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Testimony

Before the Committee on Banking and Financial Services  
House of Representatives

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**BANK OVERSIGHT**

**Fundamental Principles for  
Modernizing the U.S.  
Structure**

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# Bank Oversight: Fundamental Principles for Modernizing the U.S. Structure

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GAO's testimony identifies four fundamental principles that GAO believes Congress could use in considering the best approach for modernizing the current U.S. regulatory structure. Specifically, GAO believes that structural reform should provide for

- consolidated and comprehensive oversight of companies owning federally insured banks and thrifts, with coordinated functional regulation and supervision of individual components;
- independence from undue political pressure, balanced by appropriate accountability and adequate congressional oversight;
- consistent rules, consistently applied for similar activities; and finally,
- enhanced efficiency and reduced regulatory burden.

GAO studies on the structure and operation of bank oversight in Canada, France, Germany, the United Kingdom (U.K.), and Japan show that each of the five oversight structures reflects the four principles cited above in its own way. With few, if any, exceptions, each (1) had fewer national agencies involved with bank regulation and supervision than is the case in the United States; (2) had substantial oversight roles for their central banks and ensured that their ministries of finance were, at the least, kept informed of important industry and supervisory developments; (3) had relatively narrow roles for their deposit insurers; and (4) incorporated mechanisms and procedures to ensure consistent, consolidated oversight and limit regulatory burden.

GAO's work on these five foreign systems showed that there are a number of different ways to simplify bank oversight in this country in accordance with the four principles mentioned above. While GAO recognizes that only Congress can make the ultimate policy judgments in deciding exactly how to restructure, GAO recommends that Congress do the following:

- Reduce the number of federal agencies with primary responsibilities for bank oversight.
- Include both the Federal Reserve and the Treasury Department in bank oversight.

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**Summary**  
**Bank Oversight: Fundamental Principles for**  
**Modernizing the U.S. Structure**

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- Provide FDIC with necessary authority to protect the deposit insurance funds.
  - Incorporate mechanisms to ensure consistent oversight and reduce regulatory burden.

# Bank Oversight: Fundamental Principles for Modernizing the U.S. Structure

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Mr. Chairman and Members of the Committee:

We are pleased to be here today to discuss your efforts to modernize the federal bank oversight structure.<sup>1</sup> Recent financial market developments have clearly demonstrated that our existing regulatory structure has not kept pace with the dramatic and rapid changes that are occurring in domestic and global financial markets. Banking, securities, futures, and insurance are no longer separate and distinct industries that can be well regulated by the existing patchwork quilt of federal and state agencies. We believe that a critical first step in modernizing oversight is to begin consolidating the activities of the four federal agencies currently responsible for the regulation and supervision of almost 12,000 federally insured banks and thrifts. We recognize, however, that restructuring involves difficult and long-standing issues, and commend the efforts of you and your committee to address needed reforms.

Our work over the past few years has shown that, despite good faith efforts to coordinate their policies and procedures, the four federal banking regulators have often differed on how laws should be interpreted, implemented, and enforced; how banks should be examined; and how the federal government should respond to troubled institutions.

Bankers also contend that multiple examinations and reporting requirements add to their regulatory burden and contribute to their competitive disadvantage with regard to other financial institutions, both foreign and domestic, that are not subject to the same regulatory regime. Furthermore, U. S. bank holding companies are examined by the Federal Reserve, while their subsidiaries can be examined separately by several other regulatory authorities. Thus, there is often overlap and no clear accountability for the operations of U. S. banking organizations as a whole.

