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Deposit Insurance and Related Reforms

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Deposit Insurance and Related Reforms

SUMMARY OF STATEMENT BY
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Over the years deposit insurance has helped to maintain stability and confidence in the U.S. financial system. However, since deposit insurance was initiated in 1934, the financial system has changed drastically and banks operate today in a much riskier environment. As a result of the savings and loan debacle and concerns over the condition of the banking industry and the insurance funds, it has become evident that insuring approximately $3 trillion in deposits in the nation's depository institutions is not the relatively riskless and inexpensive proposition that it once appeared.

GAO is proposing that three sets of actions be taken to better align the design of our deposit insurance system and financial regulation more generally with the realities of today's markets.

-- First, steps must be taken immediately to stabilize the banking industry and insurance fund and to build much greater reliability into the processes used to oversee the industry and enforce laws promoting safe and sound banking practices. This can be done by (1) giving FDIC the authority to raise assessment rates beyond those currently provided in FIRREA, (2) clarifying the regulators' responsibilities and narrowing their range of discretion in overseeing and enforcing safety and soundness regulation, (3) providing for annual on-site examinations of all large and troubled banks and more frequent interim reviews of large banks, as well as changing certain accounting rules to better measure the value of banking institutions, (4) appointing a special high-level panel of experts to thoroughly evaluate the quality of the procedures, skills, resources, and training that regulators need to supervise banks and bank holding companies, and (5) providing for a greater role and accountability for bank managers, directors, and independent auditors to ensure that banks have information and other systems in place to adequately control all aspects of operations, accurately track financial condition, and comply with safety and soundness regulations.

-- Second, steps are needed to change the economic incentives that have allowed bank owners and managers to abuse the deposit insurance system. The best way to accomplish this is through (1) higher risk based capital requirements, and (2) higher deposit insurance premiums for poorly capitalized or poorly managed institutions.

-- Finally, a framework should be established to ensure that actions taken to expand the powers of banking organizations are consistent with the goal of ensuring the safety and soundness of banks and financial markets. In the long run consideration should be given to allowing banks more freedom in offering products in order to better serve customers, diversify risks, and become more competitive in world markets. However, great care must be exercised in changing banking regulations with an eye always on the safety and soundness implications of actions taken.

In this regard, powers should not be expanded for any banking institution until regulators can credibly demonstrate the ability to oversee and adequately enforce safety and soundness regulation, and the insurance fund is put on a solid financial footing. Once the Congress is assured of this result, new product line powers that bear a close relationship to traditional banking functions can be phased in--but only for well capitalized, well managed firms under arrangements that provide for holding company support, consolidated supervision by a federal regulator, and restrictions on capital flows to prevent an extension of the federal safety net.

Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss deposit insurance reform and related issues. As you know, we are studying these matters as required by the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989, and we plan to report on our results by early next year. Although our work is still in progress, at this point I would like to share with you some of our observations regarding how best to achieve meaningful and practical deposit insurance reform.

Three sets of actions need to be taken to align our deposit insurance system--and financial regulation more generally--with the realities of today's markets.

-- First, steps must be taken immediately to stabilize the financial condition of the banking industry and insurance fund and to build much greater reliability into the processes used to oversee the industry and enforce laws promoting safe and sound banking practices. This can be done by (1) giving FDIC the authority to raise assessment rates beyond those currently provided in FIRREA, (2) clarifying the regulators' responsibilities and narrowing their range of discretion in overseeing and enforcing safety and soundness regulation, (3) providing for annual on-site examinations for all large and troubled banks and more frequent interim reviews of large banking firms, as well as changing certain accounting rules to better measure the value of banking institutions, (4) appointing a special high-level panel of experts to thoroughly evaluate the quality of the procedures, skills, resources, and training that regulators need to supervise banks and bank holding companies, and (5) providing for a greater role and accountability for bank managers, directors, and independent auditors to ensure that banks have information and other systems in place to adequately control all aspects of operations, accurately track financial condition, and comply with safety and soundness regulations.

