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United States General Accounting Office

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High-Risk Series

December 1992

Medicare Claims





United States
General Accounting Office
Washington, D.C. 20548

Comptroller General
of the United States

December 1992

The President of the Senate
The Speaker of the House of Representatives

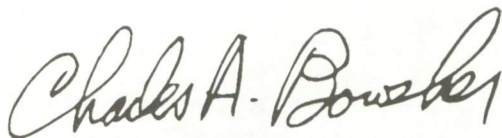
In January 1990, in the aftermath of scandals at the Departments of Defense and Housing and Urban Development, the General Accounting Office began a special effort to review and report on federal government program areas that we considered "high risk."

After consulting with congressional leaders, GAO sought, first, to identify areas that are especially vulnerable to waste, fraud, abuse, and mismanagement. We then began work to see whether we could find the fundamental causes of problems in these high-risk areas and recommend solutions to the Congress and executive branch administrators.

We identified 17 federal program areas as the focus of our project. These program areas were selected because they had weaknesses in internal controls (procedures necessary to guard against fraud and abuse) or in financial management systems (which are essential to promoting good management, preventing waste, and ensuring accountability). Correcting these problems is essential to safeguarding scarce resources and ensuring their efficient and effective use on behalf of the American taxpayer.

This report is one of the high-risk series reports, which summarize our findings and recommendations. It describes our concerns over the Medicare program's efforts to safeguard program dollars. Weaknesses in the Health Care Financing Administration's management of the program and insufficient funding of safeguard activities expose Medicare to unnecessary loss through waste, fraud, and abuse.

Copies of this report are being sent to the President-elect, the Democratic and Republican leadership of the Congress, congressional committee and subcommittee chairs and ranking minority members, the Director-designate of the Office of Management and Budget, and the Secretary-designate of Health and Human Services.

A handwritten signature in black ink that reads "Charles A. Bowsher". The signature is written in a cursive style with a large, prominent initial "C".

Charles A. Bowsher

Contents

Overview	6
Contractor Network Complicates Program Management	10
Management Weaknesses Contribute to Unnecessary Expenditures	12
Challenges Are Common to All Health Payers	22
Conclusions and Action Needed	26
Related GAO Products	28
High-Risk Series	31

Overview

The federally funded Medicare program is the nation's largest payer of health care benefits. In 1991 the program enrolled about 35 million beneficiaries and processed about 600 million claims, paying physicians and other providers over \$110 billion in medical benefits—about 15 percent of all the money spent on health care in the United States. All health insurers, including more than 1,000 private payers, face the need to control these high costs and are seeking to curb unnecessary expenditures lost through waste, fraud, and abuse.

Medicare is administered by the Health Care Financing Administration (HCFA), an agency of the Department of Health and Human Services (HHS). By law, HCFA contracts with private insurance companies to process Medicare claims and pay providers on the government's behalf and monitors the contractors' performance.

The Problem

In recent years, the Medicare program has lost billions of dollars to waste, fraud, and abuse. Though Medicare's losses cannot be quantified precisely, health industry experts estimate that fraud and abuse could account for as much as 10 percent of the nation's total health care costs.

The Causes

HCFA relies on numerous contractors to process Medicare's claims and to protect program funds through review activities called payment "safeguards." However, HCFA's inability to properly manage contractors' safeguard activities and too little money earmarked for these activities have left Medicare dollars exposed to loss and waste. For example, we have found that:

- Although many Medicare beneficiaries call in to complain about waste and abuse, contractors have often failed to investigate these complaints. In one case, follow-up on complaints about eye care services led to a provider's agreement to refund over \$2.5 million to the federal government.
- Hospitals owed Medicare over \$170 million in overpayments, but contractors did little to reclaim the money. HCFA, moreover, was unaware of contractor inaction because it had no systems to monitor this information.
- Contractors paid an estimated \$2 billion in claims that should have been paid by other health insurers.

Medicare is vulnerable to exploitation for other reasons: payment policies permit excessive reimbursement rates for certain

services, such as high-tech and laboratory services, and loose controls over who can bill Medicare have made the pursuit of fraudulent providers difficult.

**GAO's
Suggestions for
Improvement**

HCFA needs to exercise stronger leadership in managing the Medicare program. In particular, it needs to improve oversight of contractors' activities aimed at reducing waste, fraud, and abuse. HCFA also needs to reduce payments that are excessive and to tighten controls over who is allowed to bill the Medicare program. Finally, the Congress should modify budget procedures—that is, allow increased safeguard funding without having to cut spending elsewhere—to allow adequate and stable Medicare contractor funding for safeguard activities to be appropriated.

We have also emphasized that the threat of insurance fraud and abuse is endemic not just to Medicare but to the entire health care system. In a recent report and at congressional hearings, we have asked the Congress to consider establishing a national health insurance fraud commission—composed of public and private insurers, among others—that would develop

Overview

recommendations for combating health care fraud and abuse.

Contractor Network Complicates Program Management

Medicare is the fourth largest item in the federal budget after defense, social security, and interest payments on the national debt. Moreover, the program has grown considerably. Since 1975, beneficiary enrollment has grown from 25 million to about 35 million, while claims volume has increased by over 450 percent. In recent years, Medicare benefit outlays rose by 60 percent, from about \$70 billion in 1985 to over \$110 billion in 1991.

The Medicare program operates through a complicated administrative structure. More than 80 contractors process, pay, and review claims. This structure has been shaped by Medicare's historical dependence on private insurers to perform claims processing and payment review tasks.

To pay providers accurately and promptly, the law that established the Medicare program in 1965 provided for contracting with insurance companies—Blue Cross and Blue Shield plans and other private insurers. This arrangement was pragmatic in that insurance companies had both claims-processing experience and an understanding of the medical practices of their communities. Payment safeguard activities have also been largely contractor-managed

**Contractor Network Complicates
Program Management**

operations, permitting contractors broad discretion in acting to protect Medicare program dollars. As a result, there are significant variations in contractors' implementation of Medicare's payment safeguard policies.

Management Weaknesses Contribute to Unnecessary Expenditures

Over the years, the quality of contractors' administration of Medicare has been uneven, and HCFA has not adequately managed the contractor network to identify and correct program weaknesses. HCFA's lax management of the contractors has contributed to billions of dollars lost to waste, fraud, and abuse. For example, contractors have allowed complaints of fraud to go uninvestigated; had failed, until recently, to collect over \$170 million of overpayments to hospitals and other providers; and have paid nearly \$2 billion in claims that should have been paid by other insurers. Furthermore, certain Medicare payment policies have been overly generous and have unintentionally discouraged providers billing the program from prescribing services judiciously. Finally, in just a single case of fraud, Medicare lost over \$5 million due to loose controls over who can bill the program.

Inadequate Management and Reduced Funding Weaken Payment Safeguards

HCFA has not carefully monitored Medicare's payment safeguard activities, which vary by contractor and are left largely to the contractor's discretion. Moreover, reduced funding by the Congress for payment safeguard operations has caused contractors to focus more on paying claims quickly than

on reviewing the accuracy of payments made.

For example, until recently, HCFA provided virtually no guidance to Medicare contractors regarding the investigation of beneficiary complaints—a primary source of fraud, waste, and abuse leads. Contractors' failure to adequately investigate beneficiary complaints of provider fraud and abuse results in missed opportunities to (1) identify billings for services not rendered, (2) recover overpayments, (3) impose penalties, and (4) send a message to the provider community that fraudulent or abusive behavior will not be tolerated.

One case demonstrates the value of dealing with beneficiary complaints effectively. In that case, beneficiary complaints prompted the contractor initially to pursue a provider for billing irregularities. Upon further investigation, 100 apparently similar complaints surfaced, encompassing about 300 fraudulent claims. The provider involved agreed to refund over \$2.5 million to the federal government. HCFA has recently issued guidance instructing contractors on the proper handling of beneficiary complaints.

**Management Weaknesses Contribute to
Unnecessary Expenditures**

HCFA also did not give adequate guidance to Medicare contractors on recovering hospital overpayments. The refundable amounts, referred to by hospitals as credit balances, typically occurred when both Medicare and other insurers mistakenly paid for the same service or when Medicare paid twice for the same service. Many of the hospitals' credit balances had been outstanding for several years, despite attempts by some to repay the money.

The contractors we visited were doing little to identify amounts owed Medicare or to ensure that refunds were promptly recovered. Subsequently, in 1992 HCFA instructed Medicare contractors to have hospitals report amounts owed and to recover the mistaken payments. Over 9,000 hospitals and other providers reported \$171.7 million in Medicare overpayments, of which \$109.9 million had been repaid as of June 1992. HCFA recently implemented a reporting and tracking system to monitor such overpayments and ensure that they are promptly recovered.

These problems may be partly related to budget cutbacks that have affected program administration. Although Medicare's payment safeguard activities have been

consistently cost-effective—returning over \$11 for every \$1 spent since 1989—contractor budgets for these functions have not kept pace with the growth in claims volume. Specifically, from 1989 to 1992, claims volume rose by about 40 percent, while contractors' funding for payment safeguards was cut by about 4 percent.

Medicare's secondary payer program demonstrates Medicare's exposure to loss resulting from these cutbacks. In 1990 and 1991, we found a large inventory of potential mistaken Medicare payments that were not being investigated. Contractors were doing little to recover these claims, at least in part because their funding for these activities had been significantly reduced.

In mid-1991 HCFA implemented a system to track the outstanding amounts from the mistakenly paid claims. Contractors reported unrecovered payments amounting to over \$1.1 billion, along with a large backlog of additional claims for which overpayments had not been determined. We estimated that an investigation of these additional claims would reveal another \$1 billion in mistaken payments owed by primary insurers. In 1992 the Office of Management and Budget released additional

money to the contractors for recovery activities.

In its fiscal year 1993 budget, HHS increased funding for Medicare's payment safeguard activities to \$395.7 million, or 15.4 percent over the previous year's funding. The increase will allow contractors to begin replacing staff lost to cutbacks in prior years and begin accommodating the growing claims workload. Hiring and training the necessary staff and implementing expanded safeguard programs will take time; for this reason, the assurance of stable safeguard funding is needed. Payment safeguard activities save Medicare much more than they cost, but under federal budget procedures, safeguard funding can be increased only by cutting spending elsewhere. We believe the Congress should consider modifying the budget procedures to better ensure adequate and stable funding of Medicare's contractor safeguard activities.¹

¹Under the Budget Enforcement Act of 1990, the Congress provided for increasing appropriations for Internal Revenue Service compliance activities without necessitating spending cuts elsewhere. We suggest using this method of funding compliance activities as a model.

Flawed HCFA
Policies Expose
Medicare to
Waste and Abuse

Several Medicare payment policies have left the program vulnerable to provider abuse or excessive spending. For example, Medicare's high payment rates for advanced technology services have encouraged needless proliferation of diagnostic radiology equipment in certain localities. In addition, other policies overcompensate laboratory providers and health maintenance organizations (HMOs) for services rendered.

New medical technologies tend to spread rapidly once they are declared eligible for Medicare reimbursement. As new technology matures, reductions in equipment costs, improvements in efficiency, and increased utilization can decrease unit costs. In some cases, however, Medicare payment rates have not been lowered to reflect these decreased costs. This has encouraged the proliferation of high-cost, low-volume providers.

For example, Medicare payments for magnetic resonance imaging (MRI) services are based partly on the charges allowed by local Medicare contractors in the mid-1980s. The 1991 payment levels in some localities were more than twice as high as in others, reflecting wide geographic disparities in the historically allowed charges. Despite efforts

to standardize Medicare's payment for MRI services, HCFA did not fully adjust such payments to reflect declining unit costs. Accordingly, in 1992 we recommended that HCFA periodically adjust payment rates for these services and for other evolving technologies to reflect costs incurred by high-volume, efficient providers.

Medicare payments for laboratory services are also excessive. Laboratories' profit rates from Medicare business substantially exceed their overall profit rates, indicating that Medicare's fee schedules are too high. Comparable profit rates would mean that Medicare is neither subsidizing nor being subsidized by other payers. By reducing Medicare payments for laboratory services to equalize profit rates, Medicare would save approximately \$150 million annually. Accordingly, we asked the Congress in 1991 to consider legislation that would cap Medicare's payments for clinical laboratory tests and would ensure that Medicare's contribution to laboratory profits not exceed the laboratories' overall profit rate. Capping fees at 76 percent of the median of all fee schedules would accomplish this goal.

Medicare's flat-rate payments to HMOs can also be abused by providers. Medicare pays

**Management Weaknesses Contribute to
Unnecessary Expenditures**

HMOs a flat monthly fee per enrollee based on the average cost of serving a Medicare beneficiary in the fee-for-service sector. Studies suggest that HMOs attract healthier-than-average beneficiaries, however, and that HCFA does not adjust the payment rate to reflect the lower cost and utilization level of an HMO's healthier beneficiaries. As a result, HMOs have received payments estimated to be more than Medicare's costs would have been if the enrollees had remained in the fee-for-service sector.²

Other problems related to HMOs include the potential underprovision of services (such as failing to order appropriate diagnostic tests or failing to follow up on abnormal test results) and the violation of requirements that protect Medicare beneficiaries from unfair marketing practices and from inappropriate denial of claims for services. Over the past 5 years HCFA has experienced recurring problems with its enforcement of Medicare requirements regarding provision of services, marketing practices, and other practices aimed at protecting Medicare beneficiaries. Accordingly, in 1991 we recommended that HCFA establish policies that make the terms for sanctioning HMOs

²Mathematica Policy Research, Inc., The Impact of the Medicare Demonstrations on the Use and Cost of Services, Final Report, January 31, 1989.

explicit in order to prevent the abuse of program dollars and to protect Medicare beneficiaries. We also asked the Congress to consider giving HCFA greater discretion to suspend Medicare enrollment or impose civil monetary penalties when HMOs fail to correct compliance deficiencies promptly.

Weak Billing Controls Invite Exploitation of Medicare

Control over the issuance of billing identification numbers, known as provider numbers, is a long-standing program weakness that makes Medicare seriously vulnerable to fraud. Under some contractors' procedures, certain types of providers applying for billing identification numbers receive little scrutiny of their qualifications or of their business and investment relationship to other medical facilities. For these providers, contractors have difficulty identifying whether an applicant has been disciplined by the program, has outstanding Medicare debts, or has the financial wherewithal to maintain solvent business operations. In addition, HHS's Office of the Inspector General reports that Medicare contractors often cannot identify or deactivate numbers for providers that have lost the legal authority to practice.³

³Carrier Maintenance of Medicare Provider Numbers, Department of Health and Human Services, Office of Inspector General (OEI-06-89-00870, May 1991).

Limited controls over provider numbers were an integral part of a multimillion-dollar fraud scheme involving mobile physiology labs, referred to as the "rolling labs" scheme. Fraudulent billings were masked behind at least 30 different corporate names and Medicare provider numbers. The multiple provider numbers greatly complicated contractors' efforts to detect suspiciously high volumes of tests. In 1987 Medicare successfully prosecuted laboratory operators involved in the scheme, and one owner was imprisoned. However, Medicare has been unable to recover overpayments to providers affiliated with the scheme.

To respond to ownership and provider number problems, HCFA has recently issued regulations and guidance to improve contractor control over the acquisition of provider numbers. Included are provisions requiring noninstitutional providers to submit information on owners or individuals with management interests and requiring applicants seeking to qualify as equipment suppliers to meet certain standards.

Challenges Are Common to All Health Payers

Several aspects of the rolling labs scheme discussed above illustrate the vulnerability of Medicare and the other health insurers to fraud. Efforts to address fraud and abuse present all health payers with common difficulties. These include the considerable costs involved in investigating and prosecuting fraud and abuse, the difficulty of recovering lost monies, and the need to balance monetary controls with concerns over excessive regulations.

Rolling Labs Case Illustrates Systemic Health Insurance Problems

Perpetrators of the rolling labs scheme initially focused their operations on Medicare. However, once their fraudulent activities were uncovered, they shifted from Medicare to private payers. Both public and private payers found their attempts to recover overpayments stymied, despite having won convictions. In studying how the scheme managed to stay viable for several years, we found that:

- Considerable losses to the health care system can occur as a result of even a single scheme. The rolling labs operation is believed to have affected over 90 percent of the health plans in California and to have involved \$1 billion in fraudulent billings. Although Medicare uncovered the operation

and successfully prosecuted certain individuals associated with it, the program was unable to recover over \$5 million, almost the entire amount of the identified Medicare overpayments to the providers involved.

- Providers can bill insurers with relative ease, because they are often not required to meet specific requirements. The services provided by the rolling lab do not require licensure in many states, and many insurers do not have specific requirements for those who can bill for medical services. Because many of the rolling lab billing addresses were post-office boxes, payers could not identify the location of the labs.
- The obstacles to prosecuting and recovering losses are daunting. The rolling lab operators were successfully prosecuted in 1987 by Medicare and in 1990 by private insurers. Private insurers spent \$1 million in their investigative and prosecutorial efforts. Although they won an \$18 million judgment, they have recovered virtually nothing.
- The replication of similar schemes in southern California suggests that the profitability of health insurance fraud may outweigh the risk of getting caught. At least

six schemes having characteristics similar to the rolling lab are believed to exist in California. Investigators believe such schemes are also operating in other states.

Need for National Commission

Fraud and abuse problems beset all health payers. Our recent work demonstrates that Medicare's problems with prosecution and financial recovery are similar to those facing private health insurers. In addition, privacy concerns have inhibited payers from sharing data collection techniques or other strategies that could help identify questionable billing patterns.⁴ Finally, payers share concerns over how to protect benefit dollars without putting an undue paperwork burden on providers or requiring them to follow complicated regulations.

Recently we suggested that the Congress establish a national health insurance fraud commission to develop ways to enhance the efforts of independent payers, public payers, and state insurance and licensing agencies as well as state and federal law enforcement agencies. The commission would be responsible for analyzing trade-offs and

⁴With respect to standardizing claims data, HHS has already begun to develop a national strategy to coordinate independent private insurers with public payers to streamline the costs of administering health insurance.

**Challenges Are Common to All Health
Payers**

developing recommendations to the Congress. It would address such issues as (1) how insurers can coordinate and fund case development and prosecution efforts, (2) whether and how to regulate unlicensed medical facilities, and (3) how insurers can standardize claims information and billing rules.

Conclusions and Action Needed

Our work suggests that, to reduce Medicare's risk of financial loss, (1) HCFA needs to assume a more active management posture over contractors' program operations and (2) legislation is needed to assure that HCFA can adequately and consistently fund contractors' safeguard activities. HCFA's inadequate oversight of contractor operations, flaws in payment policies, loose controls over billing procedures, and weak enforcement actions against noncompliant HMOs have led to wasteful spending and program fraud and abuse. In addition, funding of Medicare's payment safeguard activities over the past decade has fluctuated, has not matched the rising volume of claims, and has hampered contractor performance of activities that protect program dollars. For each of these areas, we have made recommendations to HCFA or the Congress.

We also believe that, with efforts to detect and prosecute health insurance fraud and abuse fragmented between the independent operations of the various health insurers, a nationally coordinated effort is needed to combat fraud and abuse effectively. We have therefore suggested that the Congress establish a national commission, which could consider such issues as

Conclusions and Action Needed

- standardization of claims administration,
- sharing information on individuals suspected of fraudulent or abusive practices,
- regulation of providers,
- the creation of state model statutes, and
- joint funding of investigations and prosecutions.

Related GAO Products

Medicare: One Scheme Illustrates Vulnerabilities to Fraud and Abuse
(GAO/HRD-92-76, Aug. 26, 1992).

Medicare: Reimbursement Policies Can Influence the Setting and Cost of Chemotherapy (GAO/PEMD-92-28, July 17, 1992).

Durable Medical Equipment: Specific HCFA Criteria and Standard Forms Could Reduce Medicare Payments (GAO/HRD-92-64, June 12, 1992).

Medicare: Excessive Payments Support the Proliferation of Costly Technology
(GAO/HRD-92-59, May 27, 1992).

Health Insurance: Vulnerable Payers Lose Billions to Fraud and Abuse (GAO/HRD-92-69, May 7, 1992).

Medicare: Shared Systems Policy Inadequately Planned and Implemented
(GAO/IMTEC-92-41, Mar. 18, 1992).

