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# FINANCIAL REGULATION

# Modernization of the Financial Services Regulatory System

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## Modernization of the Financial Services Regulatory System

Summary of Statement by
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When Congress last considered expanding bank powers, the industry was not in very good financial condition. At that time, Congress chose to follow a prudent course by seeking to get both the banking and the regulatory systems back in shape before moving forward on financial services modernization. While the banking industry is clearly in better financial condition than five years ago, in GAO's view it may be premature to assume that fundamental concerns about risk management and regulatory supervision have been fully resolved.

Parts of the industry that were once separated have continued to converge, while the regulatory system has adapted to these changes incrementally and on an ad hoc basis. The result is a regulatory structure with overlaps, anomalies, and even some gaps. Recognizing that this may be an opportune time to restructure the laws and regulatory framework, GAO suggests a set of safeguards to avoid undue risk to the safety and soundness of the financial system, to the deposit insurance funds, and to consumers and taxpayers.

-- Financial services holding companies should be subject to comprehensive regulation on both a functional and consolidated basis. While firewall provisions are extremely important to prevent potential conflicts of interest and to protect insured deposits, an umbrella supervisory authority needs to exist to adequately assess how risks to insured banks may be affected by risks in the other components of the holding company structure.

-- Capital standards for both insured banks and financial services holding companies should exist that adequately reflect all risks, including market and operations risk. Because capital can erode quickly in times of stress, regulators should also be required to conduct periodic assessments of risk management systems for all the major components of the holding company, as well as for the holding company itself.

-- Clear rulemaking and supervisory authority should be established that includes specific requirements for cooperation and coordination among functional regulators.

-- Mechanisms should exist to prevent excessive concentration of economic power and to assure free entry into financial services markets, so that small businesses and consumers can be assured of receiving the benefits of modernization efforts.

Mr. Chairman and Members of the Committee,

We are pleased to be here today to discuss modernizing our financial services regulatory system. There are many good reasons for considering modernization legislation at this time, and the proposals now before this committee provide a wide range of options for restructuring the traditional relationships between banking, securities, and other related activities. We believe that enhancing financial sector efficiency is an important public policy goal but, in pursuing that goal, we should not lose sight of other important goals, such as maintaining the safety and soundness of the financial system and the deposit insurance funds, preventing undue concentrations of economic power, and protecting consumers from potential conflicts of interests.

To best ensure achieving all of these goals, we believe any move to modernize regulation of the financial services industry should (1) provide consolidated and comprehensive supervision of all companies owning federally insured depository institutions--with coordinated functional regulation of individual components, (2) ensure capital levels that adequately reflect the amount of risk-taking, and (3) ensure that regulatory resources and capabilities keep pace with expanding bank powers and increased linkages between banking and other types of financial or nonfinancial activity. We believe these are fundamental principles that should receive careful attention as Congress considers the best approach for modernizing the financial services regulatory system. Moving away from a financial services holding company approach or in the direction of allowing commercial or industrial firms to own banks raises particular questions and concerns which suggest that Congress should proceed cautiously.

## BANKS' FINANCIAL CONDITION HAS IMPROVED, BUT REGULATORY REFORMS HAVE YET TO BE FULLY TESTED

When Congress last considered expanding bank powers several years ago, the banking industry was not in very good condition. Many banks had failed or were struggling to restore their capital, and the bank insurance fund was depleted. While bank securities activities were not as prevalent at that time, many of the reasons for taking up modernization issues were clearly evident. Congress chose to follow a prudent course by seeking first to get the banking industry back in shape. An important component of this strategy was enacting the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991. This act included a number of provisions to bring the regulatory system in line with the realities of the fast-changing, highly competitive markets within which banks now operate. These provisions included prompt corrective action, under which regulators are to prevent losses to the bank insurance fund by closing banks before their capital is completely exhausted, as well as various

management, regulatory, and accounting reforms designed to strengthen bank controls over risk-taking and improve the flow of information to regulators and market participants.

