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CONDITION OF THE
BANK INSURANCE FUND

Outlook Affected by
Economic, Accounting,
and Regulatory Issues

Statement of Charles A. Bowsher
Comptroller General of the United States



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OUTLOOK AFFECTED BY ECONOMIC, ACCOUNTING, AND
REGULATORY ISSUES

TESTIMONY OF CHARLES A. BOWSHER
COMPTROLLER GENERAL OF THE UNITED STATES

BEFORE THE COMMITTEE ON BANKING,
HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

TUESDAY, 10:00 a.m., JUNE 9, 1992

The Bank Insurance Fund ended 1991 with a deficit fund balance of \$7 billion. Just 4 years ago, the Fund's balance was \$18.3 billion, its highest level ever, and the ratio of its reserves to insured deposits equaled 1.10 percent. Since then, the Fund's reserves have been depleted by losses of over \$25 billion.

Projections by the Federal Deposit Insurance Corporation (FDIC) and others show that the Fund faces significant additional exposure from troubled banks. The outlook for the Fund is made further uncertain by accounting and regulatory issues that hinder early warning of troubled banks and work against minimizing Fund losses. It is critical that the accounting, auditing, and regulatory reforms of the FDIC Improvement Act of 1991 and its provisions for rebuilding the insurance funds be effectively implemented.

In 1991, FDIC recorded \$15.5 billion in estimated losses from troubled banks on the Fund's financial statements. These banks, with total assets of \$113 billion, were still open as of year-end 1991, but were determined by FDIC to be likely to fail in the near future. We concur with FDIC's approach to estimating the Fund's losses, and are issuing an unqualified opinion on the Fund's 1991 financial statements. Our report issued last year on the Fund's 1990 financial statements disclosed that had FDIC adopted this approach, the Fund would have shown a deficit balance at that time of \$1.4 billion instead of the \$4 billion balance it reported.

A number of factors, such as changes in economic conditions and fluctuations in interest rates, can affect the actual pace of resolving the troubled banks that FDIC has estimated will result in losses to the Fund. FDIC has resolved some of the insolvent banks, and others are scheduled for resolution. However, the future of other insolvent banks is made uncertain by first quarter financial reports that indicate profits generated from sales of securities and favorable interest spreads, and, in some instances, capital infusions. While short-term profits and capital infusions can affect the future of troubled banks, they will not eliminate the losses imbedded in banks' asset portfolios. FDIC is monitoring the condition of these banks closely to determine if their situation improves or if resolution is necessary.

The Fund continues to face exposure from a significant portion of the banking industry. As of December 31, 1991, the regulators had identified 1,069 problem commercial and savings banks. The increasing size of these problem banks, and their proportion of the total assets of Fund-insured banks, cause serious concern. Assets of the problem banks totaled \$611 billion, an increase of nearly 50 percent from the \$408 billion in industry assets problem banks held just 1 year ago. Problem banks now hold nearly 17 percent of the total assets of banks insured by the Fund.

FDIC estimates that the Fund may incur costs ranging from \$25.8 billion to \$35.3 billion over the next 2 years from resolving troubled banks with assets totaling between \$168 billion and \$236 billion. Of these costs, \$16.3 billion has already been recorded on the Fund's financial statements. The Congressional Budget Office and others have developed longer-term projections of costs facing the Fund from troubled banks. These cost estimates range from \$15 billion to \$72 billion over the next 4 years.

These estimates are subject to significant uncertainties. The reliability of financial information reported by banks, future economic conditions, further industry consolidation, and the implementation of regulatory reforms mandated by the FDIC Improvement Act of 1991 could significantly affect the accuracy of these estimates. Nonetheless, the cost estimates show that the Fund has significant exposure to additional losses from troubled banks over the next several years.

While the FDIC Improvement Act provides additional funding authority to resolve troubled institutions, the adequacy of this funding is subject to future economic and market conditions that affect the cost of future bank failures as well as those already resolved. Further, the \$30 billion in loss funds the act provides are for use by both the Bank Insurance Fund and the Savings Association Insurance Fund (SAIF). If SAIF incurs resolution costs in excess of its other funding sources, FDIC could be forced to use some of the \$30 billion to cover SAIF's losses, in turn reducing the loss funds available for the Bank Insurance Fund.

The act contains provisions to rebuild the Fund's reserves to the designated ratio of reserves to insured deposits of 1.25 percent and to require FDIC to implement a risk-based premium system. FDIC recently announced its plans to increase assessment rates beginning January 1, 1993, and also proposed to shift to a risk-based premium system. Under these proposals, FDIC projects only a 60 percent probability that the Fund will achieve the designated reserve ratio over 15 years. Further, the designated reserve ratio may be low in relation to the increased risks in the banking industry. Nonetheless, it is a target that should be achieved as expeditiously as possible through industry assessments.

A key to ensuring the Fund's long-term health is to correct accounting, auditing, and regulatory problems that have contributed to bank failures and their high costs to the Fund. The FDIC Improvement Act requires such reforms to ensure timely warning of troubled institutions and thus to minimize costs. A common underpinning of these reforms is the need for accurate and consistent financial reporting. We have found that flexible accounting rules used to prepare financial reports enable banks to conceal loan losses which can delay regulatory action and increase losses to the Fund.

