14.254

United States General Accounting Office

GAO

Transition Series

December 1992

Financial Services Industry Issues

148254

148254

GAO/OCG-93-10TR

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

Comptroller General
of the United States

December 1992

The Speaker of the House of Representatives
The Majority Leader of the Senate

In response to your request, this transition series report discusses major policy, management, and program issues facing the Congress and the new administration in the financial services industry. These issues include (1) regulating financial institutions, which are at a crossroads; (2) understanding rapidly changing financial markets; and (3) strengthening insurance industry solvency regulation.

As part of our high-risk series on program areas vulnerable to waste, fraud, abuse, and mismanagement, we are issuing separate reports on the Bank Insurance Fund (GAO/HR-93-3, Dec. 1992) and the Resolution Trust Corporation (GAO/HR-93-4, Dec. 1992).

The GAO products upon which this transition series report is based are listed at the end of the report.

We are also sending copies of this report to the President-elect, the Republican leadership of the Congress, the appropriate congressional committees, and the designated heads of the appropriate agencies.

Charles A. Bowsher

Charles A. Bowsher

Contents

The Financial Services Industry

The nation's financial institutions and markets are vital to a smoothly functioning economy. Our November 1988 transition report discussed problems and solutions for our financial services industry, which was experiencing its most turbulent and troubled period since the Great Depression. Banks, savings and loans, and insurance companies were failing at rates not seen for decades. The securities and futures markets became linked, and in 1987 they experienced their most severe decline in 58 years.

Much has been done legislatively and administratively since our last transition report to address the weaknesses and vulnerabilities in the financial services industry that were evidenced during the past decade. In 1989, the Congress enacted the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) to fund the cleanup of the savings and loan disaster and better ensure that the disaster did not repeat itself. In 1991, the Congress enacted the Federal Deposit Insurance Corporation Improvement Act (FDICIA) to better ensure a safe and sound banking industry and a financially strong deposit insurance system. In the wake of the 1987 stock market crash, many changes were implemented by the market regulators and the exchanges themselves to ensure that market systems and mechanisms could better cope with any future massive shifts in investor sentiment.

Despite this progress, it is unrealistic to believe that the job is done. First, the cleanup of the savings and loan industry is not completed. The Resolution Trust Corporation (RTC) estimates that another $25 billion will be needed to finish this effort, and the industry's new insurance fund must be provided with funding in 1993 so that it can meet its responsibilities. Second, great care needs to be taken to ensure that FDICIA is properly implemented. Third, the structure of financial regulation will need to be modernized sometime during the 1990s to recognize the realities of today's highly competitive financial marketplace. However, before action is taken, very careful consideration will need to be given to how and under what circumstances to safely expand the geographic and product-line powers of banking organizations. Fourth, changes in the financial services industry continue to accelerate at a dizzying pace. Regulators need to assess and fully understand how the proliferation of new products, such as derivatives, as well as domestic and international market developments affect their ability to ensure that our markets and institutions continue to function safely, soundly, and smoothly. Finally, regulation of the insurance industry warrants more attention in light of the increasing number and size of companies that fail, the effects of those failures on policyholders, and the serious weaknesses that have been exposed in the state system of solvency regulation.

The new administration and the Congress must address these issues if we are to have a stable, efficient, and competitive financial system in the years to come.

Many of the provisions of FDICIA will, if effectively implemented, greatly strengthen the industry, the power of the regulators in identifying and acting on problems experienced by troubled depository institutions, and the deposit insurance system. FDICIA's accounting, corporate governance, and regulatory reforms are designed to accomplish these goals. Among other measures, FDICIA's early warning reforms provide for the timely disclosure of internal control weaknesses and violations of laws and regulations. The act's early intervention requirements are designed to ensure that regulators take prompt and appropriate action to correct unsafe banking practices.

