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BANKS AND THRIFTS:

Safety and Soundness Reforms Need to be Maintained

Statement of Charles A. Bowsher
Comptroller General of the United States

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BANKS AND THRIFTS

Safety and Soundness Reforms Need to be Maintained

Summary of Statement by Charles A. Bowsher

Comptroller General of the United States

GAO'S testimony discusses the key safety and soundness provisions of the landmark Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA); the condition of the banking and thrift industries and of the funds that insure them; two concerns being raised prominently today: the volume of bank lending and regulatory burden; and implications of all of this for congressional oversight and the legislative agenda for banking.

GAO's overriding message is the importance of following through on the implementation of the key safety and soundness provisions of FDICIA. There is much still to be done to realize the promise this legislation holds for helping both the industry and the deposit insurance system regain sound financial footing.

The banking industry reported strong earnings performance in the first nine months of 1992, and there are welcome signs that the health of much of the industry is improving. However, the future of both the economy and the banking system remains uncertain. Furthermore, the deposit insurance funds for both banks and thrifts are severely undercapitalized.

FDICIA AND ITS IMPLEMENTATION

Since 1980, approximately 2700 banks and thrifts have failed, costing roughly $200 billion to-date. FDICIA reforms are essential for protecting healthy banks and the taxpayers from rising deposit insurance costs. Through several key provisions that complement each other, the act provides incentives for market participants and the regulators to bring their systems for identifying and controlling risk in line with the increased riskiness and complexity of today's financial marketplace. The key provisions are (1) prompt corrective action to close institutions before their capital runs out; (2) management and auditing reforms that highlight private sector responsibility for protecting the taxpayers from losses; (3) accounting reforms to provide accurate information to management, regulators and the public; (4) annual, on-sight examinations for most banks to detect problems on a more timely basis; and (5) changes in the way banks are closed so that uninsured depositors and general creditors will be more likely to share in the losses if a bank fails. Congressional oversight of each of these areas will be crucial in the years ahead.

CONDITION OF THE BANKING AND THRIFT INDUSTRIES AND OF THE DEPOSIT INSURANCE SYSTEM

The condition and performance of the nation's commercial and savings banks improved substantially during the first nine months of 1992. However, it is too soon to conclude that problems in the industry are over. Banks still have many problem assets on their books, the current interest rate environment that has helped the industry to be profitable could change quickly, and current accounting rules limit the accuracy of reported financial information.

BIF ended the first nine months of its 1992 operations with unaudited net income of $2.9 billion. This net income reduced the Fund's unaudited deficit to $4.1 billion as of September 30, 1992. (In 1991 the fund lost about $11 billion--and ended 1991 with a deficit balance of $7 billion, the first in its history.) A number of the banks for which FDIC made a provision for loss in 1991 have not yet failed, and the agency is continuing to monitor the condition of these banks closely. GAO is currently reviewing the Fund's estimated liability from troubled banks as part of our audit of the Fund's December 31, 1992, financial statements.

FDIC now anticipates that over the next several years it will be able to meet the FDICIA target of building BIF reserves to 1.25% of insured deposits by the year 2007, as FDICIA requires. There are many uncertainties surrounding any projection. However, BIF is still insolvent and will remain undercapitalized for a number of years even if insurance losses decline in the next few years. An undercapitalized insurance fund damages the credibility of the prompt corrective action reforms contained in FDICIA because if BIF isn't well capitalized regulators may be reluctant to act on a timely basis.

There is evidence that the healthy portion of the thrift industry is also continuing to show gradual improvement. However, the deposit insurance system for thrifts is seriously underfunded. RTC doesn't have the funds it needs to close thrifts that are already in conservatorship. In addition, assets that total $210 billion--about 25% of the industry--are in institutions that are considered by OTS to be troubled and/or likely to fail. Congress needs to provide RTC with the funding it needs to handle its remaining and anticipated cases, and should also be certain that SAIF is adequately capitalized to meet its responsibilities.

CREDIT AVAILABILITY AND REGULATORY BURDEN

Although FDICIA should be effective in reducing insurance fund losses, concerns have been raised that it is having the undesirable side effects of restricting bank lending and of adding to the costly burden of regulation on the industry. GAO believes that close examination of these important concerns shows that vigorous implementation of the safety and soundness provisions of FDICIA is consistent with efforts to strengthen the economy and streamline the regulatory process.

There is substantial anecdotal evidence that some borrowers have had difficulties in obtaining loans, which is not surprising, given the number of bank failures that have occurred, the number of problem banks that still exist, and the state of the economy. GAO questions, however, the claims of many critics that efforts to improve the safety and soundness of the banking industry somehow work against efforts to strengthen the economy. Over time, a healthy banking industry is the best support for the economy.

An assessment of complaints about regulatory burden needs to consider both the costs of regulation as well as the benefits to the industry, consumers and the public. By their nature, depository institutions are going to be subject to a considerable amount of regulation to protect the taxpayers and the public. Banks also benefit from the right to raise insured deposits, access to the Federal Reserve's discount window, and protection from competition. These benefits have allowed banks to operate with lower amounts of equity capital than markets would otherwise require.

While it is true that FDICIA increased the amount of regulation, this was needed to correct safety and soundness problems. When properly implemented, the burden on healthy banks should be reduced as their deposit insurance premiums drop, and the greatest burden of new regulations should fall principally on weakly managed, poorly capitalized banks.

GAO applauds the efforts by regulators to streamline the administration of existing regulations. GAO also believes there are opportunities for simplifying the regulatory structure that should be considered.

SUCCESSFUL IMPLEMENTATION OF FDICIA PROVIDES A FOUNDATION FOR OTHER EFFORTS TO MODERNIZE THE BANKING INDUSTRY

Banks increasingly find themselves competing with other firms and Congress will no doubt be asked to address a variety of level playing field issues in the years ahead. The more successful the act's implementation, the more possible it becomes to take up other modernization questions. Implementation of FDICIA is, therefore, right at the top of the modernization agenda.

In going beyond questions of efficiency in banking, the issues that Congress must deal with are not easy ones. They raise more general questions--such as what deposits should actually be covered by deposit insurance and the appropriate uses for insured deposits. Furthermore, because banking and other financial services industries overlap in so many areas, it is not realistic to deal with some of these questions simply from the point of view of the banking industry alone. Congress must establish a regulatory framework that assures the financial system as a whole is safe and sound, that efficient service is available on an equitable basis to all segments of the public, and that the nation's savings are used to help create the jobs that are the strength of our society.

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Mr. Chairman and Members of the Committee:

We are pleased to be here to discuss the landmark 1991 bank reform legislation, the condition of the banking and thrift industries, and the state of the deposit insurance system. In keeping with the Committee's request, my testimony covers quite a bit of ground. I will:

-- review the factors that prompted Congress to pass the safety and soundness provisions of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) and summarize the progress being made on the implementation of those provisions;

-- discuss the current condition of the industry, the outlook for the Bank Insurance Fund (BIF), and the importance of FDICIA's implementation for reducing future BIF losses;

-- discuss the condition of the thrift industry, the Savings Association Insurance Fund (SAIF), and the Resolution Trust Corporation (RTC); and

-- comment on two concerns that are being raised prominently today: the volume of bank lending and regulatory burden.

I will conclude with some observations on the implications of all of this for congressional oversight and the legislative agenda for banking.

The overriding message in my testimony is the importance of following through on the implementation of the key safety and soundness provisions of FDICIA. A year after the enactment of FDICIA, Congress and the American taxpayer can take satisfaction in what has been accomplished. However, to realize the promise of this important legislation, it is crucial that Congress hold fast to the course that has been charted.

It will take time for market participants and regulators to change old ways associated with times when banks did not operate in markets that are as competitive as they are today. But accomplishing these changes is needed to protect healthy banks and the taxpayers in today's financial world. Strengthening the banking system in this way will also help to strengthen the economy. Many key regulations have yet to be put in place, though, and we have concerns in some areas that I will describe later about the progress being made. For these reasons, congressional oversight of the act's implementation is crucial.

The banking industry reported strong earnings performance in the first nine months of 1992, and it appears that there are signs that the health of much of the industry is improving. However, the future of both the economy and the banking system remains uncertain. Banks have many problem assets on their books, the interest rate environment that has been so favorable could change quickly, and under current accounting rules we cannot place too great a reliance on reported financial information. Furthermore, the deposit insurance funds for both banks and thrifts are severely undercapitalized, and the significant problems that exist in large segments of both industries suggest that more failures can be expected.

The year ahead thus promises to be a crucial one for the industry and for the deposit insurance system. While it is too early to fully judge FDICIA's effectiveness, properly carried out, it should set the stage for additional legislative action to continue to modernize the banking system.

WEAKNESSES IN BANK MANAGEMENT AND BANK SUPERVISION PROMPTED NEED FOR REFORMS

Deposit insurance permits a bank or thrift to raise about $13 or more in liabilities, most of which are typically insured deposits, for every $1 invested in the institution by its owners. With so little capital relative to the amount of liabilities, a bank can easily become insolvent and impose costs on the deposit insurance funds if it suffers losses on its assets. Effective systems for managing and controlling risk--by both bank management and regulators--are therefore essential for protecting the insurance funds from losses.

For about 50 years federal deposit insurance was widely regarded as one of the government's most successful programs. For many years, legal restrictions that insulated banks and thrifts from competition and helped to ensure their profitability contributed to the success of the program. Thus, with low insurance premiums and at no cost to the taxpayers, deposit insurance protected depositors and contributed to the great stability enjoyed by the banking and thrift industries. However, as this Committee is painfully aware, things changed. The financial world grew more complex and banks and thrifts faced new risks and greater competition from nondepository institutions. Since 1980, approximately 2700 banks and thrifts have failed, costing roughly $200 billion to-date.

In the past 5 years the banking and thrift industries paid approximately $25 billion in deposit insurance premiums. Most of the money was used to pay for the mistakes and excesses of poorly managed institutions. But the premiums were insufficient. Taxpayers were also called on to pay for the lion's share of the insurance losses in the savings and loan industry--some $100 billion. In addition, FDIC has borrowed to finance its cash flow requirements for resolving bank failures. These borrowings reached $15 billion in June, 1992 and were $10.1 billion as of December 31, 1992.

