United States General Accounting Office

GAO

Testimony

For Release
on Delivery
Expected at
10:00 a.m. EST
Wednesday
December 11, 1991

Comprehensive Deposit Insurance Reform and Taxpayer Protection Act of 1991:

Observations on Accounting Reforms and Funding for the Bank Insurance Fund

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

Before the
Committee on Banking, Finance and Urban Affairs
House of Representatives

GAO/T-AFMD-92-3

GAO Form 160 (12/87)

Mr. Chairman and Members of the Committee:

We appreciate the opportunity to appear before you today to discuss the Comprehensive Deposit Insurance Reform and Taxpayer Protection Act of 1991 recently passed by the Congress.

The legislation contains the accounting, auditing, and regulatory reforms that are critically needed safeguards. As we have stated on many occasions over the last several years, they are essential in order to strengthen the safety and soundness of the banking industry, and provide regulators a more accurate early warning of emerging problem institutions.

Since 1990, when we reported on the precarious condition of the Bank Insurance Fund, we have supported funding for the insurance fund to enable the regulators to resolve problem institutions in a timely manner. The legislation was the culmination of many months of hard work on the part of Chairman Gonzalez, Mr. Wylie, and other members of this Committee, as well as the leadership and membership of the Senate Banking Committee. You are to be commended for your leadership in passing a bill that (1) provides the $70 billion requested by the administration, and (2) provides for sound corporate governance and strengthened regulatory oversight of the banking industry.

As specifically requested in your letter, the testimony today will address my views on two critical components of the legislation--the level of funding the bill provides for the Bank Insurance Fund and the accounting reforms. I want to dispel any concerns that we are critical of these provisions.

Funding Provided for The
Bank Insurance Fund

The legislation provides the Fund with approximately $70 billion in borrowing authority to resolve problem institutions. Of this amount, $30 billion is to be provided for losses incurred by the Fund in resolving troubled institutions, which is to be repaid by the banking industry over a 15 year period through premium assessments. The other $40 billion is to be provided for working capital needs of the Fund, and is expected to be recovered through the sale of assets of failed institutions. These funds are clearly needed to allow the regulators to act quickly and decisively to resolve problem institutions to prevent the ultimate cost to the Fund from bank failures from escalating. The Fund's reserves were reported by FDIC to be about $2.4 billion as of September 30, 1991. Thus, the funding provided under the legislation for the insurance fund was absolutely essential to ensure that the regulators are not delayed in resolving problem institutions.

At the same time, we all recognize that there are significant uncertainties affecting estimates of funding needs. We addressed these concerns in September 1990, when we provided Congress with a warning that the Bank Insurance Fund was clearly in trouble[1]. Our April, August, and November 1991 reports and testimonies[2] also discussed these concerns. Regarding funding needs, we disclosed that the Fund's reserves at December 31, 1990, were dangerously low, and that the Fund in all likelihood would be insolvent by December 31, 1991. We also reported that the Fund faced costs from bank failures over the next 1 to 3 years of at least $31 billion. Additionally, we disclosed that the Fund faced a significant shortage of working capital to finance bank resolutions. FDIC's most recent baseline projection reflects estimated costs of $33 billion associated with expected bank failures, and is similar to our estimates of the minimum identifiable costs the Fund will incur. FDIC also projected a more pessimistic estimate of $43 billion in costs from bank failures if the nation experiences a prolonged recession.

Both we and FDIC have stated that these estimates are subject to significant uncertainties. Because of these uncertainties, both sets of estimates could understate the ultimate costs to the Fund from bank failures. As we stated in our report on the results of our audit of the Bank Insurance Fund's 1990 financial statements:

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

[2] Rebuilding the Bank Insurance Fund (GAO/T-GGD-91-25, April 26, 1991), Financial Analysis: Short-Term Funding Needs of the Bank Insurance Fund and the Resolution Trust Corporation (GAO/AFMD-91-90, August 22, 1991), and Financial Audit: Bank Insurance Fund's 1990 and 1989 Financial Statements (GAO/AFMD-92-24, November 12, 1991).

"The Congress is considering legislation that would increase FDIC's borrowing authority for the Fund to approximately $70 billion, the exact amount depending on the effect of a formula for limiting the Fund's outstanding obligations. However, the amount of funds that will ultimately be needed to resolve failing institutions depends on current and future economic conditions, and may thus be significantly higher than the amount of funds FDIC may receive under the proposed legislation."

Other factors, such as the oversupply of commercial real estate, and the quality of financial reports prepared by bank management, may also significantly affect the accuracy of estimates of funding needs. Finally, the unexpected collapse of any one major banking institution not presently included in any of the estimates of projected failures could significantly increase the amount of funding needed to resolve problem institutions.