We remain concerned about the lack of action by the Financial Accounting Standards Board or the federal regulators to effectively tighten the flexible accounting rules that helped to mask the industry's problems during the 1980s. Legislation needs to be considered for solving this problem. We have a number of additional concerns about the quality of bank examinations and the effectiveness of regulations that will be issued to implement FDICIA's provisions.

Though the banking industry had record profits during the first half of 1992, over 1,000 banks with assets exceeding $500 billion remain on the Federal Deposit Insurance Corporation's (FDIC) problem bank list—largely as a result of bad loans made in the past. The insurance fund itself ended 1991 with a deficit of $7 billion and, according to FDIC's estimates, faces potential costs of about $40 billion between 1992 and 1995.

A discussion of our concerns with the act's implementation as well as the condition of the banking industry and its insurance fund is contained in our high risk report on the Bank Insurance Fund.

Expanded Powers

Recent proposals to expand banks' product-line and geographic powers were not successful. But there will no doubt be similar proposals in the future. A cautious approach should be followed in expanding the powers of banking organizations. It is unrealistic to expect that deregulation of geographic and product-line powers will do much in the short run to solve the banking industry's current problems. These problems stem largely from bad loans. While institutions entering new lines of business or new territories might increase profits, they would also be exposed to the opportunity to lose vast sums of money. FDICIA's system of safety and soundness regulation should be in place and operating properly before the powers of banks are expanded.

However, implementation of FDICIA is not all that must be done to deal with the regulatory issues associated with expanded powers. Each major decision about changing powers must also seek to ensure that (1) treatment of uninsured depositors in bank failures is similar in all cases so that small banks can compete effectively with big ones, (2) holding company supervision is adequate and the responsibilities of the various federal regulatory agencies in supervising such companies are clearly defined, and (3) regulatory controls are sufficient to protect against conflict-of-interest abuses.

Regulatory Burden

With the passage of FDICIA, there is increasing concern that the cumulative effect of regulation may be placing too great a burden on the industry. Some industry-sponsored studies have estimated that FDICIA's new consumer disclosure, credit availability, and many other regulations are costly. We are not now in a position to say whether the benefits of regulation exceed its costs. Nor is anyone else. But clearly, in today's competitive financial services environment, this topic needs to be considered and reviewed carefully.

As part of formulating a plan of action to deal with concerns over regulatory burden, it is critical that certain issues be addressed. There must be a clear understanding of what is meant by regulatory burden. In this regard, more needs to be known about how the perceived burden is divided between rules and requirements designed to promote safety and soundness and those designed to protect consumers. It is also necessary to decide whether the burden lies in what the statutes and regulations are trying to accomplish or in how the regulations are administered.

In addition to understanding the nature of regulatory burden, measures of its importance should be compared to other factors, such as overcapacity, lack of experience operating in competitive environments, or poor controls over risk-taking in explaining the performance of banks. Finally, the industry enjoys significant benefits as a result of its regulated status. Any assessment of regulatory burden should weigh that burden against the benefits of a lower cost of capital, lower cost of funds, access to and control of the payments system, and access to the Federal Reserve.

The Savings and Loan Cleanup

In addition to coming to grips with further deregulation and regulatory burden issues, attention must also remain focused on the continuing cleanup of the savings and loan industry. The job is not done yet. In the more than 3 years since the passage of FIRREA, RTC has closed more than 650 failed thrifts and has sold more than $287 billion of assets as of September 30, 1992. RTC's resolution efforts have been hampered by funding disruptions, the most recent of which occurred in April 1992. Since then, RTC has been unable to fund the resolution of most failed thrifts under its control.

In September 1992, RTC estimated that the current funding disruption had already increased its cost by at least $600 million and would continue to add an average of about $6 million each day. In October 1992, RTC estimated that it would need between $8 billion and $27 billion in additional loss funds to resolve its expected remaining caseload of about 150 thrifts, bringing the total resolution cost estimate to between $95 billion and $114 billion. In December 1992, RTC's Chief Executive Officer indicated that $25 billion in loss funds would be needed—near the upper end of the range estimated in October.

