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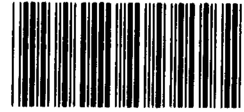

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Deposit Insurance: A Strategy For Reform

Statement of
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Comptroller General of the
United States

Before the
Senate Committee on Banking, Housing, and
Urban Affairs
United States Senate

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Deposit Insurance: A Strategy for Reform

SUMMARY OF STATEMENT BY
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COMPTROLLER GENERAL OF THE UNITED STATES

GAO is testifying today on its recent report on deposit insurance reform.[1] GAO summarizes the results of its study and compares its approach to reform with that of the Treasury Department.

In large part because of deposit insurance, our banking system today is much better protected against bank runs than in the early 1930s. However, the reasons for being concerned about disruptive runs are as valid today as when the system was first set up. FSLIC's bankruptcy made it clear that insuring almost $3 trillion in deposits in banks, thrifts and credit unions places the taxpayer at risk, and BIF's deteriorating reserves heighten concerns about further costs to the taxpayer. Reform thus must accomplish two goals simultaneously--reducing the exposure of taxpayers to loss while ensuring confidence in our banking system by preserving its stability.

GAO recommends a three-part program to preserve the benefits of deposit insurance while correcting the types of problems that resulted in massive taxpayer losses in the recent thrift industry crisis. These recommendations are designed to:

(1) strengthen the way banks are regulated and managed by giving regulators the mandate, information, and resources to take prompt action to resolve problems at all banks--but particularly at larger ones--when they are first evident;

(2) change the economic incentives of depository institutions through strengthened capital requirements, risk-based insurance premiums, and other means to ensure that owners, managers, and creditors--not the taxpayers or the insurance funds--bear most of the costs of bank failures; and

(3) update bank holding company structure and regulation to reduce risks to the banking system and prepare for financial system modernization if expanded powers for banks and other financial institutions are judged desirable by Congress.

The fundamental difference between GAO's approach to reform and Treasury's lies in their respective strategies for dealing with the fact that so many banks are in weak condition or failing. GAO agrees with Treasury that "deposit insurance reform must bolster the safety and soundness of the U.S. banking system <u>and</u> enhance the competitiveness of the industry" in order to minimize

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[1]<u>Deposit Insurance: A Strategy for Reform</u> (GAO/GGD-91-26, March 4, 1991).

taxpayer exposure to loss. GAO believes, however, that Treasury underestimates the magnitude of the improvements in supervision and regulation that are needed to bolster safety and soundness. For this reason, Treasury's strategy for enhancing the competitiveness of the industry runs too great a risk of making things worse for BIF. The more competitive markets get, the more tempting it becomes for banks to abuse expanded powers and attract federally insured deposits to take greater risks in attempts to gain market share or higher profits.

The only way to be sure that risks taken by banks do not place BIF in danger is to emphasize measures explicitly designed to encourage prudent banking and better protect the deposit insurance fund. These measures include greatly strengthened bank supervision; improved financial reporting and management controls; and strengthened capital requirements. When these reforms have been adopted, other changes designed to make banks more competitive with other financial institutions can be considered and implemented safely if they are deemed desirable.

In addition to the basic differences in strategy, GAO differs with Treasury on a number of other points as well.

-- Treasury places too much reliance on capital adequacy as the basis for improved supervision. This approach has two basic problems. First, capital is generally a lagging indicator of bank condition. Treasury's approach may therefore result in untimely and ineffective regulatory intervention. Second, Treasury's approach does not include comprehensive measures to remedy the poor quality of information on the true financial condition of banking organizations, thus making adequate capital measurement difficult. Fundamental changes in accounting rules, financial reporting, management controls and auditing are needed.

-- Treasury places more emphasis on reducing deposit insurance coverage and imposing losses on uninsured depositors than GAO believes is possible or consistent with maintaining market stability. These types of changes should only be adopted when the banking system is stronger and regulatory, capital, financial reporting and other reforms have been adopted and depositors are provided with alternatives for protecting deposits over $100,000 in return for lower interest earnings.

-- Due to the increasing complexity of banking organizations, GAO places more emphasis on strengthening bank holding company regulations. Furthermore, GAO does not believe that encouraging commercial companies to acquire banks is necessary for creating a safe and sound banking system.