-- Second, the economic incentives that have allowed bank owners and managers to abuse the deposit insurance system should be changed. The best way to accomplish this is through (1) a phase in of higher risk-based capital requirements, and (2) higher deposit insurance premiums for poorly capitalized or poorly managed institutions.

-- Finally, a framework should be established to ensure that actions taken to expand the powers of banking organizations are consistent with the goal of ensuring the safety and soundness of banks and financial markets. In the long run consideration should be given to allowing banks more freedom in offering products in order to better serve customers, diversify risks, and become more competitive in world markets. However, great care must be exercised in changing banking regulations with an eye always on safety and soundness implications. In this regard, powers should not be expanded for any banking institution until regulators can credibly demonstrate the ability to oversee and adequately enforce safety and soundness regulation, and the insurance fund is put on a solid financial footing. Once the Congress is assured of this result, new product line powers that bear a close relationship to traditional banking functions can safely be phased in--but only for well capitalized, well managed firms under arrangements that provide for holding company support, consolidated supervision by a federal regulator, and restrictions on capital flows to prevent an extension of the federal safety net.

In the remainder of my testimony I will discuss the basis for our views and more specifics about the recommendations we are making today.

THE TASK AHEAD

All industrial countries regulate and influence the operation of their financial markets. While the nature of regulation differs considerably across countries, one particularly important foundation of regulation in all countries is avoiding the disruptions associated with bank failures. Through such means as bank examination processes and discount loans from central banks, governments hope to maintain public confidence in the continuity of banking services that is needed for a modern financial system to effectively support a nation's commerce.

Over the years, our deposit insurance system has helped to maintain stability and confidence in the U.S. financial system. Despite the oil problems and inflation of the 1970s and the recession, stock market drops, and regional dislocations of the 1980s, people for the most part did not have to worry about whether their money was safe.

Although there are benefits to deposit insurance, there is now the troublesome realization that--as a result of the Federal Savings and Loan Insurance Corporation (FSLIC) debacle and concerns over Federal Deposit Insurance Corporation's (FDIC) financial condition--our current system of deposit insurance has some drawbacks. Insuring deposits that now total about $3 trillion in the nation's depository institutions is not the relatively riskless and inexpensive proposition that it appeared to be when markets were more stable and slow moving, less competitive, and less global than they are today.

A generation ago, banking was in many ways a protected industry. Entry was restricted, no interest was paid on demand deposits, and regulation Q controlled other rates. The barriers between banking and other financial services were clear, and there was little direct competition from foreign firms. Now, most of these characteristics, which helped to deflect risk away from banks, have been stripped away or significantly diminished due to advances in technology and other factors. Not only do banks compete with each other in a deregulated interest-rate environment, but virtually every service they offer--whether it involves taking money in or lending it out--has close substitutes offered by nonbanking firms. As a result,

- -- blue-chip companies can bypass banks and go directly to the securities market to finance their operations,

- -- money market and cash management funds offer what amount to interest-bearing checking accounts that have much lower costs than typical bank accounts due to lower overhead and the absence of costs associated with deposit insurance premiums, required reserves, or bank-capital adequacy requirements,

- -- a wide variety of nonbanking firms are active in consumer credit and mortgage lending, and

-- insurance companies offer a variety of tax-deferred savings products that compete with bank certificates of deposit.

These and other changes to the competitive landscape have drastically altered the assumptions and rules of the game that helped shape the design of our deposit insurance system six decades ago. Depository institutions have become riskier and the incentives factored into the business decisions that bank owners and managers make are much more worrisome than they were when banking was a protected industry.

In considering changes to the deposit insurance system, the current environment within which insured institutions operate must be taken into account. However, there is no simple or obvious way to do this. There are three major challenges that must be successfully met in order to ensure a safe, sound, and competitive financial system in the years ahead.

