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STATEMENT FOR THE RECORD

BY THE

COMPTROLLER GENERAL OF THE

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SUBMITTED TO THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS SUPERVISION,
REGULATION AND INSURANCE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

UNITED STATES HOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Committee:

I am pleased to present our views on the recent federal rescue of the Continental Illinois National Bank and Trust Company. The General Accounting Office has performed evaluations of federal regulatory oversight of the financial services industry for the past 10 years. As a result we have followed the Continental Illinois development with great interest.

The financial services industry is changing very rapidly. Much of the work that we plan to undertake in the financial institutions and markets area during the next 4 years is designed to assist the Congress in sorting out the implications of the bewildering number of industry developments for the future stability of our financial system. We also hope to contribute

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to deliberations over the design of alternative regulatory structures and approaches that will better cope with today's financial services industry environment.

My statement is comprised of two parts. I will first compare the way federal regulators handled the near failure of Continental Illinois with the handling of certain of the major federal rescues of nonfinancial organizations during the 1970s. In the second part of my statement, I will discuss the important questions that the bank's rescue raises about the future of our system of deposit insurance, bank regulation and supervision.

COMPARISON OF CONTINENTAL'S HANDLING WITH THE LARGE NONFINANCIAL CORPORATE AND MUNICIPAL RESCUES OF THE 1970s

There has been much discussion in the public press about the lack of opportunity for congressional involvement in decisions associated with the federal rescue of the Continental Illinois National Bank. Continental's handling has been contrasted with the Chrysler situation and certain of the other financial rescues of the 1970s. It has been noted that Chrysler was provided financial assistance only after intense congressional scrutiny and debate. This may be contrasted with discussions indicating that the Continental Illinois rescue was done behind closed doors by the bank regulators.

In March of this year GAO issued a report entitled "Guidelines For Rescuing Large Failing Firms and Municipalities."[1] This report provided the Congress with guidance that should be

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1/ Guidelines for Rescuing Large Failing Firms and Municipalities (GAO/GGD-84-34, March 29, 1984).

considered if the need arises in the future to assist a major failing nonfinancial firm or municipality. These guidelines were developed on the basis of past GAO experience as a member of the boards administering the Chrysler and Conrail programs and as an oversight agency of the Congress in the New York City and Lockheed programs.

The Chrysler, Conrail, New York City and Lockheed programs were all handled on an ad hoc basis. Each program evolved somewhat differently because of the peculiarities of each situation. The purpose of our work was to learn what we could from these experiences and provide the Congress with guidance that would help assure that any future rescues of this sort took advantage of our past experience.

In contrast, for bank crises, an established system for performing financial rescues has existed for many years and has been used extensively in the past. This system includes the lender of last resort role played by the Federal Reserve. It also includes an industry financed deposit insurance fund which, through various means, attempts to minimize the adverse effects of bank failures or near failures.

The guidelines contained in our report may be broadly divided into two areas.

--First, they describe considerations to weigh in assessing the nature of the situation, reaching conclusions about whether a rescue will serve the national interest, and how the rescue package should be structured.

--Second, the guidelines specify ways in which the elements of the rescue package should help assure that (1) risks are shared between the federal government and the assisted organization, (2) the program is properly overseen, (3) the government's financial interest in the firm is adequately secured, and (4) the government is adequately compensated for the risks that it assumes.

I would like to explore how the Continental Illinois rescue relates to those two categories of guidelines.

GENERAL DECISIONS ABOUT THE RESCUE

In the cases we reviewed in our report, there was extensive congressional involvement in deciding whether to provide financial assistance for the rescue and, if so, designing the broad elements of the rescue package. In Continental's case, congressional involvement in deciding the bank's fate was impractical at the time of the crisis. Immediate action had to be taken to arrest the run-off of deposits from the institution. Otherwise, the bank would have collapsed quickly. It was also believed that the potential cost of not responding rapidly was a broader financial crisis whose dimensions and duration were uncertain. Though the spillover effects were not precisely known, those making the decisions did not want to find out what the actual effects might have been.

