United States General Accounting Office

GAO

Report to the Chairman, Committee on Banking, Housing and Urban Affairs, U.S. Senate, and the Chairman, Committee on Banking, Finance and Urban Affairs, House of Representatives

March 1991

DEPOSIT INSURANCE

A Strategy for Reform

GAO/GGD-91-26

GAO
United States
General Accounting Office
Washington, D.C. 20548

Comptroller General
of the United States

B-238472

March 4, 1991

The Honorable Donald W. Riegle, Jr.
Chairman, Committee on Banking,
Housing and Urban Affairs
United States Senate

The Honorable Henry B. Gonzalez
Chairman, Committee on Banking,
Finance and Urban Affairs
House of Representatives

This report discusses issues associated with reforming the deposit insurance system. It was prepared pursuant to section 1003 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (P.L. 101-73). In conformance with the act's requirement, this report discusses changes to the deposit insurance system that will promote a safe, sound, and stable banking industry.

We are sending copies of this report to all members of the Banking Committees as well as to other appropriate congressional committees, federal banking agencies, and other interested parties.

This report was prepared under the overall direction of Craig A. Simmons, Director, Financial Institutions and Markets Issues. Stephen C. Swaim was the Project Director. Other major contributors are listed in appendix V.

Charles A. Bowsher
Comptroller General
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Executive Summary

Purpose

This report responds to the mandate contained in the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 that GAO study the nation's deposit insurance system. It discusses ways to preserve the benefits of deposit insurance while correcting the types of problems that resulted in massive taxpayer losses in the recent thrift industry crisis.

Background

Deposit insurance was initiated in the 1930s to help restore confidence in the banking system after thousands of banks failed and millions of dollars in deposits were lost during the Great Depression. Today, the federal government insures about $3 trillion in deposits in the nation's 29,000 banks, thrifts, and credit unions. This contingent liability for the U.S. government exceeds the entire federal budget for 1991.

Deposit insurance to date has fulfilled its goal of maintaining the stability of the banking system. Despite the energy price shocks and the inflation of the 1970s and the recessions, stock market drops, and regional dislocations of the 1980s, most people have not had to worry about whether their money was safe.

Unfortunately, however, insuring deposits is no longer as low risk and inexpensive as it was when markets were more stable, slow moving, and less competitive and global than they are now. When deposit insurance was established it was industry financed through low, flat-rate premiums. For the program to operate without losses to taxpayers, the system of bank regulation had to successfully limit bank failures and keep deposit insurance losses from exceeding premium income. This premise, upon which protection of the taxpayer depended, held up for almost 50 years—until the failure of hundreds of thrift institutions during the 1980s. These failures resulted in the 1989 bankruptcy of the fund that insured thrifts, which was administered by the Federal Savings and Loan Insurance Corporation (FSLIC) in one of the great financial disasters in our nation's history.

The Bank Insurance Fund (BIF), which insures deposits in commercial and some savings banks and is administered by the Federal Deposit Insurance Corporation (FDIC), is also under stress. Between 1980 and 1989, 1,085 banks failed or received assistance. In the last 3 years, 596 banks failed or received assistance. As a consequence of these failures, FDIC estimates that by year-end 1990 BIF reserves had fallen to $8.5 billion, which means that the ratio of reserves to insured deposits had reached an historical low of .43 percent. Of particular concern, more large banks are experiencing difficulty and have failed in recent years.

In September 1990, GAO reported to Congress that the Fund is too thinly capitalized relative to the exposure it faces, and that a recession could lead to a level of bank failures that would exhaust the Fund. FDIC and Congress have recognized the problem of BIF capitalization; the 1991 premium level is more than twice that of 2 years ago, and the Omnibus Budget Reconciliation Act of 1990 removed all constraints on FDIC's ability to raise deposit insurance premiums.

The problems in the banking industry are by no means identical to nor as yet as severe as those involved in the thrift failures. By and large, commercial banks are much more diversified in their activities, are not as poorly capitalized on average, and appear to be better regulated. However, GAO has found that serious weaknesses in management have contributed to the failures of many banks. Also, as was the case in the thrift industry, banks today must operate in a much more competitive environment. For example, when the deposit insurance system was established, bank loans were a major source of credit for the nation's largest corporations. Now these corporations raise much of their money directly from financial markets, thus bypassing the banks. In the years ahead the competition between banking and nonbanking firms, all of which offer similar products, can be expected to become even more intense, and the number of banks in the country is likely to decrease as a result.

The weakened condition of BIF underscores the need for reform. However, reform must be concerned with more than the Fund's current financial problems. Simply raising premiums introduces the risk of damaging healthy institutions to pay the costs of problem ones. Reform is urgently needed so that the risks inherent in banking and their associated costs are borne to a much greater degree by bank owners and managers than by the deposit insurance system. Such reform will give bank officials greater incentive to control the risks they take. The goal of reform is thus to ensure industry stability through the safe and sound operation of banks instead of through deposit insurance guarantees that result in large expenses for healthy banks and taxpayers.

Results in Brief

In considering recommendations for reform, it is important to avoid any risk of fostering a bank crisis similar to that experienced in the early 1930s. From the stock market crash in October 1929 to the bank holiday declared by President Roosevelt in March 1933, depositors in U.S. banks had a significant chance of losing some of their money. As Congress discusses what may be some of the most far-reaching bank reforms since

that time, it is imperative that such reforms not trigger a repetition of the vicious circle of vanishing confidence and financial distress that undermined our banking system nearly 6 decades ago.

GAO recommends a comprehensive three-part reform program that changes the way banks are regulated and supervised, as well as the way the deposit insurance system functions. GAO proposes

(1) strengthening supervision, bank internal controls, and financial reporting requirements so that regulators have the mandate, information, and resources they need to protect BIF from losses. In addition, regulators must take prompt action to resolve problems in all banks, but most particularly those experienced in large banking organizations, when they first are evident and to ensure that all insolvent institutions are closed promptly by sale, merger, or liquidation. It is vital that BIF be made financially sound to accomplish these objectives, and any taxpayer financing that may be required should be made conditional on the adoption of a comprehensive reform program.

(2) changing economic incentives through strengthened capital requirements, risk-based insurance premiums, and other means to ensure that owners, managers, and creditors, not the taxpayers or the insurance funds, bear most of the costs of bank failures.

(3) updating bank holding company structure and regulation to reduce risks to the banking system. These changes are also necessary preconditions to financial system modernization in the U.S. if expanded powers for banks and other financial institutions are judged desirable by Congress.

While reform is urgently needed, it must be carried out carefully and systematically to preserve industry stability. It will take time to reform a system in which the public has come to rely more heavily on the deposit insurance guarantee than the safety and soundness of banks as the basis for protection.

GAO's Analysis

The key to successful deposit insurance reform is developing incentives for bank owners, managers, and regulators to act in ways that foster a safer and sounder banking system. The reform program needs to be implemented in a coordinated way to achieve industry stability and protect taxpayer interest.

Strengthen Supervision and the Bank Insurance Fund

Currently bank regulators have the authority to take action to prevent unsafe and unsound activities, but they do not always use formal enforcement actions when they discover deficiencies. In addition, poor internal controls and inadequate financial data impede effective enforcement actions by disguising the full extent of bank problems.

GAO's review of the supervision of 72 banks that experienced capital adequacy problems in 1988 indicates that bank examiners often prefer to work informally with bank managers and directors. Examiners pursue informal channels of action partly because they lack a clear mandate and incentives to take the more forceful actions at their disposal to correct deficiencies. The informal approach does not always result in the timely, decisive actions that are needed to stop the growth of risky institutions and reduce subsequent losses. Although the goal of regulators is to close banks as soon as equity capital is exhausted, from 1985 through 1989 the losses of FDIC have averaged about 16 percent of the assets in banks with BIF insurance.

GAO's review of 39 banking organizations that failed in 1988 and 1989, including several large banking organizations with over $1 billion in assets, illustrates how important it is to seek out and address serious internal control problems. In 33 cases pervasive management problems, including inadequate supervision by a bank's board of directors, unwarranted loan concentrations, and poor loan documentation, were cited by regulators as major factors contributing to the bank's failure. One consequence of these internal control weaknesses is that managers and regulators lack accurate and timely information about the condition of insured banks. This lack of information is a particularly serious problem in large banking organizations.

GAO is particularly concerned about the ineffectiveness of bank regulation in light of the financial problems that have occurred in a number of the nation's larger banking organizations. Losses as a percentage of assets in large failed banking organizations have not been as high as those for the industry in general. Nevertheless, the increased number of large bank failures since the mid-1980s has imposed losses on FDIC that have contributed significantly to FDIC's current financial problems. The growing number of large banking organizations experiencing financial difficulty poses a major threat to the deposit insurance system in the future. Furthermore, the increasing financial vulnerability of large banking firms is a threat to the regulatory system's ability to foster financial stability and the associated confidence that it engenders.

To address the inadequacies of current regulatory incentives, Congress should require the bank regulators, in consultation with the banking industry, to develop a formal regulatory "tripwire" system that requires prompt and forceful regulatory action tied to specific unsafe banking practices. The tripwire regulations should be specific enough to provide clear guidance about what actions should be taken to address specified unsafe banking practices and when they should be taken. As examples, the regulators could impose growth restrictions on banks with lending control deficiencies, or suspend dividend payments of banks that fail to meet minimum capital levels. In this way, the mandate for more forceful regulatory action will be clear, and owners and managers of insured banking institutions will know in advance the consequences of actions that can potentially weaken the financial strength of their institutions. (See pp. 60-71.)

An important feature of the tripwire system is that the earliest tripwires enable regulators to take forceful action to stop risky practices before the capital of the bank begins to fall. When bank capital falls below the regulatory minimum it is often too late to do much about the condition of the bank or FDIC's losses.

Potential impediments to the implementation of an effective tripwire system are the frequent lack of effective internal controls and accurate information needed to identify deteriorating bank asset quality, earnings, and capital early enough to allow deficiencies to be promptly corrected. Examples of internal control deficiencies are inadequate supervision by a bank's board of directors, unwarranted loan concentrations, and poor loan documentation. These shortcomings can be mitigated by requiring (1) regulators to conduct full scope, on-site examinations of all banks at least annually; (2) regulators to develop more stringent financial reporting requirements for large, complex banking organizations and to develop the information and expertise necessary to understand those organizations so that prompt action will accompany developing problems; (3) banks to value their problem assets on the basis of existing market conditions; (4) bank managers to include in their annual reports an assessment of internal controls, and independent auditors to notify the regulatory agencies of bank internal control weaknesses and noncompliance with laws and regulations; and (5) depository institutions and their auditors to better assure compliance with safety and soundness laws and regulations and earlier identification of weaknesses in the financial health of the institutions. More stringent auditing and reporting requirements are needed for the largest

banks, the banks that pose the greatest potential danger to the deposit insurance system. (See pp. 71-75.)

Accurate and timely financial reporting by banks is critical to safe and sound bank management and operations, an effective early warning system for regulators to identify troubled banks, and to the ability of investors to make informed decisions. An essential part of accurate and timely financial reporting by banks is the presence of sound accounting and reporting rules that fairly present a bank's true financial condition. Underlying the financial reports are systems of internal controls that are the foundation for their reliability as well as safe and sound operations. Annual independent audits are an essential part of the control environment to assure the accuracy of financial reports. The absence of accurate and timely reporting by banks will continue to result in huge insurance fund losses due to the regulators' inability to promptly identify a troubled bank and institute early intervention. In addition, the absence of accurate financial reports is likely to result in poor business decisions by bank management and investors. In a similar vein, the call reports should be reviewed to be certain that the information obtained facilitates implementation of the tripwire approach.

In short, the key to successful bank regulation is knowing what banks are really worth. That requires good accounting.

To ensure that regulators have the capacity to fulfill their responsibilities, a thorough evaluation by industry experts of the best way to supervise banks is needed. This evaluation should determine how regulatory techniques and resources need to be improved to address the increasing complexity of banking. (See pp. 75-77.)

Adequate funding for the insurance fund is critical for regulators to take timely and effective action against troubled financial institutions. A bitter lesson from the thrift industry failure is that if regulators are unable to act quickly due to lack of insurance funds, the incentive becomes very strong for bank owners and managers of troubled institutions to take greater risks that could ultimately cost taxpayers dearly. Consequently, FDIC must use its new authority to raise bank premiums to recapitalize BIF. While BIF should be financed as much as possible from industry sources, it must be done in a way that does not irreparably damage healthy institutions. (See pp. 78-80.)

Change Economic Incentives

The changes GAO proposes are badly needed to strengthen bank supervision, internal controls, and financial reporting; upgrade regulatory capability; and shore up FDIC finances. However, it is unrealistic to expect even a greatly improved federal regulatory presence to always react appropriately to adverse conditions in the banking industry. For this reason bank owners and managers must take more responsibility for the safety and soundness of their institutions.

The key to increasing owner and manager responsibility is to require banks to maintain capital levels commensurate with their risk. This forces owners and managers to bear the potential losses from their activities because their investments would be the first to suffer when changes in economic conditions and poor business decisions lead to bank losses. Capital levels that reflect risk also provide a financial buffer to protect the deposit insurance system and the U.S. taxpayers. Bank risks and failures have increased considerably over the past decade, yet industry capital has not risen sufficiently to offset that risk.

To ensure that banks are adequately capitalized, strengthened minimum capital levels are needed. At present, the U.S. banking system is in the process of implementing a risk-based minimum capital standard which was developed under an international agreement among 12 industrialized countries. This standard, known as the Basle standard, is to be fully implemented at the end of 1992. At that time GAO believes that strengthened capital standards should be gradually phased in, to the extent possible, in connection with further international agreements. Among other things, the strengthened standards should require a larger role for subordinated debt in large bank funding. (See pp. 83-95.)

Owner/management incentives to control risk can also be strengthened by implementing a system of risk-based deposit insurance premiums to supplement risk-based capital requirements. As currently structured, all insured institutions pay the same premium for deposit insurance, regardless of risk. By varying premiums according to risk, the burden on well-capitalized, well-managed banks of financing resolutions of failed banks will be reduced and transferred to those that put the FDIC fund at greatest risk. (See pp. 95-96.)

One of the biggest abuses of the deposit insurance system is that risky, and sometimes insolvent, banks have easily attracted large volumes of deposits, including deposits from all over the country placed by brokers and professional money managers, simply by offering to pay higher interest rates to depositors. This has occurred because depositors, often

including uninsured ones, are confident that they will be protected if the banks fail. An essential step in stopping such abuses is for regulators to implement the tripwire proposal. By acting when problems are first identified, regulators can prevent banks that are poorly capitalized or that have weak internal controls from growing or from offering high rates of interest to attract deposits.

Another suggested way to encourage bank managers to be more concerned with the safety and soundness of their institutions would be to increase the probability that uninsured depositors in large banks would suffer losses in the event of a bank failure. However, due to the current stresses in the banking industry and the dependence many large banks have on uninsured sources of funding, GAO does not believe that placing all uninsured depositors or general creditors at greater risk is wise at this time. The potential consequences of such actions on the stability of the nation's financial system are simply unacceptable. (See pp. 96-99.)

Currently, as a result of the way failed banks are resolved, owners and managers suffer losses while uninsured depositors are usually fully protected. (Between 1985 and 1989 uninsured depositors did, however, lose an estimated $100 million in the failure and subsequent liquidation of some small banks.) The protection uninsured depositors and other general creditors have received, particularly in large banks, occurs because regulators believe such protection is essential to maintain the stability of the banking system. This systemic stability requires the continuity of banking services in the national and international economy. Uninsured depositors and other non-insured liabilities fund approximately 40 percent of all U.S. bank assets and are an even more significant funding source for many larger U.S. banking institutions. Furthermore, 10 of the top 25 banks in the country rely on uninsured liabilities for over 60 percent of their funding. The consequences that the actions of these uninsured depositors and creditors might have on systemic stability cannot be ignored.

The near-term reforms GAO is recommending to increase the incentives for bank managers to be more concerned with the safety and soundness of their institutions do not depend on placing uninsured depositors at greater risk or on cutting back deposit insurance coverage. Instead, GAO's recommendations, with respect to the treatment of uninsured depositors, rely on (1) implementing the aforementioned tripwire system, better scrutiny of large complex banking organizations; and other regulatory reforms, (2) requiring disclosure of more accurate information about banks, and (3) providing all uninsured depositors

with options for protecting their deposits. These three reforms would affect banks of all sizes, but the first two are likely to have their biggest impact on larger banks that are having difficulty maintaining adequate capital.

Allowing depositors to protect deposits over $100,000 could be accomplished in several ways. For example, depositors could be provided the opportunity to collateralize uninsured deposits with low-risk assets, such as Treasury securities, held by the bank. A second option would allow depositors to purchase additional FDIC insurance through their banks to cover those deposits. (See pp. 99-101.)

In the future, when the banking system is stronger and reforms have been adopted, GAO favors removing insurance coverage from brokered deposits and perhaps other accounts placed by professional money and pension fund managers. It may also then be possible to more consistently place at greater risk those uninsured depositors who are willing to accept higher risks in return for higher yields on their deposits. In the final analysis, however, it will probably be necessary, in some cases, to protect uninsured depositors in our largest financial institutions in the event of their failure to ensure the continued stability of the financial system.

Consequently, GAO believes that, even in the long run, a formal policy requiring FDIC to follow a least-cost resolution method and impose losses on all uninsured depositors under all circumstances would not be wise. Instead, the Federal Reserve, in conjunction with FDIC, should be given the ability to determine, on the basis of circumstances at the time, whether imposing losses on uninsured depositors in a failed bank would be detrimental to the stability of the U.S. financial system. If such a determination is made, failing banks declared essential could be resolved in ways that protect uninsured liabilities. GAO is uncertain how often such intervention would be needed but does believe that, if the other steps it is recommending are implemented, such intervention should become the exception, not the rule. (See pp. 101-103.)

Update Bank Holding Company Structure and Regulation

The regulation of the U.S. financial system has not kept pace with changes in domestic and global financial markets. As of June 30, 1990, bank holding companies controlled about 70 percent of the banks and 93 percent of the assets in the nation's banking system. Restrictions on the activities and geographic expansion of these organizations are being

eroded in an ad hoc manner as federal and state regulators and legislators have moved to allow them to adapt to advances in U.S. and global financial markets and to cross state lines. These changes may have provided benefits to some banking organizations and their customers, but the changes also involve dangers to the deposit insurance system and other aspects of the nation's financial system. As banking organizations have expanded into new activities, the responsibility of bank holding company owners and managers to protect the deposit insurance system from losses has become increasingly ambiguous. Furthermore, legal protections for consumers of bank products have not kept pace with the wider variety of products that can be offered through banks.

The need to strengthen regulatory arrangements in the current environment is clearly evident in interstate banking. Currently, principally as a result of interstate compacts, all but 4 states permit some form of interstate banking, and 27 states permit banking organizations from any part of the country to operate within their boundaries. This expansion has provided many banking organizations with the opportunity to diversify their risks and the services they offer, and further developments along these lines through elimination of restrictions on interstate branching could, on balance, be beneficial. However, GAO is concerned that in today's stressful banking environment, the regulators may seek to delay dealing with problem situations by allowing weak banks to expand through interstate mergers. To be sure that further expansion of interstate banking does not damage healthy banks or place FDIC at risk, GAO believes Congress needs to make it clear in statute that only well-capitalized, well-managed banks can expand through interstate banking arrangements. The tripwire system mentioned above provides regulators with a relatively objective basis for identifying problem institutions that should not be allowed to expand. (See pp. 109-113.)

A number of additional changes to the regulation of bank holding companies should be implemented immediately to rectify current regulatory inadequacies, to better protect the deposit insurance fund from loss, and to provide other protections to the public. These include

- requiring the holding company to serve as a source of strength to its bank subsidiaries by guaranteeing the banks' capital levels at required minimums,
- strengthening safeguards involving transactions between banks and other parts of the holding company to ensure that insured deposits are not used to finance nonbanking activities, and

- providing adequate disclosure on products sold through banks in order to protect consumer interests. (See pp. 113-123.)

GAO has no firm evidence that indicates the extent to which the banking industry or consumers of financial services might benefit from allowing banking organizations access to nontraditional lines of business, and therefore, views any decision on expanded powers as essentially a judgmental one.

If Congress decides to approve expanded bank powers once all of the above improvements are made, such approval should be subject to the following conditions: (1) allow new powers only in independent holding company subsidiaries whose transactions with banking affiliates are limited, (2) ensure adequate regulatory resources to supervise any expansion of powers; (3) allow reciprocal powers for nonbanking organizations if new powers are authorized for banks; (4) provide safeguards against unwarranted concentrations in the financial services sector; and (5) create a regulatory board to set rules that would apply to all diversified financial holding companies associated with banks. Members of the board should include the Chairmen of the Federal Reserve Board and the Securities and Exchange Commission (SEC) and the Secretary of the Treasury. (See pp. 123-141.)

Expanded powers should be approved on a case-by-case basis only for well-capitalized banking organizations that have also demonstrated adequate internal controls. Finally, all holding companies affiliated with an insured commercial bank should be required to serve as a source of strength for such banks and should be subject to consolidated capital requirements and consolidated regulation in order to ensure the holding company's financial stability.

GAO does not support allowing commercial firms to acquire banking organizations. Not enough is known about what would happen if the new conglomerates established by such a policy were to experience financial difficulty and possibly create the need for megabailouts.

Recommendations

GAO's recommendations to Congress are in three parts.

Part I: Strengthen Supervision and the Bank Insurance Fund

- ensure sufficient funding for the Bank Insurance Fund (see p. 81.);
- require the bank regulators to develop a tripwire approach to bank regulation that obligates them to take early and forceful regulatory action tied to specific unsafe banking practices (see p. 81.);
- improve information available to the regulators by requiring annual full-scope on-site examinations for all banks, more accurate information on the true financial condition of banks, and by enacting legislation to require and strengthen financial audits and communication between independent auditors and regulators (see pp. 81-82);
- emphasize closer regulatory scrutiny of large complex banking organizations, including more stringent financial reporting requirements and enhancement of the expertise necessary to understand and quickly react to problems as they develop (see p. 81); and
- ensure that bank regulators have a sufficient number of properly skilled examiners by authorizing a panel appointed by the President and Congress to undertake a thorough analysis of regulatory resource requirements and capabilities (see p. 81).

Part II: Change Economic Incentives

- require bank regulators to phase in strengthened, risk-based capital requirements—that mandate, among other things, an increased role for subordinated debt in large bank funding—after the Basle capital accord has been implemented fully in 1992 (see pp. 106-107);
- require FDIC to implement a system of risk-based premiums (see p. 107);
- require FDIC to develop options that would protect deposits over $100,000 in return for lower rates of return. Such options could include allowing depositors to collateralize deposits over $100,000 with low-risk bank assets or to purchase additional FDIC deposit insurance through their banks (see p. 107);
- direct bank regulators to require improved public disclosure of bank information (see p. 107); and
- consider, over the long term, requiring that banks be closed in the least costly manner and give the Federal Reserve, in conjunction with FDIC, the ability to determine when losses on uninsured deposits due to the failure of a large bank would be detrimental to the stability of the U.S. financial system. In such cases a failing bank could be resolved in a manner that would not impose losses on all uninsured deposits (see p. 107).

- eliminate, over the long term, deposit insurance coverage on brokered deposits and perhaps other deposits placed by professional money or pension fund managers (see p. 107).

Part III: Update Bank Holding Company Structure and Regulation

- phase out the McFadden Act and sections of the Douglas Amendment to the Bank Holding Company Act of 1956 that restrict interstate banking, but require that such expansion will be permitted only for banks that are well capitalized and well managed (see p. 143); and
- improve bank holding company regulation to protect the safety and soundness of the U.S. financial system by:
  - requiring the holding company to serve as a source of strength to its bank subsidiaries;
  - strengthening safeguards involving transactions between banks and other parts of the holding company; and
  - providing adequate disclosure relating to bank products to protect consumer interests (see p. 143).

If Congress decides to expand powers for banks, GAO recommends a phased-in approach that

- requires that only well-capitalized, well-managed bank holding companies be given access to expanded bank powers on a case-by-case basis (see p. 143);
- restricts expanded powers to nondepository subsidiaries of bank holding companies and restricts transactions between those subsidiaries and affiliated banks to ensure that insured deposits are not used to finance expanded powers (see p. 143);
- allows nondepository financial institutions to acquire banks but requires such institutions to act as sources of financial strength to their banks and other regulated subsidiaries. All financial institutions affiliated with commercial banks should be subject to consolidated capital requirements and regulation (see p. 143),
- requires controls on the sharing of confidential customer information among holding company entities (see p. 143);
- creates an interagency board, consisting of the Chairman of the Federal Reserve Board, the Chairman of the SEC, and the Secretary of the Treasury, to promulgate regulations that ensure consistent and safe financial services holding company regulations (see p. 143); and
- restricts the ability of financial institutions to merge, where the result would be an overly concentrated financial industry (see p. 144).

Major Components of GAO's Three-Part Strategy for Deposit Insurance Reform

Part I: Strengthen Supervision and the Bank Insurance Fund	• Ensure adequate funding for the Bank Insurance Fund. • Implement a tripwire approach to bank regulation that requires prompt regulatory action tied to specific unsafe banking practices. • Require annual, full-scope, on-site bank exams. • Require closer scrutiny of large complex banking organizations. • Improve accounting standards and internal controls, and require annual independent financial audits and other related reforms for all banks. • Authorize a panel appointed by the President and Congress to analyze resources and capabilities of bank regulators.
Part II: Change Economic Incentives	• Phase in strengthened, risk-based capital requirements, including an increased role for subordinated debt in large bank funding. • Implement risk-based deposit insurance premiums. • Develop options allowing depositors to protect deposits over $100,000. • Improve public disclosure of information on a bank's financial health. • Consider, over the long term, requiring that banks be closed in the least costly manner, but give the Federal Reserve, in conjunction with FDIC, the ability to determine whether protecting uninsured liabilities in individual bank failures is essential to systemic stability. • Phase out insurance coverage of brokered deposits and perhaps other professionally managed accounts.
Part III: Update Bank Holding Company Structure and Regulation	• Phase out restrictions on interstate banking but limit expansion to healthy banks. • Require bank holding companies to financially support their bank subsidiaries. • Strengthen restrictions on bank/affiliate transactions within bank holding companies. • Improve disclosure of bank/bank holding company product characteristics to consumers of those products. If Congress approves expansion of bank powers, • Phase in such powers only for well-capitalized, well-managed bank holding companies. • Restrict expanded activities to nondepository bank holding company subsidiaries. • Allow nondepository financial institutions to acquire banks, but must serve as sources of financial strength for their bank subsidiaries and be subject to consolidated regulation and capital requirements.

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Figures

Abbreviations

AICPA	American Institute of Certified Public Accountants
BIC	bank investment contract
BIF	Bank Insurance Fund
CD	certificate of deposit
CAMEL	capital adequacy, assets quality, management, earnings and liquidity
FASB	Financial Accounting Standards Board
FDIA	Federal Deposit Insurance Act
FDIC	Federal Deposit Insurance Corporation
FIRREA	Financial Institutions Reform, Recovery and Enforcement Act of 1989
FSLIC	Federal Savings and Loan Insurance Corporation
GAAP	Generally Accepted Accounting Principles
GIC	guaranteed investment contract
GNP	gross national product
IBF	international banking facility
IRA	individual retirement account
MMDA	money market deposit account
MMMF	money market mutual fund
NCUA	National Credit Union Administration
NCUSIF	National Credit Union Share Insurance Fund
NOW	negotiable order of withdrawal
OCC	Office of the Comptroller of the Currency
OECD	Organization of Economic Cooperation and Development
OTS	Office of Thrift Supervision
P&A	purchase and acquisition
REIT	real estate investment trust
ROE	return on equity
SAIF	Savings Account Insurance Fund
SEC	Securities and Exchange Commission
SIPC	Securities Investor Protection Corporation

Introduction

This report responds to the mandate contained in the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) that we study the nation's deposit insurance system. It discusses ways to preserve the benefits of deposit insurance while correcting the types of problems that resulted in massive taxpayer losses in the recent thrift industry crisis.

Background

Federal deposit insurance for commercial banks and many savings banks was first authorized in 1933 and became operational in 1934. The program was also extended to thrifts—savings and loan associations—in 1934. Credit unions were first covered in 1970.

From the outset Congress sought, through deposit insurance, to restore confidence in the nation's banks and bring stability to a banking system that had virtually collapsed during the Great Depression of the 1930s. Many banks failed not only because they had made loans that were not repaid, but also because a large portion of their depositors tried to withdraw their money at once, causing what is known as a bank run.[1] This loss of depositor confidence in the banking system contributed to the severity of the Depression. Because banks had fewer deposits, and were fearful of bank runs, they were less able and willing to make loans that would help create jobs.

The importance attached to a stable banking system reflects both the special role that deposits and depository institutions play in the economy and the risks inherent in such institutions. The public puts money in banks for safekeeping, for transactions, and for the interest that can be earned on deposits.[2] It expects a significant portion of these funds to be available immediately upon demand. By using some of the money deposited with them to extend credit to homeowners, consumers, businesses, and governments, depository institutions play an important intermediary role in helping to channel the nation's supply of liquid financial assets into longer-term productive uses. Consequently, they

[1]When runs occurred, many banks failed because they lacked sufficient liquid assets to meet the surge in demand for deposit withdrawals; the banks could neither borrow money to fund the withdrawals nor sell their other assets quickly at a high enough price.

[2]Deposits, along with currency, constitute by far the largest component of most measures of the nation's money supply. Technically, deposits in banks and thrifts are liabilities of those institutions redeemable at par, either on demand or at a specified time in the future. Deposits in credit unions are ownership shares rather than liabilities, but in practice, they too are redeemed at par in the same way as bank deposits.

bear a significant liquidity risk associated with their use of short-term deposits to fund longer-term investments.

Another significant risk associated with depository institutions is that borrowers may not be able to repay their loans. Loan defaults can be attributed to various factors, including economic downturns and poor judgment and management practices. Interest rate volatility also poses substantial risk if depository institutions are forced to pay more for short-term deposits on which interest rates are adjusted frequently than they earn from loans and other investments with fixed, long-term returns.

In a healthy bank, the costs associated with these risks are reflected in prices charged for bank services and are, therefore, normally offset by earnings. Furthermore, if equity capital adequately reflects risk, (i.e., the greater a bank's risk the higher its capital level as a percentage of assets), then losses resulting from risk should be absorbed by bank owners. Deposit insurance protects depositors in failed banks if bank capital is not sufficient to absorb the losses.

The original limit of $2,500 per insured account was quickly raised to $5,000 in 1934 when thrift coverage was enacted. The limit has been raised six times since then. The current $100,000 limit was set in the Depository Institutions Deregulation and Monetary Control Act of 1980.

Today, the deposit insurance program is administered by two federal agencies, the Federal Deposit Insurance Corporation (FDIC) and the National Credit Union Administration (NCUA). FDIC administers two separate funds—the Bank Insurance Fund (BIF), which insures deposits in commercial banks and some savings banks, and the Savings Account Insurance Fund (SAIF), which protects deposits in savings and loan associations and other thrift institutions.[3] Accounts in credit unions are insured by NCUA's National Credit Union Share Insurance Fund (NCUSIF). In FIRREA and prior enactments, Congress has reaffirmed that federally insured deposits are backed explicitly by the full faith and credit of the U.S. government.

[3]SAIF is currently accepting premiums from thrifts, but expenses for the resolution of failed thrifts, except for those chartered after FIRREA was enacted, will be covered by the Resolution Trust Corporation, which is responsible for resolving thrift failures until August 9, 1992.

Information on Depository Institutions and Deposits

As of June 30, 1990, there were about 29,000 depository institutions in the country. These institutions held roughly $5 trillion in loans and other assets. Approximately two-thirds of the total—$3.4 trillion—was held by about 12,500 commercial banks. (See table 1.1.)

Table 1.1: Assets Held by Depository Institutions, as of June 30, 1990

Dollars in billions

Type of institution	Number of institutions	Amount of assets	Percent of total depository institution assets
Commercial banks	12,502	$3,360.0	66.7
BIF-insured savings banks	461	233.4	4.6
Other savings banks and thrifts[a]	2,878	1,251.7	24.8
Credit unions	13,102	195.3	3.9
Total	**28,943**	**$5,040.4**	**100.0**

[a]Data are as of December 31, 1989, for SAIF-insured institutions and institutions in RTC conservatorships.

Source: GAO analysis of call report data.

Depository institutions vary greatly by size. Most are relatively small institutions —less than $500 million in assets, while the largest commercial banks rank among the nation's largest and most complex multinational companies. The 57 depository institutions with assets over $10 billion control roughly 30 percent of the assets in depository institutions. (See table 1.2.) The financial health of these large institutions is of particular concern because the failure of one or more of them may be great enough to affect the stability of the banking system.

Table 1.2: Asset Size of Depository Institutions, as of June 30, 1990

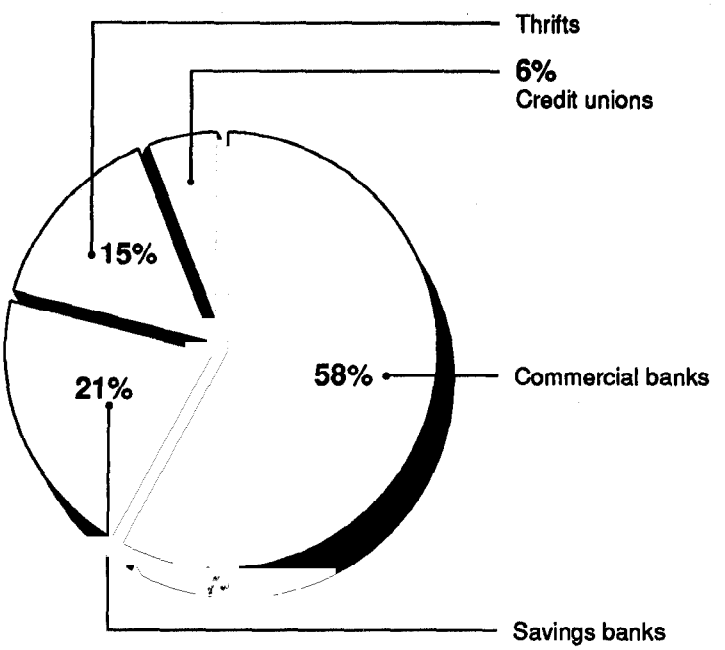
	Number of Institutions			Percent of deposit industry assets in categories
	Commercial banks	Savings banks and thrifts[a]	Credit unions	
Greater than $50 billion	7	0	0	11.7
$10-$50 billion	38	12	0	19.2
$1-$10 billion	327	268	5	35.5
$500 million -$1 billion	245	245	23	7.0
$50 million -less than $500 million	5,124	1,967	752	21.2
Less than $50 million	6,761	847	12,322	5.4

[a]Data for thrifts are as of December 31, 1989.

Source: GAO analysis of call report data.

Federal agencies estimate that as of June 30, 1990, the U.S. government insured just under $3 trillion in deposits and credit union shares. Of this total, commercial banks held 58 percent, thrifts and BIF-insured savings banks held 36 percent, and credit unions held 6 percent. (See fig. 1.1.) Additional information on deposits is contained in appendix I.

Figure 1.1: Insured Deposits Held by Depository Institutions, as of June 30, 1990



Of savings banks total, $405 billion was covered by SAIF, and $203 billion was covered by BIF.

Source: FDIC; OTS; and NCUA.

In addition to insured deposits, funding sources for depository institutions include domestic deposits over $100,000, foreign deposits, various non-deposit liabilities and capital. Among depository institutions, commercial banks, particularly the largest 45, most frequently used uninsured deposit liabilities. (See table 1.3.)

Table 1.3: Uninsured Deposits and Non-deposit Liabilities of Commercial Banks, as of June 30, 1990

Dollars in billions

	Top 45	Industry total	Amount in top 45 banks as a percent of industry
Time deposits >$100,000	$139.0	$392.1	35.5
Foreign deposits	291.8	330.0	88.4
Fed funds purchased	84.1	167.4	50.2
Repurchase agreements sold	38.5	100.7	38.2
Demand notes	14.6	28.6	51.0
Other borrowed money	75.3	121.8	61.8
Mortgage indebtedness	1.0	2.2	45.5
Acceptances outstanding	20.3	23.9	84.9
Other liabilities	61.3	91.9	66.7
Subordinated debt	15.0	19.7	76.1

Note: The top 45 are banks with assets in excess of $10 billion.
Source: GAO analysis of call report data.

Sufficient Bank Capital, Effective Regulation, and Adequate BIF Financing Are Needed to Protect Taxpayers From Loss

Deposit insurance creates a very large contingent liability for the federal government as exemplified by the fact that the $3 trillion in insured deposits greatly exceeds the entire 1991 federal budget. This exposure creates the potential for the federal government and taxpayers to sustain significant losses if numerous, high-cost bank failures occur.

The potential for losses to the taxpayer exists in part because the deposit insurance funds were never intended to be funded at a level that would create reserves sufficient to cover heavy losses from large numbers of bank failures. The program traditionally has been financed by relatively low, flat-rate premiums that, until the late 1980s, did not exceed .083 percent (8.3 basis points) of total domestic deposits.

Through the use of premium rebates, the FDIC was required to maintain the insurance fund at no less than 1.16 percent and no more than 1.40 percent of total insured deposits. Such premium rebates were given regularly until 1985. FIRREA established a designated minimum reserve ratio of 1.25 percent that could climb to a maximum 1.50 percent if FDIC determined that BIF faced significant losses. The Omnibus Budget Reconciliation Act of 1990 removed the 1.50 percent ceiling on the designated reserve ratio.

The insurance funds are protected by a regulatory system intended to reduce bank risk-taking and failures. This system includes regulation at

both federal and state levels. Federal and state laws define allowable activities for depository institutions, and federal and state regulatory authorities grant charters that can only be revoked by these same agencies. Discount loans from the Federal Reserve System, the nation's central bank, are also available to help banks deal with liquidity problems that otherwise could destabilize the banking system.[4]

The combination of federal and state chartering and regulatory agencies results in an administratively complex environment for managing deposit insurance risks. For example, within each industry component, rules differ between state and federally chartered institutions.[5] All federally insured depository institutions are, however, examined by a federal agency.[6] The Office of the Comptroller of the Currency (OCC), FDIC, and the Federal Reserve System employ a total of approximately 5,000 examiners and spend roughly $500 million annually in supervising and regulating BIF-insured banks and savings banks.

How Insolvent Institutions Are Closed

Depending on the charter, OCC or a state banking authority has the power to close a banking institution. When banks fail, FDIC is almost always appointed receiver and has several options for handling the affairs of a failed institution. It can liquidate the bank, it can sell some or all of the failed bank to another bank, it can arrange a merger, or, in some cases, it can provide assistance to keep the bank open. FDIC can also set up a bridge bank that is operated under federal auspices in cases where a bank is too large to be resolved quickly.

[4]The Federal Reserve discount window, which together with deposit insurance and bank regulation comprises the "federal safety net," protects the deposit insurance funds and taxpayers from loss by maintaining systemic stability. The availability of borrowed reserves at the discount window permits individual depository institutions, as well as the depository system as a whole, to adjust to sizable fluctuations in deposits and loan demand. This provision of credit is intended to deal both with seasonal fluctuations in the demand for transaction balances at depository institutions and with liquidity problems. In addition to having access to the Federal Reserve, thrift institutions can borrow from Federal Home Loan banks, and credit unions from the Central Liquidity Facility administered by NCUA.

[5]For example, certain state-chartered banks are permitted to sell life insurance while most national banks are not.

[6]OCC charters and supervises 4,058 national banks with about $2 trillion in assets. The Federal Reserve supervises 1,017 state-chartered banks with $567 billion in assets that are members of the Federal Reserve system. FDIC supervises 7,420 state non-member banks, 18 federal savings banks, and 460 state savings banks with a total of $1.1 trillion in assets. OTS supervises all federally insured federal and state savings associations. NCUA supervises all federally insured federal and state credit unions.

Since the 1960s, FDIC has handled most failed banks by selling some or all of the failed banks' assets through what are known as purchase and assumption (P&A) transactions. This type of transaction is significant because it generally protects all depositors—insured and uninsured—from loss. Such protection is afforded because all of the failed institutions' funding liabilities are assumed by another institution with FDIC assistance. Owners and stockholders are not generally protected in such transactions.

The decision about the type of failed bank resolution method FDIC will pursue depends, in most instances, on a cost test conducted by FDIC.[7] FDIC uses the P&A method if it is a cheaper alternative than liquidation, which FDIC has generally found to be the case.[8] FDIC can, however, disregard the cost test if it finds that protecting all of the bank's liability holders is essential to providing adequate banking services to the community.[9] As a result of FDIC's preference to use the P&A, an estimated 99.6 percent of all deposits—insured and uninsured—were fully covered in bank failures from 1985 through 1989, although an estimated 32 percent of the uninsured deposits that remained in the banks when they were actually closed suffered losses.[10] While FIRREA gave FDIC authority to vary the amounts of protection given to different classes of uninsured claimants, including uninsured depositors, FDIC does not have a general policy in P&A transactions about how different classes of uninsured claimants will be treated.

[7]Pursuant to Section 13(c) of the Federal Deposit Insurance Act, (FDIA), the cost test requires that assistance provided in connection with a failing or failed bank must not exceed the cost of a payoff and liquidation of the institution. The cost test does not require the FDIC to choose the least costly option among the nonpayoff options available but does require FDIC to estimate the ultimate cost to the public.

Application of the cost test has resulted in a higher probability that larger institutions will be handled in a way that pays general creditor claims in full. This occurs for several reasons, such as larger institutions tend to have larger relative franchise values, and the FDIC is likely to become involved earlier with publicly traded companies. With the passage of FIRREA, FDIC's maximum legal liability to uninsured depositors and creditors is that amount they would have received in a liquidation, regardless of the type of resolution option chosen. FDIC can prorate losses among uninsured depositors and creditors of a failed institution in connection with a P&A transaction.

[8]P&As and approaches that did not involve liquidation were used to resolve 708 of the 896 cases (79 percent) that FDIC handled from 1985 through 1989.

[9]Since 1980 FDIC has invoked what is known as the essentiality provision (section 13(c) of the FDIA) a total of four times. The most recent example involved the Bank of New England.

[10]Failed banks that were closed during this period had, at the time the regulators took action, an estimated $85 billion in deposits of which about $10 billion (1.2 percent) were uninsured. Of the uninsured deposits, $711 million (68 percent) were also protected in full, and an estimated $335 million (32 percent) suffered losses. In most instances, it is likely that there had been additional uninsured deposits in the banks that were withdrawn before the banks were closed.