Medicare: Payments for Medically Directed Anesthesia Services Should Be Reduced
(GAO/HRD-92-25, Mar. 3, 1992).

Medicare: Over \$1 Billion Should Be Recovered From Primary Health Insurers (GAO/HRD-92-52, Feb. 21, 1992).

Medicare: HCFA Needs to Take Stronger Actions Against HMOs Violating Federal Standards (GAO/HRD-92-11, Nov. 12, 1991).

Medicare: Effects of Durable Medical Equipment Fee Schedules on Six Suppliers' Profits (GAO/HRD-92-22, Nov. 6, 1991).

Medicare: Millions of Dollars in Mistaken Payments Not Recovered (GAO/HRD-92-26, Oct. 21, 1991).

Medicare: Improper Handling of Beneficiary Complaints of Provider Fraud and Abuse (GAO/HRD-92-1, Oct. 2, 1991).

Medicare: Information Needed to Assess Payments to Providers (GAO/HRD-91-113, Aug. 8, 1991).

Medicare: Payments for Clinical Lab Tests Are Too High (GAO/HRD-91-59, June 10, 1991).

Medicare: Flawed Data Add Millions to Teaching Hospital Payments (GAO/IMTEC-91-31, June 4, 1991).

Related GAO Products

Medicare: Further Changes Needed to Reduce Program Costs (GAO/HRD-91-67, May 15, 1991).

Medicare: Variations in Payments to Anesthesiologists Linked to Anesthesia Time (GAO/HRD-91-43, Apr. 30, 1991).

Medicare: Millions in Potential Recoveries Not Being Sought by Maryland Contractor (GAO/HRD-91-32, Jan. 25, 1991).

Medicare: Employer Insurance Primary Payer for 11 Percent of Disabled Beneficiaries (GAO/HRD-90-79, May 10, 1990).

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Farmers Home Administration's Farm Loan Programs (GAO/HR-93-1).

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Resolution Trust Corporation (GAO/HR-93-4).

Pension Benefit Guaranty Corporation
(GAO/HR-93-5).

Medicare Claims (GAO/HR-93-6).

Contracting Issues

Defense Weapons Systems Acquisition
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Defense Contract Pricing (GAO/HR-93-8).

Department of Energy Contract Management
(GAO/HR-93-9).

Superfund Program Management
(GAO/HR-93-10).

NASA Contract Management (GAO/HR-93-11).

Accountability
Issues

Defense Inventory Management
(GAO/HR-93-12).

Internal Revenue Service Receivables
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Managing the Customs Service (GAO/HR-93-14).

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High-Risk Series

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Pension Benefit Guaranty Corporation





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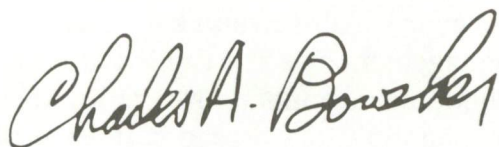
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This report is one of the high-risk series reports, which summarize our findings and recommendations. It describes our concerns over the financial condition of the Pension Benefit Guaranty Corporation (PBGC). The report focuses on three areas of critical importance to the viability of the pension insurance program: PBGC's growing deficit, primarily caused by termination of large, underfunded pension plans; weaknesses in the Department of Labor's, the Internal Service's, and independent public accountants' efforts to detect pension plan abuses that place plan assets at risk; and pressures the Congress faces to expand PBGC guarantees to cover insurance annuitants and other groups.

Copies of this report are being sent to the President-elect, the Democratic and Republican leadership of the Congress, congressional committee and subcommittee chairs and ranking minority members, the Director-designate of the Office of Management and Budget, the Secretary-designates of Labor and the Treasury, the Commissioner of Internal Revenue, and the Executive Director of the Pension Benefit Guaranty Corporation.

A handwritten signature in cursive script that reads "Charles A. Bowsher". The signature is written in dark ink and is positioned above the printed name.

Charles A. Bowsher

Contents

Overview	6
ERISA Provides Federal Safeguards	10
Growing Deficit Threatens Pension Insurance Program	12
Effectiveness of ERISA Enforcement Efforts Is Limited	21
Oversight of Annuity Provider Selections Needs Strengthening	25
Conclusions and Action Needed	28
Related GAO Products	32
High-Risk Series	35

Overview

In 1974, the Congress passed the Employee Retirement Income Security Act (ERISA) to correct weaknesses in the private pension system. ERISA set minimum funding standards for defined benefit pension plans to ensure that they would accumulate sufficient funds to pay for the benefits they promised. ERISA also established the Pension Benefit Guaranty Corporation (PBGC) to insure guaranteed benefits in the event that defined benefit plans terminated without being fully funded.

ERISA put in place a number of other provisions—reporting and disclosure requirements, minimum participation and vesting standards, and fiduciary responsibilities—to protect against waste, fraud, and mismanagement of pension plans. Responsibility for enforcing these provisions and the minimum funding standards was assigned to the Internal Revenue Service (IRS) and the Department of Labor.

The Problem

PBGC's problem is a large and growing deficit that threatens the insurance program's long-term financial viability. At the end of fiscal year 1991, this deficit—which had been accumulating since PBGC's inception in 1974—stood at an estimated \$2.3 billion. By

2001, under PBGC's most pessimistic projection, the figure could reach \$17.9 billion. PBGC's financial condition has worsened because companies have terminated pension plans that were insufficiently funded to cover the benefits they had promised their employees.

An additional problem lies with IRS and Labor, which have found that establishing effective ERISA oversight and enforcement strategies is difficult. The two agencies have limited resources relative to their responsibilities; at IRS, for example, about 1,000 revenue agents are responsible for ensuring the compliance of nearly 1 million pension plans. Both IRS and Labor have taken steps to improve their oversight and enforcement programs, but weaknesses remain. Moreover, inadequate Labor and PBGC oversight of pension plans' selections of insurance annuity providers is a contributing factor that could prompt the Congress to expand PBGC guarantees to cover insurance company annuities; a move that could further weaken PBGC's financial condition.

The Causes

Two features in the design of the pension insurance program have made it hard for PBGC to control the risks it faces due to

underfunded pension plans. First, ERISA's minimum funding standards do not ensure that pension plan sponsors will contribute enough so that if the plans terminate, they will contain sufficient assets to cover all the promised benefits. Second, the premiums that PBGC charges pension plans do not fully cover the risks that PBGC assumes. Premiums are only partially risk-related, allowing sponsoring companies and participants to engage in risky behavior in the knowledge that if the plans terminate before benefits are fully funded, the responsibility for paying guaranteed benefits will fall to PBGC.

In addition to these two program design problems, PBGC has experienced weaknesses in its internal controls and financial systems—for example, the lack of a reliable method for estimating PBGC's liability for future benefits. PBGC also has serious problems with its premium reporting and collection system. Further, its efforts to identify and collect delinquent premiums, underpaid premiums, and related interest and penalties have been inadequate.

GAO's
Suggestions for
Improvement

We have long supported legislative action to strengthen the funding standards for defined benefit pension plans. Reducing

underfunding would limit PBGC's future exposure and target the greatest threat facing the insurance program. We have also suggested that the Congress reexamine the program's premium structure, which could be made to better reflect the risks faced by the program. In particular, the premiums paid by underfunded pension plans should be more in keeping with the risks they pose to PBGC.

In addition, we have emphasized the need for PBGC to focus more attention on its management policies and systems and for IRS and Labor to improve their oversight and enforcement programs. While all three bodies have taken steps in these areas, we have made a number of recommendations that have not been fully addressed. These would correct system and control weaknesses in PBGC's liability estimation and premium and accounting operations and enhance ERISA oversight and enforcement efforts.

ERISA Provides Federal Safeguards

The Congress enacted ERISA to correct weaknesses in the private pension system that had resulted in workers and retirees losing benefits. ERISA set minimum funding standards for defined benefit plans¹ to ensure that sufficient funds would be available to pay promised benefits, and established PBGC to insure benefits in the event a defined benefit pension plan terminated before becoming fully funded. When a plan terminates with insufficient funds to pay for the benefits earned by its participants, PBGC takes over the plan and pays guaranteed benefits.

The purposes of this insurance program are to (1) encourage the continuation and maintenance of defined benefit pension plans, (2) provide for the timely and uninterrupted payment of pension benefits, and (3) maintain insurance premiums charged to pension plans at the lowest possible level. The program was intended to be self-financing, with funds being provided through terminated plan assets, recoveries from the sponsors of terminated plans,

¹These plans pay specific retirement benefits, generally based on years of service, earnings, or both; the sponsoring company bears the investment risk.

premiums collected from ongoing pension plans, and investment income.²

ERISA also established reporting and disclosure requirements, set minimum participation and vesting standards, and outlined fiduciary responsibilities.³ Primary responsibility for ensuring that ongoing pension plans comply with ERISA standards is shared by two agencies—IRS (participation, vesting, and funding) and the Department of Labor (reporting and disclosure, and fiduciary standards).

²In the event that PBGC's resources are not sufficient to pay guaranteed benefits, ERISA permits it to borrow \$100 million from the federal government.

³A fiduciary generally is anyone who exercises discretionary control over plan management or provides investment advice to it. Fiduciaries typically include plan administrators, trustees, and investment managers.

Growing Deficit Threatens Pension Insurance Program

PBGC's single-employer insurance fund⁴ has had a deficit since its inception in 1974, and this deficit is growing. This deficit threatens the insurance program's long-term financial viability. It has resulted primarily from (1) the plans of bankrupt companies terminating without sufficient funds to pay guaranteed benefits and (2) a premium structure that does not provide enough revenue to cover losses. PBGC's financial condition is further weakened by management problems that have prevented PBGC from effectively assessing and monitoring its financial condition and have resulted in lost premium income.

Plan Underfunding Presents Greatest Risk

PBGC currently has a positive cash flow—annual premium and asset incomes exceed its annual benefit obligations and administrative costs. But the longer-term prospects are troublesome, because the future benefit payments for which it has already assumed responsibility exceed the value of assets now on hand. And PBGC faces the threat of being forced to assume a substantial amount of additional liabilities if a relatively few large pension plans fail.

⁴PBGC administers two separate programs—one for single-employer plans, the other for multiemployer plans. The multiemployer plan insurance program had an accumulated surplus of \$187 million as of 1991, according to PBGC.

**Growing Deficit Threatens Pension
Insurance Program**

PBGC's current deficit measures its financial condition and reflects the resources that are needed to provide guaranteed benefits to participants in underfunded plans that have been or are expected to terminate in the near future. PBGC has had a deficit since its inception and this deficit had increased to \$2.3 billion by the end of fiscal year 1991.

PBGC's financial condition looks even worse when potential terminations of underfunded plans are considered. PBGC estimated in its 1991 annual report that \$40 billion in underfunding existed in the ongoing plans it insures. Of the \$40 billion in underfunding, PBGC estimates that \$13 billion is in plans sponsored by financially troubled firms, primarily those in the steel, tire, automobile, and airline industries. Taking this underfunding into account, PBGC's most pessimistic 10-year forecast shows that its deficit could reach \$17.9 billion by 2001.⁵

**PBGC's Limited
Ability to Deal
With Risk**

Two design features of the pension insurance program—ERISA's minimum funding standards and the premium structure—limit PBGC's ability to control the risks these underfunded plans pose. ERISA's

⁵This estimate assumes that the plans with \$13 billion in underfunding plus some smaller ones will terminate during the 10-year period.

minimum funding standards do not ensure that all plan sponsors will make sufficient plan contributions to pay promised benefits upon termination. For example, plans that had unfunded liabilities when ERISA was enacted are allowed to amortize the unfunded amount over a 40-year period; benefit increases can be amortized over a 30-year period. However, plan sponsors may increase benefits even if the existing benefits are not fully funded. As a result, many of the plans that were underfunded when ERISA was enacted remain underfunded. The Congress has enacted legislation to strengthen the minimum funding standards, most recently in 1987. However, these changes may not be enough to ensure PBGC's long-term financial viability. We are currently assessing the impact of the 1987 changes on plan funding.

The premium structure further limits PBGC's ability to manage its risks. The premiums PBGC collects from a plan do not insure the plan against a specified and limited shortfall in assets. Rather, they insure the plan against any shortfall, up to the maximum guarantee times the number of plan participants, no matter how large.

Well-funded plans are subsidizing underfunded plans through the premium

structure. Originally, the Congress set the single-employer plan premium at \$1 a year for each plan participant, regardless of the plan's funded status. To better reflect the risk PBGC faces from underfunded plans, the premium was restructured in 1987.

Underfunded plans are now required to pay a supplemental premium. Currently, each plan pays a fixed per participant rate of \$19 a year; underfunded plans pay an additional variable premium of \$9 for each \$1,000 of unfunded vested benefits per participant.⁶ The combined premium has a ceiling of \$72 per person. The fixed premium probably overcharges well-funded plans for the risk PBGC assumes in insuring them; the capped variable premium undercharges underfunded plans for this risk.

PBGC's inability to restrict claims, coupled with a premium structure that is only partially risk-related, makes it subject to a "moral hazard." Moral hazard surfaces when the insured parties—in this case, plan sponsors and participants—engage in risky behavior knowing that the guarantor will assume a substantial portion of the risk. For example, plan sponsors may divert plan funds for other uses or increase promised benefits knowing that if the plan terminates

⁶Plans are required to pay the variable premium if their liabilities for immediate and deferred vested benefits exceed their assets.

before these benefits are fully funded PBGC will assume the responsibility for paying guaranteed benefits, within certain limits.⁷ Strengthening funding standards for underfunded plans and better relating premiums to plan underfunding would reduce this moral hazard.

Improving PBGC's Financial Condition

During the previous congressional session, the administration and congressional members proposed strengthening ERISA's minimum funding standards to reduce PBGC's future liabilities. The administration further proposed legislation to freeze benefit guarantees where a plan sponsor gives a benefit increase in an underfunded plan and to change the bankruptcy code to improve PBGC's recoveries in bankruptcy proceedings. These proposals sought to limit the size of the liabilities PBGC will be asked to assume in the future; they did not specifically address the reduction of PBGC's current deficit. To reduce PBGC's deficit, the Congress historically has approved premium increases.

Proposals to limit PBGC's liabilities or reduce its deficit involve difficult trade-offs and demonstrate the tensions inherent in the

⁷PBGC phases in guarantees for new benefits over a period of up to 5 years.

pension insurance program. For example, strengthening the minimum funding standards will increase the federal deficit in the short run, because pension contributions are a tax-deductible business expense. Limiting guarantees on benefit increases will result in pensioners not becoming eligible for additional guaranteed benefits. This proposal will likely affect collectively bargained union plans the most,⁸ because the structure of many of these plans often results in negotiated benefit increases in already underfunded plans. These are also among the largest, most underfunded plans.

Enhancing PBGC's standing in bankruptcy may make obtaining credit more difficult for financially troubled firms and may force companies into bankruptcy more quickly. Giving PBGC a higher standing may also make negotiating agreements with creditors more difficult, thereby hampering firms' efforts to emerge from bankruptcy. Alternatively, concerns have been raised that increasing the fixed portion of the premium, another possible approach, will prompt well-funded plans to drop out of the system.

We believe strengthening the funding standards is the most appropriate tool for

⁸These plans are referred to as flat benefit plans.

**Growing Deficit Threatens Pension
Insurance Program**

enhancing PBGC's long-term viability. Reducing plan underfunding can be expected to lower PBGC's future losses by targeting the greatest threat to PBGC. We also believe the Congress should consider making the variable rate premium more risk-related in order to reduce PBGC's current deficit.

**Management
Deficiencies
Weaken Program
Administration**

In addition to the program design problems confronting PBGC, weaknesses in internal controls and financial systems have undermined PBGC's ability to administer the pension insurance program. We have been unable to audit PBGC's financial statements, primarily because we were unable to determine the reliability of PBGC's estimated liability for future benefits.⁹ Without reliable financial statements, PBGC cannot effectively monitor its financial condition.

Most recently, our fiscal year 1991 audit disclosed that PBGC had not developed and put into place the necessary documentation and support for the techniques and assumptions used to estimate its reported liability for future benefits. PBGC had also not assessed the completeness and accuracy of

⁹This liability account, which makes up more than 95 percent of PBGC's reported liabilities, represents the present value of the future pension benefits PBGC is committed to pay.

**Growing Deficit Threatens Pension
Insurance Program**

the data used by each estimating technique. PBGC has since made progress in addressing these weaknesses; we are evaluating this progress as part of our fiscal year 1992 audit.

PBGC has also had serious problems with its premium reporting and collection system. PBGC's efforts to identify and collect delinquent (unpaid) premiums, underpaid premiums, and related interest and penalties have been inadequate. PBGC has not made frequent attempts to collect delinquent premiums from large plans, and has not even attempted to identify or collect delinquent premiums from small plans. A breakdown in PBGC's computerized premium accounting system was a major factor in some of these problems. Moreover, PBGC normally has not used civil action to collect delinquent premiums.

PBGC's computerized premium accounting system has not been fully operational since 1988, after PBGC attempted unsuccessfully to modify the system to handle variable premiums. PBGC management has not paid sufficient attention to premium system improvement initiatives to modify the current system and procure a replacement system. As a result, PBGC has only partially

**Growing Deficit Threatens Pension
Insurance Program**

restored its premium accounting system
operations.

Effectiveness of ERISA Enforcement Efforts Is Limited

Effective enforcement of ERISA requirements is essential to reducing the risk to PBGC's insurance program. Although PBGC's primary risk involves large pension plans, its exposure is further increased by the termination of small, underfunded plans where ERISA violations are more likely to occur. These violations have added to PBGC's financial losses and increased its administrative burden.

The Department of Labor and IRS share responsibility for ensuring that ERISA violations are detected, appropriate penalties are imposed, and any plan fund deficiencies are corrected. These divided enforcement responsibilities under ERISA challenge IRS and the Department of Labor to provide effective individual enforcement and coordinate their joint enforcement responsibilities. Both agencies have made progress in improving their enforcement efforts, but problems remain.

Scarce Resources Hinder Efforts

Labor's and IRS's efforts are hindered by scarce resources relative to the size of the plan universe and disappointing enforcement targeting results. At IRS, about 1,000 revenue agents are responsible for ensuring that nearly 1 million pension plans comply with

Effectiveness of ERISA Enforcement
Efforts Is Limited

ERISA. Labor's resources are even more limited—fewer than 400 investigators oversee the pension plan universe as well as other types of benefit plans. Labor and IRS have taken steps to improve their enforcement efforts and make more effective use of these scarce resources. For example, Labor adopted an enforcement strategy in 1986 to better allocate resources for investigation. IRS is making underfunded plans, which pose the greatest risk to PBGC, a high priority in its enforcement strategy.

Both agencies are implementing new targeting systems aimed at better detecting ERISA violations. We are currently examining the effectiveness of Labor's enforcement strategy and targeting system. In 1990, we found that initial results of this new enforcement strategy were disappointing. Recently completed initial targeting test results were also disappointing in that targeting criteria identified few plans with ERISA violations.

Certain Joint
Enforcement
Efforts Have Not
Been Effectively
Coordinated

IRS and Labor efforts to better coordinate certain joint enforcement efforts—fiduciary violation actions and case referrals—have lagged. Labor has responsibility for determining whether a type of fiduciary

violation—known as a prohibited transaction—has occurred and then informing IRS of it. IRS has responsibility for imposing an excise tax, with certain exceptions, at the time of referral. However, IRS does not automatically impose excise taxes based on these referrals, and Labor officials have not followed up to ensure that IRS is imposing the prohibited transaction excise tax in all appropriate instances.

Timely identification and action on fiduciary violations can help limit PBGC's losses and reduce its administrative burden. In 11 of 40 terminated plans we examined where PBGC assumed responsibility, fiduciary breaches that drained plan assets—including prohibited loans and theft—had occurred while the plans were ongoing. PBGC was unable to recover the missing funds in four of the six prohibited loan cases, because it learned of the problem only after the plan had been terminated, when few assets remained.

IRS and Labor also have not effectively coordinated enforcement activities on other types of case referrals. Most IRS referrals to Labor involve small plans that Labor typically does not investigate. The agencies have yet to reach agreement on the best

method of selecting, handling, and following up on these referrals.