While the banking industry is clearly in better financial condition today than five years ago, in our view it may be premature to assume that fundamental concerns about risk management and regulatory supervision have been fully resolved. Although a credit risk-based capital system has been in place for a number of years and bank capital has increased significantly, much harder to measure market and operations risks have become increasingly important for many banking institutions. And, while regulators are providing improved guidance for examining risk management systems, we believe it is too early to tell whether these actions are sufficient for today's challenging environment.

LEGISLATIVE AND REGULATORY FRAMEWORKS MAY BE OUTDATED

Having adopted interstate banking legislation last year, it is certainly reasonable for Congress to consider regulatory modernization proposals at this time. At the very least, it seems reasonable to bring the regulatory system up to the point where it gives adequate recognition to the changes that have already taken place in the industry. Beyond that, we should strive for arrangements that have the flexibility to accommodate further changes without placing safety and soundness, consumers, and taxpayers at undue risk.

Both the laws governing the financial services industry and the regulatory structure that oversees it were developed for an industry that was compartmentalized into commercial banking, investment banking, and insurance. Since that structure was set up, these activities have converged to the point where many of the products and services offered by these supposedly different institutions are more similar than different. Some examples include: (1) competition by money market and mutual funds for customer funds that has been so successful that shares in such funds--many of which permit check writing--are now about equivalent in volume to insured bank deposits; (2) the securitization of more than $1 trillion of mortgage and other loans that a few years ago would have been held in portfolio by insured depository institutions; and (3) involvement of banks in securities to the extent that "Section 20" affiliates of banks account for about 15 percent of the assets of all broker dealers registered with the SEC, and that bank proprietary mutual funds account for about 14 percent of the assets of all mutual funds.

While regulators have adapted to these changes in the industry, they have done so incrementally and on an ad hoc basis. The result is a regulatory system with overlaps, anomalies, and even some gaps. For example, certain bank securities activity conducted in affiliates may be examined by both bank and

securities regulators in a way that imposes unnecessary burden on the institution. On the other hand, the capital standards applied to banks' trading activity focuses on credit risk when market and/or operations risks are equally, if not more, important.

SAFEGUARDS ARE NEEDED

While it may be an opportune time to restructure the laws and regulatory framework governing the financial services industry, we believe any legislation should include the following safeguards to avoid undue risk to the safety and soundness of the financial system, to the deposit insurance funds, and to consumers and taxpayers.

-- Financial services holding companies should be subject to comprehensive regulation on both a functional and consolidated basis. While firewall provisions are extremely important to prevent potential conflicts of interest and to protect insured deposits, an umbrella supervisory authority needs to exist to adequately assess how risks to insured banks may be affected by risks in the other components of the holding company structure.

-- Capital standards for both insured banks and financial services holding companies should exist that adequately reflect all major risks, including market and operations risk. Because capital can erode quickly in times of stress, regulators should also be required to conduct periodic assessments of risk management systems for all the major components of the holding company, as well as for the holding company itself.

-- Clear rulemaking and supervisory authority should be established that includes specific requirements for cooperation and coordination among functional regulators.

-- Mechanisms should exist to prevent excessive concentration of economic power and to assure free entry into financial services markets, so that small businesses and consumers can be assured of receiving the benefits of modernization efforts.

Supervision of Financial Services Holding Companies Should Be On a Comprehensive, Consolidated Basis

While each component of a financial services holding company can be overseen by a specific, functional regulator, we believe it is important that some supervisory authority has responsibility for the entity as a whole. For example, while the SEC might be the regulator for the securities affiliate of a holding company and the OCC might be the regulator of one of the holding company's

banks, there is still a need for some regulator to look at the holding company in its entirety.[1]

All of the approaches proposed to the committee use capital standards and firewalls as the mechanisms to protect bank capital from being used to improperly support nonbank activities or to protect insured deposits in the event a nonbank affiliate becomes insolvent. While the capital of bank subsidiaries and firewalls are important safeguards, we are in agreement with the approach taken in H.R. 1062 that provides for consolidated supervision at the holding company level, in addition to firewalls. Most, if not all, bank holding companies are managed on a consolidated basis with the risk and returns of various components being used to offset or enhance one another, and investors may make little distinction between one component of the holding company and the other affiliated companies.