Insurance Losses and Costs Increased Significantly During the 1980s

Without question, the deposit insurance program has been successful in instilling public confidence in the banking system. This has been particularly evident in the last two decades. Despite the energy price shocks and inflation of the 1970s, recessions, stock market drops, regional dislocations, and well-publicized problems in the thrift and banking industries that have occurred over the past decade, most people have not had to worry about whether their money was safe.

In the 1980s, however, losses in the credit union, thrift, and banking industries have demonstrated that insuring deposits can be very expensive. During this period depository institutions failed in record numbers. In the case of thrifts, insurance losses have spilled over to the taxpayer.

Turning first to credit unions, due principally to losses suffered during the severe recession in the early 1980s and despite the doubling of premiums in 1983, the level of reserves in NCUSIF never rose above about .3 percent of deposits. In 1984, Congress authorized all federally insured credit unions to deposit 1 percent of their insured shares in NCUSIF to recapitalize the fund. Since the recapitalization, industry losses have been within the fund's capacity.

Thrift losses mounted sharply throughout the 1980s and, despite a doubling of premiums and a special $10.8 billion recapitalization program, bankrupted the Federal Savings and Loan Insurance Corporation (FSLIC), the agency responsible for insuring thrifts until 1989. From August 1989 through December 1990, a total of 531 thrifts with about $271 billion in assets failed. The Office of Thrift Supervision estimates that another 179 thrifts will fail and that 356 institutions may lack sufficient financial resources to avoid insolvency. We estimate that, including financing costs, the thrift failures could ultimately cost the American taxpayers $400 billion to $500 billion.[11]

Many reasons have been cited for the numerous thrift failures. Some of these have to do with changes in the financial markets that subjected all institutions, including specialized housing lenders, to intensified competition. Others include the periods of inflation, recession, and fluctuating interest rates that occurred in the economy. The thrift industry was

[11]This estimate includes net cash outlays needed for FSLIC's assistance transactions and for institutions that RTC must resolve; RTC's administrative expenses through December 1996, when it is scheduled to be terminated; interest expense on bonds issued by the Financing Corporation, interest expense on bonds issued by the Resolution Funding Corporation to fund the resolution of insolvent thrifts, and monies for SAIF and potential post-RTC resolutions. Borrowing costs associated with the Treasury's contributions to the resolution effort are not included in the estimate.

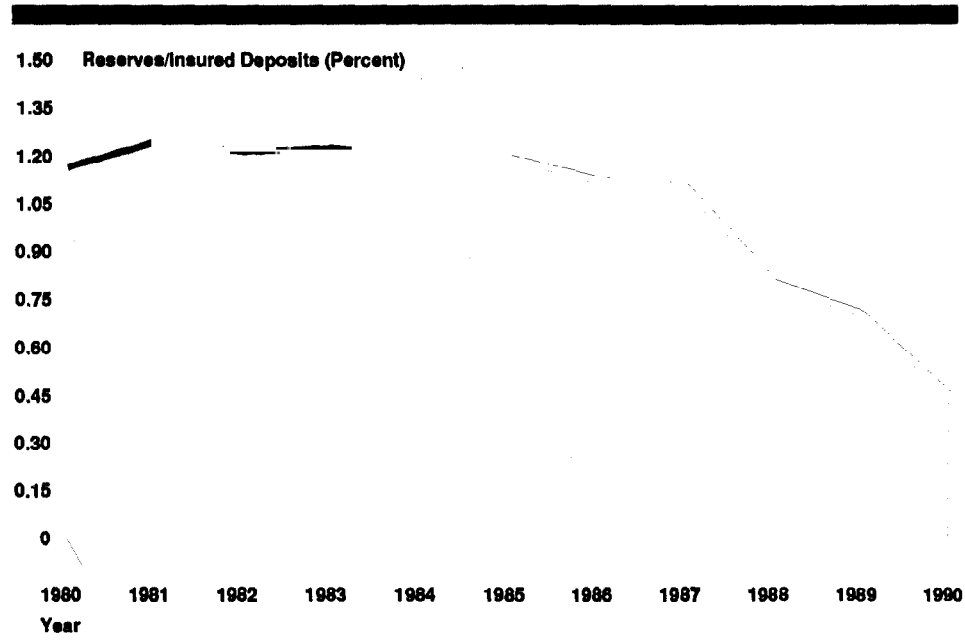
damaged badly by high interest rates in the late 1970s and early 1980s; the high rates reduced the value of their fixed-rate mortgages that constituted the bulk of their assets. The industry also experienced asset quality problems. However, the problems reached the scale they did because thrifts did not have nearly sufficient capital to absorb risks, the system of thrift regulation and supervision was woefully inadequate, and the insurance funds did not have adequate reserves.

The safeguards protecting taxpayers broke down completely when thrift regulators were unable to close insolvent institutions because FSLIC did not have enough money. This encouraged owners and managers of insolvent or unhealthy thrifts to take even greater risks with insured deposits. We estimate that, on a present-value basis, the loss to taxpayers was equal to about 10 percent of the value of insured deposits that existed at the end of 1986 when the industry first began recording its precipitous decline. This level of loss is astonishing in a deposit insurance program once thought to involve relatively little risk to taxpayers. By way of contrast, the level of loss suffered during the Great Depression by depositors in commercial banks before the deposit insurance system was enacted is estimated to have been 1 percent of total deposits.[12]

Bank failures also occurred at record rates during the 1980s. In the years 1985 through 1989, almost 900 FDIC-insured banks with a total of $109 billion in assets were closed or received financial assistance from FDIC. This figure includes 12 large banks that had more than $1 billion in assets, a sharp increase in large bank failures over earlier periods. This is of particular concern because large bank failures pose a major threat to the solvency of the Fund. Failed bank resolutions during this 5-year period will cost FDIC an estimated $17 billion. These insurance costs placed significant financial demands on the Bank Insurance Fund, which incurred a $4.2 billion net loss in 1988, the first loss since FDIC's inception. BIF lost $852 million in 1989 and an estimated $4 billion more in 1990. The cumulative effect of these losses reduced BIF's reserve to about $8.5 billion by the end of 1990. This reserve represents .43 percent of insured deposits, the lowest ever for the BIF or its predecessor. (See fig. 1.2.)

[12]For an explanation of depositor losses in the early 1930s, see p. 97.

Figure 1.2: FDIC Reserves as a Percentage of Insured Deposits, 1980 to 1990



Source: FDIC.

BIF net losses have continued despite a sharp increase in deposit insurance premiums. Pursuant to authority granted by FIRREA, FDIC has more than doubled the premiums on banks—from 8.3 basis points in 1989 to 19.5 basis points for 1991—and the premiums may go still higher because the ceiling on the premiums was removed by the Omnibus Budget Reconciliation Act of 1990.

Why Reform Is Necessary

Reform is necessary to maintain industry stability without imposing a huge deposit insurance bill on the taxpayers or on healthy banks. The need for reform is particularly urgent due to BIF's weak financial condition and stress in the commercial banking industry.

Despite the large number of commercial banks that have failed in the past several years, many problem banks remain. At year-end 1990 there

were 1,012 problem 4- and 5-FDIC-rated commercial banks,[13] with assets of about $342 billion (about 10 percent of the industry assets). An even larger number of banks—over 1,370 (about 11 percent of the industry), including one fifth of all banks with assets over $10 billion—were unprofitable in September 1990. While not all of these problem or unprofitable banks will fail, many more bank failures—and further reductions in the insurance fund—are probable, especially if the recession that has developed becomes severe.

Given the weak condition of BIF and the stresses present in the industry, making sure BIF has enough money must be part of any comprehensive deposit insurance reform program. However, our concerns about BIF involve more than simply the amount of losses that might be associated with bank failures, although that is clearly important. An inadequately financed deposit insurance program may have adverse effects on the behavior of both regulators and industry officials. As BIF reserves decline, regulators could well be tempted to defer action by not closing insolvent banks promptly. This, in turn, could send a signal to the industry that it is possible for weak institutions to take on additional risk in order to try to gamble their way out of problem situations. Such a disastrous syndrome was the final undoing of FSLIC.

Ensuring that BIF has enough money is, however, only a stopgap measure. Even if raising premiums can successfully help shield taxpayers from losses, this imposes high costs on healthy banks and does not confront the need for fundamental reform. The goal of fundamental reform must be to maintain market stability while forcing bank owners and managers to bear the costs of the risks they take.

Reform is made necessary by the nature of the changes that have occurred in the banking industry since deposit insurance was enacted. Until a generation ago, banking was in many ways a protected industry. Entry was restricted, no interest was paid on demand deposits, and the Federal Reserve's Regulation Q controlled rates that could be paid on

[13]After each regulatory examination, the examiner assigns a rating—referred to as the CAMEL rating—based on combined ratings for each of the following factors: adequacy of capital, quality of assets, performance of bank management, level and composition of earnings, and level of liquidity. The rating scale is from 1 through 5, with 1 representing the highest rating and, consequently, the lowest level of supervisory concern. A 5 rating represents the most critically deficient level of performance and, therefore, the highest level of supervisory concern. A 4-rated bank has serious financial weaknesses and potential unsafe and unsound conditions that, if not effectively addressed, could impair the bank's viability and pose a potential for disbursement of funds by BIF.

other deposits. The barriers between banking and other financial services were clear, and there was little direct competition from foreign firms.

Currently, most of these protections, which helped deflect risk away from banks and protect the deposit insurance system, have been stripped away or significantly diminished by changed regulations, advances in technology, and other factors. On the whole, banking is subject to more competition and risk. Not only do banks compete with each other in a deregulated environment, but virtually every service they offer—whether it involves taking money in or lending it out—has close substitutes offered by nonbanking firms, many of which tend to have lower operating costs than banks. Thus, bank profits are being squeezed because, for example,

- large, blue-chip companies can bypass banks and go directly to the securities market to finance their operations;
- money market and cash management funds offer what amount to interest-bearing checking accounts that have much lower costs than typical bank accounts due to lower overhead and the absence of costs associated with deposit insurance premiums, required reserves, or bank-capital adequacy requirements;
- a wide variety of nonbanking firms are active in consumer credit and mortgage lending; and
- insurance and securities companies offer a variety of tax-deferred savings products that compete with bank certificates of deposit.

Changes in bank structure have occurred as well. The number of large banks has increased. Furthermore, most banks are now owned by bank holding companies, some of which are complex financial services conglomerates that also provide banking-related services outside of the banks they control.[14] In addition, U.S. financial institutions are facing increased competition from foreign institutions in both domestic and foreign markets. These foreign firms operate in a regulatory environment that differs significantly from the U.S. system. The U.S. market share controlled by foreign banking organizations rose from about 4 percent of U.S. domestic banking assets in the early 1970s to about 23 percent in

[14]For additional discussion of holding companies, see chapter 5, pp. 113-123.

1989. In contrast, U.S. holdings of the world's banking assets slipped from 30 percent in 1970 to 10 percent in 1989.[15]

These and other changes to the competitive landscape have drastically altered the assumptions and rules of the game that helped shape the design of our deposit insurance system almost 6 decades ago. Because depository institutions have a harder time competing successfully, bank owner and manager incentives to take risks are much more worrisome than they were when banking was a protected industry.

The stress now prevalent in banking makes it imperative that reform be implemented in a way that avoids damaging an already weakened industry. While change would be easier if the industry were healthy and the economy expanding, a lesson that should have been learned from the thrift industry is not to look the other way when there is trouble. It is harder to act when there are difficulties—but it is all the more urgent that problems not be ignored.

Our Approach to the FIRREA Study

FIRREA was enacted primarily to deal with the immediate problems surrounding FSLIC's bankruptcy and the magnitude of the problems in the thrift industry. Although it also made provision for raising BIF premiums, FIRREA did not make fundamental changes in the basic characteristics of the deposit insurance systems, in basic powers of depository institutions, or in the regulatory structure (other than that applicable to the thrift industry). It did, however, require the Treasury Department and GAO to conduct separate studies of the problems in the deposit insurance system and of various proposals for reform. These proposals include changing the $100,000 insurance limit, initiating risk-based insurance premiums, requiring banks to invest insured deposits only in low-risk activities, and developing private insurance alternatives.[16]

If one were able to build a new financial system from scratch it is possible, although not likely, that one might be able to develop a banking system that was completely safe and sound, provided a level playing field for all U.S. financial institutions, and allowed those institutions to

[15]For additional discussion of the international competitiveness of U.S. financial institutions, see European Community: U.S. Financial Services Competitiveness Under the Single Market Program (GAO/NSIAD-90-99, May 21, 1990).

[16]A more detailed discussion of proposals made to reform the deposit insurance system is contained in the Congressional Budget Office study Reforming Federal Deposit Insurance, September 1990.

compete effectively overseas. In such an ideal system no depositor's savings would be at risk, all consumers would be protected from misinformation and fraud, and the taxpayer would not have to worry about covering losses from bank failures.

We have not, however, speculated on what an ideal system might look like. Rather, our purpose has been to make recommendations to create a safer and sounder banking system that can be implemented in a manner consistent with the realities of today's changing, highly competitive environment.

In our view, Congress has two sets of options for reforming the deposit insurance system. One set involves trying to protect taxpayers by making drastic structural changes in the deposit insurance program and in banking. The second involves systematically improving the effectiveness of the regulatory features of the federal safety net that protect the taxpayers from realizing losses on the deposit insurance guarantee.

We recognize that arguments can be mustered for and against each of these basic strategies, and neither approach is without problems. On balance, however, we find it more reasonable for Congress to fashion a deposit insurance reform strategy primarily around the second option—systemic reform of regulatory protections.

One of the alternatives advocated under the first option would significantly reduce deposit insurance coverage. We do not believe that this approach (assuming that uninsured depositors would be expected to take losses if a bank fails) can serve as the centerpiece for reform because it would heighten the probability of widespread bank runs. In addition, as we point out in appendix I, cutting back coverage may have very little impact on BIF losses because most uninsured depositors are likely to withdraw their funds before a bank fails.

Another structural change that some have recommended would require that all insured deposits be placed in what are often termed narrow banks. Although there are different ideas as to how a narrow bank should be defined, a common characteristic is that narrow banks would not be permitted to make commercial loans. Under many narrow bank proposals, insured deposits could only be invested in short-term, low-risk assets that earn relatively low rates of interest and can be marked-to-market on a daily basis. Once a transition to narrow banks was complete, the risk of deposit insurance losses would be greatly reduced.

There is some appeal to the narrow bank alternative because once it is phased in it would all but eliminate the dependence on the ability of bank regulators to prevent expensive bank failures and consequent BIF losses. Nonetheless, we question this approach because it would destroy key elements of bank intermediation activities because banks would be prohibited from making business loans with insured deposits. We recognize that the banking system may need to contract in order to regain profitability, and that changes in regulation and supervision may be needed to rein in lending practices that have resulted in financial difficulty, for many banks. But we do not believe that forcing all risk-taking activities out of the banking system is a desirable objective. The public is well served by having banks make loans that support job creation, provided that these activities are conducted in a safe and sound manner. Furthermore, in response to a requirement mandating narrow banks, it is likely that stability problems—problems that the government would probably still have to deal with—would become more acute outside of the banking system because many depositors, seeking higher yields, will place their money in uninsured institutions, potentially returning the United States to a pre-deposit insurance environment.

In this connection we believe it is important to note that problems in the financial sector that could potentially affect market stability are not confined to banking. In recent years many securities firms have experienced significant losses, and there have been record numbers of insurance firm failures. Some insurance companies have a significant exposure to the same real estate problems that are plaguing banks.

One final structural change that Congress could consider is the privatization of some or all of the deposit insurance system. While there may be some opportunities for private sector involvement in the deposit insurance system, primarily in the pricing of insurance and in reinsuring limited portions of FDIC's risk, on stability grounds we see no alternative to maintaining deposit insurance as a responsibility of the federal government. Experience with private deposit insurance arrangements, most recently in Rhode Island, shows that such arrangements generate instability if depositors do not trust the ability of the insurer to protect them.

Given the drawbacks of the structural changes that could be made to the deposit insurance system, we believe that the most practical and effective strategy available to Congress is reform of the existing system of deposit insurance and bank regulation. Our efforts have therefore been

directed toward this end. In the remainder of this report we first identify the problems in the system and then propose solutions to those problems.

Not surprisingly, many of the problems we identify are related to inappropriate incentives that currently exist for both market participants and regulators. We have, therefore, sought to develop a reform program that establishes, to the maximum extent possible, an environment in which owners and managers of banking organizations have compelling incentives to operate their institutions in a safe and sound manner. For this to occur, federal regulators must have compelling incentives to be diligent, forceful, and consistent in their regulation and supervision of banks.

Objectives, Scope, and Methodology

As described above, the principal objective of our legislatively mandated assessment of deposit insurance reform alternatives was to decide how best to change the deposit insurance system in ways that (1) promote a safer, sounder, and more stable banking industry and (2) avoid taxpayer financing of industry losses. Protecting industry stability is one of the reasons why the deposit insurance program was created in the first place, and the controversy surrounding the need for taxpayer assistance in dealing with FSLIC's insolvency indicates a strong preference for having deposit insurance continue to be industry financed.

In many ways the controversy over the numerous proposals that have been advanced to reform the deposit insurance system arises because the two objectives of preserving industry stability and avoiding taxpayer losses are hard to capture simultaneously in today's ever changing, highly competitive financial marketplace. Proposals to enhance industry stability often involve the assumption of potentially greater risk by the federal government, which, in turn, potentially exposes taxpayers to greater losses. Steps to avoid that outcome generally rely more on the workings of market forces and private sector absorption of risk, but with the acceptance of greater potential financial instability. Many of the judgments that we make in this report are grounded in an attempt to balance and satisfy both objectives.

Because the success of the deposit insurance program depends in such a large measure upon the effectiveness of bank regulation, the scope of our work encompassed possible improvements in the way banks are regulated and supervised. In addition, because the nature of banking and competing financial services market segments has changed dramatically

in recent years in ways that affect industry profitability, stability, and taxpayer exposure to losses, our scope also encompassed questions about the organization of services and operations of bank holding companies and of other diversified financial service firms.

This report concentrates on the Bank Insurance Fund and the banking industry because the industry receives by far the largest component of the deposit insurance coverage. We assume, however, that the deposit insurance programs for thrift institutions and credit unions should conform with the relevant recommendations made in this report.[17] Our focus on BIF and deposit insurance for banks is on the general nature of the actions needed to have a safer and sounder banking system that does not place the taxpayers at risk. In doing this we have not attempted to develop more precise estimates of BIF's funding needs beyond those developed in our last BIF financial audit. We will provide updated estimates as we do each year's financial audit.

This report draws on extensive work that we have done over the past several years on depository institutions, the deposit insurance program, the securities and insurance industries, international competitiveness, and other aspects of the financial services system in the United States and overseas. This work has covered a broad range of topics, including industry condition, financial condition of the deposit insurance funds, conflicts of interest, consumer protection, internal controls, expanded powers for banking organizations, international capital standards, foreign deposit insurance systems, and financial markets in Europe after 1992. A comprehensive list of our products addressing issues related to the financial services industry is included at the end of this report. (See Related GAO Products.)

In conducting this study we gathered information from many sources. These include the legislative history of the deposit insurance system; extensive records from congressional hearings relating to deposit insurance programs and the financial services industry; professional literature concerned with deposit insurance, bank and financial institution capitalization, and banking and financial services risks; statistical data prepared by regulatory agencies, industry associations, and rating agencies; discussions with officials of the Federal Reserve System, Office of the Comptroller of the Currency, FDIC, and the Securities and Exchange Commission (SEC); and discussions with executives of foreign and

[17]We are currently undertaking a comprehensive FIRREA-mandated study of credit unions.

domestic financial institutions and several academic and industry experts.

This report also draws on several other ongoing assignments. These studies include reviews of the condition and capital adequacy of banks as well as enforcement of capital adequacy standards in 72 problem banks, analysis of financial reporting and internal control problems found in 39 failed banking organizations, implementation of risk-based capital requirements applicable to banking organizations, several aspects of regulation of the insurance industry, foreign and domestic capital adequacy and firewalls for securities firms, the regulation of U.S. broker dealers overseas, and market value accounting issues.

To better understand bank regulators' supervisory enforcement activities, we also reviewed examination reports for five banking organizations, that either failed or required FDIC assistance and resulted in some of the largest losses to the insurance fund, to determine when the regulators identified problems and the types of enforcement actions that were taken.

To gain a better understanding of the operations of and competition among banks and other providers of financial services, we interviewed executives at a variety of financial services firms in Washington, D.C.; New York; and New Jersey to ascertain their views on reform alternatives for federal deposit insurance and alternatives for financial services modernization. They included executives of banks and other financial services firms of various sizes. We also interviewed managers, located in the United States and overseas, at six multinational firms, selected judgmentally, to obtain their views on the ability of U.S. banking organizations to service domestic and international markets.

We did our work from December 1989 through January 1991 in accordance with generally accepted government auditing standards.

Deposit Insurance Reform: An Overview

For the banking system to continue to play the role it has in the economy, three problems must be solved in order to preserve industry stability without placing taxpayers at undue risk. The problems involve an ineffective regulatory system, unhealthy incentives for market participants, and out-of-date restrictions regarding the operation of bank holding companies and other financial service companies.

It is urgent that action be taken as soon as possible to solve these problems that work against the operation of a safe and sound banking system. However, it must also be recognized that the present system has been built up over almost 60 years, and it is therefore necessary to be realistic about the length of time it will take to change certain aspects of that system. Reform must, therefore, be implemented carefully to preserve the stability that the present system provides.

To achieve a safe and sound banking system that can function in a competitive environment without placing taxpayers at undue risk, a comprehensive three-part reform strategy is necessary. The strategy involves

(1) strengthening supervision, bank internal controls, and financial reporting requirements so that regulatory officials have the mandate, information, and resources they need to be effective. The regulators must take prompt action to restrict the activities of all poorly capitalized institutions and institutions lacking adequate internal controls, giving particular emphasis to identifying and resolving problems in large complex banking organizations. All insolvent institutions must be promptly closed by merger or liquidation;

(2) changing economic incentives so that the owners and managers of individual banks, not taxpayers or the insurance funds, bear most of the costs if they fail; and

(3) updating bank holding company structure and regulation to close gaps that pose risks to the banking system. These changes are necessary preconditions to, and will simplify, financial system modernization in the U.S. if expanded powers for banks and other financial institutions are judged desirable.

Problem Number One: The Federal Bank Supervisory System Is Often Ineffective

When Congress passed FIRREA in 1989, it recognized the importance of forceful regulatory action to stop unsafe banking activities and minimize insurance fund losses. FIRREA, among other things, strengthened the supervisors' enforcement capabilities by establishing limits on poorly capitalized institutions' ability to attract volatile brokered deposits, made it easier for FDIC to terminate a bank's insurance coverage, and enhanced the supervisors' ability to place undercapitalized or unhealthy institutions into conservatorship. However, the new tools provided by FIRREA are not the complete answer because supervisors have not demonstrated a consistent ability to use the tools at their disposal and to act in a timely and forceful manner to minimize insurance fund losses. FIRREA also did not include reforms dealing with management, auditing, and financial reporting.

A revealing indicator of ineffective bank supervision is the high level of losses that exist in failed institutions when they are closed. In theory, if an institution is closed promptly when its net worth reaches zero, losses would be minimal because the value of its assets should equal the value of its liabilities. However, as is apparent from the data on cost of resolution and failed bank assets in table 2.1, from 1985 through 1989 FDIC's cost of resolving $109 billion in failed bank assets has been 16 percent of those assets. This indicates that supervisors are not taking actions that effectively prevent dissipation of assets on the one hand or closing institutions when they still have some residual value on the other. We believe the failure to take adequate supervisory actions is due to (1) the regulators' reluctance to act on indications of unsafe activities or conditions and (2) poor financial information which disguises the extent of bank problems.

Table 2.1: Costs of Bank Failures, 1985 to 1989

Dollars in millions

Year	Number of failed banks	Total assets of failed banks	Estimated losses[a]	Estimated loss as a percent of assets
1985	120	$8,822	$877	9.9
1986	145	7,686	1,815	23.6
1987	203	9,473	2,148	22.7
1988	221	53,822	6,022	11.2
1989	207	29,174	6,090	20.9
Total	**896**	**$108,977**	**$16,952**	**16.0[b]**

[a]Includes actual and estimated recoveries. Estimated recoveries may change over time due to actual recoveries.

[b]Weighted average of the losses over the 5-year period.

Source: FDIC.

In our ongoing work for the Chairman of the House Subcommittee on Financial Institutions, Supervision, Regulation and Insurance, we have found a history of significant reluctance on the part of bank supervisors to take forceful actions when serious problems are identified during the examination process. On the basis of a random sample of 72 banks that were experiencing capital adequacy problems as of January 1988, we found that regulators were reluctant to use formal enforcement tools[1] unless an unsafe practice had a demonstrated negative effect on a bank's capital level. For example, in 38 cases federal regulators identified unsafe practices but did not use available formal enforcement tools to require bank managers to correct identified deficiencies. These deficiencies included serious bank internal control deficiencies such as inadequate underwriting policies and liberal lending practices.[2] Instead, federal regulators typically relied on examination reports to convey their concerns and used informal enforcement actions. These informal actions often did not result in improved operations on the part of the bank managers, and many of the banks further deteriorated or failed.

Our work on these cases reveals that the supervisors' reluctance to initiate forceful actions is not based on a lack of formal enforcement tools but rather on a desire to work cooperatively with bank managers whenever possible. There seems to be a strong incentive for regulators to use the wide discretion they have in using enforcement actions to avoid the confrontation and administrative burdens associated with use of formal enforcement tools. To a lesser extent, the reluctance to use formal tools is based on the regulators' perceived need to obtain irrefutable evidence of capital deterioration should their actions be contested. We identified similar regulatory practices in a 1982 report.[3] If bank supervision is to be improved, the incentives that lead regulators to give preference to working informally with bank managers over an extended period of time must be changed.

[1]Federal agencies can use several formal enforcement actions against unsafe and unsound bank practices. Formalized written agreements between the regulatory agencies and bank managers require the banks to correct identified deficiencies, such as poor lending policies or excessive dividend payments. Cease and desist orders, civil money penalties, and the removal and suspension of bank officers are specifically authorized by law and may involve the presentation of evidence before administrative law judges.

[2]Our previous work has found that such internal control deficiencies were major causes of bank failures that occurred in 1987. See Bank Failures: Independent Audits Needed to Strengthen Internal Control and Bank Management (GAO/AFMD-89-25, May 31, 1989).

[3]Despite Recent Improvements, Bank Supervision Could Be More Effective and Less Burdensome (GAO/GGD-82-21, Feb. 26, 1982).

Our review of 39 banking organizations that failed in 1988 and 1989, including several large banking organizations with over $1 billion in assets, illustrated once again how important it is to seek out and address serious internal control problems. These 39 banks accounted for over 87 percent of the total assets in banks that failed nationwide during those two years. In 33 cases, we found pervasive management problems involving a broad array of internal control issues, including violations of laws and regulations. Examples of internal control problems included unwarranted loan concentrations, poor loan documentation, and inadequate loan loss reserves. The competence or integrity of management were also frequently cited by regulators as major factors contributing to the banks' failure. (See table 2.2.) One consequence of these internal control weaknesses is that managers and regulators lack accurate and timely information about the condition of insured banks. We believe this lack of information is particularly important for large banking organizations, the failures of which threaten BIF solvency and financial stability. In these organizations, the decisions by boards of directors, managers, and regulators are often based on summary information generated from many different sources. In the absence of adequate internal controls, key decisions are much more likely to be made on the basis of inaccurate and potentially misleading information.

Table 2.2: Summary of Internal Control Weaknesses Cited by Regulators for 39 Banks That Failed in 1988 and 1989

	Number of banks affected	
Internal control weaknesses	1988 (19 banks)	1989 (20 banks)
Board of director inadequacies	12	9
Inadequate operating management	15	15
Serious or continuous legal and regulatory violations	5	8
Weaknesses in loan portfolio management	15	20
Inadequate loan loss reserves	16	15

Source: See our forthcoming report, Failed Banks: Accounting and Auditing Reforms Urgently Needed (GAO/AFMD-91-43, Mar. 1991).

We also looked at the examination histories of five large banking organization failures whose resolution caused an estimated $7 billion in BIF losses. Our review focused on the largest subsidiary bank of each banking organization. In these cases the regulators identified unsafe practices but did not use formal enforcement tools to remedy them. We found that during periods of regional economic strength, the banks engaged in such risky practices as rapid growth, making loans without adequate documentation or underwriting standards, and concentrating their loan portfolios. When the regional economies deteriorated or a

class of borrowers could not repay their loans, the banks' poor lending practices exacerbated asset quality problems associated with the faltering economy.

We also found that these banks continued to engage in unsafe practices even after their responsible examiners first identified significant asset deterioration. At three of the five banks, managers adopted aggressive real estate loan growth policies without adequate lending controls. Moreover, four of the five bank holding companies that owned the banks that eventually failed ignored Federal Reserve policies on dividend payments that were designed to protect the capital base of bank subsidiaries. In those four cases, undercapitalized banks paid dividends to the holding companies in excess of their incomes.

Other problems also contribute to ineffectiveness of the regulatory system. Regulators do not have adequate information and resources to take early action to resolve bank problems. This is one reason why, in recent years, banks that appeared to have been highly capitalized have, in fact, failed rapidly. For example, our previously mentioned review of 39 failed banks showed that asset values as determined by FDIC after failure were dramatically lower than reported by the institutions' management in call reports prepared prior to failure. In comparing call reports prepared on average 6 months prior to failure to the FDIC's reports prepared immediately after failure, there was an overall increase in reported total loss reserves of $7.4 billion (342 percent)—from $2.1 billion to $9.3 billion for the 39 banks. Devaluation in the loan and other-real-estate-owned categories amounted to $7.3 billion (78 percent) and $.8 billion (9 percent), respectively, of the total $9.3 billion loss reserve estimate prepared by FDIC after failure. These value differences reflect inadequacies in the current GAAP standards that make the regulators' job more difficult.

The regulators' inability to measure accurately the value of bank capital has contributed both to bank incentives to take on risk and to the magnitude of the losses that have occurred when banks fail. Furthermore, the recent strains on BIF finances could limit FDIC's options for effectively resolving future bank failures. Unless FDIC has sufficient resources, regulators will not have the flexibility to act appropriately, a problem that hamstrung regulators during the FSLIC crisis.

Problem Number Two: Insufficient Bank Capital and Other Unhealthy Incentives Place BIF at Risk

During the past decade, incentives affecting the owners and managers of banks as well as their depositors have worked against having the stability of financial markets flow from the safety and soundness of the banking system rather than from the deposit insurance guarantee. The incentive system is skewed in favor of risk-taking, and, as a result, banks have the ability and incentives to attract large sums of deposits at low cost to fund relatively high-risk ventures.

Inadequate Capital

The most important incentive problem is that stockholders frequently have too little of their own money—equity capital—at risk in the banks they own. Adequate capital is needed so that bank owners and managers have sufficient incentives to fully consider the cost of risk-taking. Adequate capital also provides a larger buffer between the resources of the bank and the resources of the insurance fund and will give regulators more time to assess problems and resolve them.

Evidence of serious capital deficiency in the banking system can be seen in the substantial increases in bank risk over the past decades without accompanying increases in bank capital to offset this risk. Higher losses from bank failures and the increased number of bank failures are a reflection of the banks' exposure to greater risk than occurred in the past. During the 1980s, an average of 109 banks failed each year—nine times the average annual number of bank failures experienced from 1934 to 1979. Furthermore, from 1985 through 1989 an average of 179 banks have failed each year. During these 5 years 12 banks with over $1 billion in assets either failed or required assistance.

Other indicators of increased bank exposure to risk are the ratio of loan loss reserves, annual provisioning, and net charge-offs to total loans.[4] All of these ratios have increased substantially in the 1980s. From 1980 to 1989, net loan charge-offs doubled, and loan loss reserves as a percent of total loans more than doubled.[5]

While banking thus appears to have become riskier, the average equity capital-to-assets ratio has remained relatively static, at about 6 percent

[4]Loan loss reserves are funds set aside by a bank in a special account to cover anticipated losses in asset values. Loss provisions are the funds added to the loan loss reserve account in a given time period and are charged against current earnings. Net loan charge-offs represent the value of loans written off in a period minus the amount recovered on previously written-off loans.

[5]Higher reserves may partially reflect improved valuation of risk rather than an actual increase in risk.

since the mid-1980s. Prior to the implementation of deposit insurance, bank capital ratios averaged about 15 percent. Although not all of the decrease from 15 percent to 6 percent is attributable to banks' ability to substitute the deposit insurance fund guaranty for their own capital, in the absence of deposit insurance it seems likely that banks would have to hold higher capital ratios.

Another indicator that bank capital levels are lower today than bank risk would otherwise allow is the market's evaluation of the value of bank capital. The market, or economic, value of equity capital is below book, or historical, value for many publicly traded banks.[6] This low market value may expose the FDIC to larger losses if the bank fails.[7]

Market perceptions of bank risk are also reflected in the ratings that bank holding companies receive on their debt. Recent downgradings of bank holding companies by Moody's, Standard & Poor's, and other rating agencies suggest that these agencies believe that bank holding company capital levels (which are largely a reflection of bank capital levels) are too low to support the amount of risk in their portfolios.

Furthermore, regulators often do not have the time to resolve bank failures without significant loss to the insurance fund because capital has not been measured accurately. Lack of audit and management reports on internal control deficiencies also makes it harder for the regulators to act on a timely basis. Because these private sector activities that can help target problems are not in place, the regulators have a much greater burden than is necessary in trying to detect problems.

In addition, as discussed above, capital standards have not always been enforced in a clear, decisive, and predictable way. In many cases, banks without adequate equity capital have been allowed to operate, thereby

[6]The book value of a bank's equity capital represents the owners' direct investment in the bank plus its retained earnings and is based on historical accounting under Generally Accepted Accounting Principles (GAAP). Under GAAP, the calculation of equity capital may not be a true representation of a bank's economic net worth or market value. The market values of assets and liabilities may differ from their historical values because changes may occur in things such as interest rates, the value of loan collateral, or the riskiness of unsecured loans. Bank market values are approximated by the values of bank holding companies since it is their stock that is publicly traded. In most cases, the bank represents the dominant portion of the holding company's assets.

[7]Currently, bank regulators measure the solvency of a bank by the book value of its equity capital. If the market value of the bank is higher than book value, then closing the bank based on book values, when a bank's market value exceeds book value, provides an added cushion to FDIC to absorb losses. Under such circumstances, stockholders have an incentive to monitor and limit their bank's risk. When market values fall relative to book values, however, bank owners have less incentive to control risk since much of their value has already disappeared and there is little to lose if the bank fails.

contributing to their incentives to take large gambles. For example, as of June 30, 1990, 35 banks reported no equity capital on the quarterly call reports they must file with regulators[8] and another 148 reported equity capital to asset levels of 0 to 3 percent. These banks controlled about $30 billion in assets. Some of these banks have, however, been closed since June.

Other Incentives

Another incentive problem is that the current system of deposit insurance gives risky banks the ability to grow and further increase risk by attracting a large volume of deposits. Since the 1980s, this ability has been enhanced by the removal of interest rate ceilings on deposits, technological advances which make it easier to offer brokered and pass-through accounts, and by an increase in the deposit insurance ceiling.[9]

An obvious example of the unhealthy incentives in this system became apparent in the thrift industry between late 1982 and the end of 1984. In that period, poorly capitalized institutions raised large amounts of deposits by offering relatively high rates of interest, and the industry grew by 40 percent. Those placing deposits in these institutions were willing to do so because they were protected by the deposit insurance guarantee not by the quality of the institution.

Banks and thrifts that did not offer such high rates often found it difficult to compete with these "high flyers." The incentives built into the deposit insurance system thus not only left the deposit insurance agency with massive losses when thrifts failed, but also made it difficult for healthier institutions that had incentives to control risk-taking to attract funds at reasonable costs.

One of the factors that contributes to the incentive problem is the way uninsured deposits are treated when a bank fails. Although the insurance limit is set at $100,000, in practice uninsured depositors—together with uninsured holders of other bank liabilities such as federal funds—have usually been protected on a de facto basis when a bank fails. This

[8]Call reports include information on bank assets, liabilities, capital, expenses, and other financial data.

[9]Brokered accounts are those in which a broker gathers funds from clients and places them in banks. These funds are placed in the client's name and receive full deposit insurance protection for each individual. Pass-through accounts are similar, but are generally raised for a purpose such as retirement, and are placed in banks as a safe investment. They are termed pass-through accounts because the deposit insurance coverage is passed through to each beneficiary of the account. For a discussion of pass-through accounts, see appendix II.

is due either to the application of the cost test or to invocation of the essentiality clause. The de facto protection is particularly evident in the case of large banks. FDIC has always protected all deposits in failures of banks with assets over $1 billion. By contrast, FDIC liquidated 21 percent of the banks with assets under $1 billion that failed between 1985 and 1989, thereby placing uninsured depositors at risk. FDIC estimates that there was about $335 million in uninsured deposits in these liquidated banks, accounting for approximately 4.6 percent of total deposits in those banks. Given the typical loss ratio of about 30 percent for small failed banks, we estimate the total losses to uninsured depositors was about $100 million dollars.

The de facto protection given to uninsured depositors and non-deposit liabilities has led to a widespread perception in the market that some banks are "too big to fail."[10] This policy has been developed as a result of concerns that imposing losses on depositors in one large bank could result in depositor runs on other large banks, which might lead to systemic instability. However, protecting depositors in banks that are deemed "too big to fail" has also led to a belief that uninsured depositors can safely ignore the quality of a bank if it is large enough.

The actions that have been taken to protect uninsured depositors have successfully dealt with the short-run consideration of protecting systemic stability. Yet, the longer run adverse consequences of these actions on market discipline and the incentive of banks to control risk have been essentially ignored. An implicit policy of protecting all depositors, as well as other nondeposit liabilities in large, and most small, bank failures, sends a signal to the market—especially to depositors—that they will not be penalized for investing in risky banks offering high interest rates. As a result, any bank wishing to attract deposits can easily do so, even if it is a high-risk institution.

The recent failure of the National Bank of Washington in Washington, D.C., illustrates the incentive problem related to uninsured depositors. In the 18 months between June 30, 1986, and December 1987, the bank, after it had already been cited for many internal control deficiencies, increased its size by $500 million, or about 30 percent. A large part of this increase in assets was accounted for by a $310 million (110 percent) growth in real estate loans. The growth in the bank was financed both

[10]Literally speaking, banks may not be too big to fail because banks over $1 billion have been closed, and in all instances stockholders, subordinated debt holders, management, and some general creditors (such as long term leaseholders) have all suffered losses. However, in such situations those who have provided the bank's funding through deposits or other types of liabilities have not lost.

by an increase in insured deposits and by a $234 million increase in uninsured domestic and foreign deposits. When the bank failed in 1990, all uninsured deposits were protected, even though the losses in the real estate loans that had been financed in large measure by these deposits contributed in part to an estimated $300 million FDIC loss.

Problem Number Three: Holding Company Regulation and Structure Need to Be Updated

Restrictions on branching and bank powers were adopted in the late 1920s and early 1930s with the McFadden and Glass-Steagall Acts, and were expanded in the following decades.[11] However, these restrictions have been eroding over the past decade as federal and state regulators and legislators have moved to allow U.S. banks to adjust to the technological, competitive, and other advances in U.S. and global financial markets. This erosion has been facilitated over the past 2 decades as the bank holding company has become the dominant form of banking organization.[12] As of June 30, 1990, bank holding companies controlled about 70 percent of the banks and 93 percent of the assets in the nation's banking system. While efforts by banking organizations and regulators to provide a wider range of services to bank customers have positive aspects, the developments have also created numerous problems.

First, the erosion of restrictions on interstate banking poses potential risks to FDIC through the possible expansion of risky institutions. Since

[11]The Pepper-McFadden Act of 1927 gave national banks the same branching rights as state-chartered banks, except that it prohibited branching across state lines. The Douglas Amendment to the Bank Holding Company Act of 1956 gave states the power to regulate interstate expansion of banks owned by bank holding companies.

The Banking Act of 1933, commonly referred to as the Glass-Steagall Act, significantly limits the securities and other nonbanking activities of banks. It generally prohibits national banks from issuing, underwriting, selling, or distributing securities other than U.S. government and agency debt and general obligation bonds of states and municipalities. Furthermore, member banks may not be affiliated with, or participate in management and employee interlocks of, any firm engaged principally in those activities. The Glass-Steagall Act does not apply to the activities of American banks operating overseas.

The Bank Holding Company Act of 1956, as amended, administered by the Federal Reserve Board, allows bank holding company nonbank subsidiaries to engage in activities that are permissible for banks as well as those in which banks are not permitted to engage. A holding company must, however, comply with the provisions contained in the Glass-Steagall Act. Board regulations promulgated under the Bank Holding Company Act are contained in Regulation Y. Under the act, the Board can authorize bank holding companies—and their subsidiaries—to engage in activities that it determines are closely related to and a proper incident to banking.

Bank participation in insurance activities is restricted through the Bank Holding Company Act and the National Bank Act of 1864. The National Bank Act precludes national banks from underwriting insurance with several exceptions.

[12]Bank holding companies are incorporated firms that control, through stock holdings, one or more commercial banks.

1981, the primary way banks have expanded geographically is through regional compacts that have allowed bank holding companies to establish bank subsidiaries across state lines.[13] These arrangements may have enabled some banks and their customers to benefit from geographic diversification, and we believe that further benefits along these lines could be realized in the future. However, the current arrangements for interstate expansion do not contain all of the safeguards needed to keep weak banks from engaging in interstate banking and posing greater risks for FDIC. Although regulators generally must approve the expansion of banks into new areas, we have already pointed out that regulators often lack accurate information about bank condition and often have not taken early action to stop the growth of risky institutions. Furthermore, we are concerned that regulators may be tempted to deal with strains in the industry by allowing mergers across state lines that will result in the creation of large banking organizations that do not meet appropriate standards for capital adequacy and internal controls. Such institutions could damage healthy competitors and pose even bigger risks to FDIC in the future.

Second, judicial and regulatory interpretations expanding the activities of banks and bank holding companies under existing statutes have created a regulatory system that is often inconsistent and potentially risky to FDIC. A recent example of the shortcomings of piecemeal expansion is the passage of a Delaware state law allowing banks to conduct nationwide insurance underwriting activities in state-chartered bank subsidiaries. The law may have implications for FDIC's exposure to risk. It has been challenged by the Federal Reserve and is currently before a federal court to consider whether such an activity can be conducted by state-chartered banks. Another example of piecemeal expansion is the Federal Reserve's limited relaxation of traditional Glass-Steagall restrictions, which has principally benefitted the largest banks. These restrictions generally make it too expensive for smaller banks to participate.[14]

[13]Some banks also expanded through provisions of law that permit out-of-state acquisitions of failing banks.

