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Immediate Measures That Can Be Taken to
Strengthen the Bank Insurance Fund

Statement of
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Before the
Committee on Banking, Housing, and Urban Affairs
United States Senate



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Mr. Chairman and Members of the Committee:

We are pleased to be here today to provide comments on your proposal to allow the Federal Deposit Insurance Corporation (FDIC) flexibility in setting deposit insurance premiums. In recent testimony before this Committee,¹ we stressed the need for immediate actions to protect the Bank Insurance Fund until long-term deposit insurance reforms can be considered as required by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA). At that time, the Committee asked us to provide a list of actions the Congress and the administration could immediately implement to protect the nation's system of deposit insurance and, ultimately, the taxpayers. We provided this list in a letter to the Committee which contained 11 recommendations and draft legislation. I ask that this letter, dated September 13, 1990, and a follow-up letter, dated September 14, 1990, be introduced into the record at this time. I will discuss the specific recommendations later in my statement.

We are encouraged by the Committee's recognition that action must be taken quickly to strengthen the Bank Insurance Fund. The Committee's proposed amendment to the Federal Deposit Insurance Act maintains the designated reserve ratio but eliminates the restrictive caps on assessment rate increases that FDIC may charge member banks for deposit insurance coverage. It also allows the

¹Additional Reserves and Reforms are Needed to Strengthen the Bank Insurance Fund (GAO/T-AFMD-90-28, September 11, 1990).

FDIC Board of Directors to determine the appropriate assessment rate to be charged. This is an important first step toward strengthening the Fund and is similar to our proposed amendment which we offered for consideration as the first of our 11 recommendations.

Both our projections of the Bank Insurance Fund balance and FDIC's show that with the restrictions currently imposed by FIRREA on setting assessment rates the Fund will not achieve the FIRREA designated minimum reserve ratio of 1.25 percent by 1995. As we previously testified before this Committee, and as we discuss in our recently issued report,² the Fund is too thinly capitalized for the exposures it currently faces. The Fund ended 1989 with its second consecutive loss, \$852 million, which reduced the Fund's ratio to insured deposits to .7 percent, the lowest this ratio has ever been. FDIC now expects the Fund to lose as much as \$2 billion in 1990, and our own projections show the Fund's ratio to insured deposits decreasing to as low as .58 percent by year-end 1990. The allowable assessment increases designated by FIRREA will be insufficient to protect the Fund in the event of a recession that results in significant bank failures. The Fund's reserves need to be increased to ensure that a recession will not deplete the Fund and result in costs to the taxpayer.

²Bank Insurance Fund: Additional Reserves and Reforms Needed to Strengthen the Fund (GAO/AFMD-90-100, September 11, 1990).

Although we support the Committee's proposal to allow FDIC flexibility in setting assessments to maintain the designated reserve ratio, we believe the proposal could be further strengthened by (1) specifying in the amendment a target date by which the Fund balance should achieve the designated minimum reserve ratio to insured deposits, (2) providing that in setting assessment rate increases, consideration be given to the economic conditions affecting the financial health of the banking industry, and (3) removing the ceiling on the reserve ratio set by FIRREA at 1.50.

While your amendment is a necessary first step, the other steps we have recommended are also vital. We believe that this first step should be implemented in conjunction with other measures discussed in detail in our letters to this Committee. These short-term measures can be taken in this session of Congress to protect the Fund and can largely be implemented administratively. Thus, the Committee should request that:

- the Department of the Treasury include in its study of deposit insurance reform (1) an assessment of the reasonableness of the minimum and maximum reserve ratios designated by FIRREA in light of the banking industry's present condition and the Fund's exposure, (2) a reserve ratio target that would protect taxpayers in a recession, and (3) means, in addition to premium assessments, such as

increased capital levels in banks, that would reduce the Fund's potential liabilities;

-- the Chairman, Federal Deposit Insurance Corporation; the Chairman, Federal Reserve Board; and the Comptroller of the Currency immediately implement a policy to conduct annual on-site, full scope examinations of large banks and problem banks and obtain such staffing levels as are needed to perform these examinations;

