining an adequate loan loss reserve and the bank's internal and external auditors are responsible for attesting to management's determination. FRB also stated that examiners should focus their efforts on identifying deficiencies in bank methodology and, where serious deficiencies exist, require the banks to strengthen their methodology and bolster their reserves.

While we do not disagree that ultimate responsibility for establishing and maintaining adequate loan loss reserves rests with bank management, FRB has responsibility for determining the adequacy of the reserves in assessing bank safety and soundness. As discussed in this chapter, we found several instances where examiners raised concerns about the bank's loan loss reserve but did not recommend specific improvements to management's methodology or require an increase in the current reserve. We believe examiners need a reliable methodology in order to effectively challenge bank management's reserving methods and results.

FRB stated that the framework currently used by the examiners to evaluate loan loss reserves combines an assessment of the factors described in its Bank Examination Manual and the rule of thumb percentages. They noted that the rule of thumb percentages were based on analysis of actual loss experiences of the various classification categories, but acknowledged that the percentages reflect the average experience of banks and are not necessarily applicable to individual banks. However, FRB stated that these percentages are a useful tool, along with considerable examiner judgment, to assess the adequacy of a bank's loss reserves. We believe using average historical loss experience is likely to be misleading when applied to individual banks. These percentages do not account for differences in loan policies, loan administration practices, portfolio composition, and economic conditions. Furthermore, as stated in this chapter, in 6 of the 10 bank examinations we reviewed, the examiners did not adjust the rule of thumb percentages to account for these or other "judgment" factors.

FRB stated that using a single mechanical methodology would not be appropriate for all banks and would impinge on the responsibilities of bank management. As discussed in this chapter, we advocate a method that would provide field examiners with a consistent framework to evaluate loan loss reserve adequacy, while also providing flexibility to consider varying characteristics of individual banks.

FRB stated that it is participating in interagency working groups to strengthen the examiners' ability to assess the adequacy of bank reserves. However, the agencies have not reached an agreement on specific methodologies the examiners may use. The difficulty experienced by the interagency working groups in agreeing on an approach to assessing loan loss reserves further demonstrates the need for consistent guidance in this area. In addition, it highlights the critical need for definitive guidance for field examiners, who are attempting to make these difficult judgments on an ad hoc basis. We encourage FRB to continue working through the interagency working groups and to make timely resolution of this crucial issue a priority.

FRB concurred with our finding that examiner working paper documentation and supervisory review, while generally adequate, could be improved. FRB stated that it has been working on standardized working paper requirements and enhanced supervisory review procedures. We encourage FRB to fully implement these new requirements and procedures as soon as possible to ensure adequate quality control during upcoming examinations.

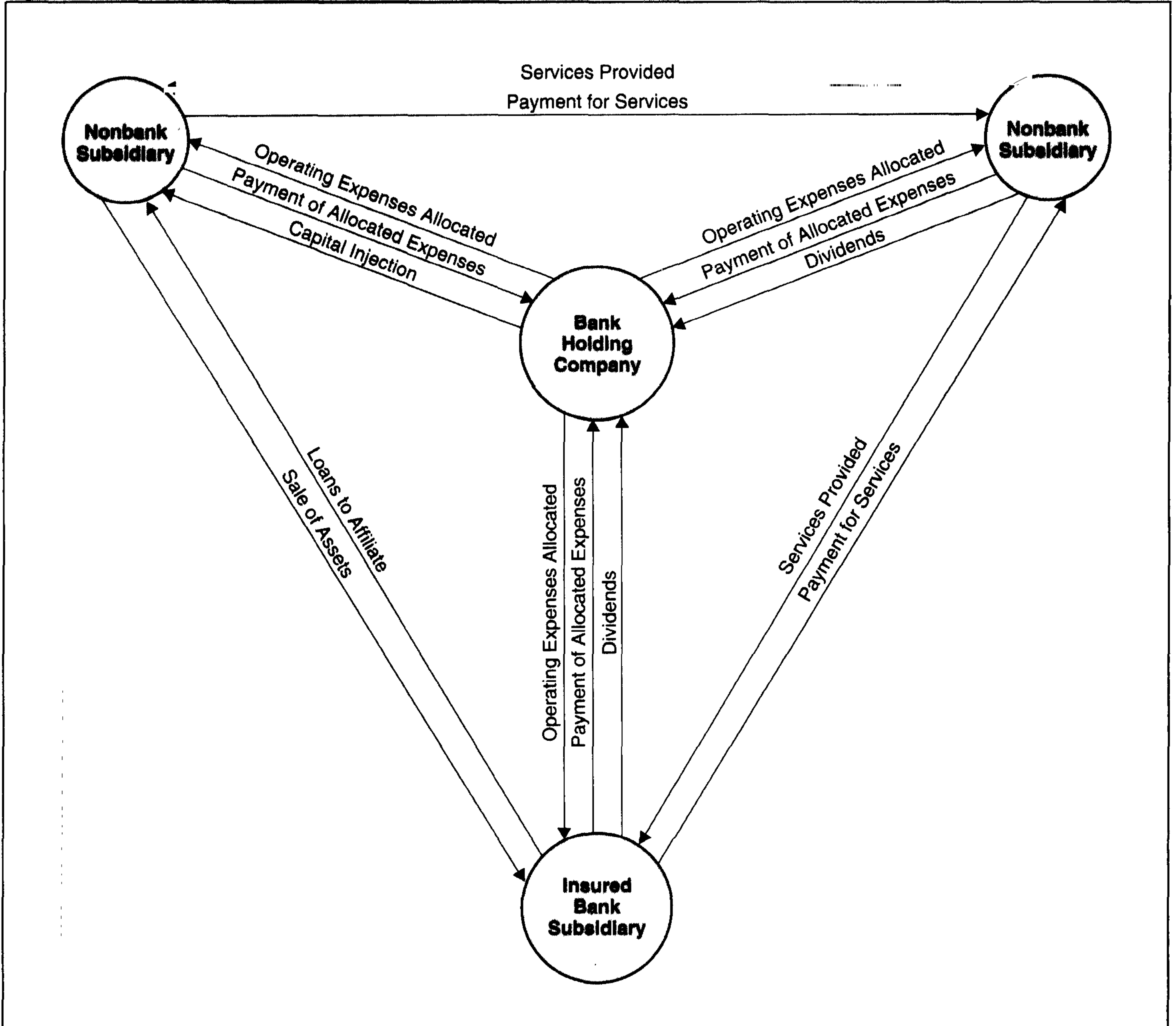
Major Risks to Insured Banks Not Assessed by Holding Company Inspections

