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BANK FAILURES

Independent Audits Needed to Strengthen Internal Control and Bank Management

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Comptroller General
of the United States

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

This report presents the results of our review of regulatory and examination documents related to the 184 insured banks which failed in 1987. Serious internal control weaknesses contributed significantly to virtually all these bank failures. We believe legislative actions are needed to address the serious internal control weaknesses cited by federal regulators, thereby aiding in the prompt detection and correction of such weaknesses as well as reducing banks' vulnerability to fraud, insider abuse, and environmental factors.

We are sending copies of this report to the Senate Committee on Banking, Housing and Urban Affairs; the House Committee on Banking, Finance and Urban Affairs; the Subcommittee on Commerce, Consumer, and Monetary Affairs, House Committee on Government Operations; the House Committee on Energy and Commerce; and other interested parties. We will send copies to others upon request.

This report was prepared under the direction of Frederick D. Wolf, Assistant Comptroller General for Accounting and Financial Management. Major contributors to this report are listed in appendix VII.

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Executive Summary

Purpose

Recent years have witnessed a steadily increasing number of insured bank failures, culminating in 184 such failures in 1987 with an expected net cost of $1.8 billion to the Federal Deposit Insurance Corporation (FDIC). Both the Congress and the public have expressed concern about this trend.

To address this concern, GAO undertook a review of recent bank failures. The objectives of the review were to (1) summarize data on internal weaknesses and environmental factors which examiners cited for insured banks which failed in 1987, (2) determine the extent to which insider abuse and fraud were present in 1987 failed banks, and (3) identify potential areas of concern and provide information which could be used by

- the Congress for oversight and policy deliberation,
- federal regulators for examination and supervision purposes,
- bank management to strengthen its own operations, and
- internal auditors or independent public accountants who perform financial audits or other bank reviews.

Background

As of year-end 1987, the nation's 14,289 insured banks were examined and supervised by three federal regulators—FDIC, the Office of the Comptroller of the Currency, and the Board of Governors of the Federal Reserve System. FDIC also serves as the insurer for the nation's banking system. (See chapter 1.)

Bank management, and in particular the board of directors, has a responsibility and a fiduciary duty to operate financial institutions in a safe and sound manner. Safety and soundness relate not only to overseeing the day-to-day operations of the bank but also to establishing and maintaining an effective internal control structure. The broad objectives of internal controls are to safeguard assets, to ensure accuracy and reliability of data, to ensure compliance with policies and applicable laws and regulations, and to promote management efficiency. As such, effective internal controls help ensure that banks operate in a safe and sound manner.

Results in Brief

During periodic bank examinations, federal regulators identified serious internal control weaknesses, which relate to elements that are under the direct control of bank management. These weaknesses contributed significantly to virtually all the 184 bank failures in 1987. Insider abuse, fraud, and environmental factors (such as adverse economic conditions) were present, but experience has demonstrated that weak internal controls greatly increase a bank's vulnerability to these factors.

Annual independent audits are an effective means to detect internal control weaknesses in banks. However, insured banks are often under no legal or regulatory audit requirement. Small banks are less likely than others to have adequate systems of internal controls and are also less likely to have independent audits which would reveal these weaknesses to management and the regulatory authorities. Only about a third of the banks that failed in 1987 had audits by independent public accountants. However, independent audits can assist bank management in fulfilling its fiduciary duties, serve as a source of greater public disclosure, and assist federal regulators in their examination and supervision responsibilities. To be most effective and useful, those audits should include reports on internal controls and on compliance with laws and regulations.

Principal Findings

Internal Control Weaknesses Were Pervasive

Of the internal control weaknesses federal regulators identified, those which contributed most significantly to the 184 bank failures were inadequate or imprudent loan policies and procedures (79 percent), inadequate supervision by the bank's board of directors (49 percent), weak loan administration (42 percent), and poor loan documentation and inadequate credit analysis (41 percent). Other internal weaknesses regulators cited related to an overreliance on volatile funding sources (32 percent), the presence of a dominant figure (31 percent), and a failure to establish adequate loan loss allowances (29 percent). (See table 2.1.)

Federal regulators cited neither a single weakness nor a specific combination of weaknesses as the sole contributing factor to a bank's failure. Rather, each bank demonstrated a unique combination of weaknesses. However, each of these weaknesses relates to some aspect of management. (See chapter 2.)

Insider Abuse and Fraud Present to a Lesser Extent

Regulators cited neither insider abuse nor fraud as the sole factor, and only rarely as a significant contributing factor, in any 1987 bank failure. Nevertheless, regulators reported instances of insider abuse in 64 percent and suspected fraud in 38 percent of the 184 bank failures. The presence of insider abuse and heavy insider involvement in fraud can create an environment conducive to further abusive practices and indicates the need for stronger internal controls in banks to reduce their vulnerability to such actions. (See chapter 3.)

Internal Controls Serve as a Buffer Against Adverse Environmental Factors

Environmental factors relate to conditions beyond the direct control of management, such as prevailing economic trends or restrictions on the extent to which banks are allowed to operate branches. While all banks in a given area were subject to the same environmental factors, some banks remained viable entities while others failed. GAO's analysis of healthy, rejuvenated, and failed banks indicated that severe internal control weaknesses often existed at problem (rejuvenated) and failed banks but were present to a much lesser extent at healthy institutions. Therefore, GAO believes that internal control weaknesses make a bank substantially more vulnerable to environmental factors. Conversely, good internal controls tend to serve as a buffer to protect banks from adverse environmental conditions. (See chapter 4.)

Independent Audits Address Internal Control Weaknesses

Federal regulators do not generally require all insured banks to have an annual independent audit. Small banks (under $50 million in assets), which accounted for the majority of 1987 failures, obtain independent audits less frequently than larger banks and, according to regulators, are less likely to have adequate internal controls or internal auditing functions. Independent audits, along with management and auditor reports on internal controls and on compliance with applicable laws and regulations, would assist bank management and federal regulators in the early detection and correction of internal control weaknesses. An October 1988 House Committee on Government Operations report on fraud and abuse in financial institutions also came to this conclusion. (See chapter 5.)

Recommendations

To address the serious internal control weaknesses cited by federal regulators, GAO is recommending that the Congress require, as a condition for federal deposit insurance, that each insured bank (1) have an annual independent audit and (2) provide federal regulators with management and auditor reports on internal controls and on compliance with laws and regulations. This should aid bank management and federal regulators in the prompt detection and correction of internal control weaknesses as well as reduce banks' vulnerability to fraud, insider abuse, and environmental factors. (See chapter 5.)

Agency Comments

The Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, and the Office of the Comptroller of the Currency concurred with GAO's findings and conclusions. However, the regulators stated that their current policy of strongly encouraging, rather than requiring, independent audits is sufficient. They estimated that most large banks are annually audited and that the cost of an annual audit for small banks would be burdensome. They noted also that bank management already has adequate guidance stressing the importance of internal controls and compliance with laws and regulations. (See appendixes IV through VI.) The regulators did not offer any significant alternatives to GAO's recommendations. Despite the regulators' belief that existing guidance—most of which was in effect during the period covered by GAO's review—is sufficient, the number of bank failures has been steadily increasing, and weak internal controls are found to be a key factor in most failures.

The intent of GAO's recommendations is to ensure greater compliance with existing regulatory guidance. GAO believes—as do the regulatory authorities—that independent audits and management reports would enhance not only the safety and soundness of banking institutions but also the integrity of the deposit insurance fund. Given the severity of internal control weaknesses identified at the failed banks and the large number of small banks where susceptibility to adverse factors is especially great, where internal control weaknesses are acknowledged to be most frequent, and where the independent audits that would help reveal these weaknesses to management and the regulatory authorities are less common, GAO believes it is time to go beyond simply encouraging such audits. Accordingly, in view of the reluctance of the regulatory authorities to require audits through regulation, GAO recommends that independent audits, including the auditor's considering and reporting on internal controls, be required by statute.

Regarding the cost of audits for smaller banks, in 1987 43 percent of banks with assets of $25 million or less received an annual audit. Of those that failed in 1987, only 23 percent had an independent audit. GAO believes an annual independent audit should be considered a necessary cost of operating a bank in a safe and sound manner.

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Abbreviations

AICPA	American Institute of Certified Public Accountants
CAEL	capital adequacy, asset quality, earnings, and liquidity
CAMEL	capital adequacy, asset quality, management, earnings, and liquidity
CPA	certified public accountant
DBS	Division of Bank Supervision
DOL	Division of Liquidation
FBI	Federal Bureau of Investigation
FDIC	Federal Deposit Insurance Corporation
FRS	Board of Governors of the Federal Reserve System
GAO	General Accounting Office
OCC	Office of the Comptroller of the Currency
SAS	Statement on Auditing Standards
SEC	Securities and Exchange Commission

Introduction

Insured banks have failed at record levels during the post-Depression era. In 1987, 184 insured banks failed, representing about 1.3 percent of the 14,289 insured banks in operation at year-end 1987.[1] As shown in table 1.1, the number of failures has increased steadily in recent years.

Table 1.1: Failed Banks—1984 Through 1987

Year	Number of banks	Increase over previous year (percent)
1984	78	--
1985	116	49
1986	138	19
1987	184	33

The Office of the Comptroller of the Currency (OCC) recently completed a study identifying and evaluating the factors contributing to the failures of national banks which it regulates.[2] OCC believed that isolating such factors would help in identifying banks likely to fail and strengthen its ability to supervise and prevent other failures. The study concluded that bank management and other internal factors have the greatest influence on whether a bank will succeed or fail.

As the insurer of commercial bank deposits, the Federal Deposit Insurance Corporation (FDIC), which the Congress established in the Banking Act of 1933, protects depositors in the nation's commercial banks, helps maintain confidence in the banking system, and promotes safe and sound banking practices. Depositors are insured to $100,000. FDIC's deposit insurance fund balance was $18.3 billion at the end of 1987.[3] Its disbursements related to the 184 closed banks were $4.4 billion, with an expected net cost of $1.8 billion.[4]

[1] There were 14,837 insured banks in operation at the beginning of 1987. The number of banks at the beginning of the year is different from the number at the end of the year because of the banks established, failed, or merged during that period.

[2] Bank Failure: An Evaluation of the Factors Contributing to the Failure of National Banks, Office of the Comptroller of the Currency (Washington, D.C.: June 1988).

[3] At year-end 1988, the deposit insurance fund balance decreased by about $4.2 billion to $14.1 billion.

[4] Expected net cost is the allowance for loss as of December 31, 1987. The allowance for loss reflects the amount of the initial disbursement plus allocated liquidation costs, less expected collections. See Financial Audit: Federal Deposit Insurance Corporation's 1987 and 1986 Financial Statements (GAO/AFMD-88-43, April 22, 1988).

Regulatory Process

Three federal bank regulators, as well as each state's banking department, are responsible for promoting and ensuring the soundness of the nation's system of insured banks. OCC federally charters, examines, and supervises national banks. Individual states' banking departments charter, examine, and supervise all other banks. In addition, the Board of Governors of the Federal Reserve System (FRS) has examination and supervision responsibilities for state-chartered banks which are members of the Federal Reserve System (state member banks),[5] while FDIC has similar responsibilities for those state-chartered banks that are not members of the Federal Reserve System (state nonmember banks). At year-end 1987, there were 14,289 FDIC-insured institutions including 4,656 national banks, 1,098 state member banks, and 8,486 state nonmember banks.[6] Table 1.2 shows the supervisory responsibilities of state and federal supervisory agencies.

Table 1.2: Supervisory Oversight Responsibility

	Bank classification		
Supervisory agency	**National banks**	**State member banks**	**State nonmember banks**
Comptroller of the Currency	X		
Federal Deposit Insurance Corporation			X
Federal Reserve System		X	
State banking department		X	X

Bank Examinations

The regulators' primary tool to discharge their responsibilities is the bank examination. Each federal or state regulator examines banks under its supervisory jurisdiction[7] using the Uniform Financial Institution Rating System. Regulators summarize examination results with a five-point rating scale covering five critical aspects of bank operations and condition—capital adequacy, asset quality, management, earnings, and liquidity—which are referred to by the acronym CAMEL. Banks receive a rating from 1 to 5 for each CAMEL component, with a 1 representing strong performance and a 5 representing critically deficient performance. Regulators also assign the banks a composite rating of 1 to 5, with a 1 representing a strong institution and a 5 representing an institution

[5]The Federal Reserve System also regulates bank holding companies.

[6]In addition, there were 49 insured institutions not technically considered commercial banks. These institutions were insured branches of foreign banks, which tended to be in major metropolitan areas.

[7]State and federal examiners may conduct cooperative joint examinations for banks under the supervisory jurisdiction of both state and federal regulators.

with a high probability of failure. The composite rating does not necessarily equal the arithmetic average of the five individual components because the examination can emphasize one component or a combination of them. It can also reflect other considerations to accurately represent the overall condition and soundness of a particular bank. Regulators generally consider banks with a composite 4 or 5 CAMEL rating to be problem banks, which will warrant special supervisory attention.

Examiners prepare examination reports on an exception basis (that is, they document what they believe are a bank's weaknesses rather than its strengths). An effective examination report evaluates and documents financial and operating weaknesses in terms of (1) the bank's financial soundness, (2) the quality of management and policies, and (3) compliance with applicable laws, rules, and regulations. A bank examination is not synonymous with a full-scope independent audit of an entity's financial statements, which is performed by an independent public accountant to express an opinion as to the fairness of the information presented in the financial statements. A financial statement audit is conducted in accordance with generally accepted auditing standards and includes such reviews of internal controls, tests, and verification of data and other activities deemed necessary by the auditor. (See chapter 5 for a discussion of independent audits.)

FDIC's Division of Bank Supervision (DBS) emphasizes monitoring problem banks[8] and large banks because of their potential effect on the deposit insurance fund. DBS can also identify potential problem banks through off-site monitoring[9] on the basis of the financial information banks submit to FDIC quarterly in the Consolidated Reports of Condition and Income, commonly referred to as call reports.

Objectives, Scope, and Methodology

We conducted this review to address congressional and public concerns over the increasing number of bank failures. Specifically, our objectives were to

- summarize data on internal weaknesses and environmental factors which examiners cited for insured banks which failed in 1987;

[8]At year-end 1987, 1,575 insured banks (11 percent of all insured banks) were on FDIC's problem bank list. The 184 banks which failed in 1987 spent an average of 1.8 years on the problem bank list.

[9]FDIC's principal off-site monitoring system is referred to as CAEL, which is an acronym derived from four of the five CAMEL bank rating system components (capital adequacy, asset quality, earnings, and liquidity) used by all U.S. bank regulatory agencies.

- determine the extent to which insider abuse and fraud were present in 1987 failed banks; and
- provide information which could be used by (1) the Congress for oversight and policy deliberation, (2) federal regulators for examination and supervision purposes, (3) bank management to strengthen its own operations, and (4) internal auditors or independent public accountants performing financial audits or other bank reviews.

We limited our review to those banks which failed in 1987, the most recent year for which complete data were readily available.[10] The results of our work are not intended to be predictive. Further, we did not attempt to assess the effectiveness of the examination and supervision processes.

For each of the 184 failed banks in 1987, we analyzed key documents obtained from FDIC, such as problem bank memos and failing bank cases.[11] These documents cited weaknesses which examiners identified as significant sources of difficulty for the institutions. For a judgmental sample of cases, we also requested complete documentation, including examination reports, correspondence folders, and supervisory enforcement files, to verify that the key documents accurately summarized data. We relied upon the examiners' judgment regarding the nature of the problems which existed at the failed banks. In addition, we selected a second judgmental sample of failed banks to compare factors present at the failed banks with those present in healthy and rejuvenated banks in the same region. We obtained from FDIC (1) examination reports for a sample of banks that were healthy in 1987 and (2) problem bank memos and other key documents for rejuvenated banks (banks once considered problem banks but which were able to recover in 1987). FDIC provided documentation on healthy and rejuvenated banks which corresponded as closely as possible (in asset size, age, and geographic location) to our sample of 1987 failed banks.

[10] In addition to handling the 184 failed banks, FDIC provided financial assistance to 19 banks which were troubled but remained open. FDIC treats these open assistance transactions differently from closed (failed) bank transactions and, therefore, does not maintain the kind of documentation which we used to analyze the failed banks. Therefore, we did not include these transactions in our review.

[11] A problem bank memo, which FDIC prepares for each problem bank, includes financial data, a section on supervisory actions, and a summary describing the bank's problems as identified in regulators' examination reports. A failing bank case, which FDIC prepares for each failing bank, is used by FDIC's board of directors to help determine the least costly method of handling an impending bank failure. The failing bank case contains information such as background on the bank, summary financial statements, and the cause of the bank's difficulty as identified in examination reports

We performed our fieldwork, which included extensive interviews with agency officials, at headquarters offices of the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Board of Governors of the Federal Reserve System in Washington, D.C. In addition, we visited FDIC and OCC regional offices in Dallas, Texas, as well as the Federal Reserve district banks in Dallas and Minneapolis, Minnesota. We performed our fieldwork from December 1987 to December 1988 in accordance with generally accepted government auditing standards. We obtained official agency comments from FDIC, OCC, and FRS.

Chapter 2 of this report discusses internal control weaknesses which affected failed banks. Chapter 3 provides information on insider abuse and fraud as they relate to 1987 failures. Chapter 4 discusses the environmental factors which may have affected failed banks and compares healthy, rejuvenated, and failed banks. Chapter 5 discusses the importance of internal controls and independent audits and provides our recommendations. Appendix I contains demographic information on 1987 bank failures, while appendix II describes the internal control structure recently issued by the American Institute of Certified Public Accountants (AICPA). Appendix III contains excerpts from a recent report on financial institutions which the House Committee on Government Operations issued in October 1988. Appendixes IV through VI provide the agency comments we received, and appendix VII lists the major contributors to this report.

Management Weaknesses Highlight the Need for Adequate Internal Controls

Regulators have often cited management-related problems as the leading factor in bank failures. For virtually all the banks which failed in 1987, regulators identified serious internal control deficiencies in various aspects of the banks' operations during the period those banks remained on the problem bank list. Regulators cited no single weakness, or recurring combination of weaknesses, as the sole contributing factor to the banks' failures, but each of the weaknesses related to some aspect of bank operations directly within the control of the board of directors and management. Accordingly, we grouped the identified weaknesses into two broad areas, management philosophy and operating styles and management operational practices. (See table 2.1.)

