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Testimony

Before the House Committee on Banking
and Financial Services

For Release on Delivery
Expected at
10:00 a.m., EDT
Wednesday
May 7, 1997

FINANCIAL REGULATION

Bank Modernization Legislation

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Financial Regulation: Bank Modernization Legislation

The laws governing the financial services industry and the regulatory structure that oversees it were developed for an industry compartmentalized into commercial banking, investment banking, and insurance. In recent decades, however, these activities have converged to where many financial products and services offered by banks, securities firms, and insurance companies are more alike than different. Attempts by financial regulators to adapt to the rapid changes taking place in the financial marketplace have been incremental and ad hoc, resulting in overlaps, anomalies and even some gaps. Thus, Congress could improve the functioning of our regulatory system by modernizing our banking laws. However, modernization should not ignore other goals, such as maintaining the safety and soundness of the financial system and the deposit insurance funds, preventing undue concentrations of economic power, and protecting consumers from conflicts of interest. GAO suggests that specific safeguards be included in any modernization legislation.

- Financial services holding companies should be regulated on a consolidated, comprehensive basis, with appropriate firewall provisions to protect both consumers and taxpayers against potential conflicts of interest and to prevent the spread of the federal safety net provided to banks and any associated subsidy to nonbanking activities.
- Capital standards for both insured banks and financial services holding companies should exist that adequately reflect all major risks, including market and operations risk as well as credit risk.
- Clear rulemaking and supervisory authority should be established that results in a consistent set of rules that are consistently applied for similar financial activities and minimizes regulatory burden.

Furthermore, while the case for modernizing our banking laws is clear, GAO would urge that Congress proceed cautiously if it decides to relax the current separation of banking and commerce. GAO found that the potential benefits of mixing banking and commerce generally lacked empirical support or could be realized without removing the current restrictions. GAO's work also indicated that eliminating the current separation could pose a variety of risks to the safety and soundness of the financial system, the deposit insurance funds, and to consumers and taxpayers.

Financial Regulation: Bank Modernization Legislation

Mr. Chairman and Members of the Committee:

We are pleased to be here today to assist your continuing efforts to modernize our financial services regulatory system. As you are well aware, both the laws governing the financial services industry and the regulatory structure that oversees it were developed for an industry that was compartmentalized into commercial banking, investment banking, and insurance. Since that structure was established more than 60 years ago, however, these activities have converged to the point where many of the financial products and services offered by banks, securities firms and insurance companies are more alike than different. Some of the most notable examples include: (1) competition by money market and mutual funds that has been so successful that the value of such funds—many of which permit check writing—now exceeds the value of insured bank deposits; (2) the issuance of guaranteed investment contracts by insurance companies that compete directly with both mutual funds and bank certificates of deposit, (3) the securitization of over \$2 trillion in mortgages and other loans that a few years ago would have been held in portfolio by insured depository institutions; (4) the increasing involvement of commercial banks in the sale of insurance products, in mutual funds, and in securities underwriting through “section 20” holding company affiliates; and (5) the increasing involvement of securities firms and insurance companies in making and syndicating commercial loans in competition with banks.

As we testified before this committee two years ago, our various financial regulators have been attempting to adapt to the dramatic and rapid changes taking place in the financial marketplace on an incremental and ad hoc basis.¹ As a result, as our work over the past few years has shown, our existing financial regulatory system has significant overlaps, anomalies and even some gaps. Thus, Congress, by updating and modernizing our banking laws, could substantially improve the functioning of our regulatory system, and we commend the committee’s efforts to do so. However, the goal of financial modernization should not be achieved at the expense of other important goals, such as maintaining the safety and soundness of the financial system and the deposit insurance funds, preventing undue concentrations of economic power, and protecting consumers from potential conflicts of interest.

¹Financial Regulation: Modernization of the Financial Services Regulatory System (GAO/T-GGD-95-121, Mar. 15, 1995). See also, Separation of Banking and Commerce (GAO/OCE/GGD-97-61R, Mar. 17, 1997), Bank Oversight: Fundamental Principles for Modernizing the U.S. Structure (GAO/T-GGD-96-117, May 2, 1996).