As BIF's solvency eroded in 1991, it became obvious that Congress needed to do more than shore up BIF. However, a practical, effective program for reducing the deposit insurance bills that would have to be paid by healthy banks and taxpayers was not so obvious. The regulatory system had failed to keep pace with the increased riskiness and complexity in the bank and thrift industries and was in dire need of reform. A host of other factors--some economic, some technological, some legal, some involving the credit cultures that have developed in banks and elsewhere in the economy--also contributed to the crisis that existed in the deposit insurance system. Most of these were not easily controlled by legislation; for the most part many of these factors had to be accepted as part of the competitive environment within which depository institutions operated. So when you came right down to it, there were basically three courses of action available to bring the finances of the deposit insurance system into balance.

One option was to scrap or drastically revise the deposit insurance system. However, this was risky in view of its role in maintaining the public confidence that continued to exist in the banking system despite all of its problems. And there was no consensus on how to do this.

A second option was to expand the powers of banking organizations in the hope that this would enable institutions to become more profitable. This was risky, too. To be sure, the business of banking certainly has changed in response to financial market developments, such as the increased ability of many corporations to bypass banks and directly access capital markets. However, given the competitive nature of the U.S. financial markets, it was quite possible that more money would be lost in ill-founded attempts to find new profit sources. Such attempts drastically increased the losses from thrift failures in the 1980s and early 1990s.

This left the third option: reform the way banks are regulated and supervised to bring these activities in line with the realities of today's financial marketplace. This option, the one that Congress adopted in FDICIA, might seem to be relatively mundane because it essentially emphasizes doing a better job at what regulation has always been expected to accomplish. But it was appropriate because an immediate response was needed, and improving the existing regulatory system was the most direct and least risky approach to accomplish these ends.

While FDICIA was the appropriate option in 1991, its passage does not negate the merits of seeking longer run improvements to the country's strategy for organizing and regulating its financial system. FDICIA does require greater regulatory involvement in banking, lending some credence to the need to carefully assess regulatory burden. However, as I have often testified in the past, long range modernization efforts for the financial system are best accomplished from a sound footing and not in a panicked or rushed atmosphere. I view FDICIA as the bridge from a weakened depository system to a sounder, more competitive system in the future. For now, FDICIA's regulatory reforms should reduce some of the extraordinary risks inherent in the existing system.

FDICIA IMPROVES INCENTIVES FOR SUPERVISORS, MANAGERS, OWNERS, AUDITORS, AND DEPOSITORS TO PROTECT BIF

Accepting deposits and investing them in loans makes banking an inherently risky business. Properly done, this activity makes a vital contribution to the economy. In recent years, however, the corporate governance, market discipline, and bank supervision systems used to manage and limit risk broke down all too frequently. For example, general credit standards deteriorated in many banks and thrifts in the 1980s. Furthermore, regulators provided limited deterrent to such behavior. They were often slow to take meaningful action to correct problems in weak institutions. GAO has reported many times that the regulators need to act promptly and forcefully to guard against disastrous insurance fund losses.[1] We will soon report on serious weaknesses in the bank examination process as well.

In passing FDICIA, Congress sought to reverse these trends. The various safety and soundness provisions of the act all focus on a simple principle: if an institution fails to operate in a safe and sound manner, it should be subject to timely and forceful supervisory response, including, if necessary, prompt closure. This approach does not prohibit risk-taking or constrain prudent lending by banks. Rather, it seeks to have such risk-taking and

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[1]See, for example, Bank Supervision: OCC's Supervision of the Bank of New England Was Not Timely or Forceful, (GAO/GGD-91-128, September 16, 1991), Bank Supervision: Prompt and Forceful Regulatory Actions Needed, (GAO/GGD-91-69, April 15, 1991), Deposit Insurance: A Strategy for Reform, (GAO/GGD-91-26, March 4, 1991), Troubled Financial Institutions: Solutions to the Thrift Industry Problem, (GAO/GGD-89-47, February 21, 1989), Bank Powers: Issues Related to Repeal of the Glass-Steagall Act, (GAO/GGD-88-37, January 22, 1988), Thrift Industry: Forbearance for Troubled Institutions 1982-1986, (GAO/GGD-87-78BR, May 6, 1987), and Thrift Industry: Cost to FSLIC of Delaying Action on Insolvent Savings Institutions, (GAO/GGD-86-122BR, September 9, 1986).

lending undertaken by banks that have effective management and the capital to control and absorb the costs of that risk-taking.

The basic principle of the act makes sense and is easy to understand. It involves a concerted effort to shift the costs of risk-taking away from the deposit insurance system and back to the failing institutions themselves. Although such a shift is consistent with how one would expect banks to operate in a market economy, it requires a fundamental change in the way many bank managers, owners, uninsured depositors, other creditors, and regulators think about risk.

In turning to the key safety and soundness provisions in FDICIA, I will try to highlight how they strengthen the industry's ability to serve the economy, and describe the status of their implementation. But in doing so I want first to emphasize that these provisions which affect regulators and various market participants should not be viewed in isolation from each other. Many of FDICIA's critics fail to grasp this essential feature and we are concerned with efforts that may be mounted to weaken some of the act's key provisions.

FDICIA's success depends largely on the behavior of regulators. It gives them a clear mandate and the tools to carry out that mandate. However, given the importance of control mechanisms in banking, it is unrealistic to expect bank supervision to bear all of the responsibility for change. Banks' internal control mechanisms also need to promote safe and sound banking practices. Thus, new accounting and auditing requirements in FDICIA should improve the quality of information available to bank managers and owners. And corporate governance changes should focus the attention of management and directors on the condition of their institutions and on their fiduciary responsibility to manage risk properly. Finally, least cost resolution and changes in deposit insurance coverage encourage greater market discipline by placing uninsured deposits more explicitly at risk.

<u>Prompt Corrective Action is the Linchpin of Supervisory Reform</u>

From 1985 through 1991, BIF's insurance losses from failed banks have averaged about 15 percent of the book value of the assets of those banks. By requiring bank and thrift regulators to take prompt corrective action when an institution becomes troubled, Section 131 of FDICIA seeks to minimize such losses. More than any other provision, this one can be expected to generate the needed change in mindset of both bankers and regulators.

Section 131 focuses largely on a bank's capital. It requires regulators to establish 5 categories for banks depending upon their capital, ranging from well capitalized to critically undercapitalized.[2] Institutions in the lower categories are subject to progressively stronger supervisory remedies and sanctions. In addition, if an institution is determined to be in an unsafe or unsound condition or it is engaging in unsafe or unsound practices, regulators may downgrade the institution's capital category and thus take the stronger supervisory actions available for that lower category. Section 131 provides lists of possible supervisory actions and requires regulators, in specified circumstances, to select at least one of them to be taken in response to an institution's problems. An institution that is critically undercapitalized--one which has a tangible equity[3] of 2 percent or less compared to total assets--must generally be placed in receivership within 90 days unless another action would better minimize the insurance fund's losses.[4] Closing institutions when they still have a small positive book value should reduce insurance fund losses, benefitting both taxpayers and healthy banks.

The prompt corrective action provisions of section 131 became effective on December 19, 1992. These provisions incorporate existing risk-based capital standards agreed to by bank regulators in industrialized countries--the Basle standards--used to define adequately capitalized institutions. Thus, the basic standard is not new, although it does add a new category called well-capitalized. Some observers believed implementation of prompt corrective action would lead to the immediate closing of

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[2]The agencies have specified three different capital ratios for the purposes of this section, and institutions are measured using each one. These are (1) total capital to risk-weighted assets, (2) tier 1 capital to risk-weighted assets, and (3) tier 1 capital to average total assets, known as the leverage ratio. Tier 1 capital consists primarily of tangible equity capital. Tier 2 capital includes subordinated debt, loan loss reserves (both subject to maximum limits), and certain other instruments. Total capital is the sum of tier 1 and tier 2 capital. Risk-based capital standards assign a risk weighting to each bank asset, based on the asset's relative default risk. These weights range from zero for assets such as cash and U.S. Treasury securities to 100 percent for most bank loans.

[3]For purposes of classifying a bank as critically undercapitalized, regulators have set the ratio of tangible equity to total assets as the sole relevant measure. Tangible equity is equity capital plus outstanding cumulative preferred stock (including related surplus) minus all intangible assets except for some amount of purchased mortgage servicing rights.

[4]A determination to pursue an action other than receivership requires concurrence of the bank's federal regulator and the FDIC, and the reason for the action taken must be documented.

many banks. The fear of this so-called "December Surprise" proved to be exaggerated. Based on September 30, 1992 data, 14 large banks met the critically undercapitalized classification. Since then, 10 of these have been closed by regulators. Of the remaining 4 large banks, FDIC expects that 2 banks are more likely than not to fail in the near future.

A number of reasons, including recent improvements in bank profitability, can be cited for why so few banks were closed when the deadline arrived. I submit that one of those reasons is that depository institutions were reacting to incentives built into the act. That is, owners and managers in many weak institutions responded by raising capital, shrinking, or arranging to be acquired. This is exactly how the incentives built into the act are supposed to work.

Section 132 of FDICIA adds a non-capital component to the prompt corrective action provisions. Among other things, it requires regulators to establish various operational and managerial standards in the areas of internal controls, information systems, internal audit systems, loan documentation, credit underwriting, interest rate exposure, and asset growth. Regulations defining such standards must take effect no later than December 1, 1993. If an institution does not have systems consistent with the regulatory standards, it must submit a plan to correct these deficiencies. Failure to submit or implement a plan subjects the institution to regulator's corrective orders or other sanctions.

We believe Section 132 is also crucial to successful implementation of prompt corrective action. Because falling capital levels are a lagging indicator of problems in a bank, this section provides regulators a basis for acting earlier to correct unsafe and unsound practices.

Section 132 has been widely misunderstood to call for highly detailed and restrictive rules for bank behavior. For example, some are concerned that strict credit underwriting rules promulgated under this section could prevent or discourage banks from making "character loans," that is, loans where the bank has to rely on the character of the borrower because the borrower does not have adequate collateral. However, I see no reason why the agencies' standards in credit underwriting would lead to such a result, nor does FDICIA require it. On the contrary, supervisory manuals and agency directives have long provided examiners with guidelines and criteria for evaluating banks in many of the areas specified by this section.

Last year, the agencies asked for public comment about what the standards should be. I do not believe that there are grounds for assuming that the standards, which must take effect no later than December 1, 1993, will be unreasonable. In general we think it will be salutary for banks to understand more specifically the standards regulators will use in examining their institutions, and what the consequences will be in given situations. For the most part, well run banks have developed their own standards in many of these areas, and we expect that their standards will be consistent with those established in regulation.

Let me now turn to other safety and soundness provisions in FDICIA. As I mentioned earlier, most of these provisions directly follow from, or are in support of, the prompt corrective action provisions.