This same type of quick response is not necessarily required in the case of a failing nonfinancial organization. For example, in Chrysler's case, two months of congressional deliberation and debate followed the initial proposal to save

the corporation. The predominant reason for the difference in the speed of the required response lies in the behavior of creditors in the two cases. Chrysler's creditors faced the difficult choice between calling delinquent loans (taking their chances on being made whole in a bankruptcy court), or forebearing on Chrysler's overdue debt in the hope that the situation would improve. They chose to carry the corporation through an uncertain period. Furthermore, creditors are not as crucial to the funding of a large manufacturing corporation as they are to banking. In Continental's case "creditors," who are the lifeblood of a banking institution's funding, had a much easier choice. Depositors could simply withdraw their funds and put them in a safer place. Holders of the bank's short-term debt could simply fail to roll the paper over when it matured. And, in Continental's case virtually all debt was very short-term in nature. Thus, Continental's depositors and creditors had no incentive to continue their relationship with the bank when uncertainty arose over its soundness. And they could eliminate their relationship with the bank quickly.

In addition to this fundamental difference, the repercussions of a major banking collapse can differ from those that would have resulted from some of the situations we reviewed in our report. In Chrysler's as well as Lockheed's case it was believed that repercussions would spread beyond the company and were of sufficient magnitude to warrant federal aid. But those effects were fairly predictable and bounded in their duration and magnitude. On the other hand, in New York City's case

repercussions from its financial collapse were believed to be potentially very widespread but not entirely certain. Uncertainty over the spillover consequences were one of the major reasons for the provision of aid to the city, first by the state of New York and later by the federal government.

Like the New York City case, responsible officials believed that the cost of not acting quickly in Continental's case was a potential rapid spread of the crisis to other financial institutions. This could have occurred either through direct transmission of financial effects as a result of interbank relationships or through a general deterioration of confidence in the banking system. It is not possible to determine whether a Continental collapse would have had repercussions that would have stabilized or become explosive.

The need for immediate action to address Continental's problems does not mean that decisions about the nature of the problem, its national interest implications, and the appropriate design of the rescue package were not made at all. As I indicated, 50 years ago the Congress created a system that delegates responsibility for making these determinations to the bank regulatory agencies.

PROTECTING THE GOVERNMENT'S FINANCIAL INTEREST

Next, let me turn to a comparison of how well the elements of the Continental rescue conform with our report's guidance on steps that need to be taken to protect the government's interest.

Risk Sharing

In our report we suggest that concessions should be sought from any group with a direct or indirect financial interest in the survival of the benefiting organization. These concessions should result in a public/private sector sharing of risk and financing, provide for a reasonably fair allocation of sacrifice, and also create a set of incentives on the part of participants to help assure the success of the program.

In Chrysler's case concessions were sought and obtained from employees, creditors, stockholders, management, suppliers, state and local governments, dealerships and foreign governments. These concessions served two purposes. First, those from employees and suppliers and, to some extent, from creditors were sought to signficantly reduce the company's cost of operations and lower its breakeven point. The other concessions were intended to provide additional sources of badly needed financing. In Continental's case, excessive operating costs were not the problem. Thus, cost restructuring was not the solution and concessions from employees and suppliers would have been inconsequential and time consuming to obtain. Furthermore, there was not so much a need for new money financing at the time of the crisis as there was a need to stabilize existing normal funding sources. And, in order to accomplish this objective it was necessary to guarantee the safety of uninsured depositor and general creditor funding. Concessions from these funding sources were out of the question given the choices they had for protecting the safety of their funds. Even

with the guarantee, not all funding sources returned to the bank. In this regard, there is some question whether the FDIC could have better communicated its intentions to guarantee the safety of funding, particularly to the bond rating services. After the statements were made regarding federal backing of the bank, the holding company's credit rating was downgraded. This development may have deterred some institutional investors from returning to the bank. One major rating service upgraded the holding company's credit ratings on November 13.