Mr. Chairman and Members of the Committee:

We are pleased to be here today to offer GAO's views on deposit insurance reform and modernizing the financial system. My statement summarizes the recommendations of GAO's FIRREA-mandated deposit insurance report,[1] compares our approach with Treasury's, and discusses the important similarities and differences in some detail.

Before turning to our recommendations, however, I want to review in a general way our perspectives on what deposit insurance reform is all about.

Deposit insurance places the full faith and credit of the United States government behind about $3 trillion in deposits in banks, thrifts, and credit unions--an amount more than twice the entire federal budget. FSLIC's bankruptcy made it clear that insuring this amount of deposits places the taxpayer at risk, and BIF's deteriorating reserves heighten concerns about further costs to the taxpayer.

However, at this crucial time in BIF's history, it would be a great mistake to focus exclusively on short-term measures designed strictly to reduce taxpayer costs, as important as this objective is. Efforts to achieve this objective, such as major

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[1]Deposit Insurance: A Strategy for Reform GAO/GGD-91-26, March 4, 1991.

increases in premiums to pay the costs of problem institutions introduces the risk of damaging healthy ones. Similarly, attempting to reduce taxpayer losses by limiting the scope of deposit insurance coverage could damage the economy by destabilizing the banking system.

Stopping destabilizing bank runs is after all one of the reasons deposit insurance was established. From the stock market crash of 1929 through the bank holiday of 1933, over 9,000 commercial banks failed. Most of these banks tended to be small, but together they accounted for about 10 percent of all bank deposits. Millions of dollars were lost in these failures. It is imperative that any reforms that are made not trigger a repetition of the vicious circle of vanishing confidence and financial distress that undermined our banking system nearly 6 decades ago.

In large part because of deposit insurance, our banking system today is much better protected against bank runs than in the early 1930s. The system has remained stable despite the energy price shocks, inflation, recessions, and stock market drops that have occurred over the past two decades. However, the reasons for being concerned about disruptive bank runs are still as valid today as when the system was first set up. Indeed, in this era of electronic funds transfers, the potential for runs in large banks that rely on uninsured deposits for a large percentage of

their funding may be even greater now than in earlier times. Reform thus must accomplish two goals simultaneously--reducing the exposure of taxpayers to loss while ensuring confidence in our banking system by preserving its stability. In light of the stress now present in the industry and the weakness of BIF, meeting these goals involves the resolution of very complex issues.

We can succeed only through comprehensive efforts that address the underlying causes of problems and that create conditions fostering safe and sound banking. Stability in today's highly competitive banking environment should flow principally from the way banks are operated, not from deposit insurance guarantees that result in large expenses for healthy banks and large exposures to loss for taxpayers.

GAO'S PROPOSALS

We are recommending a three-part program to preserve the benefits of deposit insurance while correcting the types of problems that resulted in massive taxpayer losses in the recent thrift industry crisis. Our recommendations are designed to:

(1) strengthen the way banks are regulated and managed. To protect the deposit insurance system from losses, regulators

must have the mandate, information, and resources to take prompt action to resolve problems at all banks, but most particularly those experienced by large banking organizations, when they are first evident. This, in turn, requires better information on bank condition that can only come from changes in accounting rules, financial reporting, management controls, and auditing.

It is also vital that BIF be made financially sound so that regulators can take prompt action to resolve the cases of all non-viable banks. Any taxpayer financing of BIF that may be required should be conditional on the adoption of a comprehensive reform package.

(2) change the economic incentives of depository institutions through strengthened capital requirements, risk-based insurance premiums, and other means to ensure that owners, managers, and creditors, not the taxpayers or the insurance funds, bear most of the costs of bank failures.

(3) update bank holding company structure and regulation to reduce risks to the banking system. If expanded powers for banks and other financial institutions are judged desirable by Congress, these regulatory changes are also necessary preconditions to financial system modernization.

These recommendations must be carried out carefully and systematically to preserve industry stability. Reform will take time because over the past 60 years the public has become accustomed to relying more heavily on the deposit insurance system to protect deposits than on the safety and soundness of banks.

