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NUMBER 15
SPRING/SUMMER 1992

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THE GAO JOURNAL is published quarterly by the Office of Public Affairs, Rm. 6901, U.S. General Accounting Office, Washington, D.C. 20548. First class postage paid at Washington, D.C.

WRITERS whose work appears in the GAO Journal speak for themselves only. Unless otherwise indicated, their views or opinions should not be construed as the policy or position of GAO or any other organization with which they may be affiliated.

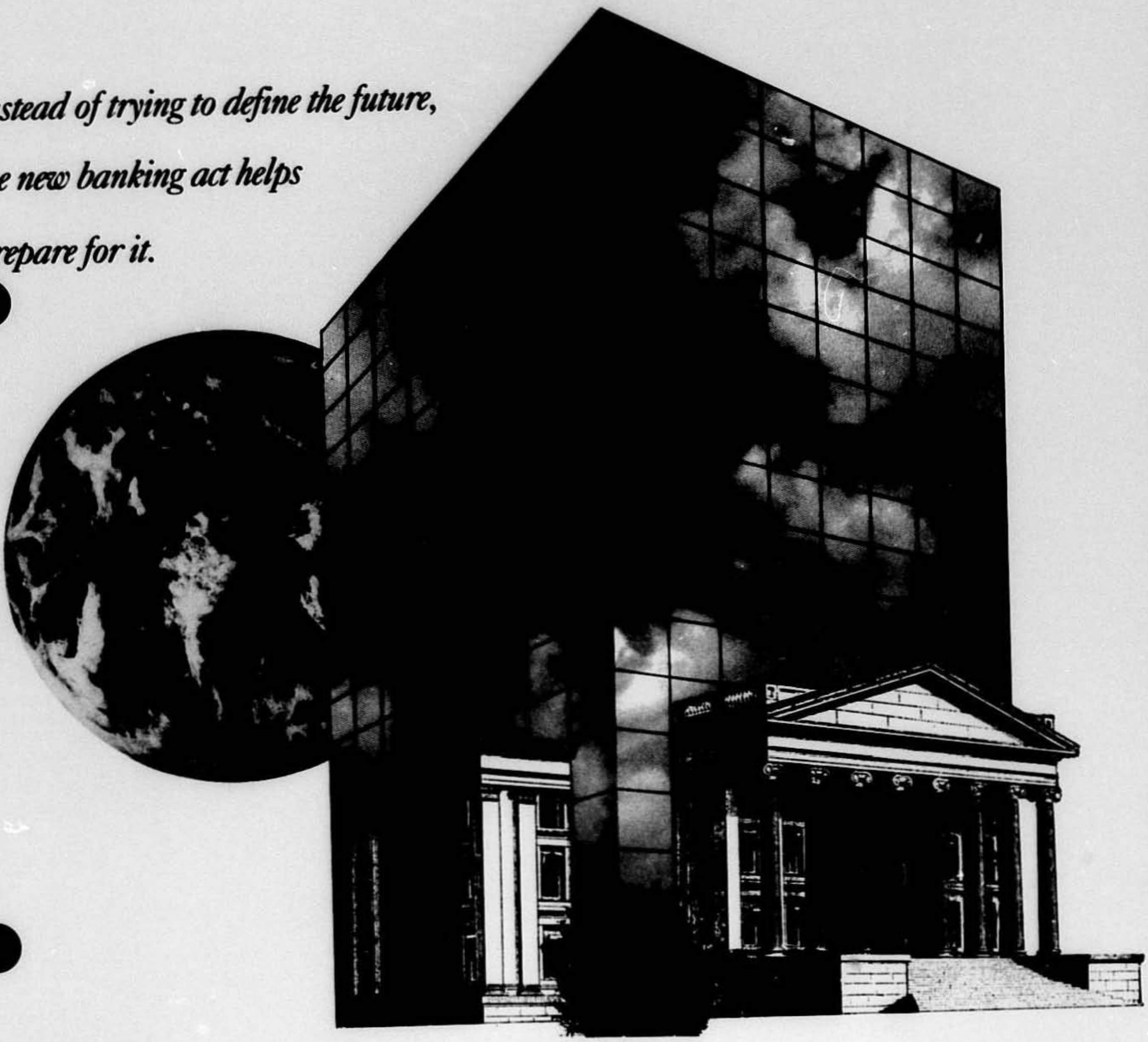
EDITORIAL CORRESPONDENCE: By mail to the above address. Letters to the editor are encouraged. Unsolicited manuscripts will be returned only if accompanied by a self-addressed, stamped envelope.

POSTMASTER: Send changes of address to the *GAO Journal*, Office of Public Affairs, Rm. 6901, U.S. General Accounting Office, Washington, D.C. 20548.

Craig A. Simmons & Stephen C. Swaim

GIRDING FOR COMPETITION

Instead of trying to define the future, the new banking act helps prepare for it.



THE LAW SAYS, IN EFFECT, THAT THE GOVERNMENT WILL PUT $70 BILLION AT RISK TO KEEP THE BANK INSURANCE FUND FROM GOING UNDER, BUT IN RETURN, THE BANKING INDUSTRY WILL HAVE TO CLEAN UP ITS ACT SO THAT A SIMILAR ACTION WILL NEVER NEED TO BE TAKEN AGAIN.

IN THE SPRING of 1991, representatives of the nation's larger banks went to Capitol Hill to seek a variety of changes in the banking system: interstate branching, freedom to get into other lines of business such as securities underwriting and insurance, and an end to restrictions against the ownership of banks by commercial companies. The bankers—along with the administration officials who backed the proposed changes as ways to help modernize the financial system—hoped that new legislation would help the industry recover from the problems that had bankrupted the Bank Insurance Fund (BIF).[1] After months of hearings and debate, however, Congress rejected the pleas for new banking powers, adopting only a set of new safety and soundness measures.

This was the third time in a decade that Congress had tried—and, ultimately, declined—to deal in a comprehensive way with many of the structural issues associated with modernizing the financial system. The legislation that Congress did adopt—the Federal Deposit Insurance Corporation Improvement Act of 1991—left many critics in its wake.

But did the act really set back the modernization effort? And does it really portend a continuation of the banking industry's problems? One can certainly understand the frustration of the many who want to modernize more quickly, but overall, the banking act should help that process. The most pressing modernization task at the moment is not to define what the banking industry will look like in 10 years. Rather, it is to determine whether the industry can become strong enough to serve as the foundation of the U.S. financial system in the future. Under the new banking legislation, the country will find this out—and will do so without unduly increasing BIF's exposure to loss or risking the stability of the financial system.

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Learning to play it safe

The key message in the new legislation is a directive to banking regulators to promptly close all banks that become insolvent. The intent behind this mandate is to put the risk of protecting depositors not on the owners of healthy banks (through higher deposit insurance premiums), nor on the taxpayers, but on the owners of banks that fail. In a sense, this stricter supervision is the price the banking industry must pay for another provision in the legislation: the $70 billion Treasury loan authority for shoring up BIF.[2] What the legislation says, in effect, is that the government will put $70 billion of taxpayer funds at risk to keep BIF from going under, but in return, the banking industry will have to clean up its act so that a similar action will never need to be taken again. Whether banking officials and regulators can live up to this challenge remains to be seen.

Traditionally, regulation has sought to keep deposit insurance losses low by shielding banks from market forces. Specifically:

- banks are, for the most part, restricted by law to activities that are thought to be devoid of excessive risk;
- the federal government insures the value of deposits—the major source of financing for this $3.5-trillion industry;
- the decision as to when banks fail is made not by creditors but by federal or state regulators;
- banks that experience financial problems have unrestricted access to loans from the Federal Reserve System;
- most bank failures are resolved in such a way as to protect not only insured depositors, but also uninsured depositors, and sometimes even general creditors.

These rules and practices, which have protected the stability of the banking industry by enabling it to retain the confidence of its customers, also helped the nation's financial system remain remarkably stable during the turbulent 1970s and 1980s. But the recent failure of so many banks, along with BIF's bankruptcy, made it clear that the old system wasn't working well anymore: In essence, too much risk had been shifted to the taxpayers, and it was costing them too much money.

The new legislation does not completely overturn the way things were done in the past. It retains the $100,000 limit on deposit insurance, and continues traditional line-of-business restrictions. Regulators are still the ones who decide when failing banks must close, and they still have the authority to take emergency actions to preserve the stability of the banking system. But by instructing regulators to deal more promptly with troubled banks, the new legislation mandates that weak banks be treated much more in keeping with the way the market treats other types of problem institutions. The key provisions that accomplish this include:

- a "tripwire system" that requires regulators to take a series of actions to restrain and ultimately close banks as their capital disappears;
- a requirement that banks must be closed in the least expensive way, even if this means leaving uninsured depositors unprotected;
- restrictions on the Federal Reserve's ability to keep insolvent banks alive by lending them money.

These provisions create strong incentives for bankers to operate more safely so that consumer confidence flows more from the soundness of each institution than from the deposit insurance guarantee. And these incentives are further enhanced by other reforms in the legislation requiring that:

- accounting methods more accurately measure the value of problem assets;
- auditors and the audit committee of each bank's board of directors take a more active role in assessing internal controls;
- auditors and bank regulators develop closer and more effective relationships.

The bottom-line effect of these reforms is to require banks to establish adequate risk-control systems and to ensure that regulators have accurate knowledge of every bank's financial condition.

The law and the industry

Last fall's legislation tells banks that if they want to be around in the future, they must get their houses in order now. If learning how to operate successfully in a more competitive environment means paying much more attention to the credit-worthiness of potential borrowers, cutting costs, downsizing, or merging, then so be it.

Not surprisingly, many bankers have complained about all of this. They say, for example, that requiring banks to be closed soon after their capital falls below minimum requirements is too strict, and that new accounting and auditing reforms are too intrusive. But while the legislation is by no means perfect in all of its details, neither does it justify all of the complaints, especially when it is measured by what needs to be done to promote the ability of the banking industry to operate successfully today.

For the most part, the types of things that the industry must do to comply with the law are things it would have to do anyway to win investor confidence in a competitive market. For example, if banking is no longer going to be run in the old "protect everybody" way, then banks must preserve their capital if they want to hold uninsured depositors, enter into long-term contracts, or provide services to corporate customers who are looking for stability in their banking relationships. (It is instructive to note that securities firms, in hopes of attracting customers, advertise the amount by which their capital exceeds regulatory requirements.) Similarly, the only way banks can control risks in today's environment is to adopt the types of management controls the legislation mandates, and which well-run institutions already have. The law should not be considered

FOR THE MOST PART, THE THINGS THAT THE INDUSTRY MUST DO TO COMPLY WITH THE LAW ARE THE THINGS IT WOULD HAVE TO DO ANYWAY TO WIN INVESTOR CONFIDENCE IN A COMPETITIVE MARKET.

draconian just because it requires the sort of behavior that is needed in order to operate successfully in a competitive world.

The law and the regulators

The market orientation contained in the 1991 legislation requires that regulators change their ways as well. The law's early-intervention provisions make it necessary for regulators to be much more timely, forceful, and consistent in their approaches toward troubled banking organizations than they have been in the past. The accounting and auditing reforms also require that regulators look at supervision in a new way. With so many changes now taking place in the financial industry, regulators cannot be expected to keep up with the risk implications of every decision taken by every bank's management. It is crucial, therefore, that regulators fully understand and monitor banks' internal control systems. Banks that have good control systems are far less likely to get into trouble when operating in competitive markets.

The requirement for early intervention will cost regulators some of their flexibility in dealing with problem institutions, and therefore, many regulators are apt not to like it. But it is important that regulators recognize how the mandated approach fits into the overall effort of bringing supervision more in line with the realities of market competition. After all, the eventual success of the incentives for banks to operate safely will hinge on the credibility of regulatory intervention if capital fails. Further, it must be kept in mind that one of the goals of the legislation—zero losses to the taxpayers on deposit insurance coverage—reflects a new sense of regulatory accountability to the taxpayers. Not just regulators, but bankers as well ought to adjust to this new spirit, if for no other reason than to reduce their deposit insurance premiums.

ONE OF THE GOALS OF THE LEGISLATION—ZERO LOSSES TO THE TAXPAYERS ON DEPOSIT INSURANCE COVERAGE—REFLECTS A NEW SENSE OF REGULATORY ACCOUNTABILITY TO THE TAXPAYERS.

The law and modernization

For quite a few years, the financial services industry has been trying to adjust to a whole host of changes, such as wide interest-rate fluctuations, the proliferation of new products, the internationalization of markets, and the emergence of new technologies. Although many banks and their federal and state regulators have had some success in adapting to these changes, many observers believe—probably correctly—that eventually Congress will have to deal more comprehensively with the powers and responsibilities of banks and the other providers of financial services. Why, then, was it reasonable last fall for Congress to defer these broader decisions?

Let's go back to what the banks asked Congress to do. The bankers said deregulate—that is, let the industry do more to compete effectively with other segments of the financial services industry and with foreign financial services providers. On the surface, it is hard to argue with their point of view: Although banking retains certain distinguishing features (for instance, deposits are still insured, and banks have direct access to Federal Reserve discount window loans and payments services), the truth is that most services offered by banks and bank holding companies can be provided by other organizations as well. Bankers in the United States, therefore, now find themselves competing head-to-head with other firms for transactions, investment, and credit services.

At present, however, financial reform proposals that promote deregulation as the principal means of improving the affairs of the banking industry contain one overwhelming weakness: *Deregulation, in the current environment, is just too risky.* Deregulation that preceded the implementation of management and regulatory reforms would ignore the reason so many banks have been doing so poorly or even failing: bad loans. If banks were better able to evaluate credit quality—one of their principal reasons for existence

—they would have rates of return much more in line with their competitors. It is true that some of the banks' poor results have been due to the fact that the world is changing awfully fast, but this does not excuse the dismal performance of so many of them. Managing risks in a changing environment requires a degree of self-control that is analogous to being able to sit beside a bowl of chocolates and not eat them all. The reality is that too many banks cannot resist the temptation; they have lost the ability to manage risks that was once the hallmark of the industry. Allowing banks that cannot manage risks in their basic business to expand into other areas would be too big a gamble, especially when one also considers the fact that banking regulators have not yet mastered the art of supervising under today's conditions.

The most legitimate gripe about the new legislation is that it inhibits even the best-run, best-capitalized banks from meeting the competition from foreign banks and other financial institutions. The complaint is worth acknowledging, but it is also likely that when the restrictions on banking powers are loosened, only the well-run, well-capitalized banks will be allowed to participate. In the interim, banks will all continue to benefit greatly from federal deposit insurance. And many banks consistently make a profit; banking *per se* is not unprofitable. Only some banking is—especially that which ignores or greatly miscalculates credit and interest-rate risks. So it cannot be said that the mandate of the new banking law goes completely against the viability of the banking business. Moreover, little evidence suggests that allowing banks to do a broad range of things would make them stronger in the near future.

THE LAW PROVIDES THE RIGHT INCENTIVES FOR THE INDUSTRY TO POSITION ITSELF FOR WHATEVER OPPORTUNITIES MAY ARISE FROM MARKET DEVELOPMENTS OR FURTHER FINANCIAL MODERNIZATION LEGISLATION.

In summary, then, the 1991 act provides the right set of incentives for the banking industry to position itself for whatever opportunities may arise from market developments or further financial modernization legislation. The industry will be stronger in the long run—and the timing of the act may itself even turn out to be propitious, given the problems that our global competitors are now facing. The banks of Europe and Japan are preoccupied with other concerns, such as the integration of European economies and, in Japan's case, falling stock market and real estate values, so there is apt to be a bit of a lull before the competition surges again.

Implementation concerns

The biggest problem with the legislation may lie in the timing of certain key changes, particularly those associated with placing uninsured depositors at risk. When a bank gets into trouble, uninsured depositors have every reason to pull their money out, since only those depositors who remain with a bank until it actually fails bear any risk of losing their money. Recognizing the potential problems associated with runs at the larger banks, GAO proposed several steps—none of which made their way into the legislation—that would have eased the transition from protecting uninsured depositors to placing them at risk.[3] GAO favored disclosure and other arrangements to better inform depositors, and also the development of voluntary options for protecting deposits, such as payroll accounts, that exceed the $100,000 insurance limit.

Because the legislation abruptly eliminated uninsured depositor protection, the banking system will face the risk of runs until it can adjust to the new realities. Knowing this, regulators are going to have to be much more aware of potential liquidity problems and more willing to act in anticipation of them. This does not mean that the government ought to manage the banking system, nor that it should try to squeeze all the risk out of the system. But it does mean emphasizing sound internal controls and developing better early-warning systems. Under the new rules of the game, regulators are still able to rescue individual banks if the stability of the banking system requires it. But if the benefits of market discipline are to be realized, such rescues by government regulators must be confined to crisis situations.

LAST YEAR'S BANKING ACT LEFT SOME ISSUES ON THE TABLE, BUT THIS SHOULD NOT BE CAUSE FOR ALARM OR DISCOURAGEMENT. IN A MARKET-DRIVEN ECONOMY, ONE MUST BE WARY OF ATTEMPTS TO DEFINE THE FUTURE TOO PRECISELY.

Other implementation concerns involve the relationship of the new legislation to BIF. The act authorized the Department of the Treasury to loan $70 billion to BIF so that regulators could continue to close insolvent banks. But because of the backlog of problems in the banking industry and the uncertain state of the broader economy, it is impossible to know if $70 billion will be sufficient to cover losses before the industry turns around. There is a danger that, in a short-sighted effort to conserve BIF's resources, regulators may be reluctant to vigorously implement the early intervention provision of the legislation. But implementing that provision is essential to create the incentives for banks to take the sorts of actions that will eventually save BIF a lot of money. One of the most important of these incentives is encouraging weak institutions to seek out merger partners before they become subject to more severe sanctions under the "tripwire" process.[4]

The future

The 1991 banking act left some issues on the table, but this should not be cause for alarm or discouragement. In a market-driven economy, one must be wary of attempts to define the future too precisely. Such attempts run the risk of freezing in place an institutional structure that is appropriate to a particular set of market conditions or favorable to a particular set of service providers. What any attempt at modernizing the banking industry must really do is ensure that the needs of the public—those who use financial services—are well served in the future. No one today can know precisely what those needs will be, but it is possible to foresee some of the broader essentials. One is that the financial system must effectively channel funds from savers to investors—investors who are involved in worthy projects capable of earning a competitive rate of return. Another is that it must make financial services accessible to small businesses and minorities as well as to large corporations. It must also contribute to the competitiveness of the U.S. economy and facilitate fair and open market arrangements. And finally, banks and other financial institutions must be safe and sound: Some means of protection must exist against instability and the associated loss of confidence in the financial system and, because confidence is so important, against conflict of interest and fraud as well.

Will banks respond in the right way to the new set of incentives that the 1991 legislation provides? It's hard to say. The country's mindset is bothersome right now. When one takes a look at American industry, notably the U.S. automobile industry, it is hard to be encouraged. One U.S. automobile industry official recently conceded that foreign competition is "beating our brains out," yet the industry's response has been to seek protection from that competition rather than take the positive steps needed to make the U.S. automobile industry more competitive. In a similar vein, banks may end up devoting more effort to fighting with other segments of the financial services industry over ways to restrict competition than to finding ways to improve their ability to manage risks in open, competitive markets.

One can certainly hope that U.S. banks will learn to operate successfully in a competitive environment. But it is important to remember that, in the long run, what is least important about modernization is the particular institutional arrangement that provides financial services. A modern financial system needs institutions that are strong, healthy, and sufficiently well-run to serve the public. During the 1980s, the distinctions between the lines of business in the various segments of the financial services industry began to blur. The truth may be that, in time, it will no longer be important whether banks, securities firms, or any other existing kinds of institutions are the ones that will eventually serve the public—only that the public be served.

Banking organizations today are in the unique position of offering products that are insured against loss by the federal government. Therefore, we must be careful when considering changes in regulation: We cannot afford to destabilize the financial system. But with that caveat in mind, Congress nevertheless must take a broader view and look to the future of the financial system as a whole. If banks and their regulators cannot make the adjustments that the 1991 legislation requires, then Congress, by default, may have to decide in favor of other institutional arrangements. These arrangements could include an emphasis on so-called "narrow banks," which would be allowed to invest federally insured deposits only in low-risk financial assets, such as short-term government securities or financial paper.

One final point: Modernization involves more than banking. Therefore, any plan for comprehensive modernization—one that would anticipate equal treatment of all financial services providers—must also encompass changes in the way insurance and diversified securities firms are regulated and supervised. These firms, too, must demonstrate that they can operate on a safe and sound basis in an increasingly competitive world.