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## Fundamental Principles to Guide Oversight Modernization

More than 2 years ago, we voiced our support for regulatory consolidation based on the extensive work we have done in areas such as bank supervision, enforcement, and failure resolution, as well as on innovative financial activities, such as derivatives. Studies we have done since then—at the request of Congressman Charles E. Schumer—of the bank oversight structures in five other major industrialized countries have reaffirmed our support for regulatory consolidation. In addition, we have

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<sup>1</sup>Federal bank oversight structure refers to federal oversight of both bank and thrift institutions along with their related holding companies.

identified four fundamental principles based on all of our work that we believe Congress could use in considering the best approach for modernizing our current regulatory structure. Specifically, we believe that structural reform should provide for

- more consolidated and comprehensive oversight of companies owning federally insured banks and thrifts, with coordinated functional regulation and supervision of individual components;
- independence from undue political pressure, balanced by appropriate accountability and adequate congressional oversight;
- consistent rules, consistently applied for similar activities; and finally,
- enhanced efficiency and reduced regulatory burden.

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## Aspects of Foreign Oversight Structures That Are Useful to Consider

Over the past 2 years, we have completed studies on the structure and operation of bank oversight in Canada, France, Germany, and the United Kingdom (U.K.), and are in the process of completing a fifth report on bank oversight in Japan. Each of the five foreign oversight structures we studied reflects a unique history, culture, and banking industry, and as a result, no two of the five are identical. Furthermore, all of the countries we reviewed had more concentrated banking industries than does the United States, and all but Japan have authorized their banks to conduct broad securities and insurance activities in some manner. Although we did not attempt to assess the effectiveness of bank oversight in these countries, we found that each reflected these four principles in some way, and with few, if any, exceptions, each

- had fewer national agencies involved with bank regulation and supervision than is the case in the United States;
- had substantial oversight roles for their central banks, and ensured that their ministries of finance were, at the least, kept informed of important industry and supervisory developments;
- had relatively narrow roles for their deposit insurers; and lastly,
- incorporated mechanisms and procedures to ensure consistent, consolidated oversight and limit regulatory burden.

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## Foreign Oversight Structures Had More Consolidated and Comprehensive Oversight Authority and Fewer Oversight Entities

In the five countries we studied, banking organizations typically were subject to more consolidated and comprehensive oversight, with an oversight entity being legally responsible and accountable for the entire banking organization, including its subsidiaries. If securities, insurance, or other nontraditional banking activities were permissible in bank subsidiaries, functional regulation of those subsidiaries was generally provided by the appropriate supervisory authority. Bank supervisors generally relied on those functional regulators for information, but remained responsible for ascertaining the safety and soundness of the consolidated banking organization as a whole.

The number of national bank oversight entities in the countries we studied ranged from one in the U.K., to three in France. In all five countries, however, no more than two national agencies were ever significantly involved in any one major aspect of bank oversight, such as chartering, regulation, supervision, or enforcement. Commercial bank chartering, for example, was the direct responsibility of only one entity in each country.

In those countries where two entities were involved in the same aspect of oversight, the division of oversight responsibilities was generally based on which entity had the required expertise. In Germany, for example, many oversight responsibilities were shared between the central bank and the federal bank supervisor. Yet, each of the two had a relatively well-defined role, agreed upon by both entities, based on their relative strengths and certain legal requirements. For example, the central bank, with more staff and a broader geographic presence than the federal bank supervisor, collected and analyzed bank data and had responsibility for most day-to-day supervision. The federal bank supervisor, on the other hand, had more responsibilities based in law, such as those of issuing banking regulations and taking formal enforcement actions.

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## Oversight Structures Generally Included Roles for Both Central Banks and Finance Ministries

The central banks in the countries we studied generally had significant roles in supervisory and regulatory decisionmaking. In large part, central bank involvement was based on the premise that traditional central bank responsibilities for monetary policy, payment systems, liquidity lending, and crisis intervention are closely interrelated with oversight of commercial banks. While no two countries had identical oversight roles for their central banks, each country had an oversight structure that ensured that its central bank had access to information about, and certain influence over, the banking industry. In the U.K., for example, the central bank was the only bank supervisor. In France, Germany, and Japan, the

central bank was one of two principal oversight agencies. And while the Bank of Canada had no direct responsibility for bank oversight, it was included on the deposit insurance board and two advisory committees, which gave it access to information about the banking industry and some influence in supervisory matters.

