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BANK REGULATION

Consolidation of the Regulatory Agencies

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Mr. Chairman and Members of the Committee:

I am pleased to be here to discuss legislation to consolidate the activities of the 4 federal agencies responsible for the regulation and supervision of more than 13,000 banks and thrifts. These institutions, together with their holding companies and the 600 U.S. branches and agencies of foreign banks that would also be affected, hold more than $5.5 trillion in assets.

I welcome the Committee's interest in simplifying the regulatory structure, and I would like to commend you for taking on this long-standing and difficult issue. Over a year ago, as part of testimony[1] that covered a number of banking and thrift issues, I suggested that there were opportunities along these lines that should be considered.

Several proposals have been made recently for consolidating the regulatory activities of the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), the Federal Reserve, and the Federal Deposit Insurance Corporation (FDIC). Some of these proposals would place all of these activities in a single independent regulatory agency, the Federal Banking Commission, while other proposals would retain more than one regulator. The relative strengths and weaknesses of each major approach need to be carefully debated, and I hope that my remarks will be helpful.

We support the objective of reducing the current number of federal banking regulators. However, until the questions about the role of the Federal Reserve in bank supervision can be resolved, we think a logical step would be to combine OTS, OCC, and FDIC's supervisory responsibilities for state-chartered banks that are not members of the Federal Reserve System into one independent agency.

CURRENT STRUCTURE LIMITS EFFECTIVE REGULATORY PERFORMANCE

Over the past several years, our studies of the banking system have included failed institutions, agency approaches to examination and supervision, regulatory burden, and implementation of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). Although we did not study the efficiency and effectiveness of the regulatory structure as a whole, our work provides a picture of the difficulties inherent in four agencies regulating banks and thrifts. For example

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

-- In our February 1993 report[2] on safety and soundness examinations, we found that these examinations were too limited to fully determine bank and thrift safety and soundness. The key weaknesses included lack of comprehensive internal control assessments and insufficient review of loan quality and loan loss reserves. A lack of minimum, mandatory examination standards in these areas was a common factor among the regulatory agencies; this deficiency limited the reliability of the examination process. We also identified significant inconsistencies in examination policies and practices, including differences in examination scope, frequency, documentation, and assessment of critical areas, such as loan loss reserves. Such inconsistencies could result in disparate conclusions regarding the safety and soundness of an institution, depending on which regulator does the assessment.

-- Differences among the regulatory agencies in the priority they give to, as well as the examination approaches they take in, enforcing consumer protection and community lending legislation have contributed to concerns about effectiveness and inconsistency in these areas. Similarly, in our examination of regulatory impediments to small business lending we also found that the agencies gave conflicting advice to their institutions about the procedures for taking real estate as collateral to support traditional small business working capital and equipment loans.[3]

-- Overlapping authority is a particularly significant problem in bank holding company regulation. Holding companies, which are all regulated by the Federal Reserve, now control 94 percent of the banking assets in this country. Except for about 970 state chartered banks that are members of the Federal Reserve System, at least two federal regulators must oversee the activities of each bank and its transactions with its affiliates. Although the regulators try to coordinate their supervision and examination functions, this effort is not always successful and questions of accountability arise. The failed Bank of New England is such a case. OCC was responsible for examining the lead bank, but the Federal Reserve was responsible for approving expansion proposals and for the holding company examinations. In this case, an early warning of problems and timely corrective action did not occur. This bank failure alone cost the bank insurance fund

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

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

about $1 billion.[4]

-- The current practice of trying to reduce inconsistency by having all the regulatory agencies adopt a common rule has resulted in cumbersome interagency rule making procedures. Although regulations are ultimately produced by this process, it is inherently inefficient and can result in delays and missed deadlines. Implementation of FDICIA is such a case. Numerous staff from each of the regulatory agencies were involved over an extended period. However, despite this effort, the statutory deadline for the noncapital tripwire provision (section 132 of the act) was missed.

IMPROVED REGULATORY PRACTICES SHOULD ACCOMPANY ANY RESTRUCTURING

Reducing the number of regulatory agencies would help solve some of the problems I have described. However, I think it is clear that efforts to improve the effectiveness and efficiency of bank regulation also should address how the agencies do their work. The need to link consolidation with improving the effectiveness of regulation is particularly important for ensuring implementation of the reforms that were contained in FDICIA.