Management and Auditing Reforms Highlight Private Sector Responsibility for Reducing Insurance Fund Losses

An effective corporate governance system is the first line of defense to ensure an institution's safety and soundness. How well an institution's board of directors and management fulfill their responsibilities, as well as the effectiveness of the institution's audit committee, greatly affect the soundness of a bank's policy and operating decisions as well as the timely identification and correction of unsound operations. This is not merely a regulatory concern. A bank's stockholders, debt holders, uninsured depositors, employees, and community all depend on the corporate governance system to properly discharge its fiduciary responsibilities.

Our reports on bank and thrift failures showed that the corporate governance system upon which so many depend was seriously flawed.[5] The failed institutions we examined had serious internal control problems, which regulators cited as contributing significantly to their failure. These problems included weaknesses in loan portfolio management, inadequate loss reserves, and deficiencies in the operating systems and procedures relied on by Boards of Directors and senior management. Had these problems been corrected, the institutions might not have failed or their failure could have been less expensive to the insurance funds.

Section 112 of FDICIA requires insured banks and thrifts with assets of $150 million or more--about 3100 institutions with 87 percent of all bank and thrift assets as of June 30, 1992--to report annually to federal regulators on their financial condition and management for fiscal years beginning after December 31, 1992. The report is to include management's

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

assessment of (1) the effectiveness of the institution's internal control structure and procedures and, (2) the institution's compliance with applicable laws and regulations. This report must be signed by the chief executive officer and the chief accounting or financial officer of the institution. In addition, the act requires the institution's external auditor to report separately on management's assertions.

A strong internal control system provides the framework for the accomplishment of management objectives, accurate financial reporting, and compliance with laws and regulations. Effective internal controls serve as checks and balances against undesired activities and, as such, provide reasonable assurance that banks and thrifts operate in a safe and sound manner.

The Section 112 requirements are intended to (1) focus management's attention on its accountability for internal controls and compliance with laws and regulations and (2) improve regulators' ability to detect unsafe and unsound conditions and support prompt corrective action to ensure that deficiencies which may threaten an institution's solvency are corrected in a timely manner. They should significantly enhance the likelihood that examiners will identify emerging problems in banks earlier.

Our recent report on audit committees of banks with assets of $10 billion or more raised serious concerns about the independence and expertise of committee members.[6] Of the 40 audit committee chairpersons responding to our questionnaire, 25 reported their membership included large customers of the bank, 19 reported their members had little or no expertise in banking, and 13 reported their members had no expertise in law and never met independently with the bank's legal counsel.

FDICIA reflects congressional recognition of these concerns and of the integral role of audit committees in systems of corporate governance for insured depository institutions. Section 112 requires institutions with assets of $150 million or more to have independent audit committees comprised entirely of outside directors whose duties include reviewing the bases for the management report I just described. In addition, the act requires the audit committees of large institutions to (1) include members with banking or related financial management expertise, (2) have access to their own outside counsel, and (3) exclude any large customers.

The audit committees of insured depository institutions required under FDICIA should have the independence, personnel and financial resources, information, and authority necessary for

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

them to effectively fulfill their corporate governance role. This should lead to earlier identification and correction of deficiencies in internal controls and compliance with laws and regulations, and more reliable information for management, regulatory agencies, and the public.

All of the corporate governance reforms contained in Section 112 that I have discussed were effective on December 31, 1992, and become applicable to each institution with its fiscal year that begins after that date. The regulators have published proposed regulations to implement these reforms. We have advised FDIC that the draft regulations, for the most part, are a good start but need considerable enhancement in several critical areas. The draft regulations excluded controls for safeguarding of assets and lacked the specificity to ensure consistent and effective management assessment and reporting on internal controls and compliance. These weaknesses will also limit the effectiveness of the independent public accountant's review of management's assertions for these requirements. Similarly, the proposed regulations lacked certain requirements necessary to shape effective independent audit committees. Unless modifications are made to strengthen the final regulations in these areas, the expected benefits from the act's internal control and corporate governance provisions will be significantly diminished.

Accounting Reforms are Necessary to Provide Accurate Information Needed for FDICIA Reforms to be Fully Effective

The adequacy of financial information reported by banks to the regulators is critical to successful implementation of prompt corrective action. This is because accounting rules are used to define a bank's capital level, and regulatory actions are triggered in large measure by those reported capital levels. Accordingly, Section 121 of the act provides that accounting principles applicable to reports or statements required to be filed with Federal banking agencies by insured depository institutions should (1) result in financial statements and reports of condition that accurately reflect the institution's capital; (2) facilitate effective supervision; and (3) facilitate prompt corrective action to resolve the institutions at the least cost to the insurance funds.

Section 121 also requires the banking and thrift regulators to review the accounting principles used by depository institutions with respect to regulatory reporting and modify any such principles that are not consistent with generally accepted accounting principles (GAAP). Further, if the regulators determine that the application of GAAP was inconsistent with the objectives stated above, the regulators are directed by the act to prescribe an appropriate accounting principle for regulatory reporting purposes. Any modifications in accounting principles are to be no less stringent than GAAP. The act also requires that regulators issue guidance regarding reporting of off balance sheet items and disclosure of the estimated market values of assets and liabilities.

We have repeatedly stated our concern that the flexibility of current accounting rules enables banks to conceal loan losses, and consequently, loss reserves may continue to be understated.[7] The level of loan loss reserves necessary is a matter of management judgment based upon an assessment of the collectability of outstanding loans. Because of the negative impact of these losses upon the reported financial conditions of banks, there is an incentive for the management of weak banks to use the latitude in accounting rules to delay loss recognition as long as possible, resulting in inaccurate financial reports that impede early warning of troubled banks and increase insurance fund losses.

The Financial Accounting Standards Board[8] (FASB) issued a proposed statement of financial accounting standards, Accounting by Creditors for Impairment of a Loan, for public comment in June of 1992. In commenting on the proposed standard, we expressed concern that the standard, as drafted, would not result in full recognition of losses on nonperforming loans because fair market value concepts were not required to be used in deriving these loss estimates. The FASB recently met to discuss their position on the draft standard and is considering several changes which would result in a somewhat more realistic measure of losses from impaired loans. We are encouraged by this progress and hope for more. However, substantive revision of the standard, as we have recommended, may delay the FASB rulemaking process such that the effective date of the new standard would be after 1994. Therefore we remain concerned, both with the effective date, and whether the final standard, when ultimately adopted, will be sufficiently definitive in requiring fair value accounting for nonperforming loans.

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[7]Our review of 39 banks that failed in 1988 and 1989 showed that flexible accounting standards allowed problem banks to unduly delay recognizing losses in their loan portfolios and to overstate the value of real estate acquired through foreclosure, thus overstating their capital. The magnitude of FDIC's adjustments to the loss reserves of these banks at the time of their failure showed that $7.3 billion in reported bank capital did not exist. See Failed Banks: Accounting and Auditing Reforms Urgently Needed (GAO/AFMD-91-43, April 22, 1991).

[8]FASB is the accounting rule setting body that promulgates accounting principles, commonly known as generally accepted accounting principles, for private sector financial reporting. Financial reports required by bank and thrift regulations are, for the most part, consistent with these accounting principles.

The potential magnitude of unrecognized losses on nonperforming loans was recently demonstrated in an article in the Wall Street Journal. This article reported recent writedowns of problem real estate loans by some of the nation's largest banks of 40 percent to 60 percent of the face value of those loans. These writedowns, which in one case reportedly amounted to as much as $1 billion, were taken in anticipation of selling the problem loans, which indicates that the loans were not previously recorded at amounts reflective of their fair market values.

We have also recently reviewed fiscal year 1991 data which indicates that the year-end book value of the stock of a number of the largest banks in the country was higher than the reported market value of the stock. The Chief Accountant of the Securities and Exchange Commission in commenting on this same data questioned whether accounting for these institutions was realistic. These data, combined with the writedowns described above, adds credence to our belief based on our previous work that some banks and thrifts have inflated balance sheets. Until the banking and thrift regulators issue definitive guidance requiring fair value accounting for problem loans, asset values and capital of many financial institutions will continue to be overstated, and regulatory intervention for weak banks may be unduly delayed.

We are also concerned that flexible accounting rules allow banks to recognize gains while deferring losses on debt investment securities. Recently proposed changes by FASB to the accounting rules for debt and equity securities are not likely to deter this type of abusive management practice--known as "gains trading" or "cherry picking." We believe fair value accounting should be required for all investment securities to avoid continued misleading financial reporting of these assets.

Another area where flexible accounting rules may be abused is accounting for related party transactions. The ambiguities in these accounting rules may allow bank holding companies to record income and require bank subsidiaries to record expenses for transactions which have the appropriate legal form, such as written service contracts and sales agreements, but in reality have provided little or no benefit to the bank. Further, the ambiguity in the accounting rules increases the possibility that intercompany transactions that place a drain on the insured bank's resources, but which have no real economic substance, may go unchallenged by auditors and regulators.

Finally, little authoritative accounting guidance currently exists for derivative products that are widely used by financial institutions today. While these products are often used to reduce risk in an institution's portfolio, their rapid growth and complexity heighten the need for definitive accounting guidance in this area.

The accounting reforms required by the act were to be completed by December 19, 1992, but had not been fully carried out by regulators as of January 15, 1993. However, based on the regulators' response to our previous recommendations on loan loss accounting and FASB'S failure to take timely definitive action to address these problems, we believe further prompting of the regulators to take action will be needed. The effectiveness of the act's capital standards, intended to minimize losses to the insurance funds, will be diminished unless accounting rules that contribute to inflated reporting of capital levels are tightened.

Improved Examinations are Essential to Promote Safe and Sound Financial Institutions

In 1990, in response to concerns that potential bank failures were not being identified early enough by regulators, we recommended to Congress that on-site full scope examinations of all problem and large banks be performed by regulators annually.[9] Beginning December 19, 1992, Section 111 of FDICIA generally requires annual full scope examinations for banks with assets greater than $100 million.

Our on-going work reviewing bank and thrift examinations, which will be completed shortly, raises concerns about the quality of these examinations. Two primary areas of concern are the review of loan quality and related loan loss reserves, and the review of internal controls. No minimum standards exist in these or other critical areas to ensure that "full scope" examinations are thoroughly covering all critical areas of bank or thrift operations. These and other examination issues will be discussed more fully in our upcoming reports on this work. However, suffice it to say that the examination deficiencies we found must be corrected for the successful implementation of this and other sections of FDICIA.

