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Expanded Powers for Banking Organizations

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Committee on Energy and Commerce
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Expanded Powers for Banking Organizations

SUMMARY OF STATEMENT BY
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GAO is testifying today on its views on modernizing the financial system. This topic is examined in greater depth in GAO's recent report on deposit insurance reform.[1]

Allowing banking organizations to engage in the full range of financial services activities has been suggested as the most effective way to solve the banking industry's, and consequently the Bank Insurance Fund's (BIF), financial difficulties. GAO questions, however, whether it would be wise to expand bank powers in the hope that this will reverse the financial difficulties that banks have been experiencing. While there may well be benefits from allowing banking organizations to further diversify the range of their activities, there are significant risks arising from competitive and other forces in the market which could exacerbate the problems of an already troubled industry and its insurance fund. Furthermore, GAO has no firm evidence that indicates the extent to which the banking industry might actually benefit from or be harmed by allowing banking organizations access to nontraditional lines of business. Thus, GAO views the decision on expanded powers as essentially a judgmental one.

If Congress decides to expand powers for banks, GAO strongly believes that Congress should make certain that two major sets of reforms are in place and effectively implemented before any newly authorized powers take effect.

First, the way banks are regulated, supervised, and operated by their owners, must be significantly strengthened and BIF must be rebuilt. GAO's reform proposals in this area require regulatory intervention before and after capital deteriorates to more effectively curtail both unsafe practices and unsafe banking conditions. This strategy depends, in turn, on strengthened financial and management reporting requirements for banks and their external auditors and other accounting and auditing improvements. Banking organizations should also be subjected to strengthened capital requirements.

Second, regulation of the bank holding company form of organization must be updated and strengthened to reduce risks to the banking system. Needed improvements include:

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

-- requiring the holding company to serve as a source of strength to its bank subsidiaries by guaranteeing bank capital levels at required minimums,

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

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

The second set of reforms is important in its own right--in order to rectify current regulatory inadequacies, to better protect the deposit insurance fund from loss, and to better protect the public--regardless of whether an affirmative decision is made to expand powers.

Once all of these reforms are in place, GAO believes that new powers could be phased in if accompanied by other appropriate safeguards designed to control the potential risks associated with such activities and assure competitive equity in the financial services industry. Specifically, approval of expanded powers should be subject to the following conditions:

(1) new powers should be allowed only in independent holding company subsidiaries whose transactions with banking affiliates are limited by amount and are required to be at arm's length,

(2) expanded powers should be approved on a case-by-case basis only for well-capitalized banking organizations that have also demonstrated adequate internal controls and management capability,

(3) reciprocal powers for nonbanking financial organizations should be allowed in the interest of fairness and equity,

(4) the capability of the regulators to oversee and regulate any expansion of new activities must be clearly demonstrated.

GAO does 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.

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to offer GAO's views on modernizing the financial system. The topics I will discuss are examined in greater depth in our recent report on deposit insurance reform.[1]

The issues you have asked me to address--those related to expanded powers for banking organizations and commercial ownership of U.S. banks--are of significant importance in their own right, but even more so in the context of the financial problems in the banking industry and a financially troubled Bank Insurance Fund (BIF).

Because problems exist in banking, decisions about expanded powers must be made very carefully by the Congress. It will be some time, at best, before expanded powers can be of much benefit to the banking industry and, secondarily, to BIF. And, at worst, expansion could endanger the industry and its Fund if new powers are authorized before regulations are in place that can provide adequate protection to the insurance fund and to the public.

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

IF ALLOWED, NEW POWERS MUST BE LINKED TO FUNDAMENTAL REFORMS

Between 1980 and 1990, 1,244 banks failed or received assistance and hundreds of additional bank failures are expected in the next several years. As a consequence of these failures, BIF is nearly exhausted and by next year, unless the Fund is rebuilt, it will almost certainly be insolvent as more troubled banks fail. On the basis of our estimates of probable and possible bank failures in 1991, we expect BIF's reserves at the end of this year to range between $1 billion and negative $5 billion. The specific outlook for the Fund beyond 1991 is more uncertain, but we see no basis for optimism. FDIC now estimates that by the end of 1992, BIF may be insolvent by as much as $11 billion. It seems clear that the fund will remain in precarious condition for the foreseeable future, unless it is recapitalized.

Allowing banking organizations to engage in the full range of financial services activities has been suggested as the most effective way to solve the banking industry's, and consequently BIF's, financial difficulties. However, BIF's deteriorating condition makes it extremely important that Congress look very carefully at the potential risks as well as the potential benefits associated with expanding the powers of banking organizations.