Our recent work indicates that neither the Financial Accounting Standards Board nor the regulators are likely to correct this critical problem. We believe there is a reluctance to value nonperforming loans at values reflecting fair value conditions. This leads to overstated asset values and capital.

We also have concerns about existing accounting rules for debt investment securities and related party transactions. Rules for securities allow banks to recognize gains and defer recognizing losses. The rules for related party transactions fail to ensure that the economic substance of such transactions is recognized in financial statements when it differs materially from the transactions' legal form. The absence of tight accounting rules for such transactions invites improprieties between bank holding companies and their insured bank subsidiaries.

We believe that the accounting rules for nonperforming loans, investment securities, and related party transactions are at odds with the objectives of accounting principles the act establishes for depository institutions' reports to the regulators. Those objectives are (1) accurate reporting of bank capital, (2) effective supervision, and (3) prompt corrective action at the least cost to the Fund.

Effective corporate governance of insured financial institutions is also vital to the health of the Fund. A key to effective corporate governance is a strong audit committee, composed of members who are independent, knowledgeable about bank operations, and with the authority to fulfill their fiduciary responsibilities. Audit committee members of large banks told us these conditions do not exist. Clearly, this is an unacceptable situation that adds tremendous risk to the Fund.

The FDIC Improvement Act contains requirements intended to establish effective audit committees and corporate governance. It also provides a framework for efficient and effective working relationships among insured institutions' management, its auditors, audit committees, and regulators to minimize losses to the insurance funds. We plan to monitor its implementation carefully to ensure that these opportunities are not overlooked. I would like to stress that the accounting, auditing, and regulatory

reforms contained in the act should not be weakened, especially when there are government borrowings and taxpayer funds at risk.

Mr. Chairman and Members of the Committee:

We appreciate the opportunity to appear before you today to discuss the results of our recently completed audit of the Bank Insurance Fund's 1991 financial statements, and to discuss certain economic, accounting, and regulatory issues that could affect the future condition of, and outlook for, the Fund and the industry it insures.

In April 1991, we appeared before this Committee and discussed the condition of the Fund.¹ At that time, we expressed concern that, given the level of exposure facing the Fund from troubled banks, it was highly likely that the Fund would be insolvent within the next year. Unfortunately, our concern has become reality. Our report on the Fund's December 31, 1991, financial statements, to be issued shortly, discloses that the Fund ended 1991 operations with a deficit balance of \$7 billion.

HIGH FAILURE RATE HAS DEPLETED

THE FUND'S RESERVES

The Fund's deficit balance at December 31, 1991, is the culmination of 4 consecutive years of net losses incurred from historically high levels of bank failures. Just 4 years ago, the Fund's reserves stood at \$18.3 billion, their highest level in the

¹Rebuilding the Bank Insurance Fund, (GAO/T-GGD-91-25, April 26, 1991).

Fund's history. At that time, the ratio of the Fund's reserves to insured deposits equaled approximately 1.10 percent. Since then, the Fund incurred cumulative losses of over \$25 billion, which have depleted the Fund's reserves.

These losses are the result of a continuing high level of bank failures that began in the latter half of the 1980s. Between 1987 and 1991, 882 banks with assets totaling \$151 billion failed. In comparison, between 1933, the year the Federal Deposit Insurance Corporation (FDIC) was created, through 1986, a period of 54 years, 1,149 banks with assets totaling about \$52 billion failed.

In the last 2 years, the number of bank failures has actually declined from a record high 206 failures in 1989 to 124 failures in 1991. While this is a significant decline, the average size of failing banks has increased sharply. In 1989, the average total assets of failed banks was about \$142 million. By contrast, in 1991, the average total assets of failed banks rose to about \$509 million. As we have seen from experience, the cost to the Fund from bank failures increases significantly as the size of the failed banks increases. For example, of the 127 banks that failed or received assistance in 1991, 12 banks with assets in excess of \$1 billion failed, at an estimated cost to the Fund of about \$4.1 billion. In contrast, the Fund incurred estimated costs of \$3.3 billion in 1991 on failure and assistance transactions for 115 banks with assets of less than \$1 billion.

RESULTS OF THE FUND'S 1991 OPERATIONS

In 1991, in addition to incurring its first deficit, the Bank Insurance Fund incurred a net loss of \$11.1 billion. The net loss, and the resulting fund deficit, was attributable to FDIC recognizing on its books in 1991 about \$15.5 billion in estimated losses for resolutions of large troubled banks.² These banks were still open as of year-end 1991, but were likely to fail in the near future. These banks had total assets of about \$113 billion at year-end 1991.

In 1991, FDIC revised its approach for determining what triggers the recognizing of estimated losses for large troubled banks on the Fund's financial statements. In addition to booking estimated losses for equity insolvent banks³ as was done in 1990,

²FDIC's analysis of large troubled banks for purposes of recognizing losses on the Fund's financial statements consists of a bank-by-bank review of the financial condition of each bank reviewed with assets in excess of \$100 million. FDIC also estimates losses for small banks (banks with assets less than \$100 million) based on historical experience. This historical experience is used to establish a general reserve for small banks, which is adjusted quarterly based on the current aggregate conditions of small banks. About \$500 million has been established as a general reserve for small banks.

