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Safeguards that Need to Accompany Changes to Glass-Steagall Laws

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House of Representatives

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SAFEGUARDS THAT NEED TO ACCOMPANY CHANGES TO GLASS-STEAGALL LAWS

SUMMARY OF STATEMENT BY
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In response to a recent request from the Honorable John D. Dingell, Chairman of the Subcommittee on Oversight and Investigations, GAO provided its views on the problems in the thrift and commercial banking industries and related safeguards that need to accompany changes to Glass-Steagall laws.

In Summary

Based on the problems and related causes that may be observed in the banking and thrift industry as well as in U.S. banks' London securities underwriting and dealing operations it is critical that steps be taken, concurrent with changes to Glass-Steagall laws, to (1) preserve bank safety and soundness, (2) protect consumer interests, (3) prevent conflict of interest abuses and, (4) minimize the chances that unforeseen events will have a destabilizing effect on our financial system. Because some of these steps will take time, GAO favors a phased approach to changes in the banking laws.

Three major elements of reform need to accompany modernization of banking laws

-- Organizational structures must be strengthened to (1) prevent the spread of losses from expanded activities to the banking institution and (2) prevent conflict of interest abuses. However, organizational changes alone cannot be expected to prevent unsafe and unsound practices or other abuses.

-- The incentives that our deposit insurance system provides for excessive risk taking must be reduced. Institutions must be closed at the point where they become insolvent and capital requirements for banks and bank holding companies must be strengthened.

-- In the final analysis, adherence of financial institutions to sound internal controls and management practices and improvements in the quality of our system of regulatory oversight are necessary. Financial institution management should be required to prepare reports on the adequacy of internal controls and compliance with whatever firewalls or other safeguards are put in place. These reports should be reviewed by outside independent accounting firms as part of a required annual financial audit. Regulators must develop and implement a plan for increasing personnel and expertise to better oversee compliance with laws that regulate the new financial services industry. As part of that plan, they should also make recommendations on how to match the introduction of new powers with enhanced regulatory capabilities.

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here to discuss steps that should be taken to protect bank safety and soundness and prevent conflict of interest abuses concurrent with changes in laws separating the banking and securities industry. In this regard, you requested that we discuss current problems in the banking and thrift industries and the lessons that can be learned from those, as well as potential problems that may be reasonably anticipated. I will first summarize our perspective on the Glass-Steagall modification question and then discuss the problems in the depository institutions industry as well as remedial actions which need to be taken.

PERSPECTIVE ON CHANGES TO GLASS-STEAGALL LAWS

Over the past two decades the financial services industry has changed dramatically. These changes have resulted in a significant erosion in the effect of laws which have separated the banking and securities industry for over 50 years. There is every reason to believe that the integration of the banking and securities industries will continue; in all likelihood gaining momentum as it proceeds. These developments are potentially dangerous because they have not allowed for the systematic consideration of the legal and regulatory structure needed to reflect the realities of today's financial marketplace.

As a result of the changes that have occurred, a Congressional consensus has emerged that laws separating the banking and securities industries must be modernized. The important question has become how best to accomplish that result. In our view, great care must be taken. Lessons from past mistakes must be recognized in order to avoid future problems. Nowhere is this clearer than in our experience with implementing the deregulation of the thrift industry. To the extent possible attempts must also be made to establish systems and structures that mitigate the consequences of unforeseeable events.

It is critical that modernized banking regulation incorporate measures to (1) preserve the safety and soundness of the banking system, (2) protect consumer interests, (3) prevent abusive conflicts of interest, and (4) minimize the chances that unforeseen events will have a destabilizing effect on our financial system. Because it will take time to fully implement some of the needed improvements in regulatory oversight capabilities and for other reasons, we believe a phased approach to relaxation of banking laws is the most prudent course to pursue.

PROBLEMS IN DEPOSITORY INSTITUTIONS

I would like to turn now to a discussion of the problems in the thrift and banking industries. I will then discuss remedies to

overcome some of these problems in order to achieve the results we desire in modernizing banking laws.

We are greatly concerned about the financial condition of the thrift industry and its insurer, FSLIC. At the end of 1987 there were 505 open insolvent savings and loans and another 435 very thinly capitalized institutions. The operating losses of these institutions are staggering. A combination of economic conditions, poor management practices, fraud and insider abuse, relaxation of capital adequacy standards, insufficient oversight and supervision, and other mistakes in implementing the 1982 regulations that expanded thrifts' powers are responsible for the industry's current condition. And, no amount of wishful thinking will reverse its plight. It is becoming increasingly clear that neither FSLIC nor the industry can fund a solution to the problem.