Deficiencies and
Limited Scope
Weaken
Independent Plan
Audits

The scarce enforcement resources available to IRS and Labor increase the significance of the independent public accountant audits of plans required by ERISA.¹⁰ Yet we found numerous deficiencies in the plan audits we reviewed that made their usefulness questionable. Moreover, ERISA allows plan administrators to exclude plan investments held by certain regulated institutions, such as banks and insurance companies, from the scope of a plan audit. These limited scope audits diminish the value of the audit and may confuse statement users. Also, neither plan administrators nor plan auditors are required to report on internal controls, including those established to ensure compliance with federal laws and regulations. The administration has proposed legislation to repeal the limited scope audit provision.

¹⁰Under ERISA, Labor requires plans with 100 or more participants to obtain an annual plan audit, which must be conducted by an independent, qualified public accountant.

Oversight of Annuity Provider Selections Needs Strengthening

The recent failures of several large insurance companies, most notably Executive Life Insurance Company, have raised concerns that federal oversight of plans' selections of insurance annuity providers is inadequate. Inadequate federal oversight may add to increasing pressures the Congress may face to expand PBGC guarantees to cover insurance annuities if the existing guarantees fail to adequately protect pensioners' benefits.¹¹ Such guarantees could increase PBGC's liability by as much as \$50 billion, according to PBGC estimates.

PBGC Guarantees Do Not Cover Insurance Annuities

Some pension plans decide to provide benefits to pensioners in the form of insurance company annuities. A plan may purchase annuities when the plan terminates, if it is fully funded, or while ongoing. Our analysis of insurance industry and government data suggests that 3 to 4 million retirees and surviving dependents receive such insurance annuities. Before these plans purchased insurance annuities, almost all of their retirees had been in defined benefit plans that were guaranteed by PBGC. However, PBGC has determined that ERISA does not provide authority to guarantee

¹¹The Congress also faces pressures to expand PBGC coverage to include so-called pension losers—people who lost their pensions before ERISA protections were enacted.

these insurance annuities, and collects no premiums for retirees paid through an insurance annuity. As a result, these pensioners lose the federal guarantee when they retire or leave the plan.

State Guarantees Leave Gaps in Coverage

In the absence of federal guarantees, pensioners receiving their benefits in the form of insurance annuities must rely on coverage provided by state guarantee laws if their insurers fail. All states—but not the District of Columbia—have set up guaranty funds to protect policyholders of insolvent health and life insurers, but variations and gaps in coverage provisions expose some to a potential loss of benefits. For example, some annuities are not covered by any state fund, due to variations in state funds' rules of coverage. Moreover, state guarantee coverage limits do not fully cover the value of pensioners' annuities in some cases.

Inadequate Federal Oversight

The threat to retirees' pension benefits due to insurance company failures, and the weaknesses in existing guarantees for pensioners' insurance annuities, have raised concerns about the effectiveness of federal regulation and oversight of pension plans' annuity purchases. To address these

concerns, Labor and PBGC—which share oversight responsibility for ensuring that pension plans act prudently in selecting insurance companies for annuity purchases—have taken steps to ensure that pension plans purchase the safest available annuity. Since March 1990, PBGC has reviewed terminating plans' selection of annuity providers and referred questionable selections to Labor. Labor investigates these referrals and pursues remedies to protect or restore participants' benefits when it determines that a fiduciary violation has occurred.

The effectiveness of these efforts is constrained, however, by two factors. First, Labor has not provided guidance to fiduciaries regarding specific factors that they should consider in evaluating prospective annuity providers. Second, neither Labor nor PBGC routinely monitors annuity provider selections of ongoing pension plans. Although fiduciary requirements apply to these ongoing plans, absent routine agency monitoring, violations may go undetected.

Conclusions and Action Needed

As long as pension plan underfunding persists, the pension insurance program and plan participants' benefits are at risk. We believe now is the time to act to reduce these risks. Reducing these threats to PBGC will require a combination of legislative actions and strengthened oversight and enforcement efforts.

We have long supported the use of strong and effective funding standards for the nation's defined benefit pension plans. The legislative proposals to strengthen the minimum funding standards have merit. Reducing underfunding would limit PBGC's future exposure and appropriately target the greatest threat confronting PBGC. While strengthened funding standards would increase the federal deficit in the short run, it is a necessary step to avoid potentially significant future costs.

In addition, the Congress should consider whether the overall premium ceiling and existing variable premium rate best reflect the risk to PBGC. Making the variable rate premium more risk-related would reduce PBGC's current deficit. The Congress should first focus on the premium paid by underfunded plans because these plans pose the greatest threat to the program.

Effective oversight and enforcement are essential to complement needed legislative changes and reduce the pressures the Congress faces to take more severe measures to protect the pension insurance program and workers' benefits. We have made several recommendations to the Department of Labor, IRS, PBGC, and the Congress to enhance ERISA oversight and enforcement and improve agency operations. All three oversight bodies and the private audit community have taken steps to improve their respective oversight and enforcement efforts to correct identified weaknesses. Key recommendations we have recently made that have not yet been fully addressed are designed to help

- correct significant system and control weaknesses in PBGC's liability estimation and premium and accounting operations, and
- strengthen pension plan reporting and enhance the effectiveness of pension plan audits by independent public accountants.

PBGC's serious operational problems indicate that PBGC officials need to focus more attention on management policies and systems. The Department of Labor and IRS need to examine ways to improve the

Conclusions and Action Needed

selection, handling, and follow-up of enforcement cases these agencies refer to one another. Also, the Department of Labor and PBGC should improve their oversight of pension plans' selection of annuity providers.

Related GAO Products

Improving the Financial Condition of the Pension Benefit Guaranty Corporation (GAO/T-HRD-92-60, Sept. 25, 1992).

Pension Plans: Benefits Lost When Plans Terminate (GAO/T-HRD-92-58, Sept. 24, 1992).

Financial Condition of the Pension Benefit Guaranty Corporation (GAO/T-HRD-92-52, Aug. 11, 1992).

Premium Accounting System: Pension Benefit Guaranty Corporation System Must Be An Ongoing Priority (GAO/IMTEC-92-74, Aug. 11, 1992).

Pension Plans: Pension Benefit Guaranty Corporation Needs to Improve Premium Collections (GAO/HRD-92-103, June 30, 1992).

Employee Benefits: Improved Plan Reporting and CPA Audits Can Increase Protections Under ERISA (GAO/AFMD-92-14, Apr. 9, 1992.)

Financial Audit: Pension Benefit Guaranty Corporation's 1991 and 1990 Financial Statements (GAO/AFMD-92-35, Mar. 2, 1992).

Financial Audit: System and Control Problems Further Weaken the Pension

Benefit Guaranty Fund (GAO/AFMD-92-1, Nov. 13, 1991).

Defined Benefit Pensions: Hidden Liabilities From Underfunded Plans and Potential New Obligations Confront PBGC (GAO/T-HRD-92-6, Oct. 31, 1991).

Pension Benefit Guaranty Corporation: Weak Financial Condition Worsened by Serious Internal Control Weaknesses (GAO/T-AFMD-91-9, Aug. 1, 1991).

Pension Plans: IRS Needs to Strengthen Its Enforcement Program (GAO/HRD-91-10, July 2, 1991).

Insurance Company Failures Threaten Retirement Income (GAO/T-HRD-91-41, June 27, 1991).

Pension Plans: Fiduciary Violations in Terminated Underfunded Plans (GAO/HRD-91-87, May 13, 1991).

Private Pensions: Millions of Workers Lose Federal Benefit Protection at Retirement (GAO/HRD-91-79, Apr. 25, 1991).

Related GAO Products

Federal Government's Oversight of Pension and Welfare Funds (GAO/T-HRD-37, June 13, 1990).

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Farmers Home Administration's Farm Loan
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Resolution Trust Corporation (GAO/HR-93-4).

Pension Benefit Guaranty Corporation
(GAO/HR-93-5).

Medicare Claims (GAO/HR-93-6).

Contracting Issues

Defense Weapons Systems Acquisition
(GAO/HR-93-7).

Defense Contract Pricing (GAO/HR-93-8).

Department of Energy Contract Management
(GAO/HR-93-9).

Superfund Program Management
(GAO/HR-93-10).

NASA Contract Management (GAO/HR-93-11).

Accountability
Issues

Defense Inventory Management
(GAO/HR-93-12).

Internal Revenue Service Receivables
(GAO/HR-93-13).

Managing the Customs Service (GAO/HR-93-14).

Management of Overseas Real Property
(GAO/HR-93-15).

Federal Transit Administration Grant
Management (GAO/HR-93-16).

Asset Forfeiture Programs (GAO/HR-93-17).

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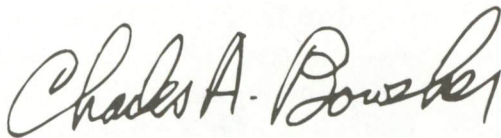
In January 1990, in the aftermath of scandals at the Departments of Defense and Housing and Urban Development, the General Accounting Office began a special effort to review and report on federal government program areas that we considered "high risk."

After consulting with congressional leaders, GAO sought, first, to identify areas that are especially vulnerable to waste, fraud, abuse, and mismanagement. We then began work to see whether we could find the fundamental causes of problems in these high-risk areas and recommend solutions to the Congress and executive branch administrators.

We identified 17 federal program areas as the focus of our project. These program areas were selected because they had weaknesses in internal controls (procedures necessary to guard against fraud and abuse) or in financial management systems (which are essential to promoting good management, preventing waste, and ensuring accountability). Correcting these problems is essential to safeguarding scarce resources and ensuring their efficient and effective use on behalf of the American taxpayer.

This report is one of the high-risk series reports, which summarize our findings and recommendations. It describes our concerns over the thrift cleanup, which is mostly under the control of the Resolution Trust Corporation (RTC). This report focuses primarily on the risks that RTC can minimize through better management of its asset disposition and contracting activities and by strengthening its information systems. The report also discusses opportunities to reduce the overall cost of the thrift cleanup to the taxpayers by providing adequate funding to RTC to carry out its thrift resolution responsibilities.

Copies of this report are being sent to the President-elect, the Democratic and Republican leadership of the Congress, congressional committee and subcommittee chairs and ranking minority members, the Director-designate of the Office of Management and Budget, the President and Chief Executive Officer of the Resolution Trust Corporation, and the Chairman of the Thrift Depositor Protection Oversight Board.



Charles A. Bowsher

Contents

Overview	6
RTC: an Organization With a Monumental Mission in a Difficult Environment	11
Resolution and Certain Financial Asset Sales Tasks Executed Fairly Well	15
Some Real Estate Disposition Practices Poorly Planned and Executed	19
Contracting System Not Adequate	24

Contents

Information Systems Are Critical to the Management and Sale of Thrift Assets	29
Financial Management and Accountability Must Be a Priority	32
Future Uncertainties Affect Resolution Activities	34
Conclusions and Action Needed	37
Related GAO Products	40
High-Risk Series	44

Overview

In August 1989, Congress established the Resolution Trust Corporation (RTC) to resolve hundreds of failed savings and loan institutions and dispose of their assets. As of September 1992, RTC had disposed of assets totaling \$287 billion, and RTC's remaining inventory was valued at approximately \$107 billion. Through November 30, 1992, RTC had used nearly \$87 billion of taxpayer funds to cover losses emanating from thrift resolutions, and it estimated that \$25 billion in additional loss funds are needed to resolve institutions that were expected to fail through September 30, 1993. Billions more may be needed to resolve thrifts that fail after that date. However, because of uncertainties involving the economy, interest rates, and asset sale recoveries, it is difficult to estimate precisely the ultimate cost of the cleanup.

RTC relies extensively on private sector contractors to manage and dispose of assets and fulfill other needs. By September 30, 1992, RTC had awarded over 95,000 contracts with estimated fees totaling about \$2.8 billion.

The Problem

RTC has discharged some of its resolution and asset sales responsibilities fairly well.

But poor planning and execution of real estate disposition strategies, problems with the contracting system, and inadequate information systems have hampered RTC's overall performance. Deficiencies in these areas reduce the amount of money RTC recovers through asset disposition and increase the likelihood that taxpayers will need to cover additional costs.

The Causes

Of the several factors contributing to the risks at RTC, two are outside RTC's control. First is the sheer amount of taxpayer funds involved in the program due to the inherent losses associated with failed thrifts. Estimates of the eventual cost to taxpayers of the savings and loan cleanup exceed \$300 billion. Second is the difficult economic environment. During the past 3 years, the demand for whole thrifts has been limited, real estate markets have declined, the availability of credit to finance asset purchases has been uncertain, and the economy as a whole has been in recession. Further, RTC's asset inventory for both financial and real estate assets is becoming increasingly concentrated in hard-to-sell categories. As a result, the final cost of the cleanup will depend not just on how well thrift regulators and RTC discharge their

responsibilities, but on the state of the economy at large.

Other factors such as disposition approaches, the contracting system, and asset information systems are within RTC's control. RTC has used a variety of techniques to dispose of its real estate assets, including individual sales, auctions, and portfolio sales. But RTC's disposition approaches have sometimes been inefficient, and it has failed to adequately plan its sales approaches.

RTC's contracting system—the means through which RTC pursues its mission—is troubled by poor planning and oversight. RTC does not adequately define what services are needed, the scope of work, and the types of contracts that would best accomplish these ends. Moreover, RTC has difficulty overseeing the tens of thousands of contractors who manage and dispose of billions of dollars in assets on its behalf.

RTC's asset information systems are inadequate. In March 1992, we reported that RTC had not adequately defined its business strategies for managing and selling assets; matched information needs with these strategies; or developed systems to provide the timely, accurate, and complete

information needed to manage and evaluate disposition programs and oversee contractors. Since then, RTC has taken steps to correct these problems, but much work remains.

In addition to these concerns, RTC's efforts have been hampered by repeated funding disruptions. RTC has run out of funds and has had to stop resolving thrifts three times since it was established. Most recently, RTC had to return \$18.3 billion to the Treasury because it did not obligate the funds before the April 1, 1992, deadline. Certain RTC operations have not been funded since that date. As a result, thrifts under RTC's control have continued to post losses that will contribute to the overall cost of the cleanup.

GAO's Suggestions for Improvement

We have made recommendations to RTC for improving its asset disposition and contracting activities and its information systems. RTC is implementing many of these recommendations, but additional actions are needed.

We continue to believe that RTC should be given the additional funds needed to pursue its resolution activities. Any further delay

merely increases the eventual cost of the savings and loan cleanup.

Finally, we have pointed out the need to prepare for the challenges that are likely to endure beyond 1993, when RTC relinquishes its resolution responsibilities, and 1996, when RTC is scheduled to close.

RTC: an Organization With a Monumental Mission in a Difficult Environment

In 1989, the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) was enacted in response to a major financial crisis. FIRREA abolished the Federal Home Loan Bank Board and the Federal Savings and Loan Insurance Corporation (FSLIC) and established RTC to resolve hundreds of failed savings and loan institutions. RTC is scheduled to stop taking in failed thrifts on September 30, 1993. Subsequent thrift failures will be handled by the Savings Association Insurance Fund (SAIF), which will be managed by the Federal Deposit Insurance Corporation (FDIC). RTC will continue to manage and dispose of its remaining inventory of thrifts and assets until its scheduled closing on December 31, 1996. At that time, any remaining assets and liabilities will be passed on to the FSLIC Resolutions Fund, which will be managed by FDIC.

The Mission

RTC resolves failed thrifts formerly insured by FSLIC before the enactment of FIRREA and for which a conservator or receiver is appointed before October 1, 1993. RTC will dispose of the assets of failed thrifts until it closes in 1996. RTC is required by FIRREA to carry out sometimes competing objectives, such as minimizing losses incurred in

**RTC: an Organization With a
Monumental Mission in a Difficult
Environment**

resolving cases, maximizing recoveries on the sale of institutions and their assets, minimizing the impact of its activities on local markets, and maximizing preservation of affordable housing. In addition, FIRREA authorizes RTC to use private sector contractors to the extent practical and efficient. Clearly, RTC's most difficult role is the management and disposition of the billions of dollars in assets from hundreds of failed thrifts. RTC's ability to dispose of these assets effectively will have an impact on the final cost of the thrift cleanup.

RTC has been provided \$105 billion¹ to cover losses from thrift resolutions. Additionally, as of November 1992, RTC had borrowed about \$41 billion from the Federal Financing Bank to be repaid from the proceeds of asset sales. Each of RTC's key functions directly affects the total cost of the thrift cleanup. Every dollar that RTC fails to recover on the resolution of thrifts or sale of assets or wastes through inefficient operations is one more dollar added to the cost of the cleanup.

As authorized by FIRREA, RTC has used private sector contractors extensively to manage

¹Of the \$105 billion, RTC returned \$18.3 billion to the Treasury as a result of the April 1, 1992, deadline on obligation of its December 1991 appropriation.

and dispose of assets as well as to fulfill other needs. From its inception through September 1992, RTC awarded over 95,000 contracts with estimated fees of about \$2.8 billion. Since RTC is not subject to the same contracting laws and regulations that federal agencies must follow, it developed its own contracting system. Because RTC achieves its mission through the use of contractors, one of its most important tasks has been to oversee the performance of thousands of contractors.

The Environment

RTC's task has been complicated by the difficult environment in which it has had to operate. During the last 3 years, there has been limited demand for whole thrifts, declining real estate markets, increasing numbers of troubled assets, uncertain availability of credit to finance asset purchases, and the recession. These factors are outside RTC's control.

While RTC has achieved good results in the sale of some types of assets, its progress in disposing of other assets has been slower. Also, its remaining assets are increasingly the hard-to-sell variety. This situation, in addition to the difficult environment, means that disposal of these hard-to-sell assets,

**RTC: an Organization With a
Monumental Mission in a Difficult
Environment**

while maximizing returns, will continue to be RTC's most difficult challenge. Also, the expected failure of more thrifts could give RTC additional inventories of assets to dispose of in the future.

Resolution and Certain Financial Asset Sales Tasks Executed Fairly Well

RTC's effectiveness in resolving failed thrifts directly affects the final cost of the savings and loan cleanup. RTC has executed its resolution tasks fairly well, resolving 653 thrifts as of November 1992. Initially, RTC's resolution strategy emphasized whole thrift sales over branch sales and liquidations. In 1991, however, RTC adapted its strategies to respond more to the market by offering branch sales as an initial option for acquirers, rather than waiting until attempts to sell whole thrifts failed. It also began offering assets for sale separately from deposits.

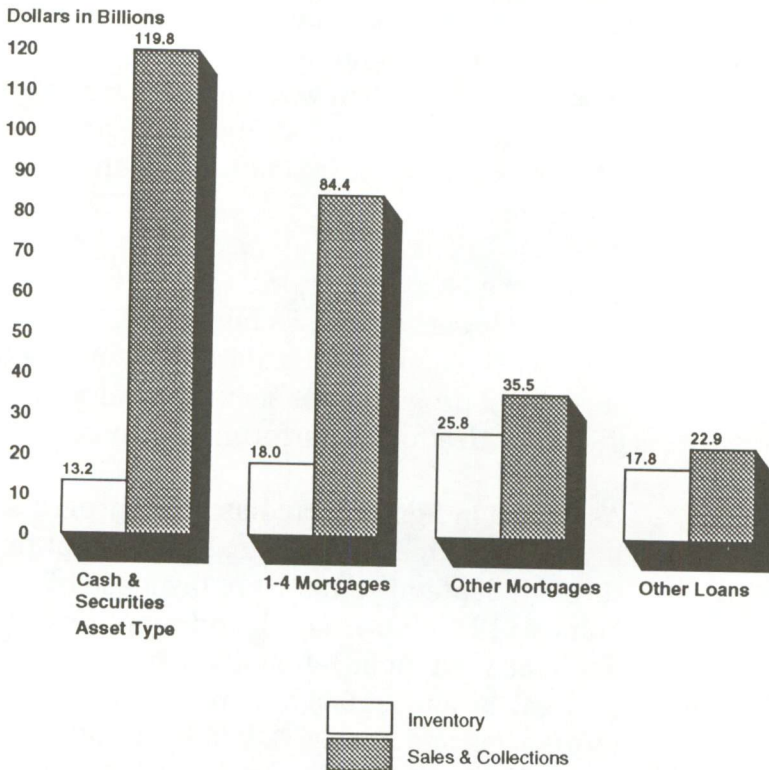
During the past 3 years, RTC executed certain financial asset sales tasks fairly well. For example, it established and implemented successful programs for securities sales and the securitization of performing loans.