Table 2.1: Summary of Internal Weaknesses Cited by Examiners for 1987 Failed Banks

Internal Weaknesses	Percent of banks affected
Management Philosophy and Operating Styles	
Inadequate board supervision	49
Overreliance on volatile funding sources	32
Presence of dominant figure	31
Excessively growth-oriented philosophies	26
Unwarranted loan concentrations	24
Excessive out-of-area lending	16
Management Operational Practices	
Lack of general lending policies	79
Poor loan administration	42
Poor loan documentation and inadequate credit analysis	41
Inadequate loan loss allowance	29
Lack of technical competence	20

Many of these weaknesses remained uncorrected despite regulators' efforts, primarily through the examination process and related supervisory enforcement actions, to encourage bank management to remedy identified internal control weaknesses. This raises concerns because the broad objectives of internal controls are to safeguard assets, to ensure accuracy and reliability of data, to ensure compliance with policies and applicable laws and regulations, and to promote management efficiency.[1] Accordingly, we believe that the internal control weaknesses in

[1]See appendix II for a description of the internal control structure as contained in the American Institute of Certified Public Accountants' Statement on Auditing Standards Number 55, "Consideration of the Internal Control Structure in a Financial Statement Audit."

the failed banks we reviewed point to the need for greater accountability for boards of directors and management in establishing and maintaining effective internal controls.

Management Philosophy and Operating Styles

Management philosophy and operating styles cover a broad range of factors under the direct control and responsibility of management. such as supervision or business strategies. In fulfilling their fiduciary duties to stockholders, bank customers, and depositors, a bank's board of directors and management are responsible for operating the institution in a manner consistent with safe and sound banking practices. All the weaknesses discussed below can lead to a breach of this fiduciary duty.

Inadequate Board Supervision

Federal regulators stated that inadequate supervision by the bank's board of directors had a detrimental effect in 49 percent of the 184 failed banks. The board of directors plays a crucial role in supervising bank management and overseeing the conduct of the institution's business. As stated in FDIC's Pocket Guide for Directors: Guidelines for Financial Institution Directors, which both OCC and FRS have endorsed, the board should

- select and retain competent management;
- establish, with management, the institution's long-term and short-term business objectives and adopt operational policies to achieve these objectives in a legal and sound manner;
- monitor operations to ensure they are adequately controlled and in compliance with laws and policies;
- oversee the institution's business performance; and
- ensure that the institution helps meet its community's credit needs.

If the board is negligent in fulfilling some or all of these responsibilities, extremely detrimental effects can occur. For example, the board of directors at one bank which failed in 1987 did not properly supervise the lending activities of one of the bank's officers, who was directly responsible for initiating many of the bank's problem loans.

Dominant Figure

Federal regulators cited the presence of a dominant figure who had a detrimental effect on the viability of the bank in 31 percent of the banks which failed in 1987. For the purposes of this report, a dominant figure is defined as a high-level individual who generally exerts a strong personal influence on critical aspects of a bank's operations. While the presence of a dominant figure may not always have a negative effect on a bank, such a situation can result in a lack of separation of duties or accountability for actions, circumvention of policies or internal controls (if they exist), or other unsafe and unsound practices to the detriment of a bank's operations. For example, the individual may initiate a large number of poor-quality loans (which may ultimately result in losses) before the board is aware of risks assumed, may commit the bank to unsound courses of action, or may undertake abusive practices. In general, the board of directors does not question or control such an individual's decisions, nor does it hold the individual accountable for actions having a negative effect on the bank. For one such bank which failed in 1987, examiners reported that the bank's problems were primarily due to the excessive influence a majority shareholder exerted over its affairs. This dominant figure failed to obtain independent management capable of restoring the bank to financial health and expanded the bank's operations into areas it was not equipped to handle, primarily international loans concentrated in Latin American countries.

Risk-Oriented Activities

Risk-oriented activities, generally a reflection of management's philosophy and business orientation, include (1) excessive growth objectives which may result in a bank's making lower-quality loans, (2) concentration of a bank's loan portfolio with certain classes of borrowers or in certain sectors of the economy, or (3) overreliance on volatile sources of funding.

Excessively Growth-Oriented Practices

Excessively growth-oriented practices, which occurred in 26 percent of the cases, result from bank management's decision to emphasize earnings while compromising the bank's credit policies, thus increasing the volume of loans made. According to regulators, emphasizing loan income rather than soundness almost always causes the bank to grant loans possessing undue risk, thus exposing the bank to unwarranted losses and increased problem loans. Regulators also believe that, in the long run, unsound loans usually are far more expensive than the amount of revenue they initially produce.

Unwarranted Loan Concentrations

Twenty-four percent of the failed banks had unwarranted concentrations of loans in specific areas of lending (such as particular geographic areas or types of business) or with specific classes of borrowers (such as particular individuals). Should a weakness develop in the area of concentration, it could not only adversely affect the individual loans making up the concentration, but it could also, in the aggregate, have a major, adverse impact on the bank's capital structure.[2]

Overreliance on Volatile Funding Sources

An overreliance on volatile funding sources occurred in 32 percent of the banks which failed in 1987. Volatile funding sources, which are particularly interest-rate sensitive, include large, short-term certificates of deposit (generally $100,000 or more), brokered deposits,[3] or out-of-area funds. Relying on such funding sources can subject the bank to greater liquidity risks. For example, the sudden loss of deposits due to interest rate changes may necessitate the costly liquidation of other bank assets. Further, according to regulators, volatile sources of funding are generally more expensive for the bank to obtain, resulting in lower net interest margins[4] on investments and loans made with them. According to regulators, lower net interest margins encourage bank management to seek higher-yielding, less secure loans and investments to maintain earnings, thus exposing the institution to even greater risk.

To illustrate these points, regulators cited a case in which one bank experienced rapid growth through the end of 1982, doubling its loan portfolio in 5 years. The bank funded this growth largely by using volatile sources. Management paid higher rates to attract deposits, which initially resulted in only mediocre earnings. Subsequently, to obtain a satisfactory profitable net interest margin, the bank used these funds for high-yielding loans concentrated in the energy industry. Net loan growth for 1980, 1981, and 1982 rose at a staggering pace, three to five times that of the bank's peer group.[5] However, management had little practical expertise in this area of lending, and the bank's performance

[2]Examination manuals state, however, that if a bank's loan distribution is heavily centered in one general class of borrowers and this condition is inherent in the economy, including these loans in the loan concentration schedule (contained in the examination report) may be inappropriate. For example, farm banks located in agricultural areas have little opportunity to make other types of commercial loans in their regions. Under these circumstances, regulators do not consider a concentration in agricultural loans unwarranted.

[3]Brokered deposits are deposits from an outside source that a bank receives, either directly or indirectly, for the account of others. In contrast, core deposits are those checking, savings, and time deposit accounts which, in the aggregate, are not volatile and represent the bank's basic level of stable deposit support.

[4]The net interest margin is the difference between a bank's cost of funds and its interest income on loans it makes.

[5]Peer group averages are average statistics for the banks that fall into the same classification by size, geographic location, or some other factor.

was adversely affected by the sudden decline in market prices of petroleum products in 1982. Shortly thereafter, management stopped extending credit to energy and related entities and began to concentrate on real estate construction and development loans, an area in which the lending staff also lacked expertise.[6] The sudden plummet in real estate values and sales in 1984 further depressed the bank's earnings and capital, ultimately causing the bank to fail in 1987.

Excessive Out-Of-Area Lending

A weakness regulators identified in 16 percent of the failed banks was problem loans caused by excessive lending out of the geographic area of competition in which the bank normally operated. Traditionally, a bank's normal trade area is the area in which the bank (1) makes most of its loans and (2) understands the regional economics and lending and banking practices. Although lending outside of a bank's normal trade area can provide some degree of risk diversification in the loan portfolio, it can often cause difficulty, as was the case for some failed banks we reviewed. Out-of-area lending may diminish a bank's ability to properly evaluate, monitor, and service loans if adequate controls and safeguards do not exist.

Management Operational Practices

Traditionally, lending has been at the core of a bank's activities, providing the greatest single source of earnings and accounting for the largest category of assets. Management operational practices deal primarily with the lending process. According to federal regulators, the objectives of this process should be to (1) grant loans on a sound and collectible basis, (2) invest the bank's funds profitably, and (3) serve the legitimate needs of the community in which the bank is located. Operational lending practices include general policies and procedures for maintaining the loan portfolio, as well as specific policies addressing credit analysis, loan documentation, credit administration, areas of competition, and the establishment of adequate loan loss allowances. Bank examiners specifically cited lending process weaknesses for 90 percent of the banks that failed in 1987.

Lack of General Lending Policies

Of the banks which failed in 1987, 79 percent had not implemented adequate and prudent general procedures to guide loan personnel in the loan underwriting and approval process. In some cases, policies and procedures existed, but bank personnel failed to follow them. Implementing

[6] This aspect of the problem also relates to "technical competence." (See page 21.)

adequate, prudent lending policies and procedures helps management and personnel to maintain proper credit standards, avoid unnecessary risks, and properly evaluate new business opportunities. Regulators emphasize, however, that such policies and procedures for granting and administering credit should not necessarily be uniform or static. Rather, they should be sufficiently flexible to allow for fast reaction and early adaptation to changing conditions in the bank's loan portfolio and its service area. Moreover, bank management should periodically review the bank's loan underwriting criteria, loan application requirements, and approval authority to determine the need for changes.

Poor Loan Documentation and Inadequate Credit Analysis

Bank examiners cited weaknesses related to poor loan documentation and inadequate credit analysis in 41 percent of the banks which failed in 1987. Gathering loan documentation, complete and accurate data to use as a basis for credit decisions, is an important aspect of granting credit and administering loans. Lending errors frequently result from management's failure to obtain and properly evaluate credit information. Current financial statements, such as the income statement and cash-flow statements, and other pertinent financial data should be obtained and evaluated. Bank credit files should also contain other essential information, such as the reason for the loan request, the intended plan or sources of repayment, progress reports, inspections, and memorandums of outside information and loan conferences. Sound credit judgment is difficult if not impossible if bank management fails to update and analyze credit files. Therefore, regulators stress the importance of proper loan documentation when first granting credit and later supervising and administering loans.

Regulators believe that relying solely on factors other than the borrower's ability to repay, such as character or collateral, to support credit decisions may lead to a buildup of problem loans and may increase the bank's exposure to loss. Thus, examination manuals state that lending policies should clearly delineate sound credit analysis and collateralization policies and that bank management should monitor exposure to risk. For example, speculative loans supported by collateral but lacking an adequate ability to repay carry greater risks than more basic business and personal consumer loans, which are based on demonstrated ability to repay and adequate collateral. Therefore, performing an adequate analysis of the borrower's ability to repay rather than relying solely on collateral provides an increased margin of security for the bank.

Lack of Technical Competence

Technical competence is also an essential aspect of the lending process. For 20 percent of the banks that failed in 1987, federal regulators noted that management was inexperienced or unqualified in some technical aspect of the lending process. For example, management was sometimes unable to analyze financial statements, did not obtain and evaluate credit information, or failed to put together a well-balanced loan portfolio. Regulators believe that weaknesses in this area are almost certain to lead to eventual loan losses. Problems can also develop when management, although technically sound in some forms of lending, becomes involved in specialized types of credit in which it lacks expertise and experience.

Poor Loan Administration

Loan administration relates to actions taken after a bank grants a loan, such as evaluating a borrower's financial condition on an ongoing basis, securing interests in collateral positions,[7] and implementing adequate collection procedures. Federal regulators identified poor loan administration as an area of concern in 42 percent of the 1987 bank failures. Failing to maintain and evaluate current, detailed financial information on borrowers once a bank has granted a loan prevents accurate, ongoing risk assessment, which in turn can delay recognition of a problem and lead the bank to take actions that would be recognized as imprudent if the true condition of the loan portfolio was known. This can lead to unnecessary losses. In addition, failing to secure an interest in collateral positions or to implement adequate follow-up and collection procedures can also result in otherwise avoidable losses to a bank. Weaknesses the regulators cited in this area included failing to enforce repayment terms, allowing borrowers to dictate or ignore repayment terms, and frequently renewing loans without requiring a significant loan repayment.

Inadequate Loan Loss Allowances

Failure to establish an adequate loan loss allowance is related to the problem of poor loan administration. Regulators cited this as a weakness for 29 percent of the 1987 bank failures. According to regulators, bank management should estimate and maintain a reserve or allowance for loan losses at a level which could absorb reasonably expected losses from uncollectible loans in a bank's loan portfolio. Such an allowance provides information on the loan portfolio's true condition and on the results of bank operations for decision-making and financial reporting purposes.

[7] Securing an interest in collateral positions results in obtaining a legal right to pledged property in the event of loan default.

During the supervisory examination of a loan portfolio, bank examiners test the adequacy of the estimated reserve amount management has determined. Examiners must decide which loans are to be subject to comment in the examination report in order to quantify and communicate the results of the loan portfolio review. Adversely classified loans are allocated to three categories based on the amount of risk they pose: substandard, doubtful, and loss. (See table 2.2.) Frequently, examiners and bank management classify the loans differently. In such cases, bank management is required to adjust the loan loss allowance for any significant discrepancies.

Table 2.2: Loss Classifications Used by Federal Regulators

Classification	Description
Substandard	A classification assigned to loans inadequately protected by the current sound worth and repayment ability of the obligor or by the pledged collateral, if any.
Doubtful	A classification assigned to loans which have all the weaknesses inherent in an asset classified as substandard and whose collection or liquidation is highly questionable
Loss	A classification assigned to 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.)

Supervisory Enforcement Actions to Correct Weaknesses

Bank regulators are responsible for promoting and ensuring the safety and soundness of the nation's banking system. To fulfill this responsibility, when regulators identify weaknesses during a bank examination, they may take formal supervisory enforcement actions requiring the bank to correct those weaknesses. Supervisory enforcement actions include memorandums of understanding, cease and desist orders, removal of officers, civil money penalties, and termination of insurance. At the time of failure, 89 percent of the 184 failed banks were subject to one or more supervisory enforcement actions. According to our review, however, compliance with certain items addressed in any outstanding supervisory enforcement actions was either unsatisfactory or only partially satisfactory at the time the banks failed.[8]

Twenty-four percent of the failed banks were subject to a memorandum of understanding, an agreement between the regulator and the bank for

[8]See chapter 4 for a comparison of compliance with supervisory actions for failed, rejuvenated, and healthy banks.

the bank to correct the weaknesses found during the examination. Regulators usually inform management that if compliance with the memorandum of understanding is not satisfactory to correct the weaknesses. regulators may initiate additional supervisory enforcement actions.

Regulators issue cease and desist orders to a bank or its officers or directors to correct unsafe or unsound practices or violations of laws and regulations and to take corrective actions. Regulators issued cease and desist orders to 53 percent of the failed banks. Examples of conditions or practices which the regulators deemed unsafe or unsound and which led them to issue cease and desist orders are

- inadequate board supervision,
- inadequate loan loss allowance,
- engaging in hazardous lending and lax collection practices,
- operating without adequate internal controls, and
- having an excessive dependence on volatile funding sources.

Removal of officer proceedings occurred in 4 percent of the cases. although regulators noted that officers tended to resign if regulators were considering such actions.[9] Regulators assessed civil money penalties against officers or directors of 4 percent of the banks that failed in 1987. Regulators may assess civil money penalties against both banks and individuals for violations of certain statutes, such as Section 23A of the Federal Reserve Act (loans to affiliates), and for violations involving changes in the control of banks. Termination of insurance proceedings, which only FDIC can initiate for unsafe and unsound bank practices not corrected under previous enforcement actions, occurred in 25 percent of the cases. An FDIC official stated that the OCC or state chartering authorities will generally close a bank before FDIC actually terminates insurance.

Management Has Often Failed to Fulfill Its Internal Control Responsibilities

A bank's board of directors, in fulfilling its fiduciary duty to its depositors, stockholders, and the public, is responsible for ensuring that an adequate internal control structure exists. For example, the Office of the Comptroller of the Currency's The Director's Book: The Role of a National Bank Director clearly states the board's oversight responsibility:

[9]Regulators stated that they often continue with removal proceedings, even after a bank closes. to bar certain individuals from reentering banking at a later time.

"While the board may depend on management's technical, industry, and management expertise to run the bank's day-to-day operations, the board remains responsible for ensuring that those operations are properly controlled and comply with board policies and applicable laws and regulations. To help meet its responsibility, the board should ensure that management has incorporated a sound system of internal controls into the bank's day-to-day operating procedures."

We noted that federal regulators review many aspects of a bank's internal control structure in their examinations. Further, regulators discuss any weaknesses noted with the bank's board of directors when they issue the examination report, and they often incorporate the need for appropriate corrective measures into supervisory enforcement actions.

As stated above, while the board of directors may not monitor day-to-day operations, the board is responsible for ensuring that bank management has implemented internal controls which are operating effectively. However, the boards failed to fulfill this responsibility for those banks which failed in 1987. The banks' pervasive internal control weaknesses indicate that their boards of directors did not ensure that bank management implemented adequate internal controls to foster safe and sound bank operations.

Conclusions

Our review disclosed that virtually all the banks which failed in 1987 had serious internal control weaknesses. No single internal weakness was cited as the determining factor in the difficulties any failed bank experienced. Rather, the difficulties arose from a number of weaknesses which may have occurred simultaneously but not in any particular combination. Nevertheless, all of the internal weaknesses did come under the direct control of the banks' management and boards of directors.

These weaknesses in management philosophy and operating styles and in management operational practices can all be considered weaknesses in the banks' internal control structures. As such, we believe that the early detection and correction of internal control weaknesses is important to safe and sound bank operations. We believe that the fact that these serious internal control weaknesses went uncorrected, despite regulators' examination and supervisory efforts, points to the need for greater management accountability. Further, we believe that regulators need to establish mechanisms (1) to ensure that boards of directors and bank management, in fulfilling their fiduciary duty to operate banks in a safe and sound manner, establish and maintain effective internal controls and (2) to enhance management accountability.