We have no firm evidence that indicates the extent to which the banking industry or consumers of financial services might benefit from or be harmed by allowing banking organizations access to nontraditional lines of business. Consequently, we view the decision on expanded powers as essentially a judgmental one. While there may well be benefits from allowing banking organizations to further diversify the range of their activities, there are competitive and other forces at work in the market which might limit the magnitude of these benefits. Furthermore, by their very nature, competitive markets pose risks for all market participants.

Today's financial markets are extremely competitive. Certain financial services industry sectors have experienced low profits and signs of financial stress. Consequently, it likely will be difficult for even well-managed, highly capitalized banking organizations to gain a stable foothold in other components of the industry. While some organizations may be able to compete successfully in these markets, it is also likely that many others would lose money in ill-advised new ventures into very competitive markets. Expansion of powers would weaken BIF if losses in new ventures spill over to the bank or if management's attention to new ventures results in a relaxation of efforts to strengthen traditional banking activities.

In view of the potential risk involved, if Congress decides to expand powers for banks we strongly believe that it should also make certain that two major sets of reforms are in place and effectively implemented before any newly authorized powers take effect. First, the way banks are regulated, supervised, and operated by their owners, must be significantly strengthened. Second, regulation of the bank holding company form of organization must be updated and strengthened to reduce risks to the banking system. This second set of reforms is important in its own right, regardless of whether an affirmative decision is made to expand bank powers. Once all these reforms are in place, new powers could be phased in, if accompanied by other appropriate safeguards designed specifically for controlling potential risks associated with such activities.

BANK SAFETY AND SOUNDNESS REGULATION MUST BE SUBSTANTIALLY UPGRADED

In our view, consideration should be given to allowing expanded powers for banking organizations only if the regulatory system can reasonably assure that these organizations are being operated in a safe and sound manner. Unfortunately, our recent reports on 39 large banks that failed in 1988 and 1989 and a sample of 72 banks that failed to meet capital guidelines show that our system of bank regulation and supervision is not performing effectively in assuring the safety and soundness of the nation's banks.[2]

The deficiencies we identified in the current system of bank supervision demonstrate the need for reforms to the oversight, supervision, and enforcement regulatory processes that concentrate on earlier and more forceful intervention by regulators to correct problems in banks. Because our work demonstrates that capital is a lagging indicator of problems in banks, we have proposed an early supervisory intervention approach focused on management problems, asset quality, and related areas. Regulatory intervention needs to occur both before capital deteriorates and after a bank breaches certain threshold levels of capital sufficiency.

The success of this early intervention strategy depends, in turn, upon the regulators having good information on the value of insured banking institutions. To accomplish this result, it is essential that Congress require regulators to develop more stringent financial reporting requirements for large, complex banking organizations, strengthen financial and management reporting requirements for banks and their external auditors, require banks to value problem assets based on existing market conditions, strengthen the corporate governance mechanisms for

[2] Failed Banks: Accounting and Auditing Reforms Urgently Needed (GAO/AFMD-91-43), April 1991 and Bank Supervision: Prompt and Forceful Regulatory Actions Needed (GAO/GGD-91-69), April 1991

banks and require annual, full-scope, on-site examinations of all banks.

The point of these reforms to improve supervision of and information on banking organizations is to enable the regulators to act decisively and promptly to close institutions before all of their economic value has been lost. When this can be done, the cost of deposit insurance to healthy banks--and potentially to the taxpayer--should decline. We question, however, whether this result can be achieved unless efforts are also made to rebuild BIF. If BIF is not recapitalized, regulators might be tempted to postpone facing up to the requirements of an early intervention strategy. Furthermore, seeing a weak insurance fund, the owners and managers of banks may take on additional risks if they believe that the regulators are unwilling or unable to move quickly to close institutions that cannot meet capital requirements.

Even with the reforms and recapitalization efforts I have discussed in place, it is unreasonable to expect that the regulatory system will be able to completely assure the safe and sound operation of all banking organizations. For this reason, bank owners and managers must also take much more responsibility for the safety and soundness of their institutions. The key to increasing their responsibility is to require banks to maintain capital levels more commensurate with their risk. This forces owners and managers to bear the potential losses from their activities and also provides a financial buffer to protect the deposit insurance system. Among other things, we believe that strengthened capital requirements should include a larger role for subordinated debt in large bank funding. Owner/management incentives to control risk can also be strengthened by implementing a system of risk-based deposit insurance premiums and by phasing out the use of brokered deposits.