BY FORCING BANKS AND THEIR REGULATORS TO DEAL MORE EFFECTIVELY WITH MARKET REALITIES, THE LAW PERMITS CONGRESS TO DEFER FURTHER MODERNIZATION DECISIONS UNTIL BANKS CAN PROVE THEIR VIABILITY IN A COMPETITIVE WORLD.

A period of transition

In the meantime—until the day Congress revisits the issue of comprehensive financial services industry reform—the 1991 legislation promises to tell us a lot about the viability of banks in that competitive environment. By forcing banks and their regulators to deal more effectively with market realities, the legislation permits Congress to defer further modernization decisions until banks show that they are up to the task.

It is now the banking industry's responsibility to demonstrate an ability to manage risks in an environment in which the distinctions between the types of financial institutions are breaking down. If it can do so, then the period of transition marked by last fall's legislation—worrisome in certain respects but heartening in others—should lay the groundwork for a financial services industry that is a source of strength to the nation's economy as it enters the new century. •

1. The Bank Insurance Fund, administered by the Federal Deposit Insurance Corporation (FDIC), insures deposits in commercial banks and some savings banks. FDIC also administers the Savings Association Insurance Fund (SAIF), which insures deposits in other savings banks and thrifts.

2. These funds were needed because the $25 billion spent in resolving about 1,000 bank failures over the past five years had exhausted BIF's reserves. In the fall of 1991, there were about 1,000 more banks with over $400 billion in assets on the list of problem banks. The assets of the banks on this list have since grown to over $600 billion.

3. See *Deposit Insurance: A Strategy for Reform* (GAO/GGD-91-26, March 4, 1991).

4. This incentive—to pursue mergers voluntarily—may itself eventually need to be strengthened by some additional changes in banking laws or regulations, especially in the area of interstate banking and branching.

E. Gerald Corrigan

COMMERCIAL BANKING IN THE UNITED STATES: A LOOK BACK AND A LOOK AHEAD

After a turbulent decade, banking faces a long and difficult road to renewal.

THE DECADE OF the 1980s was the most difficult interval faced by the [illegible] commercial banking industry since the 1930s. As the 1970s ended, the U.S. economy was in the vise-like grip of the most virulent inflation it had faced in decades. Public confidence in our ability as a nation to cope with the problem was at a low-water mark. Beginning in the fall of 1979, the Federal Reserve moved aggressively to begin the process of winding down inflation. This task, inevitably, entailed very high nominal and real interest rates. In these circumstances, net interest margins—the difference between the rates banks charge on loans and the rates they pay on deposits—were squeezed. But more importantly, the banking system faced the prospect that withdrawals might exceed deposits—a situation known as disintermediation—largely because technology and financial innovation were rapidly creating financial instruments, such as money market mutual funds, that were close substitutes for traditional bank deposits. In these circumstances, the economic and political pressures to eliminate the Federal Reserve's Regulation Q, which set interest-rate ceilings on bank deposits, became irresistible. As the process of interest-rate deregulation took hold[1] in a setting of rapid technological advance in banking and finance, it was to usher in the first stages of a vastly changed economic and financial environment in which banking institutions had to compete both with each other and with an ever-growing number of nonbank financial organizations. That transformation—from a relatively sheltered environment to a highly competitive one—has yet to run its course.

The legacy of the inflation cycle of the late 1970s and early 1980s for the banking system was not limited to the manner in which it forced elements of deregulation. Indeed, a more insidious factor was that the inflationary psychology of the period held out the prospect of seemingly limitless increases in the prices of farmland, crude oil, and other raw materials. When the inflationary bubble broke, [illegible]

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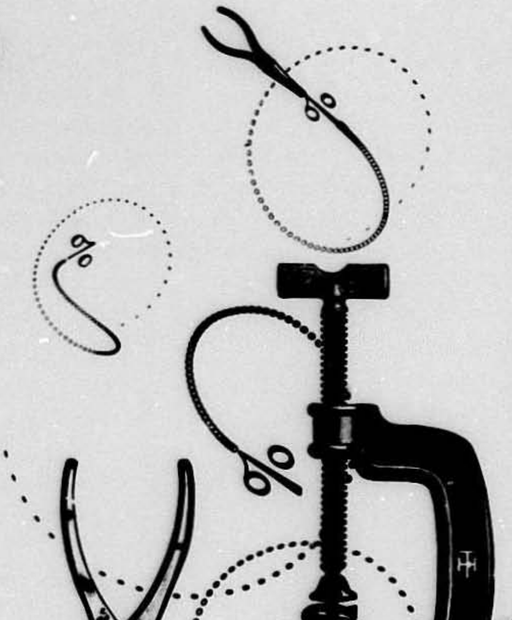
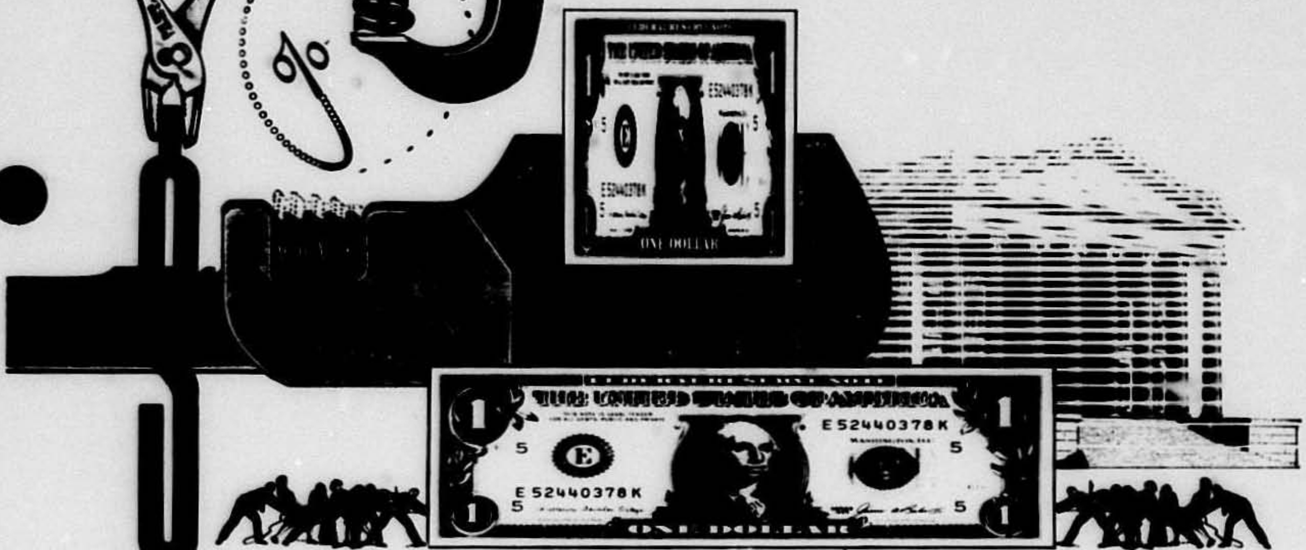
in its wake the serious, and sometimes fatal, asset quality problems—i.e., the risk that borrowers would not repay their loans on time—of hundreds of energy and agriculture banks. These same factors also played a role in the emergence of the LDC (less developed countries) debt crisis which, for most of the 1980s, was a dagger pointed at the heart of the international banking system.

Unfortunately, the manner in which inflation and inflationary expectations gave rise to serious asset quality problems in banking institutions in the early to mid-1980s was to repeat itself later in the decade. That is, while the overall rate of inflation over the balance of the 1980s behaved reasonably well, a number of related factors helped to create another wave of bad assets in banks. These factors included the rapid rise in real estate prices, the belief that components of business enterprises could be sold off at ever-higher prices in order to reduce debt, and the debt service costs associated with leveraged buy-outs (LBO's). The lingering effects of this wave of bad assets are still very much with us today.

Generalized or sector-specific elements of inflation and inflationary expectations were not the only factors eroding the fabric of the banking system during





much of the 1980s. Indeed, those problems were magnified by a new wave of technological changes that undercut important elements of the traditional banking "franchise"—that of taking deposits and making loans—by unleashing powerful new competitive forces from a wide range of sources both at home and abroad. The need to keep pace with these technological and competitive forces placed strong upward pressure on operating costs as banks sought to maintain market share and adapt their operating and business strategies to the newly emerging "high-tech" financial environment. All of this was occurring in a setting in which capital positions—that is, the "financial cushion" accumulated by banks in the event of potential losses—had been trending lower for many years, especially at many larger banking institutions. During this time, there were some observers who seriously questioned the need for even modest capital levels for banking institutions.

Taken together, the combination of rising asset quality problems, rapidly rising operating costs, competitively depressed margins and spreads, weakened capital positions, and an underlying banking structure that was (and is) increasingly out of step with the realities of the domestic and international marketplace produce a weakened and vulnerable U.S. banking system. To an extent, those sources of weakness and vulnerability were muted as long as overall economic activity remained robust. However, when the pace of economic activity slowed in 1990 and 1991, the scope of the problem became more evident, as witnessed by the sharp fall in many bank stock prices and the very appreciable widening of interest-rate spreads on bank debt relative, for example, to Treasury securities.[2]

IN THE 1980s, AN UNDERLYING BANKING STRUCTURE THAT WAS (AND IS) INCREASINGLY OUT OF STEP WITH THE REALITIES OF THE DOMESTIC AND INTERNATIONAL MARKETPLACE HELPED PRODUCE A WEAKENED AND VULNERABLE U.S. BANKING SYSTEM.

Recently, there has been a pronounced reversal of these earlier trends in that the equity and debt markets have favorably reappraised the outlook for banking institutions. This reappraisal seems to be driven by a number of factors, including:

Problem assets. There are straws in the wind to suggest that the rise in problem assets in the banking system may have peaked, even though it is true that the level of problem assets remains very high by any historical standard. Certainly, the LDC debt problem is now largely behind most major banks and the highly leveraged transactions situation looks better on the whole,[3] even though some individual problems still loom large. Commercial real estate problems remain formidable, but even there, the fall in commercial real estate prices seems to have abated in some parts of the country. If—and this remains a big if—the drag on bank earnings arising from the very high level of nonperforming and under-performing loans begins to abate, there is no question that it can have a favorable impact on bank profits and capital retention.

Capital positions. Despite the enormous drag on capital resulting from charge-offs against a wide variety of loans, major banks have substantially bolstered their capital and loan-loss reserve positions over the past several years. Indeed, the vast majority of major banks' risk-based capital ratios are now well in excess of the minimums established by the Bank for International Settlements (BIS)—a result that many observers would have regarded as unreachable only a few years ago.

In this regard, it should be stressed that the 1988 Basle capital accord, through which an internationally accepted definition of bank regulatory capital and a common weighting system for risk were developed, was one of the truly major banking and bank supervisory events, not just for the 1980s, but for the postwar period as a whole. Not only did it help establish a more level playing field in international banking and serve as a major step in the direction of strengthening the hands of supervisory authorities, but it also made it respectable for bank managers and directors to do what had to be done in any event—namely, become more aggressive and innovative in raising capital.

Operating costs. Banking institutions are becoming much more aggressive in their efforts to contain operating costs. To be sure, some of this is arising in the context of mergers, but even in the absence of such events, individual banks are having a significant degree of success in curbing operating costs. This process is painful and difficult, especially for the tens of thousands of workers who are being displaced as a part of the effort. However, its potential implications for the "bottom line" and for earnings retention and capital growth can be very powerful, especially if the drag on earnings that is arising from nonperforming loans were to abate in any material fashion.

While these and other factors go a long way in explaining the reappraisal by the debt and equity markets of the outlook for banks and the banking system, the fact remains that rebuilding the financial muscle of the U.S. banking system will be a long and difficult process that will be far from risk-free. Uncertainties about the near-term economic outlook in the United States and in much of the world tell us so in rather unambiguous terms. But there are other dangers as well. For example:

- The basic legal framework for banking and finance in the United States is increasingly out of step with the realities of the global marketplace, and with recently enacted changes in Canada and the prospects for major changes in Japan. In the near term, the situation will worsen further. This raises important competitive questions for U.S. institutions, but it also implies that it will become more and more difficult to effectively administer a policy of national treatment—that is, a policy that treats every bank operating in the United States, whether foreign or domestic, according to U.S. laws and regulations—in the sphere of international banking and finance. As U.S. firms' overseas operations benefit from structural reforms abroad and foreign firms become more frustrated by restrictions on their operations here in the United States, there is a danger of a rise in "financial protectionism" that can become still another source of unnecessary, and potentially damaging, tensions in the economic and financial relations between nations.

  Unfortunately, and despite years of debate and discussion, Congress has been unable to reach a consensus on the needed reforms—reforms that, at the least, should include the de facto repeal of McFadden, Douglas, and Glass-Steagall.[4] To be sure, these reforms will not solve all of the problems, but they will help to create the structural framework within which the process of change and adaptation can move forward in a more orderly and stable manner. They will also help strengthen the fabric of the U.S. banking and financial system, while reducing unnecessary and potentially troublesome new sources of financial and economic tensions between nations.

THE NEEDED REFORMS—THE DE FACTO REPEAL OF McFADDEN, DOUGLAS, AND GLASS-STEAGALL—WILL NOT SOLVE ALL OF BANKING'S PROBLEMS, BUT THEY WILL HELP CREATE A FRAMEWORK IN WHICH CHANGE AND ADAPTATION CAN MOVE FORWARD IN AN ORDERLY AND STABLE MANNER.

- In the eyes of many informed observers, the United States is still "overbanked." This implies that there will almost surely be a further shrinkage of relatively modest proportions in the number of banking institutions in the United States. That is a natural market process that, within limits, should be welcomed. But with banks—unlike many other forms of commercial enterprise—the precise manner in which that process of shrinkage occurs can have important implications for various aspects of public policy, including possible costs to the deposit insurance fund should banks fail. The crucial question, therefore, is not whether there will be further consolidation in banking, but whether that process can be managed in an orderly way, consistent with the public interest. That is one of the reasons why it is so important to get on with the task of progressive legislative reform along the lines discussed above.
- As the nature of banking and finance continues to change—driven still further by technology—individual firms will have to further develop and refine highly sophisticated risk-management and control systems in order to better understand and contain the credit, market, and settlement risks associated with a highly complex world of both on-balance sheet and off-balance sheet activities. The challenges in this area are formidable, not only for banking and financial institutions, but also—and perhaps even more so—for the domestic and international community of supervisors and regulators. Indeed, developing sensible, coherent, and effective reporting requirements, accounting standards, and capital guidelines governing many of these new activities will be an enormous task, even in a setting in which there are considerable goodwill and good intentions on all sides.

- Finally, there is the major question of whether bankers, legislators, and regulators will have the wisdom to benefit in a lasting fashion from the hard and painful lessons of the 1980s. The most basic of those lessons is the obvious fact that when emerging problems are not confronted early on, they only get worse—and they surely become more expensive.

None of us can see with clarity what the U.S. banking and financial system will look like five or 10 years from now, in part because none of us can fully anticipate what will constitute the banking "franchise" of the future. Yet, it is not inconceivable that the U.S. banking system will emerge from the painful and difficult decade of the 1980s with renewed strength and competitive vigor, while banking systems in many other countries will still have to cope more fully with many of the competitive and technological changes that occurred in this country over the past decade. Public policymakers have a role to play in fostering that favorable outcome for the U.S. banking system, in part by maintaining policies consistent with noninflationary growth in the U.S. economy and in part by creating a legal and regulatory environment that is consistent with a safe, sound, competitive, and contemporary banking and financial system.

But at the end of the day, it is discipline and prior restraint on the part of directors and managers of banking and financial institutions that must be sustained if we are to reach that vision of the future. As noted earlier, there are some straws in the wind to suggest that a renewed commitment to those basics of banking is beginning to take hold. If that is the case, and if it can be sustained in a setting in which public policy does its job, a more stable banking environment is within reach with all of its benefits for the nation's economy and the society at large. •

1. Deregulation got its most prominent boost in 1980, with passage of the Depository Institutions Deregulation and Monetary Control Act.

2. The interest-rate spreads between bank debt and Treasury securities is, of course, an indicator of the public perception of the risks attached to bank debt relative to that of Treasuries. Treasuries are considered safe from default risk. Other debt instruments are considered riskier and typically command higher interest rates—the higher the perceived risk, the higher the interest rate necessary to attract investors or depositors.

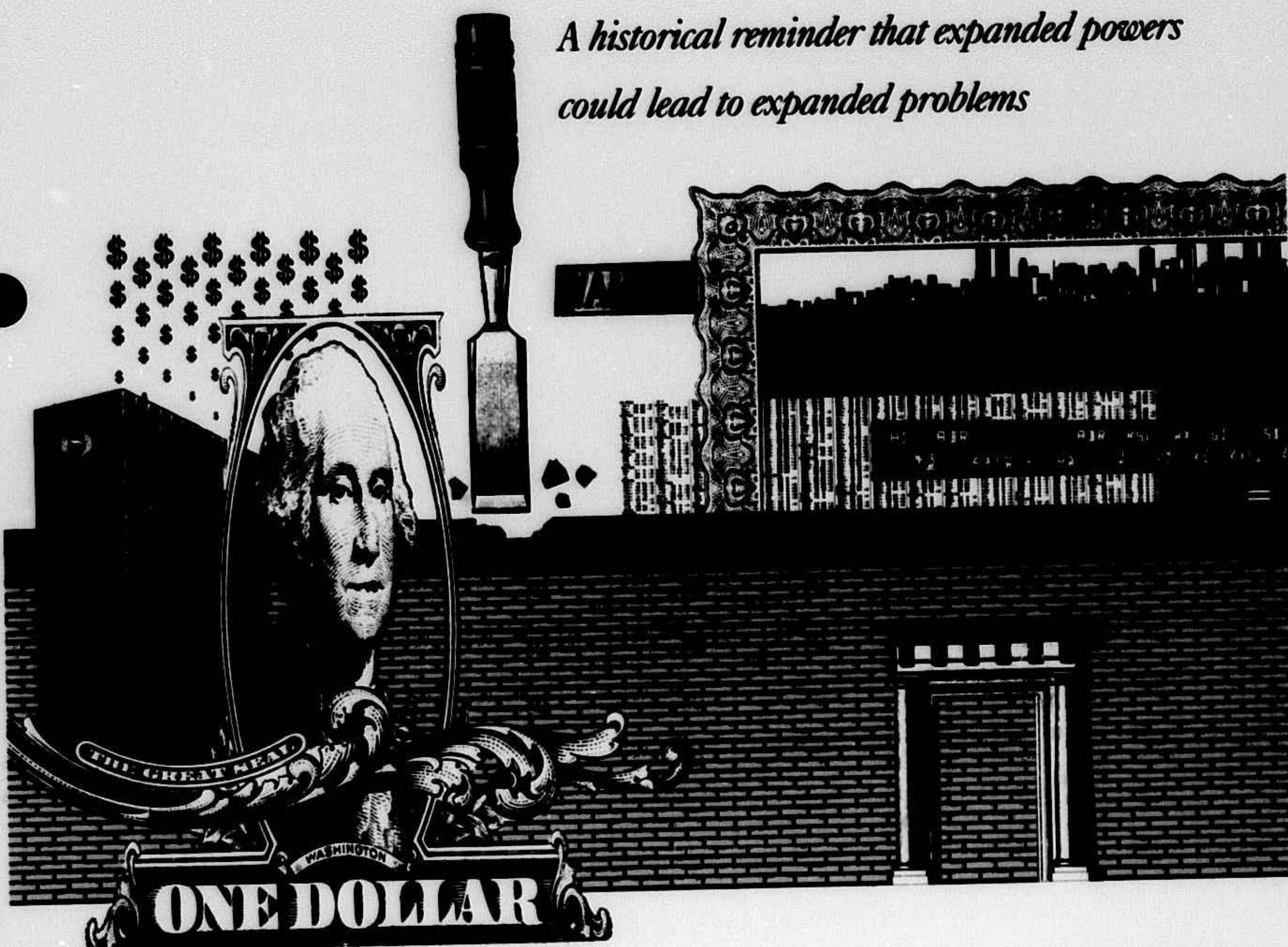
3. Falling interest rates, some loan restructuring, and the fact that fewer LBO's of mega-proportions are taking place have all have helped to alleviate the most acute stresses.

4. The McFadden Act (1927) limited the branching of national banks to within one state. The Douglas Amendment was an amendment to the Bank Holding Company Act (1956) that prohibited bank holding companies from acquiring out-of-state banks unless the acquisitions were approved by the host states. Glass-Steagall (1933, revised 1935) forbade securities firms from engaging in the banking business, and effectively separated investment banking from commercial banking.