DIFFERENCES BETWEEN GAO'S AND TREASURY'S APPROACHES

The fundamental difference between our approach to reform and Treasury's lies in our respective strategies for dealing with the fact that so many banks are in weak condition or failing. We agree with Treasury that, "In the end, the most effective way to minimize taxpayer exposure is through a strong, competitive, well-capitalized banking system. Deposit insurance reform must therefore bolster the safety and soundness of the U.S. banking system and enhance the competitiveness of the industry--both aspects of reform are crucial."

We believe, however, that Treasury underestimates the magnitude of the improvements in supervision and regulation that are needed to bolster safety and soundness. Without these improvements, Treasury's strategy for enhancing the competitiveness of the industry runs too great a risk of making things worse for BIF.

We have to be realistic about the consequences for bank regulation and deposit insurance resulting from the fact that today's banking organizations operate in a much more competitive environment than when deposit insurance was first established. Banks are now often by-passed as sources of credit by the nation's largest corporations, formerly their most important customers. In the years ahead competition between banking and nonbanking firms, all of which offer similar products, can be expected to become even more intense. In this environment there is no easy road to profitability and there are plenty of ways to lose money. The more competitive markets get, the more tempting it becomes for banks to use their ability to attract federally insured deposits to take greater risks in attempts to gain market share or higher profits.

The only way to be sure that risks taken by banks do not place BIF in danger is to emphasize measures explicitly designed to encourage prudent banking and better protect the deposit insurance fund. These measures include greatly strengthened bank supervision; improved financial reporting and management controls; and strengthened capital requirements. Only when these reforms have been adopted, should other changes designed to make banks more competitive with other financial institutions be considered and implemented if they are deemed desirable.

In addition to the basic difference in strategy, we have fundamental differences with Treasury on several other points.

-- Treasury places too much reliance on measures of reported capital levels as the basis for improvements in supervision as well as for approvals of expanded powers and interstate banking activities.

-- Treasury places more emphasis on depositor discipline than we believe is possible or consistent with maintaining market stability.

-- Due to the increasing complexity of banking organizations, we place more emphasis on strengthening bank holding company regulations than does Treasury.

-- We do not believe that encouraging commercial companies to acquire banks is necessary for creating a safe and sound banking system.

BETTER SUPERVISION OF BANKS IS ESSENTIAL

Our system of bank oversight, supervision, and enforcement needs reform. Not only has the approach used by regulators to deal with troubled and failing institutions proven ineffective, but information on the condition of banking organizations is not

sufficient to promptly identify troubled institutions. Furthermore, BIF's financial condition has reached the point where its ability to promptly resolve financially troubled institutions is being called into question.

These concerns are heightened by the problems that have occurred in a number of the nation's larger banking organizations. The increased number of large bank failures since the mid-1980s has imposed huge losses on FDIC that have contributed significantly to FDIC's current financial problems. The growing number of large banking organizations experiencing financial difficulty poses a major threat to the deposit insurance system and to market stability.

Treasury recognizes the importance of good supervision by recommending a strengthened regulatory system that requires "prompt corrective action." There are, however, two fundamental problems with Treasury's approach which, as I have indicated, focus supervisory interventions strictly on capital. First, capital is generally a lagging indicator of bank condition. For example, in problem banks we have looked at, management weaknesses often resulted in poor lending policies. The poor lending policies eventually resulted in a high level of bad loans. As these bad loans defaulted, the bank's earnings suffered. After a period of poor earnings, bank capital was depleted. Once capital is weakened, it may be too late to

reverse a bank's deterioration. Treasury's approach may therefore result in untimely and ineffective regulatory interventions in too many cases.

Second, Treasury's approach does not include comprehensive measures to remedy the poor quality of information on the true financial condition of banking organizations. The key to successful bank regulation is knowing how much banks are really worth. That requires good accounting.

We believe that our approach deals more comprehensively and effectively with the deficiencies that exist in the regulatory oversight, supervision, and enforcement process as well as in the quality of information on the condition of banking organizations currently available to regulators.