Stockholders of the bank were required to make concessions. Moreover, unlike the situations we reviewed in our report, Continental's stockholders may ultimately lose their entire existing investment even if the the bank survives. In Chrysler's and Lockheed's case no dividends were paid while federal financial assistance was provided, but the ultimate value of existing equity participation was dependent on the success of the program. In creating Conrail, there were no federal stipulations requiring concessions by stockholders of the bankrupt railroads.

While Continental's stockholders' current investment may eventually be worthless, several points are worth noting.

--During the week following the beginning of the deposit run-off, the bank's stock traded at prices that were not drastically below those existing when the run began. Therefore, there was an opportunity for stockholders to liquidate their investment without incurring enormous losses relative to prices that existed when the bank's

position deteriorated in the spring. And, based on the volume of trading in the week following the beginning of the run, some of Continental's stockholders clearly chose to liquidate their positions.

--Current shareholders have the opportunity to participate in the potential success of the program by providing up to $240 million of new capital. This opportunity is not unusual in regulator supervised assistance packages to failing banks. Stockholders are frequently asked to provide new capital as a condition for keeping a troubled bank open.

--Though Continental was technically solvent at the time of the rescue, it was treated in much the same way as insolvent banks have been treated in the past. The handling of insolvent banks is far more analogous to a corporate liquidation than a reorganization under the bankruptcy laws. In a reorganization, debt is restructured, certain assets may be sold to raise cash, and certain other agreements may be reached to reduce costs and improve the financial viability of the firm. In banking, opportunities for cost or financial restructuring do not exist to the extent they do for nonfinancial corporations. And, like a corporate liquidation, equity owners of a bank stand behind all other parties with claims on the organization and they generally do not recoup their investment. In Continental's case we have the mixed result in which the

bank was not actually liquidated but stockholders may ultimately lose their entire investment. Short of a means of handling insolvent banks that more closely resembles a Chapter 11 bankruptcy reorganization, it is unclear how bank stockholders could be treated any differently in future crisis situations.

Program Oversight

Our guidelines call for submission of forward-looking plans by the organization as well as government approval of major new contracts. The purpose of these guidelines is to impose on management the discipline of setting realistic goals and making explicit all assumptions about achieving viability. If plans are realistic, they provide a basis for tracking progress. The report's guidelines also call for avoidance by the government in the day-to-day management of the organization.

The terms of the Continental rescue package largely conform with this requirement. The bank must develop plans to restructure itself through a liquidation of assets on a scheduled basis. The Federal Reserve is to monitor progress toward achievement of semi-annual targeted asset levels. In addition, the holding company must inform the Federal Reserve of any proposals to acquire assets representing more than 5 percent of its total capital. The FDIC has indicated that it does not intend to become involved in the day-to-day management of the bank though it did reserve the right to replace certain members of the Board of Directors. On December 3, Continental announced that 9 of its current 14 non-employee directors (all of whom were elected prior to 1980) will not stand for re-election at

the Bank's annual meeting next April. This action was said to be requested by the FDIC. Two of the other outside directors will have resigned before that time.

Collateral and Security Interest

Our report's guidelines call for assuring that the government's financial interest is secure through adequate collateralization of its investment and subordination of all other claims to the government's.

Since the permanent assistance package provides that the FDIC and Federal Reserve stand ready to provide whatever support is necessary to maintain the viability of the bank should the steps taken to date prove insufficient, the question of the government's standing in the event of a liquidation may be largely irrelevant. The question is really one of the size of the government's commitment. That commitment will depend on the amount of liquidation proceeds from the loans that the FDIC acquired in exchange for its investment of $4.5 billion and the proceeds from a sale of 200 million shares of Continental Illinois common stock potentially available to the FDIC. At this time it is not possible to be certain that this arrangement adequately secures the government's investment. This is similar to the Chrysler situation in which there was never a certainty that the company's pledged assets were sufficient to secure the government's $1.2 billion exposure in the event the company failed.

The above considerations notwithstanding, it is important to point out that the FDIC expects to take "losses" on bank failures. Indeed, this is the purpose of the industry financed

insurance fund that is administered by the federal government. If there were never an expectation of losses from payouts on bank failures, there would be reason to question the need for the insurance fund.