In today's competitive markets, banks and thrifts must be well capitalized and have good internal controls to operate safely and to protect the funds of their customers and also the funds of the deposit insurance system. FDICIA contributes to accomplishing this goal in several ways. Through what is known as its prompt corrective action provision, the act creates a powerful incentive for depository institutions to operate prudently because the regulators are required to close down any bank before its capital is exhausted.

In addition, FDICIA requires that a depository institution's management, external auditor, and regulator all focus on the adequacy of the systems that are used to manage risk and that determine the bank's financial condition. Further, as previously stated, in our reports, the regulators were not comprehensively reviewing internal controls and control weaknesses contributed significantly to the failure of banks and thrifts. Under FDICIA, managers of the larger banks and thrifts must annually assess and report on the effectiveness of internal controls, and the institutions' external auditors must review and report on management's assertions. Thus, FDICIA should also reduce regulatory burden by eliminating redundancy if federal and state regulators seize the opportunity for improved coordination with, and reliance on, external auditors.

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

I cannot emphasize enough the importance of successfully implementing these reforms. Not only are they necessary in the present regulatory structure, but they are equally essential to ensuring that any form of consolidation will achieve its goals. When properly implemented, these reforms will produce better information about the financial condition of insured institutions and this better information, in turn, should result in fewer surprises from the failure of large banks and thrifts. These reforms are thus essential for reducing the potential risk in consolidating agencies or modifying the supervisory duties of FDIC and the Federal Reserve, the agencies that bear responsibility for deposit insurance and financial market stability, respectively.

MANAGING THE DEPOSIT INSURANCE FUNCTION

The administration's proposal would leave intact FDIC's responsibility for managing the deposit insurance system, including setting risk-based premiums and resolving problem cases. We are on record as favoring a strong, independent deposit insurance function to protect the taxpayers' interest in insuring more than $2.5 trillion in deposits. Although access to the information of other agencies is important, we believe FDIC needs to have the authority to go into any problem institution on its own, without having to obtain prior approval from another regulatory agency. FDIC also needs the capability to assess the quality of bank and thrift examinations generally, and it also needs backup enforcement power. However, as I suggested previously, when the prompt corrective action and related provisions of FDICIA are operating effectively, we would hope that the number of instances in which FDIC will need to conduct independent examinations to protect the insurance funds will be relatively infrequent.

THE ROLE OF THE CENTRAL BANK

Under the administration's approach, the Federal Reserve would retain its responsibilities for monetary policy, the payments system, and the discount window. Federal Reserve officials say that their ability to perform these functions would be seriously impaired, particularly in times of financial stress, if the Federal Reserve lost its responsibilities for regulating and supervising bank holding companies and state member banks. Because benefits from consolidation should not come at the cost of risking damage to the financial system or from limiting the independence of monetary policy, the Federal Reserve's concerns warrant serious consideration.

Experience suggests that in times of financial stress, such as the 1987 stock market crash, the Federal Reserve needs to work closely with the Department of the Treasury and others to maintain market stability. The Federal Reserve asserts that its

effectiveness in such situations is enhanced by its detailed knowledge of, and influence on, the operations of institutions and markets both in this country and abroad. The extent to which the Federal Reserve needs to be a direct supervisor of financial institutions to obtain the requisite knowledge and influence for carrying out its role is an important question. Until this question is answered, it could be risky to eliminate the Federal Reserve's direct involvement in bank supervision in view of the complexity of the international environment in which major banks operate.

Although no other country has a banking system exactly like ours, we think that some insights can be gained from the way other countries have set up their regulatory systems. For example, Germany has a separate agency that has the legal regulatory authority over banks; this agency is responsible to the Ministry of Finance. Nevertheless, it is required by law to consult with the central bank before issuing regulations, and the central bank can veto regulations affecting bank capital and liquidity.

Furthermore, the regulatory agency shares supervision responsibilities with the central bank. While actual on-site examinations, for the most part, are conducted by external auditors, the auditors' reports are filed concurrently with the central bank and the regulatory agency. Additionally, individual institutions file daily, weekly, and monthly reports with the central bank. The central bank, in turn, analyzes these reports and provides summaries to the regulatory agency. In addition, the central bank is in frequent contact with banks to discuss questions, issues of interest, or perceived problems.