Safeguards Are Needed

Toward this end, our work suggests that the following specific safeguards should be included in any modernization legislation:

- Financial services holding companies should be regulated on a consolidated, comprehensive basis, with appropriate firewall provisions to protect both consumers and taxpayers against potential conflicts of interest and to prevent the spread of the federal safety net provided to banks and any associated subsidy to nonbanking activities.² Our work on past financial institution failures has shown the importance of having an umbrella supervisory authority to assess how risks to insured institutions may be affected by risks in the other components of a holding company structure. While firewall provisions can be extremely important safeguards in preventing potential conflicts of interest and protecting insured deposits, firewalls may not hold up under stress or if managers are determined to breach them. Moreover, consolidated supervision is consistent with the way that most, if not all, large bank holding companies are managed today — on a consolidated basis with the risks and returns of various affiliates being used to offset or enhance one another.³ It is also compatible with a functional approach to financial regulation.⁴ For example, the SEC could be the regulator for a securities affiliate of a financial services holding company, the OCC the regulator for a nationally chartered bank affiliate, with either of these two agencies or the Federal Reserve being responsible and accountable as the umbrella regulator for the operations of the holding company in its entirety. This basic approach — i.e. having consolidated supervision of banking organizations with coordinated functional regulation of individual components — is also consistent with the approach taken by five other major industrialized

²Firewalls are systems of controls that are meant to keep bank resources from improperly being used to support other activities, such as securities underwriting, and to protect against potential conflicts of interest. The federal government provides a safety net to the banking system that includes federal deposit insurance, access to the Federal Reserve discount window, and the final riskless settlement of payment system transactions. This safety net, while helping to ensure the safety and soundness of the banking system, also provides a subsidy to commercial banks and other depository institutions by allowing them to obtain low-cost funds.

³Currently, the Federal Reserve acts as the overall regulator for bank holding companies, which includes setting consolidated capital requirements for the company as a whole, exercising supervisory authority over the company, determining what types of activities can be affiliated with banks under the holding company structure, and approving such holding company activities as mergers and acquisitions.

⁴For a detailed discussion of functional regulation, see appendix I.

countries that we recently studied.⁵ In these five countries — Canada, United Kingdom, Germany, France and Japan — if securities, insurance, or other nontraditional banking activities were permissible in bank subsidiaries, functional regulation was provided by the appropriate authority. While bank regulators generally relied on those functional regulators for information, they remained responsible and accountable for ascertaining the safety and soundness of the consolidated banking organization as a whole.

- Capital standards for both insured banks and financial services holding companies should exist that adequately reflect all major risks, including market and operations risk as well as credit risk. Because our work on failed banks has shown that capital can be quickly eroded in times of stress and can be a lagging indicator of an institution's true financial condition, regulators should be required to conduct periodic assessments of risk management systems for all the major components of a financial services holding company, as well as for the holding company itself. While the FDIC Improvement Act of 1991 requires bank regulators to take prompt corrective action against troubled institutions before their capital is completely eroded, our recent review showed that the implementation of these provisions may not be as effective in preventing deposit insurance losses as Congress originally intended.⁶
- Clear rulemaking and supervisory authority should be established that results in a consistent set of rules that are consistently applied for similar financial activities and minimizes regulatory burden. This is particularly important for critical matters, such as consolidated capital requirements, firewalls, and permissible activities, and can be accomplished in a number of ways. Having the Federal Reserve serve this function, which is the approach taken in H.R. 10, is one obvious alternative, at least for large financial services holding companies. Still another approach would be to have a special interagency rulemaking board or committee. We found that each of the five major foreign countries that we recently reviewed had unique ways to ensure that their banking institutions that were conducting the same lines of business were generally subject to a single set of rules, standards, or guidelines. The important point is to have some mechanism to achieve consistent, effective oversight and rules and to limit unnecessary overlaps and regulatory burden on our financial institutions.

⁵Bank Oversight Structure: U.S. and Foreign Experience May Offer Lessons for Modernizing U.S. Structure ([GAO/GGD-97-23](#), Nov. 20, 1996). See also, Bank Regulatory Structure: The Federal Republic of Germany ([GAO/GGD-94-134BR](#), May 9, 1994), Bank Regulatory Structure: The United Kingdom ([GAO/GGD-95-38](#), Dec. 29, 1994), Bank Regulatory Structure: France ([GAO/GGD-95-152](#), Aug. 31, 1995), Bank Regulatory Structure: Canada ([GAO/GGD-95-223](#), Sept. 28, 1995), and Bank Regulatory Structure: Japan ([GAO/GGD-97-5](#), Dec. 27, 1996).