BANK HOLDING COMPANY REGULATION ALSO NEEDS TO BE UPDATED AND STRENGTHENED

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% of the banks and 93% of banking system assets. Restrictions on these organizations, originally imposed by the 1956 and 1971 Bank Holding Company Acts, are being eroded in an ad hoc manner as federal and state regulators and legislators have moved to allow them to adapt to advances in U.S. and global financial markets. While the changes in bank powers already approved may have provided benefits to some banking organizations and their customers, they also involve dangers to the deposit insurance system and other aspects of the nation's financial system. 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 have not kept pace with the wider variety of products that can be offered through banks and their affiliated organizations.

New laws and regulations are needed to ensure that holding companies can be held responsible for the financial health of their bank subsidiaries and to control potentially harmful transactions between banks and their holding company affiliates. Changes in laws and regulations are also needed to provide consumers with information that adequately addresses the complexity of bank holding company financial product offerings. As I indicated, regardless of whether Glass-Steagall and similar Bank Holding Company Act restrictions are repealed, these reforms are needed to rectify current regulatory inadequacies, to better protect the deposit insurance fund from loss, and to better protect the public, and certainly must precede any affirmative decision on the question of bank powers.

Holding Company Structure

We believe it is in keeping with market realities to view holding companies as consolidated entities for operating purposes. Market reaction, for example, assumes that serious financial problems associated with a holding company subsidiary are likely to negatively affect the health of the holding company and all of its other subsidiaries, including any insured banks.[3] The holding company parent is the "nerve center" of the company and determines how its subsidiaries are operated.

The reforms we recommend to reflect this market reality are:

-- requiring the holding company to serve as a source of strength to its bank subsidiaries by guaranteeing the banks' capital levels at required minimums and assuring the strength of the guarantee through consolidated holding company regulation.

-- strengthening safeguards involving transactions between banks and other parts of the holding company to ensure that insured deposits are not used to finance nonbanking activities.

Unless it is clear that holding companies must take financial responsibility for their bank subsidiaries, they can attempt to fall back on their legal separateness from those bank subsidiaries if they encounter financial problems. As has happened in the past, the holding company can cite

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[3]For example, it is likely that if an insured bank had been affiliated with Drexel Burnham Lambert Group, Inc., the market would have refused to do business with the bank, just as it refused to do business with Drexel's healthy broker dealer and government securities subsidiaries. The likely result would have been a run on the bank and its probable failure.

responsibilities to shareholders and creditors and leave the bank for the FDIC, and possibly the taxpayer, to take care of.

An effective source of strength policy should provide holding company parents with an added incentive to monitor and control risk in their organizations. Holding companies that are responsible for the health of their subsidiary banks should be less tempted to take advantage of their banks--through conflict of interest abuses or other improper inter-affiliate transactions--in order to support non-bank subsidiaries or themselves.

In order to control risk to bank affiliates and to ensure that the bank holding company source of strength doctrine is an effective mechanism--and is not simply invoked when it is too late to protect the bank subsidiaries or the FDIC--we believe that bank holding companies must be regulated on a consolidated basis. Consolidated regulation offers a much higher potential for timely identification by bank regulators of financial problems in the parent company or its affiliates that might eventually tempt the holding company to circumvent capital flow regulations and jeopardize the bank and the strength of its guarantee.

In addition to these considerations, regulations designed to control the types and terms of interaffiliate transactions need to be updated to recognize some newer types of holding company transactions. Currently sections 23A and 23B of the Federal Reserve Act are designed to control such interaffiliate transactions that might drain bank assets or lead to conflict of interest abuses. They do this by limiting the amount of the transactions, and requiring that they be at arm's length. The quantitative restrictions contained in section 23A are targeted primarily at credit extensions between a bank and its affiliates. But there are many additional ways for affiliates to siphon funds out of banks--through tax sharing, asset sales, swap arrangements, management fees or data processing services. Consequently, controls on transactions between affiliates and insured banks should be strengthened to adequately control interaffiliate transactions that might drain bank assets in ways other than through extensions of credit. Moreover, existing accounting and auditing rules for related party transactions need to be strengthened to ensure compliance with safeguards separating banking and non banking activities within a holding company.