-- the bank regulatory agencies immediately require that large banks whose failure would cause a significant cost to the Fund have their quarterly call reports reviewed by an independent public accountant;

-- the Chairman, Federal Deposit Insurance Corporation, (1) closely monitor the Fund's cash resources and promptly advise the Committee of any projected cash shortages so that the Congress can consider other means to ensure that necessary regulatory action is not delayed because of a lack of cash resources, and (2) immediately revise FDIC's guidelines for recorded values of assets to include a critical review of the appraisers' underlying assumptions in valuing assets acquired from failed banks and adjust recorded values to reflect these assets' realistic values

in light of their historical experience and current conditions;

- the Committee itself reaffirm, through a Senate resolution or other means, its intent that bank regulators use the regulatory authority conferred in FIRREA and elsewhere to minimize losses to the Bank Insurance Fund and to ensure the stability of the banking system, specifying its expectation that the regulators act promptly to enforce safe and sound banking operations and protect the Fund;
- the Financial Accounting Standards Board (FASB) and the American Institute of Certified Public Accountants (AICPA) together take prompt action to clarify the authoritative accounting rules regarding loss recognition and determination of loss amounts for nonperforming loans and other real estate owned that was acquired through foreclosure. This clarifying guidance should be made available to the banking industry in time for use in the 1990 reporting cycle;
- the Securities and Exchange Commission (SEC) monitor the progress of the FASB and AICPA in developing guidance on loss recognition and determination of loss amounts for nonperforming loans and other real estate owned that was acquired through foreclosure, and issue guidance on

interpreting these accounting rules if the accounting authorities are unable to meet the December timetable. All banking institutions, including those reporting to other regulatory bodies, should then be required to follow this guidance.

The measures outlined above can, and should, be implemented before the Congress recesses. Another issue which Congress should address before the end of this calendar year is the need to enact legislation that requires comprehensive internal control, auditing, reporting, and management reforms for financial institutions. Such reforms are needed to help prevent these institutions from getting into trouble, to provide regulators with an early warning when institutions begin to get into trouble, and to protect against the kind of fraud and other illegal acts that occurred in the savings and loan industry. The government needs to take responsibility for these areas that up until now have been largely left to the private sector to better protect its interests as insurer of deposits. The government, because of its insurance commitments, has at least as much right to protection as shareholders of financial institutions.

Our past and ongoing work has disclosed serious internal control weaknesses in financial institutions. Before enactment of FIRREA, we reported that serious internal control weaknesses cited by federal regulators contributed significantly to the failure of

virtually all of the 184 banks which failed in 1987.³ We also reported that regulators' examination reports and related data showed numerous and sometimes blatant violations of laws and regulations at 26 failed savings and loans that we reviewed to determine the cause of their failure.⁴ At that time, we recommended that FIRREA include requirements for insured institutions to undergo annual financial audits and to issue management reports on the effectiveness of their internal controls and on their compliance with safety and soundness laws and regulations. To provide assurance on the validity of the management reports, we also recommended that, as part of the annual audit, auditors be required to review and report on management's assertions contained in its reports. Unfortunately, these recommendations were not included by the Congress in FIRREA.

Our ongoing work has disclosed that weak internal controls continue to be a serious problem in financial institutions and continue to contribute significantly to failures. Our review of examination reports for 39 of the largest banks of the 406 banks that failed in 1988 or 1989 disclosed that many of the institutions had serious internal control weaknesses.

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

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

Management and the boards of directors of financial institutions have a responsibility to operate their institutions in a safe and sound manner. Safety and soundness relates not only to overseeing the day-to-day operations of the institution, but also to establishing and maintaining an effective internal control structure. Such a structure increases an institution's ability to protect its assets and deal with economic adversity in an effective manner. The internal control structure should ensure that (1) transactions are executed and access to assets is permitted only in accordance with management's authorization, (2) transactions are recorded to permit preparation of financial statements in conformity with sound accounting principles and to maintain accountability for assets, and (3) the institution complies with all applicable laws and regulations, especially those relating to safety and soundness.