As shown in figure 1, RTC has made progress in selling its financial assets. From inception through September 1992, RTC disposed of almost \$120 billion in cash and securities, about \$84 billion in 1-4 family residential mortgages, almost \$36 billion in other mortgages, and almost \$23 billion in other loans. Figure 1 also shows RTC's remaining inventory of financial assets. Overall, RTC has recovered about 95 percent of book value on

Resolution and Certain Financial Asset
Sales Tasks Executed Fairly Well

financial assets it has sold. There remains, however, some risk of future claims that could reduce this recovery rate.

Figure 1: RTC Financial Assets Inventory, Sales, and Collections as of September 30, 1992



Source: RTC.

RTC's securities sales included about \$8 billion (face value) of junk bonds, and the junk bond inventory has been reduced to \$211 million (face value). The total remaining inventory of cash and securities was about \$13 billion as of September 30, 1992.

RTC's success in selling a large volume of securities is attributable, in part, to its diligent efforts to hire people with the right skills and to develop strategies responsive to market demands. In addition, generally favorable market conditions for securities have helped RTC during the past 2 years.

RTC's securitization program has also produced significant results. Agency swap transactions aggregating almost \$4 billion have been competitively awarded through July 31, 1992. In addition, 52 issues of RTC residential, multifamily, commercial, and other mortgage-backed securities with a total face value of about \$28 billion had been successfully brought to market as of September 30, 1992.

However, RTC's financial assets inventory is becoming increasingly concentrated in hard-to-sell categories such as highly leveraged transactions, limited partnership interests, equity investments, and

nonperforming loans. Hence, RTC faces the risk of lower recoveries as it sells these assets.

RTC faces two other types of risk in its financial assets activities. One of these is the contingent liability remaining from assets that have already been sold, including claims on representations and warranties in loan sales transactions, and losses charged to reserve funds on securitization deals. The other is the risk associated with the potential mismanagement of assets by RTC contractors, which could result in forgone revenues, additional expenses, and deteriorating asset values.

Some Real Estate Disposition Practices Poorly Planned and Executed

RTC has used a variety of techniques to dispose of its real estate assets, including individual sales, auctions, and portfolio sales. However, RTC's real estate disposition approaches have sometimes been inefficient, and RTC has failed to adequately plan its sales approaches. Specifically, RTC disposed of real estate assets for 3 years before studying its principal sales strategies to determine which were most effective for which type of asset. RTC's Inspector General has also examined several of RTC's real estate sales events and found deficiencies in their planning.

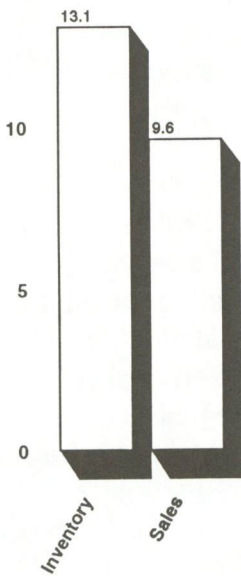
RTC has disposed of billions of dollars in real estate assets but still faces a challenge in reducing its land and commercial real estate inventories. Figure 2 shows that as of September 30, 1992, RTC disposed of about \$9.6 billion in real estate while just over \$13 billion in real estate remained to be sold. RTC has had great success in reducing its single-family real estate inventory; reducing land and commercial real estate inventories has been more difficult. Land and commercial real estate comprise about 80 percent of RTC's real estate inventory. Overall, RTC estimated that it has recovered about 63 percent of book value on real estate assets it has sold. However, much of the

**Some Real Estate Disposition Practices
Poorly Planned and Executed**

remaining land and commercial real estate are considered hard-to-sell assets, and RTC expects recoveries on these assets to be lower overall.

Figure 2: RTC Real Estate Assets Inventory and Sales, as of September 30, 1992

15 Dollars in Billions



Source: RTC.

Auctions and Portfolio Sales Frequently Used but Untested

Beginning in late 1991, RTC increased its emphasis on disposing of real estate assets in bulk through auctions and portfolio sales. This increased emphasis was due, in part, to specific disposition goals that focus on reducing book value dollar amounts within specific time frames. We pointed out RTC asset disposition planning problems in our October 1991 report assessing RTC's auction program. Additionally, it was not until its third year of operation that RTC began to study its sales strategies to determine which methods were most effective for which type of asset. It is imperative that RTC carefully evaluate its past disposition results to better plan its future disposition strategies and ensure that recoveries are maximized.

RTC has not appropriately planned its real estate disposition activities nor executed them well. Policies and procedures governing the implementation of the disposition methods are not consistently followed. RTC developed manuals and policy statements on auctions designed to minimize costly mistakes and pass on lessons learned. However, because of the decentralized nature of the organization coupled with weak internal controls and inaccurate information, guidance is not always followed.

For example, the Auction Handbook suggests marketing campaign time frames. For residential auctions, a 4-week campaign is suggested, and for commercial properties valued above \$500,000, a 60-day campaign. Our work on the Washington, D.C., area auction, which included residential, commercial, and land assets, revealed that the brochure and buyers' packages were available about 3 weeks before the scheduled auction. Furthermore, the buyers' packages did not always contain adequate or accurate information. Inadequate information and insufficient time to perform asset reviews increase buyer risk, narrow the investor market, and can reduce recovery values.

RTC's National Sales Center had completed several major portfolio sales and, as a result, a variety of real estate assets with a book value of about \$900 million were sold or under contract as of June 1992. RTC continues to conduct major portfolio sales without the benefit of comparing this method to other disposition strategies. Further, RTC, in some cases, is providing long-term financing for these sales and for other assets. RTC must ensure that these loans are properly monitored to minimize potential future losses. This monitoring is especially

important for cash-flow participating mortgages that have been used for portfolio sales. These transactions, because of their complicated nature, demand rigorous oversight to protect the taxpayers' interests.

Furthermore, although FIRREA mandated that RTC maximize recoveries on the sales of its assets, RTC has not set goals tied to maximizing recoveries. In addition, RTC has not given adequate consideration to the overall net return of the various real estate asset disposition strategies used. Instead, RTC's real estate asset disposition efforts seem to be driven by its book value reduction goals and are not balanced by goals related to maximizing recoveries.

Contracting System Not Adequate

Contractors working for RTC are primarily responsible for the management and disposition of assets from insolvent thrifts. These activities generally include such tasks as collecting income and making disbursements for the maintenance of the assets. RTC's total asset sales and collections from its inception through September 1992 were about \$287 billion; much of this was managed or collected by thousands of private sector contractors. Given that such a large amount of money is flowing through private sector contractors acting on behalf of RTC, it is critical that a comprehensive system of oversight is established to reduce the inherent vulnerabilities in such a system.

In the past 3 years, RTC has made some improvements to its contracting system, but RTC's contracting system remains a key weakness in its operations. We have identified weaknesses that have added millions of dollars to the cost of the government's cleanup efforts, but we have no way of estimating the extent that losses may be occurring. When RTC was first established, it had a mindset that essentially viewed contracting as an administrative activity rather than a key function. Downplaying the significance of contracting activities has led RTC to make a series of

strategic decisions in developing and implementing its contracting system that have increased RTC's vulnerability to mismanagement and waste.

Poor Contract Planning

Contract planning is the first critical step in effectively developing a contract. RTC must determine what services are needed, how the scope of work is to be defined, and the most efficient type of contract to achieve these goals. RTC has not performed this step well. Several recent examples have shown that RTC has issued contracts that did not describe the services needed and inadequately defined the scope of work.

RTC's handling of the Western Storm project, which was initiated by its Western Region in April 1991, illustrates poor contract planning. RTC paid about \$24 million under an improperly issued, sole-source contract for the reconciliation of assets from 92 failed institutions to RTC financial management records. RTC hired an independent auditor to review the project after the problems came to light. The contractor found that three of the project's five goals were either (1) so poorly documented that they were unable to determine the propriety of the work done or (2) not accomplished. Further, they found

that RTC's management practices and procedures were inadequate to ensure that payments to the contractor of about \$24 million were proper. Accordingly, poor planning, poor internal controls, and inappropriate contracting techniques hampered RTC's ability to monitor contractor performance and control costs and diminished the value of one of RTC's largest contracts.

Another step critical to effective project planning is having accurate information regarding the type of assets to be placed under contract. Because of inadequate information and poor compliance with policies, RTC has paid or is contractually liable for \$4.5 million in management and disposition fees to standard asset management and disposition agreement (SAMDA) contractors for work that was done entirely or primarily by staff at failed thrifts.

Also, RTC often structured SAMDA portfolios with real estate and loan assets in widely dispersed geographic locations, increasing contracting costs and risks. One-third of 98 SAMDA contract portfolios we analyzed included assets located in as many as 27 states. For example, 58 portfolios had assets located in Dallas/Fort Worth, but 40 of these

portfolios were managed from states other than Texas. In these situations, the risk of mismanagement and waste was higher because there were greater numbers of subcontractors performing services and relatively wider spans of control for RTC managers and SAMDA contractors who were charged with contract oversight.

Contractor Oversight Needs Improvement

RTC's job does not stop once a contract has been awarded. RTC must ensure that the money spent is for appropriate and timely contractor services. However, inadequate information places RTC at a disadvantage in attempting to oversee the activities of tens of thousands of contractors working on many types of assets. Contractor oversight still needs improvement, as shown by the following examples related to loan servicers and subcontractors.

RTC had not adequately overseen its inherited loan servicers, who service approximately \$7.5 billion in mortgages and loans. It did not have the necessary policies and procedures in place to monitor the inherited servicers' loan collection activities. Consequently, RTC cannot ensure that servicers are accurately accounting for and remitting loan payments. In addition, RTC does not know if its

servicers are sound financial institutions capable of maintaining the value and marketability of RTC's mortgages and loans. For example, 84 of 298 institutions servicing loans for RTC's receiverships in Florida were considered ineligible by the Federal National Mortgage Association (Fannie Mae) to service its mortgages. Furthermore, at the time of our review RTC did not have an accurate inventory of its inherited loan servicers.

Also, neither RTC's field offices nor the SAMDA contractors adequately monitored SAMDA subcontractors to ensure compliance with RTC's policies and to ensure that funds were not vulnerable to loss from unauthorized use. Several subcontractors told us that they had not been visited and their operating procedures had not been reviewed by the SAMDA contractor or RTC. Also, subcontractors were not following appropriate cash management policies and practices governing the use and control of cash from RTC properties.

Information Systems Are Critical to the Management and Sale of Thrift Assets

Information systems are critical to RTC's efforts to manage and sell failed thrift assets. Yet, until recently RTC's asset information system development efforts were disappointing. Problems include unclear or changing requirements, inaccurate and incomplete data, poor response times, and difficulty of use.

Although RTC has taken steps to better define its business needs and to strengthen its control over the corporate system development processes, more improvements need to be made. We remain concerned about the integrity of the real estate system data and the data in the systems now being used to manage and sell loan assets. Real estate system data as of January 1992 contained property records that were incomplete and inconsistent. For example, about 80 percent of the unsold properties did not have one or more key data elements, such as list price, date the property was listed for sale, and identification of the broker. Although there have been efforts to improve the data since then, these efforts have not included verifying important information such as the properties' managers, appraisals, and listings.

In addition, the Real Estate Owned Management System does not contain sufficient edit checks to prevent incorrect data from being entered into the system or adequate field office access to an audit trail of system changes for more than a day. As a result, RTC has no way of ensuring the continued reliability of these data or of knowing who changed them last. Further, RTC does not have a program to improve the data integrity of the wide variety of ad hoc field office and contractor systems it relies on to manage and sell its loan assets. RTC recognizes these issues and by March 1993 plans to have the corporate oversight programs and system changes in place to ensure the integrity of its real estate and loan systems data. Although necessary, these changes come late—after billions of dollars of assets have been placed under contract or sold.

We also continue to be concerned about the ability of the Asset Manager System to track contractors who manage, market, and sell RTC assets. Until needed modifications are completed and tested, the system will likely continue to have inadequate interfaces to account for contractors' income and expenses, insufficient automated controls to ensure that electronic funds transfers are

**Information Systems Are Critical to the
Management and Sale of Thrift Assets**

both timely and reconciled, and difficulty calculating certain management and disposition fees. Until improvements are made in these three areas, RTC has increased risk of errors and losses in the asset management system.

Financial Management and Accountability Must Be a Priority

In 1990, we were unable to express an opinion on RTC's financial statements due to weaknesses in its receivership internal controls, flaws in its methodology for estimating recoveries from the sale of receivership assets, and its significant exposure to losses from both real estate and delinquent real estate-backed loans for both resolved and unresolved institutions. During 1991, RTC acted to address the identified control and methodology problems. In addition, then-current projections indicated that RTC's universe of likely resolution candidates had significantly decreased and, therefore, its exposure to real estate-related losses in unresolved institutions was also lower. Given these factors, we were able to give RTC an unqualified opinion on its balance sheet and statement of cash flows for 1991.

While cash transactions during 1991 were valid and correctly recorded in the receiverships' general ledgers, receivership personnel could not supply all the documents necessary to confirm that transactions were processed in accordance with all of RTC's policies and standards. Although we could piece together enough of the year's transactions to ensure ourselves of their legitimacy, we were unable to assure

RTC that all of its internal controls were in place and working as intended to prevent or detect errors in future transactions. Lack of accountability and poor internal controls over cash management in RTC receiverships could increase the cost of resolutions and the amount to be paid by taxpayers and negatively affect future financial statement opinions.

Future Uncertainties Affect Resolution Activities

Costs attributable to RTC resolutions represent a significant part of the total for cleaning up the thrift crisis. In 1990, we estimated the total cleanup cost to be between \$335 billion and \$370 billion, not including the interest cost of Treasury borrowing to provide the needed funds. Current estimates of the number and cost of recent and future resolution actions support the lower end of the range. This low cost estimate is, in part, due to favorable interest rate spreads that have kept some troubled thrift institutions viable beyond expected resolution dates and reduced operating losses in institutions that did require RTC resolutions. The low cost estimate also assumes that RTC will minimize its losses by exercising proper control over its asset management and disposition responsibilities and that even hard-to-sell assets will meet certain minimal recovery rates.

However, funding disruptions have hampered RTC's efforts to resolve failed thrifts. RTC has run out of loss funds and has had to stop resolving failed thrifts three times since it was created. Most recently, RTC had to return \$18.3 billion to the Treasury because it did not obligate the funds before the April 1, 1992, legislative deadline. Certain RTC operations have not been funded since

that date. As a result, thrifts under RTC's control continued to post losses that contribute to the overall cost of the cleanup. For example, the 60 failed thrifts under RTC's control on June 30, 1992, reported net losses totaling \$283 million during the 3-month period ending in June.

In testimony on March 5, 1992, we recommended that the Congress eliminate the April 1992 obligations deadline, ask RTC to estimate its funding needs through the spring of 1993, and provide RTC with sufficient funds on a timely basis to carry out its responsibilities. Failed thrifts do not improve over time; their resolutions remain obligations that become more expensive when delayed. Therefore, we continue to believe that RTC should be provided with the necessary additional funds because without them the cost of the cleanup simply increases.

In December 1992, RTC estimated that an additional \$25 billion in loss funds would be needed for it to resolve current thrifts in conservatorship and thrifts anticipated to fail before September 30, 1993. We must caution that uncertainties beyond RTC's control related to general economic conditions present an even greater risk of

higher cost to taxpayers. Increased interest rates or further deterioration in real estate markets could cause marginally viable thrifts to fail. If additional failures occur, resolution costs will increase. These increased costs will have to be borne by RTC and after September 30, 1993, SAIF. Since SAIF is not expected to receive more than \$2 billion a year from thrift industry assessments, it will be unable to resolve many failed institutions without itself facing insolvency. If SAIF inherits a troubled thrift industry from RTC, the industry may not be able to assume full responsibility for its problems. In that case, taxpayers will undoubtedly be called on to continue funding thrift resolutions.

Conclusions and Action Needed

The total cost to taxpayers of the thrift cleanup depends both on the economy and on how well RTC discharges its responsibilities. RTC's greatest challenge in its remaining years will be to maximize the rate of return on its growing inventory of hard-to-sell assets and provide adequate contractor oversight. We have made several recommendations to RTC to minimize risks that are within its control. While RTC has acted on many of these, the following further actions are needed:

- RTC needs to better plan its real estate disposition activities to ensure that it maximizes recoveries on asset sales. Specifically, RTC needs to carefully evaluate its past disposition results to better plan its future disposition strategies and ensure that recoveries are maximized.
- Given the large amount of money flowing through private sector contractors acting on behalf of RTC, it is critical that RTC establish a comprehensive system of contract oversight.
- RTC needs to continue its efforts to improve the integrity of the Real Estate Owned Management System data and its Asset Manager System.

Additionally, we believe that the new administration needs to work with Congress to obtain the additional funds RTC needs to pursue its resolution activities. Any further delay merely increases the eventual cost of the savings and loan cleanup.

Although RTC has made progress in improving its operations and cleaning up the problems it inherited, many problems are likely to remain after 1996, when RTC is scheduled to close. Thus, the total cost of the cleanup also depends on the effectiveness of structures established to deal with thrift losses occurring after RTC relinquishes its resolution responsibilities in 1993 and all of its other responsibilities in 1996. In large part, the condition of RTC's accounting and management information systems at the time of turnover will determine how effectively the FSLIC Resolution Fund will manage the remaining responsibilities.

The Congress and the new administration will need to work together to ensure that FDIC has the capacity to carry out the resolution and asset disposition responsibilities it will inherit from RTC and that there is greater certainty that SAIF will remain solvent. Also,

consideration should be given to how best to apply RTC's investment in both processes and people skilled in the management and disposition of financial and real estate assets should a large number of banks fail in the near future. Such consideration should include whether it would be beneficial to use RTC to dispose of the assets of all failed financial institutions as opposed to increasing the capacity of FDIC to handle such tasks.

The savings and loan cleanup will remain a highly risky endeavor that bears close scrutiny. RTC can minimize the risks within its control—namely those associated with asset disposition, contracting, and information systems. Congress can help minimize the risks by continuing its oversight activities and making funds available for resolutions. We will continue to do our part to monitor RTC improvements and assist Congress in its oversight.

Related GAO Products

Resolution Trust Corporation: Subcontractor Cash Management Practices Violate Policy and Reduce Income (GAO/GGD-93-7, Oct. 20, 1992).

Resolution Trust Corporation: Asset Pooling and Marketing Practices Add Millions to Contract Costs (GAO/GGD-93-2, Oct. 7, 1992).

Resolution Trust Corporation: More Actions Needed to Improve Single-Family Affordable Housing Program (GAO/GGD-92-136, Sept. 29, 1992).

Resolution Trust Corporation: Affordable Multifamily Housing Program Has Improved but More Can Be Done (GAO/GGD-92-137, Sept. 29, 1992).

Resolution Trust Corporation: Western Storm Investigation and Related Contracting Deficiencies (GAO/T-GGD-92-67, Aug. 6, 1992).

Insurance Fund: Outlook Affected by Economic, Accounting, and Regulatory Issues (GAO/T-AFMD-92-11, June 30, 1992).

Financial Audit: Resolution Trust Corporation's 1991 and 1990 Financial Statements (GAO/AFMD-92-74, June 30, 1992).

Resolution Trust Corporation: Oversight of Certain Loan Servicers Needs Improvement (GAO/GGD-92-76, Apr. 24, 1992).

Resolution Trust Corporation: Corporate Strategy Needed to Improve Information Management (GAO/IMTEC-92-38, Mar. 5, 1992).

Resolution Trust Corporation: Further Actions Needed to Implement Contracting Management Initiatives (GAO/GGD-92-47, Mar. 5, 1992).

Resolution Trust Corporation: Preliminary Results of Western Storm Investigation and Related Contracting Deficiencies (GAO/T-OSI-92-5 and GAO/T-GGD-92-16, Mar. 3, 1992).

