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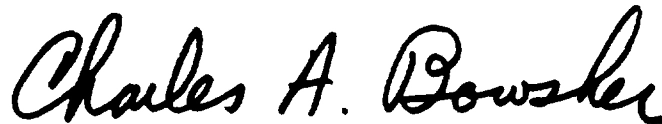
The President of the Senate
The Speaker of the House of Representatives
The Secretary-designate of the Treasury

This summary report is one in a series that addresses major policy, management, or program issues facing Congress and the new administration. The discussion of issues, the problems associated with each, and recommended actions are based on our work in the financial services industry area. Some of our concerns are relatively new, while others represent unresolved problems that have been developing over the past several years.

This report identifies four important issues we believe should be included in whatever agenda Congress and the Secretary of the Treasury, as well as the heads of banking, thrift, securities, and futures regulatory agencies set for considering our Nation's financial services industry. They are (1) handling troubled financial institutions, (2) regulating the merging of banking and nonbanking lines of business, (3) regulating linked securities and futures markets, and (4) regulating global capital markets.

These issues are discussed in detail in the reports and testimonies listed at the end of this report.



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Contents

The Financial Services Industry	3
Reestablishing Financial Stability in the Thrift Industry	5
Managing the Deregulation of Banks	9
Regulating Linked U.S. Financial Markets	12
Regulating Globally Linked Markets	15
Related GAO Products	19
Transition Series	21

The Financial Services Industry

The Nation's financial institutions and markets are in a state of turmoil. Not since the early 1930s have they faced the multiplicity of challenges they face today. Depository institutions, particularly savings and loans, are becoming insolvent or suffering problems in numbers that set post-Depression records. At the same time, in spite of laws and regulations that separate commercial banking from other lines of business, financial services firms are finding ways to combine those activities. The issue now is how best to redraw the industry structure.

Our linked securities and futures markets face new demands created by new market strategies and trading technologies, as well as products that are poorly understood and viewed with deep suspicion by even seasoned market experts. The October 1987 stock crash bared these weaknesses and also revealed how quickly financial conditions can deteriorate in emergencies. Finally, our financial markets now function in a global arena in which the competitive stakes are high and crises can spread around the world almost instantly.

The new administration must respond to these separate but closely related challenges. In so doing, it will shape the future

of the industry—for better or for worse—for decades to come.

Reestablishing Financial Stability in the Thrift Industry

In the wake of poorly implemented deregulation, mismanagement, and depressed regional economies, almost a third of the savings and loan industry is insolvent or nearly so; less than $4 billion of tangible capital backs $1.3 trillion of customer deposits; and the Federal Savings and Loan Insurance Corporation (FSLIC) is insolvent by $14 billion. The administration must decide

- how to finance the $50 billion or more that may be needed to restore financial stability and thereby prevent panic and collapse, and
- what regulatory controls are needed to prevent a repetition of today's problems.

Solving the problems of the thrift industry will entail a monumental drain on the depository industry and federal resources. In recent years, regulators and Congress have resisted massive closings of insolvent institutions in the hope that the institutions could pull themselves out of the hole. But this strategy of forebearance has failed. For the most part, it simply delayed the inevitable while adding to the eventual costs.

The time has come to move as quickly as possible to close insolvent institutions.

That means fully recognizing and finding the money to pay for the losses in those institutions—money that FSLIC does not have today. In this regard, we see the following possibilities:

- While the self-insured system we have had for the last 50 years suggests that the thrift industry should contribute to the solution, the problem is too large and the industry is too weak to solve the problem alone.

- While merging FSLIC with the healthier Federal Deposit Insurance Corporation (FDIC) has been suggested as a possibility, it would not solve the financial problems. The FDIC's reserves cannot cover the FSLIC losses. Moreover, problems in the commercial banks, especially those related to energy, real estate, agricultural, and third world lending, may require all of FDIC's present $18 billion of reserves.

- In the final analysis, those who have created the problem, those who have benefitted from the problem, and those who will benefit in the future should share in funding the solution. Sharing of costs should be based on the principles that (1) funds contributed by the thrift industry should not significantly weaken healthy institutions, (2) funds raised from other depositories

should not adversely affect their competitive position, and (3) funds provided by the insured depositing public, whether through use of general revenues or a more explicit user charge, are needed to make up for the shortfall in the costs that they have paid for deposit insurance protection.