[14]On a case-by-case basis, the Federal Reserve has authorized certain bank holding companies on a limited basis to underwrite and deal in securities that may not be underwritten or dealt in by a member bank directly. These securities activities are done in separately incorporated and separately capitalized nonbank subsidiaries of the bank holding companies. These subsidiaries are known as section 20 companies. Although not required by the Glass-Steagall Act, the Federal Reserve exercised its authority under the Bank Holding Company Act to establish capital adequacy requirements, as well as a number of prudential limitations or "firewalls," for holding companies engaging in the expanded securities activities. These firewalls limit transactions between the securities subsidiary and its affiliates in order to address the potential risks, conflicts of interest, and competitive issues raised by the activity.

Third, the responsibilities of holding company owners and managers to protect the deposit insurance system from losses are unclear, thereby providing opportunities for holding companies to evade financial responsibility for their bank subsidiaries. Because of the complexity of financing arrangements within holding companies, banks are potentially placed at risk by activities undertaken by the holding company parent or its nonbanking subsidiaries. For example, banks may find it difficult to make independent credit decisions on loans to holding company affiliates. These loans could be used to fund risky activities not allowed to the bank. If the credit judgment is not accurate, the affiliate could default on the loan, forcing the bank to take a loss. However, a recent judicial decision challenged the Federal Reserve Board's authority to promulgate a policy that required holding companies to serve as a source of financial support for their banks if the banks got into difficulty.[15] Thus, banks currently receive no mandated assurances of support from their parent holding companies if problems do arise. For this reason, holding companies do not necessarily have appropriate incentives to manage their banks in a safe and sound manner if the holding company as a whole can benefit from risky activities by the bank. Furthermore, as a result of the cross-guarantee provision in FIRREA,[16] holding companies have incentives to move valuable assets out of their insured bank subsidiaries if they feel that any of their banks might fail.

Finally, existing consumer protection measures have become inadequate as more complex and often uninsured products are sold to bank customers. As a result of inadequate disclosure protections, for example, consumers may be confused about whether or not products sold in banks are insured and what the risks associated with uninsured products are.

Figure 2.1 reproduces the advertisement (except for the name of the institution) that was displayed in the window of a mid-Atlantic bank in October 1990. It is an example of an uninsured insurance product being offered to bank customers by a bank subsidiary of a large bank holding company. Although the insurance annuity is advertised as earning more

[15]See MCorp Financial, Inc., v. Board of Governors of the Federal Reserve System, 900 F.2d 852 (5th Cir. 1990). The Federal Reserve's source of strength policy is established in Regulation Y, which says "a bank holding company shall serve as a source of financial and managerial strength to its subsidiary banks and shall not conduct its operations in an unsafe or unsound manner."

[16]This provision makes commonly controlled insured depository institutions liable to FDIC for BIF losses or anticipated losses that result from the default of an insured affiliate institution, or as a result of assistance to an insured affiliate institution in danger of default.

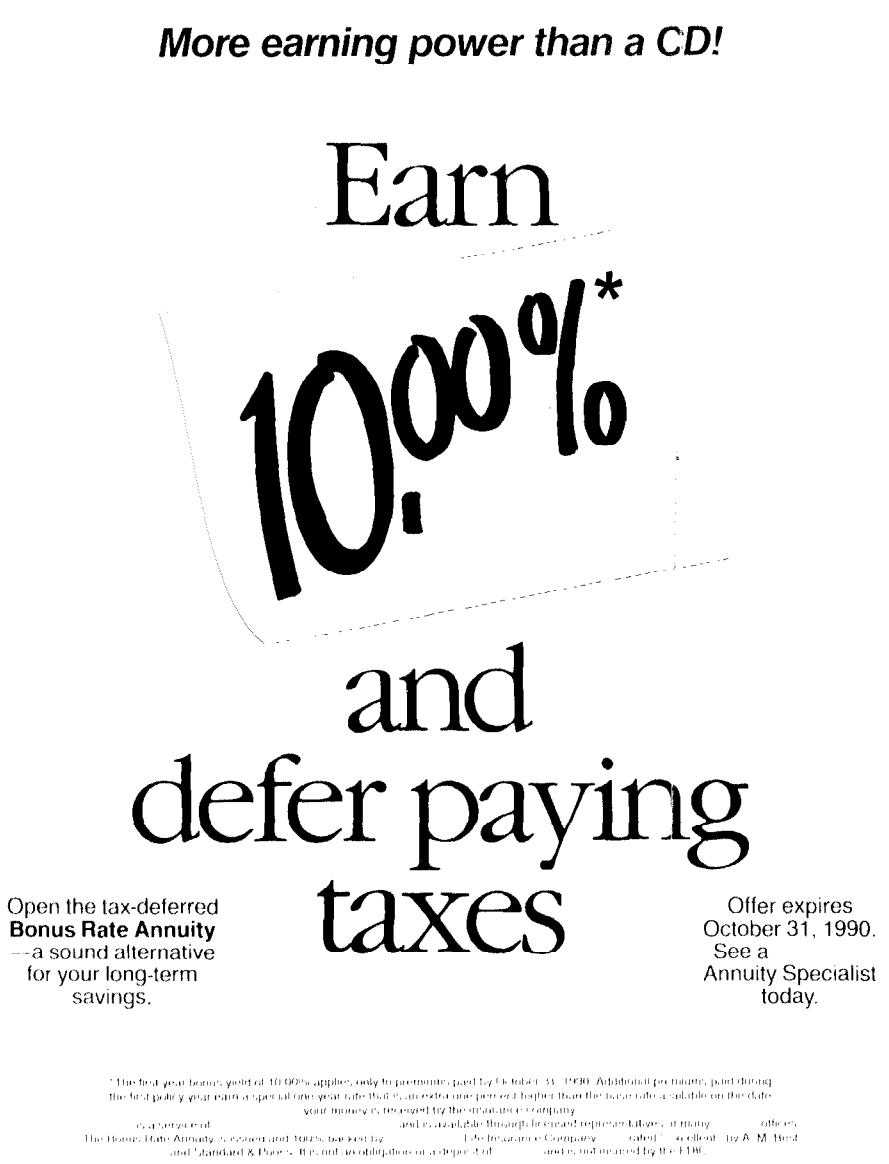
than a certificate of deposit, the advertisement does not provide an adequate basis for the consumer to make such a comparison.[17] It is also possible that consumers might assume that the annuity is backed by the federal government because it is being offered through an insured bank and is compared to a CD, which is an insured bank product. Furthermore, mention of the uninsured status of the annuity is made only in small print and then only after the statement that the annuity is backed 100 percent by the issuer. Recent examples of depositors in banks that failed being sold uninsured holding company subordinated debt[18] or commercial paper without clear disclosure of the uninsured status or added risk of these instruments demonstrate even more forcefully the need for additional consumer protection measures.[19]

[17]Banks are currently required to provide annualized yields on their deposit products such as CDs to aid consumers in comparing products among banks. Banks also must advise consumers of early withdrawal penalties and potential rate changes.

[18]Subordinated debt holders have less of a claim on assets and are paid only after other debts with a higher claim have been satisfied.

[19]Such examples include sales of uninsured products by Lincoln Savings and Loan, a California thrift, to customers who allege they believed the products were insured and similar practices by Germana Bank in Illinois. See chapter 5 for further discussion.

Figure 2.1: Advertisement for an Uninsured Insurance Product Offered by the Subsidiary of a Bank Holding Company



The problems described above must be addressed in their own right in order to close regulatory gaps that have developed as a result of a

changing financial environment. Furthermore, if a judgment is made that expanded powers should be provided to banks and other financial institutions through Glass-Steagall reform and modification of other restrictive laws, then these problems must be satisfactorily addressed before such changes are implemented.

Our Approach Stresses Incentives, Capital, and Effective Regulation

The problems we have just described are signs that the regulatory and deposit insurance systems are failing to accomplish the objectives of protecting the taxpayer from undue loss while safeguarding a stable banking system. Bank supervisors have not been provided adequate incentives to address bank problems in a timely and effective manner. And bank owners—including bank holding companies—and managers have incentives to take excessive risk. The following three chapters present our views on how to change these incentives by mandating that bank regulators act more forcefully, reducing the deposit insurance subsidies that encourage bank management to take risks and improving the bank holding company structure.

The key to reform and changing incentives, and the theme that ties all three of the following chapters together, is the importance of adequate bank capital. Emphasizing adequate capital and its enforcement is intended to create a set of incentives that better ensures that owners, managers, and regulators will accept responsibility for bank safety and soundness. If, for example, bank capital levels adequately reflect the risks associated with individual banks, then bank owners and managers will bear the costs associated with the risks they take. This gives them an incentive to consider all the costs of their activities—including the potential for loss—before engaging in them. Once adequate capital levels have been achieved, then, to a much greater degree than at present, the public's confidence in banks will flow from the banks' safe and sound operation rather than from explicit or implicit deposit insurance guarantees.

Because of the importance of capital in creating incentives for bank managers and owners, the system of bank regulation and supervision that defines and enforces capital standards must be effective. Federal regulators must have the ability and mandate to promptly and forcefully address problems that adversely affect capital levels and the safety and soundness of banks. While this is necessary for all banking organizations, special emphasis must be placed on prompt identification of problems and remedial actions in large banks because of the threat to the deposit insurance fund that large failing banks pose. Regulators

must ensure that existing capital requirements are not relaxed to accommodate institutions experiencing problems and that institutions whose equity capital is exhausted are closed promptly at minimum cost to the taxpayer. The need to improve the system of bank regulation to accomplish these goals cannot be overemphasized. Improved capital regulation will be effective in protecting taxpayers and creating healthy managerial incentives only if they are enforced rigorously.

At present, given the degree of stress in the banking industry, particularly for many large banks, efforts by regulators to hold owners and managers responsible for the costs of their operations must concentrate on acting quickly and forcefully to address problems that could affect the safety and soundness of individual banks and ensuring that FDIC has enough money to resolve cases. This can be accomplished by improving supervisory incentives to take such actions.

As soon as possible, however, the emphasis should shift toward implementing other actions that are needed to complete reform of the existing system by enhancing owner/management incentives to operate their banks safely and soundly. Such actions, which emphasize market processes, will reduce the level of subsidy inherent in the current deposit insurance and regulatory systems and should eventually result in reduced insurance premiums for healthy banks. These actions include

- gradually strengthening capital standards and increasing the role for subordinated debt in large bank funding;
- raising insurance premiums of institutions that do not meet capital standards or that are not being operated in a safe and sound manner;
- sharpening the distinction between insured and uninsured depositors, while assuring that regulators continue to have the tools necessary to assure systemic stability and that depositors also have options for protecting deposits over $100,000; and
- updating bank holding company structure and regulation to close gaps that pose risks to the financial system. Such changes could set the stage for providing expanded powers to banks and other financial institutions.

The actions we recommend preserve the basic functions of banks in our society and do not depend on drastic changes in the regulatory structure. However, they are designed to improve incentives and will influence greatly how banks are run by making safety and soundness, especially the maintenance of adequate capital, a key point in determining the further evolution of the banking system. Our proposed actions will signal the market that excessive risk will be penalized and

safe and sound banking will be rewarded. Those signals are not apparent in the system today.

The solutions to the three problems we have discussed—problems related to the bank supervisory process and BIF finances, unhealthy private sector incentives, and anachronistic holding company regulation—must be implemented in a coordinated way. Although each is important in its own right, the solutions we have developed are also meant to backstop each other since it is realistic to assume that none of them will be fail-safe. For example, while providing sufficient supervisory incentives to ensure that banks will be closed before they impose significant losses on the deposit insurance fund is a goal to strive for, it is unlikely that the supervisory system will always be successful in accomplishing this goal. Consequently, it is important that incentives for bank owners and managers are created to encourage safe and sound banking, thereby reducing the burden on bank regulators.

If a coordinated approach is not taken, some even more serious problems within the current system might occur. If the finances of the insurance fund are not stabilized and the supervisory system's role in promoting safer and sounder banking operations is not improved, steps taken in the name of deposit insurance reform to increase capital or increase depositor discipline will have little credibility and may be destabilizing. This is because the regulators will have neither the financial resources nor the incentives to take timely and effective enforcement actions when violations of the new tougher standards occur. Similarly, if the powers of banking organizations were to be expanded before reform of BIF, the supervisory system, and the economic incentives, we run the risk of repeating the major mistake that was made in dealing with the thrift industry—allowing poorly capitalized institutions to take on new risks in the hope of growing or diversifying their way out of problems.

We believe the changes we are recommending, if implemented in a coordinated manner, can be effective in achieving banking system stability without placing the taxpayer at further risk. The changes are not intended to eliminate all risk from banking. Banking is inherently risky, and eliminating that risk would destroy a significant portion of the contribution banks make to the economy. In a dynamic economy, some banks will still fail, but as a result of the changes we recommend the banking system should be strong enough to remain stable. The improvements we suggest are, however, designed to ensure that bank decisions about risk-taking are based on principles of safe and sound banking.

Deposit insurance reform will take time. Many of our proposals will require significant transition periods in order to allow banks to alter their behavior and improve their financial status, thereby minimizing potential instability. But reform must begin now.

Improving the Bank Supervisory System

As discussed in chapter 2, federal regulators must have the ability and mandate to promptly and forcefully address problems that can impair bank safety and soundness. They must also close banks in a timely manner in order to reduce FDIC losses and protect the taxpayer. However, the current federal regulatory system has been ineffective in accomplishing these objectives.

We are particularly concerned about the ineffectiveness of bank regulation in light of the financial problems that have occurred in a number of the nation's larger banking organizations. Losses as a percentage of assets in large failed banking organizations have not been as high as those for the industry in general. Nevertheless, the increased number of large bank failures since the mid-1980s has imposed losses on FDIC that have contributed significantly to FDIC's current financial problems. The growing number of large banking organizations experiencing financial difficulty poses a major threat to the deposit insurance system in the future. Furthermore, the increasing financial vulnerability of large banking firms is a threat to the regulatory system's ability to foster financial stability and the associated confidence that it engenders.

We have found that the regulators are not always willing to take timely and effective enforcement actions to stop unsafe banking activities. Furthermore, regulators often do not have the information they need to supervise the banking system, and they also may need additional resources and expertise. Finally, low BIF reserves could limit regulatory options for closing banks.

This chapter sets forth our recommended solutions to these regulatory problems. Our proposals include

- a regulatory "tripwire"[1] that provides a mandate for federal regulators to address banking problems as they arise, not after these problems have severely depleted bank resources;
- improving the quality of information on the condition and economic value of financial institutions available to the regulators by (1) requiring the regulators to do annual on-site inspection of insured banks, (2) encouraging the accounting profession to change rules that delay the recognition of loan losses, and (3) requiring bank managers to include in their annual reports an assessment of internal controls and independent

[1] The term tripwire system means the regulators take mandatory enforcement action when they identify specified unsafe activities or conditions.

auditors to notify the regulatory agencies of bank internal control weaknesses and noncompliance with laws and regulations;
- emphasizing closer regulatory scrutiny of large complex banking organizations, including the development of more stringent financial reporting requirements and other information;
- initiating a high-level, intensive study of the regulatory systems and resources needed to maintain a safe and sound banking system and to identify and react quickly to developing problems in the largest banking organizations; and
- adequately recapitalizing BIF.

Congress Should Establish a Regulatory "Tripwire" System to Improve Bank Supervision

We believe that Congress should establish a regulatory "tripwire" system that will provide federal regulators with a clear mandate to predictably address problems that impair bank safety and soundness. The mandate should direct the regulators to (1) specify unsafe activities or conditions that could potentially or have already affected the performance of insured banks, and (2) identify the enforcement actions they will take to correct the unsafe practices or conditions. The mandate should also require the regulators to use the identified enforcement actions when the unsafe practices are identified.

Such a legislative mandate would provide several advantages. Most importantly, it would require the regulators to take early and forceful actions to correct unsafe activities rather than work informally with bank managers for extended periods, which often fails to correct identified deficiencies. The mandate would also provide the regulators with additional justification for their enforcement actions should they be contested. An added benefit of such legislation is that it would clearly notify bank managers of the consequences of unsafe activities and thereby provide strong incentives for the prudent operation of insured banking organizations.

Proposals to Require a More Predictable Supervisory System Have Generally Been Too Limited

Several proposals to implement requirements for a more predictable regulatory intervention system for dealing with banking problems have been proposed recently. These proposals have tended to link a set of mandatory regulatory actions to bank capital levels, with the severity of the action tied to the degree of capital deterioration. Typically under these proposals banks failing to meet minimum capital standards would be subject to restrictions on growth and dividend payments.

While these proposals constitute steps in the right direction, we believe that regulators must act forcefully to control problems even before capital begins declining, not just afterward. Forceful action is important for two reasons. First, our separate reviews of the 72 selected banks that experienced capital adequacy problems and of 5 selected large banks that failed found that the capital deterioration is often a lagging indicator of weakening financial condition. Thus, by the time capital began to decline noticeably, management and the regulators had only limited time and opportunity to prevent a bank's failure and minimize insurance fund losses. Second, our reviews also found that regulators often identified unsafe activities well before they caused losses and capital deterioration but failed to take necessary enforcement actions. We believe that these earlier measures of unsafe activities and conditions are as relevant, if not more so, than declining capital and should also trigger mandatory regulatory action.

Explanation of Our Proposed Tripwire Approach

Our proposed strategy consists of stages of regulatory intervention that we refer to as "tripwires." The tripwire approach would be designed to place increasingly stringent controls on a bank as its condition declines. The intent of each tripwire would be to focus regulatory attention on objective indicators of unsafe activities and conditions and create a set of expectations among banks and regulators concerning the enforcement actions that will follow. The first tripwire would be used to deal with identified problems in seemingly healthy banks that, if left unattended, would result in subsequent financial difficulties. The second tripwire would address serious asset deterioration or earnings problems when they occur. If these problems are exacerbated and begin affecting capital levels, the third tripwire would be activated. Finally, the fourth tripwire would require immediate FDIC conservatorship for a bank that has fallen below a predetermined minimum capital level.

We think that bank regulators, in consultation with Congress and the banking industry, are in the best position to develop (1) accepted definitions of inherently unsafe activities and conditions that would trigger mandatory enforcement actions and (2) the specific enforcement actions that should be taken. However, we envision that the enforcement actions would include growth restrictions, limits on the ability to offer above market rates to attract deposits, restrictions on dividend payments and interest on subordinated debt, and removal of bank directors and officers. Our tripwire framework is summarized in table 3.1.

Table 3.1: Overview of Proposed Tripwire Regulatory Approach

Conditions triggering regulatory actions	Examples of enforcement actions[a]
Tripwire 1 Unsafe practices in seemingly healthy institutions	Require plan to address problems; growth restrictions; interest rate restrictions; higher capital and/or insurance premiums if improvements not made
Tripwire 2 Serious asset or earnings deterioration	Require plan to address problems; growth and interest rate restrictions; higher capital and/or insurance premiums; reduce dividend payments; civil money penalties
Tripwire 3 Capital deterioration below minimum regulatory standards	Recapitalization plan; force bank to recapitalize; suspend dividend payments; restrict or eliminate asset growth; interest rate restrictions; increase insurance premiums; prohibit subordinated debt interest payments; perform break-up analysis
Tripwire 4 Capital depletion	Place bank in conservatorship; terminate insurance; liquidate or merge bank

[a]The tripwire approach would in no way preclude federal regulators from using available informal or formal enforcement actions not listed in this table. These include such actions as removing bank officers and directors, cease and desist orders, or prohibition orders. Furthermore, application of bank enforcement actions should become progressively more severe and would include a more comprehensive set of actions as violations become more serious.

Tripwire 1 - Unsafe Practices in Seemingly Healthy Institutions

Potential safety and soundness problems are not limited to failing banks. For instance, in seemingly healthy banks, poor internal controls, excessive exposure to interest rate risk, and rapid growth during periods of economic prosperity could potentially result in asset quality problems, earnings and capital deterioration, and the eventual failure of the institutions. Regulators routinely evaluate risk factors such as bank lending policies, underwriting practices, and loan documentation, but they often do not act decisively on the problems they find because the consequences of those problems have yet to have an adverse financial effect.

The first tripwire in our system, therefore, addresses unsafe activities that indicate management inadequacies that could lead to future financial problems. If regulators detect lending control deficiencies, such as inadequate documentation or underwriting, they first would be required to make a determination concerning the severity of those deficiencies and the ultimate risk they pose to the insurance fund.

If, for example, the deficiencies are determined to be material,[2] the regulators would immediately be required to initiate forceful regulatory measures. Examples of such measures could include

- requiring the bank to develop a written plan to correct the identified problems within a specified time frame;
- limiting the bank's total asset growth as well as the growth of specific loan categories, as appropriate; and
- restricting the bank's ability to offer above-market interest rates to attract deposits.

We also believe that banks with material control deficiencies should be required to increase capital levels or pay higher insurance premiums if they fail to make improvements within specified time frames. The capital levels or premiums should be set at a level that gives bank management sufficient incentives to correct the deficiencies. The topics of setting bank capital levels and of varying insurance premiums for risky banks are discussed further in chapter 4. As is also the case in each of the subsequent tripwires, regulators are not limited to the actions we described above. They would have at their disposal all formal and informal regulatory enforcement actions to correct identified deficiencies.

We recognize that our first tripwire will raise concerns about government interference in the marketplace. As stated in chapter 2, banking by its very nature involves substantial risks. A growing economy and the legitimate credit needs of businesses and consumers still depend in large measure upon bankers' willingness to take lending risks. Questions can be raised about the regulators' ability to judge such risks and the effects an unduly restrictive regulatory system will have on the nation's economic performance.

Consequently, any attempt to improve bank supervision and protect the taxpayers must be balanced against the impacts such reforms will have on the economic system. We believe our first tripwire satisfies this balance by focusing initial regulatory attention and enforcement actions on the most objective component of the examination process—bank lending and other internal controls. While the regulators may lack the capacity to assess the potential risks associated with a particular loan, they can

[2]We believe that the regulators should develop accepted definitions of terms like "material." However, an example of a material lending control deficiency could be that a bank's credit files are so disorganized that examiners cannot make a proper determination of loan values and, therefore, the safety and soundness of the institution.

clearly judge the quality of bank procedures to guard against unnecessary losses. As examples, the regulators can determine whether banks have developed and follow written lending policies, have established complete and accurate credit files, and have required borrowers to invest some of their own funds in bank-financed projects. If the regulators identify material internal control deficiencies, we believe they will have a sound and defensible basis for initiating growth and interest rate restrictions and other enforcement actions. In addition, it will be necessary for the regulators to specify the criteria used to assess bank internal controls and the bank's appeal rights. Such criteria will protect against arbitrary enforcement actions.

Tripwire 2 - Evidence of Serious Asset or Earnings Deterioration

Serious asset deterioration and earnings problems are leading indicators of bank financial problems. For example, in our reviews of 72 selected banks with capital adequacy problems and 5 other selected large banks that failed, we found that the regulators often identify significant asset quality and earnings problems well before capital levels fell to minimum requirements. However, the regulators did not always act forcefully to prevent the managers of these institutions from continuing to engage in unsafe practices that increased the insurance fund's exposure to losses.

Consequently, we recommend a tripwire that would require regulators to impose stringent controls when specific evidence of poor asset quality or earnings is identified. With regard to asset problems, the regulators could be required to take enforcement actions when a bank's classified assets/capital ratio reaches a specified percentage. The evaluation of this ratio should be relatively straightforward since regulators already assign classifications to problem loans and evaluate the adequacy of bank loan loss reserves (see table 3.2).

Table 3.2: Regulatory Classifications Assigned to Problem Loans

Classification	Description
Substandard	A classification assigned to loans inadequately protected by the current sound worth and repayment ability of the obligor or by the pledged collateral, if any.
Doubtful	A classification assigned to loans that have all the weaknesses inherent in an asset classified as substandard and whose collection or liquidation is highly questionable.
Loss	A classification assigned to loans considered uncollectible and of such little value that their continuance as active assets of the bank is not warranted. (Loss classification does not mean that an asset has absolutely no recovery or salvage value.)

With regard to earnings deterioration, the regulators could be required to take action when they determine that a bank has insufficient earnings to absorb losses without impairing its capital adequacy.

We believe such evidence of asset quality or earnings problems should trigger a set of enforcement actions more severe than those required under tripwire one. As examples, we believe the regulators could require the banks to develop plans to minimize damage to the bank from assets classified as substandard or worse and/or improve earnings, limit asset growth, limit interest rates the banks could pay to attract deposits, restrict dividend payments, require higher capital levels and insurance premiums, or impose civil money penalties if management does not make necessary improvements.

Tripwire 3 - Capital Deterioration Below Minimum Regulatory Standard

As discussed in earlier chapters, sufficient bank capital is vital to creating proper owner/management incentives and to protect the deposit insurance fund from loss. Yet numerous banks are undercapitalized. FIRREA attempted to address capital-related problems by placing restrictions on the activities of undercapitalized banks. For example, section 224 of FIRREA restricts the ability of capital-deficient banks to accept brokered deposits.

While the FIRREA restrictions are useful, additional enforcement actions are necessary to prevent a wider range of unsafe practices in capital-deficient banks. We believe that such practices are necessary because the managers of undercapitalized banks have strong incentives to (1) take excessive risks to restore the profitability of their institutions, or (2) remove value—i.e., capital—from the institutions and thereby increase the insurance fund's exposure to losses. Better controls on the activities of such banks can be accomplished by imposing a third tripwire that would require regulators to take more stringent enforcement actions against banks once their capital levels decline below minimum requirements. Measures that should be imposed by regulators might include

- requiring bank management to develop a recapitalization plan;
- forcing the bank to recapitalize through the sale of stock or holding company assets if it appears reasonable that such opportunities exist in the market place;
- suspending dividend payments and principal and/or interest payments on subordinated debt, and prohibiting asset growth;
- limiting interest rates paid on deposits;
- limiting or prohibiting transactions with affiliates; and

- requiring the election of a new board of directors or removing bank officers if these officials prove incapable of addressing the banks' problems or refuse to comply with regulatory actions.[3]

If the bank is not recapitalized within a specified time frame, regulators should take steps that anticipate its closure. FDIC, in cooperation with the primary regulator, would perform what can be termed a "break-up" analysis to determine the bank's liquidation, rather than its book, value. The findings of the analysis would provide the regulators with (1) an accurate picture of the bank's actual prospects for recovery, and (2) a basis for deciding the best regulatory strategy to minimize BIF losses. Once the "break-up" analysis is completed, regulators should monitor the bank's liquidation value on an ongoing basis to assess management's recapitalization efforts and prepare for the institution's possible closure.

Tripwire 4 - Capital Depletion

The fourth part of our strategy would require regulators to place into conservatorship or close banks whose equity capital reaches or falls below a minimum solvency standard that the regulators develop. (For example, such a standard might be an equity level of 2 percent.) Establishing a conservatorship for banks that still have a positive net worth could give the regulators sufficient time to sell or merge undercapitalized banks and avoid or reduce BIF losses. Banks that could not be sold or merged would be liquidated. Any net proceeds realized from a sale, merger, or liquidation, would be distributed to shareholders after all creditors and other successful claimants have been paid.

Benefits of Tripwire Approach

This four-part, tripwire regulatory approach would accomplish numerous objectives. First, the approach would provide regulators strong incentives to do a better job because the approach would require specified enforcement actions and hold the regulators accountable for not acting in an early and forceful manner.

Second, making the supervisory system more credible will also provide bank owners and managers with a strong incentive to exercise better control over the risks they take. An effective tripwire system thus enhances the deterrent effects of bank supervision.

Third, our proposed approach would prevent troubled banks from running up additional losses as saving and loans were able to do in the past decade. The approach would also restrict the ability of poorly operated

[3]In many instances, however, this action would have already been taken at an earlier stage.

banks to (1) gather deposits to fund high-risk strategies that could increase BIF losses and (2) bid up the cost of funds that well-managed banks must pay to attract deposits.

Fourth, the tripwire approach would lower the cost of bank failures to FDIC if banks can be placed into conservatorship before they reach insolvency. This objective would be accomplished by implementing a closure rule that, in principle, would be similar to that used by SEC. Under SEC rules, once a broker-dealer's capital ratio falls below the minimum capital requirement, it must cease operating even if it has positive levels of capital remaining. Since broker-dealers must value their assets at the market price daily, this rule allows SEC to close broker-dealers generally with minimal cost to the Securities Investor Protection Corporation (SIPC), the securities industry insurance fund. We recognize that it is more difficult for a bank's market value, and consequently real level of capital, to be determined since many bank assets cannot easily be valued at market prices. Consequently, it is not likely that the regulators would be able to close all failing banks without loss. However, the implementation of an early closure policy should allow the regulators to close banks at a much lower cost than the average 16 percent loss incurred on banks that failed between 1985 and 1989.

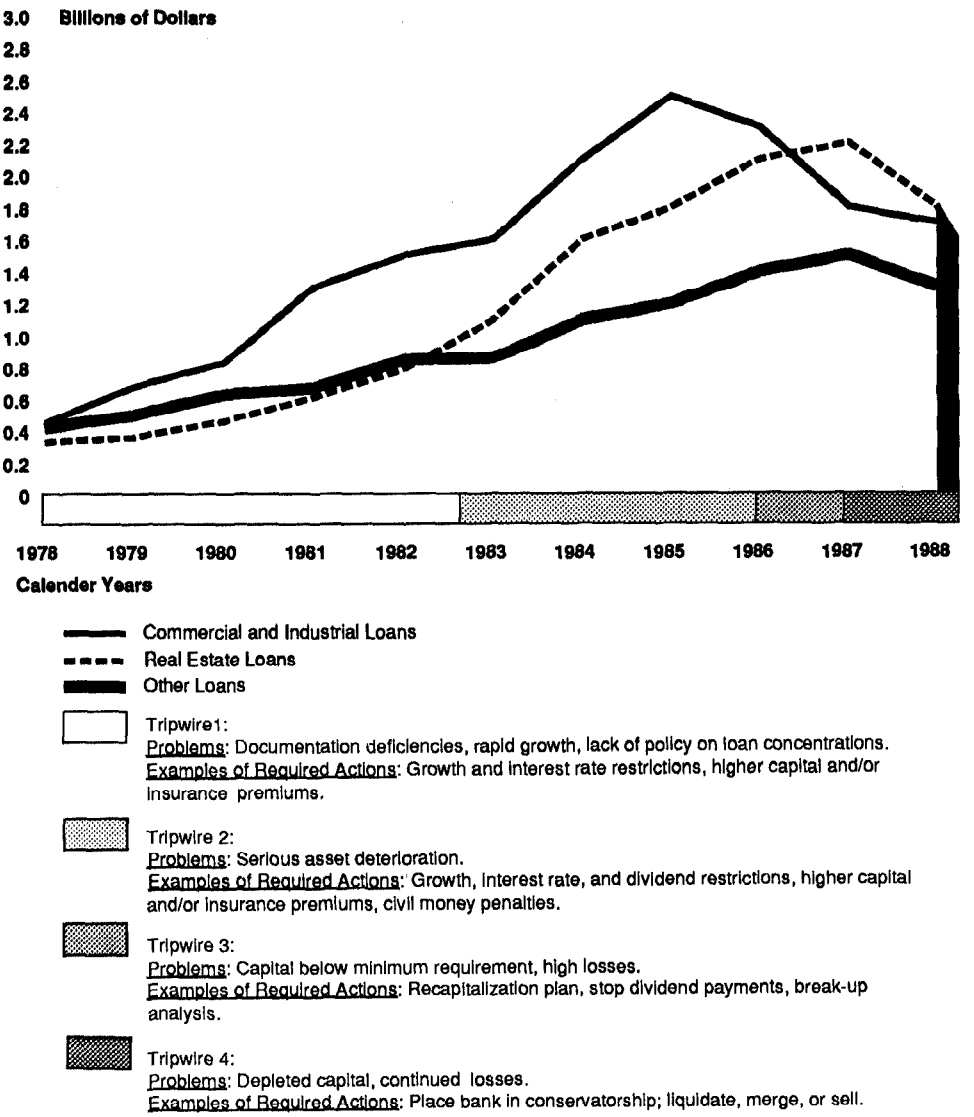
Fifth, the approach has the potential for making mergers more attractive for both bank acquirers and sellers. Potential acquirers should be more attracted to banks that have not been allowed the opportunity to continue practices that exacerbate the bank's problems. Owners of ailing banks would have an incentive to find merger partners knowing that FDIC will put them into conservatorship before they are completely insolvent.

Finally, deposit insurance premiums for well-run banks might be reduced if the plan is successful in limiting BIF costs.

Example of How Our Proposed Tripwire Regulatory Approach Would Work

In this section, we show how a tripwire approach could have reduced insurance fund losses by preventing excessive loan growth in a large bank with documented lending control deficiencies. Figure 3.1 provides historical information on the bank's commercial and industrial, real estate, and all other loans that were made subsequent to regulators first discovering internal control deficiencies. The figure also summarizes how our tripwire approach would have affected the bank's regulation.

Figure 3.1: Example of How GAO's Tripwire Approach Could Have Affected the Regulation of an Unsafely Operated Large Bank



The deterioration and eventual failure of the bank was marked by numerous warning signs that were often noted by bank examiners but generally not acted upon. An exam completed in 1978 noted that the bank had grown at a rapid rate over 3 years, had problems with its loan loss documentation, and relied on high-cost funds to finance its energy loan growth. Exams completed between 1978 and 1981 noted that the

bank had not developed policies on credit concentrations and funds management. To correct such problems, the regulator made exam report recommendations instead of initiating forceful enforcement actions. Our review indicates that the regulators' informal actions did not result in limiting the bank's overall loan growth which increased at a 27-percent annual rate between 1978 and 1982. The commercial and industrial loan category—which includes energy loans—expanded more than any other loan category, increasing from $450 million in 1978 to approximately $1.5 billion in 1982. A 1982 exam commented on the poor state of the bank's credit files and concluded that the downturn in the energy sector had seriously affected the bank's loan quality as indicated by its ratio of classified assets to capital, which had reached 50 percent. Again, the regulator did not take forceful measures to control additional lending.

Finally, in February 1984, the bank entered into an informal written agreement with its primary regulator after an exam completed in September 1983 found that the bank's classified assets had reached 108 percent of total capital. Among other provisions, the agreement required the bank to develop an effective loan review system and set aside a sufficient allowance for loan and lease losses. The agreement also required management to develop a 3-year plan that would limit outstanding loan growth to a level commensurate with the bank's ability to competently manage new loans.

Despite the agreement, the bank's overall loan portfolio grew at an annual rate of 18 percent between 1983 and 1986. While commercial and industrial loans grew at a 14-percent pace during this period, real estate loans grew at an even faster 26-percent annual rate. Additionally, even though the bank's capital level fell below regulatory minimums in 1986 and it lost $99 million, management paid out $14 million in dividends. Similarly, the bank lost $55 million in 1987 but management still paid out $6.8 million in dividends. While a 1988 exam severely criticized the bank's rapid real estate loan portfolio growth and failure to properly document new loans, the regulator did not take effective enforcement action to correct these abuses. The bank and other bank subsidiaries of the holding company failed in 1989 and will cost FDIC an estimated $2.7 billion to resolve.[4]

This failed bank example is replete with clear warnings that were not heeded by either the bank's regulator or its management. As a result,

[4]The bank was the largest banking subsidiary of the holding company and represented the largest share of FDIC losses.

the bank was allowed to continue engaging in unsafe practices that, when exacerbated by regional economic problems, eventually caused its failure. Our recommended four-part, tripwire approach would have mandated regulator and bank action long before the bank was harmed irreparably.[5]

The first tripwire would have been activated in 1978 when regulators became aware of documentation deficiencies. At this time the primary regulator would have been required to make a judgment on the seriousness of these deficiencies. If material, the regulator would have been obligated to require management to develop a plan to correct the identified deficiencies. The regulator would also have been required to take additional enforcement action such as placing limits on the bank's loan growth rate and ability to offer above market interest rates to attract deposits. Had management failed to implement the plan, the regulator would have increased the bank's minimum capital requirement and/or insurance premium payment. The regulator would also have been required to take similar steps between 1978 and 1981 when examiners found that the bank had not developed policies on credit concentrations or funds management.

In 1982, the bank's high classified assets/capital ratio would have set off another tripwire. In addition to requiring management to develop a plan to minimize the damage associated with classified assets, the regulator would have been required to take actions such as imposing loan growth and deposit interest rate restrictions and requiring the bank to immediately increase its capital or pay higher insurance premiums. Failure by management to fulfill any of the restrictions placed on the bank would have resulted in more stringent regulatory actions, such as civil money penalties.

In 1986, the bank's capital fell below regulatory minimums which would have activated our third tripwire. Regulators would have been obligated to prohibit dividend payments and require management to develop a recapitalization plan. If management failed to implement the recapitalization plan, the regulator, in conjunction with FDIC, would have performed a "break-up" analysis of the bank. The findings of the "break-up" analysis would have provided the regulators with the liquidation value of the bank, and could possibly have resulted in the closure of the

[5]The example that follows shows how the tripwire system would work as the condition of a bank deteriorates. In cases where the early tripwire interventions are successful, of course, the latter ones would not actually be needed.

institution. As the capital fell below the predetermined regulatory level, the fourth tripwire would have been activated and the bank would have been placed in conservatorship while it still had a small positive value. Any residual value after the bank's sale or liquidation would have been distributed pro rata to stockholders and creditors.

Implementation of Tripwire Approach

The implementation of our tripwire approach would expedite the development of guidelines by which to judge bank problems. For example, the Chairman of FDIC has recently proposed that a ceiling be placed on the percentage of loans that a bank may invest in any one type of asset. If that percentage is exceeded, regulators would have the authority to require the bank to reduce its loan exposure to the industry. We support such a proposal and expect that if Congress mandated a tripwire approach, regulators, in consultation with the banking industry, would develop supportable definitions of loan concentrations. Such definitions should take into account the fact that many small banks located in rural areas may have only limited opportunities to diversify their loan portfolios.

We recognize that regulator judgment will continue to play a key role in the handling of some troubled banking organizations. For this reason, once the tripwire approach is in place, regulators should be provided the ability to modify their approach on a case-by-case basis if deemed imperative to protect FDIC or the recovery of the affected bank. However, any deviation from the tripwires should be justified in writing by the regulatory authorities.

Better Information on Banks, Accounting Rule Changes, and Strengthened Reviews of Internal Controls Are Needed for an Effective System of Tripwires

Unavailable or inaccurate information on banks' conditions are a potential impediment to an effective tripwire approach. Regulators need appropriate information to ensure that they can identify deteriorating asset quality, earnings, and capital early and to ensure that any deficiencies are promptly corrected. We believe that these shortcomings can be resolved by (1) requiring regulators to conduct annual on-site exams of all banks, (2) changing accounting rules to provide for better recognition of loan losses, and (3) requiring bank managers to include in their annual reports an assessment of internal controls, and requiring independent auditors to notify the regulatory agencies of bank internal control weaknesses and noncompliance with laws and regulations.

More Frequent On-Site Exams Will Be Necessary

One of the reasons regulators do not obtain adequate information on the financial condition of banks is that they increasingly rely on off-site monitoring through unaudited call report data, rather then traditional on-site exams.[6] While call report data can be useful for data gathering purposes, over reliance on such data has two major flaws.

First, while we have not reviewed the overall quality of bank call reports, we have found evidence that some problem-bank call reports contain inaccuracies. For example, our 1990 report on BIF found that problem institutions generally understated the level of nonaccruing loans[7] in their call report submissions. Such inaccurate reporting is a reflection of manager incentives to minimize loss reserves and thus overstates interest income and net income. Taking these incentives into consideration, call report data should not substitute for frequent on-site examinations.

Our second concern is about the relative infrequency of on-site, full-scope examinations. In 1989, for example, FDIC or state examiners conducted only 3,631 safety and soundness exams for the 7,497 banks for which they were responsible. OCC completed 3,859 exams for the 4,166 banks it regulates, but this number includes multiple examinations of troubled banks and not all of the examinations were full scope.[8] The effectiveness of our recommended tripwire approach is directly related to the adequacy of information regulators receive about lending controls, asset quality, and capital levels. Some of this information, particularly regarding lending controls and asset quality, can only be obtained in full-scope on-site examinations. Without such examinations, bank management has the opportunity to continue engaging in unsafe practices that can eventually increase insurance fund losses.

A recently issued FDIC report on bank failures in Texas[9] buttresses our concerns about the regulators' decreasing reliance on on-site full-scope

[6]The off-site monitoring personnel analyze financial data contained in quarterly call reports that the banks submit to the regulators.

[7]Nonaccruing loans are assets for which banks are not allowed to accrue interest because (1) the financial position of the borrower has deteriorated, (2) full payment of interest or principal is not anticipated, or (3) principal or interest on the asset has been in default for a period of 90 days or more and the asset is neither well secured nor in the process of collection.

[8]The Federal Reserve is the only agency that has a policy of annual examinations alternating them with state examinations. It accomplished this goal in 1989, with the exception of 21 exams of well-managed banks that were completed in the first quarter of 1990.

[9]The Texas Banking Crisis: Causes and Consequences 1980-89 (July 1990).

examinations. The report concludes that, in every year between 1981 and 1989 except one, banks located in the Southwest and Texas had the lowest frequency of on-site examinations, primarily as a result of insufficient numbers of examiners. One reason for the lack of sufficient examiners is that staffing levels of federal bank examination agencies declined during the early 1980s. We believe that this absence of regular on-site examinations limited the regulators' abilities to verify the bank call report data and evaluate lending controls and consequently contributed to the substantial BIF losses associated with bank failures that occurred in Texas during the 1980s.

In order to resolve these information problems and to help prevent regional economic problems from developing into major bank crises, Congress should require annual full-scope on-site examinations of all banks. Congress should also require that regulators develop more stringent financial reporting requirements for large complex banking organizations and develop the information and expertise necessary to understand those organizations so that prompt action will accompany developing problems. This requirement is likely to demand increased regulatory resources, particularly for large banks, but could result in significantly lower costs to BIF if bank problems are detected and acted upon sooner.

Changes to Accounting Rules Needed to Fairly Value Assets

Bank regulators receive inadequate information partially as a result of several failings in the generally accepted accounting principles (GAAP) that are used to determine the value of bank assets. For example, as we observed in chapter 2, in the 39 failed banks we reviewed, asset values as determined by FDIC after failure were dramatically lower than reported by the institutions' management in call reports prepared prior to failure. The call report information, which was purportedly presented in accordance with GAAP, did not provide an accurate picture of the institutions' true financial condition immediately prior to failure because GAAP rules give bank management and auditors too much latitude in determining asset value.