⁶Bank and Thrift Regulation: Implementation of FDICIA's Prompt Regulatory Action Provisions ([GAO/GGD-97-18](#), Nov. 21, 1996).

Mr. Chairman, as you and other members of the committee are well aware, the number of banks has declined substantially over the past five years and there has been considerable consolidation among our largest banking organizations in particular. Because these trends could be accelerated even more by financial modernization, it is also important, through effective enforcement of our antitrust and banking laws, to prevent any monopolistic exercise of market power and to assure that entry into the financial services marketplace is not restricted unnecessarily. For without competitive markets, the benefits of financial modernization are unlikely to be passed on to small businesses and consumers.

Banking and Commerce

Mr. Chairman, while our work shows that the case for modernizing our banking laws is clear, we would urge that Congress proceed cautiously if it decides to relax the current separation of banking and commerce. Our recent review of the existing economics literature, which is discussed in detail in appendix II, found that the potential benefits of eliminating the current separation generally lacked empirical support and that most such benefits could be realized through other means.⁷ Furthermore, the available literature, as well as our own extensive work on the causes of past financial institution failures, indicated that eliminating the current separation could pose a variety of risks to the safety and soundness of the financial system, to the deposit insurance funds, and to consumers and taxpayers. While the exact magnitudes of such risks are uncertain and would depend, in large part, on the effectiveness of the legislative and regulatory safeguards that are put into place, our work shows that a compelling economic argument for the unbridled mixing of banking and commerce has simply not yet been made.

Mr. Chairman, this concludes my prepared statement. My colleagues and I would be happy to respond to any questions that you and other members of the committee may have.

⁷Separation of Banking and Commerce ([GAO/OCE/GGD-97-61R](#), Mar. 17, 1997).

An Explanation of Consolidated Holding Company Regulation and Functional Regulation

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

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

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

Consolidated Regulation of the Holding Company

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

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

Functional Regulation

The concept of functional regulation refers generally to a regulatory process in which a given financial activity is regulated by the same regulator regardless of who conducts the activity. In discussions about

regulation of financial service holding companies, the concept can be used in somewhat different ways.

