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STATEMENT OF

CHARLES A. BOWSHER

COMPTROLLER GENERAL OF THE UNITED STATES

BEFORE THE

SENATE COMMITTEE ON BANKING, HOUSING

AND URBAN AFFAIRS

ON

CHANGES IN THE FINANCIAL SERVICES INDUSTRY

AND THEIR IMPACT ON FEDERAL REGULATION

Mr. Chairman:

I am especially pleased to be here to discuss one of the most important questions in the financial services industry today: How is that industry changing and what should be the Government's role with respect to those changes? I think we all realize that the changes are both rapid and complex. It is appropriate, therefore, that we move with deliberate speed to address the problems caused by these changes. I say deliberate speed because our work to date indicates that some important questions need to be answered before the Congress enacts major legislation.

In my testimony today I will discuss the impact of industry changes on the protections provided to depositors and investors, and I will address the question of the continued relevance of the current financial services regulatory structure. I will highlight the conclusions we have reached from our studies to date and outline the future work that we will undertake to help the Congress address these complex issues. We have been studying some relevant issues over the past couple of years and will be looking at others in the next few years, reporting on them periodically. We will, of course, stand ready in the interim to provide assistance to the Congress.

The changes we see occurring today are the latest events in the historical development of the financial services industry. Before the financial collapse in 1929, many discrete depository, insurance, and investment organizations vied for customers' funds. In contrast to today, these organizations and markets were relatively free from regulation, and depositors and investors had relatively few protections for their savings and investments. After the collapse, the Congress created in 1933 and 1934 regulations and protections to restore public confidence in the financial system and promote the orderly intermediation of savings to investment.

I want to note here that the Congress designed the legislation of the 1930s for a financial system which, in one important respect, differs from the system we have now. The basic deposit insurance, public disclosure, and regulatory requirements designed 50 years ago assumed separate and distinct deposit and investment industries. The Congress stated its desire to keep banking separate from other lines-of-business by prohibiting federally chartered banks and Federal Reserve member banks from engaging in activities such as securities underwriting. This separation generally continued through the early 1970s.

Beginning in the late 1970s and continuing today, traditional financial institutions and nonbank commercial firms have made incursions into each others' lines-of-business, blurring the distinctions among formerly separate industries. These changes have continued to accelerate.

An early break in the traditional boundaries separating components of the financial services industry was the Merrill Lynch Cash Management Account, first offered in September 1977. This account provided customers with brokerage services, higher interest than regular depository institution savings accounts, checkwriting privileges, and use of a debit card.

More recently, some companies involved in unrelated activities have merged to expand their positions in the financial services industry. Prudential Insurance Co. acquired the Bache Group Inc., a securities firm, and has announced intentions to acquire a commercial bank; American Express Co. acquired Shearson Loeb Rhoades, a securities firm; Sears, Roebuck & Co. acquired Coldwell Banker, a real estate company, and Dean Witter Reynolds, a securities firm (adding to its existing savings and loan association and insurance company); and BankAmerica Corporation acquired The Charles Schwab Corporation, a discount broker. The savings and loan (S&L) industry created INVEST, a program through which participating institutions offer discount brokerage services. About 600 depository institutions now offer discount brokerage services to their customers or are working out the details to do so. Most of these services are offered through affiliated discount brokers.

Although depositors and investors can benefit from the introduction of new financial products, I am concerned that the merging markets are creating gaps and overlaps in the available protections. For example, transaction accounts, such as checking accounts, are now available from banks, thrifts, securities brokers, credit unions, and investment companies. A customer placing money in one of these accounts may or may not be covered by deposit insurance. The institutions offering the accounts may or may not be subject to regular, detailed scrutiny by Federal examiners, and those examinations might differ vastly in form and coverage. These differences become even more significant as the products become more complex, and it is likely that consumers can become confused about what their protections and risks really are.