³Equity insolvent banks are banks that reported negative equity capital on their quarterly financial reports filed with the regulators (call reports) and banks that reported positive equity capital on their quarterly call reports but whose reserves for loan losses, when compared to their level of nonperforming loans and loss reserve levels for similar banks in the same geographical region, were determined to be insufficient to cover the level of losses inherent in their loan portfolios. When these banks' reserves for loan losses were increased to reflect a more appropriate level of reserves needed to cover

FDIC booked losses for those additional troubled banks that reported equity but were judged to require resolution in the near future. FDIC estimated the cost for the equity insolvent banks at \$7.8 billion, and about \$7.7 billion for the additional troubled banks.

FDIC's 1991 accrual for future estimated losses is consistent with the loss recognition criteria we disclosed in our report on the Fund's 1990 financial statements.⁴ As we stated in that report, had FDIC used this approach to recognize the Fund's estimated losses from troubled banks in 1990, it would have recorded about \$5.4 billion in additional estimated losses beyond those reflected on the Fund's 1990 financial statements. The Fund would have shown a deficit balance of \$1.4 billion at that time instead of the reported \$4 billion balance. This was fully disclosed in our report on the Fund's 1990 financial statements.

Most of the large banks for which FDIC recorded estimated losses in 1991 are located in the Northeast, and have excessive concentrations in real estate lending. In general, the additional large troubled banks that were not equity insolvent as of December 31, 1991, for which FDIC recorded estimated losses, had minimal capital, excessive levels of problem assets, and earnings trends

loan losses, their equity capital was depleted, resulting in their insolvency.

⁴Financial Audit: Bank Insurance Fund's 1990 and 1989 Financial Statements, (GAO/AFMD-92-24, November 12, 1991).

that, if continued, would lead to their insolvency in the near future. In addition, some of these banks were undergoing supervisory examinations, and the examiners were finding serious problems not reflected in these banks' financial reports. In reviewing the financial condition of these banks, FDIC determined that, subject to a substantial turnaround in their operations and financial condition, these banks would more likely than not fail in the near future.

We believe that FDIC's estimated losses as reported on the Fund's 1991 financial statements reflect a reasonable estimate of the losses the Fund has incurred from open but troubled banks. As a result, we proposed no adjustments to the estimated liability for troubled banks, and are issuing an unqualified opinion on the Fund's 1991 financial statements.

PACE OF RESOLUTION ACTIVITY

MAY NOT MIRROR RECOGNITION OF

LOSSES FROM TROUBLED INSTITUTIONS

Recently, concerns have been expressed that FDIC may not be resolving troubled banks in a timely manner. Through May 22, FDIC had resolved 53 troubled banks with total assets of \$16.4 billion in 1992. The significant estimated losses from troubled banks recorded on the Fund's 1991 financial statements indicate the substantial costs the Fund faces for resolving these

banks and, on the surface, would indicate that the pace of resolution activity could have been greater than that actually experienced through the first 5 months of 1992.

However, a number of factors, such as changes in economic conditions and fluctuations in interest rates, can affect the timing of actual bank failures, and thus the pace of resolution activity. The current low interest rates can improve a troubled bank's interest margin, resulting in short-term profits that stabilize, and in some cases improve, a bank's capital position. Gains from sales of assets may also produce short-term profits which can affect the timing of regulatory action to close a troubled institution.

Regulators must address other considerations in determining what action, if any, to take to resolve a troubled institution. For example, they would consider any realistic plan the institution has to work itself out of its difficulties, the ability of an institution's parent holding company to provide capital and/or other assistance, and the most appropriate resolution to minimize the cost to the Fund.

Of the 53 banks resolved through May 22, 15, with assets totaling about \$15 billion at the time of their failure, were large banks that FDIC determined to be insolvent in 1991, and included in the estimated losses recognized on the Fund's 1991 financial

statements. We reviewed the status of the other 25 large banks FDIC determined to be insolvent in 1991, but that had not yet been resolved. For 8 of these banks, the regulators are developing resolution plans. For others, their future is made uncertain by first quarter financial reports that indicate profits generated from sales of securities and favorable interest spreads. In a few instances, there is evidence that capital infusions were received in the first quarter of 1992. While short-term profits and capital infusions can affect the future of troubled banks, they will not eliminate the losses imbedded in banks' asset portfolios. FDIC is monitoring the condition of these banks closely to determine if their situation improves or if resolution is necessary.

CONDITION AND PERFORMANCE OF
THE BANKING INDUSTRY IN 1991

The condition and performance of the banking industry in 1991 provides some insight into the outlook for both the industry and the Bank Insurance Fund. It is important to note that the reliability of the reported data is affected by flexible accounting rules that will be discussed later.

At December 31, 1991, the regulators had identified 1,069 commercial and savings banks insured by the Bank Insurance Fund as problem banks. This reversed a 3-year declining trend in the number of problem banks, and reflected a 2-percent increase in

problem banks from 1 year ago. Of the 1,069 problem banks at year-end 1991, 997 were commercial banks and 72 were savings banks.

The increasing size of problem banks and their proportion of the total bank assets insured by the Fund are highly disturbing. At December 31, 1991, total assets of problem banks equaled \$611 billion, an increase of nearly 50 percent over the \$409 billion in total assets of problem banks at December 31, 1990. Problem banks held nearly 17 percent of the total commercial and savings bank assets at December 31, 1991, compared to approximately 11 percent of total assets a year earlier. Consequently, despite some improvement in overall bank earnings and capital levels, the Fund's exposure to losses from troubled banks continues to be significant.