Internal Controls Can Help Deter Insider Abuse and Fraud

The recent increase in bank failures has focused a great deal of attention on insider abuse (activities which range from unsound, negligent management practices to violations of banking regulations) and suspected fraud (criminal activity). Regulators did not cite either insider abuse or fraud as the sole internal factor in any bank failure in 1987, and they cited it only rarely as a significant contributing factor. Nevertheless, insider abuse and fraud pose a threat to the safety and soundness of a bank's operations. Further, the presence of insider abuse and fraud also indicates a weakness in or the absence of an effective internal control structure.

Although no formally agreed upon definitions of insider abuse and fraud exist, regulators do describe actions which constitute each. According to federal regulators, insider abuse includes activities such as self-dealing;[1] undue dependence on the bank for income or services by a director, officer, or principal shareholder; inappropriate transactions with affiliates; and unauthorized transactions by management officials. Fraud, on the other hand, generally involves an action which specifically violates a fraud-related statute of the United States Code or an applicable state statute. Specific actions must be considered to determine whether insider abuse or fraud has occurred. For example, making a poor-quality loan to a company may constitute a negligent management practice, but is not considered insider abuse. However, if the loan is made to a company in which an insider is involved (for example, to a company in which the officer approving the loan also has stock), the transaction may constitute insider abuse. If the insider attempts to conceal the transaction, the action may be considered fraud.

Examiners cited at least one instance of some form of insider abuse at 64 percent of the banks which failed in 1987, while, on the basis of significant criminal referrals, they reported suspected fraud at 38 percent of the failed banks.[2] (See page 28 for a discussion of significant criminal referrals.) Twenty-seven percent of the banks had indications of both insider abuse and suspected fraud. The type and frequency of other internal weaknesses present at these banks did not differ greatly from

[1] Self-dealing refers to situations in which the interests of an insider (that is, a director, officer or principal shareholder) are placed above the interests of the bank or where insiders use their positions to conduct transactions which benefit themselves, friends, relatives, or related business interests.

[2] Regulators can report suspected instances of fraud, but only the criminal justice system can determine if fraud actually occurred.

banks with no indications of insider abuse or fraud. In addition, examiners did not note that the presence of insider abuse or fraud necessarily had a significant impact on the financial condition of the institutions.

Regulators' Efforts to Combat Insider Abuse and Fraud

In December 1984, federal bank regulators and Department of Justice officials responded to public and congressional concern over bank fraud and insider abuse by forming the Attorney General's Interagency Bank Fraud Enforcement Working Group to improve communication and coordination among its members.[3] The working group's goal is to design improvements in the detection, investigation, and prosecution of bank fraud cases. To accomplish this objective, the working group members have generated several efforts, such as increasing training in bank fraud investigation for both bank examiners and Federal Bureau of Investigation (FBI) agents and encouraging its members to establish tracking systems to monitor criminal referrals. In addition, individual regulators have taken measures to combat insider abuse and fraud. For example, FDIC issued a list of "Red Flags," warning signs of possible insider abuse and fraud, to aid FDIC examiners and the banks' internal and independent auditors.

Management's Responsibility to Prevent Insider Abuse and Fraud

Bank management has a responsibility to create an environment which encourages safe and sound bank operations and reduces the potential for insider abuse and fraud. While the acts that constitute insider abuse may not necessarily be considered illegal, insider abuse, as well as fraud perpetrated by bank directors or officers, reflects on the integrity of management and fosters an environment conducive to further abuses. Management has a responsibility to develop policies and procedures which include "a system of internal controls, designed to foster sound practices, to comply with laws and regulations, and to protect the institution against crimes and internal fraud and abuse."[4] Further, bank directors should ensure that management is aware of applicable laws and regulations and develops a system to implement and monitor compliance. Bank managers are also under a fiduciary duty to avoid behaving in a manner which places their own personal interests above the interests of the bank.

[3]In addition to FDIC, OCC, FRS, and Justice, the other members of the working group include the Federal Bureau of Investigation, the Federal Home Loan Bank Board, the National Credit Union Administration, and the Farm Credit Administration.

[4]Pocket Guide for Directors, FDIC.

Presence of Insider Abuse

Although regulators reported indications of insider abuse at 64 percent of 1987 failed banks at the time they closed, regulators did not cite insider abuse as the sole contributing factor in any failure. However, the presence of insider abuse in a bank indicates that management may have neglected its fiduciary responsibility to ensure the safe and sound operations of the bank.

Examiners cited violations of the Federal Reserve Board's Regulation O (23 percent) as the most frequent type of insider abuse present in 1987 failed banks. This regulation (1) sets limits on individual insider indebtedness, (2) establishes certain recordkeeping requirements (for example, any director or officer who obtains an inside loan from the bank must submit a personal financial statement to the bank), and (3) prohibits preferential terms or conditions (such as preferential interest rates) on insider loans. Other common examples of insider abuse that examiners cited were poor-quality loans to directors or officers (22 percent) and an excessive number of loans to directors or officers (17 percent). The two latter actions, however, are not necessarily violations of any laws or regulations; rather, they represent abusive management practices.

Indications of Fraud Present at Failed Banks

Most of the activities that constitute fraud in banking activities are subject to criminal penalties under provisions of Title 18 of the United States Code. These activities include making false statements or material omissions, embezzlement, check kiting,[5] and forgery. Although regulators reported indications of alleged fraud at 38 percent of the failed banks, they did not cite fraud as the sole cause of any 1987 bank failure. However, FDIC, as the receiver of failed banks' assets, identified 14 banks (8 percent) for which fraud was a major factor contributing to the failure. This relatively low percentage confirms regulators' belief that fraud is only rarely the sole cause or a major contributing factor in a bank's failure.

FDIC, FRS, and OCC maintain criminal referral tracking systems which identify and track suspected fraud in the respective banks they supervise. Bank officials or bank examiners use criminal referral forms to report suspected cases of fraud to the appropriate regulator and to

[5]Check kiting is a bank fraud scheme involving two or more accounts. The perpetrator writes a check in an amount sufficient to overdraw the account on which the check is written and then covers the account overdraft by depositing a similar check drawn on another bank before the first check is returned for payment. Artificial balances in the accounts are thus created through a pattern of deposits of worthless checks between the accounts.

appropriate criminal enforcement officials, including the local offices of the U.S. Attorney and the FBI, for evaluation and investigation.[6]

For banks it supervises, each regulator tracks what it considers to be the most important criminal referrals on its criminal referral tracking system.[7] Regulators then forward "significant" referrals of suspected fraud to Justice's fraud section for tracking. The Interagency Bank Fraud Enforcement Working Group defines "significant" as involving (1) a probable loss in excess of $200,000, (2) a senior bank insider such as an officer or director, and/or (3) a suspected pattern of criminal activity. However, the term "significant" does not indicate the alleged violation's impact on a bank's failure. FDIC, as liquidator of a failed bank's assets, does not attempt to allocate any portion of the total losses associated with a failure to the suspected fraud reported in a referral.

Of the 184 banks which failed in 1987, 38 percent (69 banks) had from one to seven "significant" referrals reported to the three regulators during the period January 1, 1985, to May 1, 1988, for a total of 128 referrals.[8] Most of the 128 referrals for 1987 failed banks are still pending disposition due to the lengthy time required to investigate and prosecute cases. Also, FDIC's Division of Liquidation (DOL) can generate additional referrals during the liquidation process if FDIC staff become aware of indications of suspected fraud. These referrals would not be made until after the bank had closed. DOL generated 17 of the 128 criminal referrals for 1987 failed banks.

The most common alleged criminal violations were false statements (including knowingly and willfully making an oral or written false representation or concealing a material fact) (53 instances); theft, defalcation, embezzlement (50 instances); and misuse of position or self-dealing (46 instances).[9] Other types of violations reported less frequently

[6]We did not evaluate the effectiveness of the regulators' criminal referral tracking systems or the referral process.

[7]FDIC tracks criminal referrals of $10,000 or more, FRS tracks referrals of $5,000 or more (or referrals involving $1,000 or more if the perpetrator is known), and OCC tracks referrals of $100,000 or more. The regulators' district or regional offices maintain copies of all criminal referrals for banks they supervise.

[8]Of the 69 banks having significant referrals, the majority of banks had only one referral. FDIC, in its role as liquidator of the failed banks' assets, believes that most of the banks with criminal referrals would have failed because of internal control weaknesses, even without the presence of the alleged violations.

[9]A single referral form may cite more than one type of violation. Thus, the number of instances of violations exceeds the number of referrals for 1987 failed banks.

included bribery (10 instances), falsifying information on a loan application (7 instances), and check kiting (6 instances).

Of the 128 significant referrals, 101 (79 percent) allegedly involved a bank insider, namely a director or officer. Although the dollar amount associated with a referral was often well below the $200,000 criterion, the involvement of insiders causes concern. Heavy insider involvement in fraud can create an environment conducive to other abuses. In addition, we believe insiders, because of their positions within a bank's hierarchy, may be in a position to circumvent internal controls.

Conclusions

Although regulators did not cite insider abuse or fraud as the sole contributing factor to any bank failure in 1987, the presence of insider abuse or fraud in a bank indicates that management may have neglected its responsibility to ensure the safe and sound operations of the bank. We believe that when management creates an environment with weak internal controls, the bank may be more vulnerable to insider abuse or fraud than it would be if it had strong internal controls. Conversely, a strong internal control structure effectively enforced and monitored by management helps deter insider abuse and fraud. Accordingly, we believe that such a relationship also highlights the need for effective internal controls and emphasizes the importance of management accountability for establishing and maintaining such controls to ensure that banks operate in accordance with applicable laws and regulations.

Strong Internal Controls Serve as a Buffer Against Adverse Environmental Conditions

Although adverse economic conditions and other environmental factors make it more difficult for banks to operate profitably, regulators rarely identify environmental problems as the sole contributing factor in a bank's failure. While all banks operating in a given area are subject to the same environmental factors, some banks may remain viable entities while others may fail. Our analysis of healthy, rejuvenated, and problem banks indicated that severe internal control weaknesses often existed at rejuvenated (formerly problem) and failed banks but were present to a much lesser extent at healthy institutions. Because the combined effect of internal control deficiencies weakens a bank, a bank may become more vulnerable to the impact of environmental factors. Conversely, good internal controls tend to serve as a buffer to protect banks from adverse environmental conditions. Therefore, we believe that internal control weaknesses play a very significant role in determining a bank's viability.

In this report, environmental factors are defined as conditions which affect a bank's performance but are external to the bank and, thus, beyond management's direct control. Environmental factors include national economic conditions (such as interest rates), regional economic conditions (such as performance of a key industry, for example, energy or agriculture), the state regulatory environment (such as state branching restrictions), and demographic changes.

Economic Conditions in the Southwest and Midwest

Regulators cited adverse regional economic conditions as a factor in 42 percent of the banks which failed in 1987. Of this 42 percent, approximately half were related to the agricultural sector of the economy, one third to the oil sector, and the remainder to the real estate sector. Regulators cited regional economic factors as affecting 51 percent of the banks which failed in the Southwest and 43 percent of the banks which failed in the Midwest.

The current economic problems in the Southwest began when oil prices plummeted in the early 1980s. When oil prices first began to drop, many bankers shifted their loan portfolios from oil to commercial real estate. However, commercial real estate values soon began to suffer dramatic declines. Some regulators believe that many bankers in the Southwest may have also engaged in excessive real estate speculation. One regulatory official in Dallas explained that many bankers did not realize the extent to which real estate, as well as other sectors of the economy in the Southwest, were dependent on the oil industry.[1] As a result of this dependency, real estate values declined, and many real estate loans deteriorated. Some regulators believe that the situation in the Southwest will not improve until the economic downturn reverses itself.

Although the agricultural sector of the economy showed improvement in 1987, it still adversely affected banks in the Midwest, according to regulators. Of the banks that failed in the Midwest, 88 percent were farm banks, with at least 25 percent of their loans related to agriculture.[2] However, according to one regulator, midwestern bankers generally did not tend to take the excessive risks, such as real estate speculation, that southwestern bankers appear to have taken.

Despite these problems in the Southwest and the Midwest, regulators believe that adverse regional economic conditions alone rarely resulted in a bank's failure. For example, regulators stated that although the weak local economy affected every bank in the Southwest to some extent, only 3 percent of the banks in the Dallas region failed in 1987. Further, regulators did not consider 75 percent of banks in the Dallas region to be problem banks[3] as of December 31, 1987.

Our analysis indicates that failed banks located in economically troubled regions had just as many internal weaknesses as failed banks which operated in economically sound environments. Further, OCC's study of failed national banks found that, while poor economic conditions make it more difficult for a bank to maintain a profit, the policies and procedures of a bank's management and board of directors have the greatest impact on a bank's success or failure. OCC found the following:

> "Economic decline contributed to the difficulties of many of the failed and problem banks . . . . Rarely, however, were economic factors the sole cause of a bank's decline. All but 7 percent of the failed and problem banks also had significant internal problems related to management."[4]

[1]A regulatory official stated that generally a lag of about 18 months to 2 years occurs between the onset of an economic downturn and its impact on the banking industry's financial results.

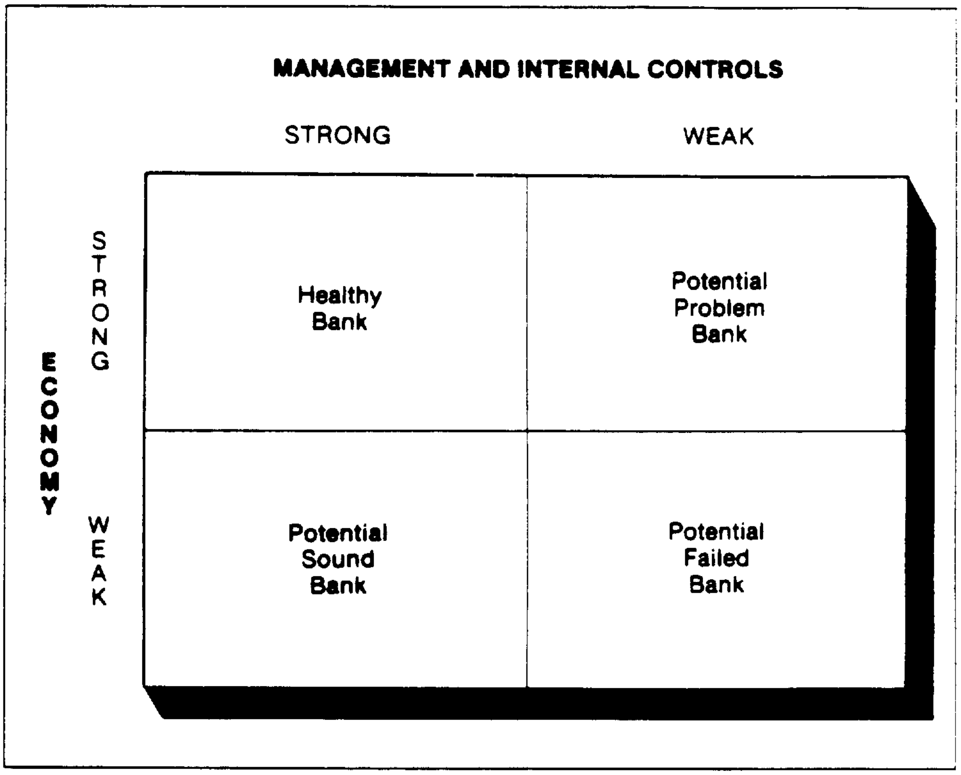
[2]Regulators do not consider these unwarranted loan concentrations (see chapter 2) since farm banks are located in agricultural areas and have little opportunity to make other types of commercial loans in their regions.

[3]Problem banks are generally those which have a composite CAMEL rating of 4 or 5.

[4]Bank Failure: An Evaluation of the Factors Contributing to the Failure of National Banks (Washington, D.C.: June 1988).

According to federal regulators, a weak economy tends to expose internal problems which may not be evident when a bank is operating in a strong economy. To illustrate this point, one regulator referred to a matrix showing the combined effects of economy and management. (See figure 4.1.) In a strong economy, a bank with strong management and strong internal controls will most likely be healthy, and even a bank with weak management and weak internal controls may be able to continue to operate, although it may be considered a problem bank. In a weak economy, a bank with strong management and strong internal controls will probably be able to remain sound, but a bank with weak management and weak internal controls is likely to fail.