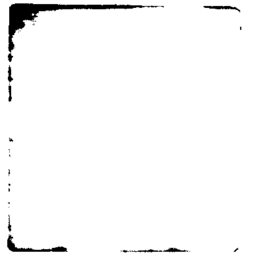
Resolving today's problems, however, will be futile if they are repeated tomorrow. Without some fundamental changes to the way the depository industry, particularly the thrift industry, is regulated, there is little to prevent a reoccurrence. Avoiding that will require:

- Strengthening the capital base of the industry and quickly and efficiently closing institutions that fail.
- Improving oversight and supervision to control risk-taking.
- Experimenting with incentives for insured institutions to control their own risk taking by giving them the option of operating under one of two deposit insurance mechanisms. Under one, premiums or capital levels based on risks would be paid to the deposit insurer for its risk bearing. Under the other, involving collateralization of deposits or significant limitations on the uses made of deposits, institutions would

internalize the costs of their risk bearing and only nominal premiums would be paid to the deposit insurer.

- Establishing firm guidelines for quickly and efficiently dealing with problem institutions, including enhancing the ability to withdraw insurance protection.

- Reconsidering the wisdom of the regulatory distinctions between thrift institutions and commercial banks. The schizophrenic position of the Federal Home Loan Bank Board as both an industry advocate and safety and soundness regulator must be eliminated.



Limits on the powers of banks are being progressively relaxed in an unplanned fashion, yielding a risky hodge-podge of banking and other functions that could imperil the safety and soundness of the banking system. The administration must decide

- to what extent and how rapidly banks and other businesses should be allowed to merge and
- what regulatory protections are needed in the public interest.

Traditionally, and especially since the 1930s, banks have been considered special because of the unique and vital functions they perform. The segregation of banking from other lines of business, the strict supervision of banks, and insurance of their deposits have all been intended to protect these essential functions.

Despite the restraints on bank powers in the Glass-Steagall and Bank Holding Company laws, various segments of the financial services industry now compete with each other directly, offering similar products and services. Some firms have successfully challenged restrictive interpretations of existing law and now offer a wide range of services; others have

been unable to do so and may be competitively disadvantaged as a result.

This ad hoc, uneven expansion of powers, which has taken place outside of the existing statutory framework, is unfair and potentially destabilizing. It is imperative that a new set of ground rules for the industry be enacted as quickly as possible. The new legislation should include the following elements:

- Relaxation of regulatory restraints should proceed in stages, keyed to the pace at which regulatory agencies are staffed and otherwise equipped to assure adequate oversight and supervision. The linchpin of the system for preserving the integrity of the financial services industry is diligent oversight by appropriate self- and government regulatory organizations. The oversight of the financial services industry has not been adequate during the past several years. It must improve.

- The holding company structure should be required for any institution that proposes to engage in both banking and nonbanking lines of business.

- Rigorous standards for adequacy of capital should be imposed at both the bank

holding company and bank levels and be firmly enforced.

- Banks should be permitted to extend credit to securities affiliates but only under carefully controlled circumstances, such as to provide liquidity in a market emergency.

- The regulatory role of the Federal Reserve should be expanded to assure effective oversight of integrated financial services firms.

Regulating Linked U.S. Financial Markets

The October 1987 crash demonstrated the volatility of financial markets, the extent to which separate markets are now intertwined, and the resulting dangers for the national economy. The administration must decide:

- how to regulate the linked markets, and
- how to prepare for a future crisis.

Since the crash, a number of changes have been suggested to enable the markets, their participants, and their regulators to better cope with sudden large swings in the price of securities. Some proposals, such as calls for changes in regulatory structure, margin requirements, and "circuit breakers," have proven highly controversial and are still being debated. Others, however, seem less open to argument and should be implemented without further delay. These include

- improving contingency planning between markets and between the different regulators;
- improving coordination of the rules and regulations that would be critical in an emergency, such as those governing the suspension of trading and those related to settlement and clearing functions; and

- retaining the Financial Market Working Group as a mechanism for assuring continued attention to the problems that emerged in the crash.

Other problems that were observed on October 19 and 20, 1987, raise fundamental questions about the adequacy of our market systems. The New York Stock Exchange (NYSE) specialist system came under heavy criticism for being unable to handle new trading volumes and interests. The over-the-counter and options markets had their share of difficulties as well. Computerized trading systems at NYSE simply could not handle the volumes experienced in October 1987. Because of NYSE's central role, its problems affected all other components in our linked futures and securities markets and fueled panicked decisionmaking. Information on the financial positions of market participants was unavailable in many cases.

There was also much confusion among banks, major clearing houses, market makers, and investors on their financial commitments to one another. These misunderstandings in the clearance and settlement process pose the greatest threat to financial stability should the circumstances of October 19 and 20 be repeated.

Finally, some investors waited for hours to find out whether their orders had been executed. Some found that they had been executed, but at prices drastically below those existing when they wanted to sell. Others did not get their orders executed at all.