In each of the five countries, the national government recognized that it had the ultimate responsibility to maintain public confidence and stability in the financial system. Thus, each of the bank oversight structures that we reviewed also provided the Ministry of Finance, or its equivalent, with some degree of influence over bank oversight and access to information. In France, for example, the Ministry of Economic Affairs was represented on each of three bank oversight committees and chaired one of them. In Germany and Canada, the principal bank supervisor reported to the Minister of Finance. Similarly, the Bank of England reported to the Chancellor of the Exchequer. And in Japan, the Minister of Finance was the principal banking supervisor.

While each country included its central bank and finance ministry in some capacity in its oversight structure, most also recognized the need to guard against undue political influence by incorporating checks and balances unique to each country. In France, for example, a three committee bank oversight structure was designed expressly to ensure that no single entity could dominate or dictate decisionmaking. Likewise, Canada's oversight structure had multiple committees designed to share information and responsibilities among all of the oversight entities. And in Germany, the influence of a strongly independent central bank helped balance decisionmaking.

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### Deposit Insurers Generally Had More Narrow Roles and Often Were Not Government Funded or Administered

While central banks and finance ministries generally had substantial roles in bank oversight, deposit insurers, with the exception of the Canada Deposit Insurance Corporation, did not. Their lack of a substantial oversight role may be attributable to the fact that deposit insurers in these countries were often industry funded and administered, with the national governments providing no explicit guarantees of the deposit insurance funds. Thus, in most of these countries, deposit insurers were viewed primarily as a source of funds to help resolve bank failures—either by covering insured deposits or by helping to finance acquisitions of failed or failing institutions by healthy institutions. Supervisory information was generally not shared with these deposit insurers, and resolution decisions for failed or failing banks were commonly made by the primary bank



oversight entities with the insurer frequently only involved when its funds were needed to help finance resolutions. Even the Canadian deposit insurer, which is similar to the Federal Deposit Insurance Corporation (FDIC) in many ways, relied principally on the primary banking supervisor for examination information to safeguard its insurance funds. It did, however, sometimes use its backup oversight authority—including requesting special examinations—to obtain additional information and insight into the safety and soundness of high-risk institutions.

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**Foreign Structures  
Incorporated Mechanisms  
and Procedures to Help  
Ensure Consistent  
Oversight and Limit  
Regulatory Burden**

Most of the foreign structures with multiple oversight entities incorporated mechanisms and procedures designed to ensure consistent oversight and limit regulatory burden. As a result, banking institutions that were conducting the same lines of business were generally subject to a single set of rules, standards, or guidelines. Coordination mechanisms included having oversight committees or commissions with interlocking boards, shared staff, or mandates to share information. In France, for example, central bank employees staffed all three committees charged with oversight responsibilities for chartering, rule-making, and supervision. And the central bank and Ministry of Economic Affairs also had a seat on each of the three committees. In Canada, the federal bank supervisor, central bank, and finance ministry each had seats on the Canada Deposit Insurance Corporation's board of directors and together with the deposit insurer, participated on various advisory committees. In Germany, the central bank and federal bank supervisor used the same data collection instruments and were legally required to share information that could be significant in the performance of their duties.

To reduce staffing needs and avoid duplication of effort, bank supervisors in three of the five countries also used the banks' external auditors to provide supervisory information. In Germany and the U.K., for example, external auditors conducted audits in lieu of full-scope bank examinations and were the principal source of examination-like information. In Canada, examinations were conducted by employees of the federal banking supervisor, but information from the banks' external auditors was used to supplement and guide these examinations. In all three countries, the oversight agencies had considerable authority over the scope and conduct of external audits of banking institutions. In Germany and the U.K., external audits were conducted using specific guidelines developed by the bank regulators, and the scope of individual audits could be expanded by the regulators, or special audits ordered, to address issues of regulatory concern. Supervisors in all three countries recognized that the auditors'

objectives for reviewing a bank's activities could differ from those of a supervisor, and that a degree of conflict could exist between the external auditors' responsibilities to report to both their bank clients and to the bank supervisory authorities. However, they believed that their authority over auditors' engagements was sufficient to ensure that the external auditors properly discharged their responsibilities and openly communicated with both their bank clients and the oversight authorities.