Currently, under the Bank Holding Company Act, the Federal Reserve acts as the overall regulator for bank holding companies. The Federal Reserve sets consolidated capital requirements for the company as a whole, has supervisory authority over the company, determines what types of activities can be affiliated with banks under the holding company structure, and approves such holding company activities as mergers and acquisitions.

The proposed financial services holding companies under H.R. 1062 resemble these current bank holding companies. And, like current bank holding companies, they are likely to be very complex organizations. Given this complexity, we question whether sufficient confidence could be placed in a regulatory framework that is strictly functional in nature and that concentrates primarily on enforcing bank capital rules and firewalls.

## Firewalls Can Be Penetrated and Capital Can Be Dissipated Quickly

Firewalls are systems of controls that are meant to keep bank resources from improperly being used to support other activities, such as securities underwriting, and to protect against potential conflicts of interest. Ensuring that appropriate firewalls are established and maintained, and that regulators have the authority to take action when firewalls are breached, is an important part of supervising banks under a functional regulation approach. The Federal Reserve, for example, has the authority to require that firewalls be established when it authorizes bank holding companies to set up affiliates under Section 20. The Fed also has the authority to examine and enforce these firewalls on an ongoing basis.

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[1]For a more detailed discussion of functional regulation, see appendix.

Periodic examinations, however, cannot ensure that firewalls will hold up under stress or if managers are determined to breach them. Thus, the protection that firewalls provide depends heavily on the fact that they are only one component of the overall regulation of bank holding companies by the Federal Reserve. Before allowing any Section 20 affiliate to underwrite corporate debt and equity, for example, the Federal Reserve uses its consolidated supervisory authority to require the holding company to demonstrate it has adequate systems in place throughout the company to manage risks and to protect the integrity of the firewalls. Such a safeguard may not exist under a strictly functional regulatory approach.

Although an appropriate focus of regulation, capital measured in financial statements is an inexact measure of financial strength. Capital is adequate only in relationship to the risks that are being taken. In today's environment, the lack of information on proprietary trading positions, or accepted standards of adequacy in areas such as interest rate risk, underscores the uncertainty about the adequacy of capital as reported on financial statements. With today's rapidly changing financial markets, measured capital can disappear quickly in poorly managed firms.

Our concerns about placing too heavy an emphasis on measured capital reflect past experiences in which capital was dissipated before regulators were able to take action. For example, regulators waited until problems at the Bank of New England had developed to the point where asset values had to be substantially written down. Thus, measured capital was a lagging indicator of the bank's true financial condition and even of its viability. The potential volatility of derivatives activities, along with weaknesses in accounting rules for certain of these activities, further erodes the value of reported capital as a measure of financial strength. Although FDICIA has given regulators the ability to adjust downward an well capitalized institution's capital rating, in the presence of management deficiencies, it is too early to tell how effectively this authority is being used.

## Capital Standards and Risk Management Evaluations Are Important Safeguards Under Any Regulatory Framework

Establishing a measure of capital adequacy is a basic component of any approach to regulating the financial services industry. Although we have suggested some limitations to using capital as the sole mechanism for protecting banks from risks arising elsewhere in the holding company, establishing risk-based capital standards that reflect all major risks is an important safeguard for both functional and consolidated regulation. In addition, regulators need to assess the risk management system for each component of the company as well as the company as a whole.

The current risk-based capital standards for banks take account of credit risk. The only mechanism that accounts for market, liquidity, operations, or legal risk is the minimum capital requirement or leverage ratio. Bank regulators have been attempting to establish capital requirements for interest rate risk, as required by FDICIA, but have yet to agree upon such standards.