One serious deficiency in the GAAP rules relates to the way in which loan losses are recognized. Under GAAP, loan losses are recognized only when it is "probable" that they will be incurred and that the amount of loss can be reasonably estimated. Such a requirement often delays the recognition of losses when, as is often the case, "probable" is inappropriately interpreted as meaning "virtually certain." Second, GAAP bases the estimate of any loan loss on the fair value concept, i.e., a seller is under no

compulsion to sell and has time to negotiate a sale. This standard is not realistic, however, since managers of undercapitalized banks are often under compulsion to sell assets to raise capital, and to do so under existing market conditions.

To resolve these problems, we believe that certain changes should be made to GAAP for nonaccruing loans and real estate acquired through foreclosure. The accounting profession and the appropriate regulatory agencies should promptly consider amending rules to require banks to

- record losses when occurrence of loss is likely (more than a 50-percent chance) rather than probable, as required under existing rules; and
- value the underlying collateral on the basis of existing market conditions.

We believe this step is needed to facilitate early detection of loan losses and enhance the protection of BIF.

Internal Control Problems Must Be Detected Early

We pointed out in chapter 2 that internal control problems such as unwarranted loan concentrations, poor loan documentation, and inadequate supervision by a bank's board of directors, have frequently been cited by regulators as major factors contributing to bank failures. We have also depicted internal control problems in depository institutions in previous reports.[10] These problems cannot be corrected quickly in a tripwire approach to bank regulation, unless they are detected promptly. Consequently, we have in the past and continue to emphasize the need for the auditing and management reporting reforms that will detect and contain internal control problems.

Annual reports on internal controls submitted by bank management to the bank's regulators are a first step in assisting regulators to detect internal control problems. Such written assessments of the adequacy of internal controls should provide information on the institution's internal control policies, procedures and practices, and their effectiveness. Mandatory independent financial audits for insured financial institutions are a necessary and complementary requirement to the reporting criteria. Such audits are necessary to verify that the information contained in the management and financial reports adheres to specific standards.

[10]Bank Failures: Independent Audits Needed to Strengthen Internal Control and Bank Management (GAO/AFMD-89-25, May 31, 1989) and Thrift Failures: Costly Failures Resulted From Regulatory Violations and Unsafe Practices (GAO/AFMD-89-62, June 16, 1989).

Auditors, for example, would be required to report on internal control problems and pursue any indicators of potential problems. Because large banks present a significant exposure to the solvency of the Bank Insurance Fund, their financial condition should be closely monitored by the regulators through special reporting and auditing requirements to assure the reliability of financial data.

In September 1990, we developed a detailed list of related actions that Congress should take immediately to strengthen accounting and auditing requirements to obtain financial reporting that better reflects the institution's financial condition.[11] A separate GAO report is being issued shortly to present these and other more detailed recommendations we have summarized above.[12] These recommendations, some of which will necessitate guidance from the American Institute of Certified Public Accountants and the Financial Accounting Standards Board, are provided at the end of this chapter.

A Commission of Regulators and Independent Experts Is Needed to Study the Adequacy of the Regulatory System

If regulators do not examine and regulate banks to adequately promote safe and sound banking and minimize FDIC losses, no reform of deposit insurance or the U.S. financial system can be completely successful. Since bank regulators are vitally important to resolving the current problems in our financial system, we believe a thorough evaluation is necessary of the regulators' ability to supervise the banking system and to carry out the recommendations contained in this chapter as well as those in chapters 4 and 5 of this report. Such an evaluation should include an analysis of the risks associated with all banking activities, particularly those of large complex organizations. The evaluation should also include the systems used to identify and monitor risk, staffing levels, examiner experience, the caliber and experience of supervisory staff, the responsibilities assigned to examiners at different experience levels, the training received by examiners, and the familiarity of examiners with complex banking products.

The high number of bank failures, discussed in chapter 2, and apparent increases in regulatory workload indicate that bank regulators may not

[11] Bank Insurance Fund: Additional Reserves and Reforms Needed to Strengthen the Fund (GAO/AFMD-90-100, Sept. 11, 1990). This report was prepared at the request of the Senate Committee on Banking, Housing and Urban Affairs and the House Committee on Banking, Finance and Urban Affairs and also included steps to strengthen BIF and improve the bank regulatory supervision process.

[12] See GAO's forthcoming report, Failed Banks: Accounting and Auditing Reforms Urgently Needed (GAO/AFMD-91-43, Mar. 1991).

have the capacity to adequately monitor and control risk-taking in commercial banks. For example, in 1989, bank examiners were each responsible for examining an average of $1.711 billion in assets and other bank activities (both on- and off-balance sheet) per year. This amount represents a 48 percent increase since 1984 when examiners averaged $1.159 billion in 1989 dollars (see table 3.3).

Table 3.3: Dollar Volume of Assets and Off-Balance Sheet Activity Per Federal Bank Examiner, 1984 to 1989

Constant 1989 dollars in billions

Year	Number of examiners	Total assets	Total off balance sheet activity	Assets and off balance sheet activity per examiner
1989	5,091	$3,298	$5,412	$1.711
1988	4,889	3,259	4,311	1.550
1987	4,879	3,231	3,738	1.428
1986	4,452	3,246	2,587	1.310
1985	4,169	3,089	2,113	1.248
1984	3,915	2,928	1,611	1.159

Source: Federal Reserve, FDIC, and OCC.

Even these statistics do not fully reflect the additional challenges that relatively recent changes in the banking industry pose to effective supervision. For example, banking is much more sophisticated, complex, and risky than it was in the 1950s or 1960s, as we discussed in chapter 1. Many commercial banks have transformed their businesses by focusing resources on the origination, distribution, and servicing of obligations rather than traditional portfolio lending. Larger banks also increasingly participate in such complex activities as futures and forward contracts,[13] option contracts, and interest rate and currency swap markets. Furthermore, as the asset side of banking has become more complex, the liability portion, or funding, has become more volatile.

In addition, these highly technical, specialized, and complex activities are being conducted in an increasingly competitive environment—both domestically and internationally. Profit margins are narrowing in banking and other financial arenas. Consequently, financial institutions may find it attractive to use products originally intended to reduce risk, such as hedging products, as vehicles to increase risk and potentially enhance profitability.

[13]Forward contracts purchase or sell a specific quantity of a commodity, government security, foreign currency, or other financial instrument at the current price, with delivery and settlement at a specified future date.

Finally, as a result of the bank holding company form of organization in the United States, bank regulators must constantly be aware of potential risk from nonbanking affiliates of insured banks. And, the regulators must increasingly become aware of and be prepared to control potential conflicts of interest that arise when one part of a bank holding company can benefit at the cost of another part of the company.

These changes in the banking industry raise serious concerns about the regulators' capacity to effectively supervise insured banks. Careful evaluation is needed to determine how regulatory capabilities must improve to deal not just with today's complexities, but those that no doubt will arise in the future—particularly if the powers of banking organizations are expanded. Questions that must be answered range from determining how examiner turnover affects the quality of bank examinations to whether the regulatory agencies have the ability to examine banks that in the future may have affiliations with organizations engaged in nontraditional banking activities. In addition, a judgment must be made about whether FDIC, specifically, has access to information that allows it to assess the risks of new deposit and banking products.

For the previously discussed reasons, we believe that a commission of regulators and independent experts appointed by the President and Congress should be established to thoroughly review what needs to be done to adequately address the oversight and supervision challenges that the banking regulators face. The review should evaluate current regulatory capabilities and recommend needed improvements. Once such recommendations are made, Congress and the Administration should act expeditiously so that the regulators fulfill their responsibility to maintain a safe and sound banking system.

Regulatory Improvements May Require Agency Restructuring

Our proposals to improve federal bank supervision by implementing a tripwire regulatory system, improving information on the condition of banks, and reviewing the adequacy of the regulatory process are needed to protect financial system stability and reduce the taxpayer's exposure to loss. While other regulatory issues have also been raised—such as whether the federal banking regulatory agencies should be restructured or consolidated—we did not develop specific recommendations in this area. Clearly, a more focused and effective regulatory system is needed. Changing the regulatory structure—either by merging regulatory functions or by changing agency responsibilities—might serve as a catalyst for the implementation of such a system and the creation of improved

regulatory incentives. Nevertheless, in the course of our reviews of capital deficient and failed banks, we have not concluded that such structural changes are necessary for accomplishing the goal of improved regulation. If structural changes do prove to be desirable or necessary for changing the focus of banking regulation as we have recommended, then such changes should take into consideration the differences between large and small banking organizations and their regulation, and the potential risks they pose to BIF.

In summary, we believe that the regulatory issue of overriding importance is implementation of our proposed regulatory improvements. If Congress decides to maintain the current regulatory structure, a tripwire intervention system and better information will be needed to ensure that the agencies act in a timely fashion to prevent continued unsafe practices on the part of bank managers. Similarly, a tripwire system and better information would also be necessary if a single bank regulator or other changes to the responsibilities of the current bank regulators were decided upon. Whether the responsibilities of regulatory organizations are changed or not, Congress should hold the regulators strictly accountable for effectively implementing a tripwire system and improving their information systems.

In addition, we have identified other regulatory changes that would not require major structural changes and could be considered to better protect the insurance funds. We believe that Congress should give FDIC the explicit authority to prevent state-chartered banks from engaging in any activity that poses a significant risk to the insurance fund. FIRREA gave such authority to FDIC to control the activities of state-chartered thrifts but did not extend the authority to state-chartered banks. Moreover, state legislatures have granted new powers to banks that may have an adverse impact on the insurance fund. For example, Delaware gave its banks the authority to underwrite insurance in 1990. We believe that FDIC is in the best position to judge risks to the insurance fund and should have the necessary enforcement authority to adequately protect the fund.

Congress Should Monitor the Adequacy of BIF Reserves

As noted in chapter 1, BIF is significantly underfunded and could restrict the flexibility of regulators to resolve banks in the least costly manner possible. FDIC has taken steps to address this problem by raising the premium rate for insured deposits from 12 basis points to 19.5 basis points starting on January 1, 1991; Congress has provided FDIC with the

authority to raise the insurance premiums further by removing the restrictions imposed by FIRREA.

In preparing this report, we have not attempted to determine precisely how much money BIF needs to ensure that it has sufficient reserves to allow the prompt closure of undercapitalized banks. The premium level depends upon such factors as the amount and timing of losses, the cash flow characteristics of case results, and the level of reserves that FDIC determines is necessary to enable it to act on a timely basis to close even large institutions whose capital falls below minimum levels.

One rough approximation of the BIF reserves and premium increases necessary over the next few years can be obtained as follows. In our report on BIF finances,[14] we described a scenario, based on a continuation of the then current negative financial trends in the banking industry, in which BIF could lose $21 billion between 1991 and 1995. To pay for the losses plus increase BIF to the level of 1.25 percent by 1995—the level of reserves FIRREA assumed would represent the minimum standard of BIF adequacy—requires total revenue for the fund of about $45 billion, or on average about $9 billion a year. A premium of approximately 30 basis points for the years 1991 to 1995 would probably be needed to generate this amount of income. We point out in the report, however, that this is not a worst-case scenario and that a severe recession would cause further losses.

Because of the uncertainty surrounding BIF's financial needs, we do not know whether all of the funds that BIF will require, including for working capital,[15] can be financed from industry sources. Higher premiums will clearly place a financial burden on U.S. banks. For example, a 30 basis point premium would be equivalent to approximately 45 percent of the commercial banking industry's net income in 1989. By contrast, the actual .083 basis point premium that was in effect in 1989 was equivalent to only about 12 percent of the industry's net income. It is also important to recognize, however, that premiums will still account for a relatively small percentage of banking industry expenses. In 1989, a premium of 30 basis points would have represented approximately 2.4 percent of total industry expenses. In determining industry ability to pay, it is therefore appropriate to consider all of the adjustments to both

[14]Bank Insurance Fund: Additional Reserves and Reforms Needed to Strengthen the Fund (GAO/AFMD-90-100, Sept. 11, 1990).

[15]Temporary funding that FDIC uses to help purchase the assets of failed institutions at fair market value. When the assets are sold, FDIC uses the proceeds to repay the working capital.

revenues and expenses that banks can make to offset the expense of higher premiums.

Despite the difficulties associated with determining appropriate premium levels, we cannot overemphasize the importance of FDIC's future efforts to restore BIF to an adequate level. Without adequate BIF cash reserves, regulators will not have the funds necessary to close institutions in a timely manner. This situation would give the managers of undercapitalized or insolvent banks an opportunity to continue engaging in unsafe practices that could further increase BIF losses and require a taxpayer-assisted recapitalization of the fund. As a result, we believe that Congress should exercise strong oversight to ensure that adequate steps are taken to replenish BIF reserves, and any taxpayer financing that may be required should be made conditional on the adoption of a comprehensive reform program.

As a tripwire approach with its early intervention arrangements is implemented, and minimum capital levels are strengthened as suggested in chapter 4, we anticipate that insurance losses should be reduced. As a result, eventually premium rates could stabilize or decline.

Conclusions

The continued stability and solvency of the federal deposit insurance system requires effective bank supervision and an adequately capitalized deposit insurance fund. To achieve those goals, the regulators must be willing and able to take timely and effective actions against the unsafe practices and conditions that lead to costly bank failures. In turn, the ability of regulators to act will depend on their access to current and accurate information on the condition of insured banks.

Unfortunately, Congress cannot be assured that federal regulators have adequate incentives or information to prevent a taxpayer-assisted rescue of BIF, as illustrated by the fact that regulators have not always acted promptly to stop unsafe activities. Regulators have preferred to work cooperatively with bank managers for extended periods of time even when it is clear the managers had not made necessary improvements. Furthermore, the available information on banks' financial condition is often unreliable because (1) data can be misleading or outdated, (2) current accounting rules do not provide for the timely recognition of loan losses, and (3) regulators have not required that bank management reports and independent audits be mandated. Moreover, regulatory agencies may lack the systems and resources needed to fulfill their

responsibilities, and the weak condition of BIF may limit the regulators' ability to promptly close undercapitalized or insolvent institutions.

Recommendations

To improve the bank regulatory system we recommend that Congress take steps to

- ensure that the regulators take timely and effective enforcement actions by mandating a tripwire intervention approach,
- emphasize closer regulatory scrutiny of large complex banking organizations, including more stringent financial reporting requirements and the enhancement of the expertise necessary to understand and quickly react to problems as they develop,
- exercise congressional oversight to ensure that BIF is adequately refinanced,
- establish a panel appointed by the President and Congress to conduct a thorough analysis of regulatory systems and resource requirements, and
- give FDIC the explicit authority to prevent state-chartered banks from engaging in activities that pose significant risks to BIF.

We have a number of other recommendations involving accounting and other reforms designed to improve information on the condition of banking organizations that are also a vital component of deposit insurance reform. With the exception of the accounting rule changes that the standard setting bodies should be given the opportunity to review, these recommendations should be enacted by Congress.

To make the tripwire system's early warning features effective,

- accounting principles for identifying and measuring loss contingencies should be revised to obtain prompt recognition of the value of banks' problem assets on the basis of existing market conditions,
- special accounting rules and audit procedures need to be developed to further clarify that affiliate transactions are required to be accounted for and reported on the basis of their economic substance,
- all banks should be audited annually by independent public accountants and receive full-scope examinations by the regulators, and
- key information used by regulators in implementing the tripwire system should be audited.

To strengthen the system of corporate governance so that it serves the regulatory need,

- fully independent audit committees should be appointed, and they should be charged with reviewing reports to regulators;
- all financial institutions should be made subject to internal control requirements like those added to the Securities Exchange Act of 1934 by the Foreign Corrupt Practices Act, and bank management should be required annually to publicly report on compliance with those requirements; and
- the adequacy of internal accounting controls and compliance with safety and soundness laws should be audited by independent public accountants.

To deal with the extraordinary risks to the BIF from large banks,

- the quarterly call reports should be reviewed by independent public accountants and
- bank management should prepare an annual financial forecast that should be reviewed by independent public accountants.

To accomplish this expansion of auditing activities, resources of the public accounting profession should be used, subject to the following conditions:

- regulators are promptly informed of internal control weaknesses and noncompliance with laws and regulations and
- only independent public accounting firms that are subject to the accounting profession's peer review program would be permitted to audit banks.

Changes in Economic Incentives That Affect Owners, Managers, and Depositors

Many of the financial problems in banking today can be traced to the fact that incentives for market participants have become skewed toward excessive risk-taking. Correcting this situation will require more forceful supervision by regulators, as we discussed in chapter 3. It will also require changing incentives that affect the economic interests of bank owners, managers, investors, and, to a more limited extent, depositors, in bank safety and soundness.

To change these incentives, we propose using market forces as well as changes in regulation to

- gradually strengthen the minimum capital requirements for banks,
- increase the role for subordinated debt in large bank funding,
- implement a system of risk-based deposit insurance premiums, and
- improve bank regulators' ability to stop risky banks from attracting deposits.

Bank Minimum Capital Requirements Must Be Strengthened

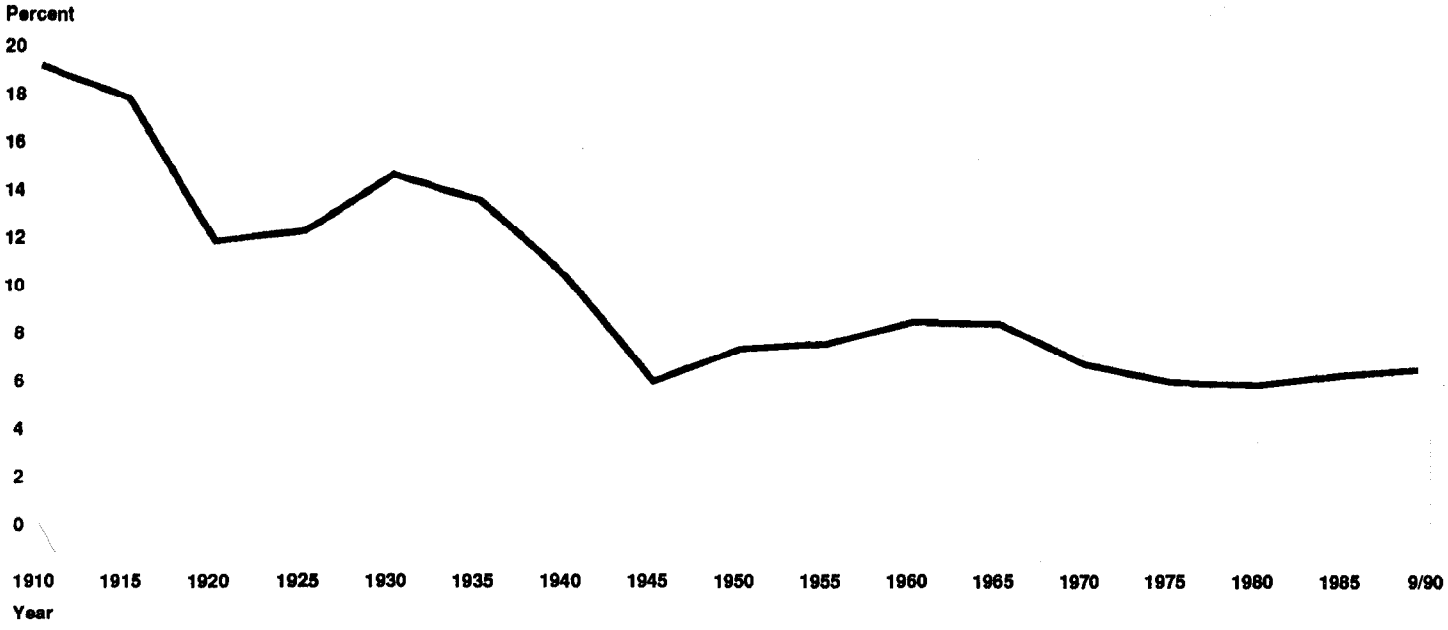
As we discussed in chapter 2, current levels of capital for many banks, both on a book and market value basis, are inadequate to protect BIF from loss. Strengthening the capital standards is essential if the stability of the banking system is to flow from the safety and soundness of the banks, rather than from the deposit insurance guarantee.

Current Minimum Capital Standards

Since the establishment of deposit insurance in 1933, the level of the average bank equity capital-to-assets ratio[1] has gone down. In 1933 banks had an equity capital-to-assets ratio of about 15 percent. Thereafter, it fell continuously, bottoming out at just under 6 percent in 1945. The ratio then rose through the post-war period, peaking at almost 8.6 percent in 1961. It remained relatively stable throughout the 1960s but began declining again in 1968. By the late 1970s the average equity capital-to-assets ratio stood at just 5.8 percent; by September 1990 it had risen to 6.45 percent. (See fig. 4.1.)

[1]Equity capital represents the book value of the owners' direct investment plus the banks' retained earnings.

Figure 4.1: Equity Capital-To-Assets Ratios for Commercial Banks, 1910 to 1990



Source: Historical statistics of the U.S., colonial times to 1970, U.S. Department of Commerce, and the Federal Reserve.

In the late 1970s, bank regulators became concerned about bank capital adequacy because equity capital-to-assets ratios of all banks, particularly large banks, were low relative to historic levels. This concern led to the establishment of uniform minimum capital standards for all banks.[2] These standards required banks to hold a specific percentage of their assets in the form of equity capital and certain other balance sheet

[2]In 1981, FDIC, the Federal Reserve, and OCC developed capital guidelines for regional and community banking organizations. Before then, regulators had imposed capital standards only on a case-by-case basis. FDIC established a minimum equity capital-to-assets ratio of 5 percent. The Federal Reserve and OCC required regional banks to have a primary capital-to-assets ratio of 5 percent and a total capital-to-assets ratio of 6.5 percent. Community banks were required to carry primary capital of at least 6 percent and total capital of 7 percent. (At this time, primary capital was composed of common stock, perpetual preferred stock, surplus, undivided profits, capital reserves, general loan loss reserves, and mandatory convertible instruments. Total capital was composed of primary capital plus limited-life preferred stock and qualifying subordinated notes and debt of the bank subsidiaries.)

In 1983, OCC and the Federal Reserve required multinational banking organizations to meet the requirement imposed on the regional banks. Through the early 1980s, bank regulators made several revisions to the definition of capital under the standards. In 1985, the three bank regulators adopted the same capital standards for all banks. This standard required all banks to hold primary capital equal to 5.5 percent of their assets and total capital equal to 6 percent. These requirements have been superceded by the risk-based capital and leverage standard being implemented in 1991.

items. These other items were included in the regulatory definition of capital because it was believed that they would absorb potential losses to BIF.

During the 1980s, the new capital standards and other market factors successfully induced banks to increase significantly their absolute levels of equity capital—by almost $100 billion from 1980 to 1989. The ratio of bank equity to assets increased as well because equity capital increased more than total bank assets (91 percent versus 78 percent). However, during the latter half of the 1980s, banks also substantially increased their off-balance sheet activities against which they were not required to hold capital.[3] These activities as a percentage of on-balance sheet activities (assets) increased from 55 percent in 1984 to 164 percent in 1989, effectively decreasing capital as a percentage of total on- and off-balance sheet activity.

One of the deficiencies of using the above described measure of capital to determine the adequacy of bank capital is that it fails to take certain bank activities, including off-balance sheet activities such as standby letters of credit, into account.[4] In an attempt to make capital requirements more sensitive to differences in bank risk profiles, regulators, here and abroad, have established risk-based minimum capital requirements for banks. The negotiation of these requirements, under the auspices of the Basle Committee on Banking Supervision (Basle Committee),[5] also recognized that banking markets have become globally integrated.

The risk-based capital standards, when implemented by national regulators, require banks to hold capital—composed of equity capital and other acceptable items—against both their assets and their off-balance

[3]Off-balance sheet activities are items not reflected on the balance sheet, but which represent a potential claim on capital. They include items such as loan commitments, letters of credit, foreign exchange contracts, financial futures and forward contracts, and interest rate or foreign currency swaps.

[4]A standby letter of credit is a document issued by a bank, on behalf of its customer, authorizing a third party to draw drafts on the bank up to a stated amount for a specified period if the customer does not perform under the terms of a contract with the third party.

Another deficiency is that the true economic value of bank equity may be less than the book value of equity that is used in the standard. One of the reasons noted in chapter 2 why more capital is needed is that many banks are weaker than the book value of their equity might suggest.

[5]The Basle Committee is composed of representatives of the central banks and supervisory authorities of the Group of Ten countries (Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, United Kingdom, United States), Switzerland, and Luxembourg.

sheet items. The absolute amount of capital required varies with the risk weight assigned to different classes of assets and off-balance sheet items. The standards became operational at the beginning of 1991 and will be fully effective by year-end 1992. When the standards are fully implemented, banks will be required to hold tier 1 capital (principally equity) equal to or greater than 4 percent of their risk-weighted assets and total capital (tier 1 plus tier 2 capital) equal to or greater than 8 percent of their risk-weighted assets.[6]

U.S. banks will also be required to meet a leverage capital requirement (tier 1 capital as a percentage of total assets) equal to 3 percent for the most highly rated banks and 4 to 5 percent for other banks.[7] The purpose of the leverage requirement is to ensure that all banks maintain a minimum amount of capital.

[6]A bank's risk-weighted capital ratios are calculated by dividing its qualifying tier 1 and total (tier 1 plus tier 2) capital by its risk-weighted assets.

Tier 1 capital is composed of core capital elements such as common stockholders' equity, minority interests in equity accounts of consolidated subsidiaries and related surplus, and perpetual preferred stock.

Tier 2 capital includes allowance for loan and lease losses (subject to restrictions and transition rules), perpetual preferred stock and related surplus, hybrid capital instruments, and a limited amount of term subordinated debt and intermediate term preferred stock and related surplus.

In order to calculate a bank's risk-weighted assets, the bank's assets are divided into broad risk categories as follows:

Category 1—zero percent risk-weight: Includes items such as cash and direct claims on member governments of the Organization for Economic Cooperation and Development (OECD).

Category 2—20 percent risk-weight: Includes items such as claims on U.S. depository institutions and OECD banks, and general obligation claims on states.

Category 3—50 percent risk-weight: Includes items such as loans fully secured by a mortgage on some residential properties.

Category 4—100 percent risk-weight: All assets not included in the categories above are assigned to this category.

Off-balance sheet items are also assigned to appropriate risk categories after they have been multiplied by a credit conversion factor, ranging between 0 and 100 percent, which depends on the estimated size and likely occurrence of the credit exposure.

Once all on- and off-balance sheet assets have been assigned a risk category, the aggregate dollar value of the amount in each category is multiplied by the risk-weight associated with that category. The resulting weighted values from each of the risk categories are added together, and this sum is the bank's total risk-weighted assets.

[7]As of December 31, 1990, the Federal Reserve and OCC had officially adopted this leverage requirement, and FDIC was expected to adopt an identical requirement in early 1991.

The most highly rated banks are those banks rated a "1" on the CAMEL rating system used by the three federal bank regulators.

By and large, most banks already meet or exceed the 8 percent risk-based minimum standard that will become mandatory at the end of 1992. As of September 30, 1990, we estimate that 96 percent of all banks in the country met or exceeded the standard. The 484 banks that were below the standard did, however, account for about 25 percent of industry assets, almost all of which were in 83 banks that had over $1 billion in assets. To meet the standard, banks can either attract more capital or shrink in size.

A Strengthened Capital Standard Is Needed

We have emphasized a number of times that a minimum capital standard serves two purposes. It provides an incentive for owners and managers to control the risks they take and it is a cushion to absorb bank losses, thereby protecting the deposit insurance fund and U.S. taxpayers. For a capital standard to successfully serve these purposes, it must be enforced. If it is not (as was the case in the thrift industry), or if its enforcement is somewhat erratic (as is evident in the banking industry where numerous under-capitalized banks are still operating), the incentives to control risks are significantly weakened, and the safety cushion is reduced. Our tripwire recommendation in chapter 3, that focuses supervision on a defined set of enforcement actions tied to specific internal control and other bank problems, is designed to facilitate the strict enforcement of capital adequacy standards.

While strict enforcement of the existing capital standard is a crucial part of changing owner and management incentives, incentives can be enhanced even further by strengthening the standard. Strengthening the standard increases the likelihood that the capital banks hold will be sufficient to cover potential bank losses.

The current risk-based minimum capital requirement is a significant improvement over previous standards. But two problems remain with the existing standard. First, the amount of capital, especially the 4-percent tier 1 standard (essentially owners' equity) is too low to adequately compensate for the types of risks that exist in today's highly competitive banking environment. Although exact interindustry comparisons are difficult to make, it seems to be the case that organizations—such as finance companies—that face risks similar to banks but operate without federal deposit insurance generally hold equity capital higher than that of banks.

Second, the existing standard does not adequately measure all types of risk. The requirement only takes credit risk into account while interest

rate risk and other market risks are not included. Moreover, credit risk appears to be treated in an arbitrary fashion because each risk category contains assets with wide variations in risk. For example, there is no differentiation in the amount of capital required against a loan made to an AAA-rated company and a loan made to a company whose debt has received a speculative grade rating.

U.S. bank regulators and the Basle Committee are currently working on incorporating other types of risk into the risk-based capital standards. While recognizing the complexity of these efforts, we believe they are vital to insure that banks in all nations have adequate capital. The better a capital standard reflects risk, the more effective and equitable it will be.[8]

The international capital standards are recognized by all parties only as minimum standards, and each country is free to exceed these standards. Thus, we think it is important that the U.S. bank regulatory agencies press forward with efforts to phase in strengthened capital standards that are appropriate for the U.S. banking system. These standards should reflect bank risk-taking and should help minimize the exposure of BIF and U.S. taxpayers.

Subordinated Debt Should Play an Important Role in Larger Banks

Subordinated debt is a type of security issued by banks that, in the event of a bank failure, will be honored only after the claims of depositors, general creditors, and FDIC. Under the current risk-based capital standards, certain types of subordinated debt are allowed, but not required, in the calculation of tier 2 capital in an amount up to 50 percent of tier 1 capital.[9] We believe, however, that requiring large, publicly traded banks to issue term subordinated debt at regular intervals directly to the market would help to bring a significant level of constructive market discipline to bear directly on those banks.

Because subordinated debt holders are in danger of losing their investment when a bank fails, they have a strong incentive to monitor and control bank risk-taking. Furthermore, because the return on their

[8]For further discussion of the international capital standards, see International Banking: Implementation of Risk-Based Capital Adequacy Standards (GAO/NSIAD-91-80, Jan. 25, 1991).

[9]In order to be counted as capital, this debt must have an average weighted maturity of 5 years. This requirement is important and should be retained because it forces the purchaser to take a longer term view of the economic condition of the banks and ensures that the debt that is counted as capital does not all mature at once.

investment is fixed, subordinated debt holders, in contrast to equity holders, do not benefit if bank risk-taking pays off.

Requiring large banks to issue subordinated debt in regular intervals would provide additional market discipline in a number of ways. First, in selling this debt the banks would have to provide detailed disclosures to prospective purchasers pursuant to securities and banking laws.[10] Second, the costs of raising subordinated debt would increase with the riskiness of the bank, and would therefore give a clear market signal to bank owners, uninsured depositors and the bank regulators of the health and perceived risk of the bank.[11] Unacceptably high costs for such debt should force bank management to reevaluate its strategies and reduce bank risk.

Another feature of subordinated debt is that it can provide a market-based mechanism for facilitating the redirection of a problem bank. Under our tripwire approach outlined in chapter 3, interest payments to debtholders can be suspended if the bank takes on excessive risk that causes losses that are high enough to reduce capital below minimum requirements. As is frequently the case with many debt instruments issued by corporations, covenants built into subordinated debt agreements could provide debtholders certain options, such as participating in a reorganization of the bank's board of directors, in the event that interest payments are missed. This feature provides an additional incentive for bank managers and directors to keep capital above the minimum requirement.

The principal reason why we favor making subordinated debt mandatory for large banks is that these banks typically obtain a significant portion of their funds from uninsured deposits and other nondeposit liabilities. As we explain later in the chapter, for stability reasons there are limits on the extent to which it is appropriate to count on uninsured depositors as a source of discipline on the risk-taking activities of bank owners and managers. A mandatory subordinated debt requirement for large banks, therefore, provides a way of obtaining many of the benefits often associated with depositor discipline while minimizing possible

[10]While banks (but not bank holding companies) are exempt from SEC registration requirements, banking agencies are responsible for enforcing essentially the same set of disclosure requirements in the banks they supervise.

[11]If a bank's assets comprise almost all of the assets of its consolidated holding company, the parent company, rather than the bank, could be required to issue the subordinated debt. In this case, the market signal from the parent debt issue will be a good proxy for the health and perceived risk of the bank.

adverse effects on the stability of the banking system. If they become concerned about the condition of a bank, holders of term subordinated debt cannot withdraw their funds from the bank. (They can, however, sell their subordinated debt to another party.) For a well-capitalized, well-managed bank, the interest costs associated with meeting the subordinated debt requirement should not greatly exceed the costs of uninsured certificates of deposit of comparable maturity.

We recognize that under the currently prevailing circumstances in the market, many large banks, particularly those with lower debt ratings, would have difficulty issuing subordinated debt at an affordable price.[12] For example, in November 1990, subordinated debt issued by a banking organization with a BBB-rating (one of the lowest investment grade ratings) cost an average of 555 basis points (5.55 percent) over the cost of similar maturity Treasury bills (Treasuries). This compares to a spread of 150 basis points (1.50 percent) over Treasuries for a banking organization with an A-rating, the third highest rating. Consequently, a flexible, phased-in approach should be implemented to allow banks time to adjust to the requirement.

A phased-in approach would also be necessary to allow time for the market for subordinated debt to develop. The market for subordinated debt would have to expand significantly. As of year-end 1989, large banks[13] had approximately $14.7 billion in subordinated debt outstanding.[14] About $14.5 billion of this debt counted as tier 2 capital. If large banks were required to hold subordinated debt equal to, for example, 2 to 2.5 percent of their risk-weighted assets, the amount of debt banks held that counted as capital would have to increase from $14.5 billion to between $22.7 and $28.5 billion.

A successful approach to requiring large banks to issue subordinated debt will not only need to be phased in, but will also require both high quality, timely public information on both a bank's condition and the implementation of the regulatory tripwire approach we are recommending. Predictable regulatory actions are essential if purchasers of

[12]Issues of both equity and subordinated debt became prohibitively expensive in 1990 due to concerns about credit and a slowing economy, and banks were forced to finance themselves through commercial paper and other short-term instruments.

[13]For this example, large banks are banks with assets over $10 billion. When implementing this requirement, regulators should determine which banks should be required to issue subordinated debt.

[14]Most of this debt appears to be held by affiliated bank holding companies, not public investors.

subordinated debt are to make accurate, market-driven judgments about bank risk.

Regulators Should Not Be Deterred From Strengthening Capital Standards

We have not attempted to determine the precise nature of the capital standard that would be appropriate. We think the task of defining such a standard is properly that of the regulatory agencies. We do recognize, however, that moving to a stronger capital standard is controversial and have consequently assessed some of the implications of generally higher capital standards.

To gain insights into the ramifications of strengthened capital standards, we studied the implication of requiring banks to meet a minimum risk-based capital standard of 10 percent. As of September 30, 1990, 11,497 banks—about 89 percent of the banks in the country—would have met that standard. However, most of these banks—11,306 of the 11,497 banks—have less than $1 billion in assets. In contrast, about 56 percent of all banks with assets greater than $1 billion would fail to meet the higher risk-based capital standard. These banks account for about 55 percent of industry assets. Consequently, the heaviest burden of raising the additional capital would fall on the larger banks. Most would need to raise their capital by about 10 to 20 percent, assuming that the magnitude and composition of bank assets remains constant.

These estimates indicate that phasing in a strengthened capital standard will likely place some strain on undercapitalized banks as they seek to attract more capital, shrink, cut costs, or rearrange their balance sheets to reduce risk. Difficulties in meeting strengthened capital standards are to be expected, but they should not deter regulators from requiring more capital. Either the deposit insurance system and creditors on the one hand, or bank owners on the other hand, have to pay for the losses associated with bank risk-taking. We believe that it makes sense for bank owners, through higher equity investments, to bear these costs.

Questions have been raised about the feasibility of phasing in strengthened capital standards at a time when the industry is under stress. However, for the following reasons, we believe that calls to defer strengthened capital standards should not be heeded.

First, since many profitable banks already hold higher capital than required by the 1992 Basle standards, strengthened standards should not be impossible to attain and will not necessarily impair the profitability of well-managed banks. Furthermore, most industry profits are

found in banks that meet or exceed the existing minimum capital standards.

Second, the reason many banks do not meet the existing capital standards and may have trouble meeting a strengthened standard has little to do with the standard itself, but rather with the way the banks are operated. The leading cause of problems within the industry is the increasingly risky nature of the loan portfolio, especially the growing levels of nonaccruing loans that have a direct negative impact on earnings and potentially on capital. These problems are obviously related to dislocations which have occurred in the economy. However, bank management must accept responsibility for a great deal of the impact of these events on their financial position because they must take potential economic downturns into consideration when making or pricing loans. Regulators have often cited management-related deficiencies as leading factors in bank failures, and our own work substantiates these conclusions.[15]

Evidence shows that profitability problems in banks have often been the direct result of making high-risk, underpriced investments. In the last 6 years about 50 percent of the before-tax earnings of the banking system have been used to provision for loan losses. (See table 4.1.) Banks with over $1 billion in assets have added more than $100 billion to their loan loss reserves. While this addition has improved large banks' ability to handle problem assets, it has resulted in significant earnings declines. Bank earnings, especially among the largest banks, fell dramatically in 1987 and 1989 as a result of these additions.

[15]For more information on these issues see Bank Failures: Independent Audits Needed to Strengthen Internal Control and Bank Management (GAO/AFMD-89-25, May 31, 1989).

Table 4.1: Bank Earnings and Loan Loss Provisioning, 1984 to 1989

Dollars in millions

Year	Industry earnings[a]	Industry provisioning	Provisioning as a percent of earnings
1984	$33,721	$13,778	41
1985	40,894	17,676	43
1986	44,157	21,900	50
1987	45,558	37,519	82
1988	51,193	17,066	33
1989	56,070	30,379	54

Note: Additions to (or reductions from) the allowance for loan and lease losses account. The additions to (or reductions from) this account are based on the evaluation by bank management of the collectibility of loan and lease financing and receivable portfolios. The allowance account must have sufficient funds to absorb anticipated losses.

[a]Industry earnings are calculated before provisioning, taxes, and the net effect of extraordinary items.

Source: GAO analysis of call report data.

Low profitability, in turn, has made it hard for the banks to generate capital through retained earnings or to attract new equity capital. Indeed, for the 3 years 1987 through 1989, dividend payments in banks with assets over $10 billion exceeded net income, thereby significantly weakening their capital position.

Third, in assessing the ability of banks to meet strengthened capital requirements it is important to recognize that banks have many options to accomplish this goal. Although we do not know how much flexibility bank managers have to reduce expenses or increase prices in a competitive market situation, an assessment of the implications of increased capital requirements on bank profitability must take into account all of the choices that bank owners and managers have with respect to both the revenue and cost sides of their operation. For example, banks can increase earnings, and subsequently retained earnings, which contribute to capital, by cutting costs or pricing loans to more effectively compensate for the risks they are taking. Such improved pricing would offset losses associated with nonaccruing loans. Banks can also reduce what they pay for funds and perhaps shrink somewhat in size to reduce the interest component of their expenses. Because banks are highly leveraged institutions, relatively small changes in their revenue or funding and other operating costs can have significant impacts on their profitability. For example, the before-tax return on equity (ROE) for average banks with over $1 billion in assets was 7.8 percent in 1989. A 5 percent

reduction in non-interest expenses would have increased this return by approximately 46 percent.[16]

Finally, it is very important to note that while raising capital may be painful for traditional banks and some banks may fail to meet the higher requirements, raising bank capital levels will be beneficial both to banks that are well managed and meet the requirements and to the banking system as a whole. As bank capitalization increases relative to bank risk, bank credit ratings should improve. Currently, only one large U.S. bank receives a AAA credit rating, the highest available.[17] As credit ratings improve, the cost of bank funding should decline,[18] which should translate into noticeable improvements on equity returns.

In addition, as strengthened capital requirements are enforced through the implementation of the supervisory tripwire approach we are proposing, capital-deficient banks will be prevented from bidding up the cost of funds, thus lowering the cost of funds for well-capitalized banks.[19]

Furthermore, strengthened capital standards will encourage banks that are not able to make the adjustments necessary to meet the requirements to seek out healthy merger partners. Banks that do not succeed may fail. While certain short-run dislocations may result, in the long run, a consolidated and appropriately capitalized banking industry will be healthier, operated in a safer and sounder manner, and easier to regulate effectively.

We acknowledge that phasing in strengthened minimum capital requirements for U.S. banks without negotiating similar standards for other countries has the potential for placing some U.S. banks at a competitive disadvantage vis-a-vis foreign banks in the short term, although tax and accounting differences and differences in market structures among

[16]This example is based on average balance sheets and income statements for all banks with greater than $1 billion in assets as of December 31, 1989.

[17]Credit ratings on long term debt calculated by Standard & Poor's range between AAA, the highest, to CCC, the lowest, with BBB the lowest investment grade rating.

[18]For example, in May 1990, a Keefe, Bruyette & Woods, Inc. index of bank holding company debt showed that BBB-rated 7- to 10-year debt was yielding an average of 270 basis points over Treasuries. At the same time AA/A rated issues yielded 150 basis points over Treasuries.

[19]In the mid-1980s banks in Texas faced what was termed the "Texas Premium." This term represented the increase in funding costs that was needed to attract depositors to these banks. Although the poorly capitalized banks paid the highest premiums, even the well-capitalized banks were forced to pay higher rates than their counterparts in other states.

countries make such comparisons difficult. In order to minimize any adverse competitive effects, to the extent possible, efforts to strengthen capital standards in the U.S. should be undertaken in connection with efforts to strengthen the negotiated international bank capital standards. However, even if such negotiations have not been completed, we also believe that it is appropriate for U.S. regulators to proceed to phase in strengthened standards that are essential for the safety and soundness of the U.S. banking system. Well-capitalized banks are in the best position to absorb temporary losses and expand their international business activities successfully. Furthermore, as the credit ratings of U.S. banks improve they will be better able to participate in certain international and domestic markets, such as the letter of credit or financial guarantee markets, that place a premium on well-capitalized banks.

Modifications Should Be Made to Deposit Insurance Premiums to Reflect Differences in Risk

Risk-based deposit insurance premiums are desirable for several reasons. First, there are equity considerations. By varying premiums according to risk, more of the burden of premium increases would be distributed to those banks that put BIF at greatest risk. Second, risk-based premiums provide an incentive for the owners and managers of institutions to control their risk. Finally, risk-based premiums help regulators focus on risks incurred by the banks they are supervising.