Figure 4.1: Matrix of Combined Effects of Economy, Management, and Internal Controls



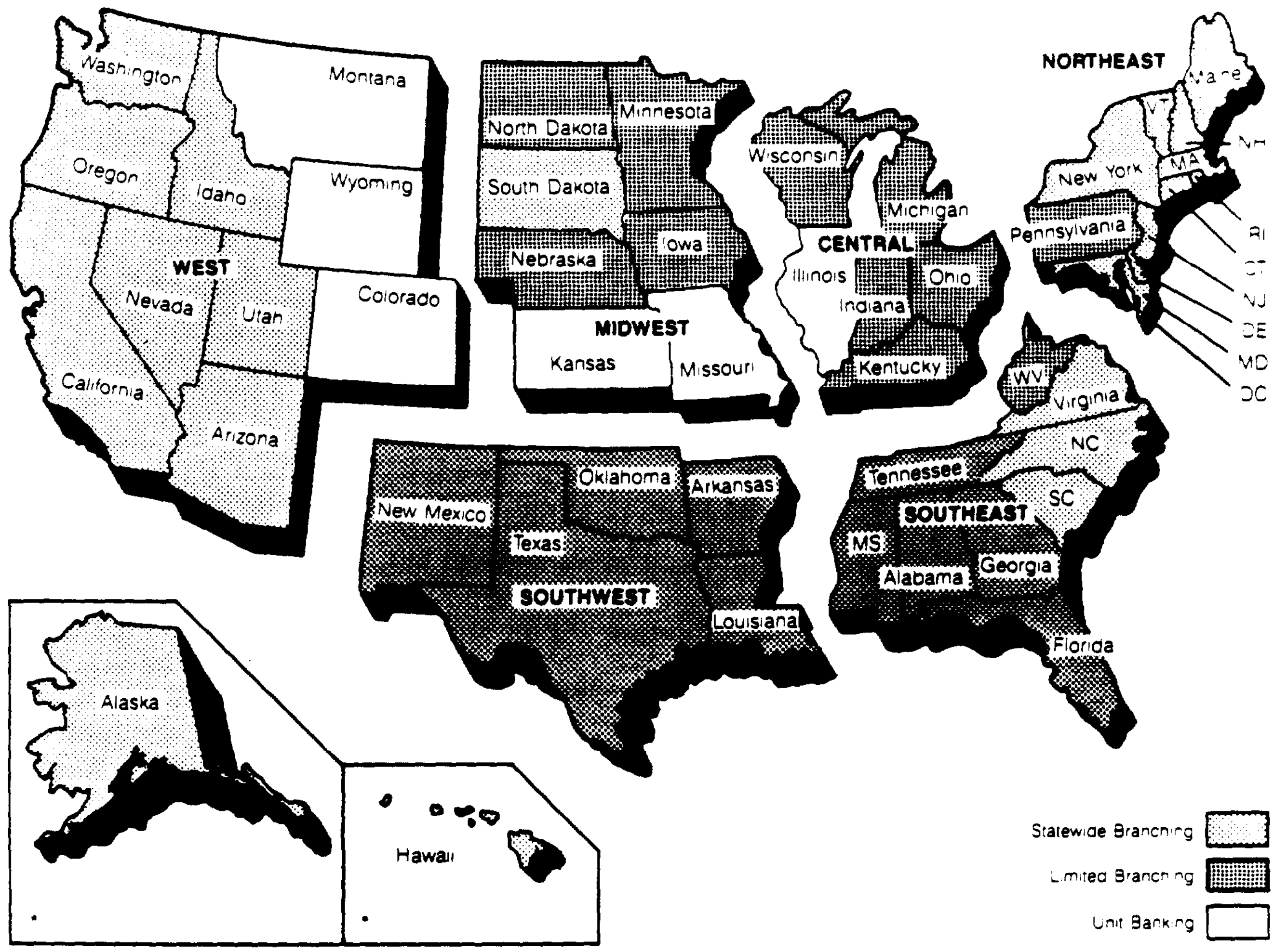
Newly chartered banks, like other new businesses, may encounter serious start-up problems and thus be more susceptible to failure, particularly in a weak economy. We noted that relatively new banks, those chartered during the period from 1980 through 1987, made up 24 percent of the banks that failed in 1987,[5] and that many of these were located in the Southwest. The energy boom attracted many banking entrepreneurs who wanted to take advantage of the tremendous growth occurring in the Southwest in the late 1970s and early 1980s. However, the supply of qualified bank management in the Southwest could not meet the demand during this period, and many of the new banks had boards of directors or managers who lacked prior banking experience. Although applications for charters were made when the economy was booming, by the time the banks actually opened (processing a charter usually takes 12 to 18 months), the economy had begun to decline. In addition, many of these new banks engaged in risk-oriented activities, such as relying on high-cost, volatile funding sources or making risky, high-yield loans. These activities made such banks extremely vulnerable to subsequent economic downturns.

The Majority of Failed Banks Were Located in States With Branching Restrictions

Individual state laws govern whether banks may operate as unit banks, limited branching banks, or unrestricted (statewide) branching banks. A unit bank operates in one location, although it may have limited satellite locations, such as a separate drive-up window. A branch bank operates a headquarters office and one or more branch offices at other locations, controlled by the headquarters office. Branch offices may be located within a single city or county (limited branching), or throughout a state (statewide branching), depending on state laws. Some states have reciprocal banking arrangements which allow a bank holding company to own banks in different states. Ninety percent of the banks that failed in 1987 were in states which allowed only unit banks or limited branching. Interestingly, the two regions that suffered most from economic problems (the Southwest and the Midwest) were composed primarily of states with branching restrictions, as shown in figure 4.2. However, we do not believe that this implies a relationship between limited branching and economic conditions of a region.

[5] New banks, those chartered during the period from 1980 through 1987, made up 16 percent of all insured banks at year-end 1987.

Figure 4.2: State Branching Restrictions, 1987



*Note: Alaska and Hawaii belong to the western region.

Note: The designation of geographic regions is based on FDIC's Quarterly Banking Review. These regions do not directly correspond to the eight regional offices of FDIC's Division of Bank Supervision.

Branching restrictions may make a bank more vulnerable to adverse economic conditions for the following reasons:

- Unit banks have less opportunity to diversify risks in terms of location or types of assets and thus are more vulnerable to economic conditions in a particular community or in particular markets.[6]
- Fewer opportunities exist for economies of scale when branching is limited or prohibited.
- Limited resources, particularly the supply of experienced, qualified management, may be a problem for banks in states with branching restrictions. For example, 10 unit banks require 10 boards of directors, while a bank with 10 branches requires only 1 board of directors.

Because branching restrictions result in an increased number of smaller banks, the number of failures appears higher in states with branching restrictions than it might have otherwise.[7] For example, three Houston banks under common ownership and management through a bank holding company failed on the same day in 1987. If Texas had permitted branching prior to 1987, there might instead have been one bank with three branches to serve the same area and number of customers, thus resulting in only one reported failure instead of three.[8] In contrast, a bank with four branches in New York, which permits statewide branching, also failed in 1987, but was counted as only one bank failure.

Other Environmental Factors

In addition to economic conditions and branching restrictions, regulators believe that other environmental factors may have also affected failed banks in 1987. Although a regulator we spoke to in the Midwest stated that the regional economy of the Midwest recovered somewhat in 1987, he mentioned other developments which have affected banks in that region—demographic changes and changes in farm payment practices.

[6]Banks diversify their loan portfolio to yield an acceptable combination of risk and return. According to the Federal Reserve Bank of Dallas, some of the risks that can be offset, at least partially, by diversification are changes in the economic environment induced by the business cycle and unforeseen shocks to a particular sector of the economy. (See Hilary H. Smith, "Agricultural Lending: Bank Closures and Branch Banking," DALLASFED, September 1987.)

[7]Branching restrictions also limit FDIC's failure resolution options because the restrictions limit the number of potential acquirers.

[8]Such could have been the case in 1988, since Texas now allows limited branching.

Demographic Changes in the Midwest

According to one regulator we spoke to in Minneapolis, some small rural banks in the Midwest are losing business to larger, regional banks as a result of the shift in population towards urban areas. Also, many midwestern farmers are now often doing business with banks in major regional centers which can provide a greater array of services, instead of with small, rural banks. As a result, some small banks have difficulty attracting local creditworthy borrowers and sometimes attempt to compensate by lending outside of their normal areas of competition and/or expertise. This practice can result in a detrimental effect on the bank. (See chapter 2.)

Changes in Farm Payment Practices

According to regulators in the Midwest, changes in farm payment practices have also caused problems for some small banks in agricultural areas of the Midwest. In the past, these banks typically made farm production loans prior to the planting season, and the farmers repaid them after the harvest. However, in recent years, the Commodity Credit Corporation has advanced subsidy payments to farmers at the start of the planting season rather than at the end. Consequently, many farmers no longer seek production loans from banks, and, as a result, these small banks are losing interest income.

Effects of Environmental Factors on Healthy and Rejuvenated Banks

We found that healthy and rejuvenated banks[9] may have been able to withstand environmental problems because they had fewer of the internal weaknesses discussed in chapter 2 and generally had stronger internal controls than the problem and failed banks we reviewed. However, during the time that they were problem banks, the rejuvenated banks generally had internal weaknesses similar to those found in failed banks. The results of our review confirm observations OCC made in its June 1988 report:

> "While a banker's job is undoubtedly easier in a strong economy, strong management and systems can prevent failure and promote recovery even during difficult economic times. Management and the board of directors must act positively to implement such controls and systems if they intend to safeguard the shareholders' capital over the long run."[10]

[9] Healthy banks are banks with a composite CAMEL rating of 1 or 2. Rejuvenated banks are banks which FDIC once considered problem banks, but were able to recover (that is, attain a 1 or 2 composite CAMEL rating), thus no longer warranting special supervisory concern.

[10] Bank Failure: An Evaluation of the Factors Contributing to the Failure of National Banks, page 12.

We compared 24 healthy, rejuvenated, and failed banks located in areas where environmental problems were prevalent. For each failed bank we selected for our analysis, FDIC provided us with information on one healthy bank and one rejuvenated bank to correspond as closely as possible to the failed bank in terms of asset size, age, and geographic location. We found that internal weaknesses that existed in problem and failed banks were not present, or were present to a much lesser degree, in the healthy banks and in rejuvenated banks after their recovery.

Healthy Banks

Healthy banks may have survived adverse environmental factors because they had fewer and/or less severe internal weaknesses than their failed counterparts. Although some healthy banks exhibited some of the same internal weaknesses as failed banks, these weaknesses were not as numerous or severe as they were for failed banks. For example, the most recent examination reports indicated that none of the healthy banks in our analysis had significant internal control weaknesses or significant violations of laws and regulations.

The specific characteristics which distinguished healthy banks from failed banks in our comparisons included

- competent, well-qualified management;
- good board supervision;
- few or minor weaknesses in policies and procedures;
- no supervisory enforcement actions; and
- no insider abuse or fraud, except for relatively minor technical violations.

Relatively minor technical violations found in many healthy and failed banks include such things as a bank's failure to maintain all necessary annual financial statements for directors and officers, as required by Regulation O. More serious, nontechnical violations, which were found primarily in failed and problem banks, include such actions as granting preferential interest rates on insider loans and exceeding limits on insider loans, both of which are prohibited by Regulation O. (See chapter 3.)

The following example demonstrates some differences between a failed bank and a healthy bank, both of which operated in the same external environment. A midsized Texas bank was established in the 1960s and failed in 1987 after being a problem bank for several years. During the same time, another Texas bank of approximately the same size and age was able to withstand the regional economic difficulties and maintain a composite CAMEL rating of 2. The failed bank had lax and liberal lending policies, an excessively growth-oriented business orientation, and a heavy reliance on volatile funding sources. In contrast, the healthy bank maintained and complied with an acceptable loan policy, did not pursue an excessive growth policy, and relied on core deposits rather than on volatile funding sources. The failed bank also had numerous legal violations, including violations related to insider abuse, and was subject to a cease and desist order. Unlike the failed bank, the healthy bank had an audit committee to oversee the bank's internal system. Also, the healthy bank had no reported violations of regulations or laws and was not subject to any supervisory enforcement actions.

Rejuvenated Banks

Our analysis indicates that the two major changes problem banks often made to strengthen themselves were to obtain additional capital and to replace weak management.[11] A bank's capital allows it to absorb losses and serves as a cushion against adverse conditions. New management was often brought into a problem bank in response to supervisory enforcement actions. In fact, one regulator stated that the primary difference between a failed bank and a rejuvenated bank was that the latter made changes in management in time to prevent failure. Moreover, the rejuvenated banks generally tended to comply more fully with other aspects of supervisory enforcement actions than did the failed banks. Also, most of the rejuvenated banks had adopted less aggressive growth strategies and depended less on volatile funding sources than the failed banks.

The following example demonstrates some differences between a rejuvenated bank and a failed bank which operated in the same environment. Two midwestern banks of approximately the same age and size were problem banks in 1986. At that time, examiners noted that both banks had lax, collateral-based lending policies, weak credit administration and collection policies, inexperienced or unqualified management, and numerous violations of laws and/or regulations. Both were subject to supervisory enforcement actions. In addition, they were dependent on the agricultural sector of the economy. In 1987, one bank failed while the other bank was able to recover, despite adverse economic conditions. The rejuvenated bank adopted a more conservative lending policy and improved its collection practices. Further, the rejuvenated bank complied with a 1985 memorandum of understanding which required it to

[11] We did not analyze how the banks obtained additional capital.

hire an experienced agricultural loan officer, revise its lending policy, and correct weaknesses to avoid future violations. In contrast, the bank that ultimately failed continued to operate under lax lending policies and did not comply with several provisions of a 1986 cease and desist order to designate a qualified managing officer and correct weaknesses pertaining to violations of laws and regulations.

Conclusions

Environmental factors cannot be controlled by bank management and are often difficult to predict. Although the adverse environmental conditions in the Midwest and Southwest certainly contributed to the problems of banks in those regions which failed in 1987, regulators indicated that the environment alone did not cause any bank to fail.

We found that, given the same economic conditions and other environmental factors, banks with fewer serious internal weaknesses—the healthy and rejuvenated banks we analyzed—were most likely to survive environmental problems. We believe that the stronger a bank's management and internal controls, the less vulnerable that bank may be to environmental factors, such as adverse economic conditions. Further, we found that rejuvenated banks had weaknesses similar to those of failed banks, though not as severe, while they were classified as problem banks. Because internal control weaknesses are a significant factor in bank failures, we believe that the presence of such weaknesses in problem banks (11 percent of all insured banks at year-end 1987) constitutes a potential threat to the safety and soundness of the banking system.

Independent Audits Are Needed to Strengthen Internal Controls and Enhance Management Accountability

The weaknesses federal regulators cite in their analyses of failed banks can be classified as internal control weaknesses.[1] Regulators stated that in examinations they emphasize the need for not only strong internal controls but also adequate auditing procedures to ensure that those controls are operating as intended. However, federal regulators do not require annual independent audits for all insured banks. Only 35 percent of the banks which failed in 1987 had audits by an independent public accountant.[2] Moreover, only about 23 percent of the small banks (those with less than $50 million in assets) which failed in 1987 obtained independent audits, yet they comprised 85 percent of the failed banks.

Serious internal control weaknesses existed at virtually all of the 184 banks which failed in 1987, as discussed in chapter 2. Although regulators cited no single weakness or particular combination of weaknesses as the sole contributing factor to a bank's failure, each of these weaknesses relate to some element under the direct control of bank management. Our comparisons of healthy, rejuvenated, and failed banks revealed that internal control weaknesses were either not present or much less severe in healthy banks than in problem or failed banks. At year-end 1987, 1,575 of 14,289 insured banks (or 11 percent) were on FDIC's problem bank list. Based on our analysis of failed banks, we believe that these problem banks may also be characterized by the types of weaknesses discussed in this report.

Increased management oversight and accountability are needed because of the pervasive nature of internal control weaknesses identified at failed banks and the potential for the emergence and growth of such weaknesses at problem banks. Full-scope independent audits by independent public accountants and reporting on accountability by bank management can help fill this need for oversight and accountability. Such audits and reports will help bank management ensure that internal controls are operating effectively, instill greater public confidence in the safety and soundness of the banking industry, and reinforce regulators' examination and supervisory work. Further, the benefits of independent audits, such as the early detection and correction of internal control

[1] The broad objectives of internal controls are to safeguard assets, to ensure accuracy and reliability of data, to ensure compliance with policies and applicable laws and regulations, and to promote management efficiency. See appendix II for the American Institute of Certified Public Accountants' description of the internal control structure.

[2] Data provided by regulators on independent audit coverage include both full-scope audits performed on a single-entity basis and audit coverage performed as part of a bank holding company audit.

problems, are increasingly important in the present age of financial deregulation.

Regulators Recognize Need for Independent Audits but Have Not Required Them for All Banks

As discussed in chapter 2, the board of directors is responsible for verifying that bank management has implemented internal controls which are operating effectively. Regulators believe that the board can effectively discharge this responsibility through an independent audit. The FDIC Board of Directors (which includes the FDIC Chairman and the Comptroller of the Currency) stated that "the large number of financial institutions experiencing financial difficulties as a result of fraud, insider abuse and mismanagement in recent years has made an external auditing program even more important." In this regard, the FDIC Chairman stated the following in the "Statement of Policy Regarding Independent External Auditing Programs of State Nonmember Banks."[3]

> "In view of its interest in the financial soundness of banks and the banking system, the FDIC believes that a strong internal auditing function combined with a well-planned external auditing program substantially lessens the risk that a bank will not detect potentially serious problems."

FDIC further states that a bank's board of directors should consider an external auditing program a necessary cost of operating a bank in a safe and sound manner.[4]

Although banks are under no general legal or regulatory requirement to have annual independent audits, some banks are subject to audits as part of the Federal Reserve bank holding company regulations,[5] Securities and Exchange Commission requirements, or state chartering laws. In addition, under the recently issued FDIC policy statement, applicants for deposit insurance coverage will be required to obtain an independent audit annually for at least the first 3 years after FDIC grants deposit coverage.

[3]FDIC adopted the policy statement in November 1988.

[4]An FDIC official stated that FDIC, however, has not required a full-scope independent audit by an independent public accountant for all state nonmember banks because OCC and FRS do not require such audits for their respective banks and the agencies were unable to reach consensus on a policy requiring audits for all banks.

[5]A bank holding company is a corporation whose assets consist almost exclusively of equity shares of other companies, one or more of which are commercial banks. The Federal Reserve requires all bank holding companies with assets greater than $150 million to have an independent audit.

All three regulators firmly encourage banks not subject to these requirements to obtain independent audits. They believe that an independent audit can greatly aid bank management in taking corrective action, particularly when auditors detect weaknesses in internal controls. Consequently, FDIC's policy statement regarding external auditing programs for state nonmember banks identifies independent audits (or specified auditing procedures) as a condition of future enforcement actions when FDIC deems it necessary or when one of certain conditions, including the following, exists:

- inadequate internal controls and internal auditing procedures,
- a directorate which is uninformed about internal controls,
- evidence of insider abuse or criminal activity, and
- questionable transactions with affiliates.

The March 18, 1985, OCC examining circular[6] on independent external audits states that OCC will generally require a bank to engage independent auditors as part of a supervisory enforcement action in cases requiring special supervisory attention where weak internal controls have contributed to a deterioration in the bank's condition. While the Federal Reserve System has not issued a formal policy statement on audits, an FRS official stated that FRS can require independent audits as part of supervisory enforcement actions. However, documentation we reviewed revealed that regulators rarely exercised this option in conjunction with supervisory enforcement actions.

Small Banks Are Less Likely to Have Independent Audits

Regulators stated that they have encountered opposition to requiring annual full-scope independent audits, especially from small banks, because of the costs of procuring such audits. The cost of an audit depends on a number of factors including, but not limited to, the quality of the institution's procedures, its internal auditing staff, the types of loans held, the nature and extent of any problems an institution may be encountering, or other business activities. However, these costs generally decrease over time. Moreover, we believe that audit costs to the banks would further be reduced if bank management improved or instituted appropriate internal controls, developed adequate accounting systems, maintained complete and accurate records, and established internal auditing staffs, since such activities reduce audit effort. Most

[6]OCC examining circulars provide bank examiners with guidance to supplement the OCC examination manual.

importantly, we agree with FDIC's position that the cost of an independent audit should be considered a necessary cost of operating the bank in a safe and sound manner.