It is noteworthy that these industry changes are taking place _in spite_ of existing laws and regulations. Various methods are being employed to avoid prohibitions. For example, the Bank Holding Company Act and the Federal Reserve's regulations were intended to confine the business of organizations owning banks to certain activities closely related to banking. But, through a series of legislative amendments, the definition of a bank for the purposes of that act was narrowed to include only those institutions which both accept demand deposits and make commercial loans. So, when Gulf and Western acquired Fidelity National Bank of Concord, California, and divested the bank of its commercial loans, Gulf and Western was not held to be a bank holding company even though Fidelity could still hold federally insured deposits and make personal loans. In this way, the restrictions of the Bank Holding Company Act were avoided.

Furthermore, not all the restrictions on federally chartered banks apply to institutions with State charters. The Glass-Steagall Act prohibits national banks and other Federal Reserve member banks from underwriting securities. But the Federal Deposit Insurance Corporation (FDIC) has determined that the act does not preclude an insured bank that is not a member of the Federal Reserve System from acquiring or establishing a subsidiary to underwrite securities, provided certain safeguards exist (such as dealing only through a bona fide subsidiary in certain types of securities with a ceiling on the amount of a bank's investment).

As this committee has heard, several States such as South Dakota and Delaware either have made or are considering changes to their own laws that would allow their State-chartered banks to conduct activities now prohibited for national or Federal Reserve member banks. This affects the banks' relative competitiveness and their risk levels. Consequently, I believe the Congress should consider assuring that all federally-insured institutions are regulated consistently to maintain the safety of our nation's banking system and to protect depositors.

In light of these events, I think it is important that the Congress ascertain the direction in which the financial services industry is headed, assess the need for changing the restrictions now imposed on the market, determine the protections to be offered depositors and investors, and carefully evaluate alternatives for improving Federal financial services regulation.

## MARKET DIRECTION SHOULD BE UNDERSTOOD

Before legislation can be designed to adequately deal with market changes, the first step is to identify what is happening in the financial services industry, why it is happening, and where things are headed. It may seem as though a lot has already been written and said on this subject. Changes have been so varied and rapid that a precise description is impossible. But I feel that a comprehensive, objective, and organized analysis of what is occurring and where the markets are headed would be of value to the Congress. We are now undertaking a study which will address

--what new products are being created and who is offering them,

--what the impact of these products is on the current regulatory structure, and

--what protections apply to the new offerings.

Early next year we should be able to provide the results of this study. Based on past work, though, we know that merely obtaining data on the various activities conducted by both depository and commercial firms will be difficult. Assessing the impact of the activities on just the firms themselves, let alone on investor protection and the regulatory structure, will be even more difficult.

The reason for the difficulty, as we stated in a report last year on depository institutions' ancillary activities, is that the various Federal regulators' reporting systems do not have enough centrally available data on what activities are being conducted and how these activities affect financial and commercial institutions. We noted two kinds of shortcomings in the data. First, not enough information is gathered by regulators. Second, not all of what is gathered can be effectively aggregated for industrywide studies. Therefore, it would be difficult for either the regulators or the Congress to base substantive policy decisions on data which the Federal agencies routinely gather and aggregate.

Federal depository institution regulators routinely collect data on the financial conditions of their constituent institutions and their holding companies; but their systems do not collect data on the full extent and nature of either banks' or holding companies' nonbanking subsidiaries. In fact, we found that even the data they collected on the <u>number</u> of subsidiaries owned by banks are sometimes unreliable.

Moreover, we noted that commercial firms conducting bank-like activities generally do not report their activities in a form that can be readily compiled and analyzed. Commercial firms submit information required by various regulations, such as the Securities Exchange Act of 1934 which pertains to publicly held companies. However, while general statistics on major industries are compiled, the available data do not show the nature and extent of banklike activities conducted by commercial firms. Financial information on these activities is not separately identified. Instead, results of these operations are consolidated with data on other operations in the firms' overall financial statements.

Notwithstanding these data deficiencies, it is imperative that we comprehend as clearly and completely as possible the implications of industry change for investor protection, competitive relationships within the industry, and a regulatory structure which was established half a century ago. The study we have just begun, and others we will do, will help assess these implications.