Regulators need to have assurance that each financial institution within a holding company, as well as the holding company itself, is capable of measuring, understanding and managing the risks it is undertaking. Without such assessments, neither the company nor the regulator can be sure if capital is sufficient to cushion against the relevant risks.

Mechanisms For Rulemaking and Cooperation Are Important for Successful Functional Regulation

Affiliations between banking and other activities could be done in any number of ways. In particular, if nonbank financial institutions are allowed to affiliate with banks, the number of possible regulatory variations could be large. To make sure that the resulting functional regulatory system is effective and at the same time not burdensome on the industry, it is important (1) to have a clear mechanism for setting rules and (2) to establish mechanisms that enhance regulatory cooperation.

We believe that there should be clear rulemaking authority on critical matters, such as consolidated capital, firewalls, and permissible activities. This can come about in a number of ways. Having the Federal Reserve serve this function, at least for large financial services holding companies, is one obvious alternative. Another approach would be to adopt an arrangement similar to that used in the Government Securities Act, in which specific agencies are given power to set rules in specific areas, with requirements for extensive consultation among the agencies. Still another approach would be to have a special interagency rule making board.

Although functional regulation sounds simple, our work makes clear that in practice it is not. No matter how much one might try to streamline regulation, our recent work reviewing Section 20 affiliates and bank mutual fund activities shows that there will be areas in which the interests and domains of different regulators overlap. Thus, we believe it is important for Congress to be as specific as possible in spelling out the need for regulators to work together to reduce unnecessary overlaps and to minimize regulatory burden.

## Maintaining Competitive Markets and Open Entry

One of the unique features of the U.S. financial system is its many banks and securities firms, which help to assure the presence of a variety of financial services in virtually every community throughout the country. In our recent report on interstate banking, we pointed out that smaller independent banks were successful in most states in maintaining their market share despite the consolidation that had been occurring.[2] Between 1986 and 1992, banks with assets of less than $1 billion, measured in constant 1992 dollars, maintained a national market share of about 20 percent of assets, and their share increased in 9 of the 16 states with a relatively large amount of interstate banking. With further interstate banking, as with developments that might occur with the establishment of financial services holding companies, these smaller institutions have no guarantee, of course, of a stable or expanding market share, and their future will depend on such things as their abilities to serve their communities, the efficiency of their management, their desire to remain independent, and the acquisition strategies of larger banks.

To encourage the viability of small enterprises and to assure that communities of all size will have access to financial services, our interstate banking report emphasized the importance of making sure that local markets remain competitive, both through anti-trust enforcement and ensuring that potential new entrants remain free of unnecessary barriers. The same principle applies to financial modernization legislation as well. It is worth noting, for example, that one of the problems with the current Section 20 companies is that the revenue limitations (i.e., nontraditional activities can account for no more than 10% of all revenues) contribute to making it difficult for a well capitalized, well managed, small bank holding company to set up a subsidiary to underwrite the debt or equity of small local companies.

## Concerns Remain About Affiliations Between Banks and Industrial Firms

Removing all restrictions on the ownership of banks would provide the market with the maximum degree of flexibility in determining affiliations between banking and other activities, both financial and industrial. However, it also raises some unanswered questions. Is such an affiliation needed to provide adequate diversification opportunities to banks or other firms? What synergies would result from such an association? How would the public respond if a major company that owned a bank got into

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[2]Interstate Banking: Benefits and Risks of Removing Regulatory Restrictions, (GAO/GGD-94-26, November 2, 1993).

trouble? How would regulators be able to maintain adequate supervision of the company as a whole?

Our concerns in this area are heightened because many of the efforts of nonfinancial firms to expand to the financial services area have not been particularly successful, and increasingly companies have been concentrating on core businesses in order to survive and do well in competitive markets.

These questions and concerns suggest that Congress should proceed cautiously with any move away from the financial holding company approach or in the direction of allowing commercial or industrial firms to own banks.