Least-Cost Resolutions Are Intended to Reduce Insurance Fund Losses and Change Incentives

The FDICIA provisions I have already discussed are intended to get banks and regulators to address problems early. To help accomplish this, Section 141 of FDICIA changed the way failed banks are resolved so that depositors over the $100,000 insurance limit and general creditors will be more likely to incur part of the losses that formerly have fallen almost exclusively to BIF and/or taxpayers. As a result, uninsured depositors and creditors have a greater incentive to monitor banks and remove their funds when a problem appears. This also means that banks

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

with uninsured sources of funding have an incentive to convince the public that they are sufficiently capitalized and effectively managed.

Section 141 requires FDIC to meet its insurance obligations using the resolution method that is least-costly to the insurance fund. FDICIA's only exception to this least-cost requirement is for cases where it would "have serious adverse effects on economic conditions or financial stability."[10] Such an exception must be approved by two-thirds of the FDIC Board, two-thirds of the Federal Reserve Board, and by the Secretary of the Treasury.

The effect of least-cost resolutions is already becoming apparent. In the three years before the passage of FDICIA, uninsured depositors absorbed losses in about 14 percent of failed banks. This was because, before least-cost resolutions were required, FDIC could more actively pursue resolution methods that usually resulted in de facto insurance coverage for uninsured deposits.[11] That is, FDIC tried to find acquirors for failed banks that would buy most or all assets and liabilities, which meant taking all deposits, not just those that were otherwise insured by FDIC. Subsequent to FDICIA, uninsured depositors absorbed losses in 49 percent of the failed banks. FDIC projects that losses absorbed by uninsured depositors in 1992 will be approximately $80 million; this amounts to about 2 percent of total expected losses in all 1992 failed banks. While it appears that FDIC is approaching resolutions in a way consistent with the congressional intent, we are currently analyzing the adequacy of FDIC's process for ensuring compliance with the least cost provisions and we will be reporting our results to you later this year.

We are not yet in a position to judge how effective the incentive of placing uninsured deposits at greater risk of loss will be. Although the least-cost requirement took effect upon passage of FDICIA, it is too early to tell how responsive uninsured depositors will be to this changed risk. We are concerned though, that some in the general public may not yet be aware of how the risks associated with uninsured deposits have changed.

This concern is increased by the fact that Section 311 of FDICIA made several changes which add even more complexity to existing insurance coverage. For example, depositors with various retirement accounts that previously were separately insured prior to FDICIA are potentially at risk because different retirement accounts belonging to one individual are to be aggregated for

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[10] FDICIA section 141 (a)(1)(C).

[11] Prior to FDICIA, FDIC could use any resolution method so long as the cost was less than that of a deposit payoff.

insurance purposes. Also, pass-through coverage given to the individual participants in employee benefit and deferred compensation plan accounts will now be granted only if the bank is allowed to accept brokered deposits.

Part of this concern about public awareness may be satisfied over time with added publicity, but there may be difficulties in doing this well. For example, the coverage rules instituted with Section 311 may be quite complicated for people to understand. Another difficulty relates to the adequacy of information available for depositors to assess their bank's condition so as to judge the potential risk of placing uninsured deposits in that bank. Until accounting and financial information reporting by banks is improved along the lines required by FDICIA, even depositors that understand the potential risk associated with uninsured deposits may not have adequate information on which to determine the relative riskiness of their uninsured deposits. As a matter of oversight, there may be a need to fix responsibility for ensuring that banks, upon request, promptly and completely disclose all pertinent information regarding their financial condition.

Information problems get more complex when a bank is part of a multi-bank holding company. There, the failure of one of the holding company's banks may result in the failure of its other banks. This is because under provisions adopted by Congress in 1989, FDIC may execute what is known as a cross-guarantee provision to tap the capital in the affiliated banks to cover losses in the failed bank. In general, applying a cross-guarantee protects the insurance fund and prevents a holding company from concentrating its losses in one bank while protecting its others. Yet, it can also have the consequence of imposing losses on unsuspecting uninsured depositors who may be satisfied with the financial strength of their bank, but not be aware that an affiliated bank is in serious trouble. If the troubled affiliated bank fails, it could also bring down the solvent bank because of the application of the cross-guarantee. Both of the failed banks would then be resolved individually, perhaps with one being acquired whole and one being liquidated, depending on the bids from potential acquirors. This means that the least cost resolution of each bank could result in uninsured depositors being protected in the insolvent bank and not in the bank that failed solely because of the cross-guarantee.

As depositors become more aware of the risk of loss on uninsured deposits, those with uninsured deposits may be more likely to withdraw their funds if they believe their bank is in trouble. If such withdrawals became widespread in a bank, it could result in a run on that bank, possibly causing a liquidity crisis for it and bringing about its failure. While there is no evidence that such runs have occurred since FDICIA's passage, FDIC is concerned about potential liquidity failures and is studying this issue to better understand depositor behavior. The possibility of liquidity failures demonstrates why the FDICIA tripwires and accounting rules are so important--the public must have confidence that financial information is accurate and that regulators will act on a timely basis so that uninsured depositors face minimal risk of loss.

When uninsured depositors become more aware of the risks and the monitoring costs involved, there also may be a tendency for them to move their funds out of the banking system to similar products in other types of financial institutions perceived as less risky substitutes for large deposits. However, the degree of safety in some cases may be questionable, as witnessed by the recent failure of some insurance companies. For example, we have reported to Congress weaknesses in how state regulators supervise insurance companies and provide protection to policyholders. In particular, we have observed that questions exist about both the capacity and the fairness of the various state insurance guarantee funds. That is, the funds may not be able to meet their obligations if insurance company failures continue to increase. Moreover, under the current system, the treatment of policyholders with similar claims against a failed insurer depends on the state in which they live.

The discussion of these concerns is not meant to be critical of what was done in FDICIA, but to underscore a matter for congressional oversight that extends beyond implementation of FDICIA--and indeed beyond the banking system. As we look down the road I think it will become harder and harder to ignore addressing some fundamental questions of what the purpose of deposit insurance should be in today's competitive, complex financial marketplace. Who needs to be protected, what types of coverage choices should be offered to consumers, and what types of notification and information should be required?

One of the more perplexing of these longer run considerations is the possibility that some depositors, especially individuals, small businesses, and non-profit organizations, may feel unable or unwilling to monitor and make informed judgments about the condition of their banks. In FDICIA, Congress recognized this concern and required FDIC to study issues relating to it. FDIC is completing the first of these studies, and recognizes that there may be a problem with depositors not fully understanding the insurance status of their deposits. I believe it would be reasonable for this committee to look more closely at ways for depositors to ensure that their interests are protected, as well as looking at whether depositors should have the option of acquiring some sort of insurance for deposits in excess of the $100,000 threshold. As we described in our report on deposit insurance reform[12], this choice could be offered in several ways. Depositors could be given the choice to insure large deposits by paying for such insurance directly or implicitly through a reduced yield. Such added insurance could be offered by FDIC or by a third party. Alternatively, depositors could be provided the opportunity to collateralize deposits over $100,000 with low-risk assets such as Treasury securities.

Foreign Bank Supervision Changes Directed at Improving Information, Shifting Risk

The Foreign Bank Supervision Enhancement Act of 1991 (FBSEA), Title II, Subtitle A, of FDICIA, strengthens federal oversight of foreign bank activities in the United States. FBSEA gives the Federal Reserve Board final authority to both conduct examinations and approve the establishment of foreign bank branches, agencies, and representative offices. Generally, FBSEA applies the incentive-changing focus of the provisions I have already described to the supervision of foreign banks operating in the United States. In particular, these changes are a response to problems in the coordination of foreign bank supervision highlighted by the collapse of BCCI, the Bank of Credit and Commerce International.

Under FBSEA, before approving a foreign bank application to operate a branch or office in the U.S., the Federal Reserve Board must ensure that the bank is subject to comprehensive supervision or regulation on a consolidated basis by the appropriate authorities in its home country. The act requires the Federal Reserve to take into account whether the home country supervisor has consented to the establishment of the bank office in the United States, whether the financial and managerial resources of the foreign bank are adequate, whether the foreign bank has provided the Federal Reserve adequate assurances that information will be available for the Federal Reserve to ensure compliance with the Act, and whether the foreign bank is in compliance with applicable U.S. law.

As is the case with the FDICIA provisions already described, the manner in which FBSEA is implemented will determine both its effectiveness and how it is viewed abroad. Foreign bank supervisors participating in the Basle Committee on Banking Supervision generally support FBSEA's premise that banks seeking to operate internationally should be subject to adequate supervision by their home supervisor, including supervision on a consolidated basis. However, if the U.S. authorization process under FBSEA appears to impose U.S. supervisory practices on other supervisors, or to impose heavy burdens on foreign banks, their

[12] Deposit Insurance: A Strategy for Reform (GAO/GGD-91-26, pages 99-103).

support and cooperation might end. The Federal Reserve is hopeful that in judging foreign bank applicants and the adequacy of their home supervision, the principles it applies will be consistent with those regarding consolidated supervision that have been developed by major international bank supervisors under the auspices of the Basle Committee on Banking Supervision. Applying Basle Committee principles would lend additional weight and legitimacy to a set of principles which represent a consensus of all the major international banking supervisors, including the United States. This could also encourage other countries to follow consolidated, comprehensive supervisory practices.

The key examination provision in the FBSEA gives the Federal Reserve the authority and mandate to conduct and coordinate examinations of branches or agencies of foreign banks operating in the United States. Each branch or agency must be examined on-site at least once every 12 months and the Federal Reserve must coordinate these examinations with the OCC, the FDIC, and the State bank supervisor. This new examination authority will require a major increase in the resources the Federal Reserve Banks devote to examining foreign bank operations in the United States. The Federal Reserve Bank of New York, the reserve bank most impacted by these expanded examination responsibilities, has completed over 50 examinations through August 31, 1992, and has begun to hire additional examiners to meet an even greater workload planned for the future.

The budgetary impact of the additional resources needed by the Federal Reserve Banks can be limited by the act's provision that the costs of Federal Reserve examinations of foreign banking offices in the United States be charged against and collected from the foreign bank or its parent. However, despite what we believe is a clear mandate in the statute to recover these costs, the Federal Reserve has not yet begun to charge foreign banks for any cost of examinations, because it is still trying to resolve the issue of how to fairly work out such charges. The issue is complicated because the foreign banks are already subject to charges for exams by their primary U.S. licensing authority--either OCC or the states.