Philip A. Lacovara

MODERNIZE BANKING . . . BUT WITH CARE

A historical reminder that expanded powers could lead to expanded problems



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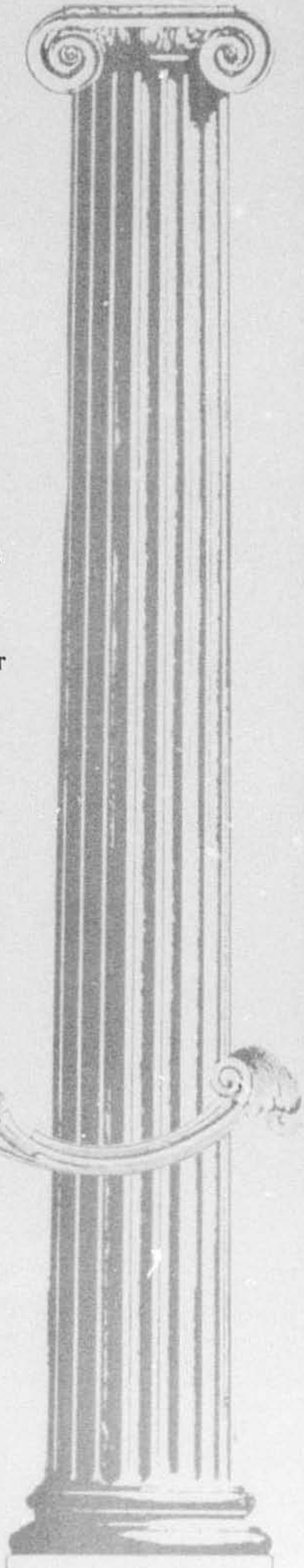


THE PREMISE OF THE GLASS-STEAGALL ACT WAS THAT EACH SECTOR OF THE FINANCIAL COMMUNITY SHOULD ACT INDEPENDENTLY, WITH NO CROSS-SUBSIDIES THAT MIGHT DRAG BANKS AND THEIR DEPOSITORS TO THE BRINK—OR OVER IT.

HISTORY, AS WE ought to know but often forget, has lessons to teach us. All too frequently, it takes a disaster to make us remember. The failure of the banking system in the 1930s was accompanied by the Great Depression. A similar failure of the banking system—and perhaps another economic calamity similar to the Great Depression—has been averted today, but only through a bailout of the nation's thrifts and commercial banks that will cost half a trillion dollars or more. For that sum, we at least ought to be reminded of the need to protect the banking system from the sort of practices that have cost us a lot of money and damaged our confidence in American financial and political institutions.

What follows is a brief explanation of one of the cornerstones of financial regulation since the 1930s: the separation between the banking sector and the securities industry. Next, a few words about a reform proposal that has recently stirred up a lot of discussion: granting banks new powers to participate in the securities field. Finally, the basic elements of a reform proposal that would encourage economic efficiency and ensure safety and soundness.

The Glass-Steagall Act of 1933

In the four-year period from 1930 through 1933, over 7,000 U.S. banks failed. These failures crippled the global financial system and served as the impetus for the establishment of the Federal Deposit Insurance Corporation (FDIC) and the enactment of the Securities Act of 1933 and the Securities Exchange Act of 1934. Congress also responded by passing the Banking Act of 1933 (known as the Glass-Steagall Act), which separated the commercial banking and investment banking industries. In essence, commercial banks accept deposits from the public and use those resources to make loans. Investment banks use their own capital—provided by partners or shareholders—to underwrite securities for companies and governmental bodies. The passage of the Glass-Steagall Act reflected a judgment that the commingling of commercial lending and securities underwriting presented temptations and conflicts of interest that threatened the credibility and soundness of the financial system. Specifically, Congress was concerned because U.S. banks had:

- channeled bank funds into "speculative" investments sponsored or co-sponsored by the commercial banks' securities affiliates;
- imprudently loaned money directly to their securities affiliates;
- loaned money to third parties to finance the purchase of securities from the banks' securities affiliates; and
- purchased stock from their securities affiliates for their own accounts or for their fiduciary accounts; in other cases, securities affiliates purchased stock in companies that were the beneficiaries of loans from the parent bank.

The institution of federal deposit insurance through the FDIC made the regulation or prohibition of these conflicts of interest even more imperative, since any financial irresponsibility on the part of bank managers would now put on the hook not just the banks' shareholders but American taxpayers as well. The Glass-Steagall Act was designed to eliminate these opportunities for double-dealing by flatly prohibiting banks from owning securities affiliates (with one notable loophole that I will mention later). The premise of the reform was that each sector of the financial community should act independently, each pursuing the distinct types of transactions in which it specializes, with no cross-subsidies that might again drag banks and their depositors to the brink—or over it.

The long calm

For more than four decades, the restructured banking system that had emerged during the Great Depression showed no signs of weakness. Banks enjoyed a very protected and cozy existence: The price they had to pay to attract deposits was limited by government-imposed ceilings on the interest rates they could offer on savings accounts, and the terms of competition were limited by legislative prohibitions on interstate branching and by similar bars to the ownership of banks by commercial firms. Commercial banks also enjoyed a monopoly over checking accounts and—even better—were prohibited by law from paying interest on demand deposits (particularly checking and payroll accounts). Savings and loans (also known as thrifts), which were developed in order to promote mortgage lending and home ownership, were also subject to an interest-rate ceiling, but they were permitted to pay a quarter-percent more in interest than commercial banks. The effect of these regulations was to force consumers to keep their liquid funds in commercial banks and thrifts at artificially low rates. Meanwhile, the banks and thrifts pocketed their monopoly profits.

FOR MORE THAN FOUR DECADES, BANKS ENJOYED A COZY EXISTENCE. REGULATIONS FORCED CONSUMERS TO KEEP THEIR LIQUID FUNDS IN BANKS AND THRIFTS AT ARTIFICIALLY LOW RATES. MEANWHILE, THE BANKS AND THRIFTS POCKETED THEIR MONOPOLY PROFITS.

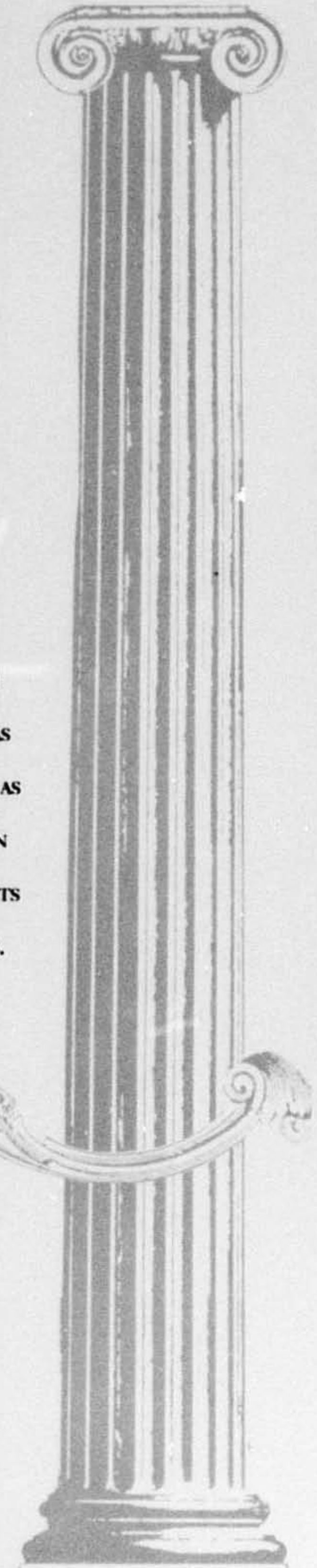
Standing behind all of this was the guarantee of federal deposit insurance and ultimately, access to the Federal Reserve System's "discount window"—the guaranteed "lender of last resort" in the event that banks needed cash. Between them, deposit insurance and the "discount window" allowed banks to take greater risks than nonbank financial institutions.

Innovation, deregulation, disaster

The banking system's strength was deceptive, however, resting as it did primarily on artificial restraints on market forces. The loosening of these restraints, when it occurred, led to a resurgence of financial irresponsibility, as bankers plunged into markets they lacked either the expertise or the judgment to serve safely and profitably.

The change began in the mid-1970s with the birth of the money market account. Investors soon found that they could invest their liquid funds in these almost risk-free accounts while earning substantially higher rates of interest than were offered by commercial banks and thrifts. Gravity makes water find its own level. In this instance, market forces had the same effect on investment: By 1982, the amount of money invested in money market accounts had risen to more than $200 billion.

Just as investors were turning away from banks and thrifts, so, increasingly, were corporate borrowers. The growth of the commercial paper market gave



corporations a chance to lower their borrowing costs by going directly to the financial markets for short-term funds rather than borrowing from banks. By 1979, $113 billion of commercial paper was outstanding.

What all this meant was that banks and thrifts were now losing their most profitable clients both on the deposit side and the loan side. The situation was particularly dire for the thrifts: Between 1980 and 1982, 28 percent of all thrifts were either liquidated or merged into stronger institutions.

In 1982, the banks and thrifts responded by asking Congress to pass the now infamous Garn-St. Germain legislation that, among other things, accelerated the deregulation of interest rates and the amount of non-mortgage lending in which thrifts could engage. The effect of this legislation was to allow banks—and thrifts, in particular—to engage in risky (or even reckless) lending and investment practices. While competing to attract more expensive, higher-interest deposits, banks and thrifts had to turn to more risky investments to cover the escalating costs these deposits entailed. Of course, federal deposit insurance stood behind these risky activities. Taxpayers are still paying the price.

It is important to remember that it was not primarily local, mom-and-pop institutions that succumbed to imprudent, reckless, or criminal mismanagement. According to the latest FDIC figures, between 1988 and 1991, banking regulators had to close 602 banks with assets totalling approximately $118 billion—a per-bank average of almost $200 million. Last year alone, the average bank that had to be seized had assets of nearly $425 million.

THE LONGSTANDING STRENGTH OF THE BANKING SYSTEM WAS DECEPTIVE, RESTING AS IT DID PRIMARILY ON ARTIFICIAL RESTRAINTS ON MARKET FORCES.

The debate over expanded powers

Against this backdrop, it would seem almost unimaginable that the banks would come forward and ask for an expansion of their power to engage in nonbanking businesses, let alone one as volatile as the securities business. I say "expansion," because each of the nation's largest banks already has taken advantage of a loophole in the law to establish what is called a "Section 20" affiliate. Section 20 of the Glass-Steagall Act prohibits banks from affiliating with any organization that is engaged "principally" in the issue, flotation, underwriting, public sale, or distribution of securities. For many years, this language served, as Congress intended, as a safety barrier to banks' entry into securities underwriting. But more recently, the Federal Reserve Board has allowed that the word "principally" suggests that banks may own affiliates that depend on securities activities for *some*, but not most, of their revenues. Recent Federal Reserve interpretations of Section 20 allow banks to establish nonbank subsidiaries that derive up to 10 percent of their revenue from a wide range of otherwise prohibited securities activities, including underwriting commercial paper, mortgage-backed securities, municipal bonds, securitized assets, and corporate bonds and equity offerings.

Many of the country's largest banks are not satisfied with this important beachhead, however, and seek to repeal Glass-Steagall completely. They argue that they are unfairly confined to traditional banking activities—activities that are no longer profitable due to the growth of money market accounts, the expansion of the commercial paper and medium-term note markets, and the development of the asset-securitization market.

Their complaint has some superficial appeal. Only one U.S. bank is numbered among the world's largest 30, suggesting that U.S. banks have become globally uncompetitive. (It is rarely mentioned, however, that Japan, the country with the most banks in the top 10, has its own version of Glass-Steagall.) The banks also point out that many European countries allow their banks to pursue securities activities, apparently without calamitous results. These foreign banks, the argument goes, are able to take advantage of the "synergies" that exist between the banking and securities markets.

Should banks have expanded powers?

Despite all the arguments for expanded powers, however, no one has yet demonstrated a compelling need to let federally insured banks move—whether directly or through affiliates—into other businesses. The vast majority of banks that did not make unwise loans to real estate developers, third world countries, or leveraged buy-out magnates remain profitable and healthy. That some banks have been so incompetent in handling their core business certainly does not recommend that we encourage them to expand into other enterprises.

Nor would entrance into the securities business be the panacea that many bankers seem to think it would be. While the securities industry has been generally profitable in recent years, it is also extremely cyclical. In 1990, for example, the banking industry—however troubled it may be—had net income of over $16 billion. During the same year, the securities industry, as a whole, lost over $160 million and had a lower return on equity than did the commercial banks. In fact, securities firms had a lower return on equity than banks in 1988, 1989, and 1990.

The argument, then, that entering the securities field would restore profitability to poorly managed banks makes no sense. Moreover, adding hundreds of new, federally insured competitors to an industry that is already highly competitive and cyclical would be a prescription for systemwide failure.

The "synergies" argument is even more disturbing. Just where these synergies might come from never seems to be quite clear, but one can only ponder the synergistic opportunities that would arise if banks were free to pursue the types of double-dealing activities that brought us the stock market crash of 1929. It is sometimes argued that synergies will come about because banks, through their loan activities, are adept at understanding and identifying sources of risk—a skill that is at the heart of the securities underwriting business. This is hardly an argument for an integrated system, even leaving aside the obvious question of why, if banks are so good at understanding and identifying sources of risk, so many of them are in such a debilitated condition.

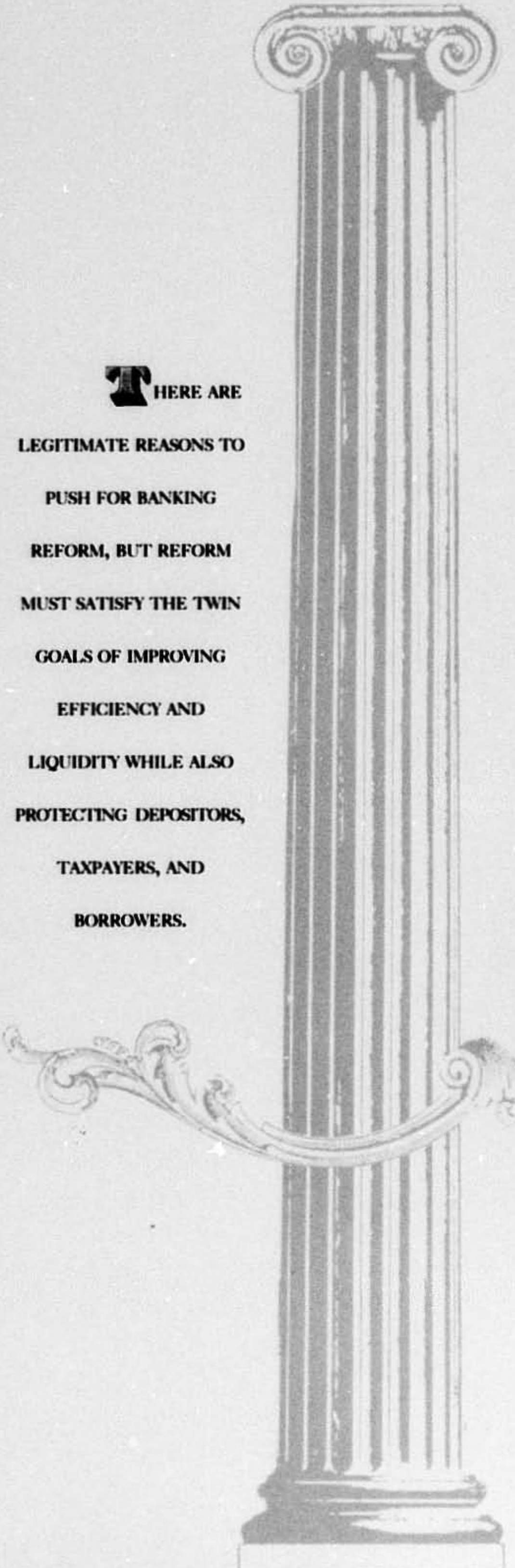
It would be one thing, of course, if the banks wanted to set up truly isolated affiliates, staffed by professionals who would conduct the securities business without involving the bank's deposits. But the bank reform debate has historically been controlled by a few large money-center banks that desire nothing less than the ability to conduct full-scale securities business supported by the federally insured resources of the bank and unconstrained by any safeguards against mismanagement or abuse. These banks resist all efforts to establish what are called "firewalls"—tough restrictions that would prevent banks from

DESPITE THE ARGUMENTS FOR EXPANDED POWERS, NO ONE HAS DEMONSTRATED A COMPELLING NEED TO LET FEDERALLY INSURED BANKS MOVE—WHETHER DIRECTLY OR THROUGH AFFILIATES—INTO OTHER BUSINESSES.

dealing with their proposed securities affiliates. The industry's aversion to firewalls is so fierce that it seems willing to scrap the entire push for expanded powers, if it has to accept firewalls to get them.

But if Congress concludes that some enlargement of banking powers could offer real benefits to the banking system, it would be crucial to balance these enhanced powers with real, practical restrictions designed to ensure that the enlarged powers do not jeopardize the legitimate expectations of depositors, the deposit-insurance guarantee backed by taxpayers, or the freedom of choice of commercial customers. If banks are to be given greater authority to underwrite and trade securities, these activities must be conducted by an affiliate that is walled off from the federally insured banking operations, so that insured deposits are not placed at risk in subsidizing or financing securities underwriting and trading activities.

In addition, Congress should protect business people who depend on a bank's lending capabilities from being blackmailed into using the bank's securities services. This risk is real: Even with the limited securities business done by Section 20 affiliates today, there have been numerous cases in which banks have conditioned their willingness to extend or renew credit to their business customers on the customers' use of the affiliates' securities services.



THERE ARE LEGITIMATE REASONS TO PUSH FOR BANKING REFORM, BUT REFORM MUST SATISFY THE TWIN GOALS OF IMPROVING EFFICIENCY AND LIQUIDITY WHILE ALSO PROTECTING DEPOSITORS, TAXPAYERS, AND BORROWERS.

Some suggestions for sound banking reform

There are legitimate reasons to push for banking reform, but reform must satisfy the twin goals of improving efficiency and liquidity while also protecting depositors, taxpayers, and borrowers.

The change that would best satisfy these goals would be a repeal of the current prohibition against interstate branching. Alone among the world's major nations, the United States fragments its banking system among more than 12,000 financial institutions. Allowing banks to solicit deposits and offer services nationwide would stimulate consolidations and offer efficiencies of scale that could significantly improve operating margins without increasing risks.

Since the nation would be starting from a wildly Balkanized system, prospects are remote for dangerous levels of concentration working to the disadvantage of depositors or customers in small towns and rural areas. Repealing the prohibition against interstate branching would do more to bolster the banking industry's efficiency and profitability than allowing it to expand its entry into the securities business could ever be reasonably expected to do. (The first step on this road was taken this spring when the administration allowed thrifts some interstate branching.)

Another reform that merits serious consideration would be loosening the constraints that currently prohibit industrial companies from controlling or owning major interests in commercial banks. Industrial corporations could provide banks an additional source of capital and provide another valuable resource as well: managers who understand the importance of efficiency.

Clearly, there is ample room to modernize the nation's banking system. But it must be done with care. The stakes are too high to forget that if the system offers opportunities for mismanagement or abuse, someone is likely to take advantage of them. That is one of the clearest lessons of history. •

Bernard Wexler

HOW DID GLASS-STEAGALL HAPPEN?

Commercial banks were in the securities business until the Great Depression–and Senator Glass–got them out.

FOR THE PAST 30 years, commercial bankers and securities industry professionals have argued about the Glass-Steagall Act of 1933, a Depression-era reform that set a barrier between commercial banking functions and much of the traffic in stocks and bonds. The conflict has focused on no less an issue than the wisdom of the reform itself and the desirability of undoing it. Bankers argue that Glass-Steagall is ludicrous and outdated. People in the securities industry argue that it is essential to the safety of the financial system.

Back in June 1933, when Glass-Steagall was enacted, there was no such controversy. Instead, there was a remarkable consensus. Virtually all interested persons appear to have thought the measure praiseworthy and long overdue. Yet only two years later, even the author of the legislation doubted its wisdom. And historians today generally agree that Glass-Steagall had little impact on the economic depression that led to its enactment.

How has this law given rise to such contradictory views? And why did it attract such universal support in the first place? A look at the world in which it came about may offer some answers.[1]

Banks and securities

Glass-Steagall reflects ideas deeply rooted in 19th-century banking theory and practice. Conventional Victorian economic wisdom held that institutions that accept demand deposits from the public should use that money to supply short-term commercial credit to entrepreneurs and should steer clear of stocks and bonds. What banks actually did always differed to some extent from the classical economists' theories about what they ought to do. Until the 1920s, however, the gap between theory and practice was relatively slight for most *incorporated* commercial banks.