For six out of the seven bank holding company inspections we reviewed, the examiners did not adequately evaluate intercompany transactions that could threaten the safety and soundness of the insured bank subsidiaries. In addition, at two of the three bank holding companies where large credit-extending nonbank subsidiaries existed, the examiners did not conduct an independent analysis of asset quality. The guidance provided to the examiners did not establish minimum mandatory procedures to ensure these areas are thoroughly evaluated. As a result, adverse intercompany transactions and asset quality problems at the nonbank subsidiaries, which could have damaging financial consequences to the insured bank subsidiaries, may not be detected.

Risks Posed to Insured Bank Subsidiaries by Holding Company Activities

The FRB Bank Holding Company Supervision Manual identified several types of intercompany transactions which examiners should review that commonly occur between the insured bank subsidiary and the holding company and/or nonbank subsidiaries. Figure 4.1 illustrates these transactions within a simple bank holding company structure.

Figure 4.1: Intercompany Transactions



The intercompany transactions illustrated in figure 4.1 have the potential to adversely impact the insured bank subsidiary. For instance, loans made

by the bank to nonbank affiliates may be made at below market rates, thereby diverting income opportunity from the bank. There is also the risk that these loans may not be repaid by the affiliate. In addition, fees charged by the parent holding company to the insured bank, such as interest expense for cash advanced to the bank, and management and service fees, may be excessive and cause a drain on the bank's capital and liquidity position. These intercompany fees also provide the holding company with the opportunity to charge the bank for expenses when no services are performed. Selling or transferring assets from nonbank affiliates to the insured bank also places the bank at risk of receiving poor quality assets.

To protect insured banks, section 23A of the Federal Reserve Act, as amended, regulates transactions between banks (and their subsidiaries) and their affiliates. For example, section 23A limits the amounts of a bank's intercompany transactions with each affiliate and all affiliates, and generally prohibits a bank from purchasing low quality assets from an affiliate. Section 23A also establishes stringent collateral requirements, which range from 100 percent to 130 percent of the outstanding balance of the loans from banks to nonbank affiliates, depending on the nature of the collateral. In addition, low quality assets are not an acceptable form of collateral. One of the primary objectives of the bank holding company inspection is to ensure that there are no violations of section 23A.

Section 23B of the Federal Reserve Act, as amended, further regulates intercompany transactions. Under this section, an insured bank subsidiary (and its subsidiaries) may engage in intercompany transactions only when the terms, including credit standards, are substantially the same as those for comparable transactions with nonaffiliated companies or as those that in good faith would be offered to nonaffiliated companies.

We have previously reported that the authoritative accounting guidance for the treatment of related party transactions is not clear when their economic substance is different from their legal form.[1] The ambiguities in these accounting rules may allow bank holding companies to record income, and require bank subsidiaries to record expenses, for transactions which have the appropriate legal form, such as written service contracts and sales agreements, but in reality have provided no benefit to the bank. Further, the ambiguity in the accounting rules raises the probability that intercompany transactions which place a drain on the insured bank's

[1] Federal Asset Disposition Association: No Economic Basis for Reported Fee Income Under 1988 Letter Agreement (GAO/AFMD-91-15, July 29, 1991).

capital, but which have no real economic substance, may go unchallenged by auditors and regulators.

In addition to the direct risk posed by intercompany transactions, asset quality problems at nonbank subsidiaries pose an indirect risk to the insured bank subsidiary. The FRB Manual states that a holding company has considerable discretion over the type of assistance it may give to an ailing nonbank subsidiary. Bank subsidiaries may be called upon to transfer large portions of their capital in the form of dividends to the parent. These funds may then be funneled to the ailing nonbank subsidiary. In addition, ailing nonbank subsidiaries may severely weaken the holding company and erode its ability to act as a source of strength to the bank.

Examiners Did Not Assess Risks From Intercompany Transactions

The primary direct risk that holding company activities pose to bank subsidiaries is intercompany transactions with negative economic impact. However, the examiners did not adequately assess the risks of intercompany transactions in six of the seven bank holding company inspections we reviewed. Specifically, the examiners' analyses of loans from banks to nonbank affiliates, fees charged by the holding company to the insured bank subsidiary, and assets transferred from nonbank subsidiaries to insured bank affiliates were not adequate to detect potential abuse of the insured bank.