CONDITION OF THE BANKING INDUSTRY AND OUTLOOK FOR BIF

The condition and performance of the nation's commercial and savings banks improved substantially during the first nine months of 1992, and these trends appear to have continued into the fourth quarter. Not only has there been a dramatic improvement in bank earnings, but there has been additional capital flowing into the industry and some signs of willingness by investors to purchase troubled loans and collateral from banks. While the numbers and size of bank failures continue to be at historically high levels, at this time the trends are downward and thus appear to provide a more favorable outlook than in recent years. I would caution, however, that the problems facing the industry are not yet over. Many banks continue to carry substantial inventories of troubled loans on their books, especially real estate loans. For some of these banks, the recent period of low interest rates may only serve to delay the inevitable. Additionally, although the banking industry has recently enjoyed a period of high earnings made possible by low interest rates and a steep yield curve, the reliability of the data reported by banks that are used to analyze industry performance continues to be affected by the flexible accounting rules I described earlier. Nonetheless, we are hopeful that the improved condition and performance of the industry coupled with implementation of the safety and soundness reforms--and the change in incentives that this will bring about--will contribute to reducing the insurance losses that past experience has shown might otherwise have been expected.

The reported financial condition of BIF also improved during the first three quarters of 1992. The decline in the rate of bank failures and indications that loss rates currently being experienced by the Fund are also declining, have helped the Fund's condition. But this is not to say that the condition of BIF is in any way sound. BIF was still insolvent at September 30, 1992, and it will remain undercapitalized for a number of years even if insurance losses decline in the next few years. The Fund is thus vulnerable to a change in economic conditions or the failure of large banks. An undercapitalized insurance fund damages the credibility of the prompt corrective action reforms contained in FDICIA because if BIF is not well capitalized, FDIC may be reluctant to act on a timely basis.

Concerns Remain Despite Record Profitability

Through September 30, 1992, year-to-date commercial bank earnings totaled $24.1 billion, an increase of 63 percent over the $14.8 billion reported for the same period in 1991. The record profits are attributable to the continued decline in interest rates, the steepness of the yield curve, gains from sales of securities, and modest improvements in overall asset quality as reported by commercial banks. Furthermore, sharply improved earnings after dividends have enabled commercial banks to significantly improve their capital base. This factor, along with the attraction of record amounts of new capital from the financial markets, contributed to a substantial increase in industry capital. For the 12 months ending September 30, 1992, the number of commercial banks declined by 4 percent (to 11,590) and bank assets grew by 1.4 percent (to $3.5 trillion). Equity capital, though, grew at a rate of nearly 12 percent over the last 12 months and totaled about $257 billion at September 30, 1992. As a result, on September 30, 1992, the commercial banking industry's ratio of equity capital to assets equaled nearly 7.4 percent, the highest level in over 25 years.

Savings banks insured by the Bank Insurance Fund also realized substantial increases in earnings during the first nine months of 1992.[13] Savings banks reported aggregate earnings totaling $933 million through September 30, 1992. In contrast, during the first nine months of 1991, savings banks posted aggregate losses totaling $787 million. Like commercial banks, savings banks benefitted from low interest rates and substantial gains on sales of investment securities. However, despite the low interest rates and overall aggregate earnings, 12 percent of savings banks located in the Northeast continued to post losses. At September 30, 1992, savings banks reported total equity capital of $17.1 billion, an increase in one year of over 5 percent. For the 12 months ending September 30, 1992, the number of savings banks declined by 5.4 percent (to 421 banks), and industry assets also declined by 6.2 percent (to $223 billion). The ratio of savings banks' equity capital to assets equaled about 7.7 percent at September 30, 1992, compared to a ratio of 6.9 percent at September 30, 1991.

While the recent improvement in earnings and capital for large segments of the industry are encouraging, it is far too early to conclude that safety and soundness concerns in the banking industry are behind us. There are a number of reasons for concern.

Although the number of commercial banks reporting losses declined significantly during the first nine months of 1992 (from just over 11 percent at the end of 1991 to about 6.5 percent at September 30, 1992), a number of the nation's largest banks continued to be among the least profitable. All told, 8.3 percent of all commercial banks with assets in excess of $1 billion posted losses through the first nine months of 1992.

The number and size of problem banks have declined in the past year and there are indications that this downward trend may

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[13]The September 30, 1992, year-to-date financial information reported by savings banks indicate a modest improvement in asset quality, as both the level of troubled loans and related loss provisioning reported by savings banks at September 30, 1992, have declined from the levels reported one year earlier. During that year, 27 savings banks with $29.3 billion in assets failed. The resolution of these institutions and thus their removal from the financial statistics compiled for the industry at September 30, 1992, account for much of the decreases in reported loss provisioning and related troubled assets in turn improving the reported earnings performance and capital for savings banks as a whole.

continue. However, problem banks still represent a significant segment of the industry. At September 30, 1992, the regulators had identified 993 banks insured by BIF as problem banks. Of these banks, 909 were commercial banks and 84 were savings banks. While the number of problem banks has declined 9 percent during the first nine months of 1992, their average size continues to be significant--$537 million for commercial banks and $838 million for savings banks. Overall, problem banks held about 15 percent of total bank assets--about $558 billion--at September 30, 1992, down slightly from the 17 percent held at December 31, 1991.

Another problem among commercial banks is that troubled real estate loans, particularly construction and commercial real estate loans in the Northeast and in California, remain at high levels. While commercial banks charged off $2.6 billion in real estate loans, the level of troubled real estate loans declined by only $824 million, indicating that real estate loan portfolios are continuing to experience problems.

The level of reserves set aside by commercial banks to cover losses on troubled loans equaled nearly 80 percent of troubled loans at September 30, 1992, their highest level since the first quarter of 1990. Despite this apparently more conservative valuation of problem loans, as I indicated in the earlier discussion on the accounting provisions of FDICIA, we remain concerned that the flexibility of current accounting rules enables banks to overstate asset values and understate loss reserves.

Savings banks are also plagued by the depressed real estate market in the Northeast. The heavy reliance savings banks place upon real estate lending, coupled with depressed real estate values and reserving for problem assets at levels significantly lower than those found in commercial banks, could lead to significant additional failures in the future.

Recent trends in bank investment decisions brought about by the current low interest rate environment also raise concerns about a potential future problem. Since short term interest rates have fallen much more than long term rates, resulting in a steep yield curve, banks that fund longer term investment securities such as Treasury bonds with shorter term deposits may be exposed to increased interest rate risk if not properly hedged. Any sudden rise in interest rates could devalue debt security portfolios, and could also negatively affect the favorable interest margins that have made the recent profits possible. Low interest rates have also resulted in increased market values for banks' investment securities portfolios, allowing banks to realize significant gains on sales of securities. Commercial banks realized gains on sales of investment securities totaling over $3.2 billion during the first nine months of 1992, or 14% of industry earnings.

The Current Condition of the Bank Insurance Fund

In June 1992, we testified before this Committee on the condition of the Bank Insurance Fund and the results of our audit of the Fund's 1991 financial statements.[14] At that time, we disclosed that the Fund ended 1991 with a deficit balance of $7 billion--the first in its history. This deficit was the culmination of four consecutive years of net losses arising from the resolution of historically high levels of bank failures. Over this four year period, the Fund's net losses totaled over $25 billion, and depleted a Fund balance that, as recently as December 31, 1987, had stood at $18.3 billion, the highest level in the Fund's history.

Since 1989, when a record 206 banks failed, the number of bank failures has actually declined each year, falling to 124 in 1991 and 120 in 1992. While the decrease in failures is encouraging, the Fund remains particularly vulnerable to the failure of larger banks. For example, of the $7.4 billion in estimated costs to the Fund arising from the 124 banks that failed in 1991, $4.1 billion, or 57 percent, was attributable to the failure of just 12 banks with assets in excess of $1 billion. During 1992, this trend continued. Of the $4.3 billion in estimated costs to the Fund arising from the 120 banks that failed during the year, $2.6 billion, or about 60 percent, is attributable to the failure of just 10 banks with assets in excess of $1 billion.

As we disclosed in our June 1992 testimony, the Fund reported a net loss of $11.1 billion in 1991. This loss was due primarily to FDIC's recognition in 1991 of $15.5 billion in estimated losses for the resolution of 72 large troubled banks containing $113 billion in assets that were determined by FDIC to be likely to fail in the near future[15]. The higher provisioning for future losses taken in 1991 was primarily due to the fact that

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[14]Condition of the Bank Insurance Fund: Outlook Affected By Economic, Accounting, and Regulatory Issues, (GAO/AFMD-92-10, June 9, 1992).

[15]FDIC's analysis of troubled banks for purposes of recognizing losses on the Fund's financial statements consists of a bank-by-bank review of the financial condition of each bank reviewed with assets in excess of $100 million. FDIC adjusts its estimates quarterly based on current financial information and changing conditions. FDIC also estimates losses for small banks (banks with assets less than $100 million) based on historical experience. This historical experience is used to establish a general reserve for small banks. About $500 million was established as a general reserve for small bank failures at the end of 1991, and it has remained unchanged.

FDIC revised its approach for determining what triggers the recognizing of estimated losses for large troubled banks on the Fund's financial statements. In addition to recording estimated losses for equity insolvent banks[16] as was done in 1990, FDIC recorded losses for additional troubled banks that reported positive equity but were judged to more likely than not require resolution in the near future. Most of these banks were located in the Northeast, and had excessive concentrations in real estate lending. In general, these banks had minimal capital, excessive levels of problem assets, and earnings trends that, if continued, would lead to their insolvency in the near future. Additionally, several of these banks were undergoing supervisory examinations, and the examiners were finding serious problems not reflected in these banks' financial reports. FDIC determined that, without a substantial turnaround in their operations and financial condition, these banks would more likely than not fail in the near future. In support of the methodology used by FDIC, we pointed out in our June 1992 testimony before this committee that a number of factors can affect the timing of actual bank failures. These factors include changes in economic conditions, fluctuations in interest rates, and inflows of capital.

The Fund ended the first nine months of its 1992 operations with unaudited net income of $2.9 billion. This net income reduced the Fund's unaudited deficit to $4.1 billion at September 30, 1992. The Fund's positive results of operations during the first nine months of 1992 is largely attributable to the following factors:

-- The Fund's assessment revenue thus far in 1992 has been higher than in previous years. This is because the assessment rate of 23 cents per $100 of domestic deposits charged to institutions for insurance coverage in 1992 was in effect for the entire year of operations. In 1991, the assessment rate in effect for the first half of the year was 19.5 cents.