But the great *private* banks of those days, which were organized as partnerships, imposed no such limitations on themselves. These firms—such as J.P. Morgan & Company, its Philadelphia affiliate Drexel and Company (later reincarnated as Drexel Burnham Lambert Inc.), Brown Brothers Harriman & Company, Lee Higginson & Company, and Kuhn, Loeb & Company—were the nation's premier investment bankers.[2] They also supplied commercial banking services to a select clientele of large corporations, public authorities, and affluent folk. Moreover, they were closely intertwined with the biggest incorporated commercial banks.

Hence people in the Progressive Era talked about the "Money Trust," which some viewed—not wholly without reason—as the mother of the other trusts and therefore the most sinister trust of the whole vicious breed. This was the era in which Lincoln Steffens called the senior J. Pierpont Morgan "the boss of the United States," and in which Woodrow Wilson, accepting the Democratic presidential nomination in 1912, warned that "a concentration of the control of credit . . . may at any time become infinitely dangerous to free enterprise." Yet all this sound and fury did little to prevent banks from expanding their operations.

Commercial banks got into the securities business in a big way during World War I, when the federal government sold its Liberty bonds through the banks. That patriotic mission familiarized banks with the techniques of the trade. And it helped them overcome the public's skittishness about securities.

Up to this point, stocks were for speculators, many of whom relied heavily on margin credit. Stock speculation with borrowed money seemed hard to distinguish from gambling. And if the customers were gamblers, the brokers who catered to them were casino operators. To respectable folk in the days before World War I, the stock market looked like a sleazy, disreputable, dishonest game in which greedy, gullible sheep were fleeced by even greedier but far more knowing professionals.

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Of course, there were always a few "blue chip" stocks of investment caliber, but those were held by the classes, not the masses. And even among the wealthy, cautious people steered clear of stocks.

This changed very fast during the Roaring Twenties. People who bought Liberty bonds from their bankers in 1917 and 1918 became good prospects for other, more venturesome securities. The two largest commercial banks in the land, Chase National Bank (now Chase Manhattan Bank) and National City Bank of New York (now Citibank), saw a golden opportunity and seized it by launching huge investment banking operations. Other institutions followed their lead.

Few found this combination of functions disturbing. Because the leading commercial banks were also the leading investment banks, and because the preeminent private investment banks were also active in wholesale commercial banking, there were no turf wars. A world in which barbers sell food and grocers cut hair—and in which the conventional wisdom regards this as fitting and proper—is no place for pitched battles between grocers and barbers over who should be permitted to do what. And if neither the grocers nor the barbers are bothered, who else will care?

SENATOR CARTER GLASS MAY WELL HAVE BEEN THE BANKERS' FAVORITE STATESMAN. YET THIS WARM FRIEND OF BANKS AND BANKERS WAS THE FATHER OF LEGISLATION THAT STRICTLY CURTAILED BANKS' ACTIVITIES.

Enter Senator Glass

When it came to banking, however, someone did care: Senator Carter Glass of Virginia. Were it not for the Glass-Steagall Act, few people would now remember Glass. (Even fewer would remember Representative Henry B. Steagall of Alabama, Glass's House counterpart and the father of federal deposit insurance.)

To history buffs, however, Glass's association with the measure that bears his name seems incongruous. In his day (and it was a very long one) Glass may well have been the bankers' favorite statesman: an old-fashioned, intensely conservative legislator, who probably wouldn't have minded being called a "reactionary," and whom some thought an apologist for and a creature of the Money Trust. How did it happen that this warm friend of banks and bankers was the father of legislation that strictly curtailed banks' activities?

Carter Glass was a critical, skeptical conservative who thought for himself. A self-educated newspaperman who became a passionate student of finance as well as a politician, Glass had helped craft the Federal Reserve system while a member of the House of Representatives. Later he was Woodrow Wilson's Secretary of the Treasury. When he went to the Senate, he appointed himself the Democratic party's in-house financial expert.

As such, Glass was "a socially conservative critic of speculation."[3] Long before the 1929 crash, he found the banks' securities-related activities inappropriate and troubling. He wanted to curb them. When he wrote the 1928 Democratic platform's banking plank, he stated: "The administration of the (Federal Reserve) system for the advantage of stock market speculators should cease. It must be administered for the benefit of farmers, wage-earners, merchants, manufacturers, and others engaged in constructive business."[4]

Today it might be hard to see how Glass-Steagall could spring from a concern about the diversion of credit from "constructive business" to presumably unconstructive stock market speculation. To prohibit banks from lending too much on securities (as Section 7 of the Securities Exchange Act of 1934 now does) is one thing. To bar them from any role at all in the distribution of new nongovernmental securities—even pure debt issues of the highest quality that no one could possibly consider "speculative"—is quite another. Yet until quite recently, that is exactly what Glass-Steagall did.[5]

But the unconstrained financial world of the twenties had neither a Glass-Steagall Act nor a Securities Exchange Act. So it was not wholly unreasonable for financial Puritans, like Carter Glass and his favorite academic economist, H. Parker Willis of Columbia University, to see a distressing link between what the banks did as lenders and what they did as securities merchants.

In their view, one hand washed the other to the detriment of productive enterprise. Banks, acting as merchants, urged their customers to buy securities. The bankers then donned their lending hats and lent those customers the wherewithal for their speculative purchases. So the bankers made a double profit: They collected a commission or a markup on the securities, and they also collected interest on the loan that paid for the securities. Yet the honest businessmen and the upstanding farmers, whom the banks were supposed to serve, couldn't get loans. Money that should have been made available to them was being "diverted" to Wall Street casino operations.

So reasoned Glass and his colleagues. These notions reflected the classical theory that long-term capital ought to come from the community's "real savings," not from money "manufactured" by entries on the books of commercial banks.

Depression and disaster

After 1929, Glass moved beyond a mere concern with credit control. He had always thought that banks shouldn't sell stocks and bonds to their customers. Now, with the stock market crash, he had incontrovertible proof that their doing so led to disaster. As Glass saw it, the link was really very simple. Not until the late 1920s had banks gone into the securities business on a huge scale. And the great collapse followed as night follows day. Now banks all over the land were closing their doors; such are the wages of sin. The problem was that those wages were being paid not by the sinful bankers, but by the hapless investors and the innocent depositors who trusted those faithless money changers.

Glass saw to it that the 1932 Democratic platform demanded "the divorce of the investment banking business from commercial banks." Today so arcane a policy doesn't sound like much of a vote-catcher. But in the Depression-tormented America of 1932, the issue had considerable electoral appeal. So the nationwide radio address in which Glass told how "with insatiable avarice, great banking institutions, through their lawless affiliates," had peddled worthless securities to trusting investors was considered "one of the most effective speeches of the whole campaign."[6]

That speech had been preceded by a barrage of publicity about the bankers' investment misdeeds. Glass held two sets of hearings, which exposed much dirty linen. As he told his colleagues, "The great banks in the money centers choked the portfolios of their correspondent banks from Maine to California with their utterly worthless investment securities, nearly eight billions of them being the investment securities of tottering South American republics and other foreign countries."[7]

The question did not arise whether this linen was dirtier than that of the firms that confined themselves to investment banking. In fact, the evidence suggests that the post-Depression performance of the issues underwritten by commercial banks was slightly less dismal than that of the securities hawked by the nonbank sector. But the times were not propitious for a defense that said, in essence, "We weren't really all *that* bad; in fact, we were at least a little bit better than the others." The essential political reality was that lots of people had lost lots of money because securities sold to them by banks had gone sour.

The bankers called this a natural consequence of the greatest contraction in economic history. They did not see what their role in the securities business had to do with it. To Glass and his allies, however, the issue was essentially ethical: Stocks and bonds had caused bankers to stray from the paths of righteousness. As Senator Robert J. Bulkley of Ohio said at the time: "If we want banking service to be strictly banking service, without the expectation of additional profits in selling something to customers, we must keep the banks out of the investment security business."[8]

Contesting the divorce

Exactly why "strictly banking service" was so much better than a broader "financial department store" vision of the banker's function was never really explained. Nor was it altogether clear that measures forcing banks to conform to the theories of Senators Glass and Bulkley would have prevented the Depression. Just how such laws would bring prosperity back was an even deeper mystery. So the case for divorce seemed thin.

To defenders of the status quo, that case appeared skeletal and specious. They pointed out, first, that divorcing investment from commercial banking in the midst of a serious depression was likely to have strong deflationary effects. (This argument carried little weight with Glass, who responded, "There are some things that ought to be deflated . . . and any time is opportune to deflate them in my judgment."[9])

Second, the link between the banks' securities activities and the bank failure epidemic was obscure. National City Bank, Chase National Bank, and First National Bank of Boston hadn't failed. The banks that closed were smaller, and few of them had much to do with securities. So why all the fuss about securities?

Third, how would turning the whole securities business over to brokers constitute an improvement? Everybody knew that *those* hucksters were even less angelic than bankers. Moreover, the banks were regulated, and in those days—before the Securities and Exchange Commission—brokers were not.

The real problem, said Glass's opponents, was overly aggressive selling and low margins. Glass's divorce hobbyhorse addressed neither of those evils. Still, 1932 and 1933 were bad years for this kind of skeptical pedantry. That the skeptics and the pedants happened to be the very bankers who stood to benefit from the perpetuation of the status quo, which had enriched them but brought their customers and the country to ruin, did not add to their credibility.

The man who was credible was Carter Glass. And he, an ultra-conservative, extremely prestigious elder statesman of finance, said that the perverse marriage between commercial and investment banking had to be dissolved in order to restore the nation's economic health. Legislators both less conservative and less at home with the mysteries of finance were not inclined to cross swords with Glass about this issue. In January 1933, lawmakers eager to appear more pro-banker than Carter Glass were few and far between. So the Senate passed his banking bill on January 25, 1933, by a vote of 54 to 9.

BANKERS DID NOT SEE WHAT THEIR SECURITIES BUSINESS HAD TO DO WITH THE DEPRESSION. TO SENATOR GLASS, HOWEVER, THE ISSUE WAS ETHICAL: STOCKS AND BONDS HAD CAUSED BANKERS TO STRAY FROM THE PATHS OF RIGHTEOUSNESS.

Scandal and success

As the battlefront moved to the House in March 1933, commercial bankers were drowning in a sea of troubles. A catastrophic nationwide banking crisis had forced the new president to close every bank in the country. The men who presided over those institutions were also in sad shape, irreparably damaged by the Senate's concurrent investigation of the securities industry.

The bankers most closely identified with the merchandising of investments, Charles E. Mitchell of National City and Albert J. Wiggin of Chase, had been exposed as tax cheats and manipulators who sold their own institutions' stock short while they urged the public to buy. Those who had taken that advice had suffered severely, while Mitchell and Wiggin had compensated themselves on a princely scale. Both found it expedient to resign.

Their successors turned over a new leaf at once. On March 7, 1933, National City Bank announced that it was liquidating its securities affiliate. The next day Winthrop Aldrich, Chase's new chief executive, commended National City's action, declaring that "intimate connection between commercial banking and investment banking almost inevitably leads to abuses."[10] Chase, and other banks, followed National City's lead.

It was all over now. And the Banking Act of 1933 speedily became law.

To most Americans, the act's federal deposit insurance provisions were undoubtedly far more important than its strictures on the banks' role in the then-comatose securities business. At that terrible time, the securities provisions were of little moment even to bankers. Investment banking was now so depressed that the right to engage in it was no longer worth a fight. A summary written at the time notes that in contrast to the banks' earlier position, now "there was no effective opposition because security selling has ceased to be profitable and some of the larger banks had already taken steps to eliminate their security affiliates."[11]

Another factor muting bankers' objections was 1933's miserable employment situation. Banks were known as penurious but steady employers. They didn't fire people unless they absolutely had to. A law barring them from the now-dormant securities business proved convenient in that it enabled banks to trim their staffs while retaining their reputation for benevolence to employees. True, the jobs were gone. But they had been destroyed by an act of Congress.

Glass's ironic encore

Of course, the Depression didn't end in 1933. It persisted for years. And private investment remained paralyzed.

That paralysis caused Glass to reconsider. In 1935, when banking legislation was on Congress's agenda once again, he came forward with a measure that would have lowered the barriers he himself had built two years earlier. His rationale was that there was a desperate need to revive investment and that readmitting the bankers to the securities business might do the trick.

The Senate passed Glass's amendment. And J. Pierpont Morgan, Jr., kept assuring his London partners that it would become law. But in late August, President Franklin D. Roosevelt made it clear he would consider no modification of Glass-Steagall. Glass's liberalizing amendment died in a House-Senate conference committee.

History's wheel turned strangely both when it produced Glass-Steagall in 1933 and then protected it from Glass himself in 1935. Glass-Steagall was in no sense a Roosevelt Administration measure; it had passed the Senate even before Roosevelt's inauguration. When enacted in 1933, it was a more or less idiosyncratic "Glassism" whose passage owed much to Glass's unique combination of enormous prestige, long experience, reputed financial erudition, intense passion, and strategic legislative position. In addition, the anti-banker climate of the day, the obvious political need to do *something* about banking that sounded vehement but wasn't really all that radical, and the bankers' decision to capitulate together led the administration to take a benevolently neutral stance.

By 1935, however, President Roosevelt and his followers were much attached to it. That Glass-Steagall's architect was now disenchanted with his 1933 design made it all the more attractive to New Dealers. Glass, the quintessential financial conservative, was identified in the public mind with the House of Morgan. President Roosevelt wasn't. Nor did he want to be—especially as he approached his campaign for reelection.

So he opposed Glass's new look. For good or ill, the wall stood.

In 1935, that wall didn't matter all that much to anyone who was neither a banker nor a broker. In fact, it may not have mattered at all. Few of today's economic historians, whatever their ideological stripe, now believe that banks' securities affiliates did much to bring on the Depression; that Glass-Steagall did much to advance or curtail the welfare of investors or the general public; or that Glass's 1935 amendment, if adopted, would have contributed materially to recovery.

But at the time, the wall had acquired great symbolic significance. Though it was not a New Deal measure to start with, and though it obviously did nothing at all to relieve the mass destitution of the time, Glass-Steagall became identified with the New Deal's spirit. It was now a token of the administration's determination to make a sharp break with the bad old days and to return the capital of the United States from Wall Street on the island of Manhattan—where it was said to have been for a long time before 1933—to Pennsylvania Avenue in Washington, D.C.

True, this move had much more than token value to the many people on Wall Street who benefited substantially (even in terribly depressed 1935) when commercial bank competition was eliminated from the stock and bond trade. But these gentlemen were not in the limelight.

The House of Morgan was. The pressure for a change in Glass-Steagall came from it and from its friend Senator Glass. To President Roosevelt and *his* friends, this was reason enough to leave Carter Glass's 1933 creation undisturbed and undiluted.

TODAY, COMMERCIAL BANKERS ARGUE THAT CARTER GLASS'S IDEAS, FORMED BY WHAT HE HAD READ BY CANDLELIGHT IN QUEEN VICTORIA'S DAY, WERE ANTIQUATED LONG BEFORE 1933. YET THE OLD-FASHIONED SENATOR STILL RULES THEM FROM HIS GRAVE.

A temporary truce

After 1935, Glass-Steagall became a non-issue. And it looked as though the bankers and the securities dealers would live happily ever after, after their divorce.

While the Depression was still on, there wasn't much worth fighting about. Memories of the 1929 crash, the ensuing catastrophic losses, and the devastating revelations of the Senate investigations were still fresh. The banks had no desire to make those recollections even more vivid than they already were. So the factors that had led them to abandon the securities ship back in March 1933 remained in place.

This was so even after the economy recovered. During World War II and for a long time after it ended, commercial banking prospered. Still, the securities business seemed incapable of returning to anything resembling its 1927-1929 level. There was lots of money around, but a risk-averse public was loath to commit those funds to stocks and bonds. High income taxes and low interest rates made bonds unattractive to private, non-institutional purchasers. As for stocks, the memory of the crash and the Terrible Thirties deterred mass investment in equities.

But the truce was temporary. The war about Glass-Steagall that the bankers chose not to fight in 1933 erupted 30 years later. By then, 1929 was ancient history—but Glass-Steagall lived on, prompting a struggle between bankers and brokers that is still going on.

By the 1960s, the nation was much richer, and the field that looked repulsively barren in 1933 was far lusher. The fly in the economic ointment was inflation. Stocks were the traditional hedge against that, so prudent people who wanted to preserve their capital found them attractive. The equity securities that looked like mere gambling vehicles to Glass in 1930 were now seen as investment necessities. Moreover, the mutual fund—a mechanism for collective investment that was still in its infancy in 1929—was bringing Wall Street to Main Street on a scale that would have boggled the minds of 1920s bankers Mitchell and Wiggin.

Their successors naturally wanted their fair share of this generous feast. It was just as natural for the securities industry to argue that Glass-Steagall's wall barred commercial bankers from the investment banquet table. Both sides turned to their lawyers. And a great battle of the books broke out about just what Senator Glass meant to prohibit and just what he meant to permit.

Still, as much as the bankers disliked the idea of any limitations, they had to concede that Glass must have thought he was prohibiting *something*. So the battle moved to the legislative arena, where it rages now. There, commercial bankers and their lobbyists argue that Glass's ideas, formed by what he had read by candlelight in Queen Victoria's day, were antiquated long before 1933. They think it preposterous that the old-fashioned senator still rules them from his grave—especially given that he himself had changed his mind way back in 1935.

Of course, the securities industry takes a

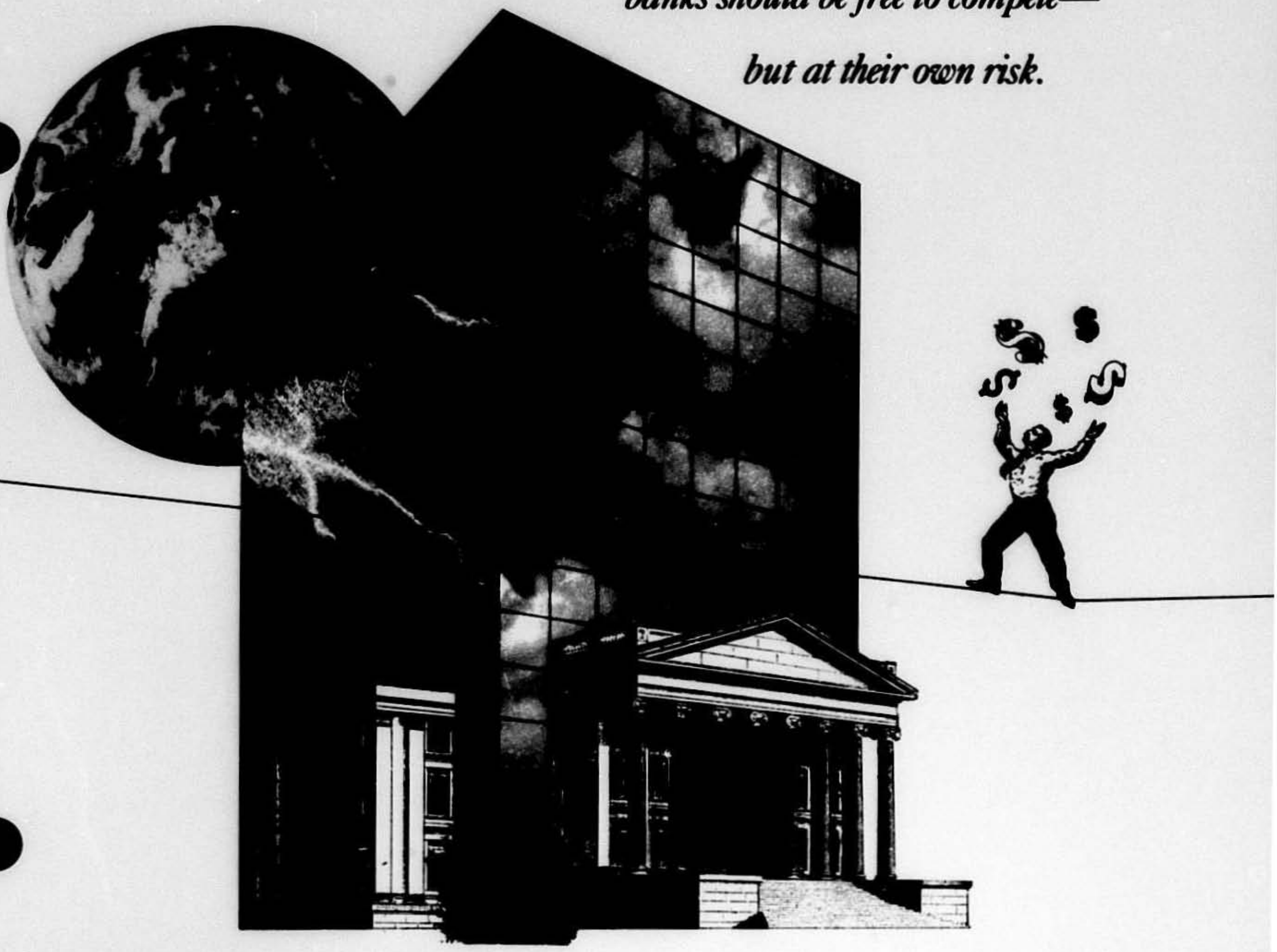
William Price

A NONBANKER'S PERSPECTIVE ON BANKING REFORM

In the financial marketplace,

banks should be free to compete—

but at their own risk.