Current measurement problems associated with determining precise differences in risk among banks make it extremely difficult to sufficiently and fairly raise premiums to fully compensate BIF for the risks banks take. Such problems are more severe for a government monopoly operating in a political environment. We believe, however, that a modified system of risk-based premiums can be used as a supplement to risk-based capital requirements. Banks with higher risk can be assessed higher premiums—perhaps up to twice the regular premium. Although not a perfect measure of risk, this higher premium can help focus bank management's attention on the cost of risk-taking.

As discussed in chapter 3, risk-based premiums should be linked to a tripwire supervisory system. Higher premiums should be charged to banks that lack adequate internal controls and/or that fail to meet their capital standards. Variations in the premium rate could be set according to how egregious these deviations are. For example, if healthy banks were required to pay the current premium of 19.5 basis points, under tripwire 1, banks with documented internal control deficiencies would be required to pay a moderately higher rate—say an additional 5 or 10 basis points. Under tripwire 3, banks that are capital deficient would

pay a higher penalty premium—a rate of perhaps twice the regular premium. The amount of the premium variation should be determined by FDIC.

Ideally, a risk-based premium system would give credit to strongly capitalized banks. However, at present we do not believe this is feasible because of the dangerously low level of BIF's reserves. In addition, the risk-based levels of capital need to be strengthened before they can serve as the basis for reducing insurance premiums. Once BIF has been recapitalized and the capital standards strengthened, premiums should be lowered for well-capitalized banks.

We recognize that risk-based premiums will be costly for troubled banks. Nevertheless, it is precisely these banks that pose the greatest threat to the fund. If their viability is seriously threatened by the increase in premium cost, then this approach appropriately expedites the merger or failure of these banks.

Incentives Affecting the Ability of Risky Banks to Attract Deposits Should Be Changed

In chapter 2 we pointed out that one of the problems in the deposit insurance system is that it is easy for undercapitalized or risky banks to attract deposits. All managers of such institutions have to do to attract money is to marginally raise the rates of interest they pay on deposits. This brings in deposits because depositors who are insured or who feel they are protected on a de facto basis do not need to worry about the safety of the institutions in which they place funds and, therefore, have a strong incentive to focus strictly on yield. We also noted in chapter 2 that the often differing treatment accorded uninsured depositors in large and small bank failures creates an incentive that favors placing uninsured deposits in large banks.

Deciding how to deal effectively and equitably with the incentive problems that make it easy for undercapitalized or risky banks to obtain funds is, in our view, the most difficult task involved in attempting to reform the deposit insurance system. Unfortunately, one potentially effective way of changing management incentives—increasing the discipline that results from depositors' decisions to deposit or withdraw their funds—may also result in an unacceptably high risk of instability.

Stability Considerations Are Important

If the deposit insurance guarantee or de facto protection for uninsured depositors were cut back, many banks would no doubt be operated more safely—for example, by increasing capital levels—in order to win and

retain depositor confidence. However, depositors who are not fully protected will also have a strong incentive to take their money out of banks at the first sign of trouble, potentially creating bank runs. In a dynamic, healthy economy, some bank failures can be expected, and an isolated bank run, even at a large bank, need not threaten the stability of the banking system as a whole. However, as was evident in the Great Depression of the 1930s, in a distressed economy, depositor reactions could generate a series of destabilizing bank runs that could prove to be extremely difficult to contain. Loss of confidence that leads to a series of bank failures could, in turn, further reduce confidence in the banking system.

Stopping bank runs that stem from loss of confidence in the banking system is one of the reasons deposit insurance was established. From the stock market crash of 1929 through the bank holiday of 1933, over 9,000 commercial banks, 20 percent of the total number of such banks, failed. Most of these banks tended to be small, but together they accounted for about 10 percent of all bank deposits—creating about a 1 in 10 chance that a deposit in the banking system would suffer at least some loss.[20]

The reasons for being concerned about disruptive bank runs are as valid today as when the system was first set up. Therefore, reform of the deposit insurance system must not inadvertently create the potential for instability that characterized the Depression. This means that the basic tools available to stop bank runs must not be drastically altered. These tools include not only deposit insurance coverage, but also discount loans from the Federal Reserve System and the ability of federal officials to step in to protect all depositors, regardless of insurance status, if circumstances warrant.

Because of deposit insurance, our banking system today is much better protected against bank runs than in the early 1930s. If the deposit insurance level is kept at $100,000, most depositors will be fully protected when banks fail and therefore will have little incentive to participate in bank runs. However, efforts to reform the deposit insurance system cannot ignore the potential threats to stability resulting from actions of uninsured depositors. Uninsured depositors and other noninsured liability holders are a major funding source for many larger U.S. banking institutions.

[20]Approximately 1.3 percent of all deposits in the banking system was lost during this time so the average loss on deposits in failed commercial banks was about 13 percent.

Uninsured deposits and other nondeposit liabilities fund approximately 40 percent of the assets of all U.S. banks. Furthermore, for large banks the percentage is often far higher than the industry average. For example, 10 of the top 25 banks in the country rely on uninsured liabilities for over 60 percent of their funding. (See table 4.2.)

Table 4.2: Reliance on Uninsured Liabilities by the Top 25 Banks, as of December 31, 1989

Percent of assets funded by uninsured liabilities	Number of banks
70+	6
60-69	4
40-59	8
Under 40	7

Source: GAO analysis of call report data.

Runs on our largest banking institutions could have significant destabilizing effects, particularly if a run at one large institution leads to runs at others.

The potential for such contagion arises from a number of factors that must be addressed before any reduction in insurance protection can be contemplated. First, uninsured depositors do not currently have options—such as purchasing additional insurance—for safeguarding their deposits in banking institutions. Second, it is not reasonable to expect uninsured depositors to make informed decisions about the condition of the institutions in which they place funds. Even the most sophisticated of uninsured depositors are unable to assess precisely the condition of institutions in which they place funds because information on those institutions does not accurately reflect their condition. If accurate information is not available, it is all too likely that runs on a bank will be caused by misinformed depositors and based on inferences about events affecting other banks thought to be similarly situated. Third, with the advent of electronic funds transfers, it has become very easy for uninsured depositors to withdraw large sums of money from a bank at any time. Fourth, the losses potentially faced by uninsured depositors could be exceedingly high. Losses in banking organizations closed by FDIC between 1985 and 1989 have averaged nearly 16 percent of the failed banks' assets, an unacceptably high level of loss for risk-averse depositors to accept.

For the reasons we have cited, we do not believe that it is possible to initiate reform of the deposit insurance system by cutting back current

deposit insurance protection, including that provided by de facto protection. In our view, the potential for systemic instability caused by reliance on uninsured depositors to discipline bank risk-taking is too high. The risk of instability is especially evident at the present time because of stress in the banking system, including some of the nation's larger banks, and the weak condition of BIF.

A Near-term Approach Is Needed That Does Not Put Depositors at Greater Risk

While we do not believe it is possible to rely more on uninsured depositors to discipline risk-taking at this time, it is possible to control the ability of risky banks to attract deposits in ways that are consistent with maintaining market stability. We recommended four reforms to accomplish this objective.

The first two of these reforms have already been discussed in previous sections of our report. First, implementation of the tripwire system discussed in chapter 3 will prevent undercapitalized banks, including those without proper internal controls, from growing and from attracting deposits—both insured and uninsured—at above-market interest rates.

Second, as described earlier in this chapter, large banks must meet a portion of their strengthened minimum capital requirements through the sale of subordinated debt to the market. The actions bank managers will have to take to reduce risk to achieve low rates of interest on subordinated debt are similar to those often associated with increased depositor discipline.

Third, disclosure policies that give depositors and the general public better information on the condition of banks must be adopted. If uninsured depositors and general creditors are to make informed decisions about where to deposit funds and whether to withdraw them, it is essential that the public be provided with sufficient information on a regular basis on which to base their decisions. This information, which must be readily available and easy for the public to understand, could include capitalization ratios and levels, the relative performance of loan portfolios, CAMEL ratings, and deficiencies noted by bank examiners. Bank regulators, in consultation with industry experts, should be required to develop appropriate disclosure requirements.

Finally, customers with over $100,000 in deposits should be provided the choice of insuring those deposits and paying for such insurance either explicitly or implicitly through a reduced yield. Uninsured depositors, no less than insured depositors, need to be able to rely on safe and

sound banking services.[21] This reform, therefore, provides them the opportunity to make a more rational trade-off between risk and return than is now possible in the banking system. This trade-off will make the banking system less susceptible to bank runs because those uninsured depositors who are most risk averse, and therefore are most likely to withdraw funds at the first signs of bad news, will have an opportunity to obtain the safety that they value. This reform may also enhance the ability of well-capitalized smaller banks to attract uninsured deposits.

Protection for uninsured depositors in both large and small banks that desire to offer such a product can be accomplished in several ways. Depositors could be provided the opportunity to collateralize deposits over $100,000 with low-risk assets, such as Treasury securities, held by the bank. Such deposits should earn lower rates of return because of the low-risk nature of the assets against which they would be collateralized,[22] thus implicitly pricing the guarantee of safety provided those deposits. Allowing depositors to collateralize their uninsured deposits has a potential drawback for FDIC because assets used to collateralize deposits would, by definition, not be available to FDIC in its efforts to recoup losses incurred when it resolves bank failures.[23]

A second option for protecting deposits over $100,000 would allow depositors to purchase additional FDIC insurance through their banks to cover those deposits. The problem associated with this option is the difficulty in accurately pricing such insurance. The cost of the insurance should reflect the risk of the bank. Yet, in the past, estimating such risk has proven difficult. Consequently, the danger would exist that FDIC could seriously underprice the insurance, thereby exposing itself to losses, or overprice the insurance thus reducing its utility. Alternatively, depositors could simply be charged a flat rate for additional coverage

[21]Deposits over $100,000 can include retirement accounts, payroll accounts, accounts of schools, churches, hospitals, and charitable organizations; deposits from other domestic and foreign banks; and deposits related to the settlement of asset sales.

[22]Collateralized accounts are deposits backed by some form of tangible security, such as Treasury notes, whose market value is approximately equal to the value of the account. In the event of failure of the bank, the collateral backing those deposit accounts would be used to compensate the depositor.

[23]For example, banks in financial difficulty could (1) attract new depositors by collateralizing their deposits with assets already owned by the bank; or (2) persuade current depositors to remain with the bank by collateralizing their deposits. In the former case the result would leave FDIC with the bank's bad assets while providing new depositors with a guarantee backed by the remaining good assets. The latter would have a result for FDIC similar to depositors withdrawing their funds from the bank yet might not be as obvious a signal to regulators that the bank is in difficulty. The tripwire approach we discuss in chapter 3 should make it easier for regulators to monitor and control such potential misuse of collateralized deposits by banks in financial difficulties.

based on the amount of money insured. This option has the disadvantages associated with flat-rate premiums, which are discussed in chapter 2.

The four near-term reforms we recommend do not require cutting back deposit insurance coverage and, for the most part, apply to the ability of risky banks to attract insured as well as uninsured deposits. These near-term reforms will also make the system fairer because they apply to banks of all sizes, although we assume that the ambiguity inherent in de facto coverage will continue to exist as regulators decide on a case-by-case basis the degree of protection to be given to uninsured depositors and general creditors in failed banks.

In the Longer Term, It May Be Possible to Increase the Exposure to Loss of Depositors Who Elect Not to Insure Their Deposits

In the past, decisions by depositors (mostly uninsured) to withdraw funds from banks such as Continental Illinois National Bank and the Bank of New England forced regulators to deal with insolvent banks that probably should have been resolved earlier. Despite the existence of de facto insurance protection, the ambiguity present in the current system generated sufficient market discipline to have been effective in finally curtailing the amount of regulatory forbearance shown toward these banks.

If such discipline is to play an expanded role in the future, several important conditions must be met so as not to jeopardize market stability. First, the banking system must be in a much sounder condition than is the case today.

Second, all of the reforms we have recommended relating to bank supervision, bank capital, and risk-based insurance premiums should be substantially implemented as well as those described in the previous section.

When these conditions have been met, it might be appropriate to consider adopting a rule for closing banks that would generally require FDIC to close banks in the least costly manner. Such a rule would make it more likely that depositors who have chosen not to insure their accounts would be exposed to losses.[24] As noted below, however, it would still be

[24]Placing uninsured depositors at risk by implementation of a rule on how banks are closed seems preferable to imposing a mandatory loss on all uninsured depositors in every instance. The closure rule would maintain an incentive for regulators to act in a timely fashion because, if action is taken promptly, assisted mergers or other actions that do not impose significant losses on uninsured depositors would still be possible because they would be least-cost solutions.

necessary to preserve the ability of federal regulators to take whatever measures are necessary, including extending de facto protection to uninsured depositors, if required to preserve industry stability.

Some have argued that deposit insurance should be withdrawn entirely from deposits placed by persons who can be considered sophisticated enough to evaluate the condition of banks. These would include brokered deposits, deposits placed by pension fund managers on a pass-through basis, and interbank deposits. We agree that in the longer term it is reasonable to review carefully the insurance accorded to these types of deposits. We favor removing deposit insurance from brokered deposits and perhaps other professionally managed accounts once the conditions described above have been met. Professional money managers should be capable of making trade-offs between yield and risk. There are often other safe investment alternatives, such as Treasury securities, available to such persons if deposit insurance were withdrawn.

Until coverage on brokered deposits and professionally managed accounts is removed, the tripwire system of bank supervision should be able to stop risky banks from attracting funds from national markets, and cutting back deposit insurance coverage immediately may, under current circumstances, contribute to increasing the chances that bank runs could occur. Because deposits in banks that are well capitalized and that do not take excessive risks typically pay lower yields than other investment alternatives, there will be a limit to the amount of professionally managed funds that end up as deposits if the tripwire system we are recommending is properly implemented.

Certain Safeguards Should Remain in Place

In a banking system that is better capitalized and better supervised than the present one, the threats of destabilizing bank runs on the banking system as a whole would, in our opinion, certainly be reduced. Domestic and foreign depositors should not frequently be caught by surprise by the failure of a bank since the bank's regulators should have been signalling the markets through regulatory enforcement actions that the bank was experiencing financial difficulties. Therefore, sudden, precipitous bank runs based on unforeseen circumstances should be less likely because uninsured depositors will have received adequate signals to withdraw some or all of their money from a troubled bank before it fails.

Nevertheless, even in a stable, healthy banking system, it is still possible that regulators may find it necessary to resolve a bank failure without

imposing losses on uninsured depositors in order to protect systemic stability. Under certain economic conditions—a severe recession or an unstable international environment, for example—the threat of irrational runs may be so great that it would be reasonable to protect uninsured depositors. Such protection would help prevent potential disruptions to the settlements system, correspondent banking relationships, or foreign and domestic confidence in the U.S. banking system.

For these reasons, we believe that even in the long run a formal policy requiring FDIC to follow a least-cost-resolution method, as some have proposed, and impose losses on all uninsured depositors under all circumstances would not be wise. Instead, the Federal Reserve, in conjunction with FDIC, should be given the responsibility to determine in particular instances if losses imposed on uninsured depositors when a bank fails would be detrimental to the stability of the U.S. financial system.

If such a determination is made, failing banks declared to be essential could be resolved in a manner that would not necessarily be of the least cost. Such methods of resolution could include protecting uninsured depositors and general creditors through purchase and assumptions, bank mergers, or open bank assistance.

Enough flexibility should be built into this structure to enable responsible officials to make the judgments necessary to balance the negative effect such action might have on future incentives against stability considerations. For example, if the Federal Reserve or other bank regulators resolved a large bank failure without protecting all depositors in order to preserve market discipline, they should simultaneously be able to announce that they are prepared to take actions so that depositors in any bank that might get caught in a domino effect would be protected for a period of time in order to preserve systemic stability. Such an option, similar to that used by the Federal Reserve to stabilize securities markets after the sharp declines in prices that occurred in 1987 and 1989, and after the failure of the Drexel, Burnham Lambert securities firm in 1990, would protect systemic stability without undercutting market discipline.

The Premium Assessment Base Should Be Changed

Because of de facto insurance protection, the assessment base for deposit insurance premiums contains inequities that should be changed. These inequities provide an incentive for banks, especially larger ones,

to acquire funds that benefit from insurance without being charged for such protection.

At the present time, BIF premiums are levied on an assessment base defined as total domestic deposits. As a result, domestic deposits over $100,000 are assessed for premiums at the same rate as insured deposits, even though they receive no de jure coverage. On the other hand, no assessments are made on foreign deposits and other liabilities that also are not protected de jure but that are generally protected when banks fail. Foreign deposits have been excluded from the base because of possible damage to the competitive position of U.S. banks overseas.

As insurance premiums increase, the equity problems associated with assessing some, but not all, uninsured sources of funding that are generally protected on a de facto basis become more of an issue. Banks paying higher premiums have a greater incentive to obtain funds through overseas deposits and non-deposit liabilities since these will become relatively cheaper than domestic deposits on which premiums have to be paid. Banks with foreign branches may thus gain a competitive advantage over banks without such branches.

Earlier in this chapter we recommended that risk-based premiums be adopted to, in part, make the assessment of premiums fairer. Another way to make the system fairer would be to change the assessment base so that the premiums are more closely related to the protection actually provided.

There are two approaches for changing the assessment base that should be explored. Each of these would provide a broader base on which premiums would be charged. By broadening this base to encompass all relevant aspects of a bank's operations, the opportunity to fund activities to get around insurance premiums would be reduced. One approach would expand the assessment base on the liability (funding) side of a bank's operations. The other would switch the basis for assessment to the asset side.

Turning first to the alternatives available for expanding the base on the liability side of a bank's operations, a flat-rate assessment could be applied to all of a bank's liabilities that are generally protected when a bank fails. We believe, however, that it would be fairer, and more in keeping with the nature of de facto protection, to consider initiating a tiered system of assessments. In such an arrangement, domestic deposits of $100,000 or less that are insured on a de jure basis would be assessed

at one rate in order to reflect the certainty of the insurance. Domestic deposits over $100,000, foreign deposits, and other nondeposit liabilities also would be assessed, but at a lower rate to reflect the degree of uncertainty in their status.

A tiered assessment system could be operated in several ways. For example, the rate applied to uninsured domestic, foreign deposits, and other nondeposit liabilities could be calculated as a percentage of the rate on legally insured deposits, with the percentage determined by the actual percentage of protection afforded these liabilities in the preceding year. For example, if uninsured liabilities were fully covered in 90 percent of the preceding year's bank failures, then current year rates on those deposits would equal 90 percent of the rate applied to legally insured deposits. In the future, if uninsured depositors were more clearly exposed to risk, the premium on uninsured deposits and other liabilities would be reduced still further, perhaps quite sharply.

The second alternative for broadening the assessment base involves switching to a system in which insurance premiums are assessed on assets rather than liabilities. The premium could be assessed on total assets. However, it could also be levied in a way that would parallel the concept of risk-based capital. (In this way the rate would be applied to an assessment base that weighted different types of assets according to risk.) This alternative has much to recommend it because it would focus the premium on FDIC's exposure to risk, which is contained primarily in the riskiness of a bank's portfolio, rather than on the precise insured status of the sources that financed that risk.

We have not attempted to determine which of the alternatives for broadening the assessment base would most fairly cover the costs of deposit insurance. We believe that FDIC, after consultation with the industry, should make an appropriate recommendation to Congress.

While broadening the assessment base makes sense with respect to apportioning the costs of deposit insurance, we recognize that the issue of competition with foreign banks is also a consideration. We have not evaluated all of the issues associated with whether competitive considerations should warrant excluding foreign deposits from an extension of the assessment base. It is certainly true that the annual deposit insurance premiums that foreign banks now pay—if any—are much lower than those currently being assessed against U.S. banks; it also seems likely that if higher premium assessments are passed on to foreign depositors there will be a reduction in such deposits in U.S. banks. In the

long run, however, we question the extent to which it is appropriate to subsidize the overseas operations of U.S. banks. The costs of de facto insurance protection in principle are no different from all other costs that must be paid by foreign branches if they are to be considered economically viable entities. (For additional discussion of assessing foreign deposits, see app. III.)

Conclusions

The current system of deposit insurance has protected depositors from loss and provided for a stable banking system. This system has, however, reduced the incentives for owners and managers to operate their banks in a safe and sound manner. In order to ensure that the stability of our banking system is more firmly grounded on safe and sound banking practices rather than expensive deposit insurance protections, changes are needed in the incentives created by deposit insurance.

The key to changing the incentives is to require banks to maintain capital levels commensurate with their risk. To accomplish this, minimum bank capital requirements must be strengthened and the role for subordinated debt in large bank funding should be increased. We also believe that a system of risk-based premiums should be implemented to supplement the strengthened risk-based capital requirements. To be sure that industry stability is not damaged, near-term efforts made to reform the deposit insurance system must rely on measures that do not place depositors at greater risk. Over the longer term, deposit insurance coverage on brokered deposits and perhaps other deposits placed by professional money or pension fund managers could be eliminated. It would also be beneficial to pursue policies that have as their ultimate goal the ability to make de facto protection much less predictable for uninsured depositors. In pursuing this goal, however, the ability of Federal Reserve and FDIC officials to take whatever actions are needed to stop destabilizing bank runs must not be compromised. Finally, it would be more equitable to change the way deposit insurance premiums are assessed to reflect the realities of de facto insurance protection.

Recommendations

We recommend that Congress take the following steps:

- Require bank regulators to phase in and strengthen risk-based capital requirements after the Basle capital accord has been implemented fully in 1992. The definition of the capital requirements should be left to the discretion of the regulators and, to the extent feasible, developed in accordance with negotiated international agreements.

- Require bank regulators to phase in a requirement for large banks to meet a portion of their capital requirement with subordinated debt.
- Require bank regulators to implement a system of risk-based deposit insurance premiums.
- Direct federal regulators to develop alternatives for depositors to protect deposits over $100,000. Such options could include allowing depositors to collateralize deposits over $100,000 with low-risk bank assets or to purchase additional FDIC deposit insurance through their banks.
- Direct federal regulators to develop the means for improved public disclosure of bank condition to enhance the ability of depositors to judge the soundness of their banks.
- Consider, over the long term, requiring that banks be closed in the least costly manner, and give the Federal Reserve, in conjunction with FDIC, the ability to determine when the failure of a large bank would be detrimental to the stability of the U.S. financial system. In such cases a failing bank could be resolved in a manner that would not impose losses on all uninsured depositors.
- Eliminate, over the long term, deposit insurance coverage on brokered deposits and perhaps other deposits placed by professional money or pension fund managers.
- Direct FDIC to develop a plan for changing the assessment base against which insurance premiums are levied. Options that should be considered include broadening the base to include all bank liabilities or switching to a system in which insurance premiums are assessed on assets rather than liabilities.

Ensuring the Safe and Sound Evolution of the U.S. Financial System: Updating Holding Company Structure and Regulation

As discussed in chapter 2, the regulation and structure of the U.S. financial system have not kept pace with changes in domestic and global financial markets. These changes have resulted in a gradual breakdown in the restrictions on the geographic service areas and products of banks and bank holding companies that have enabled banking organizations to provide a wider range of services to customers—but the changes also pose potential dangers to bank safety and soundness. Interstate branching provides opportunities for banks to diversify their risks, but the regulatory controls are not strong enough to prevent risky banks from expanding their operations and placing FDIC at greater risk. In addition, holding companies are being allowed ad hoc access to additional lines of business, yet are not required to take financial responsibility for their insured bank subsidiaries that could be adversely affected by those activities. Finally, consumer protection measures have not been modernized sufficiently to take into consideration the increasing complexity of financial products being offered by insured depository institutions.

This chapter describes how to update holding company regulation to close gaps that pose risks for the deposit insurance system. If these measures are taken, we believe that the remaining restrictions on interstate banking can safely be phased out. We also discuss how restrictions on expanding bank and other financial institution powers could be safely eliminated if such a course is judged desirable.

If Congress determines that expanded bank powers are appropriate, we believe that a phased approach to Glass-Steagall repeal and modification of certain Bank Holding Company Act[1] provisions that would allow bank holding companies to expand into other financial services and other financial services firms to participate in banking should be considered. Such a phased-in approach should be designed to preserve the safety and soundness of the banking system, protect consumer interests, and minimize the chances that unforeseen events will be destabilizing or costly for the taxpayers.

[1]The Bank Holding Company Act prohibits bank holding companies from engaging in activities, such as insurance underwriting, that are not "closely related to banking."

Interstate Banking Restrictions Can Be Phased Out for Well-capitalized, Well-managed Banks

Restrictions on interstate banking make it harder for well-capitalized, well-managed banking organizations to diversify and meet customer needs. While we believe it is reasonable for Congress to consider phasing out the restrictions which remain, this should only be done when the necessary actions have been taken to make sure that expanded interstate banking activities neither place FDIC at greater risk nor subject smaller, healthy banks to unfair competition. Congress needs to establish statutory standards that prohibit the ability of undercapitalized or poorly managed banks from expanding their interstate banking operations.

Expanded Interstate Activities by Healthy Banks Could Benefit the Public and the Banking System

The interstate expansion of banking organizations has occurred as a result of legislation passed by individual states allowing out-of-state holding companies to acquire bank subsidiaries within their boundaries. States obtain this authority through the Douglas amendment of the Bank Holding Company Act which allows them to restrict or permit such expansion. Currently all but 4 states permit some form of interstate banking, and 27 states permit banking organizations from any part of the country to operate within their boundaries. Of the 942 multibank holding companies that exist in the U.S., the Federal Reserve estimates that 49, with assets of about $1 trillion (approximately one-third of the banking system's assets), already own banks in more than one state.

The restrictions on interstate banking that currently remain limit the efficiency of the banking system. Permitting unrestricted interstate banking by repealing the Douglas Amendment that allows states to prohibit or restrict the acquisition of banks by out-of-state holding companies could, for example, allow banks to better serve their customers by providing bank customers the possibility of dealing with the same bank in different states. This would simplify financial transactions when people move, travel, or conduct business across state lines. The relaxation of branch restrictions could also enable banks to better serve their customers—both rural and metropolitan—through access to more convenient and expanded banking services. For many customers, larger banks are generally likely to offer a wider range of services than smaller, unit banks.

Greater opportunities for interstate expansion could also improve the ability of well-managed banking organizations to diversify their risk. While diversification is possible in today's banking system, such diversification may be more risky because banks often do not have a physical presence in the markets in which they are participating. For example,

banks may purchase loan participations from banks in distant geographic locations but only have a limited understanding of the value of those loans because they have a limited knowledge of the local economy. Diversification is likely to be more prudent if banks are able to physically locate in the geographic areas in which they wish to participate financially. Improved diversification by banking organizations should, in turn, reduce FDIC's exposure to deposit insurance losses. In addition, by expanding the base of stable deposits, prudent interstate expansion can reduce the dependence of well-managed banks on brokered deposits and other funds raised on national and international money markets.

One purpose of the existing restrictions on interstate banking by banks and bank subsidiaries is to help protect community and regional banks from competition from larger banks that seek to expand their operations. The presence of these small banks has contributed to the vigor of local economies throughout the country.

The viability of smaller banks, however, lies in the role that these institutions uniquely play in their communities, not in the restrictions on interstate banking and branching that currently exist in federal statutes. These restrictions notwithstanding, smaller banks throughout the country face, and survive, competition from many sources. Indeed, in many respects, we already have what amounts to national and even international markets within which all banking organizations, including smaller ones, must compete. There are, for example, active federal funds and interbank markets that for years have channelled funds from smaller banks to larger institutions. Nonbanking subsidiaries of bank holding companies can operate nationwide as can many other types of nonbanking financial services firms. Banks can also establish loan production offices throughout the country and the market for loan sales and the sales of securitized assets, which are essentially national markets, are growing. Finally, the competition faced by community and regional banks has also increased in recent years due to the adoption of state laws permitting limited interstate banking, as described above.

Despite all this competition, including that from interstate banking, the evidence appears to be strong that adequately capitalized, well-managed smaller banks are able to compete successfully in markets where larger banks also have a presence. Small banks in the U.S. have generally outperformed or kept pace with larger banks as measured by return on assets. Furthermore, the experience of California and New York, two large states with extensive statewide branching experience, suggests that small banks can survive under liberalized branching laws.

We discussed in chapter 4 that there may be a need for some consolidation in the banking industry in order to make better use of bank capital. Provided that safety and soundness standards are not compromised, there is the potential for more continuity of service and less potential cost to FDIC and the taxpayer if this consolidation can take place in the most efficient way possible, including across state lines. Many observers have suggested that most consolidation, if it occurs, will likely take place among banks with $1 billion or more in assets that already serve larger geographic areas because the cost savings are likely to be largest in such mergers. A study by McKinsey & Company, Inc. has estimated that the cost savings from mergers that would be encouraged by repeal of interstate banking and branching restrictions could total $10 billion to $15 billion in pretax earnings annually over the first five years after repeal.[2] We do not know the extent of savings that might actually be realized, but these savings have the potential to positively affect industry earnings. Portions of these savings could be retained as additional capital in the banking industry thereby increasing the safety cushion for FDIC.

While there is no empirical evidence on the costs of interstate expansion through bank subsidiaries of holding companies relative to expansion through bank branches, the bank subsidiary form of organization does not appear to be as cost effective for many banks as branching due to duplication in overhead and other costs.[3] Cost savings earned through elimination of such duplication could be applied to bank capital, thereby improving the safety and soundness of the banking system.

In the final analysis, when restrictions have been phased out, some banking organizations that want to expand may choose to expand through bank subsidiaries, others through bank branches. It is to the benefit of the FDIC and bank customers that well-capitalized, well-managed banks be able to choose the form of expansion that is the most efficient, cost-effective, and best serves bank customers.

[2]This estimate was based on evidence gained through their examination of numerous past bank mergers and expansions applied to 70 percent of the banking industry's assets. This assumes that 30 percent of the industry's assets, primarily in the nation's community banks, would be largely unaffected by McFadden repeal.

[3]Areas of duplication that could be eliminated or reduced if branching were permitted include separate financial reporting, including financial audits and regulatory information filings, such as call reports, separate boards of directors for all bank subsidiaries, and department staff that could be consolidated to a certain degree.

Strengthened Regulation Is Needed to Ensure That Interstate Expansion Takes Place in a Safe and Sound Manner

At the present time, regulatory approval is needed for acquisitions by bank holding companies, whether such acquisitions cross state lines or not. However, approval is not based on objective standards required by statute but on regulatory guidelines. These guidelines stress adequate capital and regulatory ratings.[4] However, as we discussed in chapters 2 and 3, bank regulators often do not have adequate information to identify the true condition of banks, nor do they have incentives to restrict bank growth or activities when internal control or asset quality problems first become apparent.

Thus, even though holding company acquisitions are premised on adequate capital and regulatory ratings, it is possible for holding companies that have developed internal control problems that have not yet affected capital levels to acquire additional bank subsidiaries. Such expansion could pose a significant risk to FDIC if banking organizations that have potential problems are allowed to grow and then fail. Consequently, holding company expansion should be tied statutorily to a tripwire system such as we described in chapter 3 to ensure that only well-capitalized, well-managed banking organizations are allowed to expand. The tripwire and improved information approach would make it easier for regulators to judge the risks of expansion based on relatively objective measures of bank condition such as the adequacy of internal controls and capital levels. Holding companies that have exhibited internal control or other problems, or whose subsidiary banks have exhibited such problems, should not be permitted to acquire additional banks.

The need for a well-defined, enforced regulatory standard to guide interstate expansion for banking activities is particularly critical because the current stress that is evident in the banking system has made it harder for many banks to obtain capital. Without a clear standard, regulators may find it tempting to use expanded authority for interstate banking to approve mergers across state lines that do not conform to safety and soundness standards. In their desire to deal with short-run problems, the regulators may hope that such mergers will avert the need for further regulatory action or BIF expenditures. We believe it would be unwise to look to weak interstate mergers as a way to help the banking system.

[4]The general Federal Reserve standard is that a bank that wants to expand across interstate lines must have a 1 or 2 CAMEL rating score, and must be adequately capitalized after the expansion.

Improvements to Holding Company Regulation Are Necessary Even Without Glass-Steagall Reform

New laws and regulations are needed to ensure that holding companies are more easily held responsible for the financial health of their bank subsidiaries. Changes are also needed to control potentially harmful transactions between banks and their holding company affiliates and to provide consumers with information that adequately addresses the complexity of modern financial products. These changes should be implemented whether or not Glass-Steagall and similar restrictions in the Bank Holding Company Act are repealed and should certainly precede any such reform.

The Nature of the Current Bank Holding Company Structure

Compared to arrangements in the rest of the world, bank holding companies represent a unique feature of the U.S. financial system. Set up for a variety of business, regulatory, and tax reasons, these companies have become the dominant form of banking organization in the United States. Bank holding companies now account for approximately 93 percent of the assets in the nation's banking system. (See table 5.1.)

Table 5.1: Number of Bank Holding Companies and Independent Banks and Percent of U.S. Banking Assets in These Institutions

	Multibank holding companies		One-bank holding companies		Independent Banks	
Year	Number	Percent of assets	Number	Percent of assets	Number	Percent of assets
1970	142	18.3	1,264	36.3	11,254	45.4
1975	289	31.5	1,419	30.1	10,959	38.5
1980	361	36.4	2,544	42.1	9,667	21.5
1985	869	74.5	5,077	17.6	5,111	7.9
1990[a]	942	74.4	4,912	18.8	3,750	6.9

[a]As of June 1990.

Source: Federal Reserve.

Bank holding companies are structured so that one company, called a parent company, owns other companies called subsidiaries. The subsidiaries include banks as well as other companies, such as finance or data processing companies. Typically, the parent sells debt and equity which it invests as debt and equity in its subsidiaries. Thus, the equity capital on the books of a subsidiary bank may, in whole or in part, represent funds which the parent company has borrowed from financial markets.

Bank holding companies are regulated by the Federal Reserve pursuant to the Bank Holding Company Act, first enacted in 1956. The purpose of the Act in many respects was to restrict the degree to which banking

organizations could be affiliated with (i.e., own or be owned by) industrial and other nonbanking organizations. The arrangement provides a framework for allowing banking organizations to provide more services to their customers while at the same time insulating insured bank affiliates from the risks associated with those services.

Bank holding company regulation as conducted by the Federal Reserve has several features. Within the bounds provided by other laws, such as the Glass-Steagall Act, the Federal Reserve can determine bank holding company powers. The test of an allowable power is that it be closely related to banking. The Federal Reserve can also require that certain activities be done in separate subsidiaries of the holding company rather than in a bank or a bank subsidiary. Subsidiary banks are also allowed to engage in some transactions with the parent or other subsidiary companies, but the amount and terms of such transactions are limited by sections 23 A and 23 B of the Federal Reserve Act.[5]

The Federal Reserve is responsible for supervising holding companies, although in practice it usually relies on the appropriate bank regulatory agency to supervise the bank when the bank involved is a national bank or a nonmember state bank. In the same manner, under the concept of functional regulation, SEC regulates the securities subsidiaries of bank holding companies,[6] and the Commodities Futures Trading Commission regulates bank holding company subsidiaries that fall under its jurisdiction.

As part of its regulation, the Federal Reserve has a stated policy that holding company parents should serve as a source of strength for their bank subsidiaries, which means that they should be prepared to use the resources of the holding company to make sure that the owned banks are adequately capitalized. As mentioned in chapter 2, this policy was recently struck down by a federal court. The Federal Reserve also

[5]Section 23 A of the Federal Reserve Act limits the volume of loans a bank may make to a single affiliate to 10 percent of the bank's capital, with a total maximum of 20 percent of capital to all affiliates combined. Furthermore, these loans or extensions of credit must be collateralized from 100 percent to 130 percent of value, depending on the composition of the collateral. Collateral exceeding 100 percent is necessary for certain types of financial assets that could lose value before the loan is repaid. Finally, section 23 A prohibits banks from purchasing low-quality assets from its affiliates.

Section 23 B stipulates that all transactions between a bank and its affiliates must be at market prices, or on an "arm's length" basis. That is, the terms must be similar to the terms the affiliate could arrange from a third party or be similar to those that the parent would extend to a third party.

[6]At present, such holding company subsidiaries include section 20 firms and discount brokers.

requires a bank holding company to meet on a consolidated basis the same minimum capital rules that apply to banks.

A Legislated Source of Strength Policy Should Be Imposed on Bank Holding Companies

The Federal Reserve's source of strength doctrine which requires holding companies to financially support their bank subsidiaries has been at least a perceived reality until it was struck down by a federal court. Proponents of the doctrine argue that it forces holding companies to act responsibly toward their banks and that it reflects the market reality that holding companies are operated as single, consolidated entities. Source of strength critics believe that the risks to banks from their affiliates can be minimized through strict regulation of the bank and of transactions between the bank and its affiliates and that a source of strength doctrine is superfluous. Furthermore, they believe that it places holding companies at a disadvantage with respect to nonholding company owners of banks who are not subject to a source of strength policy. Individual, noncorporate owners of banks, for example, will only lose their original and any subsequent equity investments in a bank if the bank fails. They cannot be forced to invest more funds if a bank's capital level falls below required minimums nor, in the absence of fraud or gross mismanagement, can they be forced to reimburse FDIC for any losses it incurs in resolving the bank's failure.

We believe it is in keeping with market realities to view holding companies as consolidated entities for regulatory purposes. Market reaction, for example, assumes that serious financial problems associated with a holding company subsidiary are likely to negatively affect the health of the holding company and all of its other subsidiaries, including any insured banks.[7] The holding company parent is the "nerve center" of the company and determines how its subsidiaries are operated. Thus, for example, the subsidiaries of First Republic, a large Texas bank holding company created to get around Texas branching restrictions, were, for the most part, treated as bank branches, even though they were technically and legally holding company subsidiaries. Nevertheless, in the First Republic case the holding company refused to support its subsidiary banks when they were failing and even withdrew back office support such as data processing, when the regulators took control of the banks.

[7]For example, it is likely that if an insured bank had been affiliated with Drexel, Burnham, Lambert Group, Inc., the market would have refused to do business with the bank, just as it refused to do business with Drexel's healthy broker-dealer and government securities subsidiaries. The likely result would have been a run on the bank and its failure.

We consider the reasons for holding the parent responsible for the operation of the entire organization to be sound and thus consider it logical that an explicit statutory source of strength policy be imposed on the company as a whole. Unless it is clear that holding companies must take financial responsibility for their bank subsidiaries, they can attempt to fall back on their legal separateness from those bank subsidiaries if they encounter financial problems. As has happened in the past, the holding company can cite responsibilities to shareholders and creditors and leave the bank for FDIC, and possibly the taxpayers, to take care of. This holding company position has recently been upheld in federal court in a case involving MCorp. This very serious and potentially costly problem arising from the structure and complexity of holding companies must be changed.

An effective source of strength policy should provide holding company parents with an added incentive to monitor and control risk in their organizations. Holding companies that are responsible for the health of their subsidiary banks will be less tempted to take advantage of their banks—through conflict-of-interest abuses or other improper interaffiliate transactions—in order to support nonbank subsidiaries or themselves. Consequently, a source of strength doctrine would provide a final and potent level of protection for FDIC in case other controls to limit the transmission of risk from a holding company subsidiary to a bank affiliate do not succeed.

FIRREA partially addressed the source of strength problem by requiring other bank affiliates of a failing bank to reimburse FDIC for any losses it might incur in resolving the failed bank.[8] However, this cross guarantee provision does not prevent the holding company from shielding assets from FDIC either within the parent or in nonbank subsidiaries. In fact, the provision is likely to encourage holding companies to move assets, such as data processing units, out of insured banks at the first sign of problems in any of its bank subsidiaries.

A variety of measures could be legislated and implemented by regulators to satisfy a requirement that bank holding companies act as sources of strength for their bank subsidiaries. We prefer a statutory source of strength doctrine that would require bank holding companies to guarantee the capital level of their banks at the required minimum. If a bank

[8]This provision is considered necessary partially because bank subsidiaries are not limited in their transactions with each other by sections 23 A and 23 B and, therefore, can move funds around at will among themselves.

holding company is unwilling to invest additional capital in one of its banks, it would be subject to a similar tripwire approach as laid out in chapter 3. For example, it would not be allowed to pay dividends on its stock or interest on subordinated debt, and strict limits would be placed on its growth. If the holding company continued to refuse to put capital into the bank, and the bank dropped substantially below its minimum requirements, then, consistent with our proposal in chapter 3, the holding company would be forced to either liquidate or sell the bank, or the bank would be placed in FDIC conservatorship.

Once a subsidiary bank failed and had been taken over by FDIC, however, the bank holding company would be required to reimburse FDIC for losses incurred resolving the bank failure. Two changes in current practice are necessary to implement a source of strength policy.

First, the current mechanism of reimbursement through cross-guarantees of affiliated, insured banks should be strengthened. Currently, FDIC must wait until a bank fails before it can claim affiliated bank assets. This allows the holding company time to sell healthy bank subsidiaries or other bank assets and retain the proceeds at the holding company level, to the detriment of FDIC. To discourage such sales, once the capital level of a bank within a holding company structure falls below a level determined by FDIC, FDIC should be given the authority to block such sales, or require that sale proceeds be downstreamed to the impaired bank. The cross guarantee provision also should be strengthened by requiring the bank holding company to provide FDIC with whatever support is necessary to accomplish a prompt resolution of the bank, such as using the bank's data processing units, which are now often located in holding company subsidiaries.

Second, if the net worth of the failed bank's insured affiliates were not sufficient to cover FDIC's losses, then the bank holding company and its nonbank affiliates would be responsible for covering up to an additional specified percentage of the insured bank's assets. Thus, the holding company could lose its initial capital investment in the bank as well as an additional percentage of the failed bank's assets, to be specified by bank regulators, to cover FDIC's losses.

Limiting the bank holding company's liability is reasonable because if the losses to FDIC exceed the value of the assets of all bank affiliates plus an additional set percentage of the failed bank's assets covered by the holding company, then a certain level of responsibility must be placed on the bank regulators for failing to close the bank in a timely manner.

Furthermore, it is likely that imposing unlimited liability on the bank holding company for its bank subsidiaries would make it difficult for the holding company to sell debt or raise equity.

Subject to case-by-case approval by FDIC, bank holding companies might also be given the option to contract out their guarantee to an insurance or financial guarantee company or participate with other holding companies in a mutual guarantee arrangement. Such alternatives could provide an alternative for holding companies that do not want to tie up capital to back up their source of strength responsibilities but that have the financial strength to make a private sector guarantee arrangement feasible and attractive.

Sections 23 A and 23 B of the Federal Reserve Act Must Be Strengthened

Imposing a source of strength requirement on bank holding companies should lessen the incentives for those companies to take risks that will negatively affect insured bank subsidiaries or that will lead to conflict-of-interest abuses. If the holding company is financially responsible for its bank subsidiary, it should be less likely to approve or urge actions that would be detrimental to the bank, even if those actions could be of benefit to other holding company subsidiaries. In addition, sections 23 A and 23 B of the Federal Reserve Act currently control interaffiliate transactions that might drain bank assets or lead to conflict-of-interest abuses. Bank regulators have generally found these controls to be effective but are concerned that they do not fully address some holding company transactions that have become popular since the enactment of section 23 A.