Resolution Trust Corporation: Performance Assessment for 1991 (GAO/T-GGD-92-47, Feb. 26, 1992).

Resolution Trust Corporation: Assessing Portfolio Sales Using Participating Cash Flow Mortgages (GAO/GGD-92-33BR, Feb. 25, 1992).

Resolution Trust Corporation: Effectiveness of Auction Sales Should be Demonstrated (GAO/GGD-92-7, Oct. 31, 1991).

Financial Audit: Resolution Trust Corporation's 1990 Financial Statements
(GAO/AFMD-92-20, Oct. 25, 1991).

Resolution Trust Corporation: A More Flexible Contracting-Out Policy Is Needed
(GAO/GGD-91-136, Sept. 18, 1991).

Resolution Trust Corporation: Stronger Information Technology Leadership Needed
(GAO/IMTEC-90-76, July 23, 1990).

Resolution Trust Corporation: Structure and Oversight Issues (GAO/T-GGD-91-55, July 15, 1991).

Resolution Trust Corporation: Performance Assessment to Date (GAO/T-GGD-91-07, Feb. 20, 1991).

Resolution Trust Corporation: Unnecessary Loan Servicing Costs Due to Inadequate Contract Oversight (GAO/GGD-91-19, Jan. 17, 1991).

Resolution Trust Corporation: Automation Efforts Need Management Attention
(GAO/T-IMTEC-91-1, Oct. 16, 1990).

RTC Asset Management: Contracting Controls
Need to Be Strengthened (GAO/T-GGD-90-53,
Sept. 24, 1990).

Asset Management: Resolution Trust
Corporation Needs to Build a Strong
Foundation to Support its Asset Disposition
Efforts (GAO/T-GGD-90-38, May 4, 1990).

Resolving the Savings and Loan Crisis:
Billions More and Additional Reforms
Needed (GAO/T-AFMD-90-15, Apr. 6, 1990).

High-Risk Series

Lending and Insuring Issues

Farmers Home Administration's Farm Loan Programs (GAO/HR-93-1).

Guaranteed Student Loans (GAO/HR-93-2).

Bank Insurance Fund (GAO/HR-93-3).

Resolution Trust Corporation (GAO/HR-93-4).

Pension Benefit Guaranty Corporation
(GAO/HR-93-5).

Medicare Claims (GAO/HR-93-6).

Contracting Issues

Defense Weapons Systems Acquisition
(GAO/HR-93-7).

Defense Contract Pricing (GAO/HR-93-8).

Department of Energy Contract Management
(GAO/HR-93-9).

Superfund Program Management
(GAO/HR-93-10).

NASA Contract Management (GAO/HR-93-11).

Accountability
Issues

Defense Inventory Management
(GAO/HR-93-12).

Internal Revenue Service Receivables
(GAO/HR-93-13).

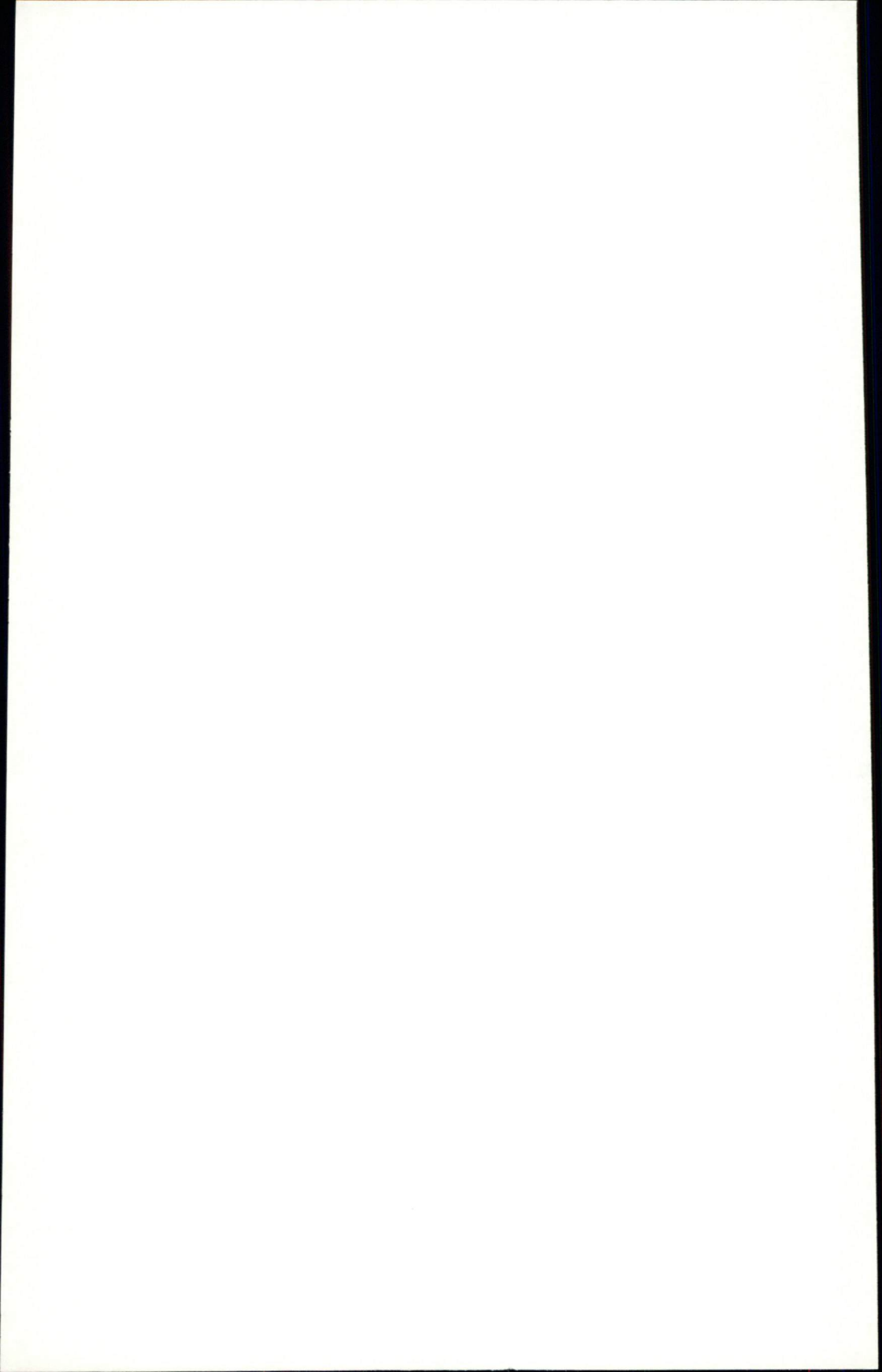
Managing the Customs Service (GAO/HR-93-14).

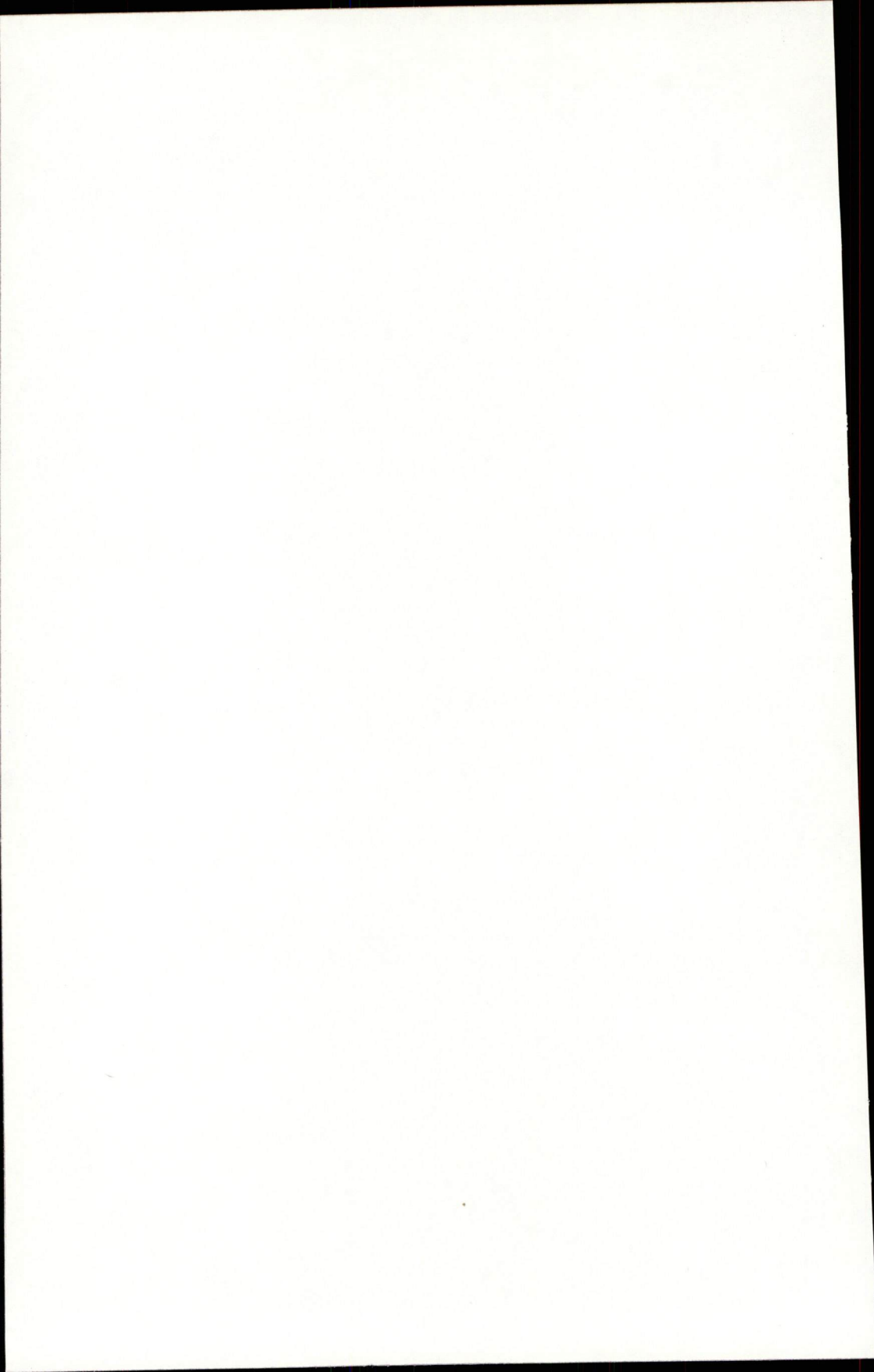
Management of Overseas Real Property
(GAO/HR-93-15).

Federal Transit Administration Grant
Management (GAO/HR-93-16).

Asset Forfeiture Programs (GAO/HR-93-17).







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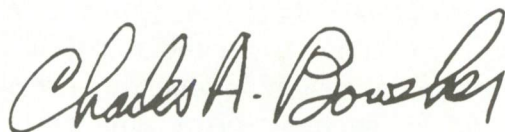
In January 1990, in the aftermath of scandals at the Departments of Defense and Housing and Urban Development, the General Accounting Office began a special effort to review and report on federal government program areas that we considered "high risk."

After consulting with congressional leaders, GAO sought, first, to identify areas that are especially vulnerable to waste, fraud, abuse, and mismanagement. We then began work to see whether we could find the fundamental causes of problems in these high-risk areas and recommend solutions to the Congress and executive branch administrators.

We identified 17 federal program areas as the focus of our project. These program areas were selected because they had weaknesses in internal controls (procedures necessary to guard against fraud and abuse) or in financial management systems (which are essential to promoting good management, preventing waste, and ensuring accountability). Correcting these problems is essential to safeguarding scarce resources and ensuring their efficient and effective use on behalf of the American taxpayer.

This report is one of the high-risk series reports, which summarize our findings and recommendations. It describes our concerns over the Bank Insurance Fund, focusing on the factors that contributed to the depletion of the Fund's reserves and discusses the need for effective implementation of the Federal Deposit Insurance Corporation Improvement Act of 1991 and improved accounting rules and bank examinations to shore up and maintain the well-being of the nation's system of deposit insurance. The desirability of the current regulatory structure also needs to be evaluated. Competitiveness issues confronting the banking industry must be resolved once the regulatory reforms are in place.

Copies of this report are being sent to the President-elect, the Democratic and Republican leadership of the Congress, congressional committee and subcommittee chairs and ranking minority members, the Director-designate of the Office of Management and Budget, and the Acting Chairman of the Federal Deposit Insurance Corporation.



Charles A. Bowsher

Contents

Overview	6
Banking Regulators and the Bank Insurance Fund	11
Regulatory System Proves Ineffective as Industry's Risks Increased	14
Successful Implementation of the FDIC Improvement Act Is Critical for the Industry and the Insurance Fund	21
Many Uncertainties Affect the Future Outlook for the Bank Insurance Fund	30

Contents

Competitiveness Issues Confronting the Banking Industry Must Also Be Resolved	35
Conclusions and Action Needed	37
Related GAO Products	41
High-Risk Series	45

Overview

The Federal Deposit Insurance Corporation (FDIC) was created in 1933 to provide deposit insurance to protect bank depositors. In addition, FDIC was authorized to make and enforce banking rules and to perform other supervisory duties as part of the insurer's role. Through the Bank Insurance Fund, FDIC insures deposits of up to \$100,000 in about 11,700 commercial banks and about 430 savings banks.

The Problem

The Fund's reserves are exhausted. In 1987, it reached \$18.3 billion—its highest level ever. But an upsurge in bank failures caused it to lose more than \$25 billion in 4 years. As of December 1991, it was \$7 billion in the red.

The Causes

In the 1980s, U.S. banks found their traditional customer base shrinking and the competition from other domestic and foreign financial services vendors on the rise. In response, banks turned to riskier lending activities—most notably, loans for commercial real estate ventures.

Weak internal controls, flawed corporate governance systems, and lax regulatory supervision put both the banks and the

insurance fund at risk, and further heightened the threat by making less likely any early warning of problems. Meanwhile, flexible accounting standards contributed to the problem by enabling weak institutions to hide the extent of their problems until their losses had grown.

In the second half of the 1980s, many of these institutions went broke: Between 1987 and 1991, 882 banks with assets totaling \$151 billion failed. By 1991, the Fund's reserves were depleted.

Even while costs to the Fund mounted, neither the Congress nor the administration received an early warning of the size of the problem from the federal budgetary system. Under the current cash-based method, costs to the deposit insurance system are already incurred by the time their impact on the budget is recognized.

GAO's
Suggestions for
Improvement

The Federal Deposit Insurance Corporation Improvement Act, enacted in December 1991, contains accounting, corporate governance, and regulatory reforms designed to correct weaknesses in the deposit insurance system. Among other measures, the act's early warning reforms

provide for the timely disclosure of internal control weaknesses and violations of laws and regulations. Its early intervention requirements are designed to ensure that regulators take prompt and appropriate actions to correct unsafe banking practices.

In addition, the act provides for the rebuilding of the depleted deposit insurance fund. The act increases FDIC's borrowing authority to cover losses incurred from resolving troubled institutions and requires FDIC to develop a recapitalization plan to increase the Fund's reserves to 1.25 percent of insured deposits within 15 years.

The provisions of the FDIC Improvement Act are largely in keeping with long-standing GAO recommendations. We believe, however, that the ultimate success of the act will depend on FDIC's use of its authority to rebuild the insurance fund and on the quality of the regulators' oversight efforts and the regulations they develop and issue to implement the new law. The current quality of examinations limits the regulators' ability to assess the safety and soundness of insured depository institutions. The merit of the regulatory structure also needs to be reviewed to provide for more efficient and effective regulation.

In addition, neither the Financial Accounting Standards Board nor the federal regulators have acted to effectively tighten flexible accounting rules. Therefore, we have asked the Congress to consider legislating certain regulatory accounting principles for nonperforming loans and more rigorous financial reporting to regulators. This would result in more accurate and useful financial reporting and enable regulators to better assess the condition of federally insured institutions.

To remedy the lagging disclosure of the cost of deposit insurance on the budget, we believe that some form of accrual-based budgeting should be adopted. This would give decisionmakers an earlier and better measure of the expected costs of deposit insurance.

Finally, numerous competitiveness issues—such as interstate branching and regulatory burden—must eventually be resolved in order to ensure the banking industry's long-term viability. We believe that the implementation of the FDIC Improvement Act will have a direct bearing on both the timing of further changes and the benefits that are likely to be realized from them. When the act's reforms have been effectively

Overview

implemented, other modernization issues can be addressed on their merits and at an acceptable risk to the safety and soundness of the banking system.

Banking Regulators and the Bank Insurance Fund

FDIC was created by the Banking Act of 1933 to stabilize or promote the stability of banks by providing deposit insurance to protect bank depositors. It was authorized to promulgate and enforce rules and regulations relating to the supervision of insured banks and to perform other regulatory and supervisory duties consistent with its responsibilities as insurer.

Enactment of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 designated FDIC sole federal insurer of all banks and savings associations and administrator of the insurance funds. The act created a new insurance fund for thrifts—the Savings Association Insurance Fund—and retitled the insurance fund for banks the Bank Insurance Fund. In its insurance capacity for bank depositors, FDIC, through the Bank Insurance Fund, covers federally insured commercial banks, state chartered savings banks, and any federal savings bank chartered pursuant to section 5(o) of the Home Owner's Loan Act. Deposits are insured up to \$100,000 in about 11,700 commercial banks and about 430 savings banks.

However, FDIC does not have primary regulatory responsibility for all banks. The Board of Governors of the Federal Reserve

System examines state-chartered banks that are members of the Federal Reserve System and bank holding companies, while the Office of the Comptroller of the Currency examines national banks. FDIC's operations include examining state-chartered banks that are not members of the Federal Reserve System, conducting liquidation activities for insured banks that have failed, and providing and monitoring assistance to failing banks.

Federally insured depository institutions pay premiums, or assessments, for insurance coverage. The premiums paid by financial institutions insured by the Bank Insurance Fund are the primary sources for funding expenses incurred by the Fund in resolving failed institutions. From 1933, the year FDIC was created, through 1989, the assessment rate charged insured institutions never exceeded 8.3 basis points. Up until 1984, this was sufficient to provide the Fund with adequate revenues to fund insurance expenses. In fact, in some years FDIC was actually able to rebate a portion of these premiums back to the industry. In 1984, insurance expenses exceeded premiums, but the shortfall was funded through FDIC's other sources of revenue, primarily investment income. This additional income was used to supplement insufficient insurance premiums

during the next 3 years. However, in 1988, the rising level of bank failures and their increasing costs resulted in FDIC incurring insurance expenses that exceeded all its revenue sources, resulting in the first net loss sustained by FDIC in its history. Although legislation was enacted in 1990 to substantially increase FDIC's authority to raise assessment rates, which FDIC did, the rising tide of insurance losses continued to exceed the Fund's revenue sources. By December 31, 1991, these losses exhausted the Fund's reserves.

Regulatory System Proves Ineffective as Industry's Risks Increased

For most of the period in which the system of federal deposit insurance has been in existence, banks faced limited competition for business. Entry was restricted, no interest was paid on demand deposits, and rates that could be paid on other deposits were controlled by Federal Reserve regulations. Particularly during the 1980s, however, many of these protections, which helped reduce risks to banks and thus protect the deposit insurance system, were eliminated or greatly diminished by changed regulations, advances in technology, and other factors. Large, blue-chip companies, which were traditionally the major customer base for banks, began to raise much of the money needed to finance their operations directly from financial markets, bypassing banks. Banks also faced increasing competition from finance companies and other non-banks, and foreign banks.

Facing increasing competition from other domestic and foreign industries with their traditional customer base shrinking, banks turned to alternative lending opportunities, such as loans to less-developed countries, loans to finance highly leveraged transactions, and loans for commercial real estate. These lending strategies carried greater risk of loss to both the insured

institution and the insurance fund. Further, banks were still restricted from engaging in interstate banking activities, effectively preventing them from diversifying the risks in their loan portfolios. This left many banks vulnerable to adverse regional economic and market conditions.