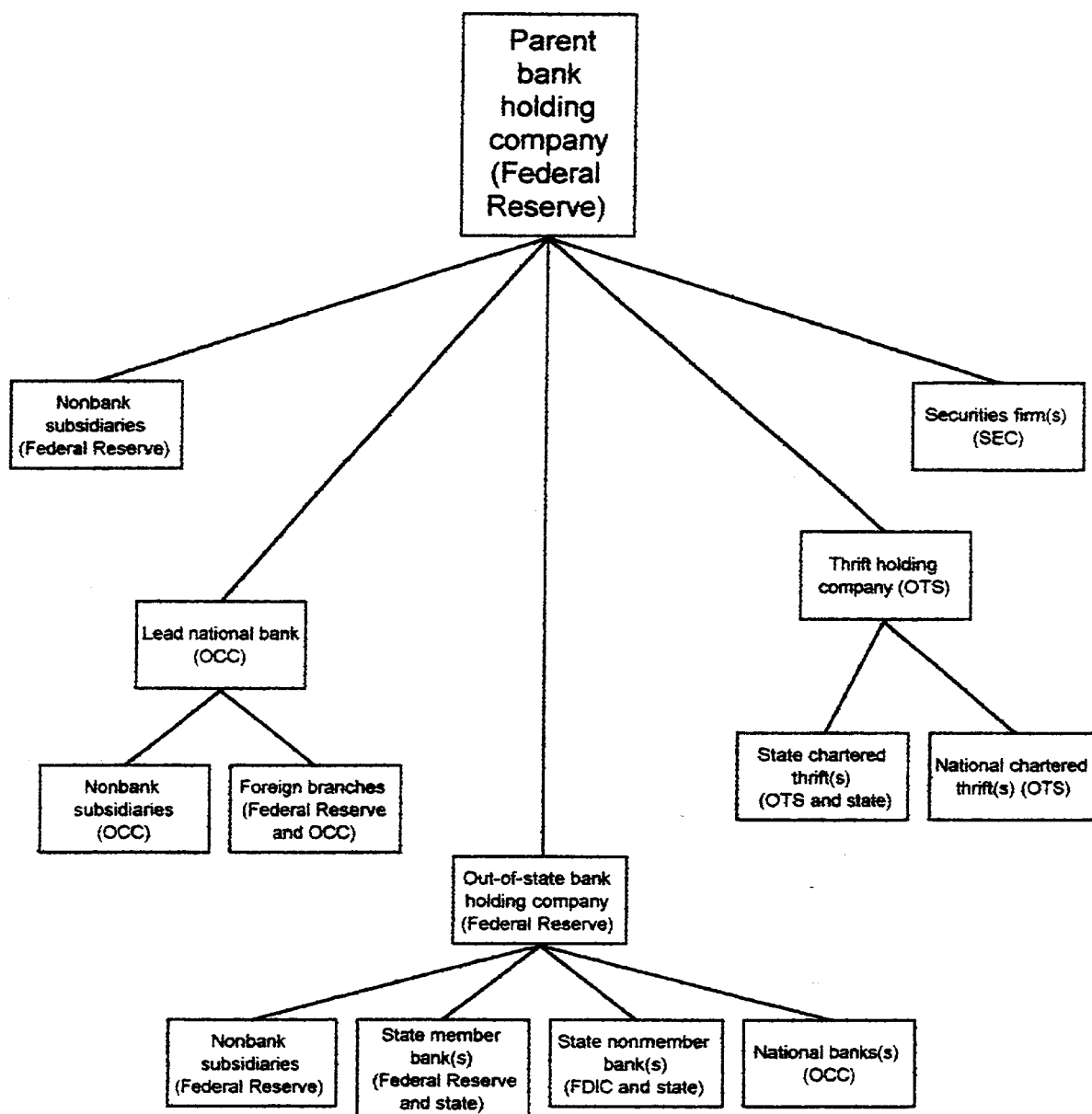
Functional regulation is sometimes used to refer principally to the idea of regulating a complex company in a way that eliminates the umbrella role, the role now played by the Federal Reserve for bank holding companies. Referring to figure 1, this approach to functional regulation means that the Federal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

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

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

Appendix I
An Explanation of Consolidated Holding
Company Regulation and Functional
Regulation

Figure 1: Regulation of a Hypothetical Bank Holding Company



Potential Benefits and Risks of Eliminating the Current Separation of Banking and Commerce

Eliminating the current separation of banking and commerce involves both potential benefits and risks. Specifically, the major potential benefits that have been mentioned in recent years in support of eliminating the separation of banking related activities and commerce include (1) increased economies of scale, (2) greater diversification of risks, and (3) synergies that may result from affiliations between banks and commercial firms.

- Increased Economies of Scale. Some observers claim that the U.S. banking industry would benefit from the relaxation of banking and commerce restrictions because it would allow banks to expand their scale of operations and lower their unit costs of production. While some early studies seemed to indicate the presence of significant scale economies in banking,⁸ the results of more recent work have been mixed.⁹ Moreover, to the extent that scale economies exist and are significant in banking, banks should be able to capture them through mergers with other banks. Banks do not need to combine with commercial firms to be able to achieve scale economies.
- Greater Diversification of Risks. Some observers also claim that banking and commercial conglomerations would be beneficial because they would allow for greater diversification of risks across more product lines and thus reduce the variability of corporate earnings. Because the gains from this type of diversification rise when firms' earnings are less correlated, and fall when firms' earnings are more correlated, this argument rests on the assumption that the earnings of commercial firms fluctuate independently of the earnings of banks. We found the empirical evidence on this point to be inconclusive. One study we reviewed found some evidence that the returns on banking stocks and commercial firm stocks were not highly correlated, and thus concluded that diversification benefits were possible.¹⁰ However, a more comprehensive study that examined a longer time period and controlled for more factors found that the variation in the stock returns of bank holding companies and

⁸A review of the literature is provided in G. Bentson, G. Hanweck, and D. Humphrey, "Scale Economies in Banking: A Restructuring and Reassessment," *Journal of Money Credit and Banking*, 14 (1982), 435-456.