Consumer Protection

Consumer protection measures must be updated. Today, consumers may choose from a wide and often confusing selection of insured and uninsured financial products and services. Banks offer insured and uninsured products in their main bank lobbies and in mailed solicitations. Some of these products are underwritten by the bank; others by the bank holding company; and still others are underwritten by non-bank financial services firms and sold by the bank. In addition, securities or insurance firms offer bank-like products that are not insured, but may also collect funds from clients and place them in bank products that are insured. As these products become increasingly complex and yet more similar across industry lines--a process likely to accelerate if banks are given access to expanded powers--it is extremely important that consumers receive adequate information which enables them to make sound investment decisions.

We have recommended three improvements to disclosure regulation that should better protect consumers. First, consumers must be fully informed about whether the products they are purchasing are federally insured. Second, consumers must be accurately informed about the financial risks associated with the products being offered by banking organizations. Third, all consumer financial service providers should be required to calculate standardized investment yields on financial products they offer.

SAFEGUARDS AND OTHER CONSIDERATIONS THAT MUST ACCOMPANY ANY EXPANSION OF POWERS THAT IS ALLOWED

The reforms to bank safety and soundness and bank holding company regulation that I have been discussing are necessary prerequisites to any repeal of Glass-Steagall restrictions and modifications to the Bank Holding Company Act. However, if an affirmative decision is made to allow for the expansion of bank powers, several additional safeguards and other requirements will also be necessary to assure that the new powers of banking organizations do not jeopardize the deposit insurance fund or create significant competitive imbalances between insured banking institutions and uninsured financial services providers.

-- Non-traditional banking activities should be conducted within holding companies, outside the insured bank subsidiary, in order to limit the liability to the U.S. government and taxpayers resulting from deposit insurance and assure competitive equity. Insured bank deposits should not be used to underwrite, and possibly subsidize, potentially unacceptable risks--including those associated with non-traditional bank powers.

-- Expanded powers should be approved on a case-by-case basis only for well-capitalized banking organizations that have also demonstrated adequate internal controls and management capability. Weak organizations must not be given the opportunity of undercutting their competition in a gamble to gain market share and a slim chance at future profits, thereby damaging healthy organizations and increasing the potential drain on BIF.

-- The rate at which organizations engage in new powers, either by merger or by establishing new companies, must be limited. Such limits should be designed to minimize possible adverse effects from institutions jumping too quickly to establish market share in unfamiliar markets and to minimize the possibility of unacceptable industry concentration.

-- If banking organizations are allowed to conduct non-traditional activities, then in the interest of fairness and equity, other types of financial services organizations should be allowed entry into banking.

-- Regulatory capability to regulate new activities must be clearly demonstrated.

Because of your committee's jurisdiction over the regulation of the securities industry and continued interest in issues involving the adequacy of regulatory resources in a world of expanded powers, I would like, at this point, to elaborate on the last two requirements that I just summarized.

Reciprocal Entry
Into Banking

If banks are allowed to engage in a wider range of financial services product offerings, then competitive equity considerations dictate that other financial services providers should be allowed entry into banking. Similarly, competitive equity considerations also mandate that the basic structure of regulation applied to banking institutions designed to protect the federal safety net also be applied to other diversified financial services firms that are associated with insured banks. The rationale for a holding company source of strength requirement, consolidated holding company capital requirements, and holding company supervision is as relevant for financial services holding companies that decide to associate with banks as for bank holding companies.

If the powers of banking organizations are expanded, it will be necessary to ensure consistency in the allowable powers of all organizations owning insured depository institutions, as well as consistency in the regulation of financial holding companies that own banks. We believe that a single set of regulations should be enforced by all regulators, much the same way the securities industry's many self-regulatory organizations apply and enforce SEC rules and regulations. To accomplish this result, we therefore favor the creation of a regulatory board that would be responsible for promulgating these rules.

The board would explore and reduce the potential gaps and inconsistencies which may occur when functional regulation is applied to a diversified financial institution that owns both banks and other regulated entities, such as a securities or insurance firm. The board's mandate should be to create rules that will enhance the overall safety, soundness and competitiveness of the U.S. financial services industry while protecting the deposit insurance fund. To ensure adequate and fair consideration of the inter-industry issues involved, we recommend that such a board be comprised of the Chairman of the Federal Reserve, the Chairman of the SEC, and the Secretary of the Treasury.

Adequacy of Regulatory Resources

In our view, the success of proposals to reform financial services in the U.S. depends crucially on the capability of the regulators to oversee the safe and sound implementation of such reform. Allowing banking organizations to expand into non-traditional activities is likely to increase the burden on bank regulators even though such activities would be restricted to holding company subsidiaries.