Unlike in the United States, bank oversight in the countries we studied also avoided a potential area of added burden by focusing almost exclusively on ensuring the safety and soundness of banking institutions and the stability of financial markets, and not on consumer protection or social policy issues. Rather than using the bank oversight function, the national governments in these countries used other mechanisms to promote social goals. Specifically, some of the policy mechanisms used to encourage credit and other services in low- and moderate-income areas in these countries included the chartering of specialized financial institutions and direct government subsidies for programs to benefit such areas. In France, for example, specialized financial institutions provided financing for affordable housing. In Canada, France, and the U.K., the banking industries, not regulators, developed voluntary guidelines related to consumer and small business lending. Only in France were bank supervisors responsible for enforcing compliance with these kinds of guidelines and best practices.

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## Recommendations

Our work on these five foreign systems showed that there are a number of different ways to simplify bank oversight in this country in accordance with the four principles mentioned earlier—i.e., consolidated oversight with coordinated functional regulation, independence, consistent rule-making, and enhanced efficiency and reduced regulatory burden. And we note that the approach taken in H.R. 17 is consistent with each of these principles. While we recognize that only Congress can make the ultimate policy judgments in deciding exactly how to restructure, we have the following four recommendations to make based on the extensive work we have done on both U.S. and foreign banking systems.

1. Reduce the number of federal agencies with primary responsibilities for bank oversight: We believe that a logical step in consolidating is to combine the Office of Thrift Supervision (OTS), the Office of the Comptroller of the Currency (OCC), and FDIC's primary supervisory responsibilities for state-chartered banks that are not members of the

Federal Reserve into a new federal banking agency or commission. Congress could provide for this new agency's independence in a variety of ways, including making it organizationally independent like FDIC or the Federal Reserve. This new independent agency, together with the Federal Reserve, could be assigned responsibility for comprehensive, consolidated supervision of those banking organizations under their purview, with appropriate functional supervision of individual components.

2. Include both the Federal Reserve and the Treasury Department in bank oversight: To carry out its primary responsibilities effectively, the Federal Reserve should, in some capacity, have direct access to supervisory information, as well as some ability to influence supervisory decisionmaking. The foreign oversight structures we reviewed showed that this could be accomplished by having the Federal Reserve be either a direct or indirect participant in bank oversight. For example, the Federal Reserve could maintain its current direct oversight responsibilities for state chartered member banks or be given new responsibility for some segment of the banking industry, such as the largest banking organizations. Alternatively, the Federal Reserve could be given major roles on the board of a new consolidated banking agency and on FDIC's board of directors. Under this alternative, Federal Reserve staff could help support some of the examination or other activities of a consolidated banking agency to better ensure that the Federal Reserve receives first hand information about, and access to, the banking industry. Even if the Federal Reserve maintains its current direct role in bank supervision, Congress may wish to consider having the Federal Reserve replace OTS on the FDIC board of directors if Congress decides to merge OTS with another agency.

To carry out its mission effectively, the Treasury Department also needs access to supervisory information about the condition of the banking industry, as well as the safety and soundness of those banking institutions that could affect the stability of the overall financial system. Our reviews of foreign regulatory structures showed that this goal could also be accomplished in several ways, such as having Treasury represented on the board of the new banking agency or commission and perhaps on the board of the FDIC as well. Currently, both OCC and OTS, which are within the Treasury Department, have seats on FDIC's board.

3. Provide FDIC with necessary authority to protect the deposit insurance funds: Under any restructuring, we believe FDIC should maintain its explicit backup supervisory authority to enable it to effectively discharge its

responsibility for protecting the deposit insurance funds. Such authority should require coordination with other responsible regulators, but should also allow FDIC to go into any problem institution on its own without the prior approval of any other regulatory agency. FDIC also needs backup enforcement power and the capability to assess the quality of bank and thrift examinations generally.