An independent audit would be especially valuable for small banks. Regulators identified internal control weaknesses more frequently in small banks because of constraints inherent in small staff size, such as the inability to adequately separate related duties. Further, smaller banks are also less likely to have an internal audit function. Of the banks which failed in 1987, only 65 (35 percent) had independent audits. However, 156 failed banks (85 percent) had assets of $50 million or less, and of these only about 23 percent had independent audits.

Data provided to us by FDIC further indicate that the likelihood of a bank obtaining a full-scope independent audit is directly related to the size of the bank. For example, 65 percent of all banks open as of June 30, 1988, had independent audits of their 1987 financial statements. However, 97 percent of banks with assets over $1 billion had independent audits, while only 43 percent of banks with assets of $25 million or less had such an audit. (See table 5.1.)

Table 5.1: 1987 Audit Coverage by Size of Insured Bank

Dollars in millions

	Percent of insured banks receiving independent audits		
Asset size	**Full-scope on single-entity basis**	**Part of bank holding company audit**	**Total[a]**
All banks	42	23	**65**
Over $1,000	35	62	**97**
$300 to $1,000	37	59	**96**
$150 to $300	45	48	**94**
$100 to $150	48	39	**88**
$75 to $100	47	32	**78**
$50 to $75	46	24	**70**
$25 to $50	45	15	**60**
$25 and below	35	8	**43**

Note: Data in this table are based on information reported to FDIC in the June 30, 1988, Consolidated Reports of Condition and Income (commonly referred to as "call reports") and, therefore, reflect information on banks open as of that date. These figures do not include limited-scope audit work performed by accounting firms. Such limited-scope audit work should not be viewed as a substitute for the discipline instilled by recurring full-scope financial audits.

[a]Totals may not add due to rounding.

House Government Operations Committee Report Identifies Similar Problems

In October 1988, the House Committee on Government Operations issued a report[7] on fraud and abuse in financial institutions. In part, the report dealt with the role of financial audits in the current regulatory process and stressed the importance of independent audits by certified public accountants for all federally insured financial institutions. The report stated that "during an independent audit, certified public accountants (CPAS) can often uncover unsafe and unsound practices, insider abuse and misconduct." The report also contained the following observations regarding audits and internal controls:

- Problem banks on the way to insolvency undergo audits substantially less frequently than those banks in healthy conditions.
- The smaller the institution, the more difficult it is to have effective internal controls.
- Smaller banks, which are often owned by one person who is in complete control, without an independent board of directors or any independent internal auditors, fail more frequently than larger banks with assets of over $100 million. Therefore, most of the smaller banks need the outside independent audit.

The report also stressed the importance of communication between federal regulators and independent auditors. For example, the Committee noted that troubled institutions may be unwilling to furnish examination reports to an independent auditor. Therefore, the report cited the need for regulators to make examination reports routinely available to independent auditors. The Committee believes that sharing bank agency supervisory and examination information with the independent auditor would provide a useful check on management and would give the auditor an objective body of information against which management data could be compared.

The report went on to recommend that all federally insured financial institutions have full-scale (full-scope) independent audits by CPAS, including a review of internal controls and compliance procedures. The Committee report recognized limited exceptions to this requirement:

> "Such regulations could allow for limited exceptions to this requirement for every other year, upon written request by institutions with assets of less than $10 million. To qualify, such institutions should meet the following criteria: (a) in existence for several years, (b) financially healthy (with a 1 or 2 [composite examination] rating),

[7] Combating Fraud, Abuse and Misconduct in the Nation's Financial Institutions: Current Federal Efforts Are Inadequate (House Report 100-1088, October 13, 1988).

and (c) willing to undergo, instead, a limited audit or review of internal controls and the financial statement."

The report also recommended that regulators should freely exchange information with the independent auditors of the banks which they regulate and that the regulatory agencies should require the prompt submission of CPA audits to supervisory agents or examiners for their review. (See appendix III for related excerpts from the Committee report.)

Annual Independent Audits Would Benefit Bank Management, the Public, and Regulators

Annual full-scope independent audits performed on a single-entity basis by an independent public accountant conducted in accordance with professional standards would provide additional discipline for bank management in fulfilling its fiduciary duty. In addition, such independent audits could instill greater public confidence in the banking industry and would serve as an additional tool for federal and state regulators in the examination and supervision process.

Independent Audits Could Help Bank Management Fulfill Its Fiduciary Duty

Bank management needs accurate financial information as a basis for business decisions. It also needs effective internal controls to ensure that decisions, once made, are properly carried out. The independent audit process, in addition to ensuring the validity of financial statements, reviews the internal control structure to assess risk in planning the audit. Further, under professional auditing standards, the independent auditor has a responsibility to consider an entity's internal control structure and to inform management of significant deficiencies in the design or operation of the internal control structure. Moreover, the independent auditor generally provides suggestions for corrective actions. Further, bank management can engage the independent auditor to assist in developing and implementing such actions or to provide other advisory services related to improving operational practices. Thus, the independent auditor can serve as an important resource to bank management in fulfilling its fiduciary duties to establish and maintain effective internal controls and to operate a bank in a safe and sound manner.

As discussed in chapter 3, indications of insider abuse and fraud were present at 64 percent and 38 percent, respectively, of the banks that failed in 1987. Independent audits also serve as a useful tool to detect and deter insider abuse and fraud. Specifically, the American Institute of Certified Public Accountants (AICPA) recently released two statements on auditing standards, Statement on Auditing Standards Number 53 (SAS No. 53), "The Auditor's Responsibility to Detect and Report Errors and Irregularities," and SAS No. 54, "Illegal Acts by Clients."[8] Through the two SASs, the AICPA's Auditing Standards Board communicates the need for auditors to be more sensitive to the possibility of material irregularities and to carefully consider and evaluate the risk that financial statement assertions may be materially misstated because of intentional misconduct (fraud) by senior management or employees. These SASs increase the independent auditor's responsibility to detect insider abuse and fraud and should serve as a deterrent to reduce the insider's ability to commit and conceal abusive activities. Both SASs require the auditor to inform the entity's audit committee or its equivalent of all consequential irregularities or illegal acts, including those involving senior management. Therefore, independent audits can also help management fulfill its fiduciary responsibility to operate banks in compliance with laws and regulations which promote safe and sound banking practices.

Independent Audits Enhance Public Disclosure

Complete and accurate financial reporting is extremely important to the disclosure system that underlies the stability and efficient operation of financial markets. Although an entity's management is responsible for preparing financial statements, the independent auditor plays a key role in the financial reporting process. Full-scope independent audits of financial statements inform users of these statements whether they are presented fairly in accordance with established criteria—generally accepted accounting principles. As such, audited financial statements provide assurance to users by determining whether (1) the information is unbiased, (2) the quality of the information presented is acceptable, and (3) the financial statements are complete. Under current auditing standards, independent auditors must also determine whether other information included in an entity's annual report containing audited financial statements is (1) materially inconsistent with information appearing in the financial statements or (2) a material misstatement of fact.

Currently, banks are only required to furnish unaudited financial data to customers upon request. Consequently, customers or other users (such as prospective depositors) have no assurance as to the accuracy of the data. Audited financial statements, on the other hand, provide such assurances and could serve as a source of greater public disclosure to

[8] The two new SASs are effective for audits of financial statements for periods beginning on or after January 1, 1989.

depositors and other bank customers on the condition of individual banks. Examination reports are confidential documents not available to the public. However, banks could easily provide the public annual reports containing audited financial statements, related financial data, and the independent auditor's opinion. Since annual reports are commonly used to provide information on the results of a business entity's operations, disclosure could be achieved in a widely accepted and familiar manner. Access to the information contained in an annual report is consistent with a bank's fiduciary duty to its depositors. Further, we believe that such public disclosure would provide an added incentive for bank management to operate banks in a safe and sound manner.

Independent Audits Can Assist Federal Regulators

As discussed in the October 13, 1988, House Committee report, a full-scope independent audit can also assist regulators in carrying out the examination and supervision process. Some federal regulators perform bank examinations annually for only the most troubled institutions, while some banks that do not warrant special supervisory concern (those with a composite CAMEL rating of 1 or 2) may receive a full-scope federal examination only once every 3 or 4 years. However, if banks were required to obtain a full-scope independent audit and forward the results of the audit to state and federal regulators,[9] the audit results could be used as a factor in scheduling the frequency and nature of subsequent examinations and could provide additional information for off-site monitoring.

Management Reports on Internal Controls and Compliance Would Strengthen Accountability

As discussed previously, pervasive internal control weaknesses cited for failed and problem banks suggest that bank management did not implement adequate internal controls to ensure safe and sound bank operations or compliance with laws and regulations. Such a breach of management's fiduciary duty points to the need for an increased awareness of this responsibility and for greater management accountability. We believe that the concept of management reporting on internal controls and on compliance with laws and regulations could increase such an awareness and help to establish accountability.

[9] Those banks not subject to audit requirements but which do have an audit submit audit reports to the regulators on a voluntary basis.

Report on Internal Controls

In response to recommendations made by the National Commission on Fraudulent Financial Reporting,[10] the Securities and Exchange Commission (SEC) issued on July 19, 1988, an exposure draft on a proposed new rule requiring a "Report on Management's Responsibilities" to be included in annual submissions for companies required to register with SEC. According to the exposure draft, this management report would contain a statement of management's responsibility to prepare financial statements and other financial data, as well as its responsibility to establish and maintain an internal control structure. Such a report would also include management's assessment of the effectiveness of the internal control structure and a statement of how management has responded to any significant recommendations concerning such controls made by its internal auditors and independent accountants. In the exposure draft, SEC emphasizes that the proposed requirements would not increase management's existing responsibilities but rather merely require management to acknowledge them.

The SEC proposal is directed towards companies subject to the reporting requirements of the Securities and Exchange Act of 1934. However, because many of the weaknesses discussed in chapters 2 and 3 are under management's direct control, we believe a similar management report to federal regulators would be appropriate for insured banks. Such a report should contain statements by management (1) describing its responsibility for preparing financial statements and establishing and maintaining an effective internal control structure and (2) containing management's assessment of the effectiveness of the internal control structure. We believe that each member of the board of directors and each key officer of the bank should sign the management report.

As stated in chapter 1, examination reports are prepared on an exception basis of reporting. At year-end 1987, 1,575 of 14,289 insured banks (11 percent) were on FDIC's problem bank list. As such, these banks may have significant internal control weaknesses similar in nature to those identified at the banks which failed in 1987. For example, during the period that these banks were on the problem bank list, regulators identified many of the internal control deficiencies which ultimately led to the failure of these banks. Our belief that similar weaknesses exist for banks currently on the problem bank list has been confirmed by interviews with regulators, the OCC study on failed national banks, and our analysis of healthy, rejuvenated, and failed banks. Consequently, we

[10] See Report of the National Commission on Fraudulent Financial Reporting (October 1987), pages 44-46. This report is also commonly referred to as the "Treadway Commission Report."

believe that a management report on internal controls would increase bank management's sensitivity to actions needed to ensure that effective internal controls are in place to operate the bank in a safe and sound manner. The report would also establish accountability for such actions.

Report on Compliance With Laws and Regulations

Since banks operate in a regulated environment designed to ensure their safety and soundness, management reporting should address compliance with those laws and regulations which have material consequences on bank operations. As noted previously, regulators cited numerous violations of laws and regulations for those banks that failed in 1987. Accordingly, federal regulators could best identify those laws and regulations which have material consequences on the safety and soundness of bank operations.

Specifically, in such a report bank management should (1) describe its responsibility for complying with laws and regulations related to the safety and soundness of bank operations and for establishing methods to monitor compliance and (2) assess the bank's compliance with laws and regulations related to the safety and soundness of bank operations.

In our opinion, a management report on compliance with laws and regulations would increase bank management's awareness of the importance of legal and regulatory requirements as well as the potential consequences of noncompliance.

Role of the Independent Auditor

The proposed SEC rule does not specifically address the role of the independent auditor. Rather, it assumes that existing responsibilities under generally accepted auditing standards[11] would require the independent auditor to read the disclosures included in the proposed report and to consider whether such information included a material misstatement of fact. However, the credibility of the management reports would be enhanced by establishing a requirement that, as part of an entity's financial statement audit, independent auditors of insured banks not only read and consider but also report on management's assertions regarding internal controls and compliance with laws and regulations. An independent auditor's report on these management assertions would

[11]Such responsibilities are contained in the AICPA's Statement on Auditing Standards Number 8. "Other Information in Documents Containing Audited Financial Statements."

provide additional public disclosure and would benefit federal regulators by providing an independent assessment of assertions contained in the reports.

Actions to Ensure That Audit and Reporting Requirements Achieve Their Intended Objectives

An independent audit should not be construed as a substitute for the examination and supervision processes, but rather as a source of additional information to enhance and strengthen such processes. If regulators are to take full advantage of audit and management reporting requirements, they must establish procedures to ensure that they (1) receive and review audit and management reports in a timely manner and (2) promptly initiate appropriate follow-up actions. Regulators should establish deadlines for insured banks to submit copies of all required reports soon after the audits are completed, rather than relying on banks to voluntarily submit the reports, as is currently the case. Further, regulators should establish a system to monitor the receipt of such reports and follow up on any delay that may have occurred. For example, a delay might indicate that the bank is experiencing some sort of problem, as in the case of the savings and loan industry, where troubled institutions have often taken longer than normal to submit audit reports or are unwilling to do so.

Information contained in the audit and management reports could serve as a valuable source of information to enhance supervisory monitoring of banks. Regulators should promptly compare call reports or off-site monitoring system results with audit and management reports and investigate any significant discrepancies. Currently, regulators generally review voluntarily submitted audit reports as part of the examination process. However, regulators should review such reports carefully and promptly since not all banks are examined on a yearly basis. Further, regulators should evaluate audit reports to identify any inconsistencies between audit reports and bank examination findings. Regulators should also pay particular attention to any bank receiving other than an unqualified ("clean") opinion. Moreover, regulators should monitor cases in which a bank frequently changes auditors, which may also indicate a potential problem. Clearly, the information gained from audit and management reports would be a useful indication of situations warranting closer supervisory monitoring or the need to revise examination schedules.

Additionally, regulators could develop guidance for items to be included in management reports. For example, regulators could identify those specific laws and regulations which have material consequences on the safety and soundness of bank operations to be reviewed and reported on.[12]

Financial Deregulation Underscores the Need for Effective Internal Controls

Financial deregulation, which began with the passage of the Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn-St Germain Depository Institutions Act of 1982, increases the need for supervision and disclosure because it creates the potential for greater risk. A broad goal of deregulation was to enable commercial banks and other depository financial institutions (such as mutual savings banks, savings and loan associations, and credit unions) to compete with nondepository financial institutions (such as life insurance or finance companies) and with each other in terms of financial products and services offered. However, according to some banking industry observers, the increased competition may have fostered increased risk-taking by banks.

To a certain extent, liberalized federal and state regulations have already granted some banks de facto expanded powers in areas which exceed traditional banking activities. For example, some state banking laws allow banks to engage in activities such as underwriting authority for securities, municipal bonds, or insurance; full-service or discount securities brokerage; or real estate development, equity participation, or brokerage.

During the 100th Congress, legislators considered further expansion of bank powers through deregulation, namely whether to amend the 1933 Glass-Steagall Act, which separated commercial from investment banking to enhance the safety and soundness of the nation's financial sector. If such an amendment had been enacted, insured banks would have gained expanded powers, potentially allowing them to affiliate with securities companies through a bank holding company structure. As we reported in 1987, concerns exist that such expanded powers could lead to bank failures and resulting losses to FDIC.[13] Therefore, safeguard provisions must be established in any legislation expanding bank powers to ensure that a securities subsidiary's activities do not adversely affect the safety and soundness of affiliated insured banks.

[12]Banks may also be subject to a variety of laws and regulations not directly related to the safety and soundness of their operations, such as laws pertaining to employment, occupational safety, local zoning laws, and so forth, which would not be relevant to the concept of management reporting as discussed in this report.

[13]Bank Powers: Insulating Banks From the Potential Risks of Expanded Activities (GAO/GGD-87-35, April 14, 1987), page 8.

In testimony on September 13, 1988, before the Subcommittee on Oversight and Investigations, House Committee on Energy and Commerce,[14] and in related correspondence to congressional committees, we recommended that any legislation to expand bank powers include audit and management reporting provisions. Our proposal called for annual independent audits of (1) any bank holding company that controls a securities subsidiary, (2) any bank or other insured institution subsidiary of such a bank holding company, and (3) the securities subsidiary. Further, our proposal advocated that any bank holding company, securities subsidiary, or bank or insured institution subject to the audit provision be required also to prepare and submit to the appropriate regulatory agencies a report on internal controls and compliance with any legislative safeguard provisions. Moreover, as part of the annual financial audit, the independent auditor would be required to read, consider, and report on the validity of management's assertions in the report.

Conclusions

Adherence to sound internal controls, management practices, and financial reporting practices is essential to ensure the safety and soundness of the nation's banking system. The pervasive nature of internal control weaknesses cited for failed and problem banks, however, suggests that bank management did not implement adequate internal controls to ensure safe and sound bank operations or compliance with laws and regulations and points to the need for an increased awareness of this responsibility and for greater management accountability. In our opinion, full-scope independent audits and management reporting on internal controls and on compliance with laws and regulations which have material consequences on bank operations could provide a means to increase such an awareness and strengthen accountability. Moreover, our proposed audit and management reporting requirements would fill a void in the financial services industry's current disclosure system and provide an additional safeguard within the nation's banking system.

While no formal requirements exist for all insured banks to obtain full-scope independent audits on a single-entity basis by independent public accountants, such an audit would be an effective tool for ensuring that financial data are reliable and that a strong and effective internal control structure is in place and functioning properly. Independent audits provide an objective assessment of the internal control structure and

[14]See Safeguards That Need to Accompany Changes to Glass-Steagall Laws (GAO/T-GGD-88-51, September 13, 1988).

identify potential control weaknesses. Moreover, a requirement for independent audits could be strengthened by requiring the independent public accountant to read, consider, and report on bank management's assertions on internal controls and on compliance with laws and regulations.