In 1991, commercial banks earned \$18.6 billion, a 15-percent increase from the \$16.1 billion earned in 1990. However, gains from sales of investment securities, increased net interest income, and lower loan loss provisioning accounted for the improvement in earnings. Gains from sales of investment securities accounted for nearly 16 percent of commercial bank earnings in 1991. The industry's earnings helped to improve its overall equity position, as its ratio of equity capital to assets increased to 6.8 percent at December 31, 1991, from 6.5 percent at December 31, 1990.

Overall, the number of commercial banks posting losses in 1991 declined to just under 11 percent of the commercial banking industry. However, these banks held 21 percent of the \$3.4 trillion in commercial bank assets at December 31, 1991. Thus, despite improved net interest margins in the fourth quarter of 1991, larger commercial banks are continuing to experience earnings problems. These losses are attributable to high loan loss provisioning and increased overhead costs.

Despite a decline in nonperforming loans, the commercial banking industry continued to experience significant asset quality problems. Nonperforming real estate loans, particularly construction and development loans, remained at high levels. Northeast banks continued to hold high levels of troubled real estate assets, and banks in the west are experiencing increasing real estate asset quality problems. The commercial banking industry's level of real estate assets acquired through foreclosure increased dramatically, to over \$26 billion. This is an increase of 32 percent from the \$20 billion in real estate assets acquired through foreclosure at year-end 1990.

While commercial banks reported aggregate earnings and increased capital levels, the nation's savings banks insured by the Bank Insurance Fund continued to report aggregate losses--\$1.2 billion--with approximately one-third of the 441 savings banks insured by the Fund reporting losses. While savings banks'

aggregate ratio of equity capital to assets at year-end was 6.7 percent, comparable to that of commercial banks, savings banks set aside a significantly lower level of reserves to cover troubled loans. Savings banks' reserves for loan losses equaled just 33 percent of total noncurrent loans. In contrast, commercial banks set aside reserves to cover about 72 percent of noncurrent loans. To some degree, the lower reserve levels of savings banks may be justified by the fact that their real estate loan portfolios consist primarily of mortgages on residential housing of 1 to 4 units, while the real estate portfolios of commercial banks are predominantly comprised of construction and development and commercial real estate loans.

At the same time, savings banks held a greater proportion of troubled assets than commercial banks. Troubled assets, consisting of noncurrent loans and real estate assets acquired through foreclosure, equaled 5.9 percent of the \$237 billion in total assets of savings banks at December 31, 1991. The ratio of troubled assets to total assets for commercial banks was 3.0 percent at December 31, 1991.

The depressed northeast real estate market continued to weaken the financial condition of savings banks in 1991. During the year, 19 savings banks insured by the Bank Insurance Fund failed, an increase of 90 percent from the 10 savings banks that failed in 1990. In contrast, between 1985 and 1989, only 5 savings banks

failed. Continued depressed real estate values could lead to significant additional savings bank failures in the near future.

OUTLOOK FOR THE BANK

INSURANCE FUND

FDIC expects the Fund to face further significant losses in the next several years from the resolution of troubled banks. It has estimated that, over the next 2 years, the Fund may incur costs ranging from \$25.8 billion to \$35.3 billion for resolving troubled banks with total assets ranging from \$168 billion to \$236 billion. Of these estimated costs, \$16.3 billion has already been recorded on the Fund's financial statements.

FDIC expects continued high levels of insurance losses due to the continued weakened condition of a significant number of insured banks and continued weakness in real estate markets. FDIC believes that, while the industry has shown some improvement in profits and capital position in the first few months of 1992, this improvement has occurred in a favorable interest rate environment. That environment has enabled banks to improve interest margins and book gains from sales of assets. Despite this apparent improvement, the industry continues to be saddled with a significant level of problem assets that could result in additional losses for banks down the road. Upward movement in interest rates could impact adversely on the industry's profitability and capital position.

FDIC recently developed a number of scenarios showing the outlook for the Fund over the next 15 years. Under these scenarios, FDIC expects both the number of bank failures, and their cost to the Fund, to taper off over the long-term as conditions improve and as the Fund resolves those clearly troubled banks. Under FDIC's more optimistic scenario, the Fund will begin to show earnings in 1994, and its deficit will be eliminated in 1996. This scenario shows the Fund attaining its designated ratio of reserves to insured deposits of 1.25 percent by 2006. Under FDIC's more pessimistic scenario, the Fund will begin to show earnings in 1995, and will begin to show positive reserves in 1999. Under this scenario, the Fund will also achieve the designated reserve ratio by 2006, but only by maintaining higher assessment rates over a longer period of time.

These projections are subject to significant uncertainties. Forecasting bank failures and their costs to the Fund over the long-term is subject to a high degree of imprecision, as problems within troubled banks may not surface in their financial reports for some time. In addition, assumptions about the level of bank failures, growth in industry assets and insured deposits, and growth in the Fund's assessment revenues over a 15-year period are subject to considerable fluctuations due to future economic conditions, further industry consolidation, and the implementation of regulatory reforms mandated by the FDIC Improvement Act. We should also note that the Fund's financial condition, as depicted

in both of the scenarios described above, assumes an increase in the assessment rate charged to insured institutions from the current level of 23 cents per \$100 of domestic deposits to 30 cents beginning January 1, 1993.