-- FDIC recorded additional estimated losses from troubled banks of only $2.7 billion for the Fund during the first

[16]Equity insolvent banks are banks which either (1) reported negative equity capital on their quarterly financial reports (call reports) filed with the regulators, or (2) reported positive equity capital on their quarterly call reports, but had levels of reserves for loan losses which were determined to be insufficient to cover losses inherent in their loan portfolios when compared to reserve levels reported by similar banks in the same geographical region. When these banks' reserve levels were increased to reflect the level of reserves FDIC deemed necessary to cover loan losses, their equity capital was depleted, resulting in their insolvency.

nine months of 1992. This is because (1) relatively few additional banks beyond those whose losses were already recognized on the Fund's 1991 financial statements were identified by FDIC as insolvent or more likely than not to require assistance in the near future, and (2) losses have been significantly lower than originally estimated for some banks that failed in 1992 for which losses were recorded on the Fund's 1991 financial statements. The decline in loss rates currently being experienced by FDIC may in part be attributable to the increasing willingness on the part of bank management to provide adequate loss reserves. To the extent loss reserves more accurately reflect the extent of problems in banks' loan portfolios, losses experienced by BIF upon the resolution of troubled banks could be substantially lower than previously experienced.

Since the time FDIC recorded the estimated losses from troubled institutions on the Fund's 1991 financial statements, of the 72 large institutions for which FDIC recorded estimated losses, 48 did not fail during 1992. These banks, with $85 billion in assets at the time FDIC recorded losses for them, generally have shown some improvement in their reported financial condition. These improvements were due to the favorable interest rates or, in some cases, the infusion of capital, either from parent holding companies or from outside parties. Our review of financial information in 1992 showed evidence that some of these institutions had also posted profits from sales of securities. Because of these conditions, FDIC revised its estimates of when these institutions are likely to fail; the revised estimates now extend into 1994. FDIC is continuing to monitor these banks closely to determine whether the conditions of some of those banks will improve sufficiently so as to remove them from the Fund's reserve for estimated losses from future resolutions.

We are currently reviewing the Fund's estimated liability from troubled banks as part of our audit of the Fund's December 31, 1992, financial statements. We will not be prepared to offer our view on adjustments to the Fund's estimated losses from troubled banks until we complete our financial audit for 1992. While short-term profits and capital infusions can improve the outlook for troubled banks, they will not eliminate the losses imbedded in banks' asset portfolios. Nonetheless, if the improving trends in the condition of those and other banks continue, it is likely that the decline in BIF's deficit will continue.

Outlook for BIF

Under FDICIA, FDIC was required to develop a recapitalization plan for the Fund that results in the Fund achieving a ratio of reserves to insured deposits of 1.25 percent by not later than 15 years after the adoption of such a plan, which means by the year 2007. Under assumptions formulated by FDIC in the development of its most recent 15 year recapitalization plan, FDIC projected that the Fund would incur insurance losses totaling $33 billion between 1993 and 1995. (Of these estimated losses, $15.1 billion had been recorded on the Fund's unaudited financial statements as of September 30, 1992.) FDIC's plan is thus consistent with an expectation of continued high levels of insurance losses due to the weakened condition of a significant number of insured banks, continued weakness in real estate markets (particularly in the Northeast and West), and an increase in interest rate risk. Under this plan, costs to the Fund from bank failures were estimated to decline significantly after 1995, although FDIC projected that the Fund would continue to incur net losses until 1996, and would not achieve a positive Fund balance until the year 2000. Based on the assumptions underlying the recapitalization plan, FDIC projected that the Fund would achieve its designated reserve ratio of 1.25 percent by 2006. It remains to be seen the extent to which recent industry conditions may affect the rate at which the Fund is ultimately rebuilt.

In considering the estimates contained in the recapitalization plan and its underlying assumptions, it should be noted that projections about future events such as bank failures and related costs are subject to significant uncertainties. Assumptions about the levels of bank failures, growth in industry assets and insured deposits, and assessment rates over a 15 year period are subject to significant uncertainty due to factors which do not readily lend themselves to prediction, such as future economic developments, continued industry consolidation, and the impact of the implementation of the reforms contained in FDICIA. In addition, the current flexibility in accounting rules, until corrected, increases the risk that problems confronting banks may not be adequately reflected in their financial reports. We would hope that the implementation of FDICIA--including prompt corrective action and improved accounting rules-- will result in owners and managers of many troubled institutions being able to turn their institutions around or sell them while value remains.

BIF Recapitalization

As I mentioned above, an adequately capitalized insurance fund is essential for maintaining the credibility of the deposit insurance system and the reforms contained in FDICIA. FDICIA increased FDIC's authority to borrow funds to cover both losses and working capital needs for resolving troubled institutions. The act increased to $30 billion FDIC's authority to borrow funds from the Treasury. The proceeds may be used by BIF and SAIF to resolve troubled institutions. However, the act requires FDIC to recover these funds through premium assessments charged to insured institutions. The act also provides authority for FDIC to borrow funds for working capital but contains a formula that limits the amount of outstanding working capital borrowing. Working capital funds are to be repaid primarily from management and disposition of assets acquired from failed financial institutions.

The adequacy of the funding provided by the act to deal with the Fund's exposure to losses from troubled banks is subject to numerous uncertainties. FDIC's ability to repay working capital borrowing is dependent on its ability to collect anticipated recoveries from the management and disposition of failed bank assets. Actual recoveries depend on current and future economic and market conditions. To the extent recoveries fall short of expectations, additional loss funds may be needed to cover the shortfall. However, as of March 31, 1992, FDIC had borrowed about $12 billion from the Federal Financing Bank for BIF's working capital needs, and we estimate that future net recoveries from BIF's March 31, 1992 inventory of failed bank assets will be about $22.5 billion.

In addition, as we have stated previously, the Fund's long-term exposure to losses from troubled institutions cannot be estimated precisely. Although the $30 billion in loss funds appears sufficient at this time, if actual bank failures greatly exceed projections, the Fund could need additional funding. The adequacy of the $30 billion may also depend on the condition of the thrift industry and its implications for SAIF, as I will explain in a moment.

Consistent with its responsibility to recapitalize the Bank Insurance Fund, and one year ahead of its requirement under the FDICIA, FDIC has implemented a risk-based premium system for 1993. Under this system, weaker, riskier institutions are required to pay more for insurance coverage than stronger, well-run and well-capitalized institutions. Such a system provides for a more equitable sharing of the burden within the industry, as well-run institutions will pay less for insurance coverage. It also provides an incentive for poorly-run institutions to improve their operations.

Under FDIC's risk-based premium system, assessments range from 23 cents to 31 cents per $100 of domestic deposits. The exact rates vary from institution to institution depending upon capital level and the regulator's evaluation of the institution's health. FDIC estimates that the average assessment rate charged to insured banks under this system in 1993 will be 25.4 cents. This represents an increase of 10 percent over the flat rate of 23 cents per $100 of domestic deposits charged to all insured banks in 1992, and, as such, represents an increase in the Fund's available funding sources. This assessment is expected to bring in over $6 billion in revenues during 1993. FDIC plans to monitor relevant developments on an ongoing basis and consider revising the assessment rates as conditions warrant.

If BIF were already at its statutory reserve ratio of 1.25% of insured deposits, it would have reserves of about $24 billion instead of a $4 billion deficit. We believe it is important that the Fund's reserves be replenished and brought up to the statutory standard as expeditiously as possible in view of the uncertainties that may ultimately impact the asset recovery values, costs from future resolution activity, and the level of loss funds that will actually be available to the Fund. The last several years have shown that unexpected events such as economic downturns, and their resulting impact on the banking industry can quickly lead to significant bank failures and rapidly deplete reserve levels once considered to be sufficient. There is no empirical formula to show that the designated reserve ratio of 1.25 percent will sufficiently capitalize the Fund and enable it to deal with existing and future exposure to losses. However, it is a target that should be achieved through industry assessments to avoid further borrowing from the taxpayers to finance losses from financial institution failures.

THE THRIFT INDUSTRY, SAIF, RTC FUNDING, AND THE IMPLICATIONS FOR BIF

As you know, the thrift industry has continued to shrink over the past year and, as I will discuss shortly, there is evidence that the healthy portion of the industry continues to show gradual improvement. However, it is not clear for how long these trends will continue. Also, failed thrifts continue to operate because RTC does not have the funds necessary to close them. In addition, about 20% of the industry's assets--$171 billion--are in institutions still considered by OTS to be troubled. Finally, the insurance system for thrifts that is guaranteeing nearly $700 billion in deposits is seriously underfunded. To address these problems, the Congress needs to provide RTC with the $25 billion it has requested to handle institutions now in conservatorship and those OTS expects to transfer to RTC's control before October 1993.[17]

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[17]SAIF was established by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) to insure the deposits of federally insured savings associations (thrifts) and thrift deposits acquired by banks under section 5(d)(3) of the Federal Deposit Insurance Act. FIRREA also established RTC to resolve troubled thrifts whose accounts had been insured by the Federal Savings and Loan Insurance Corporation (FSLIC), and that had been, or will be, placed into conservatorship or receivership from January 1, 1989 through August 8, 1992. The Resolution Trust Corporation Refinancing, Restructuring, and Improvement Act of 1991, enacted on December 12, 1991, extended RTC's resolution authority to thrifts placed into conservatorship or receivership through September 30, 1993. In addition, the act provides that

Thrift industry data through September 30, 1992, indicate that the condition of the industry as a whole has shown gradual improvement over the past two years. The quarter ending September 30, 1992, was the seventh consecutive profitable quarter for the industry. Through the first nine months of 1992, nearly 93 percent of federally insured thrifts were profitable, compared to approximately 85 percent in the previous year. From September 30, 1991, through September 30, 1992, the number of thrifts declined by 9 percent to 1954 institutions. Industry assets also declined by 9 percent to $827 billion. As a result of earnings improvement, thrift failures, and infusion of some additional capital, the thrift industry's capital position improved significantly. The industry's ratio of tangible capital to adjusted assets at September 30, 1992, equaled 6 percent; at September 30, 1991, this ratio equaled 4.6 percent.

Though the thrift industry as a whole has shown improvement in its overall condition, the exposure facing the federal government from its insurance obligations is still significant. On September 30, 1992, the Office of Thrift Supervision (OTS) classified 2 percent of the 1,954 private sector thrifts as having a high probability of failure. These institutions held assets totaling $39 billion, or 5 percent of total industry assets. OTS classified another 16 percent of the private sector thrifts as troubled thrifts with poor earnings and minimal capital at September 30, 1992. These institutions held assets totaling $171 billion, or 20 percent of total industry assets.