One examiner told us that he did not focus on intercompany transactions during the inspection of a $27 billion holding company because he relied on the examiners of the lead bank to discover and inform him of any adverse intercompany transactions during their examination. However, during 1990, the regulator of this holding company's lead bank did not review insider and affiliate transactions. Two other examiners told us that transactions which may harm the insured bank would be large and therefore easily detected. However, this may not be the case with transactions such as below market rate loans and excessive service fees. These transactions drain banks of capital and cash over an extended period. The long-term negative impact upon the insured bank may be just as severe under these circumstances as that of a single large adverse transaction.

The FRB Manual included an extensive discussion of the risks posed by intercompany transactions, as well as specific procedures to evaluate these risks. However, FRB officials told us that the Manual was intended

only to provide guidance for the examiners. FRB policy did not establish minimum or mandatory procedures designed to accomplish the inspection objectives and evaluate the risk to insured bank subsidiaries. The determination of the actual procedures to be performed is left to the discretion of the field examiners.

Risks of Intercompany Loans Not Assessed

In four of the seven bank holding company inspections we reviewed, the balance of credit extended to nonbank affiliates exceeded 5 percent of total bank capital, which we believe represented a significant exposure to the bank if these loans were not repaid. The outstanding balance of these loans ranged from $194 million to as much as $1.3 billion. At three of the four institutions, examiners did not review the terms of the loans or a sufficient amount of collateral to determine if they violated sections 23A and 23B of the Federal Reserve Act. At these institutions, the examiners' planned scope focused only on loans from bank subsidiaries to nonbank affiliates originated since the prior inspection. As a result, any loans from bank subsidiaries to nonbank affiliates made before the last inspection, whose terms may have been revised or whose collateral may have deteriorated, were not included in the examiners' reviews.

For example, at one institution, the examiners reviewed the collateral quality for $506 million of loans originated since the last inspection from banks to nonbank affiliates. The average balance of credit extended from banks to nonbank affiliates was reported to be over $1 billion. At another institution, examiners requested a schedule from bank management of intercompany loans made since the last inspection. An FRB report showed the balance of loans from bank subsidiaries to nonbank affiliates at this bank holding company totaled $577 million. However, there was no evidence in the working papers that this schedule was ever received from bank management or that the intercompany loans were otherwise analyzed during the inspection. The examiners were unable to explain why the schedule was missing.

According to the FRB Manual, the primary objectives of the inspection in this area are to assess the financial impact of loans from subsidiary banks to affiliates and to determine if these transactions should be cited as unsound. The FRB Manual suggested that the examiners perform various procedures in order to accomplish these objectives, such as reviewing the most recent FRB "Report of Intercompany Transactions and Balances" for information on loans from bank subsidiaries to affiliates. This report is filed semiannually by holding company management to assist FRB in

monitoring selected intercompany transactions and detecting violations of sections 23A and 23B of the Federal Reserve Act. The FRB Manual also suggested that examiners review thoroughly all loans which the parent company or any nonbank subsidiaries have outstanding from an affiliated bank, including all related documentation and borrowing resolutions, to ensure the loan terms were reasonable compared to current market terms. This may include evaluating collateral sufficiency and determining that the interest rate charged for the loans was at the prevailing rate. However, the FRB Manual did not establish any minimum mandatory procedures for when the examiners must review loans from banks to nonbank affiliates or the amount of collateral they must review.

Expense Allocations Not Tested

In five of the seven inspections, examiners reviewed expense allocation policies and compared total current year expenses charged by the bank holding company to the insured bank subsidiaries with prior year amounts. However, in all seven holding company inspections we reviewed, the examiners did not test these fees to determine if the banks were being charged in accordance with reasonable policies and if the banks were actually receiving services for which they were being billed.[2] Fees charged by the holding company to the insured bank subsidiaries ranged from $39 million to $467 million and ranged from 1 percent to as much as 28 percent of lead bank capital. In five of seven inspections we reviewed, these recurring fees equaled or exceeded 5 percent of the lead bank's total capital, and thus could represent a significant drain of bank capital over time. At one of the institutions we reviewed, $18 million in excess fees charged by the parent company to its bank and nonbank subsidiaries were not detected during the inspection. The discrepancy was detected, however, by the off-site surveillance staff during a review of the fourth quarter dividend proposal. Although management reclassified $8 million of these fees as dividends paid by the banks to the bank holding company, none of the overpayment was refunded to the banks.

The primary objectives established by the FRB Manual for this inspection area are to determine whether the holding company charges fees based on value received, the subsidiary actually receives these services, and these fees result in an unsafe or unsound condition in any subsidiary bank. The FRB Manual suggests that the examiners review and analyze the policies regarding fees charged to bank subsidiaries and the method for assessing the fees. It also suggests the examiners verify that the fees were charged in

[2]For one of the seven holding company inspections, the lack of fee testing was the only weakness we found. We concluded that the examiners' overall analysis of intercompany transactions was adequate to protect the insured bank subsidiary.

accordance with the pricing structure, that the pricing structure was consistently applied for all bank subsidiaries, and that the banks actually received the services for which they were billed. We found that the work actually performed did not fulfill the primary objectives outlined in the Manual. However, the Manual was designed as a reference guide to the examiners and did not include minimum mandatory procedures.