GAO's Tripwire System

Bank regulators have the authority to take action to prevent unsafe and unsound activities, but they do not always use that authority when they discover deficiencies. These deficiencies and the failure to correct them have all too often resulted in unnecessarily costly bank failures. Our review of the supervision of 72 banks that experienced capital adequacy problems in 1988 indicates that bank examiners often prefer to work informally with bank managers and directors and are very

reluctant to take forceful actions to correct the underlying causes of capital deterioration--such as poor asset quality, declining earnings, or weak management--until capital has fallen below minimum requirements. Examiners approach their responsibilities this way because they lack a clear mandate and the incentives to take the more forceful actions at their disposal to correct deficiencies. This approach often does not result in the timely, decisive actions that are needed to preclude or reduce losses.

To address these inadequacies in the supervision and enforcement process, Congress should require the bank regulators, in consultation with the banking industry, to develop a formal regulatory "tripwire" system that requires prompt and forceful regulatory action tied to specific unsafe banking practices--not just to capital levels. Supervisory intervention should be based on such unsafe activities or conditions as inadequate internal controls, excessive exposures to interest rate or credit risk, and rapid growth, in addition to low capital levels. The tripwire regulations should be specific enough to provide clear guidance about what actions should be taken to address specified unsafe banking practices and when they should be taken. Under this approach to supervision and enforcement, regulatory discretion in dealing with identified problems would be limited, and owners and managers of insured banking institutions would

know in advance the consequences of actions that could potentially weaken the financial strength of their institutions.

Better Information and Auditing Reforms Must Accompany a Tripwire Supervisory Approach

Even with the will and mandate to implement the tripwire approach we are recommending, regulators may find it difficult to do so because of the current poor quality of information on banks' financial condition. The lack of effective internal controls and accurate information impede the ability to quickly identify deteriorating bank asset quality, earnings, and capital so that deficiencies can be promptly corrected.

Our review of 39 banking organizations that failed in 1988 and 1989, including several large banking organizations with over $1 billion in assets, illustrates how important it is to seek out and address serious internal control problems. In 33 cases we found that pervasive internal control problems, including inadequate supervision by a bank's board of directors, unwarranted loan concentrations, and poor loan documentation, were frequently cited by regulators as major factors contributing to failure. One consequence of these internal control weaknesses is that managers and regulators often lack accurate and timely information about the condition of insured banks.

We agree with Treasury that annual full scope, on-site examinations of all banks will help mitigate these problems. But other steps, not recommended by Treasury, are needed as well. These include requiring: (1) regulators to develop more stringent financial reporting requirements for large, complex banking organizations and the information and expertise necessary to understand those organizations so that prompt action will accompany developing problems, (2) banks to value their problem assets based on existing market conditions, (3) bank managers to include in their annual reports an assessment of internal controls, and independent auditors to notify the regulatory agencies of bank internal control weakness and noncompliance with laws and regulations, and (4) depository institutions and their auditors to better assure compliance with safety and soundness laws and regulations and earlier identification of weaknesses in the financial health of the institutions.

BIF Financing

Both we and Treasury believe it imperative that BIF be restored to a solid financial footing. A bitter lesson from the thrift industry debacle is that the Bank Insurance Fund must have the financial resources to promptly deal with weakened or insolvent banking organizations. Otherwise, the improved auditing, financial and management reforms we are recommending will be of little use and more stringent actions by regulators under the

tripwire supervisory system we envision will have little credibility.

The failure of almost 600 commercial banks in the past 3 years has resulted in estimated losses to the Fund of about $9 billion, and the level of Fund reserves--$8.5 billion, or just .43 percent of insured deposits--is the lowest it has ever been. Of particular concern, more large banks are experiencing difficulty and have failed in recent years.

In September 1990, we reported to Congress that BIF was too thinly capitalized relative to the exposure it faces and that a recession or the failure of several large banks could bankrupt the fund. We are pleased that the Omnibus Budget Reconciliation Act of 1990 removed all constraints on FDIC's ability to raise deposit insurance premiums, but how BIF recapitalization can best be accomplished is still unresolved. FDIC must, however, begin the recapitalization process by using its new authority to raise bank premiums in a way that does not irreparably damage healthy institutions.

An Expert Panel to Evaluate Regulatory Resources

Given the importance of supervision and good information, we believe it essential that regulators have the staff, the expertise, and the systems they need to be able to do their job.

