SHADOW FINANCIAL REGULATORY COMMITTEE

Administrative Office
c/o Professor George Kaufman
Loyola University of Chicago
820 North Michigan Avenue
Chicago, Illinois 60611
TEL (312) 915-7075
FAX (312) 915-6118

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For information contact:

Paul M. Horvitz
713-743-4765

Robert A. Eisenbeis
919-962-3203

Franklin Edwards
212-854-4202

Statement of the Shadow Financial Regulatory Committee

on

Proposed Lengthening of Examination Schedules and Required Independent Audits for Thrift Institutions

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Two separate developments threaten the quality and quantity of information available to monitor the financial condition of insured depository institutions. First, a provision of the Community Development Bank Act would lengthen the maximum time between bank examinations from 12 to 18 months for banks with assets less than $250 million. Second, the Office of Thrift Supervision (OTS) has published a proposed rule which would eliminate the mandatory audit requirements for thrift institutions with assets less than $500 million.

Regulatory Examinations

Effective implementation of the prompt corrective action and least cost resolution provisions of FDIC Improvement Act of 1991 requires accurate measurement of institutions' net worth. Absent a well functioning market valuation system to measure net worth and to monitor its changes, the Committee is concerned about the availability of sufficient and timely information -- especially on the adequacy of loan loss reserves and nonperforming (or classified) assets that are a principal focus of the examination process. This information has proved to be important in identifying emerging problems in insured depository institutions and in reducing losses to the insurance funds.

For this reason, the Committee believes that the setting of examination frequency should be based upon a comparison of the costs of gathering examination data more frequently with the expected loss to the insurance fund resulting from a rapid decline in an institution's net worth. Indeed, agency spokespersons have frequently asserted that bank asset values can change abruptly, which would argue for a shorter, rather than a longer cycle. Some evidence suggests that losses to the insurance funds are lower for institutions examined on a yearly, as opposed to a longer, cycle. The frequency of examinations should not be reduced until evidence is provided on the effects of a proposed change on expected losses to the insurance fund.

Independent Audits

OTS justifies its proposed elimination of an independent audit requirement for small S&Ls on the grounds that small banks are not required to have independent audits. However, in this case the Committee believes that consistency would be better achieved by requiring independent audits of all commercial banks, as the Committee recommended in 1989 (Policy Statement 83, May 15, 1989).

Independent audits by outside certified public accountants (CPAs) play an important role for smaller institutions and for those whose shares are not publicly traded. Such institutions are less likely to have a sophisticated internal audit function in place and are less likely to have a highly knowledgeable and independent board of directors' audit committee.

Independent audits supplement examinations in important ways. They provide at least a partial "second opinion" on the asset valuation techniques employed by examiners. Both examiners and CPAs do consider the adequacy of internal controls in banks they examine. But examiners have stressed that they are not conducting an audit, and they do not conduct an in-depth search for fraud. Nevertheless, outside CPAs have often uncovered fraud in the course of their audits. In view of the attention that fraud has received as a source of insurance fund losses during the 1980s, it seems inappropriate to eliminate this protection. This becomes all the more important if the interval between examinations increases. Fraud and misappropriation of resources are much more likely to cause the failure of a small institution than a large one.

The independent auditor is responsible for seeing that an institution's financial statements conform to generally accepted accounting principles (GAAP). Although GAAP practices do not report market values (in particular, the effect of interest rate changes on the value of loans is not recorded), they do provide numbers that give insight into an institution's operations and financial position.

Finally, the requirement for a mandatory audit helps to counter certain conflicts of interest within an institution. Directors, for example, may be reluctant to push management for an independent audit for fear of jeopardizing their positions on the board.

The Committee recognizes that an audit of the financial statements and internal controls imposes a cost of doing business for a bank, as it is for other corporations to which the public has entrusted its funds. However, in the absence of an independent audit, the cost would be borne by the examiners and the insurance fund.