PROPOSALS TO REFORM the nation's banking and financial services system have been debated continually since the initial banking statutes were enacted almost 60 years ago. Despite all the discussion, however, we haven't made much progress. The current system is costing the taxpayers billions of dollars to clean up hundreds of failed banks and thrifts, and it is rewarding the weakest and most inefficient institutions at the expense of the strongest and most efficient competitors.

The past decade was one of the most chaotic periods in the financial sector since the Depression. Rather than use that turmoil as an opportunity to take a critical look at the industry, Congress has continued its piecemeal approach to the problem. The legislation passed late last year is designed to combat particular symptoms, not the root causes.

THE U.S. BANKING AND FINANCIAL SERVICES SYSTEM IS COSTING THE TAXPAYERS BILLIONS OF DOLLARS, AND IS REWARDING THE WEAKEST AND MOST INEFFICIENT INSTITUTIONS AT THE EXPENSE OF THE STRONGEST AND MOST EFFICIENT COMPETITORS.

Obviously, banking regulation involves a complex set of issues, but there are a few common principles that policymakers should keep in mind. First, any legislative or regulatory changes must protect the taxpayers and the small depositors and reduce, rather than increase, the risks they face. That means taking steps to restore the public's confidence in the financial services industry.

Second, the industry must be able to respond to the changing dynamics of the global economy. Customers are not seeking the same products and services they did 60 years ago. To compete effectively and provide needed capital, financial institutions must be free to take advantage of developing markets by offering a complete array of services. Our regulatory framework must be flexible enough to allow for this.

Third, we must level the playing field for all financial services providers: banks, thrifts, and the wide array of nonbank institutions (such as my own organization) that offer such varied services as commercial lending, leasing, real estate loans and investment, and credit card operations. This nation cannot afford the inefficiencies and inequities associated with subsidizing one sector. Yet our present regulation scheme focuses on restricting particular types of organizations rather than particular types of activities. Only free competition can eliminate inefficient and unhealthy providers and guarantee that customers receive the best products and services.

As policymakers seek to reform the banking system, they must keep these three overriding principles in mind. Given this context, several areas emerge as particularly ready for change.

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Avenues for reform

Any effort to reform the financial system must begin with deposit insurance. The initial rationale for deposit insurance was simple: to protect the small depositor and put confidence in the banking system. Fundamentally, this still makes sense. Over the years, however, the scope of deposit insurance has ballooned far beyond its initial mandate. This expansion has carried a high price: It has increased taxpayers' risk to hundreds of billions of dollars, and it has compounded the inefficiencies that arise in a regulated market.

As it stands now, deposit insurance has become a universal security blanket. Federal regulatory agencies protect almost all banks and thrifts, which pay standard fees regardless of their risk of loss. As a result, weak financial institutions are free to fund risky investments with federally insured deposits. This is what caused the huge taxpayer bailout of failed thrifts and banks.

The first step in reforming deposit insurance should be to match the cost of insurance to the risk of loss. In other words, banks and thrifts that pursue high-risk ventures should pay correspondingly high premiums for deposit insurance. Those that engage in safer practices should be rewarded with lower premiums. Risk-based premiums are a hallmark of every other kind of insurance; such an arrangement not only distributes costs more equitably, it also provides incentive to insured participants to minimize risk.

Deposit insurance reform should also seek to protect the integrity of the financial system by safeguarding deposits of individuals and small businesses. Therefore, in addition to maintaining the current limits for coverage—now $100,000 per account—another useful step would be to limit individual depositors to one insured account each. This would ensure protection for the people who need it most.

These changes would do much to reduce the risk to taxpayers and depositors. But the system still retains an underlying problem: Deposit insurance and other federal protection—such as the "too-big-to-fail" doctrine that ensures government support of large banks—insulate banks and thrifts from many of the market pressures that force responsible behavior.

Those pressures are very real for nonbank institutions. Many of my banker friends would describe companies such as mine as deregulated, or even unregulated. The truth is that we *are* regulated, but in a much different way. Our regulators are the financial ratings agencies, the Securities and Exchange Commission, and—most important—the private marketplace, upon which we depend for our funding. We do not have the luxury of low-cost, federally insured deposits. We must compete in the marketplace for funds from sophisticated investors, and to do so we must demonstrate that we are acting prudently.

In particular, companies like mine must maintain a certain level of capital—the amount of money invested in the company by its owners. The higher the level of capital, the stronger the company's financial base, and the more readily it can protect itself against failure. Ideally, capital should determine what a bank or financial services company can do and whether it can continue to operate.

THE GENERAL DEBATE OVER REFORM WILL NOT BE COMPLETED ANY TIME SOON. BUT IF EVERYONE INVOLVED CAN AGREE ON WHAT WE ARE ATTEMPTING TO ACHIEVE, THE METHODS SHOULD BECOME APPARENT.

Market competition already holds nonbank institutions such as mine to very strict capital standards. Banks and thrifts, however, have no market-based incentive to maintain high levels of capital because the backing of the government already implies protection for depositors. Banks and thrifts must meet only the minimal capital standards set by law.

This gives banks and thrifts a distinct competitive advantage over other financial services providers. While my company, for example, has far more capital for its size than the average bank, it must pay a much higher rate of interest on funds than even the weakest banks, which enjoy the protection of deposit insurance and the ability to borrow from the Federal Reserve.

As long as banks are permitted to operate with significantly lower capital levels, the risks to the system and the taxpayer will continue to escalate. It is therefore in the best interest of the government and the taxpayer to ensure that banks' capital levels are sufficient to support their activities. The 1991 banking legislation took some important steps to emphasize capitalization, specifically by spelling out actions regulators might take against banks with low capital. This is a good start—but it is only a start. The existing capitalization standards for banks and thrifts are too low to offer sufficient protection. Raising these standards would help ensure the safety of these institutions.

Ultimately, the financial marketplace is the best means of adequately assessing risk, which leads us to believe that limits on the ways in which insured funds can be used are necessary. Financial institutions should have the right to make risky investments, but they and their investors—not the taxpayers—should bear the risks associated with those investments. Tight restrictions on the ways insured funds can be invested are essential to avoiding further bailouts. By enacting such restrictions, Congress would increase the soundness of the insurance funds and at the same time require banks and thrifts to use money raised in the marketplace from knowledgeable investors to fund other types of investment. This would allow the market to more effectively measure an institution's risk while still funding worthwhile investments. And it would improve stability and competition throughout the industry.

The next chapter

These kinds of reforms—risk-based insurance premiums, increased capitalization requirements, and restrictions on the use of insured funds—are frequently cited as components of a philosophy of "core" banking or "narrow" banking, which holds that only a limited range of bank activities should enjoy federal protection. Many proposals involving such elements are now being debated.

The general debate over banking reform will not be completed any time soon. In fact, in a constantly evolving market, none of these issues can ever be completely resolved. But as policymakers seek to make improvements over the next few years, they must begin by defining the overriding purpose of banking regulation. This should be to safeguard the small depositor while allowing our economy to grow, supported by a stable financial services industry. If everyone involved can agree on what we are attempting to achieve, the methods should become apparent. •

Charles F. Baird

WHAT THE CANADIANS KNOW

Nationwide banking means better service for consumers and more stability for bankers.

IMAGINE THIS: You get off the plane on the first day of an important business trip, reach in your pocket for your baggage claim checks, and find disaster in the form of a check you thought had already been deposited in your personal bank account back home.

Disaster, because the deposit is needed to cover the automatic withdrawal of your monthly mortgage payment. Double disaster, because your spouse needs cash from that account for the household expenses. Triple disaster, because you have checks drawn against that account that will now bounce.

Fortunately there's an easy solution. You head for an automated teller machine in the airport and deposit your check. Instantly, it is credited to your

account 1,500 miles away, and as if by magic your checks don't bounce, your mortgage is covered, and your spouse can go shopping. Progress is wonderful.

There are half a dozen banks that offer the complete range of banking services to their customers anywhere in the country. But don't think about switching your account. They don't offer those services in the United States. We're talking about Canada.

For the past decade and a half, Canadians have regarded such go-anywhere-do-anything banking as normal. Need to pay your utility bills—or your parking tickets—half a continent away from home? No problem. And no long-distance charges. Need cash from your account? Easy. Want to pay your credit card bill before the monthly interest charges apply? Just find an ATM.

Maybe we can learn something here. As the U.S. banking system tries to recover from the savings-and-loan debacle, maybe we should be looking at the strengths and advantages of the nationwide system that not only provides Canadians the kind of banking service we can only envy, but is also so stable that a bank failure is as rare as a visit from Halley's comet. In the past five years some 885 U.S. banks—about 7 percent of the total—have failed. The FDIC says another 200 banks will close in 1992, and this is a conservative estimate: One industry analyst predicts that eight banks a week will go under this year. By contrast, only two Canadian banks have failed in the past 69 years. That period includes the Great Depression, during which 9,000 U.S. commercial banks closed their doors. A system that provides better service for consumers, and better stability and protection for bankers, is surely worth examining.

CANADA'S NATIONWIDE BANKING SYSTEM NOT ONLY PROVIDES CANADIANS THE KIND OF SERVICE AMERICANS CAN ONLY ENVY, BUT IT IS ALSO SO STABLE THAT A BANK FAILURE IS AS RARE AS A VISIT FROM HALLEY'S COMET.

Contrasting systems

It is ironic that both the Canadian and the U.S. banking systems began with the same document: the Charter of the First Bank of the United States, drafted by Alexander Hamilton. That Charter established a nationwide system of branch banking that was abandoned in the United States in 1836. In Canada, it continues to flourish.

The United States, with a population of about 260 million, has some 12,000 banks. Canada, with a population one-tenth that size, has six large banks that control 90 percent of all banking assets in the country. (About 60 smaller banks—56 of them foreign-owned—control the remaining 10 percent.) All of the "Big Six" banks operate from coast to coast, and four of the six each have more than 1,000 domestic branches. Together, all six serve more than 1,700 communities through 7,400 branches, and they hold about 34 million personal savings accounts—a number greater than the population. (In general, Canadians save at about twice the rate of Americans.)

This is not to suggest that Canadian banks do not face competition. They compete—sometimes very aggressively—with each other, of course. In addition, they compete with about 80 trust companies, which act primarily as mortgage

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lenders, and with about 3,000 locally based credit unions. Trust companies have combined assets totaling about one-quarter of those of the banks, and credit unions have combined assets equivalent to about 15 percent of the banks' assets. By law, the large Canadian banks are widely owned; no single interest can own more than 10 percent.

In contrast, the banking system in the United States is highly fragmented. About 12,000 independent banks control about two-thirds of all assets in U.S. depository institutions. The 3,000 thrifts—which are mainly involved in residential mortgage lending—hold about 30 percent of U.S. deposits. Credit unions account for the rest.

It is worth noting that the trend in the United States is toward the Canadian model—consolidation of many smaller banks into a few larger organizations. In each of the 10 most populous states, the five biggest banking organizations hold about 60 percent of the assets. In 36 states, the top five organizations have more than 50 percent. The pace of this consolidation has been increasing.

A STRUCTURE INVOLVING FEWER, BIGGER BANKS HAS AT LEAST TWO ADVANTAGES: THE DEPOSIT BASE IS VERY STABLE, AND THE RISK INVOLVED IN MAKING LOANS IS SPREAD IN THE WIDEST POSSIBLE WAY.

A structure involving fewer, bigger banks has at least two inherent advantages, both for the banks and for the banks' customers. First, Canadian banks have an extensive retail network, which means that the deposit base is very stable. Their money comes from millions of individuals across the country who have often dealt with the same bank for a lifetime. This contrasts sharply with what can be termed "wholesale" funds—money invested by pension plans, corporations, and other financial institutions—which provide the bulk of deposits for many U.S. banks.

Wholesale deposits can evaporate in a matter of hours on the strength of a rumor. Retail deposits are much less fluid, because a trend would require millions of individuals—not just a few institutional investors—to reach the same conclusion at the same time on the relative safety of their funds. The effect is that Canadian banks, both because of their size and because of the widespread nature of their deposits, are much less vulnerable to "a run on the bank" when times get tough. The same is true of U.S. banks that have extensive retail deposit networks—which is to say those banking organizations that have consolidated many smaller banks into a larger, more widespread entity.

Another advantage lies in spreading the risk inherent in all loans in the widest possible way. U.S. banks, even large banks, are essentially regional in nature, and their loans tend to be heavily concentrated in the geographical area they serve. This makes them especially vulnerable to regional economic disturbances. If the economy in Texas (or New England or Oklahoma, to cite some recent examples) goes down the drain because oil prices nosedive, banks that have most of their loans concentrated in the oil patch are going to go broke too—especially if they depend for the bulk of their deposits on a fickle and unstable wholesale market. It is significant that the only two Canadian banks to fail in six decades were the Canadian Commercial Bank and the Northland Bank, both of which depended heavily on narrow regional lending and wholesale funding—just like many of the failed banks in the United States.

In addition to having different structures, the two systems differ in regulation of banks. In Canada, a Superintendent of Financial Institutions oversees the activities of all the banks, as well as many trust companies and insurance companies. The provinces handle the other trusts and insurance companies, which are generally smaller and regional in nature. The relationship among regulators is on the whole marked by a willingness to consult and cooperate. In turn, their approach to the institutions they regulate is straightforward and characterized by open communications, consultation, and pragmatic problem-solving.

By contrast, in the United States, federal and state regulators often overlap and compete with one another. The system is cumbersome, adversarial—and expensive. The consumer ultimately pays the costs of unnecessary paperwork and inefficiency. Without denigrating the quality of regulatory staff in this country, I think it is fair to say there is a limited pool of people who have the knowledge and the experience necessary to carry out these functions. A smaller, more efficient system would ensure that demand for qualified regulators does not outstrip supply.

Serving the consumer

The arguments usually offered against the kind of nationwide branch banking system Canadians enjoy revolve around the concentration of power in the hands of a few bankers and the benefits to consumers of strong competition. Six banks with 90 percent of all banking assets sounds suspiciously like a cartel.

THE STRUCTURE OF CANADIAN BANKING HAS SIMPLIFIED THE ADOPTION OF BETTER TECHNOLOGY. FROM THE CONSUMER'S PERSPECTIVE, THE EFFECT OF BETTER TECHNOLOGY IS IMPROVED SERVICE.

A generation ago there may have been some justification for that argument. For many years, all Canadian banks operated on a comfortable schedule that allowed their customers to do any kind of banking they wanted—as long as they did it in their own branch, between 10 a.m. and 3 p.m., Monday to Friday. Cashing a check anywhere except in the branch that held your account was a Kafkaesque adventure: first proving your identity to the satisfaction of a suspicious teller, then waiting for telephone confirmation of the status of your account, and finally paying a fee for this "service." And Canadian folklore used to be filled with the misadventures of unlucky customers who missed the bank by one minute on Friday afternoon and spent the weekend learning the lessons of poverty first-hand.

But that was in the age of steam. Nowadays, Canadians anywhere in the country—and in many cases, outside the country—have virtually complete access to the full range of banking services from any branch of their own bank and from a network of ATMs that have become as ubiquitous as convenience stores or gas stations, which is where many of them are located.

There are two reasons for the revolution in customer service that has occurred in the last decade and a half. The first was increased competition for deposits from trust companies and other institutions that demonstrated the importance of providing service at the time and place most convenient to the customer. The second was the rapid spread of improved computer technology; the larger Canadian banks had both the size to finance the expensive acquisition of the technology and the economies of scale to benefit from it.

The structure of the Canadian banking system simplified the adoption of that technology. With six large banks dominating the system, cooperation on technical standards is relatively easy to achieve. For example, national standards have already been adopted to enable merchants to debit customers' bank accounts for purchases, and plans are already well advanced for the introduction of electronic data interchange and, eventually, image processing. The same technologies are available to U.S. banks, but the fragmented nature of the U.S. industry will slow their adoption.

From the consumer's perspective, the effect of better technology is to improve banking service. For example, Canadian consumers would stare in horror at the thought that a bank could not clear an out-of-state check in less than five business days—the normal period in most parts of the United States.

Canadians expect their checks to be credited to their accounts on the day of deposit, and almost all are.

From the bank's viewpoint, the effect of better technology is to reduce costs and increase profit margins. It is no accident that at a time when many U.S. banks are struggling to stay afloat, Canadian banks are reporting substantial profits, even in the middle of a recession that is more severe than the economic downturn in the United States. Simply put, the Canadian banks are in a much better position both to serve their customers and to survive—or in some cases thrive—in hard times.

As for the question of competition, there is at least some merit in the view that the U.S. banking industry is overcompetitive. When too many banks chase too little business, some of those banks do things that are unwise in the hope of attracting new customers.

One example is mortgage lending. I recently saw an advertisement for a small local bank that was offering residential mortgages with a fixed interest rate and a 40-year term. That's a great deal for the consumer, but potentially disastrous for the bank, which is in the dangerous position of borrowing short and lending long. If interest rates fall substantially, smart consumers will refinance that mortgage through another institution; if interest rates rise, they will stick the bank with the loss for the next four decades. Either way, the customer can't lose. The problem is that the bank can't win, and the banking system can't work if the banks don't win, too.

Responding to a somewhat similar situation, banks in Canada reformed their mortgage lending practices back in the late 1960s. Loans are amortized over 20 to 25 years, but mortgages are renewed—and interest rates renegotiated—generally for terms of six months to five years, which allows mortgages to be matched by fixed-term deposits locked in for the same period. The mismatch between loans and deposits is eliminated, and with it most of the risk involved in long-term lending. In addition, most Canadian banks carry every mortgage on the branch books, rather than in a central pool, which makes branch managers live with their own bad decisions and does wonders in developing a sense of prudence and caution among lenders.

Banks in the United States have responded to the problem by creating pools of mortgage-backed securities and selling those instruments to investors. That mitigated the risk of interest-rate swings, but it did so by passing the risk along to investors. The bank's bad mortgage decisions became the investors' bad investment decisions when they bought part of the mortgage portfolio. The bank that was relieved of the risk was also relieved of the responsibility for making good decisions, and one of the results was the kind of imprudence that led to the savings-and-loan disaster.

It seems axiomatic to me that the first responsibility of a bank—and the most important service it offers to its customers—is to avoid going broke. It is very nice to be able to access your account as easily from Austin as from Albany. It is very helpful to be able to deal with the same bank, with the same lending practices and the same banking products and services, anywhere in the country. Clearing checks in the same day is wonderful. But as a consumer, the essential requirement I have of a bank is the assurance that it will still be in business next year, and hopefully next decade.

Canadians have that assurance. Many Americans don't. I can't think of a stronger argument for a structural reform of the U.S. banking system, one that would adopt some of the measures our Canadian cousins borrowed from Alexander Hamilton more than 150 years ago. •

AS A CONSUMER, THE ESSENTIAL REQUIREMENT I HAVE OF A BANK IS THE ASSURANCE THAT IT WILL STILL BE IN BUSINESS NEXT YEAR. CANADIANS HAVE THAT ASSURANCE. MANY AMERICANS DON'T.

FEATURES

Joseph J. Eglin

UNTANGLING THE STAFFORD STUDENT LOAN PROGRAM

Policymakers face a choice this year—try to fix the current arrangement, or try something new.

JUDGING FROM THE headlines, abuse is rampant in the Stafford Student Loan Program. News stories tell of students who fraudulently obtain loans, of profit-making trade schools that take students' loan money and fail to provide an education in return, and of banks that lend to "students" who don't even exist. Other abuses are less flagrant but more common: Parents bend the truth on loan applications; school financial aid officers approve more loan requests than government regulations allow; banks do not pursue delinquent borrowers. But regardless of who perpetrates the abuse or how blatant the violation, it is inevitably the federal government—which backs, or "guarantees," student loans—that shoulders the financial responsibility.