In April 1992 testimony before this Committee, the Director of the Congressional Budget Office (CBO) assessed the condition of the Bank Insurance Fund.⁵ The CBO Director projected the Fund's costs from resolving troubled banks, and the status of the Fund's reserves, from fiscal years 1992 through 1997. CBO's projections show the Fund incurring costs of \$54 billion from bank resolution activity over this period. Under these projections, costs from bank resolutions begin to decline after fiscal year 1993, and the Fund shows positive income for the first time in fiscal year 1996.

Like FDIC's projections, CBO's estimates assume certain increases in assessment rates. For example, CBO assumed an increase to 27 cents per \$100 of domestic deposits on July 1, 1992, and a further increase, to 30 cents, on July 1, 1993. However, the current assessment rate of 23 cents will remain in effect through 1992, and a recent FDIC proposal would increase the average assessment rate to 28 cents per \$100 of domestic deposits on January 1, 1993.

⁵Statement of Robert D. Reischauer, Director, CBO, before the Committee on Banking, Housing and Urban Affairs, United States Senate, April 1, 1992.

CBO's Director included a summary of projections of failed bank costs that were developed by other government and private entities and individuals. These estimates show costs the Fund may incur in resolving troubled banks ranging from a low of \$15 billion to a high of \$72 billion over the next 4 years. The wide variation in these estimates is further evidence of the degree of uncertainty and subjectivity associated with long-range forecasts of bank resolution costs. However, they do further support the fact that the Bank Insurance Fund, already in a deficit position, faces further significant exposure to losses from troubled banks.

ADEQUACY OF FUNDING PROVIDED UNDER
THE FDIC IMPROVEMENT ACT IS DEPENDENT
ON FUTURE EVENTS

The FDIC Improvement Act provided FDIC increased authority to borrow funds to cover both losses and working capital needs for resolving troubled institutions. The act increased FDIC's authority to borrow funds from the Treasury on behalf of the Bank Insurance Fund and the Savings Association Insurance Fund (SAIF)⁶

⁶SAIF was established by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) to insure the deposits of federally insured savings associations (thrifts) and thrift deposits acquired by so-called "Oakar" banks under section 5(d)(3) of the Federal Deposit Insurance Act. FIRREA also established the Resolution Trust Corporation (RTC) to resolve troubled thrifts whose accounts had been insured by the Federal Savings and Loan Insurance Corporation (FSLIC), and that had been, or will be, placed into conservatorship or

to cover losses incurred in resolving troubled institutions to \$30 billion. However, it requires FDIC to recover these funds through premium assessments charged to insured institutions. Additionally, the act established a formula to limit the amount of outstanding FDIC working capital borrowings. These funds are to be repaid primarily from the management and disposition of failed financial institution assets.

The adequacy of the funding the act provides to deal with the Fund's exposure to troubled institutions is subject to many uncertainties. FDIC's ability to repay working capital borrowings is dependent on its ability to collect recoveries anticipated from the management and disposition of failed institution assets. Actual recoveries depend on current and future economic and market conditions. To the extent recoveries fall short of expectations, additional loss funds may be needed to cover the shortfall. Furthermore, as we have stated previously, the Fund's long-term exposure to losses from troubled institutions cannot be precisely projected. While the \$30 billion in loss funds appears sufficient to cover the losses from those troubled institutions FDIC has identified as likely to fail in the next 2 years, any additional institutions that may require assistance could create the need for increased funding.

receivership from January 1, 1989, through August 8, 1992.

The thrift industry's future condition is another uncertainty that may significantly affect the adequacy of the act's funding. Through September 30, 1993, SAIF will share resolution responsibility with RTC.⁷ At that time, responsibility for resolving all federally-insured thrifts will be shifted to SAIF. To the extent favorable interest rates delay thrift failures due to these thrifts' ability to realize short-term profits, responsibility for resolving these troubled thrifts, and the associated costs, will be borne by SAIF.

SAIF is currently barely solvent and will not have a substantial fund balance as of September 30, 1993, when it assumes resolution responsibility for troubled thrifts. If SAIF incurs costs from resolving troubled thrifts in excess of its other funding sources, FDIC could be forced to use some of the \$30 billion in borrowing authority provided under the FDIC Improvement Act to cover SAIF's losses. This, in turn, would reduce the Bank Insurance Fund's level of loss funds.

⁷The Resolution Trust Corporation Refinancing, Restructuring, and Improvement Act of 1991, enacted on December 12, 1991, extended RTC's resolution authority to thrifts placed into conservatorship or receivership through September 30, 1993. Additionally, the act provides that any thrift requiring resolution after September 30, 1993, which had previously been under RTC conservatorship or receivership, may be resolved by RTC.

EFFORTS TO RECAPITALIZE
THE BANK INSURANCE FUND

The FDIC Improvement Act contains provisions to rebuild the Fund's reserves to the designated reserve ratio of 1.25 percent of insured deposits established by FIRREA, and to require FDIC to implement a risk-based premium system. Consistent with these provisions, FDIC recently announced its plans to increase the assessment rate to 28 cents per \$100 of domestic deposits, effective January 1, 1993. The proposed rate increase is based on FDIC's analysis of the condition of the Fund and its ability to achieve the designated reserve ratio over the next 15 years.