In light of those problems, the administration must

- require the exchanges, at regular intervals, to seek independent assessments of the adequacy of computer operations, and require the regulatory authorities to strengthen their capacity to review automated systems that are critical to the effective operations of the exchanges;
- strengthen clearing and settlement arrangements to reduce the possibility of multiple defaults and provide a more informed basis for actions that might need to be taken during a market emergency; and
- require securities firms and markets to assure more equal access to markets by noninstitutional investors and to strengthen investor grievance procedures.

Regulating Globally Linked Markets

U.S. financial markets are linked not only with each other, but with markets in other nations. The next financial crisis—with potentially devastating effects on the U.S. economy—can begin anywhere in the world. The administration must decide the following:

- How to ensure that U.S. and foreign regulatory approaches to the securities and banking industries pursue consistent goals; and
- How to ensure that any future financial crisis is minimized through a coordinated international response.

Strong capital markets in other nations are linked with and aggressively compete against our own markets. Our own self-interest, as well as concern for the free world's economic stability, require that we exercise responsible leadership in assuring effective regulation of international securities markets. This will no doubt mean a considerably more important role for the Federal Reserve as central banker in the future.

The goals we should seek—consistency of objectives for regulation and improved crisis management—are clear, even if the precise steps needed to achieve those goals

are less certain. The first stage must involve getting our own regulatory house in order by (1) resolving the future structure of the U.S. financial services industry (i.e., the banking powers issues) and (2) resolving the regulatory issues already noted with respect to the securities markets. As these are accomplished, we should simultaneously:

- Take the lead in developing mechanisms for establishing and enforcing any necessary international standards for regulation of financial markets. This effort might build on the experience of the Cooke Committee of the Bank for International Settlements, which is now recognized as the authoritative source of standards for regulating international banking.
- Take the lead in developing cooperative mechanisms that will assure the prompt exchange of critical information in time of emergency. When an emergency arises in U.S. markets, such as price volatility warranting the suspension of trading, the pressure is transmitted instantly to open markets abroad, and vice versa. There must be no delay in communicating such information between national regulatory authorities so that each can take appropriate action.

- Take the lead in developing reliable procedures for international coordination of key responsibilities. There is growing recognition that some decisions by national authorities in a banking emergency, such as central bank implementation of their lender of last resort responsibilities, can have major international ramifications. This will require more explicit lodging of responsibility for actions than was heretofore needed.

The financial services industry has played a vital role in the development of the modern U.S. economy; it must continue to play that role. At the same time, we have learned how fragile the public's confidence in our financial institutions and markets can be and how devastating a collapse can be for our economy.

The government's potential stake in resolving the industry and regulatory problems is enormous, not only in conceptual terms, but also in dollars. It could cost billions to resolve the problems pointed out in this report. With so many forms of stress now being exerted on our financial system and so many unanswered questions about how to deal with them, what is needed is a fresh, innovative approach to the regulation of our new, potentially more

volatile market processes. In total, such an approach should

- protect against unacceptable financial damage to our financial institutions and markets as well as individual investors; but
- encourage innovation and be flexible enough to keep up with rapidly evolving market developments; and
- allow markets to seek their own levels of value without undue interference.

Related GAO Products

Bank Powers: Issues Related to Repeal of the Glass-Steagall Act (GAO/GGD-88-37, Jan. 22, 1988).

Financial Markets: Preliminary Observations on the October 1987 Crash (GAO/GGD-88-38, Jan. 26, 1988).

Using "Firewalls" in a Post Glass-Steagall Banking Environment (GAO/T-GGD-88-25, Apr. 13, 1988).

International Banking: Supervision of Overseas Lending Is Inadequate (GAO/NSIAD-88-87, May 5, 1988).

Thrift Industry: Trends in Thrift Industry Performance — December 1977 through June 1987 (GAO/GGD-88-87BR, May 17, 1988).

Deposit Insurance: Analysis of Reform Proposals (Summary, Vols. I & II; GAO/GGD-86-32,32A,32B; Sept. 30, 1986).

International Banking: International Coordination of Bank Supervision: The Record to Date (GAO/NSIAD-86-40, Feb. 1986).

Securities Regulation: Efforts to Detect, Investigate, and Deter Insider Trading (GAO/GGD-88-116, Aug. 5, 1988).

International Banking: U.S. Banking Supervision and International Supervisory Principles (GAO/NSIAD-86-93, June 1986).

Developments Since the Market Crash of October 1987 (GAO/T-GGD-88-33, Apr. 27, 1988).

Options for Dealing with Farm Credit System Problems (GAO/T-GGD-87-11, Apr. 7, 1987).

Banking Services: Changes in Fees and Deposit Account Interest Rates Since Deregulation (GAO/GGD-87-80, July 13, 1987).

Securities Regulation: SEC Budget and Workload Statistics, Fiscal Years 1979-1988 (GGD-87-94FS, June 22, 1987).

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