First, the condition of the banking industry and the Bank Insurance Fund (BIF) must be stabilized. As conditions develop that may result in the first recession in 8 years, there are already over 1,000 problem banks and FDIC's reserves (.7% of insured deposits) are at an all time low. There are increased risks within insured institutions--as evidenced by the increasing percentage of problem assets held by banking institutions--and increased risks to the insurance fund resulting from the large number of bank failures that continue to occur. If care is not taken, a similar situation to that which devastated FSLIC may arise--examiners failing to compel safe and sound banking practices and failing to close banks because BIF does not have the money to resolve problem institutions.

A second set of challenges involves changing the economic incentives that have allowed bank owners and managers to abuse the deposit insurance system in today's highly competitive financial environment. Since the adoption of deposit insurance, levels of bank equity capital have fallen dramatically from about 15 percent to approximately 6 percent. There is little question that banks would have to put up more of their own money to retain depositor confidence if it were not for the deposit insurance guarantee. Furthermore, deposit insurance has made it easy for poorly capitalized or high-risk institutions to successfully attract additional deposits by bidding up the cost of funds.

Third, a regulatory framework must be established that changes bank powers and financial holding company arrangements in a way which recognizes the modern financial environment in which banks operate but does not place the deposit insurance system at risk or jeopardize the stability of financial markets. Due to restrictions such as the Glass-Steagall Act, which, for example, prohibits an organization that owns a bank from providing a full range of securities underwriting services to its corporate customers, banks and other financial service firms are not fully able to respond to competitive challenges in the United States and abroad. To be sure, competitive pressures, aided in some cases by changes or reinterpretations of state and federal regulations, have broken down many of the traditional barriers that have separated banking and other industries. However, the piecemeal, ad hoc redefinition of the financial landscape that has been occurring over the last two decades is, in our view, dangerous because our regulatory system is neither equipped nor organized to deal with the changes.

These three challenges must be met in a coordinated way. If they are not, some very serious mistakes could be made. For example, if the finances of the insurance fund are not stabilized and the regulatory system's role in promoting safer and sounder banking operations is not improved, steps taken in the name of deposit insurance reform to change the incentives of bank managers to act more prudently will have little credibility and may be destabilizing. Similarly, if the powers of banking organizations are expanded before the deposit insurance fund, the regulatory system, and economic incentives are fixed, the risk exists of repeating a major mistake that was made in dealing with the thrift industry--allowing poorly capitalized institutions to take on new risks in the hope of growing or diversifying their way out of problems.

THE STRATEGY WE RECOMMEND

Ultimately, the strategy we recommend for achieving a more safe and sound financial system is driven by the need to accomplish two basic objectives: (1) ensuring the continuation of stability and confidence in the banking system and (2) greatly limiting the exposure of American taxpayers to the kind of losses they will bear as a result of the unhealthy management incentives and mistakes made in regulating savings and loans.

I would like at this point to provide our views on the steps we feel are necessary for dealing with the three challenges I have identified.

Stabilizing the Banking System and the Bank Insurance Fund

As I stated at the beginning of my testimony, there are five steps that must be taken to stabilize the banking system and the Bank Insurance Fund as well as to pave the way for more fundamental reform of the deposit insurance system. The first of these steps involves strengthening the insurance fund. The next three are concerned with strengthening the regulatory system that is essential for achieving safe and sound banking. The last of these involves strengthening the role and accountability of bank managers, directors, and financial auditors. I would like to elaborate on each of these steps.