The accounting profession also plays a significant role in ensuring corporate accountability. Unfortunately, not all banks receive an annual audit by independent public accountants. Additionally, there are deficiencies in the audits of some financial institution which are audited by independent public accountants. In recent years, the accounting profession has acted to strengthen some of the auditing procedures vital to determining the true condition of financial institutions. In our view, however, the guidance provided by the profession has not been sufficiently specific and substantive to ensure that audits are

conducted in an effective manner. Most importantly, the profession has not agreed to include a review of compliance with safety and soundness laws and regulations as part of a financial institutions annual audit.

The problems disclosed by internal control reviews and audits do not always receive the attention they should by managers of financial institutions who, particularly in times of stress, may attempt to cover up problems or protect their own actions from scrutiny. Additional measures to shore up the corporate governance process need to be taken. Communication between the independent public accountant and regulators needs to be improved, with the auditor reporting violations of laws and regulations to the regulators on a timely basis, and the regulators providing information on the condition of the institution to the auditor. The auditor's work also needs to be subject to strict peer review. Truly independent audit committees that include lawyers must be established to ensure that both managers of financial institutions and auditors perform their roles and duties in a responsible manner. We believe that all the major financial institutions players--managers, directors, auditors, and regulators--must work together and work effectively to protect the taxpayer.

We are convinced that legislation dealing with the internal control, auditing, reporting, and management problems we have mentioned is critical to reducing the risk of loss to the insurance

funds. Therefore, as stated in our recent letters to the Committee, we recommend that legislation be enacted requiring that:

- financial institutions prepare annual financial statements in accordance with generally accepted accounting principles;
- financial institutions establish adequate internal controls and annually assess and report on whether such controls provide reasonable assurance that (1) transactions are executed and access to assets is permitted only in accordance with management's authorization, (2) transactions are recorded to permit preparation of financial statements in conformity with sound accounting principles and to maintain accountability for assets, and (3) the institution complies with applicable laws and regulations including those related to safety and soundness;
- independent public accountants annually audit the institution's financial statements and examine and report on the institution's assessment of its internal controls;
- audits of financial institutions be performed only by independent public accountants who have received an adequate peer review;

- independent public accountants identify all significant related party transactions and review their financial substance;
- independent public accountants use specific procedures to determine compliance with applicable laws and regulations, including those relating to safety and soundness;
- independent public accountants review risks and uncertainties and evaluate the institution's ability to continue in business over the next year;
- independent public accountants pursue indications of illegality by the institution, inform the management and directors of the institution if it is determined that an illegality has likely occurred and, if the institution does not take corrective action on a substantial illegality, report to FDIC, resign from the audit, or both; and
- institutions establish truly independent audit committees that include lawyers whose duties include reviewing the basis for the reports issued by an institution's management and accountants.

Our initial letter dated September 13, 1990, included proposed legislation for the Committee to consider which would implement our proposed recommendations by amending the Securities Exchange Act of 1934. This proposal was offered because of consideration being given in the House of Representatives to a proposal that would repeal the 1934 Act's section 12(i) exemption for financial institutions and address some of the reforms needed. Our proposed legislation would have strengthened the House bill. Our follow-up letter included proposed legislation with respect to financial institutions by amending the Federal Deposit Insurance Act. We are satisfied that this legislation contains the measures necessary to reduce the risk of loss to the Bank Insurance Fund. We urge that this legislation be enacted before the end of the calendar year so that its provisions can be fully effective in 1991.

CONCLUSIONS

We believe that the measures we have outlined today, if promptly addressed, will assist in reducing the risk of a major crisis in the banking industry. Our goal is to ensure a sound system of deposit insurance that continues to maintain public confidence and can withstand adverse economic conditions without costing the nation's taxpayers billions of dollars. The amendment you have proposed to allow FDIC more flexibility in setting premiums is a critical first step to protect the Bank Insurance Fund.

Mr. Chairman, this concludes my prepared statement. I would be pleased to answer any questions you or other members of the Committee may have.