## REASONS FOR RESTRICTIONS NEED TO BE REASSESSED

While much has changed in the industry since the 1930s, the original policy reasons for creating regulatory restrictions must not be overlooked even as market pressures build for legislative action.

## Expanding lines-of-business create additional risks

Banks are still seen as special institutions for many reasons. As the Chairman of the Board of Governors of the Federal Reserve System has pointed out to this committee, banks play a critical role in the Nation's economy as suppliers of credit and as a link to monetary policy. Few have challenged the long-held public policy concern for maintaining confidence in the safety and soundness of the financial system in general and in depository institutions in particular. That is why deposit insurance was created; and as long as the Government insures deposits, some measure of regulation is appropriate.

GAO has reported several times in the past few years on how traditional depository institutions have actually increased their risks by diversifying into lines outside their normal ones. In 1978, we reported that savings and loan associations owned by holding companies experienced problems caused by the companies' nonbanking subsidiaries. In 1981 we reported data which suggested that bank holding companies with nonbank subsidiaries are more likely to have problems than holding companies without nonbank subsidiaries.

In our 1978 report on S&L holding companies, we noted that nonbank service corporations were increasingly being cited as contributing to the difficulties of the relatively few (at that time) S&Ls classified by the Federal Home Loan Bank Board as problem associations. Back in 1977, about 28 percent of the

81 identified problem institutions had service corporations that contributed to their problems. This was up from 25 percent (of 83 problem institutions) the previous year and 16 percent (of 63 institutions) the year before that.

More recently we reported on risks associated with bank holding companies. In 1981 we issued a report on improving the efficiency of bank holding company examinations (called "inspections"). We noted that 15.7 percent of the companies with nonbank subsidiaries experienced problems, while only 6.2 percent of the companies without nonbank subsidiaries had them, as reflected in a Federal Reserve holding company condition rating system. These figures were corroborated by Federal Reserve holding company inspectors who told us that nonbank subsidiaries, especially credit-extending ones, present a significant risk to their bank holding companies.

Risks created by a firm's opening new lines-of-business can be successfully managed. However, since banks are thought of as "special" and since public confidence in the financial system is important, the Congress should carefully reassess the need for restrictions on banks' lines-of-business before making legislative changes.

## Congress has sought to prevent overconcentration of power

Our Nation has historically been against the overconcentration of financial power and has favored full and fair competition. Major bank and bank holding company legislation since 1933 has clearly demonstrated congressional concern that banking and nonbanking businesses be separated not only to circumscribe the risks that banks could take but also to prevent overconcentration. But one of the most significant changes taking place is, in fact, a conglomeration of previously separate financial businesses with both banks and non-banks forming business combinations that make incursions into both of these previously separated territories.

Some of the latest public hearings that dealt at length with this issue were those held during the congressional deliberations over the 1970 amendments to the Bank Holding Company Act. During those hearings the Congress was told of anti-competitive practices that could occur if bank holding companies are not restricted in their lines-of-business. One example, which I believe was reiterated to this committee in last week's hearings, was the tying by banks of their lending and insurance functions, influencing customers applying for loans to take out insurance through the banks or their affiliates.

Of course, as you reminded everyone, Mr. Chairman, incursions by insurance companies, brokerage firms, and other non-banking organizations into banklike businesses can present the same concentration concerns. Witness the conglomerations that I mentioned earlier.

Some have asserted that financial industry competition can be enhanced by allowing more firms to offer similar services. Earlier this year, FDIC Chairman William Isaac told this committee that he favors allowing banks or their affiliates to engage in such activities as securities, real estate, and insurance brokerage; various forms of insurance and securities underwriting; and real estate development. He stated that he believed the general public would benefit by having more services offered at competitive prices, and since then FDIC has proposed policy changes to implement this statement.

The question of how the financial industry changes affect overall market competition is obviously complicated. Although we have not analyzed this issue in depth we intend to do so and will report on it to the Congress.