The Depository Institutions Deregulation and Monetary Control Act of 1980 increased deposit insurance coverage from \$40,000 to \$100,000. During this same period, deregulation initiatives enabled banks to assume more risk in their portfolios and at the same time reduced bank regulators' supervisory controls over banks. For example, the 1980 act decreased the number of annual examinations statutorily required for national banks from two to zero. Additionally, the Garn-St Germain Depository Institutions Act of 1982 eliminated the real estate loan-to-value restrictions for national banks. The regulators' examination staffing levels were also reduced during the early 1980s, resulting in significant declines in the number and frequency of full-scope examinations.

As the banking industry took on riskier lending strategies, bank internal controls and

corporate governance systems as well as bank regulatory supervision were not effective in minimizing these risks both to banks and to the insurance fund. Our studies of banks that failed between 1987 and 1989 found inadequate systems of internal controls including weaknesses in loan underwriting, loan documentation, asset classification and problem workout practices, and compliance with safety and soundness laws and regulations. Although bank management is responsible for maintaining an effective system of internal control, audit committees should also play a vital role in an effective system of corporate governance to oversee management's attention to internal controls. However, in response to our survey, many audit committee chairmen of the nation's largest banks advised us that committee members lacked the independence and expertise necessary to effectively perform their responsibilities.

Weakened regulatory supervision hindered regulators' ability to identify and resolve problem institutions in a timely manner. The reduction in examination staff during the early 1980s reduced the number and scope of on-site examinations and gave rise to increased use of off-site monitoring of

**Regulatory System Proves Ineffective
as Industry's Risks Increased**

banks. Bank regulators also followed a philosophy of trying to work informally with troubled institutions to correct serious operational deficiencies and improve their health and viability. This sometimes resulted in delaying needed regulatory enforcement actions and increasing the ultimate cost of bank failures to the insurance fund. When enforcement actions were taken they tended to focus on capital inadequacy, rather than on a troubled institution's underlying problems, as the key indicator of unsafe and unsound banking practices, despite the fact that bank capital is typically a lagging indicator of serious bank problems.

Our soon to be issued reports on the quality of regulatory examinations also show that the limited nature of these examinations is not sufficient to fully assess the safety and soundness of bank operations and practices. Our review of bank and thrift examinations showed serious weaknesses in the examination process, including a lack of comprehensive internal control assessments by the examiners, insufficient loan quality and loan loss reserve reviews, over-reliance on unverified data, and weak or inconsistent quality controls over the examination process. A lack of minimum, mandatory examination standards in these areas was a

common factor for each of the regulatory agencies that limited the effectiveness of the examination process as an early warning of problems.

The adequacy of financial information reported by banks to the regulators is critical to the regulatory early warning process, especially for off-site monitoring. Deficiencies in existing accounting standards contributed to hindering the early warning process by allowing troubled institutions to delay timely reporting of loan impairment and to inaccurately minimize the extent of losses suffered by the institution from asset deterioration. Our review of 39 banks that failed in 1988 and 1989 showed that flexible accounting standards allowed problem banks to unduly delay recognizing losses in their loan portfolios and to overstate the value of real estate acquired through foreclosure, thus overstating their capital. The magnitude of FDIC's adjustments to the loss reserves of these banks at the time of their failure showed that \$7.3 billion in reported bank capital did not exist. Flexible accounting rules are also used by banks to recognize gains while deferring losses on debt investment securities and to not recognize the economic substance of related party transactions when materially

different than their legal form. Such latitude contributes to banks reporting inflated capital levels and further clouds the regulators' ability to accurately assess the true financial condition of insured institutions.

The federal budgetary system also did not forewarn the administration and the Congress of the rising costs associated with the nation's deposit insurance system. Under the current cash-based budgeting treatment for deposit insurance, the costs for this program have already been incurred by the time the program's budgetary impact is disclosed. We believe that some form of accrual-based budgeting should be adopted to better measure the expected costs of deposit insurance before these costs are incurred. Such a budgetary system would give the administration and congressional leaders earlier warning of rising insurance costs, and would better assist them in policy decision-making. However, the administration's proposed accrual budgeting for deposit insurance introduced in the fiscal year 1993 budget went beyond tested accrual accounting conventions and was questionable because of the uncertain assumptions and poor data that underlie the calculations.

**Regulatory System Proves Ineffective
as Industry's Risks Increased**

The weaknesses in the regulatory early warning system and the budgetary treatment for deposit insurance hindered the regulators, the administration, and the Congress from recognizing earlier on the increasingly significant exposure to insurance losses facing the Bank Insurance Fund. These factors contributed significantly to the precipitous decline and depletion of an insurance fund that, just 5 years ago, reached the highest level in its history.

Successful Implementation of the FDIC Improvement Act Is Critical for the Industry and the Insurance Fund

The FDIC Improvement Act of 1991, enacted December 19, 1991, provides for accounting, corporate governance, and regulatory reforms that help address the serious weaknesses in the nation's system of deposit insurance that contributed to the depletion of the Bank Insurance Fund. Successful implementation of these reforms is critical to facilitating early warning of safety and soundness problems and minimizing losses to the Fund.

The act's early warning reforms, which include provisions for timely disclosure of internal control weaknesses and violations of laws and regulations, address the flawed corporate governance system. The act requires insured financial institutions with assets of \$150 million or more to submit annual reports to the regulators containing (1) a statement of management's responsibility for the institution's financial statements, internal controls, and compliance with safety and soundness laws and regulations designated by the regulators, (2) audited financial statements, (3) management's assessment of the effectiveness of the institution's internal controls, and (4) management's assessment of the institution's compliance with designated laws and regulations.

The institution's external auditors are required to report separately on management's assertions on internal controls and compliance with laws and regulations. The institution's external auditor is also required to meet certain qualifications, such as having received a peer review that meets guidelines acceptable to the FDIC, and the regulators have the authority to remove, suspend, or bar the external auditor upon showing of due cause. Additionally, the act contains a number of requirements to improve communication among the insured institution, its external auditor, and the regulators.

The corporate governance system is also strengthened by the act's independent audit committee requirements. Institutions with assets of \$150 million or more must establish audit committees made up entirely of outside directors who are independent from the management of the institution. Among its duties, the audit committee is responsible for reviewing with management and its external auditor the basis for financial reports, the auditor's opinion, management's assessment of the institution's internal controls and compliance with laws and regulations, and the external auditor's report on management's assertions on internal

controls and compliance. Audit committees for large institutions are required to include members with banking or related financial management expertise and exclude large customers of the institution. The committee must also have access to outside counsel independent from the institution.

The corporate governance reforms are effective for institutions whose fiscal years begin after December 31, 1992. The regulators have published proposed regulations to implement these reforms. We have advised FDIC that the draft regulations need considerable modifications to be effective. If these changes are not made, the benefits expected from the act's internal control and other corporate governance requirements are not likely to be realized.

The act's regulatory reforms include requirements for annual full-scope examinations for generally all institutions and for the establishment of a system of capital and noncapital "tripwires" to provide for early regulatory intervention to minimize losses to the insurance fund. The intent of the act's requirement for annual full-scope examinations is to ensure that the regulators have a sound basis for reaching conclusions about the safety and soundness of a bank's

Successful Implementation of the FDIC Improvement Act Is Critical for the Industry and the Insurance Fund

operations. The act's early intervention requirements are designed to ensure that appropriate action is taken to promptly correct unsafe and unsound banking practices.

FDIC recently issued final regulations covering the implementation of the act's capital tripwire provisions. Under these regulations, which are effective December 19, 1992, bank regulators are required to take specified actions when an institution's capital falls below certain levels. Such actions include restricting the payment of dividend and management fees, restricting asset growth, and prohibiting acquisitions, branch openings, and new business ventures. The actions taken by the regulators become more restrictive as the institution's capital declines. The regulations also require that the regulators take prompt action to resolve a problem institution before its capital is depleted, thereby minimizing losses to the insurance fund. Closure of a troubled institution can occur when a bank's tangible equity falls to 2 percent or less of its total assets.

The noncapital tripwires include safety and soundness standards relating to internal controls, loan documentation, credit

**Successful Implementation of the FDIC
Improvement Act Is Critical for the
Industry and the Insurance Fund**

underwriting, interest rate exposure, and asset growth. They are intended to facilitate timely correction of deficiencies before losses occur and capital is eroded. These standards must be developed by the regulators and are to be effective no later than December 1, 1993.

The act establishes objectives for accounting principles applicable to reports filed with the regulators by depository institutions. These objectives essentially require that the application of the accounting principles result in financial statements and reports of condition that accurately reflect the capital of such institutions, and facilitate effective supervision and prompt corrective action to resolve troubled institutions at the least cost to the insurance funds. The regulators are required to review all accounting principles used by insured institutions in developing reports filed with the regulators by December 19, 1992, to ensure they meet the objectives of reliable financial reporting established by the act. If the regulators determine that application of any accounting principle will not meet the act's objectives, the regulators have the authority to prescribe accounting principles which satisfy these objectives.

In June 1992, we presented a detailed analysis of the applicable accounting rules for recognizing and measuring losses from nonperforming loans. The analysis indicated deficiencies in existing accounting rules that contribute to unreliable financial reports of insured institutions. The Financial Accounting Standards Board (FASB) and the regulators reviewed our report, but neither appears likely to take corrective action. There still appears to be a reluctance to value nonperforming loans at values that reflect fair value conditions, although we believe this would provide the best measure of an institution's eventual recovery on such loans. Until these deficiencies in existing accounting standards are corrected, we remain concerned that nonperforming loans will not be valued consistently on a fair value basis, and that, as a result, asset values and capital will continue to be overstated. Similarly, flexible accounting rules for investment securities and related party transactions are a continuing problem contributing to banks reporting overstated capital.

Deposit insurance has proven to provide an incentive for inappropriate risk taking at the expense of the insurance fund and, ultimately, the taxpayer. To address the

**Successful Implementation of the FDIC
Improvement Act Is Critical for the
Industry and the Insurance Fund**

problem of excessive risk taking on the part of federally insured institutions, the FDIC Improvement Act places limitations on institution levels of brokered deposits, which have been used in the past as a funding source for high-risk growth. The act also requires that the regulators develop and issue revised risk-based capital standards that consider interest-rate risk, concentrations of credit risk, risks associated with nontraditional banking activities, and risks associated with multifamily mortgage lending. Regulations implementing these revised standards are required by June 1993. The act also requires that FDIC replace its premium assessment rate system, wherein all institutions were assessed at the same rate, with a risk-based premium system by January 1994. FDIC is implementing a transitional risk-based premium system effective January 1, 1993, whereby institutions posing a higher risk of failure and cost to the insurance fund, as measured in part by capital thresholds, will be charged higher premiums than those institutions considered well or adequately capitalized.

Legislation was proposed in 1992 that, if enacted, would have delayed, deleted, or modified the accounting, corporate

**Successful Implementation of the FDIC
Improvement Act Is Critical for the
Industry and the Insurance Fund**

governance, and regulatory reforms required by the FDIC Improvement Act. The most comprehensive of these were the "Credit Availability and Regulatory Relief Act of 1992" and H.R. 5433, the "Comprehensive Community Bank Burden Reduction Act of 1992." The stated purpose of the proposed legislation was to reduce the regulatory burden on depository institutions. Although we believe reducing regulatory burden has merit, these proposals were misguided. We remain concerned that such harmful proposals will be attempted in 1993 and, if enacted, would place the insurance funds at serious risk.

The bankruptcy of the former insurance fund for thrifts (the Federal Savings and Loan Insurance Corporation), the insolvency of the Bank Insurance Fund, the near insolvency of the Savings Association Insurance Fund, and the continuing high level of troubled banks and thrifts and their possible failures are further evidence of the need for the FDIC Improvement Act's accountability and supervisory reforms. The act provides the regulators with the tools necessary to obtain more accurate information on the condition and activities of insured depository institutions and clear standards by which to judge unsafe and

**Successful Implementation of the FDIC
Improvement Act Is Critical for the
Industry and the Insurance Fund**

unsound conditions, and the institutions with incentives to correct unsafe and unsound conditions in a timely manner. These reforms are critically linked to provide an early warning of safety and soundness problems and minimize losses to the insurance funds. These reforms should not be burdensome on well managed institutions. Weakening these reforms sets the stage for a repeat performance of the mistakes of the past and their costly consequences.

Many Uncertainties Affect the Future Outlook for the Bank Insurance Fund

While successful implementation of the FDIC Improvement Act's accounting, corporate governance, and regulatory reforms is critical to restoring to an acceptable level management accountability and regulatory oversight, the depleted Bank Insurance Fund must be rebuilt. The act increases FDIC's borrowing authority from the Department of the Treasury from \$5 billion to \$30 billion to cover losses incurred from resolving troubled institutions. FDIC is also required to develop and implement a recapitalization plan for the Bank Insurance Fund to increase the Fund's reserves to a designated ratio of 1.25 percent of insured deposits over a maximum of 15 years. FDIC's borrowings from the Treasury are to be repaid by the industry and would be considered in recapitalization plans for the Fund. Although statutory requirements exist to rebuild the Fund, the Fund's outlook is uncertain.

As of June 30, 1992, the regulators identified 1,044 banks with assets totaling \$567 billion as problem institutions. However, the Fund's ultimate exposure to losses from troubled institutions is difficult to predict over the long term with any level of precision. FDIC's recently approved recapitalization plan for the Fund includes estimates of the total assets of expected bank failures projected

over 15 years. These estimates indicate that FDIC expects banks with assets totaling \$233 billion to fail between 1992 and 1995, at an estimated cost to the Fund of approximately \$40 billion. Over \$16 billion of these costs were recognized in the Fund's 1991 financial statements. Under FDIC's estimates, the level of failed bank assets and the cost of bank failures to the Fund decline significantly after 1995.

In April 1992, the Congressional Budget Office testified that it and other government and private entities estimated that the Fund faced costs of between \$15 billion and \$72 billion over the next 4 years from resolving problem banks. More recently, a private study concluded that the Fund could incur costs of between \$31 billion and \$95 billion by closing or assisting banks the study determined were insolvent at December 31, 1991 after applying discounts to mark the banks' assets to market value.

The range of these estimates, as well as their various underlying assumptions, is indicative of the difficulty of reliably estimating future bank failures and their cost to the Fund. We are currently reviewing the adequacy of the Fund's reserve levels as part of our audit of

the Fund's December 31, 1992, financial statements.

The recent low interest rate environment has enabled banks to recognize profits from the favorable interest spreads. Additionally, banks have been able to realize gains through the sales of securities, further generating short-term profits. While this may affect an institution's profit picture, it does not eliminate the losses embedded in the institution's asset portfolio. If interest rates begin to rise and banks have not adequately provided for loan portfolio losses, the number of bank failures could begin to rise. Poor economic and market conditions could also adversely affect amounts FDIC expects the Bank Insurance Fund will recover from the disposition of failed institution assets, resulting in higher than anticipated losses to the Fund.

Regarding interest rates, the drop in interest rates coupled with an ample supply of funds has led banks to increase their investments in securities. FDIC recently testified that many banks have funded long-term investment securities, such as Treasury bonds, with shorter-term deposits. As of June 30, 1992, over 1,200 banks had invested at least 20 percent of their assets in

investment securities with maturities of 5 or more years. These banks hold more than 9 percent of the industry's assets. A rise in interest rates generally would devalue these portfolios of debt securities. If short-term rates rise faster than long-term rates, net interest margins will be detrimentally affected. Such conditions could result in the failure of marginally capitalized banks and add to insurance fund losses.

The future condition of the thrift industry and its insurer, the Savings Association Insurance Fund (SAIF), could also affect the adequacy of the funding provided by the FDIC Improvement Act to cover the Bank Insurance Fund's needs. The \$30 billion in Treasury borrowing authority provided to FDIC is to cover the needs of both funds. While SAIF currently has some resolution responsibility, it will assume sole responsibility for resolving all federally insured thrifts from the Resolution Trust Corporation in October 1993. If SAIF assumes full resolution responsibility with a backlog of troubled thrifts, its available funding sources may prove insufficient to meet its resolution needs. If this occurs, FDIC may be forced to use some of the \$30 billion in Treasury borrowing authority to cover SAIF's

losses, thus reducing the amount of funding available to the Bank Insurance Fund.

FDIC recently increased assessments charged to insured institutions and will implement a transitional risk-based premium system in January 1993, 1 year ahead of the date mandated by the FDIC Improvement Act. Under this risk-based premium system, weaker, riskier institutions will pay more for insurance coverage. Such a system provides for a more equitable sharing of the burden within the industry, as well-run institutions will pay less for insurance coverage. It provides an incentive for poorly-run institutions to improve their operations. Assessment rates will range from 23 cents to 31 cents per \$100 of domestic deposits, with an average assessment rate of 25.4 cents charged to insured banks. The average assessment rate represents an increase of 10 percent over the current flat rate of 23 cents per \$100 of domestic deposits charged to all federally insured banks. However, at the time the proposal was released for public comment, FDIC estimated that, under its most likely scenario, the Fund would have only a 60 percent probability of attaining the designated reserve ratio over the maximum 15-year statutory period.

Competitiveness Issues Confronting the Banking Industry Must Also Be Resolved

The reforms contained in the FDIC Improvement Act are important to reduce the costs of deposit insurance—costs for taxpayers and for the healthy banks whose premiums pay for the losses of failed banks. When implemented, these reforms will lay the groundwork for consideration of additional reforms likely to appear soon on the incoming administration's and the Congress' agenda. These additional reforms, intended to modernize the banking system, include expanding the allowable business lines of banking organizations and removing federal restrictions on interstate banking and branching. At a minimum, interstate banking offers the opportunity for more efficient banking and should be considered.

Without question, the nation's economy needs a healthy, competitive banking system, and changes in the federal laws pertaining to powers and interstate banking may prove to be essential. However, modernization efforts pose potentially large, down side risks that cannot be ignored. The FDIC Improvement Act's management and supervisory reforms are a crucial element in the modernization of the banking system precisely because they address the conditions that are needed for operating a banking system safely in today's competitive,

**Competitiveness Issues Confronting
the Banking Industry Must Also Be
Resolved**

fast changing financial markets. To operate safely, a bank that offers more products and serves wider areas must have up-to-date management systems for controlling risks and preparing accurate financial statements. Additionally, bank regulators must have the ability to know the financial condition of a bank, detect problems, and take action before a bank's capital is exhausted and the deposit insurance funds must take a loss.

When the FDIC Improvement Act's reforms are in place, other modernization issues can be addressed on their merits at an acceptable risk to the safety and soundness of the system. Thus, effective implementation of the act has a direct bearing on both the timing of further changes and the benefits that are likely to be realized.

Conclusions and Action Needed

The Congress has been very responsive to our recommendations to rebuild the Bank Insurance Fund and to put safeguards in place to improve regulation and minimize losses to the Fund. FDIC has the statutory authority to take steps to rebuild the Fund and has been given statutory power to implement reforms to minimize risks and losses to the Fund. The ultimate success of the FDIC Improvement Act will depend on FDIC's use of its authority to rebuild the Fund and the quality of the regulations developed and issued to implement the act. Proposed regulations to implement the act's internal control and other corporate governance provisions need considerable enhancement. It is critical that the incoming administration and the Congress strongly encourage the regulators to effectively implement the act.

We will continue to monitor the development and issuance of implementing regulations. However, because neither FASB nor the regulators appear willing to address the serious deficiencies in existing accounting standards for nonperforming loans, we have suggested that the Congress consider legislating regulatory accounting principles for nonperforming loans and financial reporting to the regulators. Generally, we do not advocate the use of

accounting principles that differ from generally accepted accounting principles. However, the use of more stringent accounting rules in the area of loan loss accounting and investment securities such as those we have advocated would result in more accurate and useful financial reporting and aid the regulators in better assessing the true condition of federally insured institutions. Also, the expanded use of complex financial derivatives and off-balance sheet risks by the banking industry poses considerable exposure to the insurance fund while reliable financial reporting of these activities is likely to lag. We have undertaken studies of these issues.

While the FDIC Improvement Act requires annual full-scope examinations of insured institutions, our soon to be issued reports on the quality of bank examinations show the need for substantial improvements to fully assess bank safety and soundness. If the regulators do not adequately address our recommendations to correct the serious weaknesses, the Congress may wish to enact legislation to mandate such improvements. Although we did not study the efficiency and effectiveness of the regulatory structure, we identified many inconsistencies among the regulators in their operations and practices

that may hinder how well the regulators address the problems we found in our review. The incoming administration and the Congress may wish to review the existing financial institutions' regulatory structure and consider alternatives to eliminate regulator inconsistencies and strengthen the efficiency and effectiveness of the regulatory structure.