An early priority for the Congress and the administration will be to decide how to proceed with the funding for the remaining cleanup of the industry and provide that funding before the Savings Association Insurance Fund assumes full resolution responsibility in October 1993. Steps also need to be taken to ensure that this new fund is adequately financed by that time.

In addition to completing its resolution responsibilities, RTC can also improve its asset management methods and strategies. RTC has generally done a good job selling financial assets. However, its real estate sales approaches have sometimes been inefficient, poorly planned, and poorly executed. Moreover, RTC has not evaluated its real estate sales strategies to determine which methods were most effective for which type of asset and in which particular market each method worked best. As a result, there is no assurance that RTC is maximizing recoveries on the sale of real estate assets. Furthermore, RTC's contracting system—a critical element in RTC's asset disposition approach—remains a key weakness in RTC's operations. Specific problems with the contracting system include poor contract planning and oversight. These problems have added millions of dollars in costs to the government's bailout efforts.

RTC needs to (1) better plan its real estate disposition strategies and determine which methods are most effective for different types of assets and different markets, (2) set disposition goals tied to maximizing recoveries, and (3) strengthen contract planning and the key information systems needed to oversee, manage, and dispose of assets. A more detailed discussion of these issues is contained in our high-risk report on RTC.

Better Understanding of Rapidly Changing Financial Markets Needed

In October 1987, the nation's equity markets experienced their most serious disruption since the crash of 1929. Much has been done to help ensure that our markets can better cope with a "run for the exits" should the 1987 event repeat itself. But other events have greatly changed the world since 1987.

Globalization of Trading Markets

International trading has increased, and with it so too have concerns about the risks to investors, firms, and markets resulting from differences in standards and rules that various countries use to regulate or operate their domestic securities markets. These concerns include (1) the risks of trading with firms operating in countries with lower requirements and of financial problems in one country's markets affecting firms and markets in other countries, (2) the opportunity for illegal or improper activities by individuals operating outside of the country whose markets are being abused, and (3) the ability of U.S. firms to compete with firms that are subject to lower regulatory costs in other countries.

The efforts of international organizations such as the European Community and the International Organization of Securities Commissions to harmonize standards and rules to meet these concerns have been resisted because of the vast differences among countries' regulatory approaches. None of the efforts have been completed.

As globalization of financial markets continues, U.S. regulators need to continue in their attempts to achieve meaningful harmonization. These efforts should include development of a coordinated U.S. strategy for achieving harmonized financial regulations either by working through existing international bodies or by negotiating directly with other countries. The efforts should also include an assessment of whether the current structure of regional and international financial organizations is capable of achieving harmonized financial regulations.

New Trading Systems

Here at home, the Securities and Exchange Commission (SEC) has sanctioned new trading systems in response to demands by institutional investors for lower trading costs and anonymity in their trading. Because these systems are small or only involve trading by sophisticated investors, SEC has not subjected them to the same level of regulation as existing markets. These new systems have taken some market share from the existing markets, especially the New York Stock Exchange.

There is a lack of consensus about the effects of this trend on investors and the capital formation process. For example, some argue that when order flow is dispersed from a primary market, the market's efficiency and liquidity are impaired. Others argue that efficiency is not affected and that liquidity is, in fact, enhanced. Most, however, agree that without a primary market, other trading systems could not exist. This raises a fundamental issue of fairness because trading systems that compete with the primary markets incur lower regulatory costs while deriving benefits from the primary market.

The importance of these issues raises questions about the future structure of the U.S. markets. Attention needs to be focused on understanding the risks and benefits of new market systems to investors and market participants, and deciding which market structure will best meet the future needs of U.S. business for capital formation. In addition, decisions are needed about whether new trading systems that rely on prices derived from a primary market should pay the primary market for that service.