We agree with regulator concerns that sections 23 A and 23 B should be enhanced if their effectiveness in the future is to be maintained. For example, section 23 A was enacted before many of the nonloan-related transactions between a bank and its affiliates were developed. Thus, those transactions, including tax sharing arrangements, swap arrangements and bank letters of credit are not covered under section 23 A.[9] Additional ways for bank affiliates to siphon funds out of a bank—through management fees or data processing services, for example—are also not included in section 23 A. Furthermore, although section 23 A applies to a bank purchasing assets from an affiliate, it does not cover a

[9]Tax sharing arrangements allow holding companies to consolidate the tax returns of all of their subsidiary banks to benefit from tax losses or deductions acquired by the banks. Swap arrangements involve the exchange of one security for another. A letter of credit substitutes the bank's credit for that of the purchaser of the letter of credit. Letters of credit guarantee payment of an obligation.

bank selling assets to affiliates. Those transactions are only addressed under the arm's length provision of section 23 B.

Federal Reserve officials have indicated that it would be useful to have a statutory clarification of their interpretive powers to determine the meaning of "arm's length" transactions. Such clarification would provide a clearer basis for determining transactions that are not arm's length, since such determinations can easily be challenged in court. Furthermore, we believe that if sections 23 A and 23 B are to provide regulators with effective tools to control interaffiliate transactions of all kinds that could affect a bank's safety and soundness, regulators should be able to add future transactions and products, as they are developed by financial institutions, to the list of those covered by sections 23 A and 23 B. These modifications to sections 23 A and 23 B are necessary if bank and bank holding company regulators are to be able to protect banks with insured deposits from the risks associated with their holding company parents and affiliates.

Modifications to Sections 23 A and 23 B Should Be Allowed for Low-risk, Narrow Banks

While we believe that sections 23 A and 23 B restrictions are necessary to protect BIF from loss and bank competitors from unfair competition, we recognize that such restrictions may reduce the efficiency of some banking organizations. Consequently, we propose allowing well-capitalized bank holding companies the opportunity to set up narrow banks to interact more directly with their nonbank affiliates. These types of low-risk banks need not be subject to all of the sections 23 A and 23 B restrictions on transactions with their nonbank affiliates. Such transactions would not endanger BIF because such banks are not permitted to extend credit and the deposits are backed by securities held by the bank itself. Since these banks get no advantage from a deposit insurance subsidy, they also should not possess an unfair advantage over their nonbank competitors.

Sharing of Confidential Customer Information Should Be Controlled

Banking organizations have incentives to control conflict-of-interest abuses if they wish to retain their customers, but this incentive has never been considered sufficient by bank regulators to fully protect customers from such conflict-of-interest abuses. Instead, numerous laws have been enacted to control these abuses, including the adoption in 1987 of section 23 B of the Federal Reserve Act, which as mentioned

above, prohibits nonbank affiliates of insured banks from dumping overpriced assets into the bank.[10]

There is one significant regulatory gap in this area, however: dealing with the disclosure of confidential customer information such as, for example, the credit worthiness of a customer, to an affiliate.[11] The Federal Reserve has dealt with this issue in its section 20 firewalls through the prohibition of such information sharing unless it has first been approved by the customers involved. We believe that this firewall should be imposed to cover transfers of confidential information between banks and their holding company affiliates. Limits on the sharing of confidential customer information should not, however, be interpreted as prohibiting all types of information sharing. Sharing of customer lists to facilitate cross-selling, for example, should not be affected.

Comprehensive Disclosures to Protect Consumers Are Needed

Finally, regulation of banks and bank holding companies must be improved by updating consumer protection measures. Consumers today may choose from a wide and often confusing selection of insured and uninsured financial products and services. Banks offer insured and uninsured products in their main bank lobbies. Some of these products are underwritten by the bank; others by the bank holding company; and still others are underwritten by nonbank financial services firms and sold by the bank. In addition, securities or insurance firms offer bank-like products that are not insured, but may also collect funds from clients and place them in bank products that are insured. As these products become increasingly complex and yet more similar across industry lines, it is extremely important that consumers receive adequate information that enables them to make sound investment decisions.

Consumer protection requirements that provide for adequate disclosure of the characteristics of financial products have not kept pace with the explosion of complex financial products available. Bank customers, for example, may often obtain securities, insurance, and banking products

[10]In the mid-1970s, before section 23 B was adopted, for example, banks supported Real Estate Investment Trusts (REITs) they advised by acquiring assets from the REIT through asset swaps or asset purchases at non-arm's length prices. As a result, the real estate investment problems were transferred from the REITs to the sponsoring banks.

[11]If, for example, a bank, through its loan approval process, discovered confidential information that a customer was under financial stress, it would not be allowed to share that information with its securities firm affiliate which might use that information to benefit another client, to sell its stock in that company or to advise its clients to do so.

at a single banking institution, but that institution is not required to provide information that objectively compares these often similar products. Furthermore, while banks are required to differentiate between insured and uninsured products, disclosures are often hidden in fine print. These shortcomings must be addressed if consumers are to be able to make informed investment decisions. We believe that three types of disclosure are necessary to protect consumers.

First, consumers must be fully informed about whether the products are federally insured. Bank customers may be given the opportunity by the bank to invest in numerous uninsured products such as annuities underwritten by nonaffiliated life insurance companies, bank holding company commercial paper or other debt instruments, bank notes, or even stocks and bonds (see table 5.2).

Table 5.2: Selected Uninsured Products Currently Being Sold Through Banks

Annuities (fixed/variable)
Bank holding company obligations
Certificates of deposit (over $100,000)
Commercial paper
Common or preferred stock
Corporate bonds
Mutual funds
Public limited partnerships
Repurchase agreements[a]
Subordinated debt
Treasury bills/notes bonds
Unit investment trusts[b]
U.S. Government agency obligations
Zero coupon bonds

[a]Repurchase agreements are agreements between a seller and a buyer, usually of U.S. Government securities, whereby the seller agrees to repurchase the securities at an agreed upon price and, usually, at a stated time.

[b]Unit investment trusts are investment vehicles that purchase a fixed portfolio of income-producing securities. Units in the trust are sold to investors. The portfolio of securities remains fixed until all the securities mature and unit holders have recovered their principal.

Source: FDIC.

This proliferation of uninsured products sold by banks can easily result in consumer confusion and in certain cases has caused severe financial hardship as consumers who apparently believed they were purchasing

insured, or safe, bank products instead purchased speculative and risky debt instruments or other noninsured products.[12]

To avoid this type of confusion, we believe that full written and oral disclosures should be required of the insured status of all financial products offered by banks. Federally insured financial products should be made easily identifiable via a universal symbol in all materials and advertising provided by the bank. For example, all insured products could be identified by FDIC symbol and a sentence that states that the product is "Guaranteed for Prompt Payment by the Full Faith and Credit of the United States Government." More importantly, noninsured products could be marked with an easily identifiable symbol that indicates that the product is not insured; for example, an FDIC seal with a diagonal red line across it. Furthermore, if the product is offered by a bank affiliate, it must be disclosed that the product is neither guaranteed by, nor an obligation of, the insured bank. Banks serving ethnic populations should be required to provide identical identification in the foreign languages that are relevant to their customers.

The second form of disclosure that we believe is necessary involves ensuring that consumers are accurately informed about the financial risks associated with the products being offered by banking organizations. Such disclosure must be certified to the customer in writing. It must be made clear, for example, that bank holding company commercial paper is not as safe as the insured products of the bank.

Third, all consumer financial service providers should be required, to the extent possible, to calculate standardized investment yields on financial products they offer. For example, banks offering certificates of deposit and annuities should provide information on the relative yields of the two products. Providers of financial products should also provide uniform disclosure of key costs of financial products—such as service

[12]It is difficult to estimate the extent of these problems because most are not apparent until a bank fails and depositors lose money. However, certain cases illustrate the potential for problems. For example, customers of Lincoln Savings and Loan, a California thrift, allege that they believed they were investing in safe products when instead they had purchased risky thrift holding company debt obligations. When the holding company failed, these customers lost their investments. In a similar case, small savers invested in Germania subordinated bank notes, a bank in Illinois, apparently under the misapprehension that these were safe investments. Some of these customers lost their life savings when the bank failed. Other well-known bank failures that publicized inaccurate consumer perceptions or fraud towards consumers were the recent failure of the National Bank of Washington, in Washington, D.C., some of whose customers allege that they were not informed that their deposits were being invested in noninsured products, and the 1985 failure of Golden Pacific National Bank, in which many Chinese-Americans claimed that they were not informed in Chinese that investments that they had made were not insured by the bank.

fees, withdrawal restrictions and penalties, or commissions—so that consumers can make meaningful comparisons among the competing providers.

Future experience with these disclosure requirements may reveal that banks or financial organizations selling bank products are at a disadvantage to other financial service companies not subject to these rules. If this is the case, it might become advisable to extend such disclosure requirements as relevant to all regulated financial services companies.

Any Action to Expand Powers for Banking Organizations Must Meet Several Preconditions

If a determination is made by Congress to reform or repeal laws that restrict bank activities, several conditions must be met. First, the regulatory reforms set forth in chapter 3 must be implemented and BIF must be adequately funded. Additionally, substantial progress must be made in changing owners' incentives toward risk-taking set forth in chapter 4. These reforms are intended to ensure that owners and managers of insured banks bear the costs of their operations and that even large banks can be closed by regulators on a timely basis in ways that could result in losses to uninsured depositors. Finally, a source of strength policy and improved disclosure rules must also be implemented. With these other reforms in place, the stage would be set to consider new powers for banking organizations.

We have no firm evidence that indicates the extent to which the banking industry or consumers of financial services might benefit from allowing banking organizations access to nontraditional lines of business, and we view any decision on expanded powers as essentially a judgmental one. Nevertheless, we believe that the eventual elimination of Glass-Steagall restrictions and modifications to the Bank Holding Company Act, under the conditions we lay out, would be appropriate to consider.

These laws have been ineffective in separating banking from nonbanking financial activities. Banking organizations already participate in private placements of securities; mutual fund sales; discount brokerage and investment advisory services; the distribution of asset-backed securities; and, through section 20 subsidiaries, many other securities activities. Imposing well-thought-out requirements for removing those restrictions that remain would at least ensure that the liberalization process, which is likely to continue, would be accomplished in a way that protects bank safety and soundness. Additionally, it is possible that a measure of enhanced competition would result from Glass-Steagall

repeal and Bank Holding Company Act reform and that this would benefit consumers of financial services. Allowing banking organizations to compete in other financial services, and vice versa, should make the markets more efficient by permitting these organizations to make more effective use of their capital, both human and financial.

We do not believe, however, that bank powers should be expanded in the hope that this will offset their current financial difficulties. Financial markets are currently in turmoil, as evidenced by the stock market declines in 1987 and 1989 and signs of financial stress in other financial services industries, and it likely will be difficult for even well-managed, highly capitalized banking organizations to gain a stable foothold in other financial services. It does not follow, however, that, while few profitable opportunities in these areas may currently exist, it would necessarily be impossible for any bank to be competitive in these markets. However, financial market turmoil does make it even more important that any provision of expanded powers be phased in and restricted to well-capitalized banks.

Six actions need to accompany any expansion of the powers of banking organizations. They are

- the determination of a holding company structure that will allow organizational flexibility into additional lines of business but that protects bank safety and soundness and the deposit insurance fund,
- adequate consumer protection measures,
- demonstrated regulatory capability,
- limits on expansion only to well-capitalized institutions on a case-by-case basis,
- reciprocal arrangements for nonbanking financial firms—allowing financial organizations to become affiliated with banks, and
- prohibitions on industry concentration.

It should be noted that several of these are addressed in the changes to the holding company regulation we have already proposed above.

Appropriate Holding Company Structure Balances Numerous Considerations

Deciding what holding company structure to use if the powers of banking organizations are expanded involves balancing various considerations. First, the structure must not weaken bank safety and soundness and must help protect the deposit insurance fund from loss, protect against conflict-of-interest abuses, and avoid giving unfair advantages to banks. However, the structure also needs to be flexible enough to

allow institutions to choose lines of business that they believe will best serve their customers, and there must be a reasonable presumption that services can be delivered efficiently if the company is well managed. Finally, the holding company structure must be one that enables regulators to perform adequate supervision with a reasonable amount of resources.

We believe that the holding company structure that at this time could best protect the insurance fund and provide other protections to the public would be characterized by the following features:

- New nontraditional activities would be restricted to holding company subsidiaries.
- Economic ties between banks and nonbank holding company affiliates would be allowed but would be restricted by regulatory safeguards, such as suitably strengthened versions of sections 23 A and 23 B of the Federal Reserve Act.
- The holding company would be required to serve as a source of strength to its bank subsidiaries.
- The holding company would be subject to consolidated capital requirements and consolidated regulation.

Generally speaking, the holding company structure we believe is appropriate corresponds to the existing bank holding company structure, augmented by the proposals we have made regarding a source of strength policy and better controls over transactions between banks with insured deposits and other holding company affiliates.

New, Nontraditional Activities Should Be Located in Separately Capitalized Holding Company Subsidiaries of the Bank

Some experts, citing experience in other countries, believe that additional powers should be allowed within the bank itself. Banking systems in most industrialized countries are based on various models of this universal bank concept. Thus, most foreign banks are allowed to conduct securities activities within the bank and some participate in substantial stock ownership in commercial firms. Proponents of such a system for U.S. banks argue that American banks must be allowed to compete on a level playing field with universal banks if they are to compete successfully in international markets. Others, citing the need to protect banks and the deposit insurance fund from possible losses, say that nontraditional banking activities should be conducted in separate subsidiaries. There are two options for conducting nontraditional bank activities outside of the bank: placing them in either a bank subsidiary or a holding company subsidiary.

Federal regulators generally agree that most nontraditional activities should not be allowed directly in banks but disagree about the preferred outside location of such new lines of business. Currently, FDIC allows state-chartered, nonmember banks to conduct these activities in bank subsidiaries. OCC also believes that banks should be allowed to use subsidiaries if they wish. These agencies say such an arrangement allows the flow of profits from the subsidiary directly to the bank, instead of through a holding company parent which might not downstream profits to the bank in times of need. Potential bank losses in a failed subsidiary can be limited to the bank's initial and subsequent capital investments—which could be restricted by regulation to a bank's surplus capital—as long as the bank's legal separateness from its subsidiary, or "corporate veil," cannot be pierced by creditors of the subsidiary. Both agencies believe that the risks of the subsidiary's activities and potential piercing of the corporate veil can be controlled by keeping the subsidiaries strictly separated from their parent banks. Such separation enforced through, for example, physical separation, separate accounting and other corporate records, independent policies and procedures, and clear disclosure that the bank is not financially responsible for its subsidiary, makes it difficult for creditors of a failed bank subsidiary to sue the parent bank for damages.

The Federal Reserve, on the other hand, believes that nonbank activities should be restricted to subsidiaries of the bank holding company. Such a limitation reduces the potential that a bank's corporate veil can be pierced by creditors, since a holding company subsidiary is less closely related to the bank than a bank subsidiary. OCC and FDIC concerns about the holding company failing to allocate revenues from the subsidiary to the bank in times of need have been addressed in the past through the Federal Reserve's source of strength doctrine. However, as we noted, that doctrine has recently been struck down by a federal court and, thus, underscores the need to establish this requirement by legislation.

We agree that nontraditional banking activities should be conducted outside of the bank because we do not believe that the implementation of a universal banking structure is feasible in the United States. The potential liability to the U.S. government and taxpayers resulting from deposit insurance, together with concerns of competitive equity, make it imperative that insured bank deposits not be used to underwrite, and possibly subsidize, potentially unacceptable risks—including those associated with nontraditional bank powers—as they are in universal banks.

In addition, as a practical matter, it would be extremely difficult to completely reorganize the structures of holding companies and the laws under which they operate.

Furthermore, we favor placing nonbanking activities in subsidiaries of the holding company rather than in subsidiaries of the bank because such a structure provides better protection for BIF, the deposit insurance fund. We do not believe that a bank's corporate veil can be made as impervious to piercing by creditors of a bank subsidiary as by creditors of a holding company affiliate.[13] A bank that owns a subsidiary must, for example, be capable of directing that subsidiary in ways of greatest benefit to the bank. Thus, for example, even though directors and officers may not be shared, the bank would still be responsible for appointing those directors and officers. Furthermore, a bank's reputation and its cost of funds is more likely to be adversely affected by the failure of a subsidiary than an affiliate. In addition, the parent bank's access to the safety net may be implicitly extended to the subsidiary, thus weakening market discipline and lowering the cost of funding to the subsidiary. Finally, if problems arise in the subsidiary, regulators may be more tempted to assist the parent in bailing out the subsidiary. Consequently, in order to maintain the bank's corporate veil and prevent the extension of the federal safety net, we believe that nontraditional banking activities such as life insurance or equity underwriting, for example, should be conducted in holding company subsidiaries.

We recognize that this approach to organizing the location of nontraditional activities poses major problems for small banks. Setting up a holding company structure to undertake nontraditional activities might be prohibitively expensive considering the expected return. In order to allow well-managed and well-capitalized small banks to participate in these activities, a de minimis exception for limited levels of nontraditional banking activities could be allowed. Thus, for example, banks with less than $100 million in assets might be allowed to establish bank subsidiaries in which to conduct these activities, providing these subsidiaries remain a small part of the bank's overall activities as determined by the bank's regulator. Furthermore, if larger banks wish to provide nontraditional services to only a few customers, they also might be allowed to establish subsidiaries if the subsidiaries comprise less than,

[13]The corporate veil can be pierced when a controlled corporation is a business conduit for its principal and has no separate existence of its own. As a general principle, see Craig v. Lake Asbestos of Quebec, Ltd., 843 F.2d 145 (3d Cir. 1988) and Hargrave v. Fibreboard Corp., 710 F.2d 1154 (5th Cir. 1983). This is more likely to be the case if a nonbanking firm is a subsidiary of a bank rather than a holding company affiliate.

say, 1 percent of the bank's total assets. Exceptions for well-capitalized small banks and banks wishing to conduct small-scale nonbank activities should receive case-by-case approval from bank regulators. The subsidiaries would be subject to the same rules, i.e., sections 23 A and 23 B of the Federal Reserve Act, as holding company subsidiaries.

Limited Ties Between Banking and Nonbanking Activities Would Be Reasonable

The second factor to be considered is the degree of economic and other ties that should be allowed to exist between the bank, the parent company, and nonbanking affiliates. At one extreme, in a universal bank there are no restrictions at all, and insured deposits can be used, for example, to underwrite and deal in stocks and bonds. At the other extreme, the Securities Industries Association, among others, has argued that a complete walling off of an insured bank from the rest of the holding company is essential. If bank powers are expanded, we do not believe that either extreme is appropriate.

There would be little reason to expand powers if banks and holding company affiliates were not allowed to realize the efficiencies that could be created through affiliation. However, we strongly believe that banks should not be able to use insured deposits to underwrite nonbank activities in their affiliates. Doing so would give them an unfair competitive advantage and potentially endanger the deposit insurance fund. Thus, we would believe it reasonable and safe to allow ties between affiliates but limit them in ways that will protect bank safety and soundness. The proposals we have made for strengthening sections 23 A and 23 B are essential. With these changes and with an effective source of strength policy, we believe that some of the special firewalls prohibiting interaffiliate transactions that the Federal Reserve has imposed on section 20 companies could be relaxed.

Bank Holding Companies and Expanded Powers Should Be Regulated on a Consolidated Basis

Two options exist for the regulation of holding companies and their subsidiaries. The first is based on pure functional regulation in which only the regulated subsidiaries are examined and supervised and capital is not consolidated. The second entails functional regulation complemented by consolidated holding company regulation and consolidated capital requirements. The Federal Reserve, as the regulator of bank holding companies, already has the authority to regulate nonbank subsidiaries of a bank holding company and may, for example, issue cease and desist orders to such a subsidiary if it believes that the subsidiary's actions are unsafe and unsound. The Federal Reserve Board also requires that consolidated bank holding companies abide by bank capital requirements.

We believe that in order to ensure that the bank holding company source of strength doctrine is an effective mechanism and is not simply invoked when it is too late to protect the bank subsidiaries or FDIC, bank holding companies must be regulated on a consolidated basis. We believe that holding company parents have significant influence over their regulated subsidiaries and that the risks to those subsidiaries cannot be controlled effectively without the ability to regulate the consolidated entity. Consolidated regulation will provide timely notice to bank regulators of financial problems in bank affiliates that might eventually tempt the bank to provide assistance by thwarting capital flow regulations. This will give them the opportunity to take notice of, and prevent, any prohibited assistance the bank might be tempted to provide to its affiliate. Furthermore, bank holding company guarantees are virtually worthless if their subsidiaries are not prohibited from running up losses that will bankrupt the holding company and its subsidiary banks.

Consequently, we believe that it is particularly important that as bank holding companies become more complex, regulators be able to examine each subsidiary of a bank holding company that can have a material impact on either the holding company or a bank affiliate. Subsidiaries should be examined either by the primary holding company regulator or by functional regulators in the case of regulated subsidiaries (such as insurance or securities firms). Examinations of otherwise unregulated subsidiaries would not, however, be expected to be conducted at the same level as bank exams. Instead, they would focus primarily on identifying problems that could adversely affect bank affiliates or other regulated affiliates such as securities firms or insurance companies. The holding company regulator should be given authority to impose measures—including cease and desist orders—deemed necessary to ensure such protection, but these measures should be directed at protecting banks and other regulated affiliates, not at trying to prevent unregulated affiliates from failing.

Consolidated capital requirements are also extremely important to the success of a source of strength requirement. If the holding company itself does not have sufficient capital to cover its guarantee, then it more likely will be tempted to promote risky activities that might promise high returns to the holding company at a cost of potential failure to the insured bank subsidiary or subsidiaries. Consolidated capital requirements help minimize such temptations by requiring holding companies to invest real capital in their subsidiaries.

Consumer Protection Measures Would Also Be Necessary

If Congress decides to expand bank holding company powers, then measures that give consumers accurate information about insured and uninsured products sold by a bank and its affiliates are essential. In our opinion, the improvements to consumer protection measures discussed earlier should provide the protections that would be needed (see pp. 120-123).

Adequate Regulatory Resources Will Be Needed

As discussed in chapter 3, the success of proposals to reform financial services in the U.S. depends on the capability of the regulators of those industries. Allowing banking organizations to expand into nontraditional activities is likely to increase the burden on bank regulators even though such activities will be restricted to holding company subsidiaries.

First, bank holding companies would become more complex and the regulators of those consolidated holding companies would likely require additional staff to effectively regulate them. Furthermore, that staff must be well trained in those activities, if any, that are not functionally regulated, since they would be responsible for identifying problems in those entities that might negatively affect the bank or holding company.

Second, if laws and regulations are enacted that permit increased diversity of banking operations, the potential for conflicts of interest would increase as well. While we believe that current laws and regulations appear sufficient to control most conflict situations, those laws—including strengthened sections 23 A and 23 B of the Federal Reserve Act—will be ineffective if bank regulators are not capable of enforcing them. Thus, it is likely that as the potential for conflicts of interest increase, so must the number of regulators to enforce laws and control those conflicts.

As the Federal Reserve indicated in response to our written queries,[14] there are no reliable data available on the number and size of banking institutions that might wish to engage in any particular expanded activities or on the extent to which they may want to pursue them. FDIC, assuming that only the larger banking organizations in the United States would be interested in new activities, estimated that it would require

[14]On June 6, 1990, we sent a letter to the Federal Reserve Board, FDIC, and OCC requesting their views on numerous regulatory issues. The Federal Reserve and FDIC responded, but OCC has not yet provided us with their response. The responses we received were sent to Congressman Edward Markey on November 1, 1990, in response to a request he had made.

approximately 80 "specialists" in the areas of insurance and securities underwriting.

If banking organizations were to focus on "agency" activities, such as insurance or securities brokerage where bank safety and soundness is minimally at risk, then regulatory resources would be focused primarily on consumer matters as well as on potential conflict-of-interest abuses. The Federal Reserve and FDIC do not believe that this would require significant regulatory resources. If, however, banking organizations were to become involved in such activities as insurance underwriting or securities underwriting/dealing, then bank regulators are likely to need additional training, even if those activities are conducted in functionally regulated subsidiaries. According to the Federal Reserve and FDIC, training in these areas would take at least 6 months to a year to get their staff up to speed.

We agree that it is difficult to predict the need for regulatory resources necessary to regulate expanded activities by banking organizations. However, it is certain that additional resources would be required. Consequently, we believe that case-by-case approval of new activities should be approved only as long as the resources to regulate those activities are available. The evaluation of the adequacy of the systems and resources of the regulatory agencies by the commission of regulators and independent experts that we recommended in chapter 3 will be useful in deciding how and at what speed expanded powers should be implemented.

New Powers Should Only Be Granted to Well-capitalized, Well-managed Institutions on a Case-by-case Basis

We believe that it is the regulators' responsibility to judge the risks associated with granting new powers to banking organizations and to determine whether or not they can be safely associated with banking on a case-by-case basis, if expanded powers are approved. Nevertheless, we firmly believe that a threshold requirement should exist that limits companies' expansion into new lines of business to holding companies with high capital levels. Thus, if approval were based on meeting the 1992 risk-based capital requirements, as discussed in chapter 4, 6 out of the top 50 bank holding companies in the U.S. would not be allowed to apply for additional powers because they did not meet the mandated risk-based minimum capital levels as of June 30, 1990. If the requirement were that capital levels had to exceed 10 percent, then 34 would not qualify. The tripwire and approved information approaches regulation

that we described earlier in this report would make it easier for regulators to assess management capability on the basis of relatively objective measures such as the adequacy of internal controls.

Furthermore, if a bank holding company meets the required capital levels for entering new business lines, is considered well-managed, and, therefore, is accorded the opportunity to expand its activities but subsequently falls below its capital requirements, the holding company would become subject to the tripwires discussed in chapter 3. Until its capital were improved, it could not pay dividends to its equity holders, nor interest on its subordinated debt. Additionally, its growth would be restricted and, if necessary, it would be forced to divest itself of any nonbank activities as required by its regulators.

Other Financial Organizations Should Be Allowed Reciprocal Entry But Should Be Subject to Regulation and a Source of Strength Provision

If banks are to be allowed to conduct nontraditional banking activities, then in the interest of equity and fairness, other types of financial organizations should be allowed entry into banking. As a result, nonbank financial institutions that wish to acquire or establish banks should be allowed to do so in order to level the playing field.

However, competitive equity also mandates that the basic structure of regulation applied to banking institutions designed to protect the federal safety net must also be applied to other diversified financial services firms that are associated with insured banks. The rationale for a holding company source of strength requirement, consolidated holding company capital requirements, and holding company supervision is as relevant for financial services holding companies that decide to associate with banks as for bank holding companies. Financial services holding companies associated with banks will be responsible for and direct the actions of those banks in the same way that is true for bank holding companies. Therefore, these holding companies should be held responsible for the safety and soundness of the banks. Enforcement of a source of strength requirement becomes more complex in the context of a holding company that may own numerous, regulated, financial services subsidiaries. Regulators must take into consideration that when a holding company is required to provide support for a bank subsidiary that the holding company must not be allowed to accomplish that purpose by removing resources from another regulated subsidiary, such as an insurance firm, to the detriment of the firm's customers and any guarantee funds that protect those customers from loss. Regulators could, instead, force a holding company to sell its other regulated subsidiaries and downstream the proceeds to its regulated bank or banks, if necessary. Furthermore,

we believe that holding companies should also act as sources of strength to their other regulated, financial services subsidiaries. Again, such a requirement should not be enforced to the detriment of any other regulated subsidiary—such as a bank.

Consolidated regulation is particularly important when banks are associated with nonbanking firms because bank affiliates may feel obligated to "bail out" affiliated entities, even though they have no legal obligation toward them, in order to protect their own reputations.[15] A holding company regulator should be able to spot problems in those affiliates and have authority to take whatever actions are needed to protect the banks.

In permitting reciprocal expansion into banking, some existing regulatory arrangements would not have to change much. Regulated holding company subsidiaries would continue to be regulated functionally. Thus, SEC would continue to be responsible for broker-dealer subsidiaries, and state insurance regulators for their insurance companies. However, the big change for nonbanking firms is that the holding company as a whole would be regulated by a primary, holding company regulator. The activities of the parent and of subsidiaries that could materially affect the financial health of the holding company or an insured bank affiliate would be subject to regulation. We assume that the regulation and supervision of otherwise unregulated subsidiaries would not be as intrusive as that associated with bank regulation. This should be the case with bank holding company regulation, as well. The emphasis on the examination of unregulated subsidiaries would be on capital adequacy and conflict-of-interest issues.

A problem could arise when a financial services firm wishing to acquire a bank has subsidiaries that engage in activities not permitted in bank holding companies. In general, we believe the existence of such subsidiaries should not rule out the possibility of bank ownership, unless the subsidiaries create a substantial link between commerce and banking. However, in order to maintain parity with bank holding companies, there should be a complete prohibition on transactions or marketing

[15]For example, in the 1970s, several large banks purchased loans from REITs they had advised in order to save their reputations. In 1982, two large New York banks paid a combined $190 million in interest owed by a major government securities dealer, even though the two were only financial intermediaries in these transactions. They made the payments for a variety of reasons including consideration of legal liabilities and market pressures. In another example, in 1985 a large Chicago bank incurred losses of $131 million on its $15 million investment in a Brazilian bank in an attempt to preserve its reputation and stature as a major international bank.

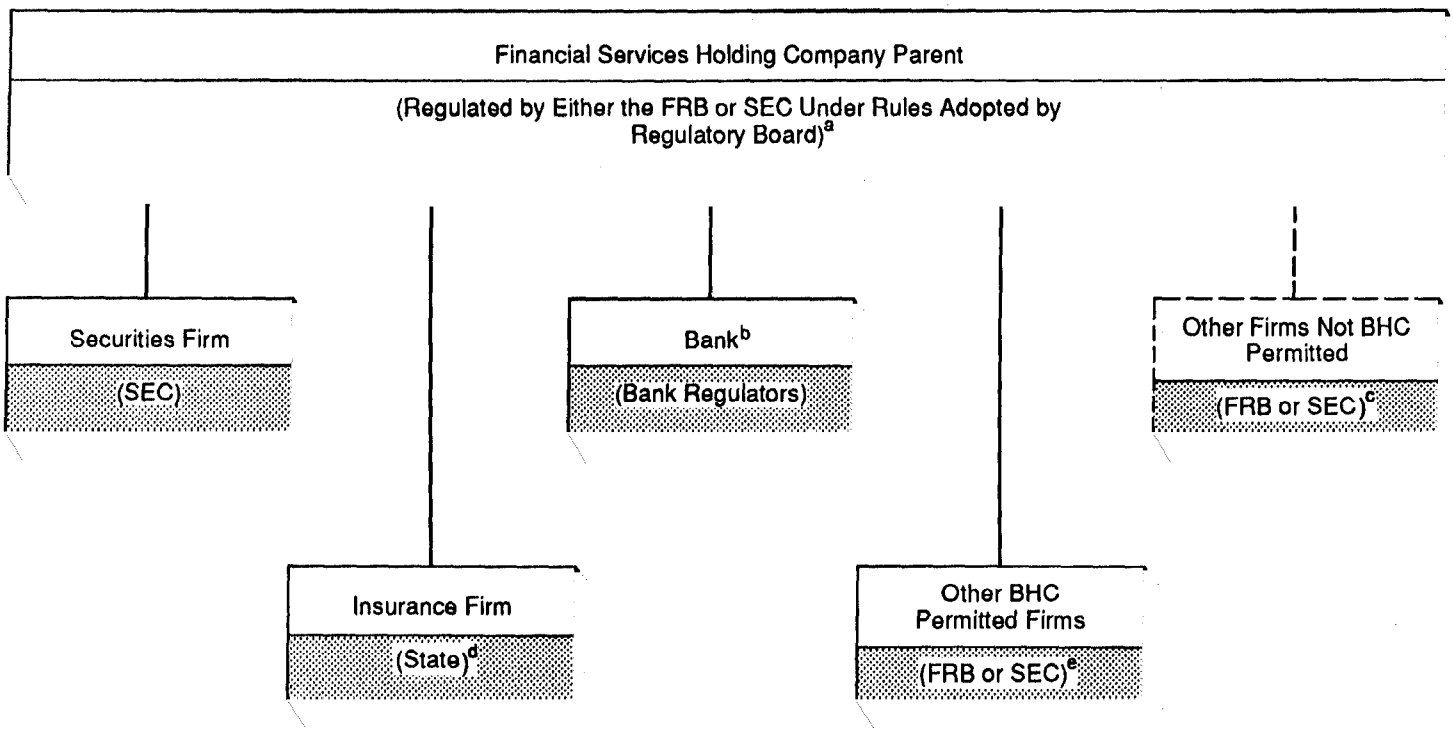
arrangements involving these affiliates that are not permitted for bank holding companies and the bank or banks with insured deposits.

Because the federal deposit insurance fund could be at risk as a result of activities within the holding company, we believe only a federal regulator should be given responsibility for the regulation and supervision of the holding company. That regulator would be the federal regulator of the largest regulated entity[16] within the holding company. For example, if a securities firm were the largest holding company subsidiary, the SEC would be responsible for consolidated holding company regulation. If an insurance company were the largest entity, the Federal Reserve or the SEC should be responsible for the regulation, since there is no federal insurance regulator. (See fig. 5.1 for an illustration of the holding company structure GAO recommends if Congress allows closer association between banking and other financial services.)

In cases where bank subsidiaries are not material to the financial holding company, the holding company could be exempted from consolidated regulation or consolidated capital requirements. However, it should be required to obtain an outside guarantee, in the form of a letter of credit or insurance contract acceptable to the bank regulator, that fully backs its own source of strength guarantee to its bank subsidiary.

[16]How to define largest, whether by assets, capital, gross reserves or other measures, could be determined by the board of regulators discussed in the following pages.

Figure 5.1: GAO's Recommended Holding Company Structure and Regulation



[a]If the largest regulated subsidiary of the holding company is a bank, then the Federal Reserve would serve as the consolidated holding company regulator. The SEC would be the consolidated holding company regulator if the largest subsidiary is a regulated securities firm. If a state-regulated insurance firm is the largest subsidiary then either the Federal Reserve or the SEC would be the holding company regulator.

The holding company would be financially responsible for its bank subsidiaries and the regulatory rule-making board would determine consolidated capital requirements for the holding company as a whole.

[b]Transactions between banks and other bank holding company subsidiaries would be restricted by strengthened sections 23 A and 23 B.

[c]Nonregulated securities or insurance subsidiaries whose activities are not closely related to banking. The regulatory rule-making board would be responsible for determining which of these activities can safely be conducted in a financial services holding company. There would be a complete prohibition on transactions or marketing arrangements involving these subsidiaries and banks with insured deposits.

[d]Assumes continuation of current laws concerning insurance regulation.

[e]Subsidiaries that are engaged in activities closely related to banking, such as data processing or finance company subsidiaries, would be regulated by the consolidated holding company regulator.

A Regulatory Board Should Be Created to Approve New Powers For and Ensure Consistent Regulation of Holding Companies That Own Banks

If the powers of banking organizations are expanded, it will be necessary to ensure consistency in the allowable powers of all organizations owning insured depository institutions, as well as consistency in the regulation of financial holding companies that own banks. We believe that a single set of regulations should be enforced by all regulators, much the same way the securities industry's many self-regulatory organizations apply and enforce the SEC rules and regulations. We therefore favor the creation of a regulatory board that would be responsible for promulgating these rules.

The board would explore and reduce the potential gaps and inconsistencies that may occur when functional regulation is applied to a diversified financial institution—any holding company affiliated with a bank and another regulated entity, such as a securities or insurance firm. Identification of gaps and inconsistencies in regulation are particularly important in order to ensure that bank holding companies owning securities firms, for example, do not have competitive advantages over securities firms owning banks. Another example of the rule-making that is needed is the consolidated capital rule that would be applied to diversified financial holding companies. The board would also decide the proper level of examination and supervision of holding company affiliates that have generally not been subject to federal examination.

The board's mandate should be to create rules that will enhance the overall safety, soundness, and competitiveness of the U.S. financial services industry while protecting the deposit insurance fund. Consequently, the board's activities would be limited to the regulation of financial services holding companies that are affiliated with insured depository institutions. The board would not have authority to take action affecting activities within the jurisdiction of pure functional regulation. For example, the board could not set capital requirements for regulated broker-dealers or banks. The topic of whether such a board might appropriately be given much broader powers to regulate the financial services industry was outside the scope of our work.

The creation of such a board has the additional benefit that it would provide a forum for the discussion and resolution of potential conflicts among financial services regulators. Consequently, to ensure adequate and fair consideration of the interindustry issues involved, we recommend that the board be composed of the Chairman of the Federal Reserve, the Chairman of SEC, and the Secretary of the Treasury.

Until Experience Is Gained With Expanded Powers, Nonfinancial Commercial Firms Should Not Be Affiliated With Banking

If Congress expands opportunities for banking organizations to own financial services firms and vice versa, we would question whether Congress should simultaneously allow nonfinancial commercial firms to own banks. We recognize that many have argued that it is necessary to allow commercial firms to invest in banking in order to provide an outside source of capital to the banking industry. However, we do not believe that the potential long-term ramifications of such a reversal of the long-standing U.S. tradition of separating commerce from banking have been thoroughly considered. Consequently, we favor continuing the separation of commerce and banking until considerable experience has been gained with outside financial ownership of banks before a judgment is made on the appropriateness of commercial ownership. This experience may serve to highlight unforeseen conflicts of interest or other problems that would suggest commercial firms should not be allowed further entry into banking. If it does not, then a considered decision can be made about such ownership on its own merit, removed from the context of the expanded powers debate.

We acknowledge that the separation of commerce and banking is not without exception. Some very large commercial firms already own insured depository institutions (thrifts and nonbank banks[17]). For the reasons discussed above, we believe it is better to have a system that contains some exceptions than to promote changes that would allow unlimited ownership of banks by commercial firms.

Furthermore, while it is tempting to believe that commercial firms might provide a significant source of capital to an industry in which many of the larger institutions are having capital adequacy problems, it is not clear that allowing commercial firms to own banks would be an answer to banks' capital adequacy problems. Certainly, commercial firms have invested significantly in other sectors of the U.S. financial sector, such as the securities industry. However, those investments were primarily motivated by the industry's profitability, and some have not worked out as well as expected. Yet, the fundamental problem in the banking industry today is low profitability. Unless that problem is addressed those banks that need capital infusions are not likely to be attractive to outside investors.

[17]Nonbank banks are limited purpose financial institutions chartered by OCC or state authorities. Because these institutions do not offer both demand deposits and commercial loans, they fall outside of the narrow definition of bank found in the Bank Holding Company Act. Consequently, commercial firms were allowed to purchase these nonbank depository institutions, called nonbank banks. This definition of a bank was changed in the Competitive Equality Banking Act of 1987, but numerous nonbank banks were established before then.

In addition, it is conceivable that, if significant financial reform is undertaken, the banking industry may regain its vitality. At the same time, it might be possible that other sectors of the U.S. economy will suffer setbacks related to turmoil in world markets, an economic downturn, a severe oil crisis, or other factors. We cannot predict what might happen under such a scenario, but it is possible that commercial firms under stress might attempt to take advantage of the financial institutions they own. These, unfortunately, could lead to the possibility of megabailouts.

We also cannot predict what other potential conflicts of interest might arise between commercial firms, the banks they own, and the customers they serve. If the trend towards self-sufficiency in financing in commercial firms continues,[18] then potential conflicts of interest related to commercial owners of banks abusing bank lending to get favorable rates or risky loans may diminish in importance. However, other conflicts could develop that could be related to the payments system, financing of potential competitors, or, at the extreme, the creation of large, anticompetitive conglomerates. Furthermore, regulation of such organizations to control potential conflict-of-interest abuses likely would be difficult.

We acknowledge that certain inequities may result from any decision to allow financial firms, but not commercial firms, to own banks. For example, securities firms now associated with nonfinancial commercial parents would not be allowed to acquire banks with insured deposits, even though such acquisitions would be permitted to securities firms without such affiliations. However, we believe that long-run considerations concerning bank safety and stability should outweigh short-term expediencies. We believe that priority should be given to developing a safe holding company structure and to integrating the financial services industry, if that is judged desirable. Then, after experience with those changes, a determination can be made about the separation of banking and commerce.

Financial firms that are affiliated with commercial firms could, however, be given the opportunity to establish narrow banks. Such banks would give these firms access to the payments system but should not raise concerns about conflict-of-interest abuses; such conflict situations

[18]Commercial firms are relying less on bank loans for their funding and are instead issuing debt through the securities markets. Furthermore, some larger firms are even bypassing having their debt underwritten by securities firms and are privately placing their debt directly with investors.

should be extremely limited due to the nature of narrow banking. Furthermore, it is unlikely that the combination of narrow banking and commercial enterprises would raise economic concentration concerns since narrow banks are limited in their investment options and consequently cannot grow beyond those available options, such as short-term Treasury bills. Finally, we believe that recent Federal Reserve Board efforts to limit daylight overdrafts, in which banks exceed their balances with the Federal Reserve over the course of a day, should alleviate concerns about allowing such firms access to the payments system. Potential changes include charging banks for such overdrafts.

Financial Industry Concentration Should Be Prohibited

It is often argued that bigger financial firms create efficiencies of production. Experience has shown, however, that this is not necessarily the case, and many large financial services conglomerates have been spinning off significant subsidiaries, presumably because they did not contribute to such economies of scale or scope. American Express, for example, sold its major insurance company venture, Fireman's Fund, in 1986 and its 50 percent share of Warner Amex Cable Communication, Inc. subsidiary in 1985 presumably because they were not profitable and because expected synergies did not materialize. Other examples include the sale of Coldwell Banker Real Estate Group's commercial real estate division in 1989 and the discontinuation of Allstate's group life/health insurance business (a Sears subsidiary) in 1987 and 1988.

While there appears to be no evidence that substantial economies of scale or scope in banking exist, there is also no significant evidence that concentration in the U.S. financial industry is a problem. In fact, the U.S. banking system is the least concentrated among all industrial countries. The top five banks in the U.S. control only 7 percent of total banking system deposits compared to 16 percent in Japan, 31 percent in Germany, 64 percent in Canada, and 84 percent in Australia. Furthermore, there are approximately 13,200 commercial and BIF-insured savings banks; 2,900 SAIF-insured savings and loans; 13,000 credit unions; 8,900 securities firms; and 6,000 insurance companies in the United States that compete with each other.