The commercial banking industry does not contain a large number of open insolvent institutions. However, we cannot be sanguine about its financial condition. More than 180 banks failed in 1987; the number of banks on FDIC's problem bank list exceeds 1500; and, at the end of 1987, 486 banks were operating with primary capital below the regulatory minimum of 5.5 percent of assets. The recent spectacular failure of several large Texas banking institutions and the prospect of other large failures

have raised the level of apprehension over the long-run viability of FDIC as well.

There are some parallels between the causes of the commercial banking industry's problems and those of the thrift industry. In general, the banking industry's problems are the result of a combination of adverse economic conditions, poor institution management practices and, in many cases, an inability on the part of regulators to identify problems and limit their effects before insolvency or an impaired capital condition occurs.

Recently completed work by the Office of the Comptroller of the Currency on the causes of bank failures since 1979 indicates that a combination of poor management and adverse economic conditions, not economic conditions alone, were the driving force behind bank failures. Eighty nine percent of the failed banks that the Comptroller studied were judged to have deficiencies in management. These institutions lacked policies, systems and controls to guide bank staff in performing duties consistent with safe and sound banking operations. Many had inadequate systems to assure compliance with internal controls, to identify problem loans, and to properly manage interest rate risk. Insider abuse or fraud was found in about one-third of the failed banks.

It is important to note that most of the banks included in the Comptroller's study were small. Their failure posed no threat to

the stability of the banking system. But, not all of the banks studied were small, and absent actions to better and more quickly identify and limit the consequences of poor management practices, it is reasonable to believe that such practices will continue to be an important reason for bank failures.

Problems in London

In our report dated August 8, 1988, to the Chairman of the Subcommittee on Telecommunications and Finance, we reviewed the London-based securities underwriting and dealing activities of U.S. banks. Our work sheds some light on the kinds of additional problems that may exist after repeal or relaxation of banking laws, if steps are not taken to prevent them. We reviewed the examination reports of 18 U.S. commercial banks with at least a minimal amount of underwriting and trading activity in London. These banks experienced a number of problems between 1986 and the present time that were related to a combination of weak management or internal control practices and the turbulence in London capital markets.

In general, during 1986 and 1987 these U.S. banks found themselves managing securities activities as relative newcomers in perhaps one of the most competitive financial markets in the world at one of the most difficult periods in recent history. I hasten to add that neither the losses of these units nor the

internal control problems identified threatened the world-wide operations of any of these banking institutions. Losses experienced as a result of the market crash and other developments were a relatively minor percentage of the consolidated worldwide capital of each of the institutions we studied.

Bank examination reports cited several common management and/or internal control problems in the institutions we studied. They included:

-- lack of a sufficient Eurodebt distribution network or customer base.

-- high overhead and staff problems.

-- absence of trading limits or exceeding established limits.

-- inadequate credit and market risk evaluation.

-- accounting and computer systems that were ill-equipped to handle the complexity and volume of transactions following Big Bang, and

-- nonexistent or inadequate written procedures for accounting, credit evaluation, and separation of duties.

GLASS-STEAGALL CHANGES SHOULD INCLUDE SAFEGUARDS TO PREVENT RECURRENCE OF CURRENT AS WELL AS POTENTIAL PROBLEMS

There are three sets of remedies that must be pursued to prevent some of the problems that can be observed in today's environment, while simultaneously establishing a modern regulatory framework for change in the financial services industry that recognizes today's and tomorrow's realities.

Reform the Deposit Insurance System

Some of the problems in the depository institutions industry may be traced to the incentives that our deposit insurance system creates for excessive risk taking. The problems in the thrift industry make clear the need for reform in the areas of closure policy, minimum capital requirements and the division of responsibility for the costs of risk bearing between insured financial institutions and their federal insurers. Institutions should be closed no later than at the point of insolvency; capital requirements should be raised to assure that both the bank and the holding company can better withstand economic adversity; and other means must be found to better assure that the institution, rather than its federal insurer, absorbs the costs of excessive risk taking. These reforms are needed to better assure that the mistakes made by insured institutions as

well as those made by the FDIC and FSLIC in underwriting risks do not threaten the viability of the deposit insurance funds.

Create Appropriate Organizational Structure and Limit Potential for Spread of Damage

It will be necessary to construct firewalls both to prevent the spread of losses from expanded activities to the banking institution and the FDIC, and to prevent abuses of conflicts of interest.

Our views on organizational structure and firewall considerations are outlined in our reports on bank powers and testimony before your Subcommittee on Telecommunications and Finance.[1] In general, our perspective on the issue of organizational structure is that firewalls are necessary to protect safety and soundness and prevent conflict of interest abuses. But like anything else that is useful, the reliance placed on them should not be overdone. Placing too much reliance on firewalls strikes us as inappropriate because

-- No set of firewalls should be viewed as completely fail-safe.