Our estimates, and those of FDIC, use historical loss rates experienced by FDIC in resolving past troubled institutions to project estimated costs of future bank failures. However, use of historical loss rates fails to consider the affects of current and future events which could render past experience on bank failure and assistance transactions virtually meaningless. For example, loss rates based on 5- to 10-year historical experience do not take into account the significant change in the composition of the banking industry's loan portfolio. Throughout the latter half of the 1980s, bank lending practices shifted toward riskier lending strategies that may dramatically increase the costs associated with future bank failures.

Historically-driven loss estimates also do not take into consideration the severe economic deterioration that has occurred in many parts of the country. Further, they do not consider the implications of the tremendous growth in the level of government-held assets that has occurred just within the past two years on the ultimate cost of bank failures. The significant overbuilding of commercial properties that occurred in the 1980s resulted in a large oversupply of commercial properties and, consequently, a severe slump in the commercial real estate market that many economists and business leaders now estimate will take many years to recover.

Additionally, the continuing high levels of bank failures and the resolution of hundreds of insolvent thrift institutions by the Resolution Trust Corporation (RTC), has led to a tremendous oversupply of government owned assets on the marketplace. This oversupply could severely hinder FDIC's ability to generate recoveries on future asset sales, thus substantially increasing the Bank Insurance Fund's ultimate cost of resolving problem institutions.

Another factor limiting the adequacy of any loss estimation process is the quality of the call report data the banks prepare for the regulators. Like FDIC, we used information from quarterly call reports extensively in our analysis of the financial condition of banks. While we did not review the overall quality of call reports, we found examples of inaccuracies in the call report data for a number of these banks. In addition, we have noted that examiners have cited deficiencies in bank call reports. For example, in our study of 39 large banks[3] which failed in 1988 and 1989, we found that regulators cited inadequate reserves being reported in the call reports of 31 of the 39 banks. The level of these understatements and their impact on the institution's financial condition varied, but we found that some of the asset classifications the examiners recommended would have significantly altered the reported financial condition of the institutions.

Because a bank's financial reports do not always reflect its true financial condition, the institutions we reviewed may be in a more severely deteriorated financial condition than we reported. Additionally, institutions not identified as problem banks by the regulators may, in fact, be in poor financial condition. The questionable quality of financial information reported by banks could thus result in our loss estimates, and those of FDIC, significantly understating the loss exposure facing the Fund.

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

The administration's funding request, which was provided in full in the banking legislation, was based on estimates of cash outlays and costs associated with institutions that FDIC believes will fail or require assistance through December 31, 1993. The FDIC Chairman recently stated in a hearing before the Senate Banking Committee that no large "megabanks" were included in the funding estimates. While we are not saying that any particular money center bank is on the verge of failing, the questionable quality of bank call report data, coupled with deficiencies in existing accounting standards, provides the potential for a large bank to unexpectedly require assistance. If this were to occur, the level of funding provided in the legislation would not be sufficient to resolve the institution and those other institutions the regulators have projected will require assistance between now and the end of 1993.

In summary, the funding authority provided by the banking legislation is absolutely essential and we firmly support it. Also, it is not a criticism to recognize that the ultimate funding needed to resolve the troubled sector of the banking industry is unknown due to the economic and accounting uncertainties I have discussed.

Accounting Rules Enable

Banks to Conceal Loan Losses

I would now like to answer the second question you asked me to address--what additional accounting reforms do I believe are necessary but were not addressed by Congress in the banking legislation. I believe the accounting reforms provided by the legislation are indeed responsive to the findings of our April 1991 report on the 39 failed banks. In fact, the timing and thrust of the legislation provides the framework to deal with the continuing problem of flawed accounting rules that allow banks to conceal loan losses.

The private standard-setting bodies now must address the specific flawed accounting rules that we have identified. It is in this context that I have been publicly stating that it is critically important for the accounting standard-setting bodies to change accounting rules so they more accurately reflect the true financial health of banks.

As you know, our study of the 39 failed banks showed that call reports submitted by the banks prior to their failure did not provide regulators with advance warning of the true magnitude of the deterioration in the banks' financial condition and performance. Asset valuations established by FDIC 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 the regulators found after the banks failed 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 simply washed off the balance sheet.

We attributed the failure by bank management to accurately report the banks' condition to breakdowns in internal controls and to deficiencies in accounting rules that allowed bank management to unduly delay the recognition of losses and mask 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.

Bank managements' loss reserve estimates were purported to have been made in accordance with generally accepted accounting principles. We believe that the accounting rules for nonperforming assets--loans not paying based on their original contractual terms and assets acquired through foreclosure--must be tightened up because they allow bank management too much latitude in when to accrue losses and in determining carrying amounts for impaired assets. Bank management has a strong incentive to use this latitude in accounting rules to delay loss recognition as long as possible and avoid recognizing decreases from historical cost to market value because of the adverse effect this has on a bank's reported financial condition. Asset write-downs add to bank expenses and reduce bank capital. A bank's capital is the critical measure of its ability to absorb loan losses.