Bank management should consider such auditing and reporting requirements as (1) a necessary cost of operating a bank in a safe and sound manner and (2) an additional method of ensuring that it has effective internal controls. In view of the extensive internal control weaknesses regulators identified in problem and failed banks and the importance of banking industry laws and regulations, the benefits of the independent audit and management reports will far outweigh any associated costs or the minimal expansion of management's and the independent auditor's responsibilities involved. Auditing and reporting requirements would be especially beneficial for small banks, which accounted for the majority of 1987 bank failures, because, according to regulators, they are less likely to have adequate internal controls and internal auditing functions. Further, independent audits can serve as an important vehicle to provide greater public disclosure. Moreover, while independent audits of banks are not a substitute for adequate examination and supervision, audits would help state and federal regulators to fulfill their examination and supervision functions. However, regulators must establish measures to ensure the prompt receipt, review, and follow-up of audit and management reports so that the benefits of independent audits are not negated.

The early detection and correction of internal control weaknesses are important because such weaknesses may make a bank vulnerable to insider abuse and fraud or environmental factors, as discussed in chapters 3 and 4, respectively. Further, the benefits of independent audits, such as the early detection and correction of problems, take on greater importance in the current age of financial deregulation as financial institutions expand their operations into new and potentially riskier activities.

Agency Comments and Our Evaluation

In commenting on a draft of this report, FDIC, FRS, and OCC concurred with our findings and conclusions. However, the regulators did not agree with our proposals establishing regulatory requirements for independent audits and management reports on internal controls and on compliance with laws and regulations. (The regulators' written comments are contained in appendixes IV through VI.)

The regulators stated that they recognize the benefits of independent audits and use the results of such audits as a tool in their examination and supervision functions. However, regulators believe that the current policy of strongly encouraging, rather than requiring, independent audits is sufficient. Regulators pointed out that over 90 percent of insured banks are audited as a result of a full-scope independent audit, bank holding company audit, or limited-scope director's examination. However, regulators may be overstating the extent of audit coverage by citing a statistic which includes recipients of director's examinations.[15] We do not believe that limited-scope audit work should be viewed as a substitute for the discipline instilled by recurring full-scope independent audits.

We do not agree with the bank regulators' statement that requiring audits places an undue cost burden on smaller institutions because the cost of an audit is based on factors other than just the size of the entity audited. These factors include the condition of the entity's books and records, the market area, the entity's negotiation abilities, and related business opportunities for the independent accounting firm. Therefore, the comment that full-scope audits impose an undue cost burden on smaller institutions is a broad generalization. Furthermore, actions of regulators have shown that cost is not a significant factor when they require audits for new banks. Current regulatory policy applicable to all financial institutions, regardless of size, requires a newly chartered national bank or a bank obtaining federal deposit insurance to procure audits for the first 3 years after the national charter is granted or insurance is obtained. Moreover, regulators stated that many such institutions willingly continue to obtain independent audits subsequent to this initial requirement, and they also pointed out that the majority of banks are currently receiving audits. Therefore, we are not convinced that the cost burden is as great as regulators have stated, even for small banks. Moreover, relative audit costs are generally higher in initial years for institutions not currently receiving a full-scope audit and tend to decrease in subsequent years.

The cost of an audit will vary according to the size of the institution. More importantly, however, regulators should recognize that the cost of an audit is also directly related to the condition of an entity's books and records. Therefore, we believe that well-managed institutions operating

[15]Only 65 percent of the banks received full-scope independent audits on a single-entity basis or as part of a bank holding company financial audit. Additionally, 27 percent of banks received limited-scope director's examinations which examined certain selected aspects of the banks' operations.

in a safe and sound manner with strong financial systems and controls will minimize the cost of their audits. Further, since the majority of banks which do not currently receive independent audits are already obtaining other limited-scope audit work, the cost of an audit for most banks would be an incremental rather than a "zero-based" cost. Since the majority of banks are willingly obtaining independent audits, we must assume that these banks believe that the benefits of the independent audits outweigh the associated costs.

While we share the regulators' concern about not wanting to impose unnecessary cost burdens on individual banks, we continue to believe that greater emphasis must be placed on the condition of the insurance deposit fund. While regulators contend that current policies of obtaining audits on a voluntary basis are sufficient, the number of insured bank failures increased from 184 in 1987 to 200 in 1988. Moreover, the cost related to 1988 failures resulted in a loss to the deposit fund for the first time in its history. Therefore, we believe that audit requirements should be viewed in the context of not only supervising individual institutions but also ensuring the continued health of the deposit insurance fund and of the nation's banking system taken as a whole.

With regard to our proposal for a management reporting requirement, regulators stated that such reports were not necessary because of existing requirements and guidance. We have not stated that insufficient guidance exists, but rather that bank management is not always following such guidance. That is, the existence of guidance does not necessarily secure management's commitment to or even acknowledgement of its responsibilities. Although supervision and examination efforts, as well as related guidance, stress the importance of sound internal controls and compliance with laws and regulations, we believe that management reporting would enhance accountability and provide greater discipline for bank management. Such reporting would require bank management to acknowledge its responsibilities as set forth in guidance issued by bank regulators. Moreover, the report would require bank management to comment on the degree to which compliance with such guidance exists.

We do not believe that such a requirement should constitute a burden for bank management since the reporting does not expand management's existing day-to-day responsibilities but rather only requires management to acknowledge and report on them. To illustrate, well-managed institutions which are fulfilling their responsibilities to operate in a safe and sound manner are already actively monitoring such factors as the effectiveness of their internal controls, compliance with laws and regulations, and the status of implementing corrective actions for deficiencies identified by auditors or examiners. Those banks not currently operating in a safe and sound manner or fulfilling other existing responsibilities will need to take additional, and in some cases significant, actions to comply with this requirement.

In commenting on this report, regulators did not offer any significant alternatives to our recommendations for remedying the types of internal control weaknesses identified at problem and failed institutions. Despite the regulators' belief that existing guidance—most of which was in effect during the period covered by our review—is sufficient, the number of bank failures has been steadily increasing in recent years. Given the severity of internal control weaknesses identified at failed banks, we continue to believe that independent audits and management reports are needed to enhance the safety and soundness of banking institutions and the integrity of the deposit insurance fund.

We have reevaluated our proposals in light of the regulators' comments on a draft of this report. We initially proposed that audit and reporting requirements be established in FDIC, FRS, and OCC regulations. We are now recommending that such requirements be implemented through legislative action. We continue to share many of the same concerns identified in the October 13, 1988, report of the House Committee on Government Operations, which also recommended audits for all insured financial institutions. (See pages 44-45 and appendix III.) The Committee report stated that if regulators were reluctant to implement audit requirements through regulation, such requirements should be implemented legislatively. Accordingly, we are now addressing our recommendations to the Congress.

Recommendations

We recommend that, as a condition for federal deposit insurance, the Congress enact legislation requiring each insured bank to

- prepare an annual management report which (1) describes management's responsibility for preparing financial statements and for establishing and maintaining an effective internal control structure and (2) contains management's assessment of the effectiveness of the internal control structure;
- prepare an annual management report which (1) describes management's responsibility for complying with laws and regulations related to

the safety and soundness of bank operations and for establishing methods to monitor compliance and (2) contains management's assessment of the bank's compliance with laws and regulations related to operations; and

- obtain an annual independent audit of the bank's financial statements, have its independent auditor report on the management assertions described above, and submit such reports with the independent auditor's report to FDIC and the bank's respective regulator.

We also recommend that the Congress require FDIC, in conjunction with other federal banking regulators, to identify applicable laws and regulations related to the safety and soundness of bank operations which FDIC determines should be reviewed and reported on in management reports.

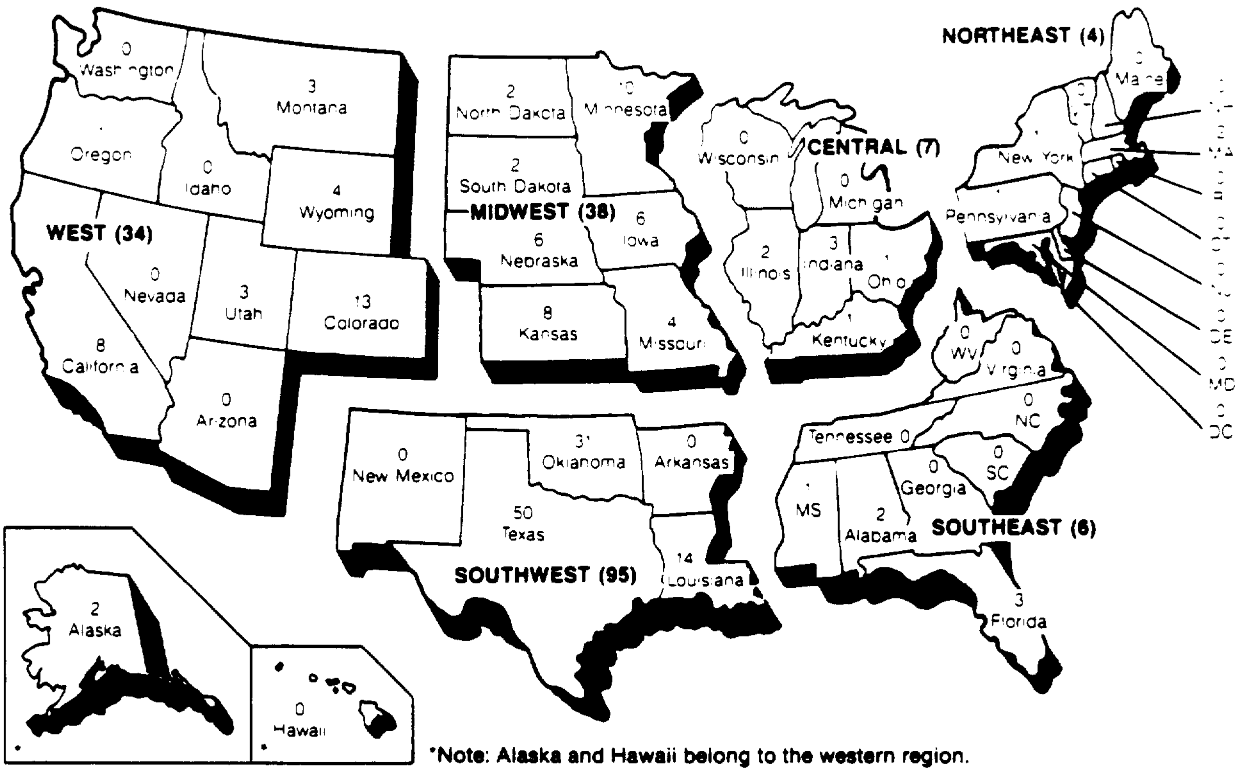
Demographics

In addition to recording internal weaknesses cited by regulators for 1987 failed banks, we collected data on demographic attributes of the banks, including their regulator, asset size, geographic region, and age. Table I.1 presents some of the demographic characteristics of 1987 failed banks. Figure I.1 shows the geographic distribution of 1987 failed banks.

Table I.1: Demographic Characteristics of 1987 Bank Failures

Characteristic	184 failed banks	
Bank Classification	**Number**	**Percent**
National	61	33
State member	12	7
State nonmember	111	60
Asset Size		
Under $25 million	124	67
$25 million to $100 million	48	26
$100 million to $300 million	9	5
$300 million to $1,000 million	3	2
Over $1,000 million	0	0
Geographic Region		
Northeast	4	2
Southeast	6	3
Central	7	4
Midwest	38	21
Southwest	95	52
West	34	18
Date Established		
Before 1900	14	8
1900 to 1949	76	41
1950 to 1979	50	27
1980 to 1987	44	24

Figure I.1: Geographic Distribution of 1987 Failed Banks



*Note: Alaska and Hawaii belong to the western region.

Note: The designation of geographic regions is based on FDIC's Quarterly Banking Review. These regions do not directly correspond to the eight regional offices of FDIC's Division of Bank Supervision.

Internal Controls

The American Institute of Certified Public Accountants recently issued Statement on Auditing Standards Number 55, "Consideration of the Internal Control Structure in a Financial Statement Audit," which clearly describes the three elements of an entity's internal control structure:

1. Control Environment: The collective effect of various factors on establishing, enhancing, or mitigating the effectiveness of specific policies and procedures. Such factors include (1) management philosophy and operating style, (2) organizational structure, (3) the function of the board of directors and its committees, (4) methods to communicate the assignment of authority and responsibility, (5) management control methods, (6) the internal audit function, (7) personnel policies and procedures, and (8) external influences concerning the entity.

2. Accounting System: The methods and records established to identify, assemble, analyze, classify, record, and report an entity's transactions and to maintain accountability for the related assets and liabilities.

3. Control Procedures: The policies and procedures in addition to the control environment and the accounting system that management has established to provide reasonable assurance that specific entity objectives will be achieved.

The weaknesses federal regulators cited during the examination process relate to the elements in AICPA's description of the internal control structure. For example, risk-oriented practices such as unsound growth-oriented policies, unwarranted concentrations of credit, or reliance on volatile funding sources all illustrate weaknesses in management philosophy, while a dominant figure who has a detrimental effect on a bank is a weakness related to management's operating style. Inadequate board supervision is a weakness in the board's function, and inadequate allowances for loan losses represent a weakness related to the valuation and allowance aspect of the accounting system. Inadequate or unadhered-to policies and procedures related to lending, documentation, credit analysis, or loan administration are examples of weaknesses in control procedures.

Excerpts From the October 13, 1988, House Government Operations Committee Report on Financial Institutions

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F. THE CIRCUMSCRIBED ROLE OF INDEPENDENT AUDITS

34. During an independent audit, certified public accountants (CPAs) can often uncover unsafe and unsound practices, insider abuse and misconduct. Yet, problem banks on the way to insolvency undergo audits much less frequently than do those in healthy condition.

35. Except for the Federal Home Loan Bank Board, none of the bank regulatory agencies require independent financial audits of the institutions which they regulate. The FDIC wants to impose such a requirement on all FDIC-insured commercial banks, but the OCC and the FRB have opposed such a requirement because they are more concerned about costs to individual banks during the first few years (estimated in the $10,000 to $20,000 range), than they are in early detection of abuses and problems and possibly reduced costs to the FDIC insurance fund.[65]

36. The sharing of banking agency supervisory and examination information with the independent auditor would prove a useful check on management. It would give the auditor an objective body of information against which management data could be compared. However, troubled institutions have been known to not volunteer critical examination reports to, or to otherwise conceal supervisory or other information from, their auditors. However, none of the banking agencies require that examination reports of, or superviso-

[65] An official of the American Institute of Certified Public Accountants has suggested that it would be less expensive in the long run to the FDIC and NCUA if they were to subsidize the cost of a regular annual full-scale audit for smaller banks than the costs incurred when smaller banks fail.

ry/enforcement actions against, an institution be provided to CPAs auditing the institution.[66]

37. Except for the FHLBB, the banking agencies do not require institutions which they regulate (a) to provide a copy of the CPA's audit report to their district or regional offices for their review and (b) to disclose reasons for changing independent auditors, similar to the SEC's requirements for publicly traded companies.

38. None of the banking agencies require that auditors of financial institutions report indications of criminal activity, similar to that required of accounting firms performing audits on government contracts or for government institutions.

III. Recommendations

A. Improvements to agency staff levels, compensation, and training

1. The Treasury Department (for the OCC), the FDIC, and the FRB should substantially increase salaries for mid- to senior-level agency examination, supervisory, and legal staff. The FDIC and the Treasury Department should take the following specific actions:

a. The Board of Directors of the FDIC should immediately increase by a fixed percentage the salaries for its mid- to senior-level examiners, supervisors, and legal staff, with anticipated greater increases thereafter. It should also then increase its examination force to the level of 2,300 by yearend 1989.

b. The Treasury Department should allocate more SES positions to OCC and increase the number of high grade GS slots.

2. The FDIC should better utilize state examining resources to examine state-chartered financial institutions. The FDIC should confer with each state banking agency and then determine how Federal and State examinations of State-chartered nonmember banks could best compliment each other, including the feasibility of joint examinations and also alternating examinations, accepting and utilizing State examination reports.

3. The Congress should (a) remove the FHLBB (headquarters' staff), the OCC, and the NCUA from the Federal appropriations process (and OMB control), since their operations are fully funded through financial institution assessments and not tax revenues, (b) study the issues of pay comparability and differentials for high cost areas for FBI agents; Federal prosecutors; the examination, supervisory, and legal staff of the OCC and NCUA; and FHLBB (headquarter's) supervisory and legal staff, and (c) establish (i) salaries for these employees which are comparable to those available in the private sector, and (ii) salary differentials in high cost cities.

4. In 1989 the Office of Personnal Management should exempt the FHLBB and the NCUA from the limitations of the Classification Act, as are all of the other banking agencies.

5. The banking agencies should substantially increase the number of examiners trained in white collar crime and insider

[66] Agency fears that auditors would not keep such information confidential are entirely unfounded in view of a CPA's ethical and contractual obligations to its clients. The fact that the agencies allow and encourage institutions to provide examination reports to auditors but do not mandate it means that their concerns are unwarranted and appear to be almost irrational.

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abuse, and should include in all training classes input from the FBI and financial institutions.

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E. EXPANDED ROLE OF INDEPENDENT AUDITS

35. The FDIC, OCC, FRB, and the NCUA should require that all federally insured institutions undergo a full-scale audit by a CPA, including a review of internal controls and compliance procedures, with a limited exception.[72]

36. All of the bank regulatory agencies should implement the following policies, to freely exchange information between them and the independent auditors of the financial institutions which they regulate:

a. All of the regulatory agencies should require that a copy of each examination report and supervisory and enforcement action (including supervisory letters) be supplied to the CPAs responsible for auditing the institutions.[73]

b. All of the regulatory agencies should require the prompt submission of CPA audit reports to district or regional bank supervisory agents or examiners for their review.

37. The regulatory agencies should require federally insured financial institutions to enter into a contractual obligation with their accounting firm auditors (a) that requires the auditors to report indications of criminal activity to Federal law enforcement agencies or, alternatively, to the banking agency (for transmission to the FBI), and (b) that states that failure to report such indications or suspicions could subject the auditor, not only to a violation of contract, but also to possible substantial liability.

38. Should each of the bank regulatory agencies fail to implement these recommendations to expand the role of independent audits, then the Congress should enact legislation to mandate them.