Banking has become very complex. Nevertheless, a top to bottom evaluation has never been made of how best to supervise banks in the age of computers, global banking, electronic funds transfers, and swaps. We recommend that such an evaluation be conducted by a panel of industry experts, appointed by the President and Congress. We would expect the evaluation to yield recommendations on the information, staffing, expertise, and other resources needed to fully understand and effectively regulate the activities of banking institutions in today's highly competitive environment.

Regulatory Structure

As you know, Treasury has recommended that regulation and supervision of commercial banks and savings and loans be consolidated into two regulatory agencies--a new Federal Banking Agency under the auspices of Treasury, and the Federal Reserve.

We believe a more focused and effective regulatory system is needed, especially for large banks that represent a significant risk to BIF. Changing the regulatory structure--either by merging regulatory functions or by changing agency responsibilities--might serve as a catalyst for the implementation of such a system and the creation of the regulatory incentives that will be necessary to implement a new supervisory system. Nevertheless, in the course of our reviews

of capital-deficient and failed banks, we did not find that the weaknesses in the supervisory enforcement process we identified were the result of the current configuration of the regulatory structure.

While we have no recommendations of our own for regulatory consolidation or reconfiguration, we are concerned about the new role of the Federal Reserve as envisioned by the Administration. Given the Federal Reserve's role as lender of last resort and the major part it plays in ensuring systemic stability, we question whether it is appropriate to sharply curtail its role in regulating and supervising large banking organizations.

ECONOMIC INCENTIVES AND THE SCOPE OF DEPOSIT INSURANCE COVERAGE

Bank risks and failures have increased considerably over the past decade, yet industry capital has not risen sufficiently to offset risks. We agree with Treasury that a key to increasing owner and manager responsibility is to require capital levels commensurate with bank risk. This will force owners and managers to absorb the potential losses from their activities because their investments will be the first to suffer when poor business decisions lead to losses. Capital levels that reflect risk also provide a financial buffer between losses resulting from poor business decisions and the resources of the Fund or U.S. taxpayers.

To ensure that banks are adequately capitalized, strengthened minimum capital levels are needed. At present, the U.S. banking system is in the process of implementing a risk-based minimum capital standard which was developed under an international agreement among 12 industrialized countries. This standard, known as the Basle standard, is to be fully implemented at the end of 1992. After that date, we believe that an additional strengthening of capital standards should be phased in gradually, to the extent possible in connection with further international agreements.

We agree with Treasury that an adjustment to the capital standard for interest rate risk should be adopted even if such a change has not yet been agreed to internationally. We further agree with Treasury on the market discipline benefits of subordinated debt, although we would go further and require that it be used as a funding means by large banks.

We also agree with Treasury's support of risk-based deposit insurance premiums. By varying premiums according to risk, the burden on well-capitalized, well-managed banks of financing resolutions of failed banks will be reduced and transferred to those that put BIF at greatest risk. However, we disagree with Treasury's sole focus on capital levels as a determinant of deposit insurance premium variations. Instead, we recommend that risk-based premiums be linked to all stages of the tripwire

approach we recommend. Thus, higher premiums should be charged not just to banks that fail to meet their capital standards but also to those that lack adequate internal controls or are experiencing other problems that have not yet had an impact on capital.

Scope of Deposit Insurance Coverage

One of the features of the deposit insurance system that must be changed is that risky, and sometimes insolvent, banks can attract large volumes of deposits simply by offering to pay higher interest rates to depositors. This unhealthy side-effect of deposit insurance occurs because depositors, often including uninsured ones, are confident that they will be protected when banks fail.

Many of those who seek to reform deposit insurance believe that the way to deal with this problem is through reductions in the scope of coverage that both insured and uninsured depositors currently enjoy. It is hoped such reductions in coverage will strengthen the role of depositor discipline in helping to achieve a safe and sound banking system; bank owners and managers would have to increase capital and reduce risks in order to attract and hold their uninsured sources of funding.

Along these lines, several recommendations proposed by Treasury would significantly reduce the scope of deposit insurance. After a 2-year transition period, Treasury would eliminate insurance on brokered deposits and most other professionally managed accounts and would reduce insurance coverage for all depositors to $200,000 per person--$100,000 in retirement accounts and $100,000 in checking, savings and other accounts--per depository institution. Treasury also believes that eventually reducing coverage to $100,000 per person system-wide is a desirable goal. Furthermore, in 3 years, FDIC would be required to resolve all institutions in the least costly way, thereby making it more likely that uninsured depositors would lose money in the resolution of failed banks.