First, financing for the Bank Insurance Fund (BIF) needs to be increased to ensure its financial integrity and support the regulators' enforcement efforts. In our recent report on the condition of the Bank Insurance Fund,[1] we found that BIF is too thinly capitalized to deal effectively with bank failures in the event of a recession. The fund is approaching the point where, even with a clear mandate and the best intentions on the part of the regulators to enforce safety and soundness regulations, actions to close imperiled banking organizations may not be possible due to limited financial resources. The recent proposal by FDIC to raise the assessment rate to 19.5 basis points (currently the rate is 12.0 basis points) is a step in the right direction. However, further increases seem necessary and, for this reason, Congress should amend FIRREA to authorize FDIC to raise the assessment rates beyond those provided under current authority. While some further increases in premiums are both necessary and feasible, I would caution that there is a limit to how high they can be raised at any one time. Although insurance premiums have been accounting for less than 1 percent of the operating costs of an average bank, at some point high premium levels could undermine the competitiveness of the institutions that pay them. In addition, on fairness grounds, as insurance premiums rise, raising all banks' premiums when not all institutions are equally risky becomes more of a concern.

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[1] Bank Insurance Fund: Additional Resources and Reforms Needed to Strengthen the Fund (GAO/AFMD-90-100, September, 1990.)

Second, it is essential that the regulators act earlier and use the enforcement tools provided in FIRREA to take more forceful actions against safety and soundness violations and capital-deficient institutions. We are concerned that the way Congress intends regulators to use their authority is not as clear as it should be.

Earlier and more forceful intervention by the regulators is crucial to stabilizing the banking industry and preserving the resources of the insurance fund. But the success of this approach depends upon the ability of regulators to do in the future what they have been unable or unwilling to do in the past --namely, restrict activities and take control of problem institutions on a timely basis. For example, four large bank holding companies that failed between 1987 and 1989 and imposed considerable losses on FDIC were identified as problem institutions during the early 1980s. The regulators identified such poor management practices as excessive dividend payments by bank subsidiaries, unreasonable real estate loan growth policies, and inadequate loan documentation. However, the regulators did not take timely, adequate enforcement actions to restrict these unsafe practices.

In 1989, FIRREA strengthened the regulators' authority to control problem banking organizations. For example, FIRREA provided the regulators the authority to prevent poorly capitalized banks from using brokered deposits to finance high-growth strategies and clarified the Office of the Comptroller of the Currency's (OCC) authority to place undercapitalized banks in conservatorship to minimize insurance fund losses.

While insufficient time has passed to fully evaluate the effectiveness of the FIRREA provisions, we are concerned that problems remain as illustrated by the results of OCC's recent closure of the National Bank of Washington (NBW). OCC used its new conservatorship authority to take over NBW while the bank still had some equity capital remaining. However, the fact that FDIC expects to spend about $500 million--approximately 30 percent of NBW's assets--to resolve the case indicates that OCC did not act soon enough to ensure that the costs to the insurance fund were minimized.

To achieve earlier, more forceful intervention, the discretion available to regulators in taking actions, such as restricting growth or the payment of dividends, should be narrowed. Furthermore, because of weaknesses in the way the value of financial institutions are measured, when the capital position of a bank begins to fall, regulators need to take earlier anticipatory steps for dealing with the institution. FDIC, in cooperation with the appropriate chartering and supervisory agencies, should be required to perform what can be termed "break-up" analyses of banks that fall below a prescribed minimum capital requirement. Such an analysis would evaluate the liquidation value of the firm and provide an appropriate basis for taking a resolution action that protects the deposit insurance system from loss. We also believe it may be necessary to give FDIC additional enforcement authority so that it can better protect the financial integrity of the insurance fund by issuing cease and desist orders to any bank it insures, including national banks.

Third, the regulators need to provide more effective supervision by conducting regular on-site examinations of financial institutions, and better measures of financial condition also need to be developed. In particular, the federal regulatory agencies should perform on site, annual, full-scope examinations for all large and troubled banks and more frequent interim reviews of all large banks. To do this, the regulators will need adequate resources and training. To better measure the financial condition of troubled institutions, accounting rules should be changed to reduce the range of discretion allowed under generally accepted accounting principles for recognizing losses on nonperforming loans. Furthermore, these rules should be modified to require that nonperforming assets of troubled institutions be valued on the basis of a near term rather than longer term sale requirement.