FDIC also recently proposed to shift to a risk-based premium system, effective January 1, 1993. Insured institutions would be charged assessments ranging from 25 cents to 31 cents per \$100 of domestic deposits. The rates would vary from institution to institution based on capital level and the regulators' assessment of the institution's health. If FDIC implements this premium structure on January 1, 1993, it estimates that an assessment rate of 28 cents would become the average assessment rate for insured institutions.

Even under the proposed assessment rate increase, considerable risk exists that the Fund will not achieve the designated reserve ratio within the maximum 15-year period the act

requires. The proposed assessment rate increase is 2 cents per \$100 of insured deposits (7 percent) below the rate FDIC used in developing its revenue projections for the Fund and for assessing its ability to achieve this reserve ratio by 2006. Even with an assessment rate of 30 cents per \$100 of domestic deposits, FDIC's projections show that the Fund has less than a 70 percent probability of achieving the designated reserve ratio by 2006. At 28 cents, the proposed assessment rate, the probability of the Fund achieving the designated reserve ratio decreases to about 60 percent.

While FDIC's projections indicate that an assessment rate of 30 cents could be gradually lowered as the Fund's insurance losses decline, the uncertainties that may ultimately impact asset recovery values, costs from future resolution activity, and the level of loss funds that will actually be available to the Fund, make it important that the Fund's reserves be replenished as expeditiously as possible. The last 4 years have shown that unexpected events such as economic downturns and their resulting impact on the banking industry can quickly lead to significant bank failures that can deplete reserve levels once considered to be healthy. There is no empirical formula to show that the designated reserve ratio of 1.25 percent will sufficiently capitalize the Fund and enable it to deal with existing and future exposure to losses. Even this level of reserves may be low when compared to the increased risks in the banking industry. However, it is a target

that should be achieved through industry assessments to avoid further borrowing from the taxpayers to finance losses from financial institution failures.

FLEXIBLE ACCOUNTING RULES HINDER
EFFECTIVE IMPLEMENTATION OF THE
FDIC IMPROVEMENT ACT OF 1991

The FDIC Improvement Act requires accounting, auditing, and regulatory reforms to facilitate timely warning of troubled institutions and to minimize costs to the bank and thrift insurance funds. These reforms include prompt regulatory actions triggered by capital levels and safety and soundness standards (tripwires), full-scope examinations, annual audits of financial statements, and management reporting on internal controls and compliance with safety and soundness laws and regulations.

A common underpinning of these reforms is the need for accurate and consistent financial reporting. However, our review of failed banks⁸ showed that flexible accounting rules used to prepare financial reports enabled banks to conceal loan losses. Our more recent work shows that neither the private standard-setters nor the regulators are likely to correct this critical problem.

⁸Failed Banks: Accounting and Auditing Reforms Urgently Needed,
(GAO/AFMD-91-43, April 22, 1991).

As you know, our study of 39 failed banks showed that call reports submitted by the banks prior to their failure did not warn regulators of the true magnitude of the deterioration in the banks' financial condition. Asset valuations FDIC established after these banks failed showed that additional loss reserves were needed to cover the deterioration in asset values. The banks had recorded reserves of only \$2.1 billion to reflect the decreased values of their assets, while, after the failures, FDIC found that reserves of \$9.4 billion were needed to reflect the fair value of the assets. In other words, \$7.3 billion in asset values or capital that the banks reported simply was not there.

Internal control weaknesses contributed to delays in recognizing these losses. Also, the disruptive process and liquidation focus inherent in resolving failed banks are partially responsible for the different loss estimates. But, we believe the accounting rules were a major factor that allowed bank management to unduly delay the recognition of losses and masked the need for early regulatory intervention. The primary areas of the banks' balance sheets that accounted for the increase in loss reserves from \$2.1 billion to \$9.4 billion were deterioration in (1) the quality of the banks' loan portfolio and (2) the value of assets acquired through foreclosure revealed by the FDIC's review after failure.

Since our April 1991 failed banks report, we have been working closely with the Financial Accounting Standards Board (FASB) to tighten the accounting rules for recognizing and measuring losses from nonperforming loans. We conducted a detailed analysis of the applicable accounting rules to determine exactly where the flaws were that were contributing to the unreliable financial reports. FASB and the bank and thrift regulators reviewed our draft report, which we just issued in final.⁹ The unfortunate conclusion in the report is that the flawed accounting rules are unlikely to be fixed. We believe the problem is that there is a reluctance to value nonperforming loans at values that reflect fair value conditions.¹⁰

The regulators acknowledged that the applicable accounting rules were ambiguous and resulted in various applications. However, they believe that FASB should address concerns with the accounting rules and that the regulators' practices and ongoing efforts to clarify evaluation of troubled loans will resolve our concerns. The regulators referred to their November 1991 Interagency Policy Statement as an example of their most recent efforts to clarify this concern. However, the statement emphasizes that markets in today's economic environment are not representative

⁹Depository Institutions: Flexible Accounting Rules Lead to Inflated Financial Reports, (GAO/AFMD-92-52, June 1, 1992).