We agree that in the long term, there is a role for increased depositor discipline. But, to avoid introducing unacceptable instability into the system and increasing the concerns of millions of people who have deposits in banks, this role can only be one that supplements other actions designed to strengthen the banking system. Particularly in today's strained banking environment we have to expect that if uninsured depositors and creditors are placed at greater risk, they will also be much more likely to withdraw funds at the first hint of problems. The potential for such behavior to result in destabilizing bank runs cannot be ignored. Uninsured depositors and other non-insured liabilities fund approximately 40 percent of all U.S. bank assets

and are an even more significant funding source for many larger U.S. banking institutions; 10 of the top 25 banks in the country rely on uninsured liabilities for over 60 percent of their funding.

Instead of concentrating on scaling back coverage of insured and uninsured depositors and risking a destabilized financial system in the near term we believe that priority should be given to improving the incentives for bank managers to manage their institutions in a safe and sound manner without greater reliance on depositor discipline. We therefore recommend (1) successfully implementing the strengthened regulatory system tha I have discussed which would prevent weak banks from growing and attracting deposits by offering high rates, (2) better scrutiny of large complex banking organizations, (3) requiring disclosure of more accurate information about banks, and (4) providing all uninsured depositors with options for protecting their deposits.

Allowing depositors to protect deposits over $100,000 could be accomplished in several ways. For example, depositors could be provided the opportunity to collateralize uninsured deposits witl low-risk assets, such as Treasury securities, held by the bank. Or, uninsured depositors could be given the opportunity to purchase additional FDIC insurance through their banks to cover those deposits.

In the future, when the banking system is stronger and the regulatory, capital, information and other reforms have been adopted, we would support some of the proposals contained in Treasury's report that would more consistently place at greater risk those uninsured depositors who choose to accept higher risks in return for higher yields on their deposits. We also agree with Treasury that deposit insurance coverage should be phased out on brokered deposits, and perhaps pass-through accounts and other accounts placed by professional money managers. But we question whether a date certain for changes in the scope of insurance coverage should be set until the other reforms I have described have been implemented.

Nevertheless, even with these reforms in place, it may still be necessary for stability reasons to protect uninsured depositors in our largest financial institutions in some cases. Consequently, we agree with Treasury that, even in the long run, a formal policy requiring FDIC to follow a least cost resolution method and impose losses on all uninsured depositors under all circumstances would not be wise. Instead, we propose that the Federal Reserve, in conjunction with FDIC, be given the ability to determine that the failure of a bank would be detrimental to the stability of the U.S. financial system. If such a determination is made, failing banks declared essential could be resolved in ways that protect uninsured liabilities. We are uncertain how often such intervention would be needed. But if

all of the reforms we are recommending are implemented, such intervention should become the exception, not the rule that it is today.

HOLDING COMPANY STRUCTURE AND FINANCIAL SYSTEM MODERNIZATION

Regulation of the U.S. financial system has not kept pace with changes in domestic and global financial markets. As of June 30, 1990, bank holding companies controlled about 70 percent of the banks and 93 percent of the assets of the nation's banking system. Restrictions on the activities and geographic expansion of these banking organizations are being eroded in an ad hoc manner as federal and state regulators and legislators have moved to allow them to adapt to changes in U.S. and global financial markets. These developments may have provided benefits to some banking organizations and their customers, but they also involve dangers to the deposit insurance system that must be corrected.

An important feature of the Treasury proposal is that it would expand interstate banking and the powers of banking organizations. In the near term, we believe that the case for expanded interstate banking by well-capitalized, well-managed banking organizations is stronger than that for expanded powers.

Interstate banking

Currently, all but 4 states permit some form of interstate banking and 27 states permit banking organizations from any part of the country to operate within their boundaries. This expansion has provided many banking organizations with the opportunity to geographically diversify their risks as well as the services they offer, and further developments along these lines through elimination of restrictions on interstate branching could, on balance, be beneficial. In many respects, therefore, we agree with Treasury's recommendation to remove interstate banking restrictions. However, while Treasury would expedite approval for interstate branching for the most well-capitalized banks, it is not clear whether Treasury's proposal would allow less well-capitalized or poorly managed banks to expand under normal, non-expedited processes.