New Financial Products

There has been an explosion in the development and use of new financial products, such as currency and interest rate swaps. For example, the worldwide market for interest rate swaps grew from its inception in 1981 to a notional principal amount over $3 trillion by 1992. These products, called derivatives, offer a way for financial institutions and corporations to protect themselves from volatility in interest and foreign exchange rates.

These products are risky, and they are generally unregulated. Information about financial institutions' losses from trading these products is limited. But some firms have lost hundreds of millions of dollars trading derivatives because of mispricing, poor risk management systems, or inappropriate trading strategies.

Financial regulators have expressed uncertainty and concern about the risks of derivative products and the potential threat they pose to the financial system. More needs to be known about the nature and extent of use of these products as well as the risks they pose to the financial system, including (1) the extent to which financial institutions use these products and have adequate systems to manage their risks,

(2) the resources and abilities of financial regulators to evaluate the risks these products pose, and (3) whether a different U.S. regulatory approach toward derivatives would be viewed as harmful by market participants and drive the business overseas.

In addition to these emerging market developments and the concerns they pose, some other areas also need attention.

Oversight of Investment Advisory Industry

Legislation is needed to strengthen SEC's oversight of the investment advisers industry. This industry, consisting of about 17,500 registered advisers who manage a total of more than $5 trillion in assets, affects the lives of millions of Americans who set up a plan for retirement, for their children's education, or for their survivors. It is also an industry that has significantly damaged the lives of many individuals through fraud, embezzlement, or the provision of misleading or inappropriate advice.

SEC's current oversight program may be doing more harm than good by giving investors a false sense of confidence that SEC-approved advisers are both well qualified and well regulated. In 1992, SEC had only 46 inspectors for all registered advisers. In

1990, almost 60 percent of advisers registered for more than 1 year had never been inspected. SEC needs additional resources and enhanced registration and inspection programs. Enhanced programs would (1) verify adviser-supplied education and experience information and check all available federal criminal history sources; (2) identify advisers who should be registered but are not; (3) register all individuals at advisory firms who give advice; and (4) inspect adviser business operations within a reasonable time, such as within 1 year of registration, and periodically thereafter according to risk.

Government Securities Markets

The market for U.S. Treasury and agency securities is perhaps the largest, most liquid securities market in the world, and it works reasonably well. However, the 1991 revelations of irregularities in bidding and secondary market trading by Salomon Brothers highlighted some impairments to the efficiency and integrity of the market that could raise the interest rates that Treasury has to pay on the debt. Interest on the national debt is now the third largest item in the budget. A slight increase in the interest rate Treasury pays on its marketable debt would add billions of dollars to the deficit. The following actions are needed:

- Treasury rule-making authority under the Government Securities Act of 1986 should be renewed. This authority expired in 1991, and Treasury is now unable to update or promulgate rules involving prudential regulation of the government securities market as required by the 1986 act.

- Sales practice rules should be extended to the government securities market. Market participants need to be protected against such things as churning and unsuitable investments just as participants are protected in markets for corporate stocks and bonds.

- The government should be given backup authority to require that information on interdealer broker screens be made available to the public.

- Bidding arrangements should be changed to protect against rigged bids and to encourage the widest possible participation in auctions.

Strengthened Insurance Solvency Regulation Needed

Insurance is an important component of the financial system. Between 1988 and 1991, an average of about 60 insurance companies failed each year. These failures have raised serious concerns about the quality of insurance regulation as well as the strength of the state guaranty funds that protect individuals when their insurers fail. Solvency regulation of the insurance industry is conducted solely by the states. However, because the business of insurance involves interstate commerce and because adverse developments in the industry could harm policyholders, the federal government has both ultimate responsibility for and an interest in its safety and soundness. In this regard, the Congress has exercised a direct oversight role through investigations and hearings.

We have several concerns about the quality of insurance solvency regulation and the protection for policyholders in the event of insolvency:

- The quality and usefulness of financial and management information provided to regulators and others is insufficient to evaluate the risks faced by and the solvency of insurers.