¹⁰Fair value is the amount that the debtor could reasonably expect to receive in a current sale between a willing buyer and a willing seller other than in a forced or liquidation sale.

of fair values and discourages the use of such transaction data in valuing troubled loans. Therefore, we remain concerned that nonperforming loans are not being valued consistently on a fair value basis, and that asset values and capital are overstated as a result.

FASB's draft standard for loan impairment, which the Board has not yet approved, reflects progress in improving loan loss accounting, but it fails to require loss estimates that reflect fair value--a major weakness that is leading to overstated asset values and capital.

The draft standard is an improvement in that it will require (1) creditors to determine whether debtors are able to repay all amounts due (principal and interest) according to the terms of the loan agreements and (2) cash flows to be estimated using present value techniques. Previously, creditors judged a loan's collectibility by comparing the carrying value of the loan to the undiscounted cash flows. We believe that judging a debtor's ability to repay all amounts due and recognizing the time value of money through discounting techniques are more appropriate accounting rules to determine if a loss has been incurred.

However, the draft proposed standard does not require market transaction data to be used in valuing cash flows from the collateral for the troubled loan or market interest rates to be

used in discounting cash flows. Further, the proposed standard does not change the loss recognition criteria from the current "probable" criteria, which is undefined in the accounting literature and has been inconsistently applied, to a criteria which would result in more timely recognition of losses. We have recommended that "probable" be replaced with "more likely than not," in order to emphasize that losses should be recognized if there is at least a 51 percent probability of loss. The bottom line is that FASB's proposal will likely result in loan loss reserves that fail to recognize the full impairment of troubled loans.

The role of accounting is to report the facts. The troubled real estate market is a reality that has very much adversely affected the recovery values of collateral for nonperforming loans. Although writedowns of such assets to fair values will negatively impact bank capital, the result will be a clearer and more accurate picture of the banks' financial position. The FDIC Improvement Act provides essential reforms to improve federal oversight of banks and thrifts and to protect the insurance funds. Reliable financial data on the condition of the institutions is fundamental to the success of these reforms. The regulators need to be able to rely on the accuracy of reported bank capital.

Capital levels are the trigger points for regulatory action to protect the insurance funds under the FDIC Improvement Act. The

FDIC's recently proposed risk-based premiums are also determined partially through bank capital levels. Further, the regulators are considering rules regarding bank access to brokered certificates of deposit using capital levels as a key determinant. Meeting capital levels is indeed a "high stakes" requirement. There is an incentive for management of weak banks to use the latitude in accounting rules to delay loss recognition as long as possible, resulting in inaccurate financial reports that impede early warning of troubled banks and add to insurance losses.

As stated in our recent report on flexible accounting rules, we believe that the Senate and House Banking Committees may want to urge the regulators to adopt accounting rules that will reflect the fair value of nonperforming loans for regulatory financial reports. The Committees may also wish to urge FASB to adopt such accounting rules as the principles for impaired loans that are currently being developed. Absent the adoption of such accounting rules by either the regulators or FASB, the Congress may wish to consider legislation imposing such requirements for financial reports prepared for the banking regulators. Generally, we do not advocate the use of accounting principles that differ from generally accepted accounting principles (GAAP). However, the use of regulatory accounting principles (RAP) in this instance would strengthen GAAP in the critical area of loan loss accounting and should not be confused with previous uses of RAP that weakened GAAP for savings and loans.

Other Accounting Rules

That Cause Concern

For the nation's banks, investment securities represent about 20 percent of assets, second only to loans which comprise about 60 percent of assets. Investment securities portfolios comprise about 30 percent of assets for banks with less than \$100 million in assets and about 10 percent for the largest banks with more than \$30 billion in assets. Flexible accounting rules for investment debt securities are contributing to practices that allow banks to recognize gains and defer recognizing losses--a practice known as "gains trading" or "cherry picking."

Debt investment securities are included in a bank's investment portfolio, as opposed to its trading account, when management has the ability and intent to hold the securities for investment purposes. Trading account securities, which comprised an average of 1 percent of bank assets at December 31, 1990, are held by banks for short-term liquidity and speculative trading purposes, not for long-term investment. Trading account securities are generally accounted for at market value. Debt investment securities held by banks are recognized in financial statements at historical cost, adjusted for amortization of premiums or discounts from the face amount of the security. Thus, changes in their value due to fluctuations in interest rates or credit quality determinations

made in the market place after their acquisition are generally not recognized.

Banks may choose to recognize gains by selling securities that have appreciated in value, while retaining securities in their portfolio that have declined in value. Because debt investment securities are accounted for at historical cost, management can significantly impact earnings, and defer significant losses, through such strategies. It should also be recognized that banks are not currently required to account for the impact that interest rate changes, which may have given rise to such gains, will or have had on the liabilities and informal hedges related to the securities sold. Thus, gains can be recognized while economic losses in other debt investment securities, and in liabilities relating to debt investment securities, are deferred.