The Stafford program, founded in 1965 as the Guaranteed Student Loan Program, has accomplished its primary objective of providing loans to eligible student borrowers. Some 45 percent of all financial aid to students in the 1990-91 school year was through federally guaranteed student loans, and few complaints arise about access to loan funds. But the large, decentralized arrangement through which so much money flows is hard to manage and monitor. In general, the federal government lacks the means to spot and correct either outright fraud or unintentional misuse. In late 1989, GAO identified the Stafford program as one of 14 major federal programs at "high risk" of fraud, abuse, and mismanagement.[1]

The financial risk involved in the Stafford program reflects in part its phenomenal growth. Over the course of the 1980s, the annual amount of new loans under this program increased two and a half times—from $4.8 billion in fiscal year 1980 to $12.3 billion in fiscal year 1991. But defaults have grown at a far greater rate, multiplying tenfold in the same period—from $239 million in 1980 to $3.6 billion in 1991. Of the $52.6 billion in Stafford loans outstanding as of September 30, 1991, some $12.3 billion worth was in default, according to the Department of Education (DoE), which administers the program.[2]

Although these problems have been well documented and publicized, changes have been slow to come, and not all of them have improved

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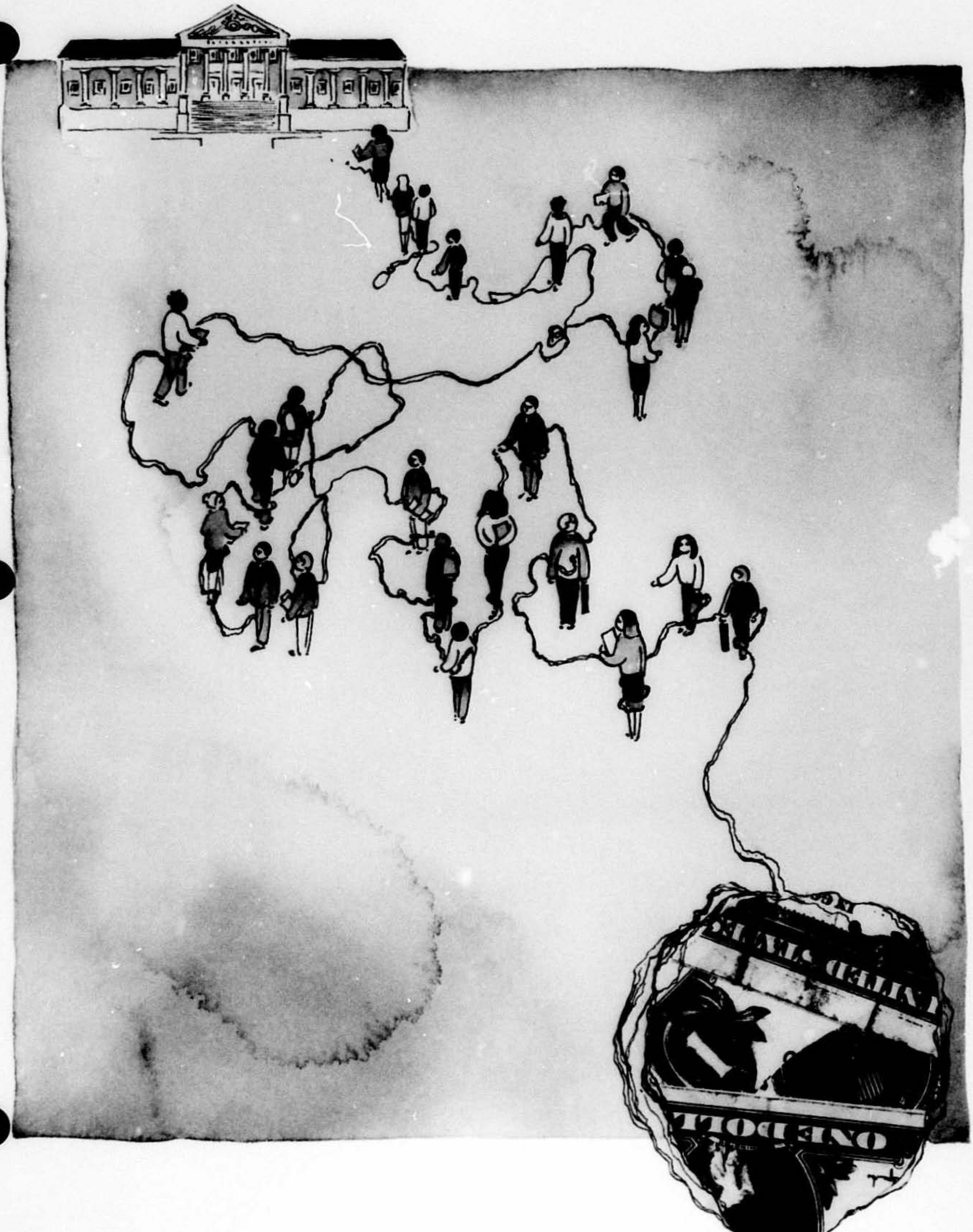

the situation. As Congress prepares to reauthorize the act under which the Stafford program operates, policymakers face a choice: to take more determined steps to fix the current arrangement, or to revise the program completely.

How the program works

The Higher Education Act of 1965 provided two major types of aid to postsecondary students: grants for students from low-income families, and subsidized loans for students from middle-income families. Eventually, as college costs skyrocketed and the federal budget tightened, both types of aid shifted mostly to low-income students.

Most students seeking aid apply first for Pell grants, which gave more than $4 billion to 3 million students in the 1990-91 school year. But Pell grants are limited in size, and they apply only to tuition and fees. Students who cannot get Pell grants, or whose grants don't go far enough, may then turn to federal loans.

A Stafford loan is a good deal for students: The government pays the interest while the borrower is in school, and promises to cover the debt if the borrower does not.

The Stafford program, the main source of federal assistance for postsecondary students, includes four kinds of guaranteed loans. The most popular by far is the federally subsidized Stafford loan. By all measures, a Stafford loan is a good deal for students, many of whom would have no hope of obtaining a commercial loan. Interest is normally paid at below-market rates. The government pays the interest while the borrower is in school and during certain grace and deferment periods. (These payments constitute the "subsidy" unique to the Stafford loan.) The loans are also guaranteed; that is, the government promises to cover the debt if the borrower does not.

To ensure open access, the government places few restrictions on borrowers. Students must be citizens or permanent resident aliens. They must meet certain standards for income and need. They must be enrolled at least half-time in an institution approved by DoE. And they must maintain "satisfactory progress," as defined by the school.

Of the $12.3 billion in student loans the Stafford program provided during fiscal year 1991, $9.6 billion came in the form of Stafford loans, according to DoE. The outright cost to the government was far less, however, because student loan money does not come directly from government coffers. Loan capital comes from private lenders—typically commercial institutions such as banks, savings and loans, and credit unions. Federal funding, which totaled about $4.6 billion in fiscal 1991, mostly went to cover administrative costs, subsidies, and payoffs of defaulted loans.

Each lender makes and holds loans with a guarantee from a guaranty agency, an entity designated by the state to administer the program for DoE. When a borrower fails to make payments, and lenders cannot collect after following specified procedures over a certain time period—or if the borrower is dead, disabled, or bankrupt—the guaranty agency pays the lender's default claim. The agency, in turn, takes responsibility for collecting the money owed.

DoE normally reimburses the guaranty agency for the full amount of the default claim through an arrangement called reinsurance. Even after the government has paid off the defaulted loan, the guaranty agency continues to pursue the delinquent borrower. If the agency eventually manages to collect any money from the borrower, the agency keeps 30 percent of the payment and sends the re[st] to the government.

The Stafford program also offers two loans for people who fail the income-and-need test but meet certain other conditions. Supplemental Loans for Students (SLS) typically go to independent and graduate students, and Parents Loans for Undergraduate Students (PLUS) go to parents of undergraduate students. These are generally not subsidized—that is, the government does not pay the interest while the students are still in school—but both types of loans are guaranteed against default, disability, or bankruptcy. A fourth kind of loan—a consolidated loan—allows borrowers with total student loan debt over $5,000 to refinance that debt into one loan.

Where the problems lie

In general, all three loans are easy for borrowers to obtain and carry little risk for lenders. Still, the system is hardly user-friendly; its complexity frustrates students, schools, and lenders alike. For example, while the government sets eligibility requirements, each lender may have its own application procedures. And although lenders follow federal requirements in handling loans, each carries out those operations in its own way.

Also, a lender might sell loans it holds to a secondary-market lender, such as the Student Loan Marketing Association (Sallie Mae), the largest holder of student loans.[3] Or it might contract with a third party to service and collect the loan. Such arrangements easily confuse students, who may be dunned after sending payments to the wrong place.

Because the point of the Stafford program is to give low-income students easy access to funds, many loans go to people normally considered bad credit risks.

Meanwhile, DoE must struggle to keep track of 47 guaranty agencies, 8,500 lenders, 7,000 schools, millions of borrowers, and billions of dollars parceled out into small units. DoE must rely on other entities to record and control the generally small dollar transactions involved in each of those loans. Overall, the Stafford program is a management nightmare.

Such a complicated operation is vulnerable to mistakes and misuse. And in fact, GAO, congressional investigators, and DoE's Office of Inspector General (OIG) have documented improper practices by all parties in the loan process—students, schools, lenders, guaranty agencies, and DoE itself. In most cases, GAO and others have also proposed steps to remedy these problems.

High-risk student borrowers

By its very nature, the Stafford program is susceptible to financial risk. Because the point of the program is to give low-income students easy access to funds, many of the loans go to people normally considered bad credit risks. The law generally makes Stafford loans available to eligible students regardless of their financial experience or credit history, unless they are already in default on another student loan.

In accordance with this policy, lenders are not required to make credit checks of loan applicants under age 21. (The Emergency Unemployment Compensation Act, enacted in 1991, calls for credit checks of applicants age 21 or older.) Applications require little documentation and undergo minimal scrutiny. Lenders rely primarily on students' statements that their forms are truthful and on schools' assurances that loan applicants are enrolled in qualifying programs.

This leniency leaves the program open to abuse—both unintentional and intentional. Some applicants simply make mistakes in filling out the forms. Some, hoping to obtain as much financial aid as possible, understate their income or exaggerate the number of their dependents. Some misrepresent their dependency on their parents in order to qualify for subsidized Stafford loans rather than having to settle for PLUS or SLS loans.

A few people go much further. One borrower fraudulently obtained more than $101,500 in student aid by using different names and Social Security numbers, lying on loan applications, and forging the signatures of school officials. He was sentenced by a U.S. district court in Arizona to two years in prison and ordered to repay the money. Another borrower was convicted by a U.S. district court in Massachusetts of failing to disclose on seven loan applications that he had defaulted on an earlier loan. He was sentenced to four years of probation and ordered to pay $85,000 restitution.

Still, cases of deliberate fraud by borrowers are relatively uncommon. The real problem inherent in the program's acceptance of high-risk borrowers is the resulting high rate of default. While defaults have risen steadily since the program's inception, the problem became worse after various changes in the 1970s loosened the program's criteria. Of particular importance was the Middle Income Student Assistance Act of 1978, which eliminated the financial-need test and made many more students eligible for subsidized loans.

Another factor was 1972 legislation that provided access to Stafford loans for some previously ineligible students attending proprietary schools (profit-making trade and technical schools). Specifically, a student who did not have a high school diploma—the accepted key to college—could receive a Stafford loan if he or she had a GED (general educational development) certificate or if a school official judged that the student had an "ability to benefit" from a particular educational program. With this change, the volume of Stafford loans rose sharply. So did federal subsidy costs. And so did the rate—and the dollar total—of defaulted loans.

While proprietary school students account for 33 percent of Stafford loans, they are responsible for 48 percent of defaulted loans. In a 1988 study of more than 1 million students who received loans in 1983, GAO found that 18 percent had defaulted by the end of 1987. But borrowers who attended proprietary schools defaulted at a rate of 35 percent, roughly twice the overall rate and three times the rate of students in two-year or four-year colleges.[4] Defaults were also disproportionately high among students who attended school one year or less, came from families with low income, or were "independent" (that is, not receiving financial assistance from a parent).

Early in 1981, Congress reinstated a financial-need test for Stafford loans, but it retained the provisions regarding proprietary-school students. Although Congress has considered several proposals to eliminate access to loans for students without a high school diploma—particularly those who fall under the "ability-to-benefit" clause—these students remain eligible.

To address the problem of the high default rate among students who drop out before graduation, GAO has recommended that the six-month grace period on repayment—now given to virtually all students when they leave school—be eliminated for those who do not complete their programs. This would encourage borrowers to continue their studies and, in turn, might help reduce defaults.[5]

In 1988, GAO examined more than 2,000 loan accounts at 16 lenders and found that 18 percent were in error or inadequately documented.

Dishonest school officials

While it is obvious that proprietary-school students are a chief source of defaults, anecdotal evidence suggests that much of the blame lies not with these students, but with some of their schools. Some—but not all—proprietary schools have been accused of bending eligibility rules to get access to loan funds, persuading students to borrow large amounts, and operating scams.

The media have publicized some of the more sensational cases. For example, NBC's "Expose" news show reported on March 10, 1991, that some "students" at one trade school were homeless or unemployed; some could barely read or write. They did not attend classes, and they did not realize that they had signed loan agreements that required them to repay the money borrowed with interest. On that show, Congressman Bart Gordon of Tennessee went "under cover" to meet with a school financial aid officer. While a hidden camera recorded the conversation, the official told Gordon that it was easy to get a Stafford loan and that he need not worry about repaying it. Additional reports have told of other schools that collected students' loan money and then closed their doors, leaving students with outstanding loans, no training, and no refund.

Much of OIG's work has centered on identifying abuses by proprietary schools. A recent report describes several schools that violated federal eligibility requirements, especially the ability-to-benefit rule. One school in New York acquired $1.7 million in federal student aid through ineligible students. At eight proprietary schools, OIG found that students who dropped out of school did not receive refunds of their tuition, which totaled more than $5.3 million. OIG also reported that some programs were not long enough to be eligible for federal student aid.[6]

Congress has taken some steps to prevent such abuses. Since July 1991, schools have been subject to penalty if their students default at high rates. Schools whose default rates exceed specified levels for three years running may be barred from federal student aid programs. Also, schools are now required to counsel student borrowers who leave school about their responsibilities to repay their loans and the consequences of defaulting.

This is a good start, but more could be done. In September 1991, GAO identified six requirements, already in use by some states, that DoE could use to strengthen its school certification procedures. For example, DoE could review schools' performance in such areas as course completion and job placement. It could approve newly participating schools on a conditional or temporary basis. And it could require independent audits of school financial reports.[7]

Negligent lenders

The Department of Education depends on lenders to document loan disbursements and payments and to bill the government for interest subsidies. While most lenders have reliable systems for accounting and management, others lack the necessary controls. In 1988, GAO examined more than 2,000 loan accounts at 16 lenders with large loan volume and found that 18 percent of the accounts were in error or inadequately documented. GAO estimated that in the three months covered by its audit, DoE overpaid the 16 lenders at least $1.8 million.[8]

Guaranty agencies were designed to operate as agents of the federal government. But GAO has reported that some guaranty agencies do not work aggressively to prevent defaults.

Although GAO did not attribute these overpayments to fraud, other lenders have been convicted of illegal practices. For example, in one of the largest student loan fraud schemes ever discovered, Florida Federal Savings and Loan Association officials were found guilty in 1990 of submitting more than 17,000 fraudulent claims for $35 million in defaulted student loans. The bank's vice president was convicted of conspiracy, perjury, mail fraud, and theft of government funds and sentenced to four years in prison.

Another lender, First Independent Trust Company of Sacramento, California, was the subject of a 1990 GAO report on its questionable student loan practices. At 1990 hearings on abuses in the Stafford program, the Senate Permanent Subcommittee on Investigations, of the Committee on Governmental Affairs, referred to GAO's report in charging that the trust company failed to pay the government more than $18 million in fees lenders are required to collect from student borrowers and that it also fraudulently made loans to fictitious students. The case is still under investigation, and litigation is pending.[9]

GAO has made several recommendations to tighten the practices lenders use in making, servicing, and collecting guaranteed student loans. Some, such as stricter collection standards, have been adopted.[10] Others have yet to be put in place—for instance, assessing penalties against lenders who inappropriately bill the government for interest subsidy payments.

Unreliable guaranty agencies

The legislation that created the Guaranteed Student Loan Program called for establishing guaranty agencies to ease the burden on DoE, which had not been managing existing loan programs efficiently by itself. The agencies were designed to operate as agents of the federal government and to bring the loan program closer to students, schools, and lenders.

Each state and territory, as well as the District of Columbia, designates an agency to guarantee loans involving state residents or schools in the state. Some states, eager to make student loans accessible to their residents, seized the opportunity to establish guaranty agencies themselves. Other states passed the function to private nonprofit agencies. Independent agencies and some state-established ones may operate across state lines.

The 1990 insolvency of the Higher Education Assistance Foundation (HEAF) demonstrated that the system of guaranty agencies is not failsafe. In the 1980s, HEAF—then the largest guaranty agency—guaranteed a large number of loans to proprietary-school students, many of whom eventually defaulted. Lenders began filing billions of dollars in claims, and HEAF did not have the funds to pay them all.

Although the government is under no legal requirement to bail out guaranty agencies, DoE—fearing that the loan program's credibility was at stake—is paying off outstanding claims as loans default. The Department estimated that its action would cost no more than $30 million. GAO, however, calculated that full payment of default claims for all the loans HEAF guaranteed would most likely cost the government between $175 million and $200 million more.[11] This is proving to

The Department of Education's administration of the loan program has been criticized almost from its inception. The most conspicuous troubles involve accounting and information management.

be the case; in April 1992, GAO estimated that through the end of September 1991, DoE incurred more than $175 million in additional costs from defaulted HEAF-guaranteed loans, with more claims continuing to come in.

HEAF's case is an extreme example. But GAO and OIG have documented other problems with guaranty agencies. One concern is poor record-keeping. According to OIG, one agency failed to properly document that it complied with federal requirements in attempting to collect on loans obtained after paying lenders' default claims. The agency eventually repaid the government $761,000 it inappropriately received on the loans. GAO has also reported that some agencies do not work aggressively to prevent borrowers from defaulting, sue through administrative or legal channels to collect defaulted loans, or send defaulted loans to DoE for further collection attempts.[12]

GAO has made many recommendations for strengthening the guaranty agencies' operations. At GAO's suggestion, Congress has agreed to continue the IRS income tax offset, which enables the government to collect unpaid debt from defaulted borrowers' income tax refunds. GAO also has recommended that DoE tighten deadlines for guaranty agencies to submit the government's share of collections, and that DoE receive a share of all default payments, including any collection costs. Such changes have been proposed but have yet to be made final.

Inadequate government oversight

The Education Department's administration of the Stafford program has been criticized almost from its inception. Most recently, a joint task force of DoE and the Office of Management and Budget reviewed DoE's entire student aid operation, listing concerns and recommendations at length in a 1991 report.[13] GAO, OIG, and others had raised many of the same issues in the past. Charges range from inadequate staff training to poor oversight of lenders, schools, and guaranty agencies. But perhaps the most conspicuous troubles are those in accounting and information management.

For example, the program's records are in such poor condition that GAO has been unable to audit the student loan fund since its inception in 1965. Both GAO and OIG have attempted over the years to work with DoE to clean up its records so an audit could be conducted. But DoE has yet to prepare accurate financial statements, and an audit will not be done until at least late 1992.

Another obvious problem is DoE's lack of an on-line computer system for monitoring borrowers' loan activities. The guaranty agencies submit loan data electronically to DoE once a year. The information is then stored in a database nicknamed the "tape dump." This mass of unverified, sometimes incomplete records is the only national database on the Stafford program.

Because no one routinely cross-checks applications against current records, loans are sometimes made to borrowers who have defaulted on earlier student loans or whose debt totals have already reached federal limits. GAO estimates that more than $109 million in new loans have been made to 32,000 defaulted borrowers over the years. Subsidies alone on those loans could cost the government up to $65 million.[14] Congress has authorized DoE to develop a computer system that should give DoE, guaranty agencies, and lenders access to up-to-date information, but the system will not be in place until the end of 1993 or later.

Simplifying the Stafford program

Congress could cut down on the waste and error in the Stafford program if it acted on the many existing recommendations for change. Still, most of these suggestions involve only minor adjustments to current procedures. Such tinkering would do little to address one of the program's chief flaws—its complexity. Congress should not ignore the possibility of strengthening the loan program by simplifying it.