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[1] Bank Powers: Insulating Banks from the Potential Risks of Expanded Activities, (GAO/GGD-87-35, April 14, 1987); Bank Powers: Issues Related to Repeal of the Glass-Steagall Act, (GAO/GGD-87-37, January 22, 1988); Issues Related to Repeal of the Glass-Steagall Act (GAO/T-GGD-88-9, February 10, 1988); and Using Firewalls in a Post Glass Steagall Banking Environment, (GAO/T-GGD-88-25, April 13, 1988).

-- The benefits of Glass-Steagall changes that may flow from corporate synergies and joint product of services might be lost.

-- Complete prohibitions on lending by bank subsidiaries to securities subsidiaries could cause serious cash flow problems for the securities subsidiary during periods of financial turmoil such as that which occurred in the markets last October, and

-- Other mechanisms may be superior in appropriately balancing the benefits of Glass-Steagall changes with concerns over safety and soundness. These include capital requirements that create an appropriate set of incentives for control of risk taking, requirements for the holding company to act as a source of strength for banking subsidiaries, and significantly increased civil and criminal penalties for those who choose to operate outside of the newly formulated rules of the game.

Improve Regulatory Oversight and the Internal Controls of Institutions

In the final analysis, the workability of capital requirements, firewalls and other regulatory actions believed necessary as an accompaniment to changes in Glass-Steagall law will be determined by the adherence of financial institutions to sound internal controls and management and financial reporting

practices, and to the quality of our system of regulatory oversight. The problems in the depository institutions industry that I described earlier in my statement demonstrate the importance of this last set of considerations.

Good management and financial reporting practices as well as sound internal controls in financial institutions provide an important line of defense against unsafe and unsound banking operations and conflict of interest abuses. In our August 5, 1988, letter to you, we stressed the importance of requiring that bank holding companies with securities affiliates obtain annual independent financial statement audits and submit the results to the appropriate regulatory agencies. Requiring such audits would fill a void in the financial services industry's current disclosure system and would provide an additional safeguard to ensure that the securities affiliate's actions are not adversely affecting the safety and soundness of affiliated banks.

We also expressed the view that it would be beneficial, both to the regulators and to users of financial reports, to require management to report on the adequacy of its internal controls and on its compliance with whatever firewalls and other safeguards are ultimately adopted. To enhance the usefulness and credibility of the management reports, as part of the annual financial audit, the independent auditors should also review and report on the accuracy of management's assertions regarding

internal controls and compliance. At your request, we have prepared, and are appending to this testimony, legislative language for an amendment to require independent audits and management reports.

In our January report on Glass-Steagall issues, we expressed considerable concern over regulators' current ability to oversee today's and tomorrow's complex and fast moving financial markets. We indicated that:

-- The desired frequency of bank examinations is not being met. Because of the number of problem banks, resources are being devoted to resolving known problems and away from prevention through oversight. Oversight shortcomings are an important cause of the growth in the thrift industry's problems.

-- Oversight of compliance with consumer protection and other laws may have suffered because of the regulators' understandable preoccupation with safety and soundness problems. In a world of expanded powers it will be more important than ever to assure that consumers know the risks and returns from alternative deposit and investment options.

-- The SEC's resources have, until recently, remained stagnant in the face of explosive industry growth. Despite recent increases in staffing levels, we remain concerned about the

SEC's ability to effectively oversee securities market activities.

Permitting securities powers in bank holding companies will exacerbate existing oversight problems. Therefore, achieving a satisfactory degree of oversight will require increased staffing and additional training for new and existing personnel. It will also be necessary to assure that each regulator oversee activities of holding company subsidiaries for which it has primary expertise. The Federal Reserve should examine and supervise the holding company and its relationship with its component parts in order to assure oversight of the entire integrated financial services firm. Because augmentation of oversight capabilities will take time, we continue to favor a phased approach to changes in Glass-Steagall and related banking laws.

Proposed legislation for changes to Glass-Steagall laws includes a requirement that the regulators develop a compliance monitoring program. We believe that such a program should specify (1) the increases in personnel and training necessary to oversee the new activities, (2) the period of time it will take to increase oversight capability, (3) the cost of and mechanism for funding the compliance monitoring program, and (4) recommendations on the matching of increases in regulatory capabilities with the introduction of new bank powers. We believe that the development

and implementation of the compliance monitoring program is particularly important if a decision is made to allow banks to underwrite and deal in equities powers.

That concludes my prepared statement. We would be happy to answer questions.