⁹See L. Mester, "Efficient Product of Financial Services: Scale and Scope Economies," Federal Reserve Bank of Philadelphia Business Review, January/February (1987), 15-25, and S. Shaffer, "A Revenue-Restricted Cost Study of 100 Large Banks," mimeo, Federal Reserve Bank of New York, 1988,.

¹⁰A. Saunders, and P. Yourougou, "Are Banks Special: The Separation of Banking from Commerce and Interest Rate Risk," *Journal of Economics and Business*, 42 (1990), 171-182.

nonfinancial companies are reasonably highly correlated and concluded that the benefits of diversification are overstated.¹¹

Moreover, banks do not need to combine with commercial firms to reduce the variability in their earnings through diversification. For example, banks can diversify their assets through their loan portfolios and other investments, and their ability to diversify geographically was recently enhanced by the Interstate Banking and Branching Efficiency Act of 1994.

- Synergies. Some observers argue that conglomerations of commercial firms and banks might result in other efficiencies, often referred to as synergies. Two possible sources of synergies are economies of scope and information efficiencies. Economies of scope exist if a combined firm can produce a mix of products at a lower cost than if the products were produced separately. The main source of the cost savings comes from using the same inputs to produce multiple outputs. The virtually unanimous finding in the literature is that economies of scope are insignificant in banking.¹² We were unable to find any studies on the existence of potential economies of scope between banking and commercial activities.

Another possible synergy might result from improved informational flows within a combined entity. For example, by combining with commercial firms, banks might obtain better information about the commercial firms' activities, which the banks could then use to reduce the default rate on their loans. In addition, the commercial firms could benefit by obtaining bank loans at lower interest rates. However, the increased information flows might also induce banks to approve more risky loans.¹³ We were unable to find any studies that attempt to quantify these potential effects.

- Other Theoretical Arguments. Some observers have also argued that restrictions on bank affiliations lead to inefficiencies, because such restrictions impede the free flow of capital or managerial resources.¹⁴ Although impediments to resource flows can lead to inefficiencies in

¹¹M.J. Isimbabi, "The Stock Market Perception of Industry Risk and the Separation of Banking and Commerce," *Journal of Banking and Finance*, 18 (1994), 325-349.

¹²Mester (1987) surveys a number of studies.

¹³A summary of the trade-off is provided in K. John, T.A. John, and A. Saunders, "Universal Banking and Firm Risk-taking," *Journal of Banking and Finance*, 18 (1994), 307-323.

¹⁴See A. Saunders, "Banking and Commerce: An Overview of the Public Policy Issues," *Journal of Banking and Finance*, 18 (1994), 231-254.

certain cases, we found no clear evidence that such inefficiencies exist in the banking industry at the present time.

Those who argue that there is a capital shortage in banking believe that banks have a difficult time attracting capital, and that allowing banks and commercial firms to affiliate is necessary to allow the banking industry to attract capital from other industries. However, there are many sources of capital, such as new stock issues, that are open to banks and we are not aware of any empirical evidence that the U.S. banking industry is currently suffering from a capital shortage. In fact, the banking industry currently is very well capitalized by historic standards. The average capital asset ratio in the industry in 1996 was 8.3 percent, compared to 6.7 percent in 1991.¹⁵ By regulatory standards, capital in the banking industry is also high. At the end of 1995, 98.4 percent of banks were considered well capitalized, compared to 93.8 percent at the end of 1992.¹⁶

Another argument, which holds that separating banking and commerce causes inefficiencies by blocking resource flows, focuses on managerial talent and cost consciousness. According to this argument, allowing banks and commercial firms to merge would generate fears of a potential takeover resulting from poor performance and thus would induce managers to increase efficiency. It should be noted, however, that this type of discipline can take place even if banks and commercial firms are not allowed to merge. As long as better managed banks are allowed to purchase weaker banks, this efficiency-enhancing mechanism, to the extent that it works, would still be operable.

Our review of existing studies, as well as our own prior work assessing past financial institution failures, indicated that eliminating the separation of banking and commerce might subject the financial system, the deposit insurance fund, and consumers and taxpayers to a variety of risks.¹⁷ The primary risks include those associated with (1) a potential expansion of the federal safety net provided banks to commercial operations, (2) the potential for increased conflicts of interest within a banking and commercial conglomerate, (3) the potential for contagion effects from

¹⁵The FDIC Quarterly Banking Profile: Commercial Banking Performance-Third Quarter 1996, p. 5.