4. Incorporate mechanisms to help ensure consistent oversight and reduce regulatory burden: Just reducing the number of federal bank oversight agencies from the current four would, of course, help improve the consistency of oversight and reduce regulatory burden. Should Congress decide to continue to have more than one primary federal bank regulator, we believe that mechanisms should be incorporated to enhance their cooperation and coordination and reduce burden. Such mechanisms could include

- expanding the current mandate of the Federal Financial Institutions Examination Council to ensure consistency in rule-making for similar activities as well as consistency in examinations;
- assigning specific rule-making authority in statute to a single agency, as has been done in the past when the Federal Reserve was given statutory authority to issue rules for several consumer protection regulations that are enforced by all of the bank regulators;
- requiring enhanced cooperation between examiners and banks' external auditors; (While we strongly support requirements for annual full-scope, on-site examinations for large banking organizations, we believe that examiners could take better advantage of the work already being done by external auditors to better plan and target their examinations.)
- requiring enhanced off-site monitoring to better plan and target examinations, as well as to identify and raise supervisory concerns at an earlier stage.

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Mr. Chairman, this concludes my statement, and I would be pleased to respond to any questions that you or other Members of the Committee may have.

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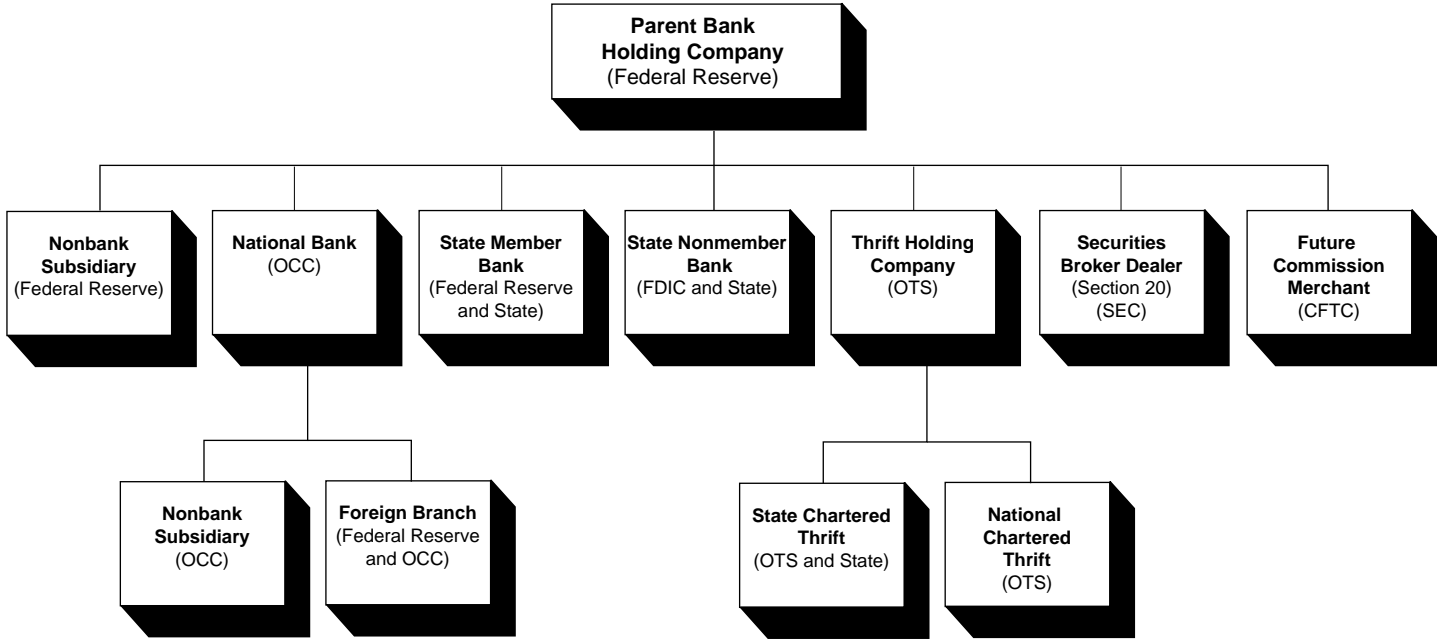
Figure I.1 : Responsibility for U.S. Bank Oversight Functions