There is reason to be concerned over the standing of the general creditors of the bank's holding company that resulted from the design of the rescue. Apparently, in this specific case, federal regulators were left little choice but to infuse assistance through the holding company. This had the effect of placing the holding company's general creditors in a senior position relative to the government with respect to claims on assets. The protective covenants associated with holding company debt prevented a restructuring of the bank's capital. Furthermore, much of the holding company's debt was in the form of bearer bonds. It would therefore have been infeasible to promptly obtain debt holder approval for a financial restructuring of the bank. It is not clear how we can insure that this result does not occur in the future.

Risk Compensation

The federal government should require compensation for the risk that it assumes in large scale financial rescues. Our guidelines suggest that risk compensation should create incentives on the part of program beneficiaries to return to financial health as quickly as possible but not be so onerous that it undermines the chances of survival. We also suggest that this compensation should provide for government participation in the financial success of the borrower.

Unlike the Chrysler, New York City, and Lockheed programs, there are no fees accruing to the government from the FDIC

$4.5 billion combination loan and preferred stock purchase. On the other hand, the Federal Reserve's continuing liquidity support does carry a penalty rate of sorts amounting to nearly 3 percentage points over the discount rate. The package's provisions also provide for federal participation in the potential success of the bank. In much the same way as stock warrants allowed the government to participate in Chrysler's recovery, the equity participation of the government in the bank provides similar potential opportunities.

CONCLUSIONS FROM THE COMPARISION

My overall conclusion from the comparison of the rescue package that was structured to prevent the failure of the Continental Illinois National Bank and Trust Company is that it conforms with the guidelines contained in our report, where possible. But there are important instances of nonconformance resulting from two main factors. First, a system has been in place for 50 years that delegates responsibility for handling banking emergencies to the bank regulatory agencies. This system was established because, among other things, there was a recognition of the need for quick action and the impracticality of congressional involvement at times of banking crises. Second, due largely to the nature of banking and the system within which it is regulated, once a decision was made to keep Continental open, options associated with risk sharing and protecting the government's financial interest were severely limited.

Assuming we were not prepared to let Continental fail, I believe that the regulators had to respond quickly. Congressional involvement at the time of the crisis would have been impractical. However, I also believe that now that the situation has stabilized, the time is appropriate for intense congressional scrutiny of how the system dealt with the Continental crisis and what the events imply for the adequacy of our deposit insurance system and the way our banking system is structured, supervised, and regulated.

IMPLICATIONS OF THE RESCUE FOR THE FUTURE OF BANK REGULATION

With the above in mind, I would like to turn now to the second part of my statement and present our views on the broader ramifications of the Continental Illinois rescue. I will first discuss the nature of the precedent set by the rescue. As a result of the rescue, attention has been focused on the reality that there are two classes of banking institutions in this country that are treated quite differently when problems arise. On the assumption that few are totally satisfied with that reality, I then discuss four avenues through which regulatory reform might take place. My objective in this regard is to highlight the difficult choices that will have to be made in reaching a concensus on the configuration of a more equitable and efficient system of bank regulation.

THE EQUITY OF CURRENT BANKING REGULATION

The rescue package that was put together for Continental Illinois was unprecedented in its size as well as in the degree

of support that the government has indicated it will provide the bank in the event that steps already taken prove insufficient. The Continental result has many of the aspects of FDIC's purchase and assumption transactions of the past in which most or all of the claims of uninsured depositors and general creditors have been satisfied. However, it does represent significant further movement down a road whose ultimate destination is worrisome. Continental's uninsured depositors and general creditors may have had reason to believe that they would be defacto insured, but there was no certainty that this would be true in every case. For example, in the Penn Square case and in the modified payoff experiment early in 1984, uninsured depositors were not totally covered and these situations could have elevated the concern of Continental's funding sources when rumors of the bank's problems began circulating in May.