On a related issue, regulatory burden and its effect on bank operations, costs, and competitiveness continues to surface as banking becomes more complex and competitive both domestically and internationally. We have undertaken a review of the regulatory burden facing the banking industry to determine both its extent and areas in which it might be reduced without damaging the achievement of the safety and soundness and consumer protection objectives of the FDIC Improvement Act.

With regard to our concerns about the usefulness of the budgetary process as an early warning of rising deposit insurance costs, we view improving budgeting for these activities as a longer-term project that should be given high priority by the Congress and the incoming administration.

Accrual-based budgeting for deposit insurance, as well as similar programs, has merit and, if properly developed, could provide useful information on emerging issues to foster proactive versus reactive policy decisions. As with the successful implementation of credit reform, we expect such a project will take several years to develop reliable historical data and estimation techniques.

The competitiveness issues confronting the banking industry need to be resolved to foster the industry's long-term viability. Successful implementation of the accounting, corporate governance, and regulatory reforms is critical to ensuring that modernization reforms are balanced with safety and soundness.

Related GAO Products

Financial Audit: Bank Insurance Fund's 1991 and 1990 Financial Statements
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Condition of the Bank Insurance Fund: Outlook Affected by Economic, Accounting, and Regulatory Issues (GAO/T-AFMD-92-10, June 9, 1992).

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

Accrual Budgeting (GAO/AFMD-92-49R, Feb. 28, 1992).

Bank Supervision: Observations on the National Bank Examiners' Conference
(GAO/T-GGD-92-10, Jan. 3, 1992).

Comprehensive Deposit Insurance Reform and Taxpayer Protection Act of 1991: Observations on Accounting Reforms and Funding for the Bank Insurance Fund
(GAO/T-AFMD-92-3, Dec. 11, 1991).

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

Bank Powers: Bank Holding Company Subsidiaries' Market Activities Update (GAO/GGD-91-131, Sept. 20, 1991).

OCC Supervision of the Bank of New England (GAO/T-GGD-91-66, Sept. 19, 1991).

Bank Supervision: OCC's Supervision of the Bank of New England Was Not Timely or Forceful (GAO/GGD-91-128, Sept. 16, 1991).

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Credit Unions: Reforms for Ensuring Future Soundness (GAO/GGD-91-85, July 10, 1991).

Expanded Powers for Banking Organizations (GAO/T-GGD-91-52, July 10, 1991).

Resolving Large Bank Failures (GAO/T-GGD-91-27, May 9, 1991).

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

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Deposit Insurance: Observations on
Approaching Reform (GAO/T-GGD-90-20, Feb. 21,
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Minimum Capital Requirements for Banks
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(GAO/T-GGD-90-5, Oct. 25, 1989).

Financial Condition of the Federal Deposit
Insurance Corporation's Bank Insurance
Fund (GAO/T-AFMD-89-15, Sept. 19, 1989).

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

Bank Failures: Independent Audits Needed
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Guaranteed Student Loans (GAO/HR-93-2).

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Resolution Trust Corporation (GAO/HR-93-4).

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Medicare Claims (GAO/HR-93-6).

Contracting Issues

Defense Weapons Systems Acquisition
(GAO/HR-93-7).

Defense Contract Pricing (GAO/HR-93-8).

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(GAO/HR-93-9).

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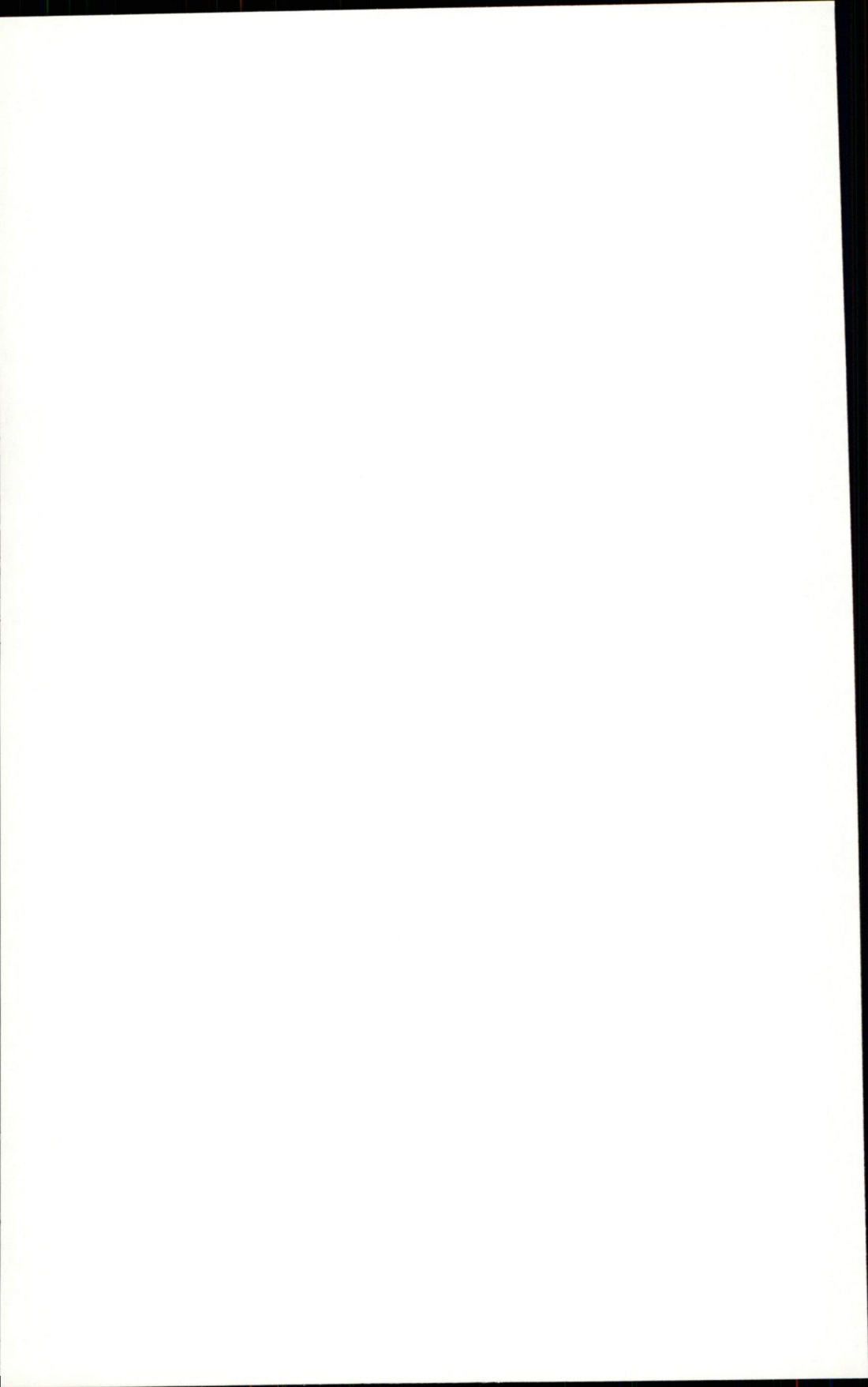
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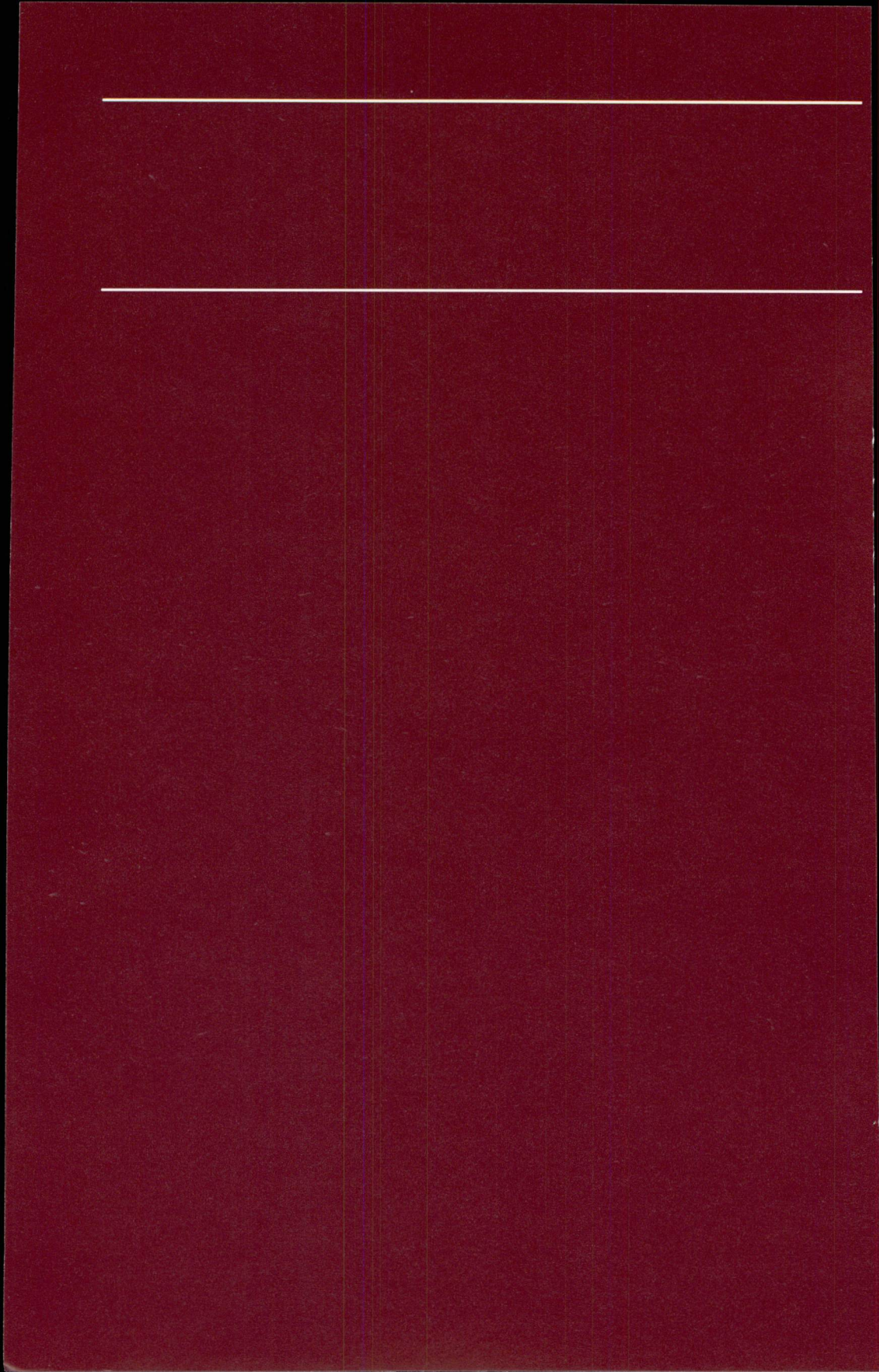
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December 1992

Federal Transit Administration Grant Management







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Comptroller General
of the United States

December 1992

The President of the Senate
The Speaker of the House of Representatives

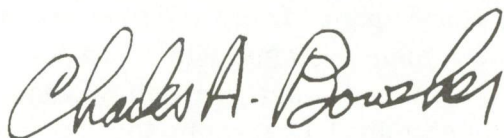
In January 1990, in the aftermath of scandals at the Departments of Defense and Housing and Urban Development, the General Accounting Office began a special effort to review and report on federal government program areas that we considered "high risk."

After consulting with congressional leaders, GAO sought, first, to identify areas that are especially vulnerable to waste, fraud, abuse, and mismanagement. We then began work to see whether we could find the fundamental causes of problems in these high-risk areas and recommend solutions to the Congress and executive branch administrators.

We identified 17 federal program areas as the focus of our project. These program areas were selected because they had weaknesses in internal controls (procedures necessary to guard against fraud and abuse) or in financial management systems (which are essential to promoting good management, preventing waste, and ensuring accountability). Correcting these problems is essential to safeguarding scarce resources and ensuring their efficient and effective use on behalf of the American taxpayer.

This report is one of the high-risk series reports, which summarize our findings and recommendations. It describes our concerns over the management and oversight of federal transit grants by the Department of Transportation's Federal Transit Administration. It examines the agency's failure to use its monitoring and enforcement tools to detect and correct serious, widespread, and often long-standing noncompliance and inappropriate expenditures of funds by grant recipients. It also discusses new initiatives that the agency is taking to better safeguard future grants, including implementing most of our numerous recommendations. We will continue to monitor the agency's progress to confirm that the new oversight strategy is in place and achieving its objectives.

Copies of this report are being sent to the President-elect, the Democratic and Republican leadership of the Congress, congressional committee and subcommittee chairs and ranking minority members, the Director-designate of the Office of Management and Budget, the Secretary-designate of Transportation, and the Administrator of the Federal Transit Administration.

A handwritten signature in black ink that reads "Charles A. Bowsher". The signature is written in a cursive, flowing style.

Charles A. Bowsher

Contents

Overview	6
FTA's Grant Programs	10
Past Oversight Did Not Protect Scarce Federal Transit Funds	12
FTA Has Charted an Ambitious Course for Implementing Needed Changes	24
Conclusions and Action Needed	34
Related GAO Products	36
High-Risk Series	38

Overview

The Federal Transit Administration (FTA), within the Department of Transportation, provides federal grants to help states and localities develop new mass transit systems and operate, maintain, and improve existing ones. FTA, mostly through its 10 regional offices, is responsible for monitoring grant recipients in their use of federal funds and enforcing their compliance with federal regulations.

FTA currently administers about 4,400 active grants totaling \$35 billion. Funding for mass transit—and therefore the risk of mismanagement—could grow significantly: Recent legislation has increased authorized annual funding from \$3.2 billion to \$5 billion and allowed up to \$70 billion in highway funds to be used for transit needs over the next 6 years. In addition, the current focus on expanded federal infrastructure investment, including mass transit, together with a potentially rapid infusion of funds, increases the need for making wise investments and carefully monitoring federal funding.

The Problem

FTA's ineffective oversight of transit grants has enabled grant recipients to misuse millions of dollars in federal funds.

Grant recipients' problems with financial management, procurement, and inventory control have gone undetected or uncorrected for as long as a decade or more.

We have documented waste and mismanagement at grant recipients in several FTA regions. For example, even after it became apparent that Pittsburgh Port Authority Transit lacked the engineering skills to complete a nearly \$20 million trolley rehabilitation project, FTA's Philadelphia region continued to fund the project for several years, without requiring corrective action. In the San Francisco region, grant recipients spent almost \$40 million more in federal funds on buses than federal guidelines allowed. Although entrusted with \$1.6 billion in active FTA grants, the Chicago Transit Authority, in FTA's Chicago region, had significant management problems that went uncorrected for over a decade. In FTA's New York region, a major construction project at the Long Island Railroad more than doubled in cost—from an estimated \$171 million to nearly \$400 million—and was completed 5 years late.

The Causes

Until recently, FTA focused its resources on awarding grants rather than on ensuring

their proper use. Although FTA rules call for regular progress reports, reviews, and audits, FTA monitored recipients superficially and inconsistently. Furthermore, it seldom used its enforcement powers to compel recipients to fix problems, even when the recipients had long histories of noncompliance. Instead, FTA relied primarily on recipients' assurances that they would manage funds properly. Whether intentionally or not, FTA's "hands off" approach to oversight conveyed the message that federal grant regulations were not important and federal funds did not need to be safeguarded.

**GAO's
Suggestions for
Improvement**

We have made numerous recommendations for correcting FTA's oversight practices and safeguarding federal transit funds. Among other things, we called for FTA to ensure that its grant recipients have adequate management systems, strengthen its reviews of recipients, and link grant funds to compliance with rules.

In the spring of 1992, FTA acknowledged the problems cited by GAO and also by the Department of Transportation's Office of Inspector General (OIG). In August 1992, FTA began implementing an oversight strategy that incorporates GAO's recommendations.

The strategy involves performing annual risk assessments of each grant recipient, establishing detailed procedures for monitoring recipients, and adopting a comprehensive enforcement system, among other actions. In addition, the Federal Transit Act, signed into law in December 1991, addressed our long-standing concerns with FTA's oversight of safety and process for awarding discretionary grants.

FTA faces several hurdles in implementing the new oversight strategy; in particular, it must resolve issues of staffing and use of contractors. FTA will have to be persistent in its efforts to ensure that implementation of the new strategy does not lose momentum. Successful implementation will ultimately depend on the support that the administration and the Congress give to FTA's actions to impose appropriate controls on grant recipients, including taking enforcement action and withholding funds when warranted against noncompliant recipients. But if carried out in full, the new strategy should substantially improve grant recipients' compliance and better safeguard federal transit dollars.

FTA's Grant Programs

FTA provides federal assistance grants for the development of new mass transit systems and for the operation, maintenance, and improvement of existing systems. Since its inception in 1964, FTA has provided over \$67 billion in transit grants, and it currently administers over 4,400 active grants totaling \$35 billion to state and local transit providers (grantees).

Grantees must comply with a variety of rules, including the requirements of the Federal Transit Act and regulations, such as the Buy America provisions, that apply to recipients of federal grants. Grantees certify to FTA that they have the ability and intention to meet these requirements. Whereas grantees are responsible for the day-to-day management of their grants, FTA is responsible, primarily through its 10 regional offices, for ensuring grantees' compliance with federal requirements and proper use of federal funds.

FTA has many tools for monitoring grantees and enforcing their compliance with federal requirements. In the past, however, FTA has not taken advantage of these tools and has instead relied primarily on grantees' certifications of their intent to comply with grant requirements. Furthermore, FTA has

focused its resources on awarding grants rather than on ensuring the proper use of grant funds. On the basis of our work and that of the OIG, the Secretary of Transportation cited FTA's inadequate oversight of grantees as a material internal control weakness in the Department's Federal Managers' Financial Integrity Act reports to the President and the Congress for fiscal years 1989, 1990, and 1991.

Past Oversight Did Not Protect Scarce Federal Transit Funds

FTA's former approach to oversight clearly placed scarce transit funds in jeopardy. FTA did not give high priority to overseeing grants; rather, it relied primarily on assurances by grantees that they would manage federal funds properly. However, as we and the OIG have documented in numerous reports, grantees have had serious deficiencies in financial, technical, procurement, inventory, and other management controls that have resulted in noncompliance with federal requirements and improper use of grant funds.

Because FTA failed to oversee grantees' activities effectively, such problems often went undetected and uncorrected for up to a decade and longer. This "hands off" approach to oversight conveyed to grantees—whether intentionally or not—that federal grant regulations were not important and federal funds did not need to be safeguarded.

Grantees' Inadequate Controls and FTA's Ineffective Oversight Placed Funds at Risk

We examined grantees' management and FTA's oversight in four FTA regions that together oversee more than 60 percent of FTA's total active grants. These reports revealed significant, long-standing deficiencies that had led to grantees' wasting

and mispending federal funds. Our work disclosed the following:

- In FTA's Philadelphia region, transit grants were vulnerable to fraud, waste, and mismanagement because grantees did not have adequate financial and other management systems to ensure compliance with federal requirements and the proper use of funds. For example, Pittsburgh's Port Authority Transit did not have (1) adequate inventory controls to prevent the use of parts purchased with FTA funds for non-FTA purposes or (2) the technical engineering skills to complete a nearly \$20 million trolley rehabilitation project.

When these and other problems were brought to its attention, the region did not require the grantees to take prompt corrective actions. Indeed, FTA continued to fund the trolley rehabilitation project for several years after it was apparent that the project's progress was both costly and slow. We concluded that the region's "hands off" monitoring stance contributed to the grantee's violations of FTA rules and inefficient and inappropriate use of federal grant funds. We made several recommendations to strengthen the region's oversight and minimize the inappropriate

expenditure of federal transit funds in the future.

- In FTA's San Francisco region, financial, procurement, and property management deficiencies existed at over half of the grantees. These deficiencies led to noncompliance with federal grant requirements and inappropriate expenditures of federal funds. For example, four of the region's grantees did not have adequate property management controls to ensure that the number of buses purchased with federal funds complied with FTA rules. As a result, according to the OIG, the grantees inappropriately spent almost \$40 million in federal grant funds to purchase more buses than their service needs warranted.