Two approaches stand out as particularly promising: reducing the number of lenders and guaranty agencies participating in the program, and changing the guaranty agencies' role. Neither of these strategies would prove popular with the institutions it seeks to restrict. But both would help simplify the program and, most likely, make it less vulnerable to abuse.

Eliminating participants

The program's dependence on a large number of lenders and guaranty agencies reflects early concerns about access to loans. Previous student loan programs had not worked well partly because students, lenders, and schools all had to deal directly with the federal bureaucracy. In designing the Stafford program, legislators hoped to avoid this problem by using "neighborhood" lenders and state-based guaranty agencies.

But this decentralized arrangement may have outlived its usefulness. For one thing, access to loans no longer depends on the presence of local lenders. Students today can apply for a Stafford loan without ever entering a bank. Some lenders provide schools with loan application forms, which students complete and submit to banks through school financial aid offices. These practices, along with the advances of electronic banking, have made it common for students to receive loans from out-of-state institutions.

"Neighborhood" lenders and state-based guaranty agencies may have outlived their usefulness to the loan program. For one thing, access to the program no longer depends on the presence of local lenders.

Similarly, there is little need today for guaranty agencies to operate on a state-by-state basis. Plenty of examples illustrate that guaranty agency functions can be performed satisfactorily across state lines. HEAF's failure did not reflect inefficiency; before it went insolvent, HEAF was the designated guarantor for five states and the District of Columbia. Another major guaranty agency, United Student Aid Funds, is the designated guarantor for three states and the Pacific Islands. Other state agencies are expanding into other states to stay competitive. Such examples raise the issue of whether there is still any need for every state to designate its own agency.

The large number of intermediaries may no longer be necessary to ensure access, and they are without doubt a burden on the program. Needless to say, neither lenders nor guaranty agencies would welcome a move to reduce the number of participants. Still, Congress may wish to consider whether such a change might improve the program.

Changing guaranty agencies' role

A second proposal for simplifying the loan program would be to reduce the role of the guaranty agencies. Specifically, DoE could take over responsibility for default collection, leaving the guaranty agencies to focus on default prevention.

Under the present arrangement, guaranty agencies do not pass along the loans to the government even after the government has paid them off. Instead, the guaranty agencies continue to pursue defaulted borrowers. This activity provides much of the agencies' income, as the agencies retain 30 percent of any funds they eventually collect.

Another role of the agencies is to help keep defaults from occurring in the first place. However, the agencies receive little compensation for preventing defaults. Typically, a lender alerts a guaranty agency when a loan is 60 to 90 days overdue, and the agency provides the lender "preclaims assistance" in locating the delinquent borrower and encouraging payment. DoE and the guaranty agencies believe that preclaims assistance does help prevent defaults. Still, the only benefit guaranty agencies might enjoy from reduced defaults is to avoid a small penalty DoE exacts from agencies with high default claims. In other words, the incentive for agencies to prevent defaults is minimal compared to the potential reward from collecting defaulted loans.

A 30 percent commission might seem a reasonable fee for the government to pay agencies for recovering funds already given up for lost. Yet the government may have more tools for collections than the agencies do. Since 1986, the government has had the power to recoup funds from defaulted borrowers by seizing their income tax refunds. But this can happen only if the guaranty agencies assign defaulted loans to DoE for collection. As things stand now, agencies are not required to ask for the government's help, and they have no monetary incentive to do so, because they receive no part of any money the government collects.

If agencies were compelled to relinquish custody of defaulted loans when the government pays the loans off, the agencies would no longer have either the responsibility or the reward for collecting defaults. But reimbursing the agencies for successful default prevention efforts would keep them solvent and help reduce the government's exposure to defaults. This shift might encourage agencies to work more closely with lenders to prevent defaults.

Considering the alternative

As policymakers consider various recommendations—major and minor—they must also address one overriding question: Can the Stafford program be fixed? Or is there a better way to provide financial aid to students?

Some in Congress have suggested that a viable alternative might lie in direct loans. A direct loan, as its name implies, would be made directly from the federal government to the student borrower. A direct loan program would require neither lenders nor guaranty agencies. Their functions would be carried out by DoE and the schools.

A direct loan program would require neither lenders nor guaranty agencies. Their functions would be carried out by the Department of Education and the schools.

With direct lending, the loan process would be substantially simpler. DoE would transfer loan funds electronically to schools, which would credit students' accounts accordingly. (Such a procedure is already in use for Pell grants.) Schools would prepare a promissory note in the borrower's name, obtain the borrower's signature, and send the note to a central service center managed by a DoE contractor. There would be no need to generate, deliver, or endorse checks or to complete most of the paperwork lenders now require.

As students obtained additional loans over the course of their schooling, the loans would be added together automatically. As a result, each student leaving school would have a single, consolidated debt for all money borrowed. Students would not have to deal with different lenders, and the note holder would never change. Nor would students need to go through a separate process to consolidate their loans, as they now do. Defaulted loans would remain at DoE's service center; without lenders or guaranty agencies, there would no longer be a need for default claims and payments.

DoE has tried direct loans before. The Federally Insured Student Loan (FISL) program failed both because it was too far removed from students and schools and because DoE could not administer such a large operation. The Stafford program was designed to overcome these obstacles, and in part, it has succeeded: Students now have easier access to loans. But the decentralized arrangement that made this possible may no longer be necessary, and it has its own problems. Perhaps direct loans deserve another chance.

Supporters of direct loans, including many in the education community, point out that direct lending would not only be simpler, it could also save federal money by eliminating interest subsidies, streamlining administration, and possibly reducing abuse. And because lenders now operating in the Stafford program could bid on contracts for servicing direct loans, the government could choose the ones with the most efficient operations.

From a budget standpoint, direct loans appeared for many years to be more costly than Stafford loans. Then the Federal Credit Reform Act of 1990 changed the way in which guaranteed loans are counted in the federal budget. Before credit reform, the Stafford program's chief costs in a given year were interest subsidies and loan defaults that occurred in that year. Direct loans would have called for a much higher initial cost in the outlay of loan principal; defaults and repayments would have been counted later, in the years they occurred. Therefore, the Stafford program appeared to put less strain on the budget.

With credit reform, the two programs can be compared on an equal footing. Now, the budgetary cost for either program is figured as the net value of all its costs. The Stafford program's cost is the discounted value of *all* interest subsidy and default costs—not just this year's. A direct loan program's cost would be the initial outlay less anticipated payments. GAO estimates that a direct loan program proposed by the National Association of State University and Land Grant Colleges would save the government about $1 billion on one year's loans, compared to the Stafford program.[15]

The direct loan concept is not without its critics—in particular, commercial lenders and guaranty agencies, as well as DoE itself, which has gone on record as opposing the idea. One concern is an increase in federal debt. Credit reform permits a more equitable comparison between the programs, but direct loans would still involve the additional cost to the federal government to borrow the funds to support direct lending. According to the Congressional Research Service, the administration believes that such borrowing would add $200 billion to $300 billion to the national debt over a 20-year period, and repayments would take longer to offset this debt.[16]

The real question facing policymakers is whether a change to a new system would be a better federal investment than continued attempts to fix the troubled Stafford program.

Another issue is the administrative burden on DoE and the schools. Although DoE would no longer have to monitor lenders and guaranty agencies, it would have new responsibilities, and it would need to overhaul its procedures and staffing to meet them. The administrative costs of a new system, and the transition, are unknown. Schools would need to prepare promissory notes, and some would have to establish procedures for making loans. Still, many schools already have such systems in place, particularly those in the Perkins program (a government-sponsored program under which schools make loans) and those that already act as "institutional" lenders in the Stafford program.

The Higher Education Act, which includes the Stafford program, is up for reauthorization now. Bills in both the House and Senate incorporate changes meant to save money and simplify the loan process, and the House bill contains a proposal for direct loans. A compromise is still under discussion. Meanwhile, a proposal to test direct lending—part of the House bill—could be effective by July 1, 1994. Such a test could demonstrate any operational problems of a direct loan program and either verify or settle critics' concerns.

In any case, as Congress considers reauthorizing the Higher Education Act, policymakers have an opportunity to substantially improve the federal financial aid program. In doing so, they will need to decide whether to put their efforts into changing to a new loan system or trying to fix the existing Stafford program. •

1. Letter from the Comptroller General of the United States to the Chairman, Committee on Governmental Affairs, U.S. Senate, and the Chairman, Committee on Government Operations, House of Representatives (GAO/OCG-90-1, Jan. 23, 1990).

2. Figures for fiscal year 1991 are preliminary data supplied by DoE officials. Figures for earlier years are from DoE's *Guaranteed Student Loan Program Data Books.*

3. Sallie Mae is a congressionally established corporation that buys and holds guaranteed student loans. By selling loans to Sallie Mae, lenders gain liquidity that allows them to make additional Stafford loans.

4. *Defaulted Student Loans: Preliminary Analysis of Student Loan Borrowers* (GAO/HRD-88-112BR, June 14, 1988).

5. *Guaranteed Student Loans: Potential Default and Cost Reduction Options* (GAO/HRD-88-52BR, Jan. 7, 1988).

6. *Semiannual Report to Congress, October 1, 1990 - March 31, 1991, No. 22,* U.S. Department of Education, Office of the Inspector General.

7. *Student Financial Aid: Education Can Do More to Screen Schools Before Students Receive Aid* (GAO/HRD-91-145, Sept. 27, 1991).

8. *Guaranteed Student Loans: Lenders' Interest Billings Often Result in Overpayment* (GAO/HRD-88-72, Aug. 31, 1988).

9. *Student Loan Lenders: Information on the Activities of the First Independent Trust Company* (GAO/HRD-90-83FS, Sept. 25, 1990).

10. *Defaulted Student Loans: Private Lender Collection Efforts Often Inadequate* (GAO/HRD-87-48, Aug. 20, 1987).

11. Letter from Franklin Frazier, Director, Education and Employment Issues, GAO, to the Chairman, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Nov. 9, 1990.

12. *Guaranteed Student Loans: Legislative and Regulatory Changes Needed to Reduce Default Costs* (GAO/HRD-87-76, Sept. 30, 1987).

13. Department of Education and the Office of Management and Budget, *Administration Adopts Plan to Reorganize Student Financial Assistance,* April 1991.

14. *Stafford Student Loans: Millions of Dollars in Loans Awarded to Ineligible Borrowers* (GAO/IMTEC-91-7, Dec. 12, 1990).

15. *Student Loans: Direct Loans Could Save Money and Simplify Program Administration* (GAO/HRD-91-144BR, Sept. 27, 1991).

16. Congressional Research Service, *Direct Student Loans: A Pro and Con Analysis,* Sept. 23, 1991.

William M. Layden

FOOD SAFETY: A PATCHWORK SYSTEM

Despite a sheaf of laws and regulations, the government still lacks any comprehensive food safety policy.

ASSUME THAT THE 250 million people in the United States eat three meals a day. That means the nation's food safety policies directly affect Americans nearly 274 ***billion*** times a year—not including snacks.

These policies have generally served us well. Food is relatively cheap, plentiful, and wholesome. In fact, the United States has generally been thought to have the safest food supply in the world.

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But perhaps it is not safe enough. Every year, enough contaminated food falls through the safety net to kill at least 9,100 Americans and make at least 6.5 million others sick, according to researchers from the Centers for Disease Control (CDC).[1] And that's only acute illness; the extent of long-term disease related to food is unknown. In addition, the social costs of food-borne illness, such as medical expenses and lost productivity, are sizable, estimated to reach between $4 billion and $8 billion annually.[2]

The problem is not simply that individual food safety laws are not achieving what they were

designed to achieve. Rather, it is that most of these policies were created one by one to address specific problems, not in concert to achieve consistent, broad-based goals. Viewed in its entirety, the existing regulatory structure is inefficient, cumbersome, and costly.

More important, it has not kept up with today's needs and concerns. Changes in scientific and medical knowledge, trade and technology, and consumer demographics and behavior have expanded the definition of "safe food" in ways that were never envisioned when the policies were created. In turn, the public has begun to raise legitimate questions about the government's ability to ensure the safest possible food supply.

The nation's food safety laws were created one by one to address specific problems, not in concert to achieve consistent, broad-based goals.

Many Americans have begun to realize that their outdated food safety system is not giving them their money's worth, and the last two decades have seen many calls for reform. But the government must do more than simply improve existing programs. Rather, policymakers need to rethink the nation's overall approach to food safety regulation. Only when they define what role the government should play in food safety will they be able to determine what steps to take next.

A century's worth of rules

Although growers, manufacturers, and retailers retain primary responsibility for the safety of their products, the federal government, in cooperation with state and local governments, keeps watch over the industry. Altogether, 12 federal agencies spend about $1 billion a year to ensure the safety and quality of the food we eat.[3] Two organizations account for most of that spending: One is the Food and Drug Administration (FDA), which falls under the Department of Health and Human Services. The other is the U.S. Department of Agriculture (USDA), which includes five agencies that address food safety issues.

The federal government involves itself in virtually all stages of food production and marketing, from raw agricultural commodity to finished product. It sets standards for specific foods; approves certain food preparation equipment and processes; inspects facilities and products; sets legal limits for chemicals in food and tests food for compliance; regulates labeling and packaging; monitors state and local inspection programs; conducts research and consumer education efforts; takes action against illegal products; and monitors food-borne illnesses and other problems.

Obviously, this is a mammoth effort. Some 6,100 meat and poultry plants and more than 50,000 food establishments are subject to inspection by USDA or FDA. About 537,000 commercial restaurants, 172,000 institutional food programs, 190,000 retail food stores, and 1 million food vending locations submit to state and local inspection with FDA oversight. And the government keeps tabs on more than 70,000 separately labeled food products, 23,000 pesticides, 12,000 animal drugs, and thousands of additives—as well as $22 billion worth of food and agriculture imports.[4]

Its magnitude notwithstanding, this regulatory system did not develop under any rational plan. Programs emerged piecemeal, typically in response to particular health threats or economic crises. The earliest federal food safety laws, passed in the late 1800s, addressed such obvious problems as filth and fraud—for example, preventing manufacturers from adding impure or imitation ingredients to such products as tea and butter. Regulations were also designed to promote trade; for instance, meat and poultry inspection was introduced to certify the wholesomeness of meat exports. The first comprehensive federal food safety laws, the Food and Drugs Act of 1906 and the Meat Inspection Act of 1907, were intended to exclude misbranded or adulterated products from interstate commerce.

Over the course of this century, food production grew from a relatively simple, localized, farm-based industry into a multibillion-dollar enterprise. As food production and processing moved from the home to the factory, the responsibility for ensuring food safety shifted away from consumers to processors, retailers, and—in particular—government regulators, whose role increased substantially.

At the same time, scientists learned that food could be contaminated not only with visible filth or impure fillers, but also harmful microorganisms (such as bacteria, viruses, and fungi); parasites (such as tapeworms); intentionally or unintentionally added chemicals (such as pesticides, animal drugs, flavor and color additives, industrial chemicals, or environmental contaminants); and natural poisons (such as the toxins in some fish). As understanding of food-borne hazards grew, so did concerns over food safety. Addressing one new worry after another, legislators amended old laws and enacted new ones. Today, a century's worth of such rules constitutes the complicated network that is our food safety system.

As food production moved from the home to the factory, the responsibility for ensuring food safety shifted away from consumers to processors, retailers, and the government.

Inconsistency and inefficiency

The food safety laws have unquestionably improved the safety and purity of the nation's food supply. But overall, the system suffers from its longstanding lack of coordination. The dozen federal agencies involved in food safety operate under different mandates and definitions. Too often, they duplicate efforts in some areas while ignoring others entirely. More important, their standards of risk are inconsistent with one another.

The most obvious problems lie in the division of responsibilities between USDA and FDA. For the most part, USDA oversees products containing meat and poultry, while FDA regulates all other food products. The arrangement is not quite as simple as it sounds. For example, the two organizations share jurisdiction for egg products. FDA also is responsible for products containing less than 3 percent raw meat or poultry as well as those containing less than 2 percent cooked meat or poultry. And both organizations monitor domestic and imported food for potentially harmful chemicals, such as pesticides, animal drugs, and environmental contaminants.

Yet these two organizations operate under substantially different statutory mandates. For instance, USDA carries out a massive "continuous inspection" program at slaughterhouses, which by law may operate only when one of the department's 7,350 field inspectors is on duty. USDA also inspects all meat and poultry processing plants daily. In contrast, FDA inspects facilities under its jurisdiction, on average, once every three to five years. Due in part to budget constraints, FDA and state inspections cover less than one-fourth of the nation's 50,000 food manufacturers, packers, processors, and warehouses each year.[5]

The differences in the two organizations' approaches mean that food products that pose similar risks may receive widely varying scrutiny. For example, canned soup containing more than 2 percent meat poses essentially the same risk of contamination as canned meatless soup; in both cases, the health hazards rest not with the soup's ingredients, but with the canning process. Yet USDA conducts daily inspection of the plant producing the soup with meat, while FDA may visit the plant producing the meatless soup only once every few years. Even without knowing what level of supervision is actually necessary, any observer can see that something is wrong: Either USDA is wasting its time and money in daily inspections, or FDA is potentially allowing dangerous products to reach the market.

Even as the inspectors concentrate on some products, they ignore other areas of equal or greater concern entirely. Fish—especially shellfish—caused 21 percent of all food poisoning cases arising from meat, fish, or poultry reported to CDC between 1978 and 1987.[6] Yet seafood is not subject to mandatory federal inspection. In other words,

The dozen federal agencies involved in food safety operate under different mandates and definitions. Too often, they duplicate some efforts while ignoring other areas entirely.

the same system that requires continuous inspection of chicken practically ignores tuna.

The incongruities between USDA and FDA extend well beyond their inspection methods. For example, meat and poultry products must have a USDA stamp of approval for interstate sale, but food products under FDA jurisdiction generally require no pre-market certification. USDA reviews construction plans for all manufacturing facilities for meat products, but non-meat food producers are not required to notify FDA about a plant's construction, or even its existence. And while USDA has legal authority to examine company records, FDA does not. As early as 1972, GAO noted that this impaired FDA's ability to protect the public.[7] Other GAO and congressional reports have suggested that FDA needs additional authority to halt the distribution of questionable products and to order recalls.[8]

Over the last 20 years, many investigators have documented—and criticized—the inconsistencies of the existing arrangement. The Senate Committee on Governmental Affairs reported in 1977 that the division of responsibility between USDA and FDA "has resulted in a regulatory program which is often duplicative, sometimes contradictory, undeniably costly, and unduly complex. . . . There is no rationale, other than a historic one, to justify maintaining two separate, inconsistent, and costly systems for inspecting and otherwise regulating production of processed foods."[9]

While the division between USDA and FDA provides the most obvious example of disarray, conflicts are evident throughout the food safety system as a whole. For instance, FDA's proposed new labeling rules would not apply to food advertising, which is controlled by the Federal Trade Commission (FTC). That means that companies may soon be prohibited from making certain claims on food packages, yet still make those claims in ads. Another example is cancer policy: FDA and the Environmental Protection Agency (EPA) follow contradictory standards, mandated by separate laws, for determining the maximum level of cancer-causing chemical residues allowed in various food products.[10]

Federal agencies have developed at least 50 formal agreements to coordinate their roles in regulating food. But GAO and others have shown that many of those arrangements don't work. Little has changed since the Senate Governmental Affairs Committee's 1977 report cited "an unrealistic demand for close cooperation between agencies which proceed under substantially different statutory direction and philosophies of regulation." In some cases, the report added, uncertainty over jurisdictions "has led to an excess of deference and the failure of either agency to act effectively in the face of a regulatory need."[11]

Recent coordination between USDA and FDA on the new food labeling regulations probably reflected in part the fact that USDA Secretary Edward Madigan had helped shepherd the law through enactment when he was in Congress in 1990. Such cooperation is not the norm. This year, GAO found that USDA and FDA failed to work together in at least two other important areas: development of a database on pesticides and efforts to control salmonella.[12]

USDA and FDA do not work well with each other or with the other agencies that share responsibility for food safety. On an even more basic level, neither USDA nor FDA has its own house in order. GAO reported in March 1991 that USDA lacks a comprehensive food safety policy and plan. That means not only that different USDA agencies may be working at cross-purposes, but also that USDA is missing opportunities to link its various agencies' work. For example, USDA's agency for animal health (the Animal and Plant Health Inspection Service) could be working with its agency for human health (the Food Safety and Inspection Service) to control animal infections that can contaminate human food.[13]

USDA and FDA do not work well with each other or with the other agencies involved in food safety. On an even more basic level, neither USDA nor FDA has its own house in order.