- The willingness and ability of state regulators to develop regulatory capabilities, consistent rules, and interstate coordination is insufficient to effectively regulate national and international insurance entities.

- The strength and fairness of the state guaranty funds is not adequate to protect policyholders should their insurer fail.

Insurers are required to report their financial results to the responsible state regulators using "statutory accounting principles." Statutory accounting, in theory, is more conservative than generally accepted accounting principles, but in practice it has allowed insurance companies to overstate the value of their assets and inflate their reported surplus. Adoption of generally accepted accounting principles for insurance companies could provide a common framework for more meaningful financial reporting to the regulators. However, flexibility in generally accepted accounting rules for treatment of problem loans and investment securities still provides too much latitude to company managers in reporting asset losses. The accounting rules for insurance companies need to be strengthened to better ensure that financial information provided to regulators and others is reliable for evaluating insurance company risks.

The need for more consistency in insurance regulation and the need to strengthen the regulatory capabilities of some states have become widely recognized. Several options at the state and federal levels have been proposed or implemented to address this problem.

First, the National Association of Insurance Commissions (NAIC) has established Financial Regulation Standards that it believes are necessary for effective state-by-state solvency regulation. A program to accredit states that adopt these minimum standards has also been created. We doubt the ability of NAIC to get the necessary degree of cooperation from the states because it has no authority either to require the states to adopt consistent laws or to monitor state compliance with the Financial Regulation Standards. Moreover, the standards themselves are weak, and the accreditation process lacks credibility.

Second, the National Conference of Insurance Legislators has proposed an interstate compact to shift some state authority to an interstate insurance regulatory agency. This proposal could solve the lack of authority that cripples NAIC but only if all the states could agree on the form of the compact and the degree of authority that would be surrendered.

Third, two congressional bills have been introduced in the Congress that would create a federal agency with responsibility for regulating some insurers and for overseeing insurance regulation in the states. Direct federal involvement in insurance regulation could impose a consistent regulatory framework on the insurance industry and reduce the regulatory burden that large insurers now face in the 50 states. However, establishment of a new federal agency could be costly and could result in either an explicit or an implicit expansion of the federal safety net in the event of mounting insurer failures.

While many unanswered questions remain about the advantages and disadvantages of these specific regulatory alternatives, we believe that there is a clear need for a more consistent, uniform system of insurance regulation than currently exists in the state-by-state system. Moving toward a more effective national (although not necessarily federal) insurance regulatory system will require considerable discussion of the alternatives and may entail greater federal-state cooperation.

The financial services industry has played a vital role in the development of the modern U.S. economy, and it must continue to play that role. The United States has learned an enormously costly lesson from its experience with the savings and loan disaster. We must ensure that this episode in our nation's financial history is never repeated.

Our financial system continues to change, and with this change come a host of issues that need to be addressed to ensure the system's safety, efficiency, and competitiveness. This job will not be easy. But it remains as important today as it was in 1988 that the approach taken to addressing the issues remains focused on

- protecting against unacceptable financial damage to our financial institutions and markets as well as individual investors,

- encouraging innovation and flexibility to keep up with rapidly evolving market developments, and
- allowing financial markets to function without undue interference.

Related GAO Products

Bank Insurance Fund (GAO/HR-93-3, Dec. 1992).

Resolution Trust Corporation (GAO/HR-93-4, Dec. 1992).

Insurer Failures: Regulators Failed to Respond in Timely and Forceful Manner in Four Large Life Insurer Failures (GAO/T-GGD-92-43, Sept. 9, 1992).

Securities and Futures Markets: Cross-border Information Sharing Is Improving, but Obstacles Remain (GAO/GGD-92-110, July 28, 1992).

Investment Advisers: Oversight Is Inadequate for Investor Protection (GAO/T-GGD-92-46, June 4, 1992).