Fourth, with so much depending on the ability of the regulators to take timely actions, we must insure that they have all of the incentives, procedures, resources, and training that are needed. I cannot overemphasize the importance of ensuring this result. To accomplish this result, a high-level panel of experts should be established to help thoroughly evaluate the procedures, skills, resources, and training that the regulators must now have to properly supervise banks and bank holding companies. This presidentially appointed panel would be charged with conducting a top to bottom evaluation of the skills needed to adequately conduct oversight of banking institutions in today's world.

Finally, bank managers and directors should be held more accountable for reporting on the effectiveness of their internal control structures and for their compliance with laws and regulations related to safety and soundness. These officials are the first line of defense in making sure that institutions are run in a way that protects the deposit insurance fund and the public. It is essential that bank managers and directors ensure that their firms have information and other systems in place to adequately control all aspects of operations and accurately track financial condition. To help assure this result, it would be useful to require that insured depository institutions have independent audit committees.

As we have recommended in the past, banks should undergo annual financial audits and the role of independent auditors should be expanded to assess management's reporting and the adequacy of financial information. In addition, consideration should be given to strengthening auditing procedures to assess an institution's ability to continue as a going concern and increasing auditor's responsibilities for detecting violations of law or regulations.

Changing Economic Incentives to Discourage Abuse of the Deposit Insurance System

To ensure long-term stability of the banking system, changes must be made to the incentives that have allowed imprudent risk-taking by depository institutions, particularly by those that are troubled. Highest priority should go to holding the owners and managers of banks responsible for the risks generated by the activities of their banks. While the more forceful enforcement actions discussed earlier are part of the solution, the other important ways to accomplish this goal are higher capital requirements and risk-based insurance premiums.

It is essential that capital be increased to put more of a financial cushion between the decisions of bank managers and the exposure of taxpayers, because no regulatory process can be expected to perform perfectly in all situations. Capital provides the best means of both ensuring the continued stability of the banking system and limiting the liability of the government from losses in failed financial institutions.

While we are still evaluating the nature of such a changed capital requirement, at the present time we believe it would

-- gradually increase the current Basle minimum risk-based capital requirement;

-- allow for greater use of subordinated debt by all banking institutions and perhaps require a specified percentage of such debt for our largest banking institutions to encourage creditor discipline;

-- incorporate measures of interest rate and perhaps, portfolio concentration risk; and

-- be phased in over a fairly long period of time following full implementation of the current Basle standards in 1992.

We are mindful of the concerns that have been expressed about the potential effects of an increased capital requirement on the domestic and international competitiveness of our banking system. However, we also recognize that many banks already have capital well above regulatory minimums and, in general, earnings tend to be higher at well capitalized institutions. To lessen potential problems, we would allow for a long transition period of at least 5 years. As an incentive for banks to obtain capital, opportunities could be provided for well capitalized banks to obtain additional powers that may enhance profitability in future years, as I will discuss.

Creating incentives that foster safe and sound banking practices can also be augmented by increasing premiums for banks demonstrating higher risks. We recognize that there are practical limitations on the ability of a government agency to accurately assess risk or raise premiums enough to really compensate the fund for the risks being taken. However, we think that increasing premiums when capital deficiencies exist or where there is evidence of poor loan documentation or other breakdowns in internal controls will reinforce the importance of capital adequacy and good management. It will introduce an element of fairness into the deposit insurance premium structure and will provide an added incentive for prudent operation of banks.

Our preference for relying on capital along with its strict enforcement, augmented by variations in deposit insurance premiums is based on our view that, compared to the alternatives, the approach offers the lowest possibility of destabilizing the system. Let me briefly discuss our current thinking on some of the more prominent alternative reform measures that have been proposed: reducing insurance coverage and shifting the costs of risk bearing to the banks themselves.