¹⁶See Bank and Thrift Regulation: Implementation of FIDICIA's Prompt Regulatory Action Provisions (GAO/GGD-97-18, Nov. 21, 1996), p. 28.

¹⁷See, for example, Thrift Failures: Costly Failures Resulted From Regulatory Violations and Unsafe Practices (GAO/AFMD-89-62, June 16, 1989), Bank Supervision: OCC's Supervision of the Bank of New England Was Not Timely or Forceful (GAO/GGD-91-128, Sept. 16, 1991), and Bank Insider Activities: Insider Problems and Violations Indicate Broader Management Deficiencies (GAO/GGD-94-88, Mar. 30, 1994).

commercial operations spreading to insured banks, and (4) a potential increase in economic power exercised by large conglomerate enterprises.

- Potential Expansion of the Federal Safety Net. Allowing conglomerations of banks and commercial firms would increase the risk that the safety net, and any associated subsidy, might be transferred to commercial operations and result in inappropriate risk-taking, misallocations of resources, and uneven competitive playing fields in other industries. While such risks could be mitigated by establishing firewalls between banks and their commercial affiliates, our work has shown that such firewalls may not work in times of stress, or where managers are determined to evade them.¹⁸ Moreover, firewalls require regular monitoring and enforcement by regulators and, if set too high, may prevent the realization of whatever potential benefits were expected to derive from allowing such conglomerations to occur.
- Potential for Increased Conflicts of Interest. Allowing conglomerations of banks and commercial firms could also add to the potential for increased conflicts of interest and raise the risk that banks might engage in anticompetitive or unsound practices. For example, some have argued that, to foster the prospects of their commercial affiliates, banks might begin to restrict credit to their affiliates' competitors, or tie the provision of credit to the sale of products by their commercial affiliates.¹⁹ Perhaps more likely, banks might begin to extend credit to their commercial affiliates when they would not have done so otherwise, thus increasing the risks to the deposit insurance fund and to taxpayers.²⁰ Such behavior could also undermine the valuable monitoring function that banks provide in our economy. As long as banks are perceived as providing credible, objective assessments of the creditworthiness of companies and their activities, bank credit decisions can provide valuable information to the market about the soundness of these companies and their activities. The value and reliability of such signals could be diminished if banks were viewed as having conflicts of interest that adversely affected the objectivity of their credit decisions.
- Potential for Increased Contagion Effects. Allowing conglomerations between banks and commercial firms could also increase risks to the

¹⁸Using Firewalls in a Post Glass-Steagall Banking Environment ([GAO/T-GGD-88-25](#), Apr. 13, 1988).

¹⁹A. Saunders, "Banking and Commerce: An Overview of the Public Policy Issues," [Journal of Banking and Finance](#), 18 (1994), 231-254.

²⁰In our review of the 286 bank failures that occurred in 1990-1991, we found that insider problems and associated conflicts of interest were cited as contributing factors in 175 of the failures. See [Bank Insider Activities: Insider Problems and Violations Indicate Broader Management Deficiencies](#) ([GAO/GGD-94-88](#), Mar. 30, 1994).

deposit insurance fund and taxpayers if affiliated commercial firms were to extend any financial stress they experienced to their banking affiliates. Even if firewalls were able to keep such problems from actually being transmitted to bank affiliates, depositors who believed that commercial affiliates were experiencing financial problems might decide to withdraw their funds from the commercial firms' bank affiliates for fear that the banks' soundness might also be in jeopardy. If enough depositors did this, the fear could be self-fulfilling in that the viability of both the affiliated banks and the commercial firms could become threatened.

- Possible Increased Concentration of Economic Power. There are also concerns that ending the current restrictions between banking and commerce could promote the formation of very large conglomerate enterprises with substantial amounts of economic power. Such enterprises could adversely affect the efficient operation of the economy and place consumers at risk of increased prices if they began to exert market power in either their banking or commercial operations. This risk would be enhanced to the extent that these new conglomerates could effectively access the subsidy inherent in the safety net and gain advantages over their competitors.

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