	Developing and issuing regulations	Licensing/chartering banks	Bank information reporting and analysis	Bank examinations	Enforcement authority	Deposit insurance	Failure resolution	Lender of last resort	Crisis management
Treasury <sup>a</sup>									•
OCC	•	•	•	•	•				•
OTS	•	•	•	•	•				•
Federal Reserve	•		•	•	•		•		•
FDIC <sup>b</sup>	•		•	•	•	•			•

<sup>a</sup>OCC and OTS report to Treasury.

<sup>b</sup>The Board of Directors of the FDIC includes the heads of OCC and OTS as well as three independent members, including the Chairman and the Vice-Chairman who are appointed by the President and confirmed by the Senate.

Figure I.2: Regulation of a Hypothetical Bank Holding Company



**Table I.1: Aspects of Bank Oversight in Canada, France, Germany, Japan, and the U.K.**

	CANADA	FRANCE	GERMANY	JAPAN	U.K.
Number of national agencies authorized to issue bank regulations	2	1	1	1	1
Number of national agencies authorized to perform major supervisory functions	2	1	2	2	1
Consolidated and comprehensive oversight of a banking organization?	Yes	Yes	Yes	No	Yes
Mechanisms to ensure cooperation and coordination among regulatory bodies built into oversight system?	Yes	Yes	Yes	No	N/A
Consistent supervisory and regulatory standards?	Yes	Yes	Yes	No	Yes
Finance ministry included in key decisionmaking?	Yes	Yes	Yes	Yes	Yes
Central bank had supervisory access to and influence over banking industry?	Yes	Yes	Yes	Yes	Yes
Deposit insurer had supervisory access to and influence over banking industry?	Yes	No	No	No	No
Bank supervisors relied extensively on external auditors' work, or intended to increase their reliance?	Yes	Yes	Yes	No	Yes
Social policy goals were major part of banking legislation, regulations, or oversight?	No	No	No	No	No



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# Related GAO Products

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Bank Regulatory Structure: Canada (GAO/GGD-95-223, Sept. 28, 1995).

Bank Regulatory Structure: France (GAO/GGD-95-152, Aug. 31, 1995).

Bank Regulatory Structure: The United Kingdom (GAO/GGD-95-38, Dec. 29, 1994).

Bank Regulatory Structure: The Federal Republic of Germany (GAO/GGD-94-134BR, May 9, 1994).

Financial Derivatives: Actions Needed to Protect the Financial System (GAO/GGD-94-133, May 18, 1994).

Financial Regulation: Modernization of the Financial Services Regulatory System (GAO/T-GGD-95-121, March 15, 1995).

Bank Regulation: Consolidation of the Regulatory Agencies (GAO/T-GGD-94-106, Mar.4, 1994).

Bank and Thrift Regulation: FDICIA Safety and Soundness Reforms Need to Be Maintained (GAO/T-AIMD-93-5, Sept. 23, 1993).

Bank Regulation: Regulatory Impediments to Small Business Lending Should Be Removed (GAO/GGD-93-121, Sept. 7, 1993).

Bank Examination Quality: OCC Examinations Do Not Fully Assess Bank Safety and Soundness (GAO/AFMD-93-14, Feb. 16, 1993).

Bank and Thrift Regulation: Improvements Needed in Examination Quality and Regulatory Structure (GAO/AFMD-93-15, Feb. 16, 1993).

Bank Examination Quality: FDIC Examinations Do Not Fully Assess Bank Safety and Soundness (GAO/AFMD-93-12, Feb. 16, 1993).

Bank Examination Quality: FRB Examinations and Inspections Do Not Fully Assess Bank Safety and Soundness (GAO/AFMD-93-13, Feb. 16, 1993).

Banks and Thrifts: Safety and Soundness Reforms Need to Be Maintained (GAO/T-GGD-93-3, Jan. 27, 1993).

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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