If our banking system structure has changed to the point where we cannot afford to let any of the largest banks in this country fail, then we have altered the philosophy for which our system of deposit insurance and liquidity support was established 50 years ago. Deposit insurance was created to avert system-wide bank runs. There was a clear recognition in the 1930s that individual banks would continue to fail. But with a system of deposit insurance and liquidity support for the banking system in general, it was believed that the spillover effects from those failures could be contained.

Today, our banking system contains institutions which have become so large and have established so many financial

relationships with other participants in the financial services industry that the threat of a single large bank failure is perceived by regulators as equivalent to system-wide instability.

The Continental Illinois situation underscores the widely held belief that there are two classes of banking institutions in this country: those that we cannot afford to let fail and those whose failure has little effect on system-wide stability. Yet, the system's regulatory rules of the game have been largely the same for both types of institutions. Should this continue to be the case or should we begin thinking about instituting a regulatory quid pro quo for the different protections afforded the two classes of banking institutions? Have we reached the point where for our very large banks, we need to redefine the types of business actions that, from a regulatory perspective, are strictly private? For these very large banks, is special regulatory intervention necessary because of their potential to seriously affect the public interest?

AVENUES OF REFORM

The implications of these considerations are potentially far reaching and require that we come to grips with the various economic and regulatory factors affecting contemporary banking practices. At a minimum we need to explore approaches through four avenues of change to our banking regulatory system. These include:

—changes to our system of deposit insurance in light of its seeming expanded coverage.

--changes in our system of bank examination and supervision to better assure that existing procedures are adhered to, and revisions to existing regulatory procedures and rules regarding when supervisory actions may be taken as well as the nature of the actions.

--changes to disclosure requirements that would better enable depositors and general creditors to evaluate the condition of banks and their management, and

--changes to standards of capital adequacy.

It is important to realize that choices for change within these avenues are not mutually exclusive, nor do we intend this list to be necessarily exhaustive. Changes in one area could affect the need for changes in another. For example, deposit insurance serves as an inexpensive substitute for capital in helping assure the safety of deposits. Furthermore, bank supervision, if done well, can be viewed as a means of limiting the risk associated with a given level of insurance coverage.

The range of choices for establishing a more appropriate regulatory relationship is very broad. Even with the best objective analysis, choices about change will still involve complex value judgments that will generate disagreements based on different perceptions of fairness. Nevertheless, let me elaborate on some of the considerations associated with each of the avenues of reform.

<u>Deposit Insurance</u>

There are three fundamental issues that the Continental Illinois case raises with regard to deposit insurance.

--Should we explicitly broaden the coverage of deposit insurance to cover large depositors in order to prevent runs on large banks?

--If we do broaden the coverage, who should pay for it?

--Regardless of coverage, should insurance be priced to more closely conform with variations in risks assumed by different banking institutions?

As I indicated, broadening coverage of deposit insurance to all uninsured depositors and general creditors is not so drastic an action as it might first seem. Many of FDIC's past purchase and assumption transactions have accomplished this result. One option that would fall short of full coverage would be to fully insure all demand type savings and transactions accounts but to severely limit coverage of time deposits. In this way the size of bank runs might be limited when problems are initially experienced and there might be sufficient time to reach solutions that would eliminate the incentive to withdraw time deposits when they mature. While this option has some appeal it also has drawbacks. It might encourage excessive reliance on very short-term funding and increase interest rate risk. It also might not prevent withdrawal of money market certificate type savings accounts despite the interest penalty associated with premature withdrawal.

If coverage is expanded, the question becomes: who should pay for the increased risks assumed by the government? There are two points worth noting with regard to this issue.

--If the bank supervision and examination processes were sufficiently rigorous that banks were merged or

liquidated at the precise time when the value of the assets was exactly equal to the value of the liabilities, the current level of insurance premiums would be more than adequate to cover all deposits and other borrowings of banks. The problem is that this rarely occurs. In general, and largely as a matter of policy, liquidated or merged banks have been insolvent for some time prior to the actual declaration of insolvency. Thus, the risks faced by the government from de jure or de facto coverage of all uninsured depositors and general creditors are a function of both the inherent riskiness of a bank's operations and the policy of not liquidating banks at the exact moment they become insolvent.