FASB is working on a proposed accounting rule change to consider market value accounting for debt investment securities and related liabilities matched to the investment. There are difficult issues associated with valuing these assets and liabilities on a market value basis, and FASB does not plan to issue an exposure draft for comment until the third quarter of this year. Assuming that the difficult valuation issues can be worked out, we believe that a market value basis of accounting for debt investment securities and related liabilities would result in more accurate reporting of bank assets and capital. Banks are heavily invested

in debt securities that are adversely affected by rising interest rates. They are currently making profits on the favorable interest rate margin between their cost of funds and investment earnings. That positive interest spread could change if interest rates begin to rise and could change dramatically if interest rates were to rise rapidly such as happened in the late 1970s when the savings and loan industry lost billions in equity.

Another area of concern is the accounting and auditing standards for related party transactions. We do not believe these standards ensure fair presentation of such transactions. When the terms of related party transactions differ from the transactions' substance, existing accounting rules appear only to require disclosure in notes to the financial statements. Further, accounting rules do not specifically require that the economic substance of these transactions be given accounting recognition in financial statements.

The continued creation of large bank holding companies and industry exposure to the Bank Insurance Fund are such that additional standard setting is needed to ensure fair reporting of related party transactions. Given the current accounting rules and auditing standards, it is likely that auditors will identify only the most egregious transactions requiring appropriate accounting or a qualified audit report. We believe that accounting rules and auditing standards need to be revised to ensure that related party

transactions are accounted for based on economic substance when the substance of transactions are materially different than their legal form.

Review of Accounting Rules

Required by FDIC Improvement Act

Related to our concern regarding the accounting rules, the FDIC Improvement Act sets objectives for accounting principles applicable to reports filed with federal banking regulators by insured depository institutions. It also requires that each regulator review within 1 year all accounting principles the institutions use relating to reports they file with the regulators. The act provides that accounting principles should:

- result in financial statements and reports of condition that accurately reflect the capital of such institutions,
- facilitate effective supervision of the institutions, and
- facilitate prompt corrective action to resolve the institutions at the least cost to the insurance funds.

We believe that the accounting rules for nonperforming loans, investment securities, and related party transactions are at odds with the objectives of accounting principles established by the act

for reports prepared by depository institutions for the regulators.

INDEPENDENT AUDIT COMMITTEES

ARE NEEDED TO STRENGTHEN

CORPORATE GOVERNANCE

Our failed banks report identified numerous deficiencies in internal controls, financial reporting, and compliance with laws and regulations at failed institutions. Certainly, the regulators have a responsibility to identify and obtain correction of such weaknesses in a timely manner. However, the report also pointed out that an effective system of corporate governance, including an audit committee, should have identified the deficiencies and caused them to be corrected before they contributed to the banks' failure.

The FDIC Improvement Act imposes several financial management requirements on insured depository institutions with assets of \$150 million or more. It requires bank management to annually assess and report on the condition of its internal controls and compliance with laws and regulations related to safety and soundness identified by the regulators. The institution's external auditor is required to report on management's assertions as an independent check on their validity. The act also requires independent audit committees and establishes specific requirements for committee members of large institutions. These are important reforms to address serious deficiencies. The regulators are currently

drafting detailed regulations to implement these requirements. We have made suggestions to the regulators over the past few months to ensure that the many technical issues related to these reforms are appropriately addressed in the regulations. We will be evaluating the draft regulations when they are issued for formal comment, which we understand will be around the end of this month.

I would like to say a few words about the current condition of audit committees, their unique responsibility, and what needs to be done. In our review of audit committees¹¹ of banks with \$10 billion or more in assets, many audit committee members told us they lacked independence, lacked the expertise related to their responsibilities as audit committee members, and lacked adequate information on internal controls and compliance with laws and regulations in key areas of the bank's operations. Clearly, this is an unacceptable situation.

The audit committee is charged with the unique responsibility of overseeing management's fulfillment of its fiduciary obligation to maintain a sound system of internal controls to safeguard assets, comply with laws and regulations, and produce accurate financial reports. In 1985, the National Commission on Fraudulent Financial Reporting (Treadway Commission), which was formed to look for ways to minimize the incidence of fraudulent and misleading

¹¹Audit Committees: Legislation Needed to Strengthen Bank Oversight, (GAO/AFMD-92-19, October 21, 1991).

corporate disclosures, also took the view that audit committees were a key component of corporate governance. The Commission stated: "The mere existence of an audit committee is not enough. The audit committee must be vigilant, informed, diligent, and probing in fulfilling its oversight responsibilities."

The audit committees of insured depository institutions created under the FDIC Improvement Act should have the independence, personnel and financial resources, information, and authority necessary for them to effectively fulfill their corporate governance role. This should lead to earlier identification and correction of deficiencies in internal controls and compliance with laws and regulations, and more reliable information for management, regulatory agencies, and the public. To ensure that the audit committee can obtain the information it needs to fulfill its responsibilities, the audit committee should oversee both internal and external auditors. Such a role will heighten audit committees' accountability, but we believe such responsibilities are appropriate and have suggested that they be included in the regulations being drafted to implement the act.

We believe the FDIC Improvement Act provides a framework for efficient and effective working relationships among insured institutions' management, its auditors, audit committees, and regulators. We plan to monitor its implementation carefully to ensure that these opportunities are not overlooked. I would like

to stress that the accounting, auditing and regulatory reforms contained in the act should not be weakened, especially when there are government borrowings and taxpayer funds at risk.

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Mr. Chairman, this concludes my prepared statement. My colleagues and I will be pleased to answer any questions you or the Members of the Committee may have at this time.