Furthermore, the region did not exercise adequate oversight of its grantees' activities. Although the region did recover some misspent funds, it did not routinely compel grantees to correct underlying management deficiencies to prevent future abuses. We concluded that the region must target its oversight efforts to ensure the adequacy of grantees' management systems and the quick detection and correction of deficiencies. Without such actions, the region's grants would remain vulnerable to fraud, waste,

and mismanagement. We made recommendations to improve the reliability of grantees' compliance assurances and to minimize the vulnerability of the region's grants.

- In FTA's New York region, deficiencies in procurement, quality assurance, and other management controls at the Long Island Railroad more than doubled costs for a major construction project—from an estimated \$171 million to nearly \$400 million—and delayed the project's completion from 1986 to 1991. At the New York City Transit Authority, inadequate management controls led to the waste, misuse, or mismanagement of more than \$90 million, as documented by the OIG over a 4-year period.

Although the region knew about these problems and had frequently instructed grantees to correct the deficiencies, it did not confirm that corrections were made promptly. Problems continued at both grantees for several years. We concluded that until the region moved quickly and aggressively to bring grantees into compliance with federal requirements, funds would continue to be misspent. We made several recommendations to improve the

region's oversight of grants and to ensure grantees' proper use of federal transit funds.

- In FTA's Chicago region, deficiencies in the Chicago Transit Authority's procurement process, capital program management, and financial and inventory control systems permitted the misuse and mismanagement of millions of dollars.

Although the region was responsible for overseeing more than \$1.6 billion in active grants to the authority, it did not exercise sufficiently rigorous oversight to detect the magnitude and severity of the management weaknesses. The region allowed some problems to go uncorrected for over a decade. We made several recommendations to strengthen the region's oversight and ensure that grantees have adequate systems for managing their federal transit grants.

Additional information about these problems appears in the reports and testimonies listed under Related GAO Products at the end of this report.

Work performed by the Department of Transportation's OIG supports our findings. In 109 reports issued between January 1988 and May 1992, the OIG documented

numerous instances of noncompliance and deficiencies in grantees' management systems that resulted in the waste, misuse, and mismanagement of nearly \$400 million. For example, the OIG reported that 31 of 48 grantees examined had overcharged FTA \$85.6 million to purchase more buses and bus parts than FTA's policies allow. The OIG also reported that 36 of 60 grantees examined had charged FTA \$50 million for items, such as extended warranties, that were not eligible for reimbursement under FTA guidelines.

FTA Did Not Use Its Monitoring Tools Effectively

The Federal Transit Act and FTA regulations provide numerous tools for monitoring grantees' activities. These tools include quarterly progress and financial reports, annual financial audits (called single audits) conducted by public accounting firms, comprehensive management reviews (called triennial reviews) generally conducted at each grantee every 3 years, grant closeout audits, OIG audits, and procurement system reviews. FTA also uses contractors to monitor grantees' activities. However, FTA has not effectively and consistently used these tools to verify that grantees have adequate management controls to reasonably ensure

compliance with federal requirements and the proper use of funds.

Descriptions of FTA's principal monitoring tools follow:

- Quarterly progress and financial reports—These reports are FTA's most timely source of information about grantees and should enable FTA to identify problems, such as cost overruns or program delays, and implement appropriate changes before funds are wasted or mismanaged. However, FTA has not consistently reviewed the reports' contents or even required all grantees to submit reports.
- Single audits—FTA requires its grant recipients to submit copies of audits performed pursuant to the Single Audit Act of 1984. The objectives of a single audit include determining whether an entity (1) has internal control systems to provide reasonable assurance that it is managing federal financial assistance programs in compliance with applicable laws and regulations and (2) has complied with the laws and regulations that may have a material effect upon each major federal financial assistance program.

The audit tests performed to assess compliance with a program's requirements are suggested by the agency administering the program—in this case the Department of Transportation—and are compiled in a “compliance supplement” to the single audit guidance published by the Office of Management and Budget (OMB). FTA believes that the single audits have not been particularly useful in gauging either the adequacy of grantees' internal controls or actual compliance. FTA attributes these inadequacies to the limited detail on audit work suggested in the current compliance supplement, which the agency has targeted for complete revision.

- **Triennial reviews**—Until recently, FTA headquarters limited the scope and depth of triennial reviews and, hence, their usefulness as an oversight tool. Although the law calls for “a full review and evaluation of the performance of a [grant] recipient in carrying out the recipient's program, with specific reference to compliance with statutory and administrative requirements,” FTA's reviews focused primarily on grantees' certifications and assurances. The reviews included little or no testing for compliance to ensure, for example, that procurement

actions had been competitive or that grantees had adequate controls over federally funded inventories. In several instances, triennial reviews did not detect existing problems. We have repeatedly questioned the value of FTA's limited triennial reviews, noting that the abbreviated scope could not provide a full and complete review of grantees' control systems.

- Grant closeouts—When closing a grant after a project has been completed or terminated, FTA relies on single audits to verify the appropriateness of costs. We have recommended that FTA reassess its practice of relying on single audits to verify the appropriateness of costs when closing grants. Because the single audit is not grant-specific—it focuses on the grantee rather than on individual grants—we continue to believe that its usefulness for reconciling completed or terminated grants is limited.
- Other monitoring tools—FTA considers site visits, quarterly progress review meetings, procurement system reviews, day-to-day contacts, OIG audits, and GAO reports as monitoring tools. However, site visits were often made only once every 3 years during triennial reviews, quarterly progress reviews

were held at a few grantees but not at the majority, and only seven procurement system reviews have been conducted since the agency's inception even though we and the OIG have repeatedly reported problems with grantees' contracting activities. Also, day-to-day contacts may supplement other oversight efforts, but they cannot be a substitute for monitoring grantees' performance. Finally, periodic GAO and OIG reviews do not relieve FTA of its responsibilities to monitor grantees' compliance or obviate the need for FTA to detect and correct problems before funds are misspent.

- Contractor-provided oversight—FTA has not made full use of contractors to augment the oversight performed by its staff. FTA has authority to use contractors to provide direct, on-site project management oversight and to conduct grantee compliance, safety, financial, procurement, and management reviews. For fiscal year 1991, FTA had \$35.3 million available to contract for oversight assistance but spent only \$14.8 million. FTA has no written procedures for its staff to use to oversee the contractors' work, and responsibility for overseeing contractors rests at FTA headquarters in Washington, D.C., rather than in the regions

where the work is done. We repeatedly recommended that FTA strengthen and properly use its monitoring tools and contracting authority.

When we surveyed FTA's regions on their use of grant-monitoring tools, we found no consistency in the level of effort or focus. Some regions dedicated a few staff to monitoring grants, while others assigned nearly all staff to at least some monitoring tasks; some regions gave triennial reviews higher priority, while others stressed quarterly reports. Ironically, the region responsible for overseeing the most grant money devoted one-third less time to monitoring than the region with the least grant money.

FTA Has Been Reluctant to Use Its Full Range of Enforcement Tools

In each region we reviewed, we found instances in which long-standing noncompliance was allowed to continue essentially with impunity. FTA often did not take timely and necessary enforcement actions to compel grantees to correct problems and usually continued to fund grantees that remained out of compliance.

FTA's enforcement tools range from sending letters of notice to reducing or withholding

federal funds when federal requirements have not been met or to seeking reimbursement when funds have been misspent or mismanaged. However, FTA seldom used its most stringent enforcement tools. Rather, FTA relied primarily on notification letters and other correspondence, arguing that such limited action was justified by the continuing nature of the grantee/grantor relationship. We cautioned FTA that its use of correspondence could not be considered either timely or appropriate because such notifications failed to compel grantees to correct noncompliance within a reasonable time. We have recommended that FTA impose strict sanctions on noncompliant grantees and insist that corrective actions be taken on significant noncompliance before new funds are approved. When FTA fails to detect and compel grantees to correct noncompliance in a timely manner, it suggests to grantees that federal requirements are not important and that grant funds do not need to be safeguarded.

FTA Has Charted an Ambitious Course for Implementing Needed Changes

In response to our and the OIG's reports documenting the waste and mismanagement of federal transit grants, FTA has developed and begun implementing an oversight strategy that incorporates the majority of our recommendations to safeguard funds. In addition, the Federal Transit Act, signed into law in December 1991, addressed our long-standing concerns with FTA's oversight of safety and process for awarding discretionary grants.¹ These actions are particularly timely because the new law substantially increases FTA's authorized annual funding, raising it from about \$3.2 billion to about \$5 billion. It also allows the use of up to \$70 billion in highway funds for transit needs over 6 years.

In our most recent report, we described FTA's new approach to oversight and the steps that the agency had taken to strengthen grant management. If fully implemented, the new strategy and mandates would stand as a major accomplishment resulting from the attention that our high-risk work brought to problems in the grant program. However, because the new strategy represents a significant departure from FTA's previous oversight approach, the agency will need to

¹The Federal Transit Act, which is title III of the Intermodal Surface Transportation Efficiency Act of 1991, amended the Urban Mass Transportation Act of 1964.

pay close attention to ensure that implementation does not lose momentum. We will continue to monitor FTA's progress in achieving full implementation and confirm that the new initiatives provide adequate oversight of federal transit funds.

FTA's Approach to Oversight Has Changed

In commenting on drafts of our reports on FTA's regional oversight activities, FTA repeatedly asserted that grantees had adequate internal control systems, its own oversight was sufficient, and its enforcement was timely and appropriate. FTA maintained that we misrepresented the facts, that problems were the exceptions, and that FTA was aware of and acting on these problems.

Unexpectedly, in the spring of 1992, FTA reversed its position after a task force, convened by the FTA Administrator, reviewed and confirmed the oversight deficiencies that we and the OIG had been reporting. The task force agreed with our assessment that FTA had an adequate assortment of oversight tools but had not been using them effectively. Recognizing the need "to have an oversight system in place that provides an acceptable level of stewardship," the task force concluded that "a new comprehensive ordering of oversight priorities and

methodologies has to be developed." In May 1992, FTA's Administrator approved a task force plan to revise grant monitoring and enforcement practices. FTA now acknowledges that its problems are indeed extensive and serious and that the agency had not adequately carried out its fiduciary responsibilities.

New Initiatives
Parallel GAO
Recommendations

We have made 22 recommendations that focus on FTA's (1) ensuring that grantees have management systems adequate to account for and protect funds; (2) requiring that triennial reviews evaluate, analyze, and test grantees' compliance; (3) using quarterly report data to identify cost, schedule, and performance problems; (4) coordinating oversight efforts with state and local audit entities that also oversee grantees; (5) tracking corrective actions on audit findings and withholding funds when grantees remain out of compliance; (6) resolving significant noncompliance on existing grants before distributing additional funds; and (7) ensuring that contractors have adequate guidance for performing oversight and that resources are appropriately allocated to carry out oversight tasks. FTA has fully concurred with 18 of these recommendations and concurred in part

with the others. FTA has incorporated implementing actions in its new oversight strategy.

In addition, the new strategy (1) requires an annual risk assessment of each grantee to target monitoring efforts and resources, (2) uses a matrix developed by the task force to determine the appropriate form of oversight for any given circumstance, (3) clearly defines the roles of headquarters and regional offices, (4) makes use of expanded contracting authority, (5) delineates the specific roles of the single audit and the triennial review, (6) revises and clarifies guidance for the single audit and the triennial review, and (7) defines the appropriate form of enforcement necessary to deter or remedy grantee noncompliance. The task force also recommended standardizing policies and guidelines and evaluating staffing levels and the allocation of personnel at headquarters and in the regions.

The plan signed by the Administrator set an ambitious June 1992 date for fully implementing the new strategy. FTA did not meet that date. FTA officials expected that the strategy would be in place in December 1992 and that all grant oversight

activities thereafter would use the new procedures. As part of its effort to implement the new strategy, FTA has

- revised guidance on single audits: FTA has reviewed and is revising the single audit compliance supplement and other guidance used by private accounting firms to ensure that the audits reflect the adequacy of grantees' systems and indicate past compliance performance. This exercise included developing detailed audit steps needed to assess compliance with over 20 standard grant requirements. As we have advised, FTA is working with OMB on the compliance supplement, which cannot be implemented without OMB's approval.
- revised guidance on triennial reviews: To make more effective use of this monitoring tool, FTA revised triennial review guidance to ensure that procedures measure compliance with all requirements, review efforts focus on assembling and analyzing information, and maximum advantage is taken of the results of other types of monitoring. To further improve the quality of the reviews, FTA plans to provide extensive training for the staff performing the triennial reviews.

- completed grantee risk assessments: Regional offices completed risk assessments of all grantees scheduled for triennial reviews in fiscal year 1993. Regional managers are using these risk assessments to develop and implement regional oversight plans. These plans will be used by the regions to allocate staff and by FTA headquarters to allocate contractor resources.
- expanded regional office responsibilities: FTA is working to achieve greater consistency in regional offices' approach to project management and to provide a minimum level of oversight on each project. As part of this effort, FTA is defining, for the first time, the specific roles and responsibilities of regional and headquarters personnel in supporting oversight efforts.
- increased grantee accountability and use of enforcement: FTA intends to hold members of grantees' governing boards and their financial, accounting, and legal advisors accountable for false or otherwise erroneous certifications. FTA is also increasing emphasis on ensuring that grantees have the internal audit capabilities to which they certify. At the same time, FTA is developing procedures to make full use of enforcement

authorities, including withholding funds if necessary, and setting time limits for correcting continuing violations of grant requirements.

Recent Legislation Has Addressed Other GAO Concerns

The Federal Transit Act addressed concerns that we first raised in 1989 regarding FTA's oversight of safety and process for awarding discretionary grants. In December 1989, we reported that FTA's oversight was not adequate to assess safety conditions at a local transit authority and that we were unable to determine the factors that the FTA Administrator had considered in awarding section 3 discretionary grants. We recommended that FTA obtain more complete and accurate information on accidents and maintain documentation on the section 3 award process. We reiterated our concerns in reports and testimonies during deliberations on the recently enacted Federal Transit Act.

The new law requires a comprehensive report to the Congress on current transit safety conditions. Among other things, that report is to

- summarize all deaths and injuries to passengers and employees resulting from

unsafe conditions in any facility, equipment, or operation financed with FTA funds;

- describe the actions that FTA has taken to alert transit operators to unsafe conditions and to correct or eliminate such conditions;
- consider the actions taken by grantees to correct unsafe conditions before FTA awards a new grant or makes funds available under existing grants; and
- recommend legislative or administrative actions needed to ensure that grant recipients will use the best means available to correct or eliminate hazards of death or injury.

The agency has gathered and analyzed data from states and begun to draft an initial report. Although the law specified that the report was to be issued by June 1992, FTA does not expect to issue it until April 1993.

In addition, under the Federal Transit Act, a section 3 grant for a new fixed guideway system—such as a subway line—cannot be made until the Administrator has determined that a proposed project is (1) based on an analysis of alternatives; (2) justified by its capacity to improve mobility, environmental

benefits, cost-effectiveness, and operating efficiency; and (3) supported by an acceptable degree of local financial commitment. The law further requires FTA to issue guidelines for evaluating these criteria.

Barriers Could Delay the Implementation of New Initiatives

Potential barriers to the successful implementation of FTA's new oversight initiatives stem from the agency's inconsistent allocation of staff and inadequate use of contractors for oversight tasks. Although most oversight and all day-to-day contact with grantees take place in FTA regional offices, the effort expended on oversight and the focus of oversight activities vary from region to region. In early fiscal year 1992, the number of regional staff performing oversight ranged from 2 to 12; the proportion of staff time spent on oversight ranged from 8 percent to 38 percent; and some regions emphasized triennial reviews while others stressed quarterly reports. A planned study to determine the most appropriate level and mix of staff among regional offices and headquarters has been postponed until 1994. However, in a September 16, 1992, letter, the Department of Transportation informed us that the FTA Administrator was examining FTA's organizational structure and would

**FTA Has Charted an Ambitious Course
for Implementing Needed Changes**

take steps in the near term to ensure that resources were appropriately allocated to provide adequate attention to oversight functions.

Conclusions and Action Needed

With the support of the Department of Transportation, FTA has made a commitment to improving grant oversight. This is a marked departure from the past when FTA relied primarily on grantees' assurances that they would properly manage federal funds. As FTA begins to monitor grantees' activities rigorously and to compel timely corrective actions at a few large grantees, other grant recipients should respond with better self-monitoring. Indeed, such action will clearly indicate to grantees that FTA is serious about enforcing compliance with grant requirements and committed to safeguarding federal transit funds. In addition, since transit needs far outstrip available funding from all sources—federal, state, or local—more needs can be met when funds are used efficiently and effectively.

FTA recognizes that a sustained, long-term effort will be needed to fully implement the new oversight strategy. However, commitment by FTA and the Department of Transportation alone may not be sufficient. Given the extent to which the new initiatives differ from FTA's past laissez-faire approach to grant oversight, successful implementation will ultimately depend on the support that the administration and the Congress give to FTA's efforts to impose

appropriate controls on grantees. Appropriate controls would include taking enforcement action and withholding funds when warranted against noncompliant grantees. Support for such action will be particularly important over the next several years, given the potential for increased funding and a rapid infusion of federal transit funds.

Related GAO Products

Mass Transit Grants: If Properly Implemented, FTA Initiatives Should Improve Oversight (GAO/RCED-93-8, Nov. 19, 1992).

Special Report on contractor improprieties at an FTA Region II grantee (GAO/OSI-92-7, Sept. 10, 1992).

Mass Transit Grants: Risk of Misspent and Ineffectively Used Funds in FTA's Chicago Region (GAO/RCED-92-53, Mar. 4, 1992).

Mass Transit Grants: Noncompliance and Misspent Funds by Two Grantees in UMTA's New York Region (GAO/RCED-92-38, Jan. 23, 1992).

Mass Transit Grants: Improved Management Could Reduce Misuse of Funds in UMTA's Region IX (GAO/RCED-92-7, Nov. 15, 1991).

Mass Transit Grants: Development Time Frames for Selected UMTA Projects (GAO/RCED-91-184FS, July 11, 1991).

Mass Transit Grants: Scarce Federal Funds Misused in UMTA's Philadelphia Region (GAO/RCED-91-107, June 13, 1991).

Mass Transit: Significant Federal Investment Is Not Adequately Protected (GAO/T-RCED-91-68, June 12, 1991).

Mass Transit: Reauthorization Offers Opportunity to Address the Appropriate Federal Role (GAO/T-RCED-91-41, Apr. 24, 1991).

Mass Transit: Historical Patterns and Future Outlook (GAO/T-RCED-91-15, Mar. 5, 1991).

UMTA Project Oversight and Mass Transit Issues (GAO/T-RCED-90-102, Aug. 8, 1990).

UMTA Project Oversight and Mass Transit Issues (GAO/T-RCED-90-103, Aug. 7, 1990).

Mass Transit Grants: UMTA Needs to Increase Safety Focus at Local Transit Authority (GAO/RCED-90-41, Dec. 1, 1989).

Mass Transit Grants: UMTA Needs to Improve Procurement Monitoring at Local Transit Authority (GAO/RCED-89-94, Mar. 31, 1989).

High-Risk Series

Lending and Insuring Issues

Farmers Home Administration's Farm Loan Programs (GAO/HR-93-1).

Guaranteed Student Loans (GAO/HR-93-2).

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Contracting Issues

Defense Weapons Systems Acquisition (GAO/HR-93-7).

Defense Contract Pricing (GAO/HR-93-8).

Department of Energy Contract Management (GAO/HR-93-9).

Superfund Program Management (GAO/HR-93-10).

NASA Contract Management (GAO/HR-93-11).

Accountability
Issues

Defense Inventory Management
(GAO/HR-93-12).

Internal Revenue Service Receivables
(GAO/HR-93-13).

Managing the Customs Service (GAO/HR-93-14).

Management of Overseas Real Property
(GAO/HR-93-15).

Federal Transit Administration Grant
Management (GAO/HR-93-16).

Asset Forfeiture Programs (GAO/HR-93-17).

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