—Assuming that the delay policy will not be changed, should large banks pay for the assumption of additional coverage that the government might consider assuming? Most of the exposure from coverage of uninsured deposits rests in large banking institutions. Should we raise premiums paid by the large banks because of this increased exposure or make other provisions for industry provision of funds for large bank problem situations through contingent assessments? Should we, for example, institute a system of interest bearing deposits with the FDIC that resembles the arrangement for the deposit of funds by credit unions with the National Credit Union Share Insurance Fund? The fact of the matter is large

banks pay more now in relation to the level of insured deposits because premiums are levied against all domestic deposits, not just insured deposits. On the other hand, total exposure is a function of all deposits and other liabilities including foreign deposits which are found mainly in our large banking institutions; foreign deposits are not insured and are not subject to insurance premiums. If it is our intention to guarantee foreign deposits in the future, then an insurance assessment should be levied against these deposits as well.

Is deposit insurance appropriately priced? Answers to this question depend on what we want the deposit insurance premium structure to accomplish. Many people believe that deposit insurance premiums are structured in such a way that they encourage banks to take risks that they would not take in the absence of deposit insurance. Do we want the level of premium collections structured in such a way that the fund will be adequate to cover the full range of bank failure outcomes that the insurance fund might face? Most people agree that it is not possible to actuarially estimate reasonable worst case scenarios of fund exposure. Despite the bank failures of the 1980s, FDIC's fund has grown. On the other hand, deposit insurance is inexpensive relative to rates of return that banks must earn to attract capital. Should we price deposit insurance so that its cost more closely conforms to the cost of attracting equity capital? What would we do if this built up a very large fund?

Should deposit insurance premiums vary with the riskiness of a bank's operations? Answers to this question depend on whether we believe deposit insurance should serve as a deterrent to excessive risk taking and if so, whether it can be priced to provide an effective deterrent. Can we be confident about the capability of the bank regulators (or anyone else) to accurately assess the riskiness of a bank's decisions when those decisions are made? If we cannot, then increasing the level of premiums or varying them according to the riskiness of a bank or class of banks would occur on an after the fact basis. And, if this is the case, higher premiums should be more appropriately viewed as punitive, not preventive. The question then becomes whether this is desirable from the standpoint of the strength of the banking system. If not, we need to ask ourselves whether there might be a better set of deterrent alternatives.

Bank Supervision

Concerns have been expressed about the quality of the regulatory supervision and examination of Continental Illinois. Is it enough to expect that closer adherence to examination procedures will reduce the probability of similar future situations? If better supervision is not enough, should we consider increasing the regulators' abilities to impose their recommendations on bank management or changing the circumstances under which binding recommendations can be made? When, and under what circumstances might more intrusive supervision come into play--when banks are first classified as problem banks? How can this be reconciled with the fact that most of the banks

on problem lists do not fail and eventually come off those lists without highly intrusive supervision? Is it reasonable to expect bank examiners to possess the extraordinary foresight that closer supervision would imply?

Ultimately, in the area of bank supervision the question is: can we be satisfied that, at least for large banks, the public interest ramifications of their private business decisions warrant more direct and intrusive supervision? If so, what should be the nature of that supervision?

Increased Disclosure

Would increased disclosure of banks' financial condition result in more informed decisions by depositors and creditors regarding placement of funds? Is there any reason to believe that release of more financial information would enable the public to make better decisions than bank examiners about the relative riskiness of a bank? Some would argue that those with money at stake do make better decisions, but the point is certainly debatable. Assuming that decisions about risk are made equally well by both parties, is it reasonable to expect the public to impose more discipline on a bank than bank examiners are equipped to do?

Assuming increased disclosure did result in a more informed public, might it not simply result in a better delineation of risks and returns among which choices could be made just as they are in today's financial markets? Some investors are comfortable with high risk-return tradeoffs; others are not. If funds continue to flow to high risk institutions at premium

rates would that not increase the riskiness of those institutions? On the other hand, if disclosures were made that had the effect of seriously undermining confidence in a bank (as opposed to simply having the effect of raising rates a bank must pay to attract depositors), would a bank run result? What if this occurred at a large bank? How can these considerations be reconciled with the de facto or de jure extension of insurance to all depositors and general creditors?