A. THE IMPORTANCE OF INDEPENDENT AUDITS IN UNCOVERING ABUSES AND MISCONDUCT AND THE LACK OF AUDITS PRIOR TO MANY BANK FAILURES

The Federal Home Loan Bank Board requires all FSLIC insured institutions to undergo annual audits (exceptions are permitted on a request basis for institutions with less than $10 million in assets), a requirement in effect since the early 1960's. And Chairman Wall elaborated on the need for it:

> The Board is convinced that such a requirement serves the best interest of the financial industry, the regulatory agencies and the general public. In addition, it adds to the public's confidence in the integrity of the depository institution's operations. . . .[424]

Problem banks on the way to insolvency undergo audits substantially less frequently than those that are in healthy condition. The FDIC has found that failing banks have audits at just half the percentage which nonfailing banks do, and believes that there could be some benefit to expanding the audit requirement, especially to smaller banks who do not undergo them with the same frequency. Of the 254 closed banks during the period 1986 through 9/20/87, 216 had assets of under $50 million, and only 23% of these banks had a full scope audit, as compared to 52% of all commercial banks with assets of under $50 million. Similarly, only 36% of the 25 closed banks in the $50 to $100 million range had full scope audits, while 74% of all commercial banks in this asset range had full audits, a very large disparity.[425] (For those failed banks ongoing an audit, 32 percent of the audits presented qualified opinions; that is, the auditor would not give the institution a clean opinion.)[426]

The FDIC believes that banks themselves bear the primary responsibility for preventing fraud and abuse, because "examiners are present in a bank for a very small amount of time and misconduct can be concealed from them" (the stated reason). In addition, audits are especially needed for state nonmember banks because of the FDIC's inadequate examination schedule. In sum, the FDIC encourages the "accounting profession to assume a geater responsibility for fraud detection when conducting outside audits.[427]

[424] Hearings (November 19, 1987), p. 209.
[425] Ibid., p. 461.
[426] Ibid., p. 134.
[427] Ibid., pp. 146-147.

B. FDIC'S LIMITED PROPOSAL TO REQUIRE INDEPENDENT AUDITS: WHY THE FRB AND THE OCC KILLED IT

In 1987, the FDIC had proposed requiring all State nonmember banks (a) to undergo independent financial audits by CPAs, (b) to have each bank's board of directors timely review both the management letter and the auditor's report, (c) to send copies of these reports to the FDIC regional director, and (d) to notify the FDIC when the bank changes auditors. However, the FDIC believes that "for an audit requirement to be most effective, it should apply to all insured banks," not just the banks for which it is the primary regulator", on which it could impose such a requirement. Hence, the FDIC had been working with the OCC and the FRB to gain their cooperation in developing a joint audit requirement applicable to all banks. (The FHLBB supported the efforts of the three banking agencies to develop joint audit requirements, similar to its own.)

At the time of the subcommittee's November 1987 hearing the FDIC believed that an interagency agreement was likely. FDIC Chairman Seidman stated:

> We have gotten, I believe, tentative agreement with the other agencies, of looking at, at least requiring an audit for, all institutions with assets over $100 million. The other regulators can qualify in this opinion of that. We would suggest we start at that level.[428]

The FDIC's optimism was not justified. During the hearing, the Federal Reserve Board indicated its subtle opposition to such a requirement, "because of the added costs that would impose on small organizations and because, in general, we believe internal audits can adequately serve the needs of these smaller organizations."[429]

Unfortunately, it is those smaller banks, often which are owned by one person who is in complete control, without an independent board of directors or any independent internal auditors, which fail more frequently than larger banks with assets of over $100 million, and which therefore most need the outside independent audit. FDIC Chairman Seidman recognized that when he testified that "internal control becomes more and more difficult as the institution becomes smaller. That means you have more and more detailed auditing, and it is not an easy task."[430] But the Federal Reserve refuses to recognize the merit of the FDIC's position, nor does the OCC which believes that "something less than a full-scale opinion audit may provide equal benefit." [431]

Thereafter, in view of this opposition, on 1/5/88, the FDIC suspended work on a regulation requiring independent audits for state

[428] Ibid., 134.
[429] Ibid., p. 278.
[430] Ibid., p. 134.
[431] See Ibid., pp. 391-92. The NCUA opposes an independent audit because "[t]he vast majority of credit unions are small and the expense of a required audit could adversely impact upon their financial condition and, in turn, the financial health of the NCUSIF." Ibid., p. 365. The NCUA's position is more justifiable than are those of the FRB and the OCC, because some credit unions are very small. However, we believe that the NCUA overstates the costs and exaggerates the impact on its own deposit insurance fund.

nonmember banks, because of concerns about costs to smaller banks. In the words of the FDIC,

> [A]gencies have been unable to agree on a size threshold that is low enough to significantly add to the number of banks already obtaining audits voluntarily or as a result of Federal Reserve bank holding company regulations because of [SEC] requirements.[432]

Costs concerns continue to predominate, but the OCC and the FRB are very shortsided in failing to recognize the benefits. Moreover, the following information from the FDIC indicates, that, as with all S&Ls which undergo such annual audits, the costs decrease as time goes on:

> From discussions with AICPA representatives, the FDIC staff was advised that initial audit costs of small financial institutions are usually higher than the audit costs for institutions of similar size that have been undergoing audits for several years because many small institutions do not have adequate control systems in place when they are first audited. As they institute appropriate internal controls, the audit cost may be reduced or not increase as rapidly as it would have otherwise. In addition, any cost estimates for an audit also depend on a number of factors including but not limited to, the quality of the institution's procedures, its internal audit staff, the types of loans held, the nature and extent of any problems it may be encountering, and its other business activities, if any.[433]

Subsequently, on April 19, 1988, the FDIC issued a Federal Register Notice (53 Fed. Reg. 12817 et seq.) requesting comments on a "Statement of Policy Regarding Independent External Audits of State Nonmember Banks." That statement (1) touts the benefits of such audits for State nonmember banks, (2) "strongly encourages" all such banks to engage C.P.A. firms to undergo such an audit, (3) continues the requirement of such audits for newly chartered banks and where a supervisory agreement so mandates, and (4) requires the board of directors to consider annually the need for such an audit, to record those deliberations in committee minutes, and to fully document the board's reasons for not undergoing such an annual audit, including several listed factors to be evaluated. If the board decides not to undergo a full audit, then the board of directors is required to consider other approaches, such as a review of financial statements by an independent auditor. Finally, it emphasizes that a full independent audit annually may be required by future enforcement actions, including in cases of known or suspected criminal activity or where there is evidence of insider abuse. The Statement of Policy states the importance of such audits:

> An annual independent external audit complements both the FDIC's supervisory process and bank internal auditing programs by further identifying or clarifying issues of potential concern or exposure, and it can greatly aid

[432] Ibid., p. 460.
[433] Ibid., p. 462.

management in taking corrective action, particularly when weaknesses are detected in internal control or management information systems. (53 Fed Reg. 12819)

The OCC follows a similar policy, encouraging boards of directors to document and explain in board or committee minutes the decision not to use outside auditors, while not requiring independent audits. However, ironically, in its "The Director's Book," the OCC states that the board and the public "receive only limited assurance that the bank's condition is accurately represented" by a typical limited scope audit, which reports on only the adequacy of internal controls and the accuracy of certain information but little else.[434] Instead, the OCC continues to emphasize that it will require special audits, when examiners detect higher than normal risks, find inadequate internal controls and audit procedures, and when uncovering evidence of insider abuse. These OCC policies consider audits as a remedial device to help it monitor a known bad situation.

To substitute for a full audit, the FDIC has been discussing with the American Institute of Certified Public Accountants the possibility of developing something less than an audit for smaller banks, which they would find affordable, focussing on potential problem areas, such as internal abuse. Such a review could include financial statement reviews or compilations, specified audit procedures, and directors' examinations. As the FDIC concluded, "it is difficult, if not impossible, to judge the type or cost of audit work actually performed for these banks."[435] A key AICPA official rejects the FDIC's alleged criticism that AICPA has not been that supportive in this effort, but still maintains the importance of a full audit:

> Wm. J. Dolan, chairman of AICPA's Banking Committee, denied that the Institute is "dragging its heels." Dolan . . . told BAR [the trade publication]: "We have been working with the FDIC for months to help them come up with something less than an audit for small banks. It will probably be adapted from a directors' examination, which virtually every state already requires.
>
> We want the FDIC to find out precisely what the directors' examination entails. Then our banking committee can hone in more specifically on the details of what we CPAs can an 'agreed-upon procedures' engagement. It's a step above a regular review," said Dolan.
>
> However, he still believes that a *a full-scale audit for all banks "is the way to go, even though we recognzie how expensive it is. I think everyone wants to do the right thing, but there is no magic formula."*
>
> One observer has suggested to BAR that in the long run it would probably save the various banking industry insurance agencies money if they helped to subsidize the cost of regular annual full-scale audits for smaller banks. "It

[434] Office of Comptroller of the Currency, "The Director's Book: The Role of National Bank Director," June 1987, p. 36.
[435] Hearings (November 19, 1987), p. 462.

> would be cheaper than bailing them out after they fail," he said.[436] (Emphasis added.)

We commend the FDIC for keeping the issue alive, but we criticize it for its timidity. The FDIC is like the bather at the beach who loves to swim but sees no one else enter the water. Its sister agencies refuse to go into the water and have dissuaded it that it should not go in without them. Yet, it inches into the water, very slowly, but refuses to get more than its feet wet, while seeking reassurance from the athlete nearby that swimming is healthy, or coming back to the situation at hand, that it is all right to proceed without the FRB and the OCC, to require independent annual audits.

It is very unlikely that nonmember banks will switch their status in order to come under the jurisdiction of the FRB or the OCC, solely because the FDIC requires such audits and the other agencies do not. The FDIC should overcome its timidity and require of State nonmember banks what the Bank Board has required of S&Ls for years. If anything, State nonmember banks need such audits more than other kinds of banks because of the FDIC's limited examination resources and deficient scheduling.

The Director, Accounting and Financial Management Division, General Accounting Office, has recommended that independent auditors be required to review and report on management's assertions regarding internal controls and compliance, to determine whether the bank and any securities affiliate have controls to "provide reasonable assurance that it complies with the law." He has also recommended that if a bank or bank holding company has a securities affiliate, it should be required to obtain an annual independent audit of both the bank and the securities entity's financial statements and to submit the reports to the appropriate banking agency. He stated:

> An effective system of internal controls is essential to banks and other entities operating in today's complex and fast-moving financial markets. In this regard, our ongoing analyses of the factors contributing to the failures of banks and [S&Ls], as well as the June 1988 [OCC] report on national bank failures, *clearly show that inadequate internal controls are a primary factor in the vast majority of those failures*. Since financial audits are an integral part of the system of safeguards for banks and the banking system, *reviewing internal controls and compliance with the [banking legislation under consideration] as part of these audits would greatly enhance their purpose and usefulness.*
>
> Requiring internal control and compliance reviews and reports is not a new concept. The SEC has recently issued for comment proposed rules that would require public companies to assess and report on their internal controls. Also, in 1984, the Congress passed the Single Audit Act of 1984

[436] Bob LaVine, "Auditors Blamed for U.S. Bank Failures," *Bank Accounting Report*, February 1988, p. 8.

(Public Law 98-502), which requires most state and local government units to have independent audits. . . . [437]

C. BANKING AGENCY FAILURES TO REQUIRE THAT EXAMINATION REPORTS BE SHARED WITH INDEPENDENT AUDITORS

None of the bank regulatory agencies requires that examination reports be provided to independent auditors hired by those financial institutions undergoing audits. In their responses to the subcommittee, all of the agencies (but the NCUA) expressed concerns that mandating disclosure of examination reports to independent auditors would compromise the ability to keep the reports confidential. However, this committee is concerned that institutions in which misconduct is occurring will not volunteer examination reports, and believes that it is possible to place conditions on the auditors who review such reports to assure their confidentiality. These conditions could include onsite reviews and pledges of confidentiality, particularly appropriate in view of a certified public accountant's ethical duties to its client.

This committee has previously officially recommended such a practice in its report on the failure of the "Butcher Banks" in Tennessee, which stated:

> The FDIC should make available directly to a bank's independent auditor copies of examination reports . . . The sharing of bank supervisory information with the independent auditor should prove to be a useful check on bank management because it would give the auditor an objective body of information against which management data could be compared.[438]

That recommendation was directly an outgrowth of the following situation, as well described by subcommittee Member John Spratt:

> [W]hen we looked at the UAB [United American Bank, Knoxville] failure, we found a rather phenomenal situation where Ernst and Whinney, the outside auditors for UAB, were in the bank at the same time that scores of FDIC examiners were there scurrying about making a determination as to the health of this bank, in late November and through December at yearend. UAB prevailed upon their auditors to give them an auditor's return, a P&L statement for the yearend . . . and they obtained a slightly qualified certification somewhere in mid-January. In mid-February [1983] the bank failed. . . .
>
> . . . One of the things we discovered is that the examiners, regardless of which regulatory body they come from, and the outside auditors also don't talk to each other, even when they were in the bank at the same time, and it must have been clear to everybody that some sort of crisis was

[437] Frederick D. Wolf, Director, Accounting and Financial Management Division, GAO, August 5, 1988, Letter to Hon. John D. Dingell, Chairman, House Committee on Energy and Commerce, G-229444, p. 2.

[438] "Federal Supervision and Failure of United American Bank in Knoxville, Tenn., and Affiliated Banks", 23rd Report by the Committee on Government Operations, November 18, 1983, House Report No. 98-573 (98th Cong.), p. 16.

> impending. . . . [T]he FDIC takes the attitude that what we have got here is a [examination] report that nobody can see except the ultimate insiders, the directors. Nobody else can see it, which I think is outmoded in today's world. . . . But I think quality information is a premium, and we need to look at the barrier between those two examiners and see if we can't breach it.[439]

Both the auditors and the examiners have, among other things the duty to report any fraud, embezzlement, and insider abuse which they uncover.

The agencies continue to "scream and kick" about such a requirement, often reacting in a "knee-jerk" reaction to any such proposal. The paranoia surrounding examination reports is evident from the follow FDIC's position (which ironically recognizes the importance of auditor reviews of such reports):

> While the FDIC has long opposed mandatory disclosure of examination reports to independent auditors hired by financial institutions because of our concern for the confidential nature of the report, the financial integrity of the bank, the legitimate privacy interests of any individual named in the report, and the independence of the supervisory agencies and their examination process, we are considering a requirement that audited banks show the bank examination report to their independent auditor.
>
> In our opinion, independent auditors should review the most recent supervisory examination report and, in their capacity as bank agents, they are allowed to review examination reports routinely without prior FDIC approval. . . . [The statement then goes on to detail how an auditor could make a specific request to the FDIC if a bank refused to provide the examination report.][440]

The FHLBB had "no objection" to an informal release of the examination report to auditors when such "does not compromise the examination process," since such "informal" sharings have occurred for a number of years. The FHLBB opposes formal release for the following reason:

> The formal release of the examination report to individuals not employed by the institution or involved in its supervision, may pose a threat to the integrity of the examination process. The more an examiner is aware that his/her comments are subject to review and critique by persons other than those on the supervisory staff, the more his/her candor will decrease. The examination report would lose some of its value if the full scope of a problem is not presented.
>
> Nonetheless, we agree that there may be a merit in some instances to require a troubled institution to release its exam report. We are currently reviewing our policy.[441]

[439] Hearings (November 19, 1987), p. 23.
[440] Ibid., pp. 155–156.
[441] Ibid., p. 210.

The FDIC has been studying this requirement since the early 1980's, and nothing happens. The FHLBB's review will hopefully result in some action. In any event, it would be useful if each of the banking agencies recognized that auditors/CPAs are not in the business of disseminating information to the public, like newspaper reporters, and if each agency took into account a CPA's ethical obligations to its clients.

In October 1987 Subcommittee Chairman Barnard sent to the Federal Reserve Board his views on a proposed regulation which would have made it more difficult for auditors to review examination reports (in each instance a bank would have had to obtain prior approval from the agency), and he urged that such examination reports be furnished to independent auditors.[442] During the November hearing, Governor Heller basically stated one of the continually-repeated arguments why such a requirement is not necessary:

> I might note . . . it is our experience that almost all independent public accountants already request access to an institution's examination report, and they are routinely granted such access.[443]

Of course, one can repeatedly wonder, *if CPAs normally obtain such examination reports, although not in all instances, why are the agencies so opposed to requiring it or themselves providing the reports.*

Governor Heller's remarks were a precursor to the FRB's final decision on this issue. On 6/1/88, the Chairman of the FRB advised Chairman Barnard that the Board had deleted provisions requiring banks to consult with the Federal Reserve and to secure written confidentiality commitments before making examination reports available to outside auditors. However, the Board refused to require that examination reports be made available to auditors; it stated:

> . . . auditors do not need access to reports of examination in all circumstances in which they may be retained . . . and that, as a practical matter, bankers will not deem it prudent to deny auditors access to documents which the auditors believe are needed in preparing an opinion.[444]

Accordingly, the Board's final regulation only permits banks to disclose examination reports to auditors, but *it does not require it.*

We cannot understand the absence of such a requirement whenever an auditor makes such a request during a full audit. Financial institutions have been known to conceal information from auditors, and it is reasonable to expect them to deny or not volunteer examination reports (by not revealing that a recent examination took place) if they have something to hide. It is unlikely that a troubled instituion will voluntarily furnish a critical examination report to an independent auditor. The Board, the OCC, and the FDIC completely disregard that situation, and those officials and opposed to

[442] The letter is reprinted in ibid., pp. 1045–1046.
[443] Ibid., p. 255.
[444] Ibid., p. 1121.

full disclosure live in a "fantasyland" where all financial institution managers are honest and reputable and always ready to volunteer such reports. Once again, the aura of secrecy and the fear of disclosure irrationally pervade and distort a banking agency's consideration of a reasonable and prudent policy.

It is imperative, therefore, that all of the banking agencies require that management make examination reports and supervisory agreements and orders available to independent auditors, or better yet, furnish copies of such directly to the outside auditors.[445] If they refuse, Congress should mandate it.

D. LACK OF TIMELY INTEREST BY BANKING AGENCIES IN AUDIT REPORTS

The Federal Home Loan Bank requires the submission of audit reports by thrift institutions to district bank supervisors within 15 days of the receipt of the audit report. However, all of the other Federal bank regulatory agencies require only that examiners review the report during the next examination. The FRB believes that, since it examines state member banks once per year, its examiners can wait until then to review the audit report, a rather shortsided-view, since problems can severely worsen in a 6 to 11 month period. In view of the frequency of OCC and FDIC examinations, bank agency regional examination staff should promptly receive and review audit reports, and, as necessary, take prompt supervisory action.