Nevertheless, although it may appear unlikely, the possibility exists that, over the long term, several large conglomerates might emerge and potentially gain control over significant percentages of U.S. financial services and markets. Current antitrust laws might not prove sufficient to control potentially detrimental mergers. Thus, since mega-mergers

could in the long run be damaging, we believe that certain additional merger limits should be applied.

Merger limits might be imposed for two other reasons. First, when a new market opens, market entrants often have a tendency to try to immediately establish a significant market presence. This tendency to jump first and think later proved detrimental to several U.S. banks in the post-"Big Bang" market in London, which accompanied the deregulation of the United Kingdom's financial markets. U.S. banks incorrectly estimated costs and effects of cultural differences, and the cost of learning the equities business proved very expensive, even for strong institutions.[19] Limits on the allowable sizes of mergers would force financial institutions to gradually establish themselves and gain from smaller scale experiences in new lines of business. Second, diversification effects are more likely to be positive if additional lines of business are less significant than the main holding company activities.

Thus, until a certain level of experience has been established in this area, we believe that well-capitalized, well-managed bank holding companies should be limited to either de novo securities or insurance activities, approved on a case-by-case basis, or acquisitions of established firms that would add less than some relatively low limit, such as 10 percent, to the bank holding company in 1 year. Furthermore, any merger associated with a bank should be approved by the bank's regulator and the regulator of the holding company. Such limits would not block the benefits that might be associated with interindustry mergers but would inhibit the creation of conglomerates that might have a negative impact on financial markets in the United States.

Initial Restrictions May Be Modified Once Adjustments to New Structures and Activities Have Been Made

As financial institution regulators and institutions associated with banking become more experienced with the new structures and activities, we believe that it should be possible to modify limitations that we currently support as necessary to ensure safety and soundness during the initial phases of financial modernization should such modernization be approved. One such modification might allow banks to perform certain expanded activities with risk characteristics similar to those associated with banking either in a bank or a bank subsidiary. Numerous nontraditional activities and products such as debt underwriting or life insurance annuities accomplish the same traditional intermediation

[19]See International Finance: Update on U.S. Commercial Banks' Securities Activities in London (GAO/NSIAD-90-98, May 7, 1990).

function as do banking products. Another modification could allow service firms (such as American Express) or even commercial firms to become affiliated with banks in ways that do not endanger the safety and soundness of the banking system or the federal safety net. However, such modifications should be delayed until experience with the plan outlined above dictates that they can be safely implemented.

Conclusions

Numerous regulatory gaps characterize the current system for restricting banking activities and for accommodating the need for banks to adapt to changes in world financial markets. These gaps—the absence of a clear set of safety and soundness standards for use in approving interstate banking arrangements, allowing holding companies to avoid responsibility for their bank subsidiaries, the potential for consumer confusion and conflicts of interest, and the built-in inequities of the regulatory structure—all add up to the possibility of serious problems in the future. These problems must be addressed before further changes are made to banking powers.

Once these regulatory gaps have been addressed, issues associated with expanded bank powers could be addressed. If a judgment is made by Congress that bank powers should be expanded, then a system must be established that protects banks associated with holding companies. Consumer interests must also be protected, particularly as financial products become more complex. The potential for conflict-of-interest abuses must be seriously addressed. Furthermore, competition among financial institutions must be on a level playing field and must maintain the unconcentrated nature of today's financial system.

In order to ensure that further evolution of the nation's financial services system enhances service to the public, promotes fair competition and does not place the deposit insurance system at risk, a number of steps must be taken.

- The McFadden Act and sections of the Douglas Amendment to the Bank Holding Company Act should be phased out in order to further allow banks to meet customer needs and diversify their activities in less costly ways, but only well-capitalized, well-managed banking organizations should be allowed to take advantage of the change.
- Bank safety and soundness should be protected through a source of strength policy for all holding companies affiliated with banks. The success of that policy will depend on a system of consolidated holding company capital and regulation.

- A package of consumer protection measures that adequately addresses the complexity of insured and uninsured financial products must also be implemented.
- Most potential conflict-of-interest abuses can be addressed through the enforcement of both the source of strength provision and measures that control financial and information flows between banks and their affiliates. But there must be assurances that the regulators can enforce such provisions before relaxing current restrictions on activities.
- To guarantee equity of competition, financial firms must be allowed to acquire banks if banks are allowed to compete in their products and services. Equity of regulation would be ensured through the creation of a regulatory board responsible for promulgating holding company regulations.
- Furthermore, provisions that control mergers of financial institutions that have the potential of concentrating the U.S. financial markets must be adopted.

If these steps are taken, we believe that the ability of financial service firms, including banks, to adjust to changing competitive conditions through liberalization of restrictions on their powers can be implemented safely. Banking and financial services organizations could also be given the opportunity to avoid certain restrictions through the creation of narrow banks, which pose minimal risks to the deposit insurance fund.

It should be clear from these conditions that we do not believe that commercial banking organizations should be granted new powers in the hope that they will be able to grow out of their current financial problems. Such a strategy was tried and failed in response to financial problems in the thrift industry in the early 1980s. Instead, once the regulatory system has been updated, if Congress decides that bank powers should be expanded, only well-managed and well-capitalized banking organizations should be given the opportunity, on a case-by-case basis, to mobilize their capital in ways that allow them to adapt to changing markets and competitive conditions, providing them with the potential to better serve their customers.

Recommendations

To resolve the regulatory gaps that currently characterize the regulation and structure of bank holding companies in a way that will protect the safety and soundness of the U.S. banking system, we recommend that Congress take the following steps before expanding bank powers:

- Phase out the McFadden Act and sections of the Douglas Amendment to the Bank Holding Company Act that restrict interstate banking, but only after controls are adapted to be certain that only well-capitalized, well-managed banking organizations can take advantage of the new opportunities for interstate expansion.
- Enact a source of strength doctrine that will require holding companies to take responsibility for the financial health of their bank subsidiaries and the potential losses incurred by FDIC in resolving bank failures.
- Require that holding companies associated with banks be regulated in a consolidated manner, with functional regulation of regulated subsidiaries, and that they be subject to consolidated capital requirements.
- Legislate improvements to sections 23 A and 23 B of the Federal Reserve Act that will enhance regulators' abilities to protect insured banks from risks undertaken by their nonbank affiliates.
- Require uniform disclosure of federally insured and uninsured products, comparable cost and yield information on similar types of financial products, and information regarding brokers' commissions and fees.

These recommendations are necessary to protect the banking system now, but they are also imperative if a decision is made to expand bank powers. If Congress decides to enact legislation to allow banks access to expanded powers, we recommend that expanded powers be phased in by taking the following steps:

- Require that only well-capitalized, well-managed bank holding companies be given access to expanded bank powers on a case-by-case basis.
- Restrict expanded powers to nondepository subsidiaries of bank holding companies and restrict transactions between those subsidiaries and affiliated banks to ensure that insured deposits are not used to finance expanded powers.
- Allow nondepository financial institutions to acquire banks but require such institutions to act as sources of financial strength to their bank and other regulated subsidiaries. All financial institutions affiliated with commercial banks should be subject to consolidated capital requirements and regulations.
- Require controls on the sharing of confidential customer information among holding company entities.
- Create an interindustry regulatory board to promulgate regulations that ensure consistent and safe financial services holding company regulation. The Board should consist of the Chairman of the Board of Governors of the Federal Reserve System, the Chairman of the SEC, and the Secretary of the Treasury.

- Restrict the ability of financial institutions to merge in ways that will allow the creation of a concentrated financial industry.

Information on Deposits and the Effects of Changing the Definition of an Insured Deposit

The Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989 required GAO to address the effects of proposed changes to the definition of a "deposit" on market discipline and on the ability of other participants in capital markets to raise funds. This appendix supplements the discussion of these topics contained in chapter 4 and provides background information on how a deposit is defined and data on the amount and type of funds on deposit with banks. We also discuss the relationship between the definition of a deposit and the government's potential liability in the case of bank failures. In keeping with the scope of this report, the discussion focuses on deposits in Federal Deposit Insurance Corporation (FDIC) insured banks.

Nature of Insured Deposits

The definition of a deposit covered by federal deposit insurance and the level of insurance coverage for deposits are two separate but closely related issues that are important in considering deposit insurance reform. Together they determine the nature and extent of the federal deposit insurance program. Generally speaking, deposits are funds placed in banks for various purposes. These include transaction and payroll accounts, demand (checking) deposits, savings deposits, time deposits, and retirement accounts. These deposits come from many sources, including individuals, corporations, all levels of government (including foreign governments), other banks, and charitable organizations. In some cases the deposits are placed in banks by professional money managers, investment firms, managers of pension funds, or brokers acting as agent for, or on behalf of, their clients. Subject to certain restrictions discussed below, these deposits, except those in foreign branches of U.S. banks, are all currently insured up to $100,000.

Banks also manage a significant number of trust fund accounts on behalf of their customers. These do not constitute bank liabilities, although many of these accounts are covered by federal deposit insurance.

Definition of an Insured Deposit

While the present federal deposit insurance program came into force in 1934, it was not until the Banking Act of 1935 that Congress enacted a statutory definition of what was meant by a deposit. Subsequently incorporated into the Federal Deposit Insurance Act (FDIA) of 1950, the act defines deposits as:

the unpaid balance of money or its equivalent received by a bank in the usual course of business and for which it has given or is obligated to give credit to a commercial, checking, savings time or thrift account, or which is evidenced by its certificate of deposit, and trust funds held by such bank whether retained or deposited in any department of such bank or deposited in another bank, together with such other obligations of a bank as the board of directors shall find and shall prescribe by its regulations to be deposit liabilities by general usage.[1]

Congress has also passed other legislation affecting the scope of deposit insurance, including the National Housing Act of 1934 which established the Federal Savings and Loan Insurance Corporation. The Federal Deposit Insurance Act further codified deposit insurance and specifically provided for what has become known as "pass through" deposit insurance, wherein deposit insurance passes through the principal account to each individual beneficiary of a trust fund, pension, and Individual Retirement Account (IRA)/Keogh Plan retirement account. Each beneficiary's interest is separately insured up to $100,000. This insurance protection is additional to any other insured accounts maintained by the individual in the same bank. This is an important provision of the deposit insurance program because deposit insurance protection for eligible retirement and pension fund accounts is not limited to $100,000 but rather to $100,000 times the number of pension or retirement plan participants or beneficiaries provided for by the account.[2]

Through the years, federal banking legislation has also specifically excluded certain deposits from deposit insurance, including bank obligations located in offices outside of the United States and its territories and deposits located in international banking facilities. These deposits are not federally insured and are excluded from the deposit insurance assessment base.

Congress, in enacting the Federal Deposit Insurance Act, anticipated that changes in the banking industry would result in the creation of new depository instruments. Accordingly, Congress empowered FDIC, in consultation with the Comptroller of the Currency and the Board of Governors of the Federal Reserve System, to determine whether new financial products constituted insured deposits for the purpose of deposit insurance protection. FDIC exercises this authority by issuing regulatory and advisory opinions. FDIC Advisory Opinions are issued in response to petitions filed by interested parties seeking clarification as to whether a

[1]See Banking Act of 1935 and Federal Deposit Insurance Act, section 3(l)(1), et seq.

[2]For example, should a retirement account have 20 beneficiaries, the interests of each one would be insured up to $100,000.

particular financial instrument is entitled to deposit insurance protection. Advisory Opinions are published in the Federal Register as they are issued and establish precedent (i.e., they apply to all such products and not just the ones issued by the petitioner). FDIC also publishes deposit insurance regulations in the Federal Register. Subject to public comment and judicial review, these regulations provide guidance as to how the deposit insurance program operates and what is and is not insured.

In recent years, federal deposit insurance has been extended to a number of new depository instruments that have been developed. These included Negotiable Order of Withdrawal (NOW) accounts, Money Market Deposit Accounts (MMDA), brokered deposits, and Bank Investment Contracts (BIC).[3] The innovation that has given rise to these new products reflects changes in technology, competition from nonbanking firms, and relaxation of the Federal Reserve's Regulation Q[4] and other restrictions on demand and savings deposits.

Insurance Coverage

Federal law and FDIC regulations provide that the amount of deposit insurance coverage be based on ownership rights. Subject to certain exceptions noted below, all accounts owned by an individual in a single bank are aggregated for deposit insurance purposes and covered up to $100,000 per depositor per insured institution. For example, if a depositor has both checking and savings accounts in the same institution, both accounts taken together would be insured up to $100,000. However, should an individual also hold a joint account with another person in the same bank, this joint account would be separately insured up to $100,000.[5] An individual can thus significantly increase his or her insurance coverage in a single bank by establishing multiple accounts with different family members. One bank advertisement that we have seen shows how a family of three can take advantage of deposit insurance

[3]NOW accounts are interest-bearing checking accounts; MMDAs are interest-bearing savings accounts permitting a limited number of transfers, and BICs, discussed in appendix II, are investments used to finance pension funds and placed with banks by pension fund managers.

[4]Regulation Q, among other things, prohibited the payment of interest on demand deposits and set ceilings for the amount of interest that could be paid by banks on savings accounts. Today, its only impact is prohibiting the payment of interest on demand accounts.

[5]The regulations governing these situations are complicated. FDIC has held that joint accounts are only eligible for separate deposit insurance protection when the "joint tenant" is an immediate relative. FDIC regulations also provide that accounts held by an individual acting in a custodial or executor capacity are separately insured from other accounts held by the individual in the same institution.

regulations to increase their insurance coverage to $1.2 million by holding various types of accounts in a single institution.[6]

It is also important to note that there is no limit to the number of insured accounts an individual may have in different banks. Additional federally insured accounts can therefore be obtained by establishing accounts in other insured institutions. Some securities firms or investment companies advertise organized arrangements that automatically transfer funds in excess of $100,000 to an insured account in another institution.

In 1967, FDIC adopted regulations specifying the various capacities in which funds may be owned and separately insured for deposit insurance purposes. This represented the first time FDIC published specific regulations. Previously, the deposit insurance program operated on the basis of staff opinions. Following enactment of FIRREA, the FSLIC was abolished and its activities assumed by FDIC. As required by FIRREA, FDIC issued uniform regulations governing both banks and thrift associations. Previously, separate regulations had governed deposits insured by FDIC and those insured by FSLIC, and in certain instances similar deposits had been treated differently by the two insurers. FDIC's regulations, summarized in table I.1, came into effect on July 29, 1990, and were mailed to all

[6]This can be done as follows:

Type of account	Insurance amount
Individual	
Husband	$100,000
Wife	100,000
Child	100,000
Joint	
Husband and wife	100,000
Husband and child	100,000
Wife and child	100,000
IRA/Keogh	
Husband	100,000
Wife	100,000
Revocable trust	
Husband as trustee for wife	100,000
Husband as trustee for child	100,000
Wife as trustee for husband	100,000
Wife as trustee for child	100,000
Total insurance coverage	$1,200,000

bank customers with their statements and are displayed in all FDIC-insured institutions.

Table I.1: FDIC Uniform Deposit Rules Governing Insured Deposits

Type of account	Insurance coverage
Commercial accounts	
Business, corporate, and partnership accounts	All accounts in same institution are aggregated and insured up to $100,000.
Personal accounts	
Single ownership accounts	Insured up to $100,000.
Joint ownership accounts	Each owner insured up to $100,000 ($200,000 aggregate coverage).
Testamentary accounts	
	When payable to a spouse, child, or grandchild, the account is insured up to $100,000 separate from the insurance granted to individual or joint accounts. (However, when a couple together establishes a single revocable trust naming each other as sole beneficiary, the account is treated as a joint account.)
Retirement accounts	
IRA and Keogh plan accounts	A person's deposits in either of these accounts is insured up to $100,000 separate from any interests that person may have in other accounts at the same institution.
Trusteed pension plans	Insured up to $100,000 for the interest of each individual pension plan participant, regardless of source of funds.
BICs	Insured up to $100,000 for the interest of each individual pension plan participant.
"457 plan accounts"	"457 plan" accounts established by state and local governments are insured up to $100,000 in aggregate, not per employee or participant. Deposits of 457 plans now in existence will continue to be insured up to $100,000 per participant/employee until January 29, 1992. These differ from BICs in that for tax purposes the account is in the name of the governmental jurisdiction, not the individual beneficiary.
Other types of accounts	
Public unit accounts	Time deposits, savings deposits, and NOW accounts of a public unit in an institution in the same state will be insured up to $100,000 in aggregate separate from the $100,000 coverage for the public unit's demand deposits in the same institution. A public unit's funds in an out-of-state institution will have a single $100,000 limit for all its time, savings, and demand deposits. (n.b.: Some states require or permit such accounts to be collateralized; collateralization is prohibited in other states).

(continued)

Type of account	Insurance coverage
Mortgage servicing accounts: deposits representing principal and interest	Deposits representing principal and interest at any one institution are insured up to $100,000 per account owner.
Mortgage servicing accounts: deposits representing tax and insurance	Deposits representing tax and insurance will be added together with any single ownership accounts that the person holds at the same institution (and the total insured up to $100,000).
Unit investment trust deposits	A unit investment trust's CDs will be treated as a corporation's deposits and will be insured up to $100,000 in aggregate, not per investor, in the trust.
CDs used to fund life insurance and annuity contracts	The interest accruing on these accounts is used to finance annuity or insurance contracts. Such accounts will be insured up to $100,000 per individual, provided (1) the life insurance company establishes a separate account for the funds, (2) the account cannot be used for any other business of the company, and (3) the account cannot be accessed by other creditors if the life insurance company becomes insolvent and its assets are liquidated.
Accounts held by depository institutions acting in fiduciary capacities	Such accounts will be insured for up to $100,000 for each owner or beneficiary and will be insured separately from any other deposits of the owners or beneficiaries at the same institution. Funds held as executor or administrator for a deceased person's estate will be insured up to $100,000 per estate.

Note: In off-setting account balances, instances in which a depositor has an outstanding loan in the same institution where he maintains a deposit, the outstanding balance due on the loan is deducted from the deposit balance in calculating the reimbursement due the depositor. The same applies in the case of trusts, business, and retirement accounts.

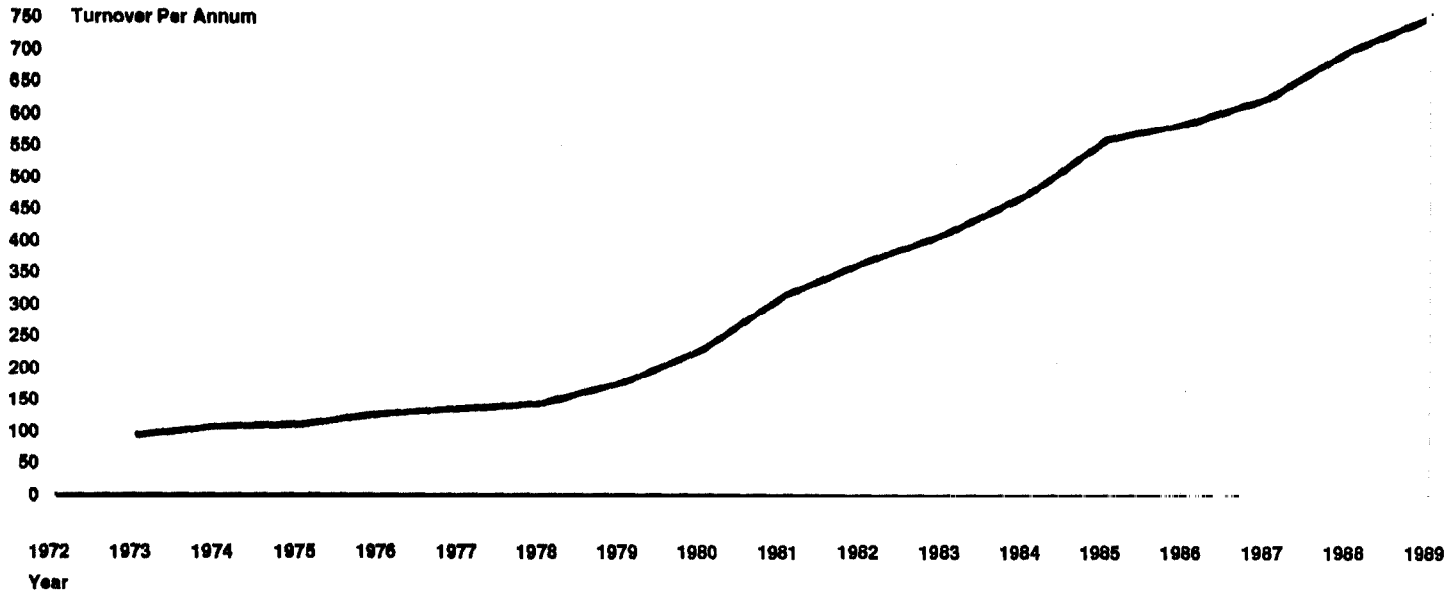
For treasury tax payments, deposits in a bank representing federal tax payments (withholding, FICA, etc.) are separately insured up to $100,000.

Source: FDIC.

Market Innovation

Changes in financial markets that affect deposits are, however, by no means limited to the development of new types of insured deposits. For example, the development of electronic funds transfer arrangements and the use of computers have enabled a given amount of deposits to be used much more efficiently in executing transactions throughout the economy. Thus, for the banking system as a whole, Federal Reserve statistics show that from 1970 to 1990 the balances in demand deposits approximately doubled, an increase far less than the increase in the gross national product (GNP) (which increased five-fold). However, the number of times the average deposit turned over during the year increased 10-fold (see fig. I.1).

Figure I.1: Average Yearly Turnover of Demand Deposits, 1972 to 1989



Note: Figures are seasonally adjusted.
Source: Board of Governors of the Federal Reserve.

The increase in deposit turnover was even greater for major banks in New York City, where it increased by more than 15-fold. Part of this increase in efficiency in the use of deposits has been accomplished by cash management services that allow customers to maintain zero balances in their draft (checking) accounts until checks are actually presented for payment, when the funds are transferred from companion investment accounts to cover checks. These companion accounts pay higher interest than ordinary savings or NOW accounts.

Other developments have allowed nonbanking financial services firms to offer services to the public that have many of the features traditionally associated with bank deposits. A prime example of this is the money market mutual fund (MMMF). Funds deposited in such accounts are typically invested in very short term, high-quality assets, such as Treasury bills, certificates of deposit (CD), or commercial paper; and can often be transferred by check, (usually subject to certain restrictions on the minimum size or number of checks per month) through arrangements with a

participating bank. Although uninsured, these highly successful deposit substitutes are perceived by the public to have little risk, but they often have higher yields than checkable deposits. These high yields are possible in part because these accounts are not subject to deposit insurance premiums, reserve requirements, bank capital requirements, or corporate income taxes, and the operating expenses associated with such accounts are also lower than for most bank transaction accounts.

Quantitative Information on Deposits

This section provides detailed information about deposits. Specifically, it includes data on trends in deposit insurance coverage and in the role of insured deposits, types of deposits, insured and uninsured deposits by bank size, sources of deposits, and sizes of accounts.

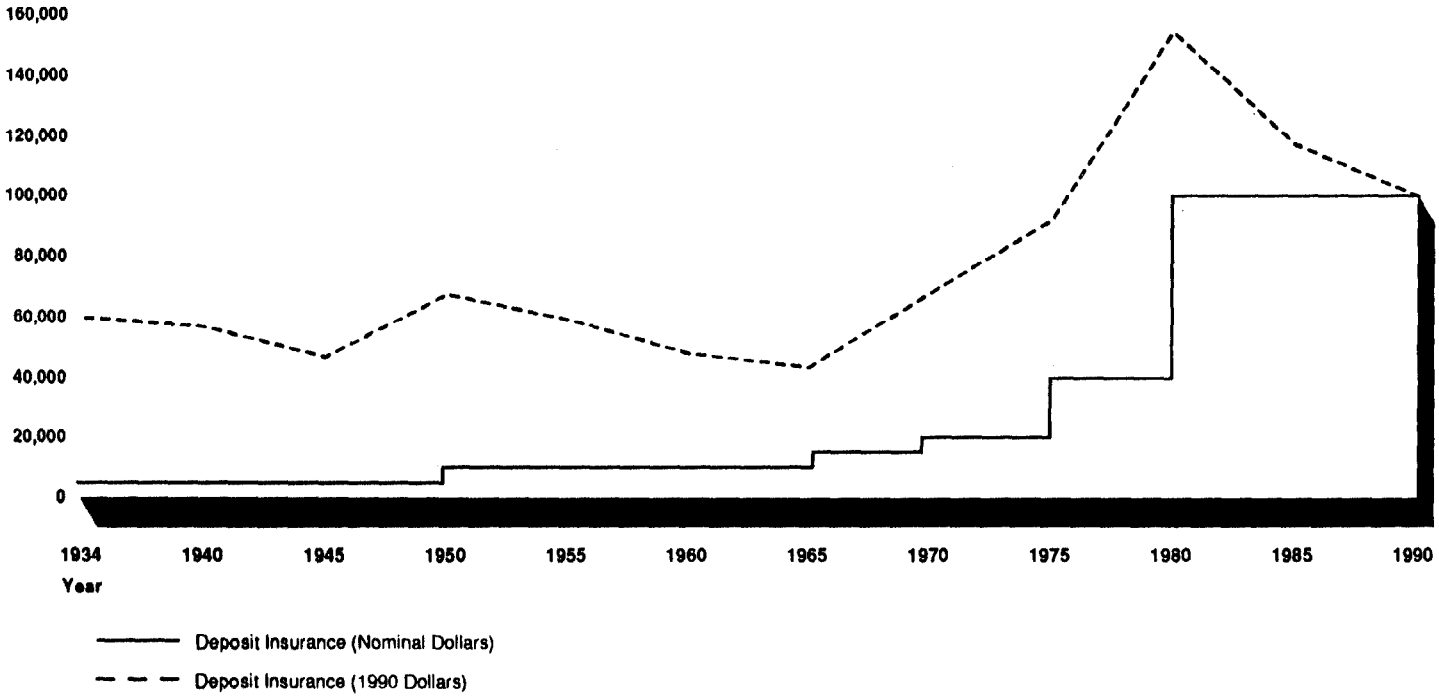
Trends in Deposit Insurance Coverage and in the Role of Insured Deposits

Since 1934, when deposit insurance coverage was set at $5,000, Congress has increased the deposit insurance ceiling five times, the latest being in 1980 when the ceiling was increased from $40,000 to $100,000 with passage of the Depository Institutions Deregulation and Monetary Control Act.[7] However, as shown in figure I.2, the value of the insurance limits that has been set has also varied in terms of constant purchasing power. The $5,000 deposit insurance ceiling established by Congress in 1934 would be equivalent to $36,000 in today's dollars.[8] Thus, as measured in dollars of constant purchasing power, the insurance limit in 1990 was about 2.8 times greater than it was in 1934. The real value of the insurance limit has, however, fallen by about one-third since it was last raised to $100,000 in 1980. The $100,000 limit was, in 1980, worth the equivalent of $155,000 in 1990 dollars. (See fig. I.2.)

[7]The limits were increased as follows: in 1950 to $10,000; in 1960 to $15,000; in 1969 to $20,000; in 1974 to $40,000; and in 1980 to $100,000.

[8]Calculation of real dollar equivalents is based upon the GNP deflator as of June 30, 1990, as determined by the President's Council of Economic Advisers and published in the Budget of the United States Government.

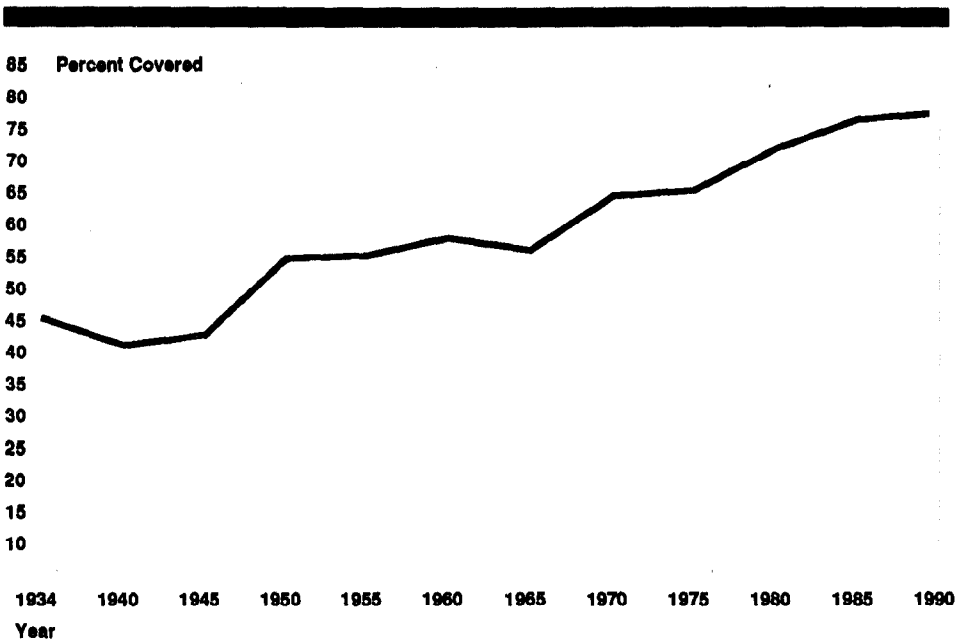
Figure I.2: Deposit Insurance Coverage in Constant (1990) and Nominal Dollars, 1934 to 1990



Source: GAO analysis.

Overall, as a result of increases in the insurance limit and innovation and changes in the nature of insured deposits, the proportion of deposits that is insured has steadily increased through the years. In 1934 when deposit insurance was first instituted, approximately 45 percent of all domestic bank deposits were insured. By 1989, this percentage had increased to 76 percent. Figure I.3 illustrates this trend.

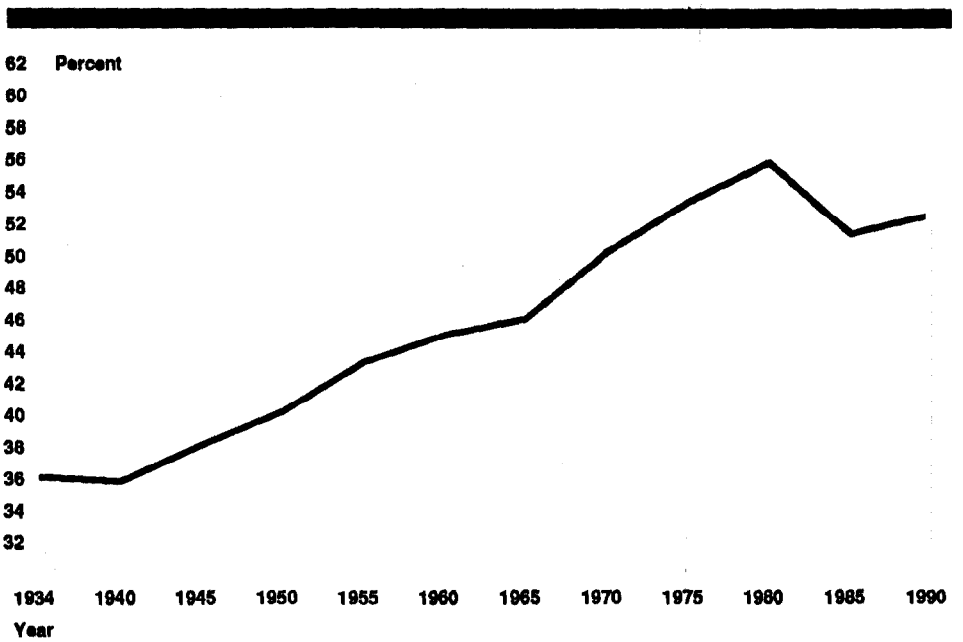
Figure I.3: Percentage of Domestic Bank Deposits Covered by FDIC Deposit Insurance, 1934 to 1990



Source: FDIC.

Insured deposits have also increased as a percentage of the funding for total bank assets. In 1934, insured deposits funded an estimated 36 percent of bank assets. In 1989, this percentage had increased to about 52 percent. Thus, over the life of federal deposit insurance, the portion of bank assets funded by insured deposits has increased by about 45 percent. (See fig. I.4.)

Figure I.4: FDIC-insured Deposits as a Percentage of Bank Assets, 1934 to 1990



Source: U.S. Department of Commerce; FDIC.

Since 1980, the percentage of insured domestic bank deposits increased from 71.6 percent to 77.0 percent of all deposits in 1990. However, there has actually been a slight decline in the role of insured deposits in funding bank assets. Whereas insured deposits equalled an estimated 56 percent of bank assets in 1980, that percentage had declined to approximately 52.5 percent as of June, 1990. (See table I.2.)

Table I.2: Insured Deposits as a Percentage of Total Deposits and Total Assets for FDIC-insured Institutions, 1980 to 1990

Dollars in billions

Year	Insured deposits	Insured as percent of total domestic deposits	Insured as percent of total assets
1980	948.7	71.6	56.0
1981	988.9	70.2	53.6
1982	1,134.2	73.4	55.8
1983	1,268.3	75.0	57.7
1984	1,389.9	76.9	51.7
1985	1,503.4	76.1	51.2
1986	1,634.3	75.4	51.4
1987	1,658.8	76.9	50.8
1988	1,750.3	75.1	51.2
1989	1,873.8	76.0	52.4
1990[a]	1,903.0	77.0	52.5

[a]As of June 30.
Source: FDIC.

The reason that insured deposits have increased as a percentage of all deposits but decreased as a percentage of bank assets is that nondeposit liabilities have grown over this same period. The growth of repurchase agreements has been particularly significant. Though technically uninsured, the liability is legally secured by collateral and hence virtually immune from loss if the bank were to fail. Loans to banks from the holding company with which they are affiliated, which are counted as nondeposit liabilities on the books of banks, have also increased during this period.

Types of Deposits

As of June 30, 1990, a total of $2.8 trillion was on deposit in FDIC-insured banks. About 12 percent of this total was foreign deposits, with the remaining 88 percent divided among 6 domestic account categories. FDIC estimates that about $1.9 trillion, or 77 percent, of domestic deposits are insured by BIF. Uninsured domestic deposits involve the portion of time deposits that exceeds $100,000, demand deposits over $100,000, and accounts in other account categories that, when aggregated with other accounts, exceed the $100,000 limit.[9] Table I.3 details the most recently available data on total bank deposits in U.S. banks.

[9]However, some accounts over $100,000 are protected because they are collateralized (as in the case of certain government accounts). Loans to a borrower are subtracted from deposits of that borrower in determining deposit balances for insurance purposes.

Table I.3: FDIC-insured Bank Deposits, as of June 30, 1990

Dollars in billions

Type of deposit	Amount of deposits	Percent of total deposits
Domestic deposits		
Demand deposits	$430	15.5
NOW accounts	209	7.5
MMDA deposits	386	13.9
Savings accounts	232	8.4
Time deposits < $100,000	775	27.9
Time deposits > $100,000	409	14.7
Subtotal domestic deposits	**$2,447**	**88.1**
Foreign deposits	$330	11.9
Total funds on deposit[a]	**$2,771**	**100.0**
Memorandum:[b]		
Brokered deposits	78	2.8
IRA/Keogh accounts	143	5.2
Interbank deposits	51	1.8

[a]Totals may not add due to rounding and presence of miscellaneous items.

[b]Memorandum items are included in deposit categories listed above.

Source: FDIC Call Report Data, June 1990.

Insured and Uninsured Deposits by Bank Size

Total insured and uninsured deposits by bank size can be estimated from FDIC call report information. As of June 30, 1990, the 46 BIF-insured commercial and savings banks with assets over $10 billion held 22 percent of total insured deposits and 59 percent of uninsured deposits. Banks with less than $1 billion in assets held 44 percent of insured deposits and 14 percent of uninsured deposits. (See table I.4.)

Table I.4: Amount and Percentage of Insured and Uninsured Deposits by Bank Size, as of June 30, 1990

Dollars in billions

Bank size	Number of banks	Insured deposits		Uninsured deposits	
		Amount	Percent	Amount	Percent
Greater than $10 billion	46	$414.7	22.1	$531.4	59.2
$1-10 billion	377	637.3	33.9	244.9	27.3
Less than $1 billion	12,540	828.0	44.0	121.1	14.0
Total	**12,963**	**$1,880.0**	**100.0**	**$897.4**	**100.0**

Note: Numbers may not add due to rounding. Table includes BIF-insured commercial and savings banks.

Source: GAO analysis of call report data.

Sources of Deposits

Information on the sources of deposits is contained in the Flow of Funds tables published by the Board of Governors of the Federal Reserve System. These tables analyze the financial assets and liabilities of both the financial sector of the economy and several broadly defined nonfinancial sectors. While these analyses provide valuable insights into the origin of deposits, they are not without their limitations because Flow of Funds tables combine currency and checkable deposits, in some instances, and deposits held in banks by nonfinancial sectors of the economy with those held in savings institutions. Furthermore, these analyses net out interbank deposits and bank floats so that the deposit base differs from that derived from call report information.

According to Flow of Funds tables, the overwhelming source of deposits in the economy comes from "Households, Personal Trusts and Non-Profit Organizations." This sector alone accounts for approximately 78 percent of all deposits and currency. (See table I.5.) Federal Reserve household survey data suggest that approximately half of this amount (38 percent of all deposits) is from households.[10] By contrast, corporations and other nonfinancial businesses hold just 11 percent of all funds on deposit.[11]

[10]The information is from the 1983 Survey of Consumer Finances. The survey consists of interviews with 4,103 U.S. households drawn from two sampling frames: a randomized geographic sample and a special sample of wealthy households. The information we have used is from the appendix to the September 13, 1990, testimony by Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, before the Committee on Banking, Finance and Urban Affairs, U.S. House of Representatives. On page 4 of the appendix, the Federal Reserve estimates that 37.6 percent of total deposits was held by households in 1983.

[11]One factor that possibly contributes to the relatively small share of deposits held by nonfinancial businesses is that under Regulation Q banks cannot pay interest on demand deposits.

Table I.5: Deposits in All Depository Institutions and Currency Held by Different Sectors of the Economy, as of December 31, 1989

Dollars in billions

Type of account	Amount	Percent of total
Households, personal trusts and non-profit organizations		
Checkable deposits and currency	$492.9	11.7
Small time and savings deposits	2,227.8	60.8
Large time deposits	222.1	6.0
Nonfinancial businesses		
Checkable deposits and currency	220.7	6.0
Time deposits	186.9	5.1
State and local governments, general funds		
Checkable deposits and currency	20.6	0.6
Time deposits	57.6	1.6
U.S. government and federally-sponsored credit agencies and mortgage pools		
Checkable deposits and currency	28.4	0.7
Time deposits	1.3	0.0
Foreign sector		
U.S. checkable deposits and currency	21.6	0.5
U.S. time deposits	43.1	1.2
Commercial banking		
Checkable deposits and currency	3.2	0.0
Private nonbank financial institutions		
Checkable deposits and currency	68.6	1.9
Time and savings deposits	142.0	3.9
Total	**$3,735.9**	**100.0**

Notes: The Flow of Funds statistics exclude interbank deposits. Currency outside of banks amounts to $231.8 billion.

Source: Flow of Funds, Board of Governors of the Federal Reserve.

Although determining the precise sources of uninsured deposits is not possible given current reporting procedures, detailed information from the Flow of Funds statements is available about a major component of uninsured deposits—time deposits over $100,000. As shown in table I.6, about one-third of these deposits are business deposits, and about 28 percent are deposits by the financial sector.

Table I.6: Origin of Time Deposits Over $100,000, as of December 31, 1989

Dollars in billions

Source of funds	Amount	Percent of total
Private domestic nonfinancial sectors		
Households	$140.1	23.4
Businesses	205.6	34.5
State and local governments	39.1	6.5
Subtotal	**$384.8**	**64.4**
Foreign deposits	45.0	7.6
Financial sectors		
Savings and loan associations	7.4	1.2
Credit unions	12.3	2.1
Private pension funds	92.1	15.5
State and local government retirement funds	22.4	3.7
Money market funds	32.8	5.5
Subtotal	**$167.0**	**28.0**
Total assets	**$596.8**	**100.0**

Note: Numbers may not add due to rounding.

Source: Flow of Funds, Board of Governors of the Federal Reserve.

Size of Accounts

The only information available on the size of individual insured and uninsured accounts is contained in the Federal Reserve's 1983 Survey of Consumer Finances.[12] According to this publication, between 85 and 91 percent of the $950 billion invested in household deposit accounts was insured in 1983. About 85 percent of all insured deposits was estimated to be below $50,000, and the average household account was valued at between $4,000 and $9,000.[13]

Using the synthetic account definition adopted by the Federal Reserve, the survey also estimated that 2.6 percent (2.2 million) of all households had an account of $75,000 or more at an insured institution. This group is estimated to account for 28 percent of all insured household deposits and 38.6 percent of total household deposits. Compared to the general

[12]See footnote 10. The Federal Reserve is currently updating information on deposits in its 1989 Survey of Consumer Finances. The results are expected to be available in early 1991.

[13]The survey reported two sets of results because two different assumptions were used for evaluating the distribution of deposits: (1) the "synthetic account" definition assumed all accounts held by a given household at a given type of institution are actually accounts owned by the same person and that the accounts are held at the same institution, and (2) the "individual account" definition assumed all accounts are either owned by different household members or are held at different financial institutions.

population, households with accounts of $75,000 or more tended to have higher income and were older, more likely to be retired, and more likely to own corporate stocks, a business, or investment real estate. About half of this group had insured deposits over $100,000.

Issues Associated With Changing the Definition of a Deposit

Changing the definition of an insured deposit is significant only if a meaningful distinction is made between insured and uninsured accounts. The question of how depositors would react to a change in the definition of an insured deposit is, therefore, clouded by the de facto insurance protection accorded the overwhelming majority of uninsured deposits. For example, if depositors feel that they are covered by de facto protection, a change in the definition of a deposit that reduces coverage may have little or no effect on depositor behavior.

Changes in the definition of an insured deposit to cut back coverage, coupled with an increased likelihood that uninsured depositors will experience losses in the case of a bank failure, will provide an incentive for depositors to reconsider their investment decisions and place their money in what they perceive to be the best alternative with respect to yield and risk. This may be in the form of a deposit in another bank (perhaps one that is considered protected by de facto insurance) or may involve investment in financial instruments such as cash management accounts or money market accounts offered by securities firms.

Another consideration that affects depositor behavior is the relative cost and trouble of determining how sound a given bank is versus the cost and trouble involved in moving the deposit to another bank or financial institution thought to be safer. If it is less costly and easier to move the deposit than it is to determine if the bank in which it is placed is sound, depositors who feel their funds are at risk will tend to move their funds at the first sign of any problems. This can be done quickly by large depositors and, given the advent of electronic banking, makes even the largest banks susceptible to bank runs.