Through December 14, 1992, RTC had closed 653 thrifts with assets totaling about $216 billion at the time of resolution at an estimated cost of $84 billion. RTC had another 81 institutions in conservatorship at that date, with assets of about $40 billion. Additionally, RTC estimates that it will receive at least another 60 to 90 thrifts, with assets ranging from $41 to $47 billion, from OTS for resolution before RTC's authority to take control of additional thrifts expires on September 30, 1993.

To date, RTC has been provided with $105 billion to cover losses associated with its resolution responsibilities.[18] However, RTC returned $18.3 billion to the Treasury in April 1992, when its

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any thrift requiring resolution after September 30, 1993, which had previously been under RTC conservatorship or receivership, may be resolved by RTC.

[18]FIRREA provided RTC with $50 billion in August 1989. The Resolution Trust Corporation Funding Act of 1991 provided an additional $30 billion in March 1991. The Resolution Trust Corporation Refinancing, Restructuring, and Improvement Act of 1991 provided another $25 billion in December 1991, but it was only available for obligation until April 1, 1992.

most recent appropriation became unavailable for new obligations. There have been only two thrift resolutions since April. To resolve those institutions currently in conservatorship and handle the resolution of at least the 60 to 90 additional thrifts expected to be transferred, RTC estimates that it will need another $25 billion in loss funds, bringing the total costs incurred by RTC from thrift resolutions to between $110 billion and $115 billion.

Assuming its projections are correct, the additional $25 billion in loss funds will allow RTC to carry out its resolution responsibilities through September 30, 1993. RTC has stated that if Congress and the new Administration take prompt action on funding, it will be able to finish resolving troubled thrifts by the end of 1993. If funding is not provided, RTC will not be able to complete its resolution responsibilities, leaving SAIF with a backlog of troubled thrifts awaiting resolution. Additionally, like troubled banks, the actual number and timing of thrift failures is difficult to predict accurately. To the extent favorable interest rates act to delay but not to avoid thrift failures, responsibility for resolving these troubled thrifts, and the associated costs, will be borne by SAIF.

Present law provides SAIF with two primary revenue sources--insurance assessments and Treasury payments--that may be used for resolution activity. To the extent that insurance assessments deposited in SAIF do not total $2 billion a year, Treasury is required to fund the difference for each fiscal year from 1993 through 2000 with funds appropriated for that purpose. Assuming funds are appropriated, SAIF will have at least $16 billion in either assessment income or Treasury payments during this 8-year period. Treasury is also required to make annual payments, out of appropriated funds, as necessary to ensure that SAIF has a specified net worth, ranging from zero during fiscal year 1992 to $8.8 billion during fiscal year 2000. Under the FDI Act, SAIF's minimum net worth is required to be maintained at $1 billion during fiscal year 1993, and $2.1 billion during fiscal year 1994. The cumulative amounts of the net worth payments cannot exceed $16 billion. The FDI Act authorizes funds to be appropriated to the Secretary of the Treasury for purposes of these payments. As of this date, however, none of these funds have been appropriated.

As of September 30, 1992, SAIF had an unaudited fund balance of $195 million. SAIF is not expected to have a substantial fund balance by September 30, 1993, when it assumes responsibility for the resolution of troubled thrifts. If SAIF incurs costs from resolving troubled thrifts which exceed its other funding sources, FDIC may be forced to use some of the $30 billion in borrowing authority provided under FDICIA to cover SAIF's losses. This, in turn, would have to be repaid by SAIF-insured thrifts and would reduce the level of loss funds available to BIF.

CREDIT AVAILABILITY AND REGULATORY BURDEN

Although FDICIA should be effective in reducing insurance fund losses, concerns have been raised that it is having the undesirable side effects of restricting bank lending and of adding to the costly burden of regulation on the industry. I believe the Committee will find that close examination of these important concerns shows that vigorous implementation of the safety and soundness provisions of FDICIA is consistent with efforts to strengthen the economy and streamline the regulatory process.

Strong Banks are Needed to Support the Economy

Credit supplied by the banking system is an essential element in a sound economy. For that reason, many have been concerned that for over two years there have been extensive reports in the press and elsewhere of a nationwide shortage of business credit. This condition is commonly referred to as a "credit crunch." The term credit crunch has been traditionally used to describe a limited supply of loanable funds compared to the demand for credit. This condition has existed in the past when higher interest rates available elsewhere took deposits away from banks. In the present case, however, the reported credit shortage is being ascribed to a reluctance to lend on the part of institutions that are highly liquid.

As evidence that regulation has contributed to shutting off the supply of credit to the economy, some have cited the fact that commercial and industrial loans outstanding have decreased to some extent in the past year or so, while bank investments in U.S. government securities have grown to the point that, for the first time in 27 years, they exceed the level of commercial and industrial loans. This is said to be caused in part by the fact that some banks are being forced to shrink their loan portfolios in order to meet their risk-based capital requirements. Also, it has been asserted that bank regulators have intimidated banks about new risk taking, even to the point that creditworthy borrowers are being turned away.

I do not doubt for a minute the anecdotal evidence that some borrowers have had difficulties in obtaining loans. Indeed, this would be expected in light of the many bank failures that have occurred, the large number of problem banks that exist, and evidence from periodic Federal Reserve surveys that banks tightened their credit standards during 1990 and 1991. Difficulty in obtaining loans would be especially likely for some types of real estate loans, where a large portion of the banking industry's problem assets are still concentrated. After the trauma of years of bad loan performance, it would be easy to understand if at least some bank examiners and individual loan officers were gun shy about new credits.

I question, however, the claims of many critics that efforts to improve the safety and soundness of the banking industry somehow work against efforts to strengthen the economy. The critics would have a point if it were true that provisions in FDICIA and elsewhere somehow cut off the ability of banks to make loans to creditworthy borrowers, but this is not the case. As I have indicated earlier, even with respect to character loans for small businesses, all that FDICIA would require is that the bank making such loans have policies and procedures that recognize and control for the inherent risks of such lending.

Many important factors besides supervision and regulation affect the supply and demand for bank loans. Although the role that bank regulation has recently played in influencing credit flows cannot be precisely measured, regulatory agencies have not demonstrated that FDICIA or other safety and soundness regulations have unduly restricted bank lending looking at the nation as a whole. To be sure, many small businesses--a group that is of particular concern because they are the source of so much employment in this country--have no doubt experienced problems if their bank has failed or if they are located in an area such as New England, where numerous banks may have been marginally capitalized. However, a 1992 survey of thousands of small businesses conducted on behalf of the National Federation of Independent Business did not show any unusual or widespread lack of credit availability to small businesses, nor do Federal Reserve surveys of banks show a reluctance to lend to creditworthy borrowers.

We are persuaded that it is unfair to blame FDICIA (which was adopted just over a year ago, some time after the credit crunch issue was raised) or safety and soundness regulation in general, for perceived credit availability problems. The evidence is too strong that other factors have been dominating the picture. These factors include:

-- low demand for commercial loans, which is typical of economic recessions. Loan demand has been reported by many observers, including the Federal Reserve Chairman, to be by far the most important factor influencing the level of commercial loans at banks;

-- the deleveraging of corporate borrowers, as well as the banks themselves, in correcting the excessive reliance on debt in the 1980s;

-- higher standards for real estate loans have been put into effect by numerous institutions. Surely, the disastrous experiences of many banks and thrifts with this type of lending in the 1980s called for higher standards; and

-- continued loss of the market share of banks in commercial lending because of competition from finance companies, commercial paper, and other credit sources.

In addition, because of the federal deficit, the amount of marketable Treasury debt outstanding has increased by more than $700 billion in the last 3 years. Most of this had to be financed out of the nation's savings pool, and, given the state of the economy and the steep yield curve that currently exists, it would be expected that a significant portion would show up in the banking system.

The most pressing matter for this Committee, of course, is what should be done now. Should regulation be relaxed in order to spur on the economy?

Looking forward, we can ask whether the current lack of an interest rate risk component to the Basle capital standards and the zero capital requirement for Treasury securities may provide inappropriate incentives for banks to invest in securities rather than in loans. Nonetheless, the current system of bank regulation as a whole does not undermine the economic incentive for a bank to make sound loans. Most banks have considerably more capital than the regulatory minimums, so that, with some exceptions, capital is not a binding constraint. Much has been made of the earnings banks have made from investing in securities in the current interest rate environment that is characterized by a steep yield curve. Nonetheless, for most banks, loans remain good investments if they meet sound underwriting standards and are priced correctly. Compared to Treasury securities, loan yields are higher, are less vulnerable to interest rate risk, and have the potential to be part of a larger commercial relationship that will benefit the bank.

Since most banks have the capital and incentive to make loans, what is to be gained by relaxing safety and soundness standards? From all available evidence, the amount of capital that the regulators require to be held against loans is certainly not excessive compared to the risks involved--in fact, it is below the amount of capital that unregulated entities such as finance companies have to hold in order to attract market funding to make such loans. Relaxing the existing capital standards would unfortunately invite marginally capitalized banks to expand their lending. Similarly, relaxing underwriting standards or having bank examiners look the other way would invite a return to the time when too many banks appeared to be more concerned with getting the money out the door than with the chances of getting it back again. Banks must take risks, but the risks must be prudently managed. The economy was not well served by all of the vacant office buildings and other poor investments financed by poorly managed, weak banks.

Rather than moving away from the risk-based capital standards, we would urge that the regulators continue to broaden the capital standards to reflect the full range of risks that banks face. In particular, we support efforts underway by U.S. regulators and their counterparts from other nations to measure interest rate risk in an appropriate manner and to adjust required bank capital accordingly.

On balance, I think that Congress, the Administration and the financial regulators should exercise great caution in considering short term measures to encourage more liberal lending practices by insured institutions. While banks have made good progress in the past several months, they continue to have relatively large amounts of problem assets compared to earlier times. A relapse would be extremely unfortunate. Over time, a healthy banking industry is the best support for the economy, and it would be foolish, in my opinion, to attempt to periodically weaken and tighten bank regulation in response to recession and inflation. Had the banking system not dissipated its capital in the 1980s by making so many bad loans, it would have been better able to handle some of the problems encountered in this recession.

<u>Reducing Regulatory Burden Must Not be Achieved at the Expense of Safety and Soundness</u>

With the passage of FDICIA, complaints from banks and thrifts about regulatory burden have become much more intense. These complaints should be considered and reviewed carefully, in an assessment that considers both the costs of regulation and the benefits to the industry, consumers, and the taxpayers. I would like to offer several comments regarding what is meant by the concept of burden and the issues involved. In addition I would like to highlight some opportunities for reducing burden, particularly in the area of simplifying the regulatory structure.