In its proposed "Statement of Policy" regarding independent audits (discussed in part A.), the FDIC would require that any state nonmember bank undergoing any audit work furnish a copy of the auditor reports to the appropriate FDIC regional office soon after receipt. The FDIC, to be commended for this proposal, should implement this policy immediately.

Closely related, the banking agencies should require that the institutions they regulate disclose reasons for changing independent auditors. Under present SEC rules, a public company is required (a) to file a report with the SEC explaining why it has changed auditors, and (b) to get a letter from its former accountant stating whether the firm agrees or disagrees with the company's filings. The banking agencies should be apprised of the same information by the institutions which they regulate.

E. DISCLOSURE BY AUDITORS TO THE JUSTICE DEPARTMENT AND THE BANKING AGENCIES EVIDENCE OF WRONGDOING1ABUSE, OR SUSPECTED CRIMINAL MISCONDUCT

FBI's Executive Assistant Director Revell testified that the accounting community has "much to stand accountable for in this whole process and that it is starting to occur through the civil RICO statutes." He suggested that federally insured finanical institutions should be required to enter into a contractual obligation

[445] The OCC initiated discussions with the AICPA's banking committee to improve coordination and cooperation between external auditors and its examiners. Subsequently, it implemented a pilot program last year to improve this interaction and share targeted risks and audit examination methodologies. The OCC hopes that auditors' and examiners' efforts would better complement each other, to provide more comprehensive coverage and improve the quality of audit work. Ibid., p. 423.

with their accounting firm auditors, which would require that the firm "report indications of criminal activity," similar of what is required of accounting firms which do audits on government contracts and for Government institutions. All contacts between the auditors and federally insured financial institutions would be required to contain such an obligation, and the auditor's failure to report indications of criminality would subject them, not only to a violation of the contract, but also to possible substantial liability. The Federal banking agencies should by regulation require this obligation under their existing authority to prevent unsafe and unsound conditions. Copies of such reports or referrals would be sent to the regulatory agency.[446]

Mr. Revell also recommended that auditors receive more training on the "indicia of crimes," including detecting patterns of criminality.

[446] Ibid., pp. 587-89. Mr. Revell further suggested giving the accounting firms some protection from lawsuits from suspects of criminal miconduct arising out of the filing of such reports, if that is an overriding concern, although existing protections and immunities may well apply.

Closely related, the SEC is trying to persuade the American Institute of Certified Public Accountants to require its members to disclose evidence of financial fraud whenever they resign or are fired by a client firm, to overcome the fear of lawsuits by client firms. *Washington Post*, "SEC's Ruder Backs Disclosure Law for Accountants," by David A. Vise, May 3, 1988, p. C1 & 7.

Comments From the Federal Deposit Insurance Corporation

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

FEDERAL DEPOSIT INSURANCE CORPORATION

OFFICE OF THE CHAIRMAN

January 25, 1989

Dear Fred:

Thank you for the opportunity to review and comment on your draft report entitled, "BANK FAILURES - Independent Audit Needed to Strengthen Internal Control and Bank Management."

We have reviewed this report and agree generally with its findings and conclusions. We note these findings and conclusions largely summarize information derived from various examination reports and other agency records pertaining to the failed bank cases reviewed.

We do, however, have a number of reservations about the recommendations made. These are discussed more fully in the enclosed listing.

See comment 1.

It is my understanding that FDIC staff met with GAO staff on January 9 and pointed out various technical matters for the GAO's consideration.

With best wishes.

Sincerely,

Bill

L. William Seidman
Chairman

Mr. Frederick D. Wolf, Director
Accounting and Financial Management
Division
United States General Accounting Office
Washington, D.C. 20548

Enclosure

See comment 2.

GAO Recommendations

In order to address the deficiencies in internal controls (broadly defined to include policies, management philosophy and style, etc.) that led to the failures reviewed in the draft report, the GAO is making five recommendations to the banking agencies. These are listed below followed by the FDIC's comments.

1. The banking agencies should require bank management to prepare an annual management report to their federal regulator acknowledging management's responsibility for preparing financial statements; establishing and maintaining an effective internal control structure; assessing the effectiveness of the system of internal controls, including those controls for achieving compliance with laws and regulations which have material consequences on the safety and soundness of bank operations; and adequately responding to any significant recommendations resulting from any internal or external auditor or state or federal regulator.

Comment

We do not believe that such reports are necessary in the context of the ongoing regulation and supervision of banks. We believe that, by and large, bank mangements are aware of their responsibility for preparing accurate financial statements and establishing and maintaining an effective system of internal controls, including elements designed to assure compliance with laws and regulations related to safety and soundness.

Our examiners normally review a bank's internal audit program during an examination as well as any external audit reports. Their findings and recommendations are routinely discussed with management. More recently, we adopted a policy statement (see attached copy) calling for the prompt submission of copies of external audit reports to our regional offices where they are carefully reviewed. The various state and federal regulators, of course, routinely share relevant information including supervisory recommendations and bank responses to those recommendations.

We agree that the recommendation would help increase management and director awareness and accountability for internal controls and indeed, even recognize possible benefits in helping to establish director and officer negligence in failed bank cases. However, we do not believe these benefits justify the costs and burdens associated with the proposal for all banks over time.

In the event the SEC adopts a similar reporting requirement for registered companies, we would, of course, be obligated to reconsider the issue in the context of public disclosure by registered banks within our supervisory jurisdiction. If adopted and our experience over time with registered banks seemed to justify it, we would be prepared to extend the requirement to all insured nonmember banks within our supervisory jurisdiction.

2. The banking agencies should require all banks to obtain an annual independent audit and require banks to submit such audit reports to the federal regulator.

Comment

We agree in principle with the desirability of an independent audit for all insured banks, with perhaps some special allowance or exemption for very small banks, and the prompt submission of audit reports to the appropriate federal regulator. In keeping with these views, we recently adopted the attached policy statement that strongly encourages all insured nonmember banks within our supervisory jurisdiction to adopt an annual independent external auditing program. The statement also suggests that all state nonmember banks establish an audit committee composed entirely of outside directors and calls for the submission of copies of external auditor's reports to the appropriate FDIC regional office as soon as possible after receipt by the bank. The statement reiterates our expectation that newly insured banks obtain an outside audit for at least the first three years after deposit insurance is granted. In point of fact, we require such audits as a condition for granting deposit insurance.

Although the policy statement strongly encourages external audits, we have not required them as a matter of regulation because of our desire, insofar as possible, to maintain uniform requirements and burdens for all insured banks. By way of background, we should explain that staff members from the FDIC and the other two banking agencies met with representatives of the banking industry and accounting profession in 1987 to consider the development of a regulation requiring banks to obtain annual audits by independent public accountants. In early 1988, we decided not to impose an audit regulation on state nonmember banks since it was estimated that over 90 percent of banks with assets totalling more than $100 million are already covered by annual audits and because the banking agencies were unable to agree on a size threshold low enough to add significantly to the number of banks that are audited. Other factors bearing on our decision not to pursue an audit regulation at the time included the belief that all insured banks must be covered by such a requirement in order for it to be equitable and effective; the undue burden that the cost of a full opinion audit may impose on smaller banks; and the difficulty that some banks in nonmetropolitan areas may have in obtaining competent bank auditors in their area. For these reasons, the FDIC staff has been working with the accounting profession to develop a series of basic external auditing procedures that, as a minimum, all banks should have performed annually. We hope to have these procedures available in several months. Despite the fact that our policy statement lacks the force of law, we are, nevertheless, very confident that over time the flexible application of the policy statement by our examiners and regional office staff will achieve positive results in terms of a much expanded use of external audit programs by insured nonmember banks under our supervisory jurisdiction.

See comment 3.

See comment 4.

3. The banking agencies should require all banks to have their independent auditor review and report on the management assertions described above and to submit such reports with the independent auditor's audit report.

- 3 -

Comment

This recommendation is dependent on the implementation of the first recommendation. However, to the extent that insured nonmember banks undergo external auditing work, our policy statement makes clear that any letters to management should accompany the copy of the audit report submitted to the FDIC regional office.

4. The banking agencies should identify applicable laws and regulations which have material consequences on the safety and soundness of bank operations to be reviewed and reported on in management reports.

Comment

This recommendation is also dependent on the implementation of the first recommendation. Nevertheless, it is pertinent to note in this regard that we plan to include in the basic audit procedures we are currently developing some reference to certain safety- and soundness-related laws and regulations that we believe especially important. The results will be included in the audit reports we are asking the banks to submit to our regional offices for review.

5. The banking agencies should develop methods to track and follow up on the required audit and management reports to ensure such reports are used to enhance current supervisory efforts.

Comment

See comment 5.

We can assure the GAO that all information received by our regional offices regarding the condition of insured banks, including external audit reports, is appropriately maintained and utilized. Our examination and call report databases are being revised to capture the level of external audit review undergone by each insured bank. Our regional offices already have procedures in place to follow up on uncorrected problems or open promises and commitments. We see no need for any separate tracking system for external audit reports.

The following are GAO's comments on the Federal Deposit Insurance Corporation's letter dated January 25, 1989.

GAO Comments

1. We have incorporated FDIC's technical corrections where appropriate in the text of the report.

2. See appendix II for a description of the internal control structure as contained in SAS No. 55.

3. Our recommendation, when implemented, would provide for such uniformity of audit coverage since each insured bank would be required to obtain an annual independent audit.

4. We believe that such interaction among regulators and the accounting profession is desirable. However, we continue to believe that limited-scope audit work should not be viewed as a substitute for the discipline instilled by an annual full-scope independent audit of an entity's financial statements.

5. We do not believe that a separate tracking system is necessary if current systems can be modified to track information related to audit findings and management reporting. In any event, since we now recommend that the Congress enact legislation requiring management and audit reports, our previous recommendation to the banking agencies that they monitor such reports will depend upon congressional action on our recommendations.

Comments From the Office of the Comptroller of the Currency

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

Comptroller of the Currency
Administrator of National Banks

Washington, D.C. 20219

February 7, 1989

Mr. Frederick D. Wolf
Director
Accounting and Financial Management Division
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Wolf:

Thank you for the opportunity to review and comment on your draft report titled "Bank Failures: Independent Audits Needed to Strengthen Internal Control and Bank Management." The draft provides a discussion and analysis of the reasons banks failed in 1987 and concludes that better management and internal control systems and independent audits of banks would help to reduce the number of bank failures in the future. Accordingly, the draft report recommends that the OCC require bank management to prepare an annual management report, to obtain an annual independent audit, and to have the independent auditor review and report on the management report. In addition, GAO recommends that OCC identify applicable laws and regulations that have material consequences on bank safety and soundness to be reported on by bank management and that OCC develop methods to track and follow up on the required reports.

We concur with the draft's conclusions and do, indeed, find independent audits useful in our supervision of national banks. However, we believe that the recommendations may not be necessary and could be impractical for OCC to implement.

The OCC encourages all national banks to have an annual audit performed by independent external auditors. Currently, 98% of national bank assets supervised by the OCC are subject to independent audit. Audits are required when weak internal controls or management information systems have contributed to a deterioration in the bank's condition that necessitates special supervisory attention. Also, the OCC generally requires new national banks to obtain, for a period of three years, independent external audits. The OCC has found that most banks continue to engage independent auditors after the required time period. The results of the audits are a component of OCC's supervision of national banks.

The usefulness of an independent audit depends upon its quality. Examiners review the analysis of the adequacy of external audit coverage as it appears in the minutes of the banks' board of directors' meetings. In addition, examiners review audit reports and/or engagement letters. Procedures adequately performed by independent auditors are usually not duplicated by examiners and assist in determining the scope of examiner supervision. Alternatively, if an examiner believes that a national bank could benefit from an independent external audit, specific written comment is directed to the bank. The examiner recommends that an audit be conducted in accordance with generally accepted auditing standards and be of sufficient scope to enable the auditor to render an opinion on the financial statements. In addition, whenever appropriate, examiners remind the board of directors that the responsibility for ensuring the adequacy of internal controls rests with them. Without mandating annual independent audits for all national banks, we are generally pleased with the coverage already achieved.

See comment 1.

An earlier attempt to implement requirements such as GAO recommends met with legitimate resistance. There is a positive relationship between the cost of an audit and its quality. Likewise, the smaller the bank, the more burdensome is the cost. More than one federal statute requires OCC to demonstrate that the benefits to be derived from mandated auditing and reporting outweigh the cost and paperwork burdens associated with such requirements. OCC would find it difficult to justify such requirements for smaller banks.

See comment 2.

As a practical alternative, OCC has established a three-pronged communication network involving national banks, accounting firms and the OCC. Its goal is to increase the overall quality and usefulness of independent audits of national banks. Discussion issues include information-sharing, audit requirements, and disclosure.

See comment 3.

Additional comments on the draft report of a technical nature were conveyed to GAO evaluators in a meeting held on January 19.

Sincerely,

Judith A. Walter

Judith A. Walter
Senior Deputy Comptroller for Administration

The following are GAO's comments on the Office of the Comptroller of the Currency's letter dated February 7, 1989.

GAO Comments

1. The same professional standards and requirements apply to all audits, regardless of cost. As stated in chapter 5, we believe that bank management should consider the cost of an annual audit as a necessary cost of operating a bank in a safe and sound manner.

2. We are now recommending that the audit and management requirements be legislatively required as a condition for federal deposit insurance. Accordingly, federal regulators would not be required to perform such an analysis.

3. We have incorporated OCC's technical comments where appropriate in the text of the report.

Comments From the Board of Governors of the Federal Reserve System

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

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

WILLIAM TAYLOR
STAFF DIRECTOR
DIVISION OF BANKING
SUPERVISION AND REGULATION

January 23, 1989

Mr. Frederick D. Wolf, Director
Accounting and Financial
Management Division
General Accounting Office
Washington, D.C. 20548

Dear Mr. Wolf:

I am responding to your letter of December 29, 1988 to Chairman Greenspan requesting the Board's comments on the General Accounting Office's draft report on factors related to bank failures in 1987. Your report provides a useful analysis of the factors responsible for bank failures. The draft report also offers a number of recommendations, including (a) that banks prepare an annual management report acknowledging management's responsibility for the bank's accounting systems and internal controls including compliance with relevant laws and regulations and (b) that all banks be required to obtain an annual independent audit which, among other things, would report on the accuracy of the bank's annual management report. I would like to offer comments on these two recommendations on behalf of the Board.

With respect to the recommendation for an annual management report, I would note that the Federal Reserve already has in place guidelines and requirements for state member banks that serve to promote the same objectives as the proposed annual management report. In particular, the Federal Reserve requires state member banks to have written operating policies, the purpose of which is to set down guidelines and specifications that will result in the banks operating in a safe and sound manner and in compliance with federal and state laws and regulations. State member banks are also required to have adequate internal control systems that will ensure that management and staff are aware of and comply with the operating policies. The internal control systems are comprised, in part, of accounting and other information systems that are to assist senior management and board of directors in determining whether the operating policies are being followed and are achieving their basic goals.

There are other important arrangements that encourage banks to have appropriate operating policies and effective internal control systems. The Federal Reserve advises all banks to have an independent audit function and specifies that an important element of this function, whether performed by external or internal auditors, is to review the organization's operating policies and to determine that the internal control systems are adequate. In conducting annual examinations of state member banks, Federal Reserve examiners check carefully to see that banks have appropriate operating policies and effective internal control systems.

Also, as part of the examination process, examiners discuss with bank management the recommendations of the bank's audit function as well as comments and criticisms offered by regulatory authorities during earlier examinations to determine if they have been fully and properly addressed. Upon completion of the examination, a detailed examination report is prepared that reviews the findings of the examination and highlights any identified problems and deficiencies, including those pertaining to operating policies and internal control systems. This report is routinely distributed to the bank's board of directors and management, and is also made available to the institution's legal counsel and auditors upon their request. Moreover, to make sure that a bank's board of directors are fully informed of significant weaknesses and problems uncovered during an examination, the Federal Reserve provides them with a written summary report and an oral presentation that highlight these weaknesses and problems and emphasize the board's responsibility to resolve them.

See comment 1.

A main objective sought by the recommendation for a management report -- that boards of directors be made aware of their responsibility that their bank is operated in a safe and sound manner and in compliance with relevant laws -- is also fostered in another important way. A handbook outlining the role and responsibilities of a bank board member, written by the Federal Deposit Insurance Corporation and endorsed by the Federal Reserve and the Office of the Comptroller of the Currency, has been distributed to every state member bank.

To summarize, the Board believes that the annual management report, as recommended in your draft study, would be duplicative of the many arrangements that the Board currently has in place to increase the awareness of state member banks' management and board of directors to their many responsibilities.

Regarding the recommended requirement that banks have an annual external audit, the Board has long encouraged banks to have such audits and, in fact, most banks are so

- 3 -

audited. In 1987, nearly two-thirds of all commercial banks in the country were either independently audited or were subsidiaries of bank holding companies that were independently audited on a consolidated basis by outside certified public accounting firms. These banks hold over 90 percent of the assets of the banking system. When banks that received a directors' examination conducted by a CPA firm in accordance with Generally Accepted Auditing Standards are also considered, the number of banks subject either to outside independent audits or to CPA-conducted directors examinations amounted in 1987 to over 90 percent of the industry holding 98 percent of banking assets.

While the Board recognizes the advantages of outside audits, it remains reluctant to impose such a requirement, in part, because it would significantly increase costs to smaller banking organizations. In addition, the Board believes that the required internal audit function adequately serves the needs of smaller organizations, particularly since the findings of each bank's audit function, the qualifications of the personnel conducting the audit function, and the procedures that they employ are reviewed on an annual basis by Federal Reserve Board examiners.

We appreciate the opportunity to comment on your draft report and the recommendations it contains.

Sincerely,

The following is GAO's comment on the Board of Governors of the Federal Reserve System's letter dated January 23, 1989.

GAO Comment

1. We agree that guidance is an important method of fostering safe and sound bank operations. However, the existence of regulatory guidance does not ensure that bank management will always comply with it. Much of the existing regulatory guidance was in effect during the period the 184 banks in our review failed.

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