Varying degrees of investor protection cover similar products

Earlier I expressed concern that the merging product markets are creating gaps or overlaps in protections for depositors and investors. I would like to elaborate on this point because I feel that it is important.

I believe that the variety of competing products now being offered can confuse consumers, especially small depositors, who have a variety of investment motives. And beyond this, I believe that the sometimes subtle differences in the protections covering those products can also be confusing. Finally, it is possible that the most basic protection offered bank customers, deposit insurance, could be undermined by changing the risks assumed by depository institutions.

We have recently completed a study that describes the differences in these protections--onsite examinations, disclosure of information, and insurance--for the depository, securities, and commodities industries. We found that differences in regulation exist in (1) the degree to which regulators manage intermediaries' risk exposure through geographic and product line or asset and liability restrictions, (2) the policy of direct supervision of intermediaries versus reliance on self-regulatory organizations for this function, (3) the amount and types of information required to be disclosed to the investing public, and (4) the extent to which regulators impose restrictions on or establish criteria for advertisement of intermediary services.

Financial industry regulators have also adopted different approaches to protect investors from loss. Depository institution regulators are primarily concerned with the safety and soundness of the institutions they regulate and generally protect investors by providing account insurance. Commercial bank trust departments are supervised by the appropriate Federal and/or State regulator primarily to determine whether fiduciary standards are being observed for the purpose of protecting the customer and the institution. Trust assets are not insured unless the funds are invested in insured deposit accounts or held in bank accounts as uninvested trust funds. These accounts are, however, subject to the same insurance limitations as all other accounts.

Securities and commodities industry regulators provide protection through such methods as public disclosure and maintaining orderly markets. Securities industry investors are protected against losses not related to market conditions when a brokerage house enters into insolvency. There is no insurance of commodity investors' accounts.

Variances exist between Federal insurance programs for depository institutions and the Securities Investor Protection Corporation (SIPC) coverage for securities investors. The most important difference is that deposit insurance covers all losses related to an institution's insolvency, up to $100,000 per account, while securities investors are only protected against the loss of cash and securities held by the brokerage house should it fail or become insolvent. This protection extends only to the return of cash and securities to customers and not to losses incurred from market transactions. Federal deposit insurers also have broader regulatory and supervisory powers than the SIPC and thus are in a better position to reduce the risk to their insurance reserves and assist troubled institutions.

Let me illustrate what these variances might mean to small depositors or investors. I noted earlier that banks, savings and loans, and money market mutual funds offer similar deposit-like products in which customers may place even modest amounts of money. If, for example, a bank or S&L became insolvent, deposit insurance would generally cover each account up to the $100,000 maximum. However, if a mutual fund suffered a drastic drop in the value of its investment portfolio, the value of investors' shares would also drop, but no comparable insurance would cover the investors.

Deposit insurance also helps prevent bank failures by discouraging "runs" on banks that have financial problems. If investors lose confidence in a money market mutual fund, no similar insurance would decrease the likelihood of a run on it, nor, in a worst case scenario, runs on several funds with comparable investment portfolios.

Depositors and investors make decisions on where to place their money for many reasons, and it is not easy to associate specific flows of funds with specific motives. However, available data can demonstrate that consumers do shift funds readily in response to market changes and therefore could face some confusing comparisons for similar products. Offering checkwriting features and interest rates higher than the regulated rates in depository institutions, money market mutual funds grew enormously in the late 1970s and early 1980s, reaching a peak of about $240 billion in late 1982. These funds increased their market share of financial assets from 0.1 percent in 1976 to 4.4 percent in 1981. At the same time, depository institutions suffered a slight loss of market share, from 62.9 percent to 58.4 percent, much of it attributed to outflows to the money market mutuals.