In response to a request by this subcommittee about the adequacy of regulatory resources needed to control risk associated with expanded powers, we sent a letter to the Federal Reserve Board, FDIC and Office of the Comptroller of the Currency requesting their views on numerous regulatory issues, including regulatory resources. The Federal Reserve and FDIC responded some time ago to our request. The Office of the Comptroller of the Currency responded only very recently and we are currently reviewing their submission.

As the Federal Reserve indicated in response to our written questions, there is no reliable data available on the number and size of banking institutions that might wish to engage in any particular expanded activity or on the extent to which they may want to pursue them. If banks were to focus on so-called "agency" activities, such as insurance or securities brokerage where bank safety and soundness is minimally at risk, then regulatory resources would be focused primarily on consumer matters and on potential conflict of interest abuses. The Federal Reserve and FDIC both do not believe that this would require significant regulatory resources. If, however, banks were to become involved in such activities as insurance underwriting or securities underwriting/dealing then bank regulators believe that additional training will be needed, even if those activities are conducted in functionally regulated subsidiaries. According to the Federal Reserve and FDIC, training in these areas would take at least six months to a year to get their staff up to speed.

Clearly, it is difficult to predict the need for regulatory resources necessary to regulate expanded activities by banking organizations. However, it is certain that additional resources would be required since regulators would have to be aware of a wider set of potential risks arising from new nonbanking affiliates of insured banks. And, the regulators would also have to become aware of and be prepared to control a wider range of potential conflicts of interest that arise as the result of the new activities.

We, therefore, recommend that an evaluation of the adequacy of the system and resources of the regulatory agencies by a commission of regulators and independent experts be substantially completed before deciding at what speed provisions for expanding powers should be implemented.

NON-FINANCIAL COMMERCIAL FIRMS SHOULD NOT BE AFFILIATED WITH BANKING

If Congress expands opportunities for banking organizations to own financial services firms and vice versa, we would question whether Congress should simultaneously allow non-financial commercial firms to own banks. We recognize that many have argued that it is necessary to allow commercial firms to invest in banking in order to provide an outside source of capital to the banking industry. However, we do not believe that the potential long-term ramifications of such a reversal of the long-standing U.S. tradition of separating commerce from banking have been thoroughly considered. Consequently, we favor continuing the separation of commerce and banking until considerable experience has been gained with outside financial ownership of banks before a judgment is made on the appropriateness of commercial ownership. This experience with expanded financial powers may serve to highlight unforeseen conflicts of interest or other problems that would suggest commercial firms should not be allowed further entry into banking. If it does not, then a considered decision can be made about such ownership on its own merit, removed from the context of the expanded powers debate and BIF refinancing.

It is not clear that allowing commercial firms to own banks would be an answer to bank capital adequacy problems. As former Federal Reserve Board Chairman Paul Volcker stated in testimony before the Senate Banking Committee recently, " the basic plea--that commerce-banking combinations are needed to bring adequate capital resources to banking--suggests a degree of imperfection in U.S. capital markets for which no evidence is advanced." Certainly, commercial firms have invested significantly in other sectors of the U.S. financial sector, such as the securities industry. However, those investments were primarily motivated by the industry's profitability. Yet, the fundamental problem in the banking industry today is low profitability. Unless that problem is addressed, those banks that need capital infusions are not likely to be attractive to outside investors.

At the same time it must also be expected that firms in other sectors of the U.S. economy that now appear to be healthy will suffer setbacks related to turmoil in world markets, an economic downturn, a severe oil crisis, or other factors. We cannot predict what might happen under such a scenario, but it is possible that commercial firms under stress might attempt to take advantage of the financial institutions they own. If this were to occur, it could lead to the possibility of mega-bailouts.

We also cannot predict what other potential conflicts of interest might arise between commercial firms, the banks they own, and the customers they serve. Conflicts could develop related to the payments system, financing of potential competitors, or, at the extreme, the creation of large, anti-competitive conglomerates. Furthermore, regulation of such organizations to control potential conflict of interest abuses likely would be difficult.

We acknowledge that certain inequities may result from any decision to allow financial firms, but not commercial firms, to own banks. For example, securities firms now associated with non-financial commercial parents would not be allowed to acquire banks with insured deposits, even though such acquisitions would be permitted to securities firms without such affiliations. However, we believe that long-run considerations concerning bank safety and stability should outweigh short-term expediencies. We believe that priority should be given to developing a safe holding company structure and to integrating the financial services industry, if that is judged desirable. Then, after experience with those changes, a determination can be made about the separation of banking and commerce.

That concludes my prepared statement. My colleagues and I will be pleased to answer questions.

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