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Mr. Chairman, this concludes my statement. My colleagues and I would be pleased to respond to any questions you may have.

APPENDIX

## An Explanation of Consolidated Holding Company Regulation and Functional Regulation

The closest model for a financial services holding company is the existing bank holding company structure. This appendix explains how bank holding companies are regulated, as well as the concepts of consolidated regulation of the holding company and functional regulation.

Large Bank holding companies are complex. They consist of combinations of banks, thrifts, subsidiary holding companies, securities firms, and other nonbank firms (such as mortgage, finance, or data processing companies). In total, these large firms typically have many separate subsidiaries, with operations conducted throughout the U.S. and overseas.

The regulation of a bank holding company can be shown with a simplified illustration of such a company, as in figure 1. The company in this illustration consists of a national bank, a subsidiary bank holding companies, a thrift holding company, a securities firm registered with the SEC, and another nonbank subsidiary. The diagram also shows how each entity is regulated.

### Consolidated Regulation of the Holding Company

Under current bank holding company regulation, the Federal Reserve System is responsible for regulating the company as a whole. This means that the Federal Reserve sets capital requirements on a consolidated basis for the company as a whole, has authority to supervise all parts of the company, determines what activities can be affiliated with banks, and approves holding company mergers and acquisitions. Consolidated supervision typically involves concentrating on capital structure, key risk management systems, and the flow of funds within the company.

The holding company regulation provided by the Federal Reserve can be referred to as "umbrella" type regulation because it is in addition to other regulation of holding company subsidiaries or of the markets within which the entities of the holding company operate. This other regulation is provided by various federal and state regulators. The authority of the Federal Reserve is limited in that in some circumstances a bank regulator such as OCC can, for example, authorize activities for a national bank that the Federal Reserve cannot authorize at the holding company level.

Functional Regulation

The concept of functional regulation refers generally to a regulatory process in which a given financial activity is regulated by the same regulator regardless of who conducts the activity. In discussions about regulation of financial service holding companies, the concept can be used in somewhat different ways.