Things changed dramatically after the Garn-St Germain Act allowed depository institutions to offer money market deposit accounts (MMDAs) to compete with the mutual funds. The MMDAs began by offering higher interest rates than the funds (though the rates have since dropped). MMDAs were also covered by deposit insurance. According to the Federal Reserve, the MMDAs grew to $320.5 billion from their introduction in December 1982 through March 1983. Correspondingly, assets in money market mutual funds dropped $44 billion to a total of

$197 billion. A good portion of this drop went to the depository institutions' MMDAs--estimates from various sources range from $30 billion on up.

While exact motives for the money movements cannot be associated with specific amounts, it is clear that many consumers have exhibited preferences for both higher rates of return and a higher degree of protection. That is why I think that the variances in investor protection, coupled with the variety of risk/reward alternatives offered in today's market, can confuse the average financial services customer.

New strains on traditional deposit insurance

The most basic protection afforded small savers is deposit insurance, providing a virtually risk-free investment product. However, as we testified before this committee on October 30, 1981, new products offered by depository institutions which involve different risks may put new strains on traditional deposit insurance.

Deposit insurance was developed at a time when policies regarding competition, lines-of-business, and interest rates could successfully remove much of the risk from banking or thrift institutions. In this environment, FDIC and the Federal Savings and Loan Insurance Corporation (FSLIC) were able to minimize insurance payouts to depositors by assisting orderly mergers or purchase and assumption transactions of failing institutions.

Now, however, new risks for the depository institutions may mean that more of them could require assistance from the insurance funds or that payouts could increase. Acknowledging the potential increase in risk to insurance funds, FDIC Chairman Isaac has suggested changing the insurance program to incorporate

--premiums adjusted to the risk of each institution,

--coinsurance for deposits greater than $100,000, and

--modified payoffs to depositors in failed institutions.

The role, structure, and financing of deposit insurance will have to be carefully considered in formulating a new regulatory environment. Even the Federal insurers appear to have differing views on this subject, judging from their studies recently submitted to the Congress as required by the Garn-St Germain Act. These differing views and the importance of the role of insurance have prompted us to study the deposit insurance programs, including alternatives to the current insurance arrangements, so we can assist the Congress as it considers proposed changes. We intend to do this by looking at

--the current operations of the funds as compared to their established purposes,

--staffing and other costs of administering the funds,

--agencies' fund investment practices,

--benefits and problems of consolidating the funds, and

--the ramifications of deregulation on the funds.

Again, we hope to be able to provide useful information to the Congress on these matters later this year.

MANY REGULATORY STRUCTURE ALTERNATIVES EXIST

Once the Congress has a better idea of where the market is headed, and after the need for various restrictions has been reevaluated, alternative regulatory approaches can be studied. The restructuring of Federal financial industry regulators has been debated for many years. In the past, the call for restructuring was based on perceived inefficiencies and lack of coordination among the depository institutions regulatory agencies. Now, though, the debate also focuses on the market changes that may render inappropriate the current structure for regulating all financial industry activities.

Efficiency, coordination issues have been addressed inconclusively

Many studies have been made in the past about restructuring depository institutions regulation to make it more efficient, effective, and consistent. Although possible improvements in efficiency have been cited, the case was never made strong enough to effect changes. The Congress tried to improve the coordination among the depository institutions regulators by creating the Federal Financial Institutions Examination Council (Council) in 1978. But although the Council has achieved some worthwhile accomplishments, we do not believe that it can totally fulfill the greater objectives set for it by the Congress because the member agencies are still divided on key issues.

As I said, many studies have been made just of the question about restructuring depository institutions regulators. We summarized the arguments, pro and con, in a report issued in 1977 on debate over the restructuring question to help the congressional deliberations then taking place. The arguments in favor of consolidating the agencies were that consolidation would

--increase the effectiveness of handling problem or failing banks,

--increase the effectiveness of dealing with bank holding companies,

--improve the efficiency of overall regulatory operations,

--increase the accountability of the agencies to the Congress and the public,

--insure more uniform treatment of all banks, and

--better integrate bank supervision with monetary policy.

The arguments against consolidation were

--the current system was working well,

--consolidation would centralize regulatory power and weaken the State/Federal "dual" banking system, and

--regulatory innovation would be stifled.