These arrangements give the central bank a significant role in working with the supervisory agency to identify and deal with both problem situations and issues facing the banking system as a whole. The German case suggests it is possible to work out practical arrangements that enable both central bank and bank supervisory functions to be effectively carried out. The German system also shows, as I previously stated, that effective use of external auditors can reduce regulatory burden.

In summary, many factors should be taken into consideration in determining how best to achieve the independence of monetary policy and the proper implementation of other central bank functions. In the final analysis, these factors involve policy judgments that only Congress can make.

DUAL BANKING SYSTEM ADDS TO COMPLEXITY

State-chartered banks are a unique and valuable part of the U.S. financial system, accounting for 69 percent of the banks and 43 percent of bank assets. The major safety and soundness problems with the dual banking system that have concerned us in the past

include the adverse impact on the bank insurance funds arising from poor supervision and the ability of state-chartered institutions to engage in risky activities that were not allowed for federally chartered institutions. These problems have been addressed in recent legislation. Pursuant to provisions of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) and FDICIA, FDIC must determine that there is no undue risk to the insurance funds from any state bank activity that is not allowed for a national bank. In addition, all banks, regardless of their charter must be examined either annually or every 18 months, depending on their size and financial condition.

As Congress considers consolidation proposals, we believe it is important to keep in mind that arrangements to preserve a dual banking system should not create new incentives to weaken essential regulation by allowing banks to play one regulator off against the other. One incentive that should be reexamined is the present practice of charging national banks, but not state banks, for federal examinations.

ALTERNATIVE APPROACHES

The Federal Banking Commission proposed by the administration clearly provides a way to deal with the problems of inefficiency and overlapping authority that I described earlier. However, as I have indicated, that approach is not without its risks. Progress can also be made in other ways.

We support the objective of reducing the current number of federal banking regulators and in doing so creating an independent regulatory body. However, until the questions about the role of the Federal Reserve can be resolved, one logical step would be to merge OTS, OCC, and FDIC's primary regulatory responsibilities for state-chartered nonmember banks. Consolidating the primary regulatory functions of these agencies into one independent body should improve the efficiency of rulemaking and produce some administrative cost savings.

Further efficiencies could be gained by reducing the current overlapping responsibility for supervision of a holding company and its subsidiaries. Key areas of risk-taking by a holding company are usually centrally managed, and experience shows it is difficult to completely isolate a bank from ties to its holding company. Therefore, if the Federal Reserve maintains its regulatory responsibilities, it would make sense to strive for consolidated supervision of each holding company and all of its subsidiary banks by the lead bank regulator. The details that would need to be worked out include the Federal Reserve's role in (1) supervising large banking companies; (2) rulemaking; (3) approving applications of individual holding companies in areas such as mergers and participation in nonbank activities; and (4) supervising foreign banks, branches, and agencies. Efficiencies

from reducing overlapping responsibility at the bank and holding company levels could also be achieved within the present regulatory structure and should be addressed even if a consolidation plan is not implemented.

IMPLEMENTATION AND TRANSITION ISSUES

Even a consolidation approach that is well conceived may not accomplish much if it is not effectively implemented. There are many practical problems associated with creating a new agency or consolidating existing functions. It seems reasonable to expect savings in administrative and operating costs, all of which should reduce industry compliance costs. However, time and time again, in both government and the private sector, we have seen that consolidation has not automatically created an organization that demonstrates effective efficient operations. Thus, it is important that transition and implementation issues be included when considering consolidation, particularly in view of the need to improve many regulatory practices.

CONCLUSION

Mr. Chairman, in passing FDICIA this committee took a major step toward modernization of the banking system. Taking action to simplify the regulatory structure represents another important step. As this step is being contemplated, however, I think it is useful to bear in mind that there are additional opportunities for bringing more effectiveness and simplicity to the regulatory system. Some of these involve the banking industry itself. For example, authorizing interstate branching would simplify the regulatory process by giving institutions the opportunity to simplify their corporate structures.