FRB officials at one Reserve Bank stated that the examiners were alert for instances of fee abuse, but a complete review of this area could not be accomplished due to resource limitations. These officials added that the risk to the bank would come from large transactions that would be easily identified. As discussed previously, we believe that the long-term negative impact of excessive service fees may be as severe as that of a single large adverse transaction.

Asset Transfers Not Reviewed

In one holding company inspection we reviewed, loans secured by real estate totaling nearly $286 million, or more than 20 percent of the lead bank's capital, were transferred from nonbank affiliates to insured bank subsidiaries. The examiners did not review the assets to determine if poor quality loans were being passed on to the insured banks in violation of section 23A of the Federal Reserve Act.

The FRB Manual stated that the objective of the bank holding company inspection in this area is to ensure that transfers of assets are carefully evaluated to determine if the transfers were done to avoid classification of poor quality assets and to determine the effect of the transfer on the condition of the bank. In order to accomplish this objective, the FRB Manual suggested that the examiners determine whether any of the loans transferred were nonperforming at the time of transfer or for any other reason were considered to be of questionable quality. However, FRB policy did not require the examiners to perform any of these procedures.

Examiners Relied on Management's Assessment of Nonbank Asset Quality

At two of the three bank holding companies where large, credit-extending nonbank subsidiaries existed, the examiners did not conduct an independent analysis of nonbank asset quality. Despite increasing trends in problem assets at these nonbank subsidiaries, the examiners' analysis of nonbank asset quality was limited to reviewing management's quarterly internal reports.

For example, at one institution, nonbank assets totaled 20 percent of total consolidated assets. The examiner-in-charge told us they had been relying solely upon management data to evaluate nonbank asset quality for several years, despite known problems at several nonbank subsidiaries. These problems included increasing mortgage delinquencies, significant interest rate risk, continued net losses, high levels of classified loans and an inadequate reserve for loan and lease losses. A large credit-extending nonbank subsidiary at this institution had never been examined by FRB. However, when OCC reviewed this nonbank subsidiary because it was being transferred to the lead bank, OCC noted significant increases in problem loans and credit losses directly attributable to underwriting deficiencies.

At the other institution, total assets of credit-extending nonbank subsidiaries were reported at 8 percent of total consolidated assets. At the largest nonbank subsidiary, examiners reported that asset quality was less than satisfactory. Problem assets at this subsidiary had increased 45 percent since the prior inspection and totaled nearly $114 million. However, the examiners did not conduct an independent evaluation of these assets to determine if management had identified all the poor quality loans or had established adequate reserves for losses on these loans.

The FRB Manual provided no definitive guidance in the area of nonbank subsidiary asset quality. It stated that the examiner should concentrate on appraising the quality of assets held by the nonbank subsidiaries since asset problems at these entities could lead to financial problems at the banks. However, the Manual did not establish criteria for when asset quality reviews are necessary. The Manual had no guidelines to assist the examiner during the planning phases of the inspection to establish materiality limits or assess the potential impact of poor asset quality on the nonbank subsidiaries. This lack of adequate guidance, combined with FRB's view that examiners are not required to follow the Manual, leads to inconsistent and inadequate procedures for the review of nonbank asset quality.

The risks to the insured bank from not evaluating nonbank subsidiary asset quality are great. Without an independent evaluation of asset quality at the nonbank subsidiaries, FRB examiners are forced to rely on management to disclose the extent of asset quality problems at these subsidiaries. As a result, the risk that these poor quality assets pose to the bank holding company and ultimately to the insured bank may not be detected until they result in losses to the holding company and a drain on

bank liquidity and capital. Management reports may intentionally or unintentionally mislead examiners. Since management's operating style or philosophy may be the cause of the asset quality problems, total reliance upon management to disclose the nature and extent of these problems is not prudent.

Supervisory Review and Quality of Working Papers Were Inconsistent

Although the examiners' working papers generally provided adequate evidence of the work performed, we found instances where the documentation was incomplete. Working papers often lacked an indication of information sources, the purpose of procedures performed, and the conclusions reached on specific procedures or analyses. In addition, documented supervisory review of the working papers was inconsistent. The FRB Manual did not provide any guidance with regard to working paper preparation or how supervisors should review working papers. Four of the seven examiners-in-charge acknowledged that the working paper documentation could be improved. Examiners also told us that they reviewed the working papers, although they did not always document their review. We believe that working paper documentation should be adequate to allow an objective reviewer to understand the work performed and the conclusions drawn from that work. We also believe that consistently documented supervisory review is an important quality control measure to ensure that risks to the insured bank subsidiary are properly identified and that the reviewer agrees with the conclusions presented in the inspection report.

Conclusions

The lack of specific guidance and minimum standards for the inspection of the potential risks from intercompany transactions and asset quality has resulted in a superficial approach to the holding company inspection process. Under the current inspection approach, examiners may not detect adverse intercompany transactions and overlook the potential erosion of bank capital, especially from less flagrant adverse transactions. As a result, the current approach fails to appropriately protect the insured bank subsidiaries from the direct risk posed by intercompany transactions and the indirect risk from asset quality problems at the nonbank subsidiaries.

Examiners' lack of consistent working paper documentation and supervisory review weakens quality control over the inspection process. Inspection quality control is important to ensure that conclusions reached are properly supported and have been verified by an objective reviewer.