At that time there were no arguments persuasive enough to undertake a major reorganization, so the Congress created the Council in the Financial Institutions Regulatory and Interest Rate Control Act of 1978 to accomplish some of the efficiency and uniformity objectives.

The Council's purpose was to prescribe uniform principles, standards, and report forms for the Federal examination of financial institutions by the Office of the Comptroller of the Currency, the FDIC, the Federal Reserve System, the Federal Home Loan Bank Board, and National Credit Union Administration, and to make recommendations to promote uniformity in their supervision of financial institutions.

In a report on the Council that we will be issuing in a few months, we conclude that the need for uniformity in the supervision and regulation of depository institutions is as great or greater today than it was when the Council was established. One of the Council's most important projects, a Study of Examination Philosophies, Concepts and Procedures, was not able to reconcile differences between agency examination policies. The examination process is the heart of depository institutions supervision. Although the Council has taken 11 actions to establish uniform examination principles, standards, and report forms, we found that these actions did not result in significant progress toward uniformity.

In 1981 we reported on ways to improve the Federal structure for examining depository institutions. We recommended that the Council prepare a plan to have the Federal regulators share examination workloads and study the feasibility of consolidating agency examination staffs. The Council and its member agencies disagreed with our recommendations, citing a number of philosophical and organizational problems. While we agreed that some problems existed, we still believed that opportunities existed for improved efficiencies.

So in light of the inability of the Council to reach its congressionally mandated objectives, we will be suggesting that an alternative to the presently structured Council is needed. Possible alternatives include

--modifying the present Council to make its policies mandatory and give it a permanent staff,

--establishing a common examination force, or

--consolidating the depository institution regulators.

<u>Market changes now also drive consideration of regulatory structure changes</u>

Many suggestions have been made for a new regulatory structure based on the changing markets, but the alternatives seem to fall somewhere in the spectrum between regulating institutions regardless of the products they offer (the current structure) or regulating products regardless of who offers them. The latter has attracted much interest, but I can envision that this product orientation form of regulation, given the multiproduct organizations that are developing, could have its drawbacks. For example, an organization like Sears that offers a full range of financial products would find itself dealing with several different regulators under that alternative.

Those who propose a product-line oriented, or functional, regulatory structure, argue that now, with different institution-oriented agencies regulating similar products, the regulatory treatment of these products could differ. In the competition of the financial marketplace, these differences could become critical if they create advantages for some businesses over others. For example, as pointed out in a recent Conference on Major Issues Confronting the Nation's Financial Institutions, mutual funds, commodity pools, and common and collective trust funds serve similar functions. However, because of their historical origins they are regulated respectively by the Securities and Exchange Commission, the Commodity Futures Trading Commission, and the banking regulators under widely differing disclosure, advertising, and conflict of interest rules. We have a job underway now comparing the regulation of some of these services which we will be reporting on next year, and which I think will help lay the basis for a detailed, yet organized,understanding of whether product-line regulation is needed.

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As I mentioned earlier we are now conducting or will be starting a number of studies to help the Congress evaluate this and other regulatory structure alternatives. The overall question that will drive these studies is, "What type and mix of regulation and oversight is appropriate for each type of investment risk to assure adequate protection to investors?" The basic protections--insurance of investor funds, onsite examinations, and disclosure of information--can be altered and combined in a variety of ways to suit particular products or institutions.

Consequently, we will study, in a series of jobs

--the changes in and direction of the markets;

--the effect these have on the current regulatory structure;

--the role and structure of the various regulatory tools, including the best ways to assure adequate protections for depositors and investors;

--the nature of the risks involved with various product lines; and

--the strengths and weaknesses of alternative regulatory structures.

Although we intend to report periodically on the results of these studies over the next 2 years, we expect, as I mentioned earlier, to be able to offer valuable information to the Congress in the interim.

Mr. Chairman, that concludes my statement. We would be happy to respond to any questions you or other Committee members might have.