We do not believe that weak banks should be allowed to expand through interstate mergers. We are particularly concerned that regulators not use liberalized interstate banking laws to avoid dealing with problem cases by allowing, through interstate mergers, the creation of weakly capitalized, poorly managed, large banking organizations. To be sure that further expansion of interstate banking does not place FDIC at risk or damage healthy banks, we believe Congress needs to make clear in statute that only well-capitalized, well-managed banks can expand through

interstate arrangements. The tripwire system and improvements to auditing and financial reporting that we recommend will provide banking regulators with a relatively objective basis for identifying problem institutions that should not be allowed to expand.

Expanded Powers

Treasury recommends Glass-Steagall repeal and would permit well-capitalized banks to be affiliated with Financial Services Holding Companies that could also own firms that provide a full range of securities, mutual fund, and insurance services. We believe, however, that before expanded powers can be given serious consideration, priority must be given to changing the regulation of bank holding companies to better protect the deposit insurance fund from loss, and to provide other protections to the public. As banking organizations have expanded into new activities, the responsibility of bank holding company owners and managers to protect the deposit insurance system from losses has become increasingly ambiguous. Furthermore, legal protections for consumers of bank products have not kept pace with the wider variety of products that can be offered through banks. The changes we recommend include

-- requiring the holding company to serve as a source of strength to its bank subsidiaries by guaranteeing the banks'

capital levels at required minimums,

-- strengthening safeguards involving transactions between banks and other parts of the holding company to assure that insured deposits are not used to finance non-banking activities, and

-- providing adequate disclosure on products sold through banks in order to protect consumer interests.

These recommendations are similar to those of the Treasury Department, but unlike Treasury we believe that these changes should be made before consideration is given to expanded powers, not coincident with their approval.

We have no firm evidence that indicates the extent to which the banking industry or consumers of financial services might benefit from allowing banking organizations access to nontraditional lines of business. Therefore, we believe decisions on expanded powers are essentially judgmental. However, we do have views on how best to safely and soundly contain the risks from expanded powers, should they be approved. Our views are the same as Treasury's in some cases but differ in several very important respects in other cases.

If Congress decides to approve expanded bank powers, we agree with Treasury that (1) new powers should only be conducted in

independent holding company subsidiaries whose transactions with banking affiliates are limited, and (2) reciprocal powers for nonbanking organizations should be allowed.

But in addition to these steps, we believe others are necessary. First, adequate regulatory resources must exist to supervise any expansion of powers; second, safeguards against unwarranted concentrations in the financial services sector should be in place; and third, a regulatory board should be created to set rules that would apply to all diversified financial holding companies associated with banks. Members of the board should include the Chairmen of the Federal Reserve Board and the Securities and Exchange Commission (SEC) and the Secretary of the Treasury.

Furthermore, while we agree with Treasury that expanded powers should be approved only for well-capitalized banking organizations, we also would require that such banks be well-managed with demonstrably adequate internal controls. In addition, as I indicated earlier, we do not agree with Treasury's views on regulation of holding companies. Rather than just relying heavily on functional regulation of the component activities of Financial Services Holding Companies, we believe that the Financial Services Holding Companies, themselves, should be subject to consolidated capital requirements and consolidated

regulation in order to ensure the holding company's financial stability and ability to act as a source of strength.

Finally, unlike Treasury, we do not support allowing commercial firms to acquire banking organizations. Not enough is known about what would happen if the new conglomerates established by such a policy were to experience financial difficulty, and possibly create the need for mega-bailouts.

CONCLUSION

In conclusion, I want to stress once again how important deposit insurance is for preserving market stability--and how great the potential losses for the taxpayers can be if the program is not well-designed and well-managed. As Congress wrestles with how best to modernize the financial services system, greatest priority at this time must be given to strengthening those things that lead to safe and sound banking and that are essential for protecting the interests of the taxpayers. Above all, this involves ensuring that we have effective bank supervision; improved internal controls, auditing, and financial reporting; and adequate capital.

Mr. Chairman, this concludes my prepared statement. My colleagues and I will be pleased to answer questions.

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