Recommendations

We recommend that the Chairman of the Federal Reserve Board of Governors establish minimum bank holding company inspection procedures that include

- assessing the actual and potential adverse impact of intercompany transactions upon the insured bank,
- conducting independent asset quality reviews of any nonbank subsidiary where the failure of that subsidiary would have a significant impact upon the capital of the holding company and its ability to operate as a source of strength to the bank, and
- consistently documenting the procedures performed and the supervisory review of the inspection working papers.

Agency Comments and Our Evaluation

FRB did not concur with our finding that the bank holding company inspection process did not effectively assess major risks to insured bank subsidiaries. It stated that our findings did not accurately portray its activities in reviewing intercompany transactions and nonbank subsidiary asset quality. We found the deficiencies discussed in this chapter in inspections performed by examiners from four different Federal Reserve Banks. In addition, the seven lead banks included in our sample of bank holding companies accounted for 24 percent of the total assets of all banks with assets greater than $10 billion. Therefore, we believe our work clearly portrays an extensive problem regarding the adequacy of FRB's inspection process in protecting insured bank subsidiaries from harmful affiliate activities.

FRB stated that the main objective of a bank holding company inspection is to assess the impact that a parent organization and its nonbank affiliates may have on the safety and soundness of insured bank subsidiaries. It noted that the review of transactions between insured bank subsidiaries and nonbank affiliates is customarily performed in all full scope inspections to assess compliance with sections 23A and 23B of the Federal Reserve Act. However, as illustrated in this chapter, the examiners' analysis of intercompany transactions in six of the seven bank holding company inspections we reviewed was inadequate to assess the risk these transactions posed to insured bank subsidiaries.

Although FRB believes examiners should be afforded discretion in establishing the scope of on-site reviews of credit-extending nonbank subsidiaries, it said it would review its procedures and practices in this area and emphasize the importance of regularly assessing asset quality at

the nonbank subsidiaries. FRB stated that its existing policies require examiners to assess the quality of loans to determine the extent of an insured bank's potential risk exposure to nonbank affiliates. However, FRB's Inspection Manual, which contains several hundred pages of optional guidance for the examiners, devotes only five pages to the discussion of asset quality at credit-extending nonbank subsidiaries. This section of the Manual does not contain inspection objectives or any required inspection procedures. We believe FRB should develop minimum mandatory procedures that examiners should perform to assess the risks that material credit-extending nonbank subsidiaries may pose to the insured bank subsidiary.

Comments From the Federal Reserve Board

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

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

RICHARD SPILLENKOTHEN
DIRECTOR
DIVISION OF BANKING
SUPERVISION AND
REGULATION

November 10, 1992

Mr. Donald H. Chapin
Assistant Comptroller General
Accounting and Financial Management Division
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Chapin:

Thank you for the opportunity to comment on the GAO's draft report addressing the quality of examinations of banks and bank holding companies conducted by the Federal Reserve. The report's findings are critical of the Federal Reserve's activities in four principal areas: review of internal controls, assessment of the adequacy of loan loss reserves, assessment of the risks to insured bank subsidiaries resulting from transactions with nonbank affiliates and from poor asset quality of these affiliates, and the preparation and supervisory review of examination and inspection workpapers. The GAO report also suggests that the Federal Reserve's examination manual and procedures are not sufficiently structured or systematic to provide adequate guidance to examiners in these areas. The GAO concluded that the deficiencies it found limit the ability of the Federal Reserve to fully assess the safety and soundness of banking organizations.

The Federal Reserve recognizes the desirability of continually reviewing and, where appropriate, taking steps to strengthen its examination and inspection program. Thus, the Federal Reserve intends to evaluate carefully the findings the GAO has reported and to consider judiciously the recommendations for how the System should enhance its examination and inspection policies and practices going forward. But, that being said, let me immediately state that we strongly disagree with the GAO's overall conclusion that the Federal Reserve does not fully assess safety and soundness.

See comment 1.

2

In our view, the basic framework employed by the Federal Reserve for the conduct of examinations and inspections is sound and the execution of that framework by our examiners has proven to be effective. The two fundamental cornerstones of the Federal Reserve's examination philosophy have long been: first, every state member bank should receive at least one on-site, full-scope examination annually; and, second, each examination should include a thorough asset quality review of sufficient scope to reliably determine the true risk profile of the banking organization. We believe these two fundamental examination policies, which lie at the heart of the Federal Reserve's supervisory program, have contributed significantly to the safety and soundness of the banking system and have helped to minimize losses to the Bank Insurance Fund.

See comment 1.

As noted in the GAO report, the record number of bank failures over the past several years has caused the Bank Insurance Fund to be in deficit balance. With that in mind, it is pertinent to point out that a 1991 House staff report disclosed that the deposit insurance premiums paid to the Bank Insurance Fund by state member banks from January 1986 through June 1991 exceeded the cost of resolving the state member banks that failed over this period.[1]

See comment 2.

The House staff report also concluded that annual full-scope examinations are the best supervisory tool presently available to control risks to the deposit insurance fund and maintain public confidence in the integrity of the banking system. It also suggested there is a strong link between the level of net losses suffered by the Bank Insurance Fund and the level of coverage of supervised assets of a full-scope examination. In short, we believe the House staff report provided strong endorsement of a principle that has long been a key element of the Federal Reserve's examination program. That endorsement also was translated into action in FDICIA which mandates that each agency perform annual full-scope examinations of the insured depositories they supervise.