At the request of this Committee, we are presently evaluating studies of regulatory burden that have been conducted by bank and thrift industry groups and the regulatory agencies. Industry studies are, for the most part, opinion surveys that provide extensive lists of issues causing concern among bankers, including issues like bank secrecy reporting, community reinvestment requirements, truth-in-lending provisions, and accounting and auditing requirements. These studies concentrate on the costs of such regulation without recognizing that there are benefits related to bank or thrift charters.

Agency studies, on the other hand, are limited to those issues that regulators can address, like reporting requirements or regulatory requirements beyond those spelled out in the law.

Agency officials have advised us that they are taking steps to implement changes that are within their control; however, they have also indicated that they do not expect those changes will significantly reduce the overall burden on banks. The regulators' efforts to reduce burden within their purview, including coordinating among themselves and their state counterparts to minimize duplication, should be applauded and encouraged. Even so, from a structural standpoint, banks still must deal with multiple regulatory agencies as well as FDICIA-related increased oversight from external auditors, directors, and audit committees. In implementing FDICIA, particularly provisions like those related to corporate governance and accounting and auditing, the regulators should work closely with both the public accounting and banking industries to ensure those responsible for bank oversight have carefully defined roles that complement rather than duplicate one another.

To place the issue of regulatory burden in perspective, it is necessary to recognize that, by their nature, depository institutions are going to be subject to a considerable amount of regulation, with its associated costs. The costs include deposit insurance premiums, maintaining interest free reserves at Federal Reserve banks, and paying for the costs of bank examinations. In our system, banks also must bear the costs of complying with other laws and regulations concerning such areas as money laundering, community reinvestment, and consumer protection.

These regulatory costs associated with a bank charter are not, however, without some substantial benefits. Taken as a whole, the regulatory structure applicable to depository institutions is designed to benefit the public by providing industry stability, protection of funds, and availability of service. In addition, the system has provided many benefits to the institutions themselves. These benefits include the right to raise insured deposits, access to the Federal Reserve's discount window, and protection from competition. These benefits have also allowed banks to operate with lower amounts of equity capital than markets would otherwise require.

From the point of view of many banks, I suspect that the balance between regulatory benefits and costs appears to have shifted unfavorably in recent years. The cumulative impact of additional regulation, including that associated with FDICIA, no doubt accounts for many of the complaints that are now forthcoming. Thus, deposit insurance premiums have increased, the cost of bank examinations has increased, requirements such as truth in savings have been added, and banks are no longer as well protected from competition. Indeed, restrictions on what banks can do in the way of branching and product lines--once part of the safety net that protected banks by keeping others out of banking--are now also viewed by some elements of the industry as limitations on banks that make them less competitive.

There is no question that FDICIA has increased the amount of regulation that exists in the banking industry, and we should be sensitive to the industry's concern over unnecessary, inefficient, or inappropriate requirements. FDICIA requires many changes and it is not surprising that there are complaints. I would urge Congress to listen carefully to what the industry and the regulators say about implementation, for in implementing such a complicated law there may be ways to do some things better or more efficiently. However, as I have described in this testimony, corporate governance, market discipline, and regulatory oversight all failed to prevent huge losses in thousands of failed depository institutions. Taxpayers put up billions of dollars to cover losses in the thrift industry and have now lent money to support BIF. Given these developments, the safety and soundness regulations contained in FDICIA are essential to preserve the public's confidence in depository institutions.

Although FDICIA has some up front costs, all of its provisions are not in the direction of making it harder for banks to make a living. If FDICIA is properly implemented, the burden on healthy banks should be reduced as their deposit insurance premiums drop because they no longer have to pick up so many large bills for problem banks. Furthermore, FDICIA has also made important steps in making distinctions between banks depending upon how well capitalized and managed they are. The greatest burden of new regulations--such as those concerning operational and managerial standards in section 132 of the act--will fall principally on weakly managed, poorly capitalized banks that do not already have such standards. Banks that are successful in adopting risk management systems in compliance with the act's mandate are likely to benefit by a reduction in loan losses--the major item responsible for the poor earnings of the industry in previous years. In addition, the act provides for risk-based insurance premiums for the first time, and applies certain restrictions such as those on brokered deposits only to those institutions that are not well capitalized. More progress in the direction of making distinctions between well-capitalized, well managed institutions would be desirable and represents an important area for Congressional oversight.

During this testimony, I have frequently noted that FDICIA essentially calls for encouragement of prudent banking practices. It is worth remembering that, although the losses and mistakes of troubled banks received many headlines in recent years, all along a significant number of banks have remained prudently managed, profitable, and well-capitalized. Moreover, even before FDICIA, a number of banks that had slipped into less prudent practices in the 1980s began to correct their own internal deficiencies. Among other factors, we can thank market forces for this, as falling stock prices and more costly funding reminded smarter managers that unsafe and unsound policies would not work for the long term. In essence, FDICIA directs regulators to bring the rest of the industry back to prudent banking practices, and to ensure that well-run banks do not backslide.

Looking ahead, I want to emphasize again that we cannot afford to let concerns with regulatory burden impede efforts to achieve effective safety and soundness regulation. Banking, like other financial industries, is getting more diverse and complex, as a result of such factors as technological advances, competitive forces, globalization of markets, and increasing customer sophistication. We must make every effort to try to be sure that the way we regulate and supervise banks keeps up with this changing world.

The need for vigilance is evident in interest rate swaps and other derivative products. Today our major banks are significant players in markets in which large volumes of such products are traded daily. To minimize the chances that developments in these markets do not damage the U.S. banking system, we must not only look to what the U.S. bank regulators do. We also need to be concerned with the regulation of banks and securities firms around the world. As the Committee is aware, we are conducting a major study of derivative products and look forward to further discussions of this important topic.

I mentioned earlier there are opportunities for reducing regulatory burden by, among other things, considering ways to simplify the regulatory structure. Today a banking organization may be subject to regulation of three federal banking agencies--for its holding company, state, and nationally chartered banks--as well as by agencies of the states in which it does business. Most of the evidence that we have seen suggests that these larger banking organizations are centrally managed in most essential respects; therefore, one regulator could conceivably perform the examination of the entire operation. I fully recognize that in trying to simplify the regulatory structure there are difficult areas to work out, such as responsibility for holding company supervision and protection of the deposit insurance system. However, given the benefits to the public of having a simpler system, these areas should not present insurmountable obstacles. At this time we do not have a specific proposal to offer, although we feel strongly that the independence of the bank regulatory system must be assured in any such simplification or streamlining.

One other issue related to congressional regulatory oversight involves trying to achieve a level playing field. Banks are subject to safety and soundness and consumer protection regulations that are not applicable to (or are not as burdensome for) other financial institutions operating in the same markets. This is an important point, although we should keep in mind that all competitors do not have benefits such as federal deposit insurance. In addition to looking closely at bank regulation, in many instances we need to look more closely at the effectiveness of regulation in competing industries. I earlier mentioned problems in how state regulation supervises insurance firms, and GAO has also reported on potential difficulties associated with the lack of adequate regulatory supervision of the holding companies of securities firms. One of the great oversight challenges that faces Congress is how best to bring safety and soundness regulation into line across industries that increasingly compete in the same markets, both in this country and overseas.

As you can see, regulatory burden encompasses an array of important issues for the industry and the Congress. We believe a deliberative, comprehensive approach, rather than a regulation-by-regulation approach, is important for evaluating the cumulative impact of regulation on the industry and understanding how best to alleviate it without sacrificing industry stability, safety and soundness, or consumer protections. We look forward to assisting the Congress in this area.

SUCCESSFUL IMPLEMENTATION OF FDICIA PROVIDES A FOUNDATION FOR OTHER EFFORTS TO MODERNIZE THE BANKING INDUSTRY

In conclusion I would like to make a few observations on the implications of what I have said for congressional oversight and the legislative agenda for banking.

There is no question that FDICIA left some issues on the table. Banks increasingly find themselves competing with other firms for transaction, investment, and credit services, and Congress will no doubt be asked to address a variety of level playing field issues in the years ahead. However, given the safety and soundness problems that existed in banking, it was essential for Congress to address those matters first. In my view, the more successful the act's implementation, the more possible it becomes to take up other modernization questions.

Implementation of FDICIA is, therefore, right at the top of the modernization agenda. I have indicated in my testimony a number of very important areas affecting safety and soundness in which continued congressional oversight will be essential. These include accounting and auditing reform, prompt corrective action, non-capital tripwires, least-cost resolutions, foreign bank supervision, BIF recapitalization, and funding for RTC and SAIF. We have ongoing work in most of these areas and are, of course, prepared to assist the Committee in this endeavor, which is likely to take a great deal of this Committee's time during the 103rd Congress.

While additional experience is being gained under FDICIA, it would make sense, as a further step toward modernization, to look for ways to help the industry to become more efficient. This would include continuing with efforts to streamline enforcement of existing regulations and simplifying the structure of the regulatory system.

As the FDICIA reforms take hold and we can be more confident of our ability to successfully supervise banks in today's competitive marketplace, it becomes more feasible for Congress to consider ways of expanding the business opportunities for the industry without placing the deposit insurance system and the taxpayers at risk. At the request of this Committee, we will be reporting shortly on one such area where change may be appropriate--removing or relaxing the federal restrictions on interstate banking and branching.

In going beyond questions of efficiency in banking, the issues that Congress must deal with are not easy ones. They raise more general questions--such as what deposits should actually be covered by deposit insurance and the appropriate uses for insured deposits. Furthermore, because banking and other financial services industries overlap in so many areas, it is not realistic to deal with some of these questions simply from the point of view of the banking industry alone. Congress will have to consider the various links between banking and other industries that are appropriate, including the degree of regulation and supervision that is needed for complex holding companies that combine banking and other activities. As I have indicated earlier, it is also appropriate for Congress to look closely at the adequacy of safety and soundness regulations in competing industries--and indeed in other nations as well--so that our banks are not placed at a disadvantage with their competitors.

In the final analysis, Congress must establish a regulatory framework for banking and other financial service providers to serve the interests of the public. Over the long run, what is most important is that the financial system as a whole be safe and sound, that efficient service be available on an equitable basis to all segments of the public, and that the nation's savings be used to help create the jobs that are the strength of our society.

In closing, Mr. Chairman, I would like to say that we look forward to working with the Committee in its oversight of FDICIA's implementation and in its consideration of other issues associated with the future of banking and the financial services industry.

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