Other issues, such as regulation of mutual funds and derivatives, require looking beyond the banking industry to the broader financial services marketplace. In the derivatives area, for example, the major players include securities and insurance companies, in addition to banks. We are currently studying this issue and will soon provide Congress with our conclusions and recommendations. However, improvements in the regulatory structure need not be delayed because of these complicated issues.

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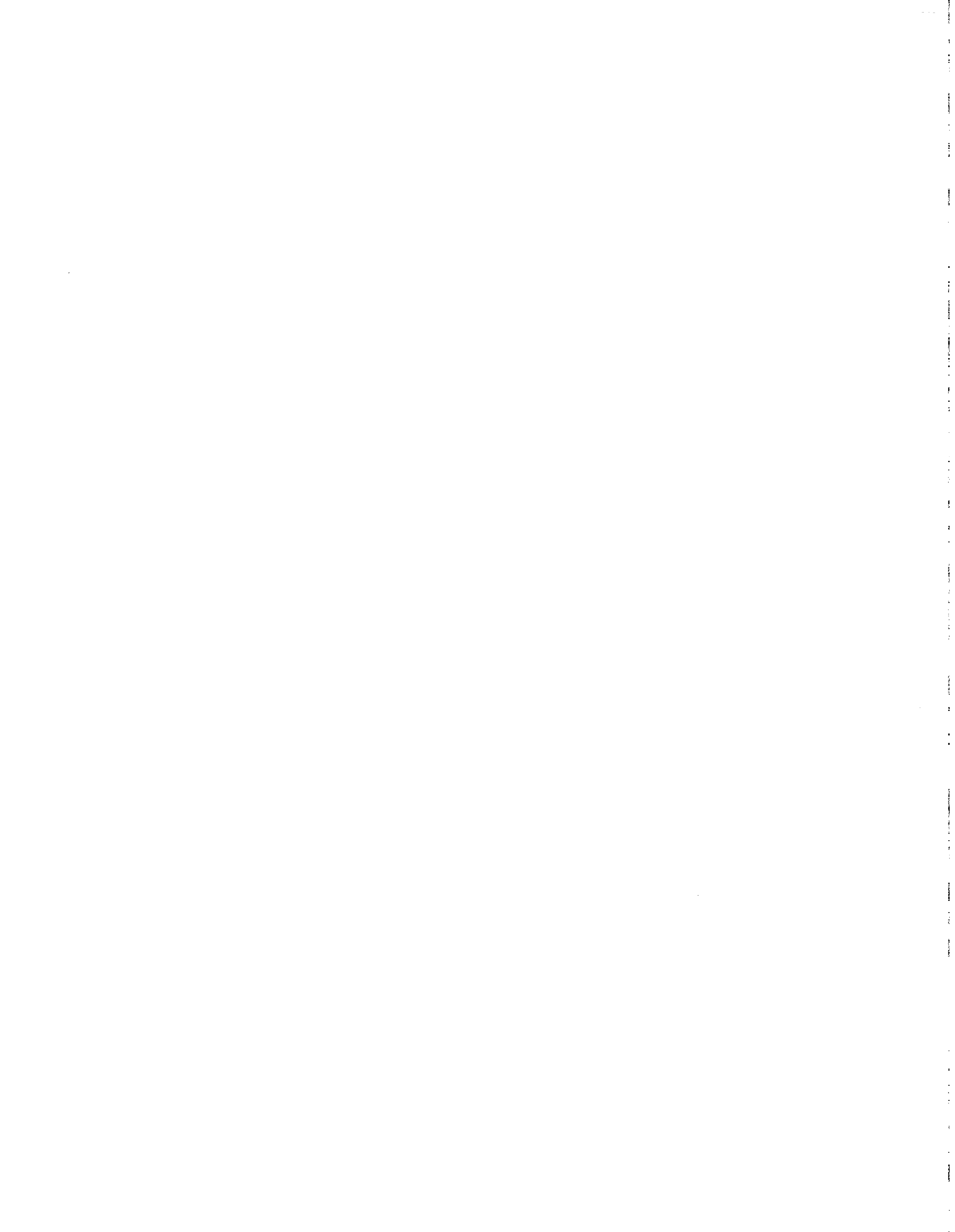
Mr. Chairman that concludes my prepared statement. My colleagues and I would be pleased to answer questions.



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