See comment 1.

<u>Assessments of Internal Control Systems</u>

Turning to the GAO's criticism of the Federal Reserve's approach to evaluating internal control systems, the GAO appears to believe that each examination should consist of an extensive and irreducible core of work to (a) verify the existence of a comprehensive set of policies and control systems and (b) assure

See comment 1.

[1]"Analysis of Bank Deposit Insurance Fund Losses", staff report to the House Committee on Banking, Finance and Urban Affairs, September 9, 1991.

the institution is in compliance with these policies. Therefore, the essence of the GAO's criticism of the System's review of internal controls appears to be that in most of the examinations reviewed, the Federal Reserve did not follow every procedure laid out in our Bank Examination Manual, or that the manual did not distinguish those minimum procedures that had to be followed in all cases from those which are optional. Put somewhat differently, the GAO objects to the Federal Reserve's practice of assigning to examiners discretion to decide on the breadth and depth of the review of internal control systems that is performed during the examination of a bank.

The Federal Reserve concurs fully with the GAO on the importance of banks having effective internal control systems and on the need for the examination process to verify the existence of such systems. It is our considered view, however, that affording examiners discretion to decide on the scope of reviews to accomplish that verification is altogether appropriate, for it enables the targeting of scarce examination resources to areas requiring the greatest attention. At the same time, we believe that commissioned Federal Reserve examiners -- i.e., those individuals who are typically in charge of leading examinations -- have the training, the experience and the necessary information to enable them to make informed judgments regarding the appropriate scope of the internal control review.

The Federal Reserve's annual full-scope examinations are comprehensive in nature, designed to assure that all significant operating activities of a bank are adequately evaluated. Experience has clearly demonstrated, however, that, with very few exceptions, credit quality problems are the overriding cause of serious financial problems and bank failures. Thus, a substantial portion of our examination efforts and resources is directed to a thorough evaluation of credit quality and a rigorous testing of the bank's internal process of evaluating and classifying its assets. The GAO, we would note, concluded that our examiners reviewed a sufficient amount of loans to be reasonably confident that bank management had identified all significant loan problems.

The review of asset quality and testing of internal classifications, however, are vital not only for determining the current condition of a bank, but also are of considerable importance in deciding how much additional review and testing of the internal control systems pertaining to the credit function are required. If loans are found to be of high quality and performing consistently with their terms, if the documentation of the loans reviewed is in good order, if the terms under which the credits were extended appear prudent and in line with the policies established by the Board of Directors of the bank, and if the bank's classifications appear consistent with those

assigned by the examiner, then the examiner can conclude that a less intensive review of other elements of the internal control system for the lending function is warranted. If, on the other hand, the examiner identifies deficiencies in any of these areas, he or she is expected to carry out a more comprehensive and rigorous review of the internal control system.

Examiners also have access to other important information in reaching a determination on the required breadth and depth of the review of internal control systems. As a part of the planning process preparatory to an examination, the examiner reviews previous examination reports and analytical reports of the off-site surveillance staff that are based on Call Reports, regulatory filings and other relevant information. In addition, the examiner reviews the reports of, and holds discussions with, the bank's internal and external auditors, meets with bank management, and discusses the condition of the bank with other regulators. These various sources provide a historical perspective of a bank's past strengths and weaknesses and relatively detailed information on the bank's current policies and adherence to those policies. This information, when considered together with the thorough assessment of the quality of the asset portfolio, enables the examiner to reach an informed judgment on the degree to which an extensive review of the bank's internal control systems is needed. The in-depth review of asset quality will also influence the examiner's judgment regarding other key areas reviewed in an examination under the general categories of capital adequacy, earnings, management and liquidity and can result in a shading up or down of the overall examination rating assigned to the bank.

As the GAO notes in its report, examiners will soon have an additional source of information to assist in determining the scope of internal control reviews. FDICIA requires that a bank's management report annually on their assessment of the effectiveness of the institution's internal control structure and procedures, and the bank's auditor must attest to the accuracy of management's assessment. The examiners will be able to review the management reports to identify emerging internal control weaknesses, and integrate their findings into the examination process.

Finally, the GAO notes that weaknesses in internal control systems identified by examiners are not always set forth in the section of the examination report pertaining to internal control systems. While deficiencies in internal controls may not always be separately identified in an examination report as internal control problems per se, criticisms of control systems are often presented, as appropriate, in the asset quality, accounting, loan policy and administration, and management sections of the report. Furthermore, comments are made by our

examiners in the examination workpapers relative to corrective action to be taken by management and examiner follow-up.

Assessing Loan Loss Reserving Practices

See comment 3.

The GAO report concludes that Federal Reserve examiners do not have a sufficient basis for assessing the adequacy of bank loan loss reserves. In the GAO's view, the FRB manual identifies the proper variables that should be taken into account -- such as risks from identified problem loans, quality of loan portfolio management, adequacy of loan policies, current economic conditions, and the composition of the loan portfolio. The GAO notes, however, that a specific methodology for quantifying these variables is lacking and that, in the absence of better guidance, examiners fall back on "rule of thumb" percentages which the GAO believes can be quite misleading in the case of individual banks, given their wide differences of circumstance.