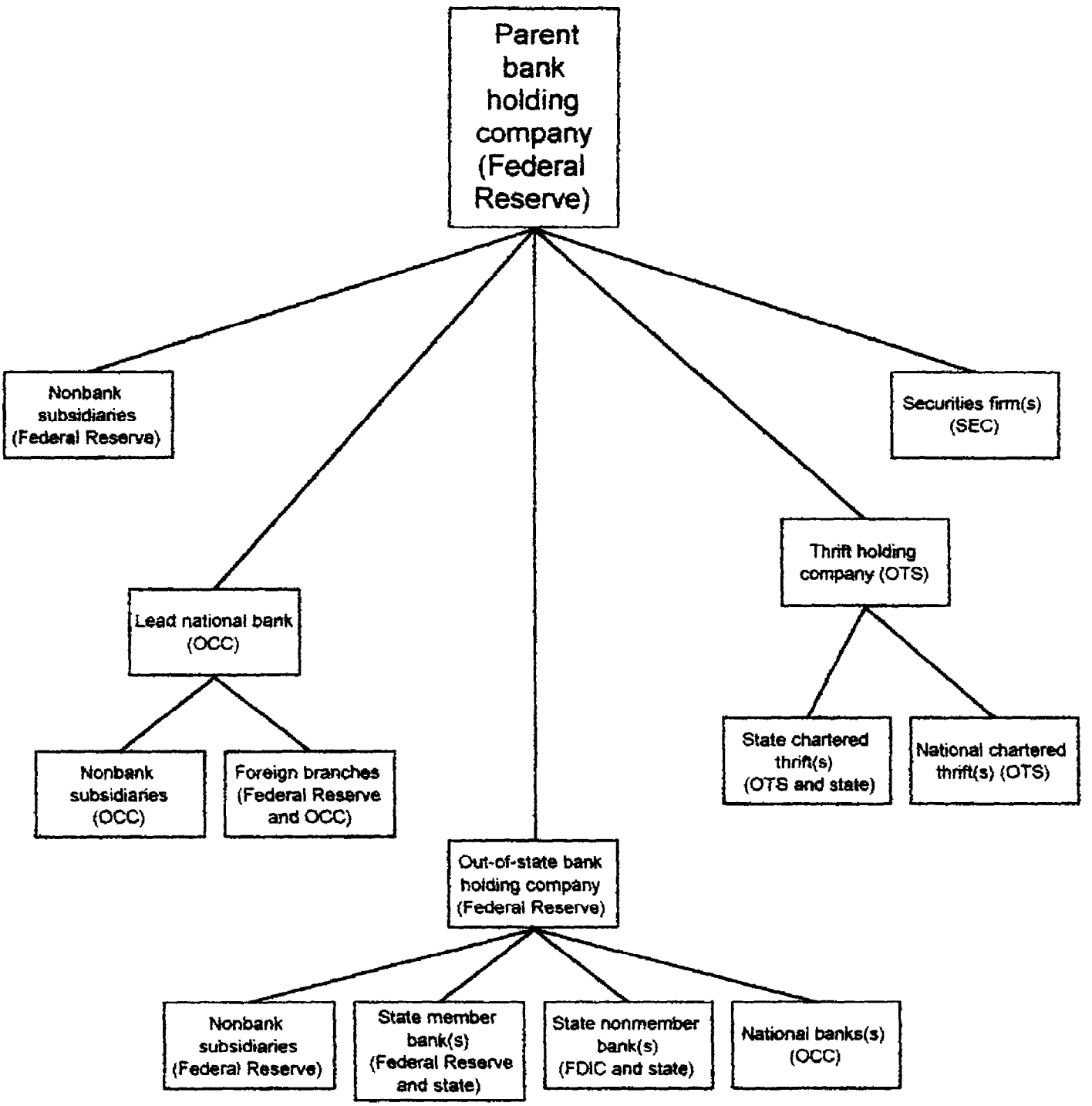
Functional regulation is sometimes used to refer principally to the idea of regulating a complex company in a way that eliminates the umbrella role, the role now played by the Federal Reserve for bank holding companies. Referring to figure 1, this approach to functional regulation means that the Federal Reserve regulation of the parent and of nonbank subsidiaries would disappear from the diagram. Regulation would then be focussed solely on the various regulated subsidiaries. For example, OCC would continue to regulate the lead national bank and the national bank in the subsidiary holding company, while the SEC (in part through the involvement of securities regulation) would regulate the securities affiliate. OCC would be responsible for setting the capital requirements for the national banks and using its supervisory authority over those banks to see that capital is not drained away by the actions of the holding company parent or of any affiliates. OCC also would enforce the firewall limitations applicable to the national banks, in which capacity it would have the ability to obtain records from other parts of the holding company.

Functional regulation can also be used to emphasize the way in which regulatory responsibilities are divided up among the various regulatory bodies. This concept is particularly important because the U.S. regulatory system combines both regulation of markets (securities exchanges, futures exchanges, and over the counter trading) and regulation of firms (banks, securities firms, thrifts, and insurance companies). With functional regulation defined in this way, the SEC, as regulator of securities markets, would set rules that apply to all firms active in those markets, whether those firms are banks, registered broker dealers, or insurance companies. The enforcement of the SEC rules can be done either by the regulator of the market or the regulator of the firm.

As the activities of various types of financial institutions have converged, the concept of regulating by function is likely to take on greater significance, extending across traditional definitions of markets as well as firms. For example, sales practice rules could be developed to apply to many products sold by many different firms in many different markets. Functional regulation viewed in this way is not inconsistent with consolidated supervision of the activities of companies which participate in many different markets.

APPENDIX

## Figure 1: Regulation of a Hypothetical Bank Holding Company



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