The definition of fair market value in the accounting standards is another area of flexible accounting rules that can result in overstated asset values. Existing accounting rules permit the use of fair market values based upon assumptions of a so-called "normal market" and one where the seller is not compelled to sell. These assumptions are frequently not usable when a bank is experiencing financial difficulties and when regulators are required to dispose of a failed bank's assets. As a rule, regulators dispose of failed bank's assets under existing market conditions, which result in much lower fair market values than those that result from using the hypothetical fair market value definition in existing accounting standards.

An effective early warning system is paramount for regulating financial institutions and for determining an accurate estimate of the Bank Insurance Fund's needs. Without accounting rules that generate realistic asset values, it is impossible to know the true worth of a financial institution and also impossible to have an effective regulatory early warning system (i.e. the "tripwires" just enacted) for financial institutions. The key to successful bank regulation is knowing what banks are really worth.

As part of the solution for making the early warning system more effective, we recommended in our 39 failed banks report that the accounting standard-setting bodies--the Financial Accounting Standards Board (FASB) and the American Institute of Certified Public Accountants (AICPA)--should revise accounting principles for identifying and measuring loss contingencies so that the value of banks' problem assets is promptly recognized based on existing market conditions. Also, we recommended that if the accounting standard-setting bodies are unable to resolve the issue during 1991, they should notify the appropriate regulatory bodies for depository institutions. In the absence of prompt resolution of the above concerns by the accounting rules setting community, we recommended that the FDIC, the Office of the Comptroller of the Currency, and the Federal Reserve Board promulgate accounting standards for financial institutions along the lines we recommended.

In other words, I believe that the authorities who set accounting rules for the private sector should be given the opportunity to work out a solution to the need for better accounting rules. This past year, we have been working very hard with the FASB and others to tighten up the accounting rules. In that respect, I would like to submit for the record some of our letters and proposals. Reaching consensus on accounting rules is much like enacting legislation: it is a difficult process with many interests to be heard from. We are continuing to work with the FASB and expect to know their intentions within the next few months. If the accounting standard setting bodies are unable to arrive at an acceptable solution, then the banking reform legislation provides the appropriate charge to the regulators to adopt accounting rules that will provide for accurate financial reporting and disclosures.

Unfortunately, the economy continues to falter and the Congress and the regulators, now more than ever, need reliable financial data. In that respect, I am concerned that the November 7, 1991, Interagency Policy Statement on the Review and Classification of Commercial Real Estate Loans may seriously add to the problem of unreliable financial data by allowing real estate evaluations that hide loan losses. We have concerns that too much emphasis is being placed on the return to "normal" conditions in depressed real estate markets, with little emphasis on current market conditions--the very condition we found in our study of 39 failed banks. As a result, there will be more banks failing without reasonable warning, the extent of losses will be hidden, and the regulatory process will be severely hampered.

Further, the interagency policy statement seems to place more of a burden on the examiner who disagrees with judgements by banks on which loans should be classified and on the amount of necessary reserves for loan losses. In the past, the independent judgement of the examiner limited the discretion of banks in interpreting accounting rules. The policy statement appears to limit the examiner's right to exercise his best judgement. It has been the intention for the examiner to be a primary force preventing the manipulation of accounting to conceal losses and risks. If that force is handcuffed, the effectiveness of independent public accountants auditing financial statements will also be limited. They will be in a very difficult position to argue for reserve levels that differ from those accepted by examiners.

We believe that the interagency policy statement is at odds with the objectives of accounting principles for financial institutions set by the banking reform legislation; namely, 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.

The regulators will hold a meeting of senior examiners on December 16 and 17 to review the interagency policy statement. We will be interested to see how the regulators resolve the apparent dilemma of conflicting direction from the administration and the recently passed bank legislation.

As a further observation, a March 22, 1991, op-ed piece written by Lawrence J. White, a former Federal Home Loan Bank Board member, for the Wall Street Journal is very insightful. He wrote the article in response to the administration's loan-splitting proposal.

"Ten years ago, in response to similar pressures, the S&L regulators began their march down the same road of accounting forbearance. Weak or insolvent thrifts were made healthy on paper. Hundreds of S&Ls took advantage of these false appearances to 'grow their way out of their problems.' We now know the horrendous costs of that escapade." Mr. White went on to say:

"The regulators should face up to reality and require the writedowns that would bring banks' assets closer to current market values. More banks would be shown to be insolvent or close to insolvency. But that is the truth that the markets have been trying to tell the regulators."

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Mr. Chairman, the nation needs to know the facts. If the real economic facts show a larger problem, the leaders of government and the private sector should provide program initiatives to deal with those problems. I would like to again emphasize that the accounting and auditing reforms and the funding authority for the Bank Insurance Fund provided by the banking legislation through the diligent efforts of this committee and the Senate Banking Committee are without question responsive to our recommendations. This concludes my prepared statement. I would be pleased to answer any questions.