The Federal Reserve's longstanding policy has been that bank management is responsible for establishing and maintaining an adequate loan loss reserve, with the bank's internal/external auditors assigned the necessary work of attesting to management's determination. Given this policy, our examiners have been instructed to focus on identifying deficiencies in the methodology used by a bank in determining the reserves it needs to cover future loan losses. Where serious deficiencies have been found, we have required banks to strengthen their methodologies and bolster their reserves.

The framework presently in place to carry out that evaluation combines an assessment of the factors specified in our Bank Examination Manual, along with rule of thumb percentages of loss exposure for each loan classification category. These percentages are based on analyses of actual loss percentages in the various classification categories. They are, of course, reflective of the average experience of banks and not necessarily applicable to any individual bank, but they do serve as a useful tool for examiners in reaching judgments on a bank's reserving policies and practices.

The GAO suggests the desirability of establishing and using a single methodology for evaluating the adequacy of bank loan loss reserves, one that is primarily developed by the regulatory agencies. Evaluating loan loss reserve adequacy is not an exact science and considerable judgment must be exercised by both bank management and examiners to take into account the myriad circumstances that can affect different banking organizations. Nevertheless, while a single, mechanical methodology will not serve in all cases and would involve the regulators overstepping a boundary of responsibility that is properly the province of management, the Federal Reserve

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recognizes that there is room to improve the existing framework used throughout the System and among the various regulatory agencies in evaluating the adequacy of loan loss reserves. Accordingly, the Federal Reserve System has been participating in interagency working groups to consider what the agencies might do to strengthen the ability of examiners to better assess bank reserving practices in order to promote greater assurance of adequate bank reserve levels. To date, the agencies have not reached agreement on what might be done to accomplish the objective of this exercise but some possible avenues for improvement are under review.

Bank Holding Company Inspections

See comment 4.

The GAO's review of bank holding company inspections concludes that insured banks are exposed to major risks from holding company affiliation and that the Federal Reserve's holding company inspections do not effectively assess these risks. We believe these findings do not accurately portray the Reserve Banks' general activities in reviewing intercompany transactions and evaluating nonbank subsidiary asset quality.

The main objective of a bank holding company inspection is to assess the impact that a parent organization and its nonbank affiliates may have on the safety and soundness of insured depositories in the organization. In carrying out this objective, we assess how banks are shielded from being harmed by the activities of parent and nonbank affiliates and how well the parent holding company manages risk within its subsidiaries. Consequently, the review of transactions between insured depositories and other entities of the holding company is customarily performed in full-scope bank holding company inspections, regardless of size. The procedures, which are specified in the holding company inspection manual, require examiners to assess loans from bank to nonbank affiliates, "covered" transactions under 23A and 23B of the Federal Reserve Act, payments from subsidiary banks forwarded to a parent to contribute to the organization's consolidated tax obligations, and management fees paid by the banks to other entities in the holding company.

Federal Reserve policy also requires examiners to review the quality of loans and the loan administration function at nonbank subsidiaries that extend material amounts of credit. In addition, examiners are instructed to determine reserve adequacy of such credits and to review parent company control of credit extending functions, all with the intent of evaluating the extent of an insured bank's potential risk exposure to nonbank affiliates.

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Reserve Banks exercise some discretion on the scope of on-site reviews and when they are to be conducted, although assessment of risk conditions at nonbank subsidiaries is an integral part of all inspections. The GAO found some cases where a Reserve Bank decided not to carry out an on-site review. While we believe Reserve Bank judgment and discretion are important here too, we intend to review our procedures and practices in this area. Moreover, we intend to follow up these efforts by emphasizing to Reserve Banks the importance of regularly assessing transactions between insured depositories and their holding company affiliates and determining the financial soundness of affiliates whose condition can significantly affect the health of the insured depositories.

Examination/Inspection Paper Work

See comment 3.

The report concludes with a finding that while the Federal Reserve's examination and inspection workpapers generally provided adequate evidence of work performed, documentation was sometimes lacking on sources of information, purposes of procedures performed, and conclusions reached on specific procedures and analysis. In addition, the report notes that reviews of the workpapers by supervisors were sporadic. The Federal Reserve recognizes there is room for improvement in this area. Over the past year, the System has been working to develop standardized workpaper requirements for both bank examinations and bank holding company inspections. These workpaper standards will require a clear recounting of tasks performed at the examination or inspection. The examiner-in-charge will be responsible to review the completed workpaper packet. And, as an additional quality control measure, a supervisory review of the workpapers will also be performed to ensure the report comments are consistent with, and supported by, information in the workpapers.

See comment 5.

See comment 6.

The GAO report findings are based on System examination practices that were observed from 1990 examinations and inspections. Prior to the start of the GAO review, the System had recognized some inconsistences among the Federal Reserve Districts in the implementation of certain of our examination and inspection policies and procedures, and certain examination practices that needed strengthening. In 1991, a major System initiative set about addressing those inconsistences and made many recommendations presently offered by the GAO report. Some are in place, others are under development, and several have evolved more broadly into interagency efforts, most notably the project to strengthen the assessment of loan loss reserves.