-- Reducing deposit insurance coverage. We have not ruled out attempts to provide incentives for people to be more careful about where they place their funds. However we question, on grounds of stability, whether reducing deposit insurance coverage or imposing greater losses on individual depositors should be the centerpiece of reform. We do not think that heightening the probability of widespread bank runs is the way to maintain confidence in the safety and soundness of our financial system.

We do believe, however, that efforts should be made to limit the coverage of large deposit accounts directed by professional money managers. These accounts include brokered deposits and possibly pension fund placements and bank insurance contracts that currently receive so-called pass-through insurance coverage. Under these arrangements a deposit that may involve millions of dollars is completely insured because the deposit is made in the name of many individual persons. While FIRREA provides for a prohibition on use of brokered deposits to sustain the operations of undercapitalized institutions, it does not provide a similar prohibition for other types of accounts that receive pass-through coverage. We are considering whether similar provisions should exist for those accounts and, in addition, whether pass-through coverage on bank insurance contracts and similar types of accounts should be eliminated altogether.

-- Shifting the costs of risk-bearing to the banks themselves by means other than increased capital requirements or higher premiums. Several proposals have been advanced to accomplish this result

o Narrowing uses of insured deposits. If deposits are placed in a so-called narrow bank and if those deposits are invested only in short-term, low-risk assets that earn relatively low rates of interest and that can be marked to market on a daily basis, the insurance system can clearly be protected from loss. However, such an approach would significantly alter the commercial banking system. It would change many of the patterns for financing business loans and would be likely to result in reduced interest earnings for depositors. In addition, it would accelerate the reduction of the proportion of financial assets held in banks, because many depositors seeking higher yields would place their money elsewhere. As the role of banks becomes smaller, it is likely that stability problems--problems that the government would still have to deal with--would become more acute outside of the banking system. Since other nations appear to be moving in the opposite direction, it might also undercut the competitiveness of our financial institutions. Although we do not favor requiring narrow banks, we do favor allowing depositors choices for protecting their funds that would tend to move certain banks in that direction. We are considering, for example, the possibility that depositors (such as hospitals or small businesses) could set up collateralized accounts in excess of $100,000 in the same way as is now permitted for many state and local governments. (Under this arrangement banks would be required to pledge specific assets such as Treasury securities to protect the deposit.) Accounts collateralized by low-risk, low-yielding assets would allow the public the opportunity to protect payroll and similar accounts whose average balances exceed $100,000.

- Private sector insurance arrangements. Under this approach, the private sector--or under other proposals the banking system itself--would price and bear some or all of the risks associated with insuring deposits. We have serious reservations about trying such an arrangement on a national scale in a manner that would largely replace the current federal system. Nonfederal systems have not generally been successful, because they have not had sufficient financial resources to convince the public that the insured banks were safe. We are concerned about whether relying on a new private sector arrangement for the entire banking system is a viable means of preserving confidence and stability.

On the other hand, if there are groups of banks or other financial guarantee firms that believe a combination of higher capital and insurance premiums are unreasonable in relation to the true economic costs of providing deposit insurance, these institutions should be given the opportunity to develop an effective guarantee mechanism that would supplement the FDIC program. Any such arrangement should be approved and supervised by FDIC. Agreements among major banks to guarantee payments in the Clearing House Interbank Payments System could be viewed as a possible model for such an arrangement.

There is, however, one aspect of increasing private sector responsibility for bearing deposit insurance costs that should definitely be implemented. This concerns the so-called source of strength doctrine. This doctrine, which calls for holding company support for troubled banking subsidiaries, should be strengthened through its codification and/or holding company indemnification agreements designed to limit FDIC losses.