Market Discipline

If depositors' funds are at risk, they will have an incentive to take their funds out of a bank that is known to have problems. Cutting back deposit insurance coverage, therefore, may make bank owners and managers more concerned with operating their banks in a safe and sound manner to retain the confidence of depositors. Unfortunately, the market discipline that would result from actually imposing losses on

depositors also carries with it the potential for introducing greater instability into the banking system because depositor reactions can result in bank runs. However, the near-term reforms recommended in this report, which would make it harder for problem banks to attract funds, would not increase the potential for destabilizing bank runs.

There is no information on exactly how effective more depositor discipline would be in influencing the behavior of bank owners and managers. Many of the decisions that bank officials can make to improve banks' financial conditions are constrained by the consequences of past decisions. For example, once long-term loan or investment decisions are made, there are limits to what a bank can do to resolve the problems that result. Therefore, during the transition period, if bank managers are already trying to work their way out of a problem situation, increased depositor discipline may have little positive effect. Also, for managers inclined to take risks, depositor discipline may have little effect on the amount of risk taken, although it should make risk-taking more expensive.

Changing the definition of an insured deposit is not essential to the near-term reforms we have recommended. We view the decision of whether or not to change the scope of insurance coverage as primarily a judgment call but one that should be considered after other reforms are implemented and the industry is stronger.

The Effect of Changing the Definition of an Insured Deposit on the Cost of Raising Funds to Banks and Other Players in Capital Markets

Without question, deposit insurance makes it easier for banks to attract deposits. In the absence of this protection, banks that make commercial loans and engage in other types of risky activities would likely have to hold more capital and/or pay higher rates on deposits. Furthermore, the funds of some risk-averse depositors would probably be moved to banks considered to be more sound or to institutions outside the banking system.

Even without deposit insurance, nonbanking organizations can compete successfully for funds by convincing market participants that the rates offered are favorable compared to the risks involved. Examples include the sharp increases in funds attracted by money market funds and by finance companies.

An increase in money invested in products outside of the banking system does not, however, necessarily imply an immediate decrease in deposits in the banking system as a whole. When a depositor moves

funds to a financial institution that is not a bank, the money would generally be deposited in that institution's bank account. The ultimate net effect on the volume, location, composition (e.g., insurance status or maturity) and ownership of deposits depends on the nature of the decisions made by depositors and other financial intermediaries and on the monetary policy actions taken by the Federal Reserve.[14]

Although cutting back the definition of an insured deposit may not affect the volume of deposits in the banking system as a whole, bank loans would tend to become more expensive for at least some classes of borrowers in some banks. To pay higher rates to retain deposits, banks are likely to seek more revenue by raising the price of services, including loan rates. A bank operating in competitive markets, however, is constrained in how high it can raise its loan rates because borrowers will turn to competitors. Furthermore, if a bank loses deposits, it may have less money to lend, reducing the supply of credit for some of the bank's customers.

The Effect on Taxpayer Liability of Changing the Definition of an Insured Deposit

Since federal deposit insurance is backed by the full faith and credit of the U.S. government, the contingent liabilities of the deposit insurance fund can be viewed as potential claims against taxpayers. Cutting back on the definition of an insured deposit would potentially increase the amount of uninsured deposits, and thereby reduce the contingent liability of the federal government. However, as described in the next paragraph, creating more uninsured deposits would not necessarily reduce the magnitude of the costs that may actually be incurred by the deposit insurance funds or, ultimately, taxpayers.

To illustrate the relationship between the amount of uninsured deposits and insurance fund losses, consider two situations. In the first, a commercial bank entirely funded by insured deposits fails and is liquidated. The loss to FDIC in this situation (apart from administrative expenses) is the difference between the market value of assets and the amount of insured deposits. Compare this with a second situation in which the definition of an insured deposit is cut back and the same set of assets is now funded by a combination of insured and uninsured deposits. If this bank fails and is liquidated, whether or not FDIC's losses are less in the second situation than in the first depends entirely on the amount of uninsured deposits remaining in the bank when it fails. If uninsured

[14]By open market operations and other actions, the Federal Reserve can greatly influence the overall volume of deposits in the economy.

depositors were not able to withdraw their money, the uninsured depositors will share a portion of the loss that in the first situation fell entirely on FDIC. However, if the uninsured depositors were able to withdraw their money before the bank fails, all remaining deposits will be insured and the bank will have fewer and lower quality assets available to absorb FDIC losses.

When the bank fails after the uninsured deposits are withdrawn, FDIC's losses will still be the difference between the value of the remaining assets and the value of the insured deposits. This difference should be virtually the same as in the first situation because all of the problem assets are still in the bank.[15] This example shows that cutting the definition of an insured deposit will be certain to reduce FDIC's losses in the case of bank failures only if the cutback induces bank management to acquire fewer risky assets or to hold more capital.

An associated issue concerns the effect of potential reforms on the deposit insurance assessment base. Should changes to federal deposit insurance result in a reduction in the assessment base, then the possibility exists that taxpayer liability could actually increase. This would occur should the assessment base erode to such an extent that the deposit insurance fund's reserves are inadequate to cover bank losses.

[15]Another way to look at the same result is that with the withdrawal of uninsured deposits, the cost of the bank failure expressed as a percentage of assets in the failed banks will be higher.

The Implications of Federally Insuring BICs for Banks and BIF

Pursuant to the study mandate contained in FIRREA, this appendix evaluates the risks associated with Bank Investment Contracts (BICs) to both issuing institutions and BIF. We also discuss BICs in relation to the general concept of "pass-through" deposit insurance.

The Nature of BICs

BICs are medium-term investment instruments[1] offered by banks to institutional investors who manage pension funds. Generally speaking, BICs are purchased by pension fund sponsors of defined contribution plans[2] and bear a fixed rate of interest and maturity. They are analogous to, and compete with, the insurance industry's guaranteed investment contracts (GIC).

Operating much like fixed-rate Certificates of Deposit (CD),[3] BICs differ from traditional CDs in three important respects:

(1) A "deposit window" feature permits pension plan sponsors or participants to make deposits into a BIC-financed pension plan account during a specified "open season" period.

(2) A "benefit response" feature permits participants to make withdrawals prior to maturity without penalty, under certain conditions. Typically, these conditions include termination of employment, hardship, illness, or disability.

(3) BICs have "pass-through" insurance protection, wherein the interest of each beneficiary of a BIC-financed pension plan or retirement account is separately insured up to $100,000.[4] This contrasts with ordinary CDs where the CD is insured up to $100,000.

[1]This adopts the common nomenclature of classifying investments of 1 to 3 years' duration as medium-term.

[2]Retirement income received under defined contribution plans depends on how much a participant (and the employer) contributes to the plan during the participant's working career, and the earnings on these contributions. This differs from defined benefit plans wherein retirement income is fixed and is not dependent on the amount of contributions.

[3]A CD is a bank receipt for a cash deposit, bearing a fixed date of maturity before which withdrawal generally may not be made unless an "early withdrawal" penalty is paid. Certificates of Deposit bear interest related to the length of maturity, and can be offered for as little as 3 months or as long as 10 years or more.

[4]For example, a pension plan may invest in a $1 million BIC for its 10 employees, each of whom receives $100,000 of deposit insurance. Thus, the entire $1 million is insured.

Data on Average Size of BICs and the Overall BIC Market

Current Call Report requirements do not require banks to separately report Bank Investment Contracts, and instead they are aggregated with other time deposits for reporting purposes. In an attempt to elicit information on the size of the BIC market, the Federal Reserve conducted a "Senior Financial Officer Survey" in March-April 1990, and this survey represents the most complete data currently available.[5] In conducting the survey, the Federal Reserve sought to capture all institutions that were major participants in the BIC market, and counted a total of 51 banks.

Size of BICs

Estimates are that at the end of 1989, the BIC and GIC market totaled approximately $172 billion, with approximately $30 billion in new contracts having been written in 1988 alone, and slightly less in 1989. Research by the Federal Reserve indicates that at year-end 1989, BICs accounted for about $7.5 billion, or 5 percent, of the guaranteed contract market. The Federal Reserve projects that the volume of BICs continued to grow in 1990, with the total amount of BICs outstanding expected to exceed $10.4 billion at year-end, and with BICs accounting for about 10 percent of new contracts written (BICs and GICs).

In general, the Federal Reserve found a wide disparity of contract sizes, both across and within banks. Surveyed institutions reported BICs ranging in size from $4 million to $59 million, with the most common size being $13 million. There also appears to be a positive relationship between a bank's average contract size and its total value of BICs outstanding, this being attributed to the tendency of big players in the BIC market to get the largest contracts.

Although contract length varied from 1 month to 30 years, nearly all respondents reported their most common contract length as less than 3 years, with no discernible relationship existing between contract length and the volume of BICs outstanding. According to an FDIC study,[6] bank involvement in the guaranteed contract market is concentrated in the shorter maturity end of the market, i.e., maturities ranging from one to three years. This is in keeping with an overall trend in the BIC/GIC industry towards shorter maturities.

[5]See Results of Senior Financial Officer Survey on Bank Investment Contracts, Division of Monetary Affairs and Division of Research and Statistics, Board of Governors of the Federal Reserve System.

[6]Findings and Recommendations Concerning "Pass-Through" Deposit Insurance, FDIC, February 1990.

Basis for the Insured Status of BICs

Pursuant to a December 15, 1988, FDIC Advisory Opinion, BICs are treated as insured deposits when placed in insured financial institutions (FDIC Advisory Opinion 88-79). According to this Opinion, BICs are held by federal regulators to be equivalent to CDs and are therefore accorded deposit insurance protection under section 1813(l) of the Federal Deposit Insurance Act. In keeping with the FDIC's "pass-through" regulations, deposit insurance protection of BICs accrues to individual participants, with each participant/potential beneficiary separately insured up to $100,000.[7] Such "pass-through" protection has been in existence for many years and was formally codified in the Federal Deposit Insurance Act (see app. I).

Risk to Banks

From the standpoint of risk and the deposit insurance fund's contingent liability, BICs are somewhat riskier than traditional certificates of deposit as a result of the deposit "windows" and early withdrawal features of many BICs. With BICs, the issuing bank has no way of knowing in advance precisely how much will be invested; thus "hedging," or otherwise provisioning for interest payments, is more difficult. Contributions to a BIC-financed plan can also vary depending on a number of variables beyond the control of the bank, and therefore very difficult to forecast, including layoffs, early retirements, and new hiring. Marked variations in predicted participation rates—with either many more or many fewer employees participating than originally forecasted—can significantly affect the relative cost (and thereby riskiness) of BICs as compared to CDs.

In the case of early withdrawals, the easier (and less costly) it is for depositors to withdraw their deposits, the greater the risk to the issuing institution, particularly under volatile interest rate conditions. Since many BICs permit early withdrawals for stipulated reasons (though these are becoming increasingly restricted), issuing banks are exposed to "outflow" risks that are difficult to forecast and hedge. Unlike CDs where depositors usually directly sustain some loss in the case of early withdrawals, many BICs allow depositors to withdraw their accumulated claims at par value, significantly reducing any disincentive to break an investment.[8]

[7]This pass-through interpretation is consistent with FDIC's general pass-through insurance policy, which has been in effect for many years and was formally codified in the FDIA.

[8]The extent to which this is true, however, is diminishing with an increasing number of banks imposing penalties for early withdrawals.

In the case of BICs, both the "deposit window" and "benefit response" features have been significantly restricted in recent years, and the average duration of a BIC has been reduced from the 5- to 10-year maturity originally offered, to the more common 1- to 3-year maturity that now prevails. This tightening in the investment provisions associated with BICs is a reflection of the interest-rate risks associated with fixed-term deposits and intensified by the previously generous deposit and withdrawal features.

While these factors do increase the relative riskiness of BICs as opposed to other financial instruments offered by banks, it must be acknowledged that all time deposits entail interest rate risks, which increase with the maturity period. Similarly, there is always the danger of unforeseen or precipitous early withdrawal of funds, just as in the case of mortgages where there is the risk of early repayment. To a large extent, this accounts for the progressive shortening of the "window" periods in BICs and GICs as issuers seek to limit their exposure to interest rate risks.

Another significant factor affecting BICs is the "rollover" risk inherent to all time deposits: banks are exposed to the possibility that depositors will elect to withdraw their deposits and not roll them over upon maturity. To the extent that banks have based their lending on the expectation that such funds would continue to be available, any marked departure from forecasted rollover projections would substantially affect bank operations.[9]

Risk to the Deposit Insurance System

Of potential consequence to the deposit insurance funds is the use of BICs by poorly capitalized banks as a means for attracting additional funding. In much the same fashion as these institutions have offered high-yield certificates of deposit to attract funds, they can be expected to do so in the case of BICs. Actual data on the extent to which this is a problem is unavailable as bank regulators do not have information on the extent to which failed banks have held BICs or on the extent to which BICs are held by weak or poorly managed institutions.

Given the size, deposit flow, and interest rate risks discussed earlier, BICs represent a riskier form of deposit for banks than ordinary CDs. For

[9]To the extent that BICs are issued with progressively shorter maturities, the risk of money leaving to find a higher return is increased, although depositors can always withdraw funds on deposit if they are willing to accept the penalties incurred in doing so.

poorly capitalized banks, these conditions, combined with the temptation to offer very high yields in order to attract deposits, are particularly dangerous and increase the likelihood for losses to the deposit insurance fund in the event of a bank failure. For these reasons, poorly capitalized banks should be prohibited from offering BICs, just as we recommend that they be barred from offering any other long-term high-yield depository instrument (i.e., "jumbo CDs").

BICs and Pass-through Insurance

Another issue involving BICs concerns "pass-through" insurance for pension fund accounts. FDIC has ruled that, as in the case of other testamentary and pension fund accounts, each pension plan participant's interest in a BIC is separately insured up to $100,000.[10] This has the effect of increasing the exposure of the deposit insurance fund in the event of the failure of a BIC-issuing institution. Given the attractiveness of such depository instruments to poorly capitalized institutions in search of funds, the existence of pass-through insurance is another tool they can use to solicit deposits by reassuring depositors that their pension plan contributions are fully protected by the U.S. government. Such risks strengthen calls for prohibiting poorly capitalized institutions from offering BICs.

Deciding how to treat BICs has implications for how we handle and fund pensions. In doing so, it is important to bear in mind that the Social Security system is not intended to be a complete pension system and that government policies have tended to encourage private sector supplements to Social Security. These supplemental arrangements need safe and sound investment options. However, given the existence of other safe and secure investment options, such as government securities, changing the federal insurance of BICs is unlikely in the long run to affect either the ability of individuals or companies to finance pensions or find safe investments for their pension plan accounts.

[10]See previous discussion of "pass-through" insurance in appendix I.

Foreign Deposits

This appendix discusses the relationship of foreign deposits to the deposit insurance system. The discussion presents information on foreign deposits and issues associated with whether foreign deposits, which are not legally insured, should nonetheless be included in the assessment base for FDIC premiums.

Definition and Current Treatment of Foreign Deposits

Foreign deposits are deposits made at foreign branches of U.S. banks overseas as well as deposits in International Banking Facilities (IBF) and Edge Corporations in the United States. IBFs and Edges are located in the United States, but are engaged primarily in international banking transactions. Foreign branches are legal extensions of the parent bank and are therefore subject to the laws governing their parents. For purposes of this discussion, deposits at foreign subsidiaries of U.S. banks are not considered foreign deposits, since such deposits are made into legal entities incorporated under and subject to the laws of the country in which they are located (i.e., the "host" country). Foreign subsidiaries can be set up either by a bank or a bank holding company. Foreign deposits are usually, though not necessarily, denominated in dollars.

Foreign deposits are neither assessed for deposit insurance nor explicitly covered under the system. This practice was established in 1935 as a matter of public policy that sought to encourage the foreign trade and commerce of the United States. The Banking Act of 1935 expanded the assessment base for deposit insurance to include all domestic deposits, not just insured deposits. Foreign deposits were excluded in part because of the detrimental effect such an assessment could have upon the international competitiveness of U.S. banks. Subsequent Congressional debates and actions have reaffirmed that foreign deposits should not be assessed. In 1981, the International Banking Facility Deposit Insurance Act expressly excluded deposits at international banking facilities from FDIC assessments.

Although not insured, foreign deposits, like uninsured deposits over $100,000, have generally been protected when a bank fails. As discussed elsewhere in this report, when the case of a failing bank is resolved by a purchase and assumption (P&A) arrangement, assisted merger, or open bank assistance, foreign deposits are transferred to the books of the purchasing bank in the same manner as are all other liabilities.

Under FIRREA, FDIC can make distinctions among different classes of depositors when deciding how to resolve a failed bank. In theory, therefore, FDIC could decide to treat foreign depositors differently from

domestic ones. To date, the most noteworthy post-FIRREA bank failure that raised the issue of possible differential treatment of domestic and foreign depositors was the National Bank of Washington case. Although FDIC considered a resolution to protect all domestic deposits but not foreign ones, in the end all deposits were fully protected.

Information on Deposits

The following section details the amount, concentration, location and composition of foreign deposits.

Amount

Table III.1 shows the size of foreign deposits relative to the banking industry. Foreign deposits have remained relatively stable at around $300 billion since 1980. Since the assets of the industry have grown in the past 10 years, foreign deposits represent a declining percentage of a source of funding for the industry.

Table III.1: Foreign Deposits Compared to Industry Assets, December 1980 to June 1990

Dollars in billions

Year[a]	Total industry assets	Total foreign deposits[b]	Foreign deposits as a percent of assets
1980	$1,538	$294	19.1%
1981	2,029	318	15.7
1982	2,193	306	14.0
1983	2,341	308	13.2
1984	2,498	317	12.7
1985	2,716	321	11.8
1986	2,915	313	10.7
1987	2,998	341	11.4
1988	3,130	315	10.1
1989	3,298	311	9.4
1990	3,360	330	9.8

[a]As of December 31 for 1980 through 1989. As of June 30 for 1990.

[b]Call report data include deposits in foreign subsidiaries of U.S. banks. According to unpublished data from the Federal Reserve, such deposits amounted to approximately $50 billion at year-end 1989. Deposits in foreign branches of U.S. banks (and in IBFs and Edges) therefore amounted to approximately $260 billion at the end of 1989.

Source: FDIC and call reports.

Concentration

Most foreign deposits are deposited with banks which have over $10 billion in assets. Table III.2 shows the amount of foreign deposits in banks, grouped according to size. The 45 banks in the U.S. that had assets over $10 billion in 1990 held 88.4 percent of all foreign deposits; banks with less than $1 billion held about 1 percent of such deposits.

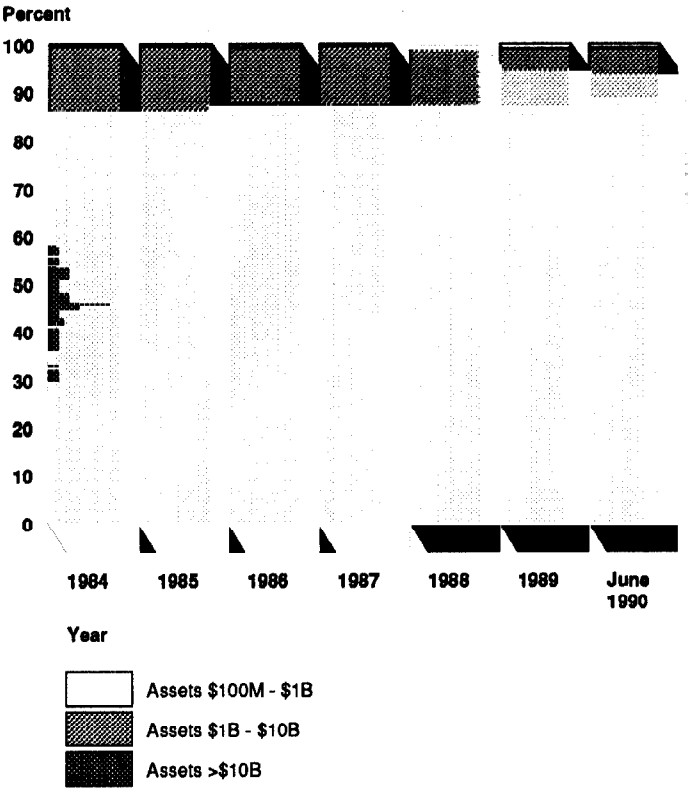
Table III.2: Concentration of Foreign Deposits According to Bank Size, as of June 30, 1990

Bank size (assets)	Percent of foreign deposits
Greater than $10 billion	88.4%
$1 billion to $10 billion	10.6
$100 million to $1 billion	1.0
Less than $100 million	0.0
Total	**100.00%**

Source: Call reports.

Figure III.1 shows that the ownership concentration of foreign deposits by large banks has not changed much over time. Since at least 1984, banks with assets over $10 billion have held at least 85 percent of all foreign deposits.

Figure III.1: Ownership of Foreign Deposits by Bank Size, 1984 to June 1990



Note: In all cases banks with assets <$100M held less than 0.05 percent of total foreign deposits.
Source: Call reports.

Table III.3 further details the percentage of foreign deposits found in the 45 largest U.S. banks (according to assets). Over half of such banks used foreign deposits for less than 10 percent of their funding. Factors such as bank strategy and history, as well as international events, determine whether banks focus overseas.

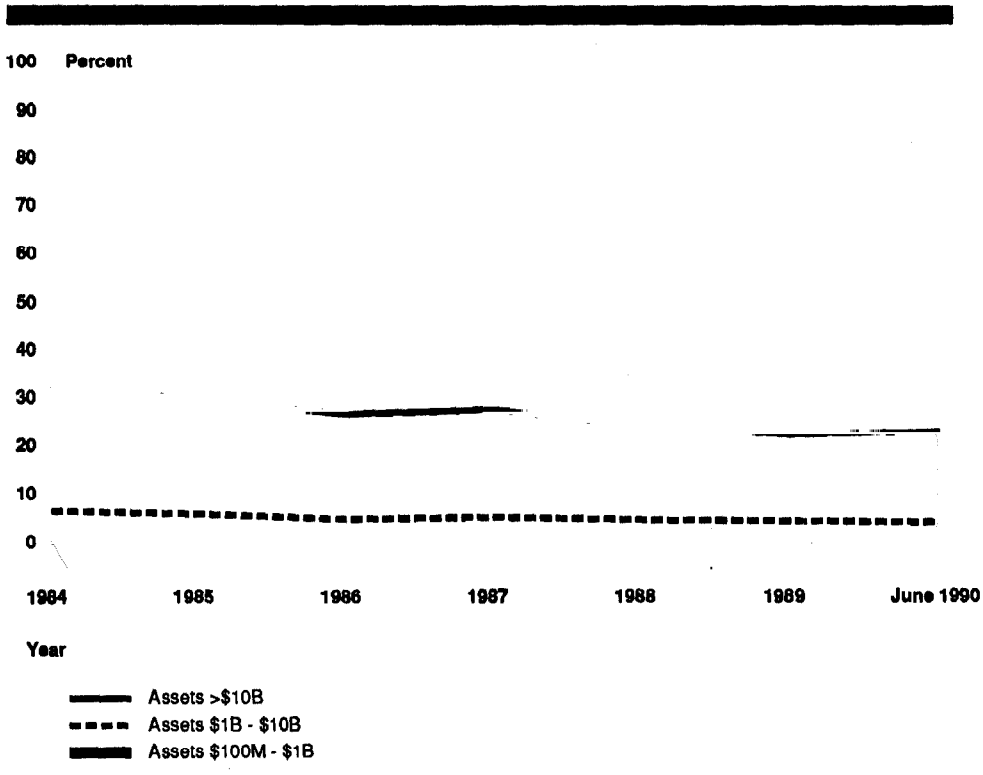
Table III.3: Foreign Deposits as a Percentage of Bank Assets for Banks With Assets Greater Than $10 Billion, as of June 30, 1990

Percent of foreign deposits	Number of banks
Less than 10	26
10 to 20	7
20 to 30	4
30 to 40	3
40 to 50	5

Source: GAO analysis of call report data.

Figure III.2 shows the use of foreign deposits as a funding source according to bank size. The reliance upon foreign deposits by large banks as a group has been steadily declining in the past 6 years. Use of foreign deposits dropped from a high of approximately 30 percent in 1984 to approximately 20 percent by 1990. Medium-sized banks (those with assets between $1 billion and $10 billion) also experienced a drop in the use of foreign deposits, but the drop was less severe since such banks never relied heavily on foreign deposits. Between 1984 and 1990, foreign deposits fell from about 6 percent of all deposits at medium-sized banks to about 3 percent. (See fig. III.2.)

Figure III.2: Percent of Foreign Deposits by Bank Size, 1984 to June 1990



Note: In all cases banks with assets <$100M had fewer than 0.05 percent foreign deposits.
Source: Call reports.

Location of Foreign Deposits

Foreign deposits are booked in many countries around the world as well as in the IBFs and Edges located in the United States. Table III.4 shows where foreign deposits were booked in 1989. These percentages reflect only foreign deposits outside the United States since, according to the Federal Reserve, deposits in IBFs are not reported separately from the

institutions' other foreign deposits, and information about Edges is neither readily available nor of a significant amount.

Table III.4: Location of Foreign Deposits in 1989

Area	Percent of total foreign deposits
Europe	48.7%
Far East	20.8
Middle East	1.1
Caribbean	27.4
Latin America	1.6
Africa	0.4
Total	**100.0%**

Source: Federal Reserve.

Historical data on the location of foreign deposits are not available, but the Federal Reserve has data on the location of assets in foreign branches. Table III.5 shows these data and a shift in the assets of foreign branches of U.S. banks between 1975 and 1989 from Europe to the Caribbean and Asia. These data also reflect that the offshore banking centers (the Bahamas and Cayman Islands) in the Caribbean and economic opportunities in Asia are increasingly attractive to U.S. banks.

Table III.5: Percent of Assets of Foreign Branches of U.S. Member Banks, 1975 and 1989

Area	1975	1989
Europe	56.5%	43.3%
Far East	12.9	20.1
Middle East	1.3	1.0
Caribbean	23.2	30.4
Latin America	4.1	2.5
Africa	0.1	0.3
U.S. Territories	1.9	2.4
Total	**100.0%**	**100.0%**

Source: Federal Reserve.

Composition of Foreign Deposits

Five types of deposits exist in U.S. branches overseas—interbank, foreign government, transaction, consumer, and investment. According to call report data from June 30, 1990, interbank deposits account for approximately one-third of foreign deposits and consist of deposits of banks into other banks. Foreign governments are sometimes required by

their respective laws to purchase U.S. financial instruments. The previously mentioned call report data show that such accounts represent about 7 percent of all foreign deposits in U.S. banks. The remaining 60 percent of deposits are divided among transaction, consumer, and investment accounts, but no determination of the amounts of these separate categories can be made since such data are not reported. Transaction accounts include firms that engage in international trade. These firms rely on banks for payments to overseas suppliers and receipts from their international purchasers. The firms also rely on banks for the safety and liquidity of their funds. Investors, both domestic and foreign, are attracted to the overseas branches of U.S. banks in order to receive higher yields on their deposits. According to one industry economist, American banks with Aa ratings paid 1.1 percent more on their foreign deposits than on their domestic large CDs of comparable maturity during the first half of 1990. Consumer accounts are relatively unimportant for most foreign branches of U.S. banks.

The Assessment of Foreign Deposits

At the present time, domestic deposits over $100,000, also not insured, are included in the assessment base for deposit insurance so that an assessment of de jure uninsured deposits would not be unprecedented. This section addresses the impact of assessing foreign deposits on market stability, equity, the competitiveness of U.S. banking institutions, and BIF revenues.

Market Stability

Foreign deposits have an important bearing on the stability of the U.S. banking system. Foreign deposits constitute about one-third of all uninsured deposits in U.S. commercial banks and are particularly more important for larger banks where these deposits are concentrated. The withdrawal of foreign deposits from Continental Illinois Bank in 1984 was reported to have been one of the events that triggered the rescue of what was one of the largest banks in the country at that time.

Because of stability concerns, our recommendations for near-term reforms to make it harder for risky banks to attract deposits does not depend on placing all uninsured deposits—including foreign deposits—at greater risk than they are now. Under the reforms we recommend, foreign depositors would be offered the same opportunity as domestic ones for making provision to safeguard deposits over $100,000 in return for reduced yield. In the future, when reforms have been implemented and the banking industry is healthier, large banks with the largest amounts of foreign deposits are still likely to pose serious systemic

problems. The Federal Reserve, working with other bank regulators, therefore needs to retain the ability to deal with problems in those institutions on a case-by-case basis in ways that preserve market stability.

Equity

On the grounds of equity it can be questioned why foreign deposits, but not uninsured domestic ones, should benefit from de facto insurance protection without contributing to the financial needs of the deposit insurance system. Furthermore, now that the insurance premiums on domestic deposits have been raised, the issue of whether the treatment of domestic and foreign uninsured deposits is fair takes on more significance. The existing arrangement provides an incentive for banks to find ways to channel funds through foreign branches, giving potential competitive advantages to banks whose scale of operation is large enough to include foreign branches.

The question of equity does not, however, concern foreign deposits alone. Other nondeposit liabilities such as Federal Reserve Funds are not included in the assessment base for purposes of deposit insurance calculations, however, they are also covered if a troubled bank is resolved through a P&A arrangement, assisted merger, or open bank assistance. We therefore believe that the question of assessing foreign deposits should be looked at as part of a general effort to broaden the deposit insurance assessment base to eliminate distortions that are exacerbated by the deposit insurance rate increases.

Competitiveness of U.S. Banks

The competitiveness of U.S. banks overseas depends on many factors in addition to the assessment of foreign deposits. Even without assessing such deposits, their overall level has remained relatively static over the decade, and the share of U.S. banks in worldwide markets has fallen. In recent years, many U.S. banks have reduced their presence overseas due to low profitability.

Deposit insurance costs borne by banks in other countries are generally much lower than in the U.S.—even Germany, where the deposit insurance coverage in large banks can far exceed that in the United States.

The degree to which the competitiveness of U.S. banks would be negatively affected by a change in the assessments of foreign deposits depends on how the premiums are levied and on banks' ability to absorb cost increases. The effect on American banks operating in the international banking community could be ameliorated if assessments were

introduced gradually, if the rates paid were not as high as assessments made on domestic deposits, and if changes were introduced in connection with risk-based premium adjustments.

Because U.S. banks do not have a large market share in any of the major industrial countries, it would be much harder to pass the cost of assessments on to customers than it would be in domestic markets where all banks pay the same premium.

Industry representatives say that since foreign markets are so competitive, deposit insurance premiums on foreign depositors could have a significant influence on the decisions of bank managers and depositors in the international market. Faced with the added cost of deposit insurance, bank managers could decide to convert their overseas branches into subsidiaries, where deposits would not be assessed by U.S. officials, or to close their branches altogether. If premiums charged on foreign deposits resulted in lower interest payments to foreign depositors, interest rate sensitive depositors would also have an incentive to move their funds to more lucrative accounts in foreign banks not subject to the higher premium assessment. Among those most likely to move would be those U.S. depositors who place their money in offshore banks to obtain higher yields.

Some disruptions in the ability of U.S. banks to meet the demands of their customers could result if branches were closed. While well-established companies could, and indeed already do, obtain funds from indigenous banks overseas, companies just beginning to expand internationally could experience difficulty raising funds from bankers who do not know them. U.S. firms could borrow from U.S. banks located in the United States for overseas projects. Lenders, however, usually prefer to be close to where their borrowers' projects are, to make certain that funds are being used properly. Other services, such as identifying merger and acquisition possibilities and introducing clients to the local community, could be affected.

U.S. banks could continue to offer overseas financial services if they converted their foreign branches to foreign subsidiaries; however, a subsidiary is usually not able to provide the same level of service as a branch. In most countries, branches enjoy the powers of their parent including, for example, lending limits based upon the parent's worldwide capital. A subsidiary does not enjoy these privileges and could be forced to reduce its activities if lending limits are based upon its individual level of capital.

BIF Premiums

If the current rate of 19.5 basis points were applied to the level of foreign deposits at the end of 1989—$260 billion—the potential addition to BIF revenues would be about $500 million per year. However, the types of competitive reactions mentioned above would reduce the assessment of premiums FDIC would collect from foreign branches. The potential closing of branches, the converting of branches to subsidiaries, and the movement of deposits to accounts in non-U.S. banks would mean FDIC would not raise the theoretic $500 million, but a smaller sum. The Congressional Budget Office estimates that about $300 million would be raised from the assessment of foreign deposits in fiscal year 1990 and $320 million in the four fiscal years thereafter. An industry study suggests that the revenue actually collected by BIF would be even less.[1]

[1] "The Sensitivity of Foreign Deposits to FDIC Assessments," Gendreau, Brian C., J.P. Morgan, April 26, 1990.

Characteristics of the U.S. Financial Services Industry and the Top Firms in Each Component

The financial services industry can be defined as those firms in the business of lending money, accepting deposits, providing insurance, managing money, creating markets, selling securities, and transferring funds. The major financial intermediaries that make up the financial services industry include commercial banks, savings and loan associations, finance companies, insurance companies, and securities firms.

While there is a history of federal and state law that established and maintains distinctions among financial intermediaries, technological advances and market innovations have significantly eroded and blurred these distinctions. Thus, it has become more difficult to distinguish differences between the financial services offered to the consumers by the various financial intermediaries.

The following tables identify the top firms in major industry groups.

Table IV.1: Top 25 U.S. Bank Holding Companies Ranked by Total Assets, as of December 31, 1989

Dollars in millions

Firm	Assets	Stockholders' equity
Citicorp, NY	$230,643.0	$10,076.0
Chase Manhattan, Corp., NY	107,369.0	4,994.0
BankAmerica Corp., San Francisco	98,764.0	5,534.0
J.P. Morgan & Co., Inc., NY	88,964.0	4,495.0
Security Pacific Corp., Los Angeles	83,943.0	4,637.0
Chemical Banking Corp., NY	71,513.0	3,705.0
NCNB Corp., Charlotte, NC	66,190.8	2,961.5
Manufacturers Hanover Corp., NY	60,479.0	3,381.0
First Interstate Bancorp., Los Angeles	59,051.4	2,339.3
Bankers Trust New York Corp.,	55,658.4	2,385.7
Bank of New York Co. Inc.,	48,856.5	2,764.3
Wells Fargo & Co., San Francisco	48,736.6	2,860.9
First Chicago Corp.,	47,907.0	2,692.0
PNC Financial Corp., Pittsburgh	45,660.7	2,829.6
Bank of Boston Corp.,	39,177.9	2,096.6
Fleet/Norstar Financial Group, Inc., Providence, RI	33,440.8	2,288.7
First Union Corp., Charlotte, NC	32,130.6	2,076.1
Mellon Bank Corp., Pittsburgh	31,467.0	1,549.0
SunTrust Banks, Inc. Atlanta	31,043.6	2,088.9
First Fidelity Bancorporation, Lawrenceville, NJ	30,727.8	1,565.0
Bank of New England Corp., Boston	29,772.7	457.7
Continental Bank Corp., Chicago	29,549.0	1,680.0
Barnett Banks, Inc., Jacksonville, FL	29,006.7	1,690.7
Shawmut National Corp., Hartford, CT	27,855.0	1,397.7
Marine Midland Banks, Inc., Buffalo, NY	27,066.5	1,178.5

Source: American Banker, (Top Numbers, 1990 Update, p. 59).

Table IV.2: Top 25 U.S. Savings Institutions Ranked by Total Assets, as of December 31, 1989

Dollars in millions

Firm	Assets	Stockholders' equity
H.F. Ahmanson & Co., Los Angeles, CA	$44,651.5	$2,000.8
Great Western Financial Corp., Beverly Hills, CA	37,176.4	1,988.3
CalFed, Inc., Los Angeles, CA	26,190.8	1,424.9
GlenFed, Inc., Glendale, CA[a]	25,626.1	1,146.7
Golden West Financial Corp., Oakland, CA	19,520.6	1,046.3
Homefed Corp. San Diego, CA	17,766.7	1,042.3
Great American Bank, San Diego, CA	15,898.6	373.5
CrossLand Savings FSB, Brooklyn, NY	14,102.4	647.2
Goldome, Buffalo, NY	12,999.1	101.7
Meritor Savings Bank, Philadelphia, PA	12,639.8	303.7
Dime Savings Bank of New York, NY	11,652.2	631.9
FirstFed Michigan Corp.,	11,490.4	437.4
Franklin Savings Association, Ottawa, KS	11,353.3	391.9
Coast Savings Financial, Los Angeles, CA	11,243.7	225.7
Imperial Corp. of America, San Diego, CA	10,960.8	140.4
Empire of America Federal Savings, Buffalo, NY	10,272.5	(53.5)
Standard Federal Bank, Troy, MI	9,638.4	440.8
Columbia Savings & Loan Assn., Beverly Hills, CA	9,253.2	77.6
Centrust Bank, Miami FL[b]	8,975.7	234.8
Anchor Savings Bank, Hewlett, NY[a]	8,968.8	437.6
Northeast Savings, Hartford, CT[c]	7,942.7	283.3
Atlantic Financial Federal, Bala Cynwyd, PA[b]	7,583.3	61.4
People's Bank, Bridgeport, CT	7,054.4	480.7
Washington Mutual Savings Bank, Seattle, WA	6,594.2	424.7
Perpetual Financial Corp., Vienna, VA[d]	6,170.6	315.3

[a]Figures are for fiscal year ended June 30, 1989.

[b]Figures are for fiscal year ended September 30, 1989.

[c]Figures are for fiscal year ended March 31, 1989.

[d]Figures are for fiscal year ended October 31, 1989.

Source: Fortune, June 4, 1990, p. 318.

Table IV.3: Top 25 U.S. Securities Firms Ranked by Total Consolidated Capital, as of December 31, 1989

Dollars in millions

Firm	Total consolidated capital	Excess net capital[a]
Merrill Lynch & Co.[b]	$10,048.4	$1,052.8
Shearson Lehman Hutton	8,996.0	1,140.0
Salomon Brothers Holding Co.	5,757.0	878.7
Goldman, Sachs & Co.[c]	4,018.0	684.0
Morgan Stanley & Co.	2,648.0	382.7
Prudential-Bache Securities	1,840.4	275.1
First Boston Corp.	1,783.0	508.0
PaineWebber Group	1,523.1	386.6
Bear, Stearns & Co.	1,444.0	277.0
Dean Witter Reynolds[d]	1,429.0	604.0
Smith Barney, Harris Upham & Co.	927.0	184.0
Donaldson, Lufkin & Jenrette	900.0	189.0
Kidder, Peabody & Co.[e]	728.0	161.0
Shelby Cullom Davis & Co.	550.7	397.1
BT Securities Corp.	479.0	380.0
J.P. Morgan Securities	469.0	264.0
Nomura Securities International	376.0	153.0
Charles Schwab & Co.	344.0	77.0
A.G. Edwards & Sons	304.0	135.0
UBS Securities	293.0	185.5
Dillon, Read & Co.	251.0	44.0
Deutsche Bank Capital Corp.	249.0	52.0
Oppenheimer & Co.	247.9	78.2
Aubrey G. Lanston & Co.	247.1	106.1
Spear, Leeds & Kellogg	243.0	125.0

[a]Excess net capital shows by how much the institutions' broker-dealer subsidiaries exceed SEC minimums.

[b]As of December 29, 1989.

[c]As of November 24, 1989.

[d]Represents U.S. broker-dealer only.

[e]As of December 25, 1989.

Source: Institutional Investor, April 1990.

Table IV.4: Top 25 U.S. Insurance Companies Ranked by Total Assets, as of December 31, 1989

Dollars in millions

Firm	Assets
Prudential of America, NJ	$129,118.1
Metropolitan Life, NY	98,740.3
Equitable Life Assurance, NY	52,511.9
Aetna Life, CT[a]	52,022.6
Teachers Insurance & Annuity, NY	44,374.1
New York Life, NY	37,302.4
Connecticut General Life, MD[b]	33,991.2
Travelers, CT	32,087.5
John Hancock Mutual Life, MA	30,924.8
Northwestern Mutual Life, WI	28,500.0
Massachusetts Mutual Life	28,842.3
Principal Mutual Life, IA	24,825.5
Mutual of New York, NY	17,181.3
New England Mutual Life, MA	16,666.7
Lincoln National Life[c]	16,161.9
Executive Life, CA	13,168.2
IDS Life, MN[d]	13,150.2
Mutual Benefit Life, NJ	11,601.3
Connecticut Mutual Life, CT	11,133.7
Allstate Life, IL[e]	10,994.1
Variable Annuity Life, TX[f]	10,857.7
State Farm Life, IL	10,839.0
Nationwide Life, OH	10,451.7
Aetna Life & Annuity, CT[g]	9,731.9
New York Life & Annuity, DL	9,567.9

[a]Wholly owned by Aetna Life & Casulty.

[b]Wholly owned by Cigna.

[c]Wholly owned by Lincoln National.

[d]Wholly owned by American Express.

[e]Wholly owned by Sears, Roebuck.

[f]Wholly owned by American General.

[g]Wholly owned by Aetna Life & Casulty.

Source: Fortune, June 4, 1990, p. 322.

Table IV.5: Top U.S. Finance Companies, as of December 31, 1989

Dollars in millions

Firm	Total assets	Equity capital
General Motors Acceptance Corp.	$103,562.4	$7,782.0
General Electric Capital Corp.	58,696.0	5,571.0
Chrysler Financial Corp.	30,909.0	2,758.0
Ford Motor Credit Corp.	54,931.3	4,433.5
Xerox Credit Corp.	5,486.8	716.8
Sears Roebuck Acceptance Corp.	14,381.0	2,705.3
Associates Corp. of North America	14,786.2	1,717.3
Household Financial Corp.	15,116.4	1,279.8
Transamerica Finance Group, Inc.	8,896.4	1,493.1
ITT Financial Corp.	10,589.2	1,183.0
Security Pacific Financial Services, Inc.	13,815.0	1,646.0
CIT Group Holdings, Inc.	10,145.4	1,377.6
Heller Financial, Inc.	6,906.3	1,021.5
American Express Credit Corp.	12,610.0	1,422.0
American General Finance Corp.	5,821.8	1,173.9
Westinghouse Credit Corp.	9,300.1	1,169.5
John Deere Capital Corp.	3,187.3	649.6
Commercial Credit Corp.	5,198.3	858.0
Avco Financial Services, Inc.	4,483.6	656.8
Beneficial Corp.	7,947.5	911.1
J.C. Penney Funding Corp.	2,524.0	895.0
Barclays American Corp.	5,770.6	524.1
IBM Credit Corp.	9,747.3	820.5
Phillip Morris Capital Corp.	3,531.3	683.2
Norwest Financial Services, Inc.	3,181.3	369.1

Source: American Banker, November 8, 1990.

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