Capital Adequacy

Are banks adequately capitalized? Capital serves to buttress a bank against insolvency during periods of depressed earnings. But capital cannot be expected to be sufficient to protect a bank against the consequences of a run-off of deposits. Insulation against bank runs is dependent on the liquidity of bank assets and the maturity composition of liabilities. Considerations regarding capital adequacy are also complicated by the fact that increasing capital requires increasing earnings to pay for the attracted capital. If increased earnings are accomplished through acceptance of increased risks, a given bank would be no less vulnerable to insolvency at a higher capital asset ratio than at a lower ratio.

As I indicated, deposit insurance can be viewed as an inexpensive substitute for capital. If there were no deposit insurance or if its coverage were significantly reduced, it is interesting to contemplate the level of, and return on, investment that would be required to attract permanent capital to the banking industry.

Should we be satisfied with our current definition of capital adequacy? Is a capital/asset ratio of, say, 6 percent an accurate measure of the financial cushion in view of the questionable means by which many of a bank's assets are valued? For example, is any measure of capital adequacy meaningful that does not take into account the contingent liabilities resulting from the growth in off-balance sheet transactions such as standby letters of credit and recourse loan sales? Should we define capital adequacy as a percentage of deposits which are not so subject to judgmental measurement as assets? Another option would be for regulators to consider more systematically the market as well as book value of all assets in the course of supervisory examinations to gain a greater appreciation of the ability of an institution to withstand a sustained erosion in earnings or a run-off of deposits. This would also enable examiners to better identify circumstances under which a bank truly becomes insolvent.

CONCLUSIONS ON THE IMPLICATIONS OF THE CONTINENTAL ILLINOIS RESCUE

I have tried to highlight some of the difficult choices that we face in deciding how to design our system of deposit insurance, bank supervision, and regulation. Each has pitfalls. And, because of this we need to be very careful about changing a system that has worked reasonably well even during the current difficult period. I suspect that some of the problems that Continental has demonstrated can be dealt with by more vigorous

adherence to existing examination procedures. I suspect that others must eventually be dealt with through changes within the four avenues I have outlined. Whether these changes imply continuation of a two-tiered regulatory system is uncertain; but we need to begin seeking the answers.

Further analysis will be helpful in answering some of the questions that are raised by the Continental situation. For example, is banking becoming riskier? Are large banks riskier than small banks? What effect has interest rate deregulation had on the risks faced by the banking system? What are the potential risks of expanding product offering powers beyond those currently allowed banks? We do not have good answers to these questions.

In addition to seeking these answers we need to decide what combination of changes are necessary (if any are necessary) that best mutually satisfy the objectives of fairness, efficiency, and confidence in our banking system. In order to decide we must know the relative advantages and disadvantages of each and the extent to which changes in one area mitigate against or reinforce the need for changes in another.

Even with answers to these questions, it will still be necessary to make value judgments about where we draw the boundaries of regulatory intervention into private decisions versus those that truly affect the public interest. The important thing about the deliberative process we should go through is that the more answers we have about changes in the nature of banking risk and the interrelationship among and pitfalls of the

various avenues through which reform can take place, the more limited will be the number of decisions that will rest on value judgments or misinformation.

We in GAO are currently pursuing many of the questions that the Continental Illinois situation raises. We expect to issue a report on the deposit insurance system this spring. We expect to point out more specifically than I have done today where more information is needed, indicate some of the tradeoffs associated with the major proposals to reform the system, and provide the Congress with an agenda it may wish to follow in pursuing a solution to the problems we perceive. We also are in the process of implementing a series of studies which will help provide answers to the changing nature of banking risks and the reasons for and relative importance of changes in various types of risks. We also plan to assess the extent to which increased product offering freedoms might affect the riskiness of the banking sector of our financial system. It is our hope that this work will contribute to resolution of many of the questions that situations like Continental Illinois raise.