Developing a Framework For Allowing Closer Association of Banking and Other Activities

Changes to insurance funding, regulation, and economic incentives need to be made whether or not changes are made to the product offering powers of banks and other financial firms. Nevertheless, the existing structure, which constrains the product offering powers of financial institutions, makes it more difficult for banks and other financial firms to use their capital in ways that they believe would best meet the needs of their customers and allow them to compete both in this country and overseas. Furthermore, as I indicated earlier in my testimony, the ad hoc and very uneven expansion of the activities of financial industry participants into each other's business may well pose safety and soundness risks to our financial system.

To address these concerns, we have concentrated on trying to define the conditions under which banking and other financial services could safely move into closer association with each other. These conditions include both the types of powers that could be allowed and the regulatory structure that would be appropriate.

Before implementing any changes in the relationship between banking and other activities, the measures I have discussed to stabilize banking and to change incentives under deposit insurance need to be in place. Then, only those institutions whose capital is considerably in excess of regulatory minimums and that are well managed should, through case-by-case approvals, be allowed to engage in nonbanking activities.

If organizations gaining additional powers are to be able to take advantage of opportunities to use their capital efficiently, some flexibility should be permitted in how these activities are structured--that is, in the bank itself, in a bank subsidiary, or in a holding company subsidiary. Furthermore, if banks are to be allowed entry into other areas, on fairness grounds other types of organizations should be allowed entry into banking.

It should also be recognized that banks compete against financial firms that are not subject to the interstate branching restrictions now in force under the McFadden Act. If an environment is created in which banks can compete more effectively and safely, we believe that such restrictions should be removed for banks that are well capitalized and that can demonstrate good management.

We have not completed our work and reached conclusions on the various combinations of powers, corporate structure, and regulatory controls that would be needed to provide adequate protection to the deposit insurance fund if powers of banking organizations were to be expanded; however, certain elements are clear. One is that federal regulators of entire organizations that own banks must provide adequate capital enforcement and supervision. Furthermore, assurance is needed that flows of funds from insured banks do not provide unfair competitive advantages to these banking organizations or put the deposit insurance fund at undue risk. Controls such as sections 23A and 23B of the Federal Reserve Act, which limit the transactions between a bank and its affiliates, help provide such assurances. However, we are particularly concerned that the regulator for the entire firm be able to track and enforce these and other provisions designed to control capital movements between the parent and its subsidiaries and among subsidiaries. Finally, the supervisory tasks must be as simple as possible while still being effective. Along these lines, we are concerned with the complexity of multi-bank holding companies and believe that some of the firewalls that have been introduced into bank holding company regulation may be unnecessary.

Finally, any modernization changes must be phased in so that any use of expanded powers does not outrun the capability of regulators. In addition, we believe that the deposit insurance system finances should be established on a sound basis before changes in bank powers take effect.

CONCLUSIONS

In summary, we are at a crossroads in coming to grips with the future of our financial industry. We must address the challenges presented by the many changes which have occurred over the past decade to reestablish the health of our financial system and allow our institutions to compete successfully in the future. We have outlined today a strategy for achieving a more safe and sound financial system. In the short-term we believe that actions are needed to stabilize the banking industry and the Bank Insurance Fund. Then, additional steps must be taken to change the economic incentives that have allowed imprudent risk-taking in the deposit insurance system. Finally, a framework should be established to ensure that actions taken to expand the powers of banking organizations are consistent with the goal of ensuring the safety and soundness of banks and financial markets. The success of this strategy will depend upon the ability of bank managers, directors, regulators, independent auditors and market participants to each do their part and work together to meet these challenges.

As I stated earlier, our work is not complete. We are continuing to work on several issues relating to the insurance treatment of different types of deposits, the appropriate regulatory structure and responsibilities under expanded powers, capital regulation of holding companies and their subsidiaries, and the types of firewalls needed. We are also considering reciprocity issues relating to how nonbanking firms may engage in banking activities and steps needed to level the playing field on which competition between depository institutions and other financial firms takes place.

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