In summary, we acknowledge that certain aspects of our examination process can and should be strengthened and we intend to give careful consideration to those recommendations suggested

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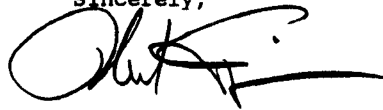
by the GAO in its report. At the same time, we would emphasize that certain report findings do not accurately reflect how we generally examine banks and inspect bank holding companies. Most importantly, we take strong exception to GAO's criticism of our ability to fully assess the safety and soundness of banks through our examination process. We believe that the record shows that the Federal Reserve's fundamental examination policies (annual, on-site, full-scope reviews with a special focus on asset quality) and the manner in which the policies have been carried out in our examination program have been effective in identifying bank risks and in promoting the safety and soundness of banking organizations under the System's jurisdiction.

Sincerely,



The following are GAO's comments on the Federal Reserve Board's letter dated November 10, 1992.

GAO Comments

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

2. FRB's comment refers to the September 1991 report published by the House Committee on Banking, Finance and Urban Affairs entitled, Analysis of Bank Deposit Insurance Fund Losses. Although the House report notes that state member banks' deposit insurance premiums exceeded the cost of resolving these banks from 1986 to 1991, it also states that "analysis of the data by region indicates that the FRB's performance was aided by the fact that they supervised relatively few banks in the Southwest, the most volatile in terms of bank problems." According to this report, losses from state member banks totaled $572 million. In addition, a recent FDIC report that analyzed failed bank costs from 1985 to 1991 stated that FRB had a 26 percent loss-to-assets ratio. This was the highest among the three bank regulators.

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 3 as it relates to working paper documentation and supervisory review.

6. We requested a copy of the major system initiative implemented during 1991 in order to review the policies and procedures established under the initiative. FRB provided us with a listing of project recommendations, some of which pertained to various findings in this report. However, no formal policies have yet been implemented as a result of these project recommendations.

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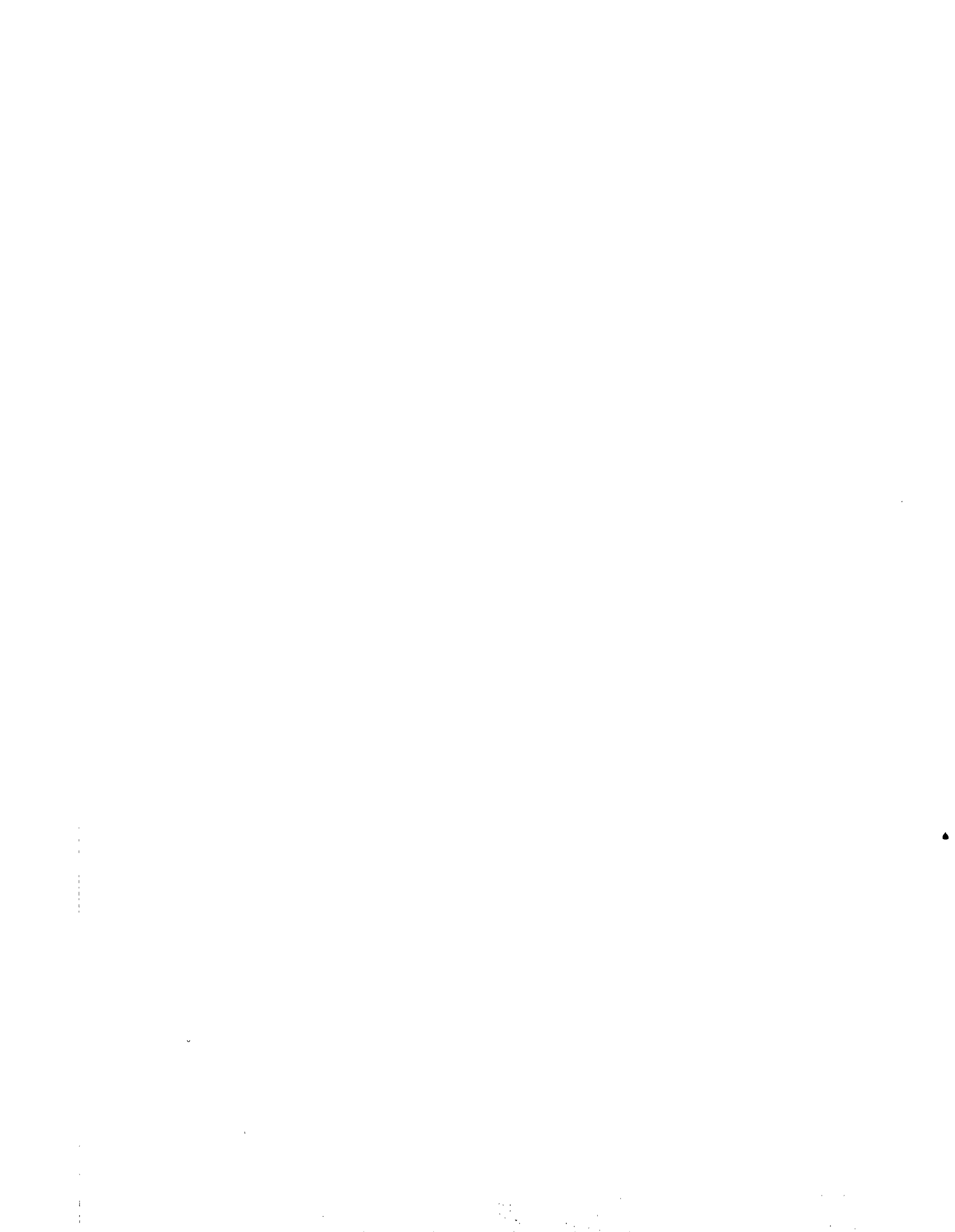

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