Depository Institutions: Flexible Accounting Rules Lead to Inflated Financial Reports (GAO/AFMD-92-52, June 1, 1992).

Insurance Regulation: The Financial Regulation Standards and Accreditation Program of the National Association of Insurance Commissioners (GAO/T-GGD-92-27, Apr. 9, 1992).

Securities Markets: Challenges to Harmonizing International Capital Standards Remain (GAO/GGD-92-41, Mar. 10, 1992).

Audit Committees: Legislation Needed to Strengthen Bank Oversight (GAO/AFMD-92-19, Oct. 21, 1991).

Credit Unions: Reforms for Ensuring Future Soundness (GAO/GGD-91-85, July 10, 1991).

Failed Banks: Accounting and Auditing Reforms Urgently Needed (GAO/AFMD-91-43, Apr. 22, 1991).

Bank Supervision: Prompt and Forceful Regulatory Actions Needed (GAO/GGD-91-69, Apr. 15, 1991).

Deposit Insurance: A Strategy for Reform (GAO/GGD-91-26, Mar. 4, 1991).

U.S. Government Securities: More Transaction Information and Investor Protection Measures Are Needed (GAO/GGD-90-114, Sept. 14, 1990).

Investment Advisers: Current Level of Oversight Puts Investors at Risk (GAO/GGD-90-83, June 26, 1990).

Financial Services Industry Issues
(GAO/OCG-89-4TR, Nov. 1988).

Transition Series

Economics

Budget Issues (GAO/OCG-93-1TR).

Investment (GAO/OCG-93-2TR).

Management

Government Management Issues (GAO/OCG-93-3TR).

Financial Management Issues (GAO/OCG-93-4TR).

Information Management and Technology Issues (GAO/OCG-93-5TR).

Program Evaluation Issues (GAO/OCG-93-6TR).

The Public Service (GAO/OCG-93-7TR).

Program Areas

Health Care Reform (GAO/OCG-93-8TR).

National Security Issues (GAO/OCG-93-9TR).

Financial Services Industry Issues (GAO/OCG-93-10TR).

International Trade Issues (GAO/OCG-93-11TR).

Commerce Issues (GAO/OCG-93-12TR).

Energy Issues (GAO/OCG-93-13TR).

Transportation Issues (GAO/OCG-93-14TR).

Food and Agriculture Issues (GAO/OCG-93-15TR).

Environmental Protection Issues (GAO/OCG-93-16TR).

Natural Resources Management Issues (GAO/OCG-93-17TR).

Education Issues (GAO/OCG-93-18TR).

Labor Issues (GAO/OCG-93-19TR).

Health and Human Services Issues (GAO/OCG-93-20TR).

Veterans Affairs Issues (GAO/OCG-93-21TR).

Housing and Community Development Issues (GAO/OCG-93-22TR).

Justice Issues (GAO/OCG-93-23TR).

Internal Revenue Service Issues (GAO/OCG-93-24TR).

Foreign Economic Assistance Issues (GAO/OCG-93-25TR).

Foreign Affairs Issues (GAO/OCG-93-26TR).

NASA Issues (GAO/OCG-93-27TR).

General Services Issues (GAO/OCG-93-28TR).

*U.S.G.P.O.:1993-336-740

Ordering Information

The first copy of each GAO report and testimony is free. Additional copies are $2 each. Orders should be sent to the following address, accompanied by a check or money order made out to the Superintendent of Documents, when necessary. Orders for 100 or more copies to be mailed to a single address are discounted 25 percent.

Orders by mail:

U.S. General Accounting Office
P.O. Box 6015
Gaithersburg, MD 20877

or visit:

Room 1000
700 4th St., NW (Corner of 4th & G Sts., NW)
U.S. General Accounting Office
Washington, DC

Orders may also be placed by calling (202) 512-6000 or by using FAX number (301) 258-4066.

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

Official Business
Penalty for Private Use $300

First-Class Mail
Postage & Fees Paid
GAO
Permit No. G100