To add to USDA's internal confusion, the department must play two roles—promoting agriculture and protecting the public. Since its creation in 1862, USDA has concentrated on helping the agricultural industry produce a cheap and plentiful food supply. But its emphasis on the health of the industry may overshadow its responsibility to ensure the health of the consumer. Critics argue that industry pressure can inhibit USDA from working more aggressively to reduce food contamination or encourage alternative agriculture practices that lessen pesticide use.

This issue drew media attention in April 1991, when USDA decided to postpone introducing the "Eating Right Pyramid" as a replacement for the "Four Basic Food Groups," a traditional consumer dietary guide. One goal behind the pyramid was to persuade consumers to eat fewer high-fat, high-cholesterol meat, dairy, and egg products—the very products that USDA has traditionally promoted. While the Secretary stated that the pyramid was withdrawn because it had not been tested sufficiently among children and low-income Americans, others saw the move as evidence of USDA's conflicting roles. After conducting more tests, USDA adopted a slightly altered version of the pyramid in April 1992.

FDA suffers from a different problem: It is buried beneath several layers of bureaucracy within the Department of Health and Human Services (HHS). Although FDA's jurisdiction over food, drugs, and medical devices affects 25 cents of every consumer dollar, the agency enjoys less independence than other agencies, such as the FTC or the EPA, that deal with consumer health issues. According to a 1991 report from the Edwards Committee—a blue-ribbon advisory panel named for its chair, former FDA Commissioner Charles C. Edwards—FDA confronts unreasonable barriers in such essential areas as hiring senior executives and scientists, acquiring facilities and equipment, arranging for international travel, and producing publications on public health. Such impediments, the committee maintained, diminish FDA's authority and prevent it from carrying out its responsibilities.[14]

Unplanned obsolescence

The disarray of the food safety system has not gone unnoticed. Bills to correct particular problems have cropped up occasionally, and Congress is debating some of these issues now. Still, it is becoming increasingly obvious that incremental attempts to shore up weak points won't address an underlying problem of the system: its inability to adapt to changing circumstances.

While the food safety system was initially designed to find and deal with such problems as outright fraud or grossly unsanitary practices, it is less well-prepared to address the troubles of most importance today. Scientific understanding of food-borne hazards, technology for producing food, consumer demographics and eating behavior, and the public's expectations of the system have all changed since the major links in the network were established. That network, however, has failed to keep pace with these changes.

New food-borne threats

Of the various sources of food contamination, microbes probably pose the greatest risk to human health. Harmful microbes in food cause nearly all cases of acute food-borne illness in the United States each year. Because many cases go undiagnosed, the actual figure is probably much higher than the conservative figure of 6.5 million annually—at least 24 million, according to an estimate by officials at FDA.[15]

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Most people have heard of salmonella. But scientists have lately identified other harmful organisms, such as listeria and campylobacter, as serious threats. That is partly because scientists have better ways of detecting microbes, but it also reflects trends in food distribution that leave products vulnerable in new ways. For example, we depend on refrigeration to keep food safe in transport, but the listeria bacterium can survive refrigeration. Each year, listeriosis strikes about 1,850 Americans; nearly one-fourth of those people die.[16] Similarly, campylobacter, the leading cause of bacterial diarrhea in the United States, tends to cause illness only when it reaches high levels in food. Developments in packaging that allow longer food storage may enable the bacteria to grow to dangerous proportions.

Even more worrisome is the appearance of new or stronger strains of contaminants. A generation ago, an uncracked egg was assumed to be a bacteria-free package; legislators responded by requiring cracked eggs—potentially infected with salmonella—to be used only in cooked products, because cooking destroys salmonella bacteria. Today, however, at least one strain of salmonella is able to pass from an infected chicken to a developing egg, so that eggs perfect to the eye might still be contaminated. Increased use of antibiotics in meat and poultry may also encourage the development of resistant strains of bacteria.

While scientists believe microbes are today's chief food-borne threats, public attention tends to focus on pesticides, animal drugs, and other chemicals in food. Chemical residues may not make individuals fall ill immediately, but some people suspect them of causing cancer, birth defects, and other problems.

These types of contaminants can provoke outrage far out of proportion to the risks they pose. That is partly because many Americans view chemical contamination as an unnecessary risk, imposed on an unsuspecting population by food manufacturers who profit from the use of the chemicals. This perception surfaced in two episodes in 1989: first when consumer groups objected to the use of the pesticide Alar on apples, and later when import inspectors found some Chilean grapes tainted with cyanide. While no one became ill in either case, both episodes damaged consumer confidence and caused severe losses in the marketplace.

Yet for the most part, USDA's methods for inspecting meat and poultry cannot detect microbial or chemical contamination. Standard inspection procedures—smelling, feeling, and looking at the product—date from an earlier era when easily identifiable conditions, such as obvious disease or spoilage, were considered the chief dangers of these foods. But today, such visible problems are minimal compared to the invisible threats, which can be detected only through laboratory analysis. USDA's grading standards for produce are equally out of date, relying on criteria that are mostly cosmetic and therefore may encourage excessive use of pesticides.

Even if they had the resources to try, USDA and FDA could not identify all foods with illegal chemical residues and keep them from reaching the consumer. The government has no useful methods for detecting many of the residues it is supposed to monitor.[17] Even where detection is possible, there are simply too many products to examine and too many contaminants to check for in the limited time before the product is sold and eaten. The government is seeking better ways of sampling and testing for residues. But for now, government inspection may provide a false sense of security to those consumers who believe it means products are free of all contamination.

Improved technology

Technological advances in agriculture and the food processing industries have made it possible to offer a larger population a food supply that is cheaper, more varied, and more convenient than in the early 1900s. Yet some of the same tools that have dramatically expanded agricultural production—pesticides, fertilizers, and animal drugs—have themselves become cause for concern. Recent rules meant to ensure that newly introduced substances are safe to use have had the unintended effect of discouraging the development of safer chemical products; manufacturers and consumers instead stick with products that were approved under older, less stringent standards.

Food inspection procedures date from an era in which visible disease or spoilage were considered the chief dangers. Today's invisible threats can be detected only through laboratory analysis.

Mechanical improvements have introduced food safety problems, too. Traditional inspection methods cannot keep pace with high-speed equipment that allows only a few seconds for inspectors to examine each piece of meat and poultry. And the inability of inspectors to detect microbial contamination becomes even more worrisome in modern plants, where one infected chicken can swiftly contaminate hundreds of other birds processed with the same equipment.

Better storage and transport means that food moves farther and faster than ever before—and, in turn, that a single source of contamination can affect more people in a larger area and in a shorter period of time. Given the sheer quantity of food in production, even small risks can cause harm on a huge scale.

In general, technology is raising new questions faster than regulators can answer them. For instance, some consumer advocates worry that new genetically engineered food products may cause unforeseen harm. While FDA is authorized to approve food additives, it has no comparable authority to review new *foods* before they enter the market. This issue drew attention in 1991, when Calgene, a California biotechnology firm, asked FDA to informally concur with its plans to market a tomato genetically engineered to remain firm during shipment. FDA is still reviewing the case.

Changed consumer behavior

As the demographics of a population change, so does its risk of disease. People who are older or immune-compromised—two rapidly growing groups—are more vulnerable to food-borne illness than younger, healthier people. Eating patterns also shift with demographics. For example, Americans eat almost 60 percent more seafood now than they did 10 years ago, partly because of growing numbers of minorities and senior citizens, who consume high proportions of fish.[18] Risk has increased accordingly, as seafood is highly susceptible to contamination.

Changes in lifestyle make a difference, too. To meet consumer demand for low-processed, ready-to-eat foods, manufacturers are packaging more types of food than ever in convenient forms. Consumers, taking for granted that all packaged foods are safe, may overlook directions to refrigerate containers or to stir foods during microwave cooking—steps necessary to control microbes in certain products.

The trend toward eating out adds to risk as well. USDA estimates that almost half the money consumers spend on food now goes to meals and snacks away from home. At the same time, budget constraints are limiting state and local inspections of retail food operations. Underinspected establishments, such as self-serve counters at grocery stores, run an increased risk of food contamination.

Americans seem increasingly unaware of the importance of cooking and storing food properly. FDA estimates that 30 percent of food-borne illness involves unsafe food handling in the home.

And much of the responsibility rests with consumers themselves. Even as Americans have become further removed from the sources of their food, they have developed what may be a dangerous dependence on others to ensure the safety of their food. In general, Americans seem increasingly unaware of the importance of cooking and storing food properly to destroy microbes and keep contamination from spreading. FDA estimates that 30 percent of food-borne illness involves unsafe food handling in the home.

Greater expectations

In this century, diseases caused by nutritional deficiency—such as beriberi, pellagra, and scurvy—have almost disappeared. However, in their place, we have seen a rise in problems linked to dietary excess, such as heart disease and cancer. While once people worried about getting enough calories, protein, and fat from their food, health professionals now warn against eating too much of these substances, especially fat.

In the wake of this reversal, some federal food quality standards appear particularly outdated. For instance, under USDA's decades-old ranking system, the "best" grades of meat—Prime and Choice—are those with the highest proportion of fat. Similarly, the definitions for butter, cheese, and other foods prescribe certain levels of fat, which means that low-fat versions must be labeled as "imitations." The proposed labeling changes include revisions in some of these standards.

Growing evidence suggests that overall dietary behavior has far more impact on health than food contamination does. For example, various studies estimate that perhaps one-third of all U.S. cancer deaths may be diet-related. In contrast, chemical additives in food—such as colorings and preservatives—may contribute to less than 1 percent of cancer deaths.[19] In other words, modifying dietary behavior might contribute more to public health than eliminating all intentional additives from food. It remains an open question exactly what role the government can, or should, play in overseeing Americans' food choices—and whether consumers will demand that the government try to restrict "unhealthy" foods as well as "unsafe" ones.

Broad-based reforms

The problems of the food safety network are far too broad and varied to be solved with narrowly targeted corrections. Real improvement will require large-scale reforms. These two steps would make a good beginning:

Restructure the network to work efficiently and consistently. Any change should begin with the two organizations that share most of the responsibility for food safety, USDA and FDA. The government has already taken some steps to clean up internal problems; in response to GAO's

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recommendations, the Secretary of Agriculture announced in September 1991 that he would name a commission to consider how USDA can better manage cross-cutting issues within its own walls.

As for FDA, the 1991 Edwards Committee report recommended elevating the agency's status within HHS to put FDA on a par with its corresponding regulatory agencies, such as EPA, FTC, and the Occupational Safety and Health Agency. The committee also proposed that if HHS failed to act, Congress should consider restructuring FDA as a free-standing executive agency. HHS and the administration, however, received that proposal with little enthusiasm. Meanwhile, Congress is considering legislation to enhance FDA's enforcement authority.

Resolving the internal problems of USDA and FDA is just the beginning. Policymakers must also deal with the historically inconsistent treatment of food risks by the dozen agencies involved in food safety, as well as the ways in which they work—or don't work—together.

One alternative would be to consolidate food safety functions into a single agency, with all activities carried out within a unified framework. In fact, in 1977, the Senate Committee on Governmental Affairs recommended uniting federal responsibility for food regulation under FDA and elevating that agency's status within its parent department. "Appropriate overall organization of the regulatory structure can help government to operate at maximum efficiency and economy, avoiding conflicts and duplication of effort," the Committee noted. "This is especially necessary in times such as the present when money for new programs is in short supply, and the only opportunity to finance new initiatives is to save resources by reducing inefficiency, waste, and outmoded or unnecessary efforts."[20]

In response to that report, GAO stated that the concept of consolidation had considerable merit but that more work was needed to determine whether to consolidate food safety responsibility in FDA or create some new federal entity.[21] That remains the case, although consolidation has been suggested many times in the years since.

Redesign the inspection system to place more responsibility on industry. Government's traditional approach to food safety has been to inspect finished products. But as FDA has noted, "Quality cannot be inspected into a product. If a quality product is to be produced, then the basic manufacturing system must be designed to ensure its production."[22]

The existing inspection system is not only expensive and inadequate, it is also counterproductive. Fifteen years ago, GAO found that the mere presence of USDA inspection may discourage industry from building quality and safety into its operations, because plants have come to rely on inspectors to provide quality control.[23]

GAO and others have long recommended that daily inspection of meat and poultry processing plants should be phased out. Instead, government must formally pass that responsibility, and its cost, to industry. A recent internal USDA report also affirmed the need to shift responsibility to industry for producing quality meat and poultry products and to redirect federal resources to public health-oriented objectives.[24]

Under proposed arrangements, the government would continue to set standards for food, but it would require industry to develop its own quality control systems. Federal regulators would approve and audit those systems and conduct occasional unannounced inspections, penalizing manufacturers for noncompliance when necessary. Such a strategy would make far better use of limited resources now wasted on ineffective inspections.[25]

However, FDA and USDA are finding it difficult to shift the burden onto industry. In 1988, under direction from Congress, USDA proposed reduced inspections at meat and poultry processing plants, but the proposal never got beyond preliminary testing. FDA would like to adopt similar approaches, but is handicapped because it may lack the necessary authority over industry.

No system can guarantee the purity of every bite Americans take. The system needs to ensure some level of safety while being flexible enough to respond to changing circumstances.

Rethinking the system

Such reforms as reorganizing the food safety network and restructuring the inspection system would help. But as useful as these changes might be, they would, like earlier improvements, provide only temporary relief unless they were made in concert with a comprehensive national policy for food safety.

To begin with, policymakers need to define the federal government's mission concerning food safety and quality. Because no system can guarantee the purity of every bite Americans take, the overall goal cannot be to seek an unattainable, immovable ideal of absolute protection. Rather, the system needs to ensure some level of safety while being flexible enough to respond to changing circumstances and expectations.

In setting objectives, policymakers need to weigh the importance of known physical risks (such as bacterial contamination) against perceived risks (such as chemical residues that may pose relatively little hazard but still arouse consumer outrage and fear). They must also determine just what "safe food" means: Is it "food that will not make you sick," or "food that does not pose long-term hazards," or "food that is good for you"? At some point, the desire to protect individuals from danger clashes with personal liberty and responsibility, not to mention free enterprise. This issue will become particularly apparent as federal attempts to screen out harmful substances evolve into efforts to promote "healthy" eating.

Given a clear mission and objectives, the next step will be to decide how much the nation can and should invest in food safety and quality. If current trends continue, funding will only get tighter; real federal spending for food safety agencies has generally decreased since 1980, while work loads have grown. Still, adding funds will not in itself solve the problems. Policymakers must focus their efforts on getting the most from the nation's investment in food safety and quality—a process that almost certainly will involve reorganizing the system's approach and structure.

Finally, the government must develop ways to measure its progress. At present, regulators generally monitor an agency's performance by keeping track of what it does, not what it achieves. For example, we know how much meat and poultry is inspected, but we have no data on whether that inspection really prevents illness. Without real measurements, no one can tell whether the nation is spending its food safety resources wisely.

These issues have yet to be resolved, and the solutions are by no means clear or easy. Each question raises new ones; ultimately, food policy touches dozens of other major issues, ranging from international trade and environmental pollution to agriculture and public health. But at base, if

If policymakers truly want to establish a consistent and cost-effective approach to ensuring the safety of all foods, they must break away from the legacy of disorder and rethink their goals.

policymakers truly want to establish a consistent and cost-effective approach to ensuring the safety of food, they must break away from the legacy of disorder and rethink their goals. Without that, any reforms will simply further confuse the complicated patchwork we call our food safety system. •

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BOOK REVIEWS

CLASS CONSCIOUS

Jonathan Kozol

SAVAGE INEQUALITIES: CHILDREN IN AMERICA'S SCHOOLS

New York: Crown, 1991. 262 pp.

By Robert Geen

Every day in Chicago, 5,700 children come to school to find they have no teacher. In New York, blackboards are "so badly cracked that teachers are afraid to let students write on them for fear they will cut themselves." In East St. Louis, schools have been shut down repeatedly when "sewage flowed into the basement, through the floor, then up into the kitchen." In the inner-city schools of which Jonathan Kozol writes, education takes a back seat to survival.

These schools may have as many as 39 children in a class and dropout rates as high as 86 percent. Gyms and libraries often double as classrooms, with several classes held in one room simultaneously. Yet in nearby suburbs, Kozol observed classes as small as 24 students—or even smaller for slower-learning children. *Town and Country* described one suburban school as a "huge, well-equipped building, which is immaculately maintained by a custodial staff of 48." Dropout rates are as low as 2 percent; as many as 93 percent of students continue on to four-year colleges.

Kozol uses these contrasts to illustrate the "savage inequalities" of our public school system. His argument is simple: Because public school funding comes primarily from local property taxes—a direct reflection of local wealth—rich suburban neighborhoods have well-funded schools, while impoverished inner-city neighborhoods have poorly funded schools. Moreover, Kozol argues that racial discrimination is a major factor maintaining this funding structure. He concludes that we have not progressed much since *Plessy v. Ferguson*, the 1896 case that allowed segregated schools for blacks as long as they were equal to those provided for whites. For black and white children today, the public school system remains separate and unequal.

Kozol's chief complaint concerns the "arcane machinery by which we finance public education." State contributions, which account for only about half as much of public school budgets as do local funds, have generally failed to make up for local variations in wealth. The federal contribution is even smaller. This system has led to wide funding disparities between the inner cities and the suburbs. For example, in 1988-89, schools in New York City received an average of $7,299 per student, while those in neighboring Manhasset received more than $15,000. Schools in Camden, New Jersey, received an average of $3,538 per student, while the figure for nearby Princeton was over $7,700.

The numbers speak for themselves, and Kozol's vivid descriptions of decaying, unsanitary, and ill-equipped inner-city schools demonstrate that they are in no shape to serve our children. If Kozol had simply documented the dramatic disparity in funding and the decrepit condition of these schools, he would certainly gain many allies. But he goes much further, advancing a populist argument that is likely to alienate more moderate readers, who may see his critique as unfair and exaggerated.

Noting that some people defend the current school financing structure as "the survival of the fittest," Kozol argues that "it is more accurate to call

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the survival of the children of the fittest—or the most favored." Quoting John Coons, author and law professor at University of California, Berkeley, he maintains that the freedom of the rich to give their children "preferential education, and thereby achieve the transmission of advantage by inheritance, denies the children of others the freedom inherent in the notion of free enterprise. . . . What democracy cannot tolerate is an aristocracy padded and protected by the state itself from competition from below." Kozol blames the government for this unfair advantage afforded to the rich; government, after all, "does assign us to our public schools."

Kozol asserts that funding for the schools should be equal, or even redistributive, with needy schools receiving more funds than their wealthier counterparts. I wonder, however, whether the funding disparity itself should command our attention. One might argue instead that we should ensure that all schools achieve a certain base standard of performance that is sufficient to produce competent students. This almost certainly would mean funneling more money into impoverished schools, but it would not necessitate equalizing funding across all schools.

Kozol does not consider whether other interventions—beginning with some change in school financing, but going beyond that as well—might help inner-city schools achieve better results. Looking strictly at the money going into the schools, he concludes that the decreed "foundation" (the minimum level of school funding, established by each state) is typically too low to provide a truly good education. He maintains that if our goal is to make sure a "child of low income [can] enter into equal competition with the children of the rich, then the foundation level has to be extremely high." In other words, he finds the disparity itself to be the problem.

Kozol documents the almost absolute racial segregation that exists between inner-city and suburban schools, and he concludes that racial discrimination has helped maintain the unfair system of public-school financing. However, Kozol himself notes that schools in many poor rural white communities suffer from the same disadvantages as those in the inner cities. This would suggest that socioeconomic factors, regardless of race, may be responsible for inequalities among schools. Kozol offers no convincing evidence for his contention that racial discrimination is the true cause of the disparities. In fact, he dismisses the issue: "Whether it is race or class that is the major factor in denial of these children," he writes, "the question always strikes me as a scholar's luxury."

Whatever the reason, the public school financing system's apparent discrimination against the poor has led various groups to challenge the system's constitutionality at both the federal and state levels. The first noteworthy case occurred in 1971, when a district court in San Antonio held that Texas violated the Equal Protection Clause of the U.S. Constitution. The Supreme Court overruled that decision in 1973, with Justice Lewis Powell writing that education "is not among the rights afforded explicit protection under our Federal Constitution," and that in cases involving disparities in wealth, "the Equal Protection Clause does not require absolute equality."

Unlike the U.S. Constitution, however, most state constitutions make specific reference to public education. Since the Texas decision, advocates for school financing reform have concentrated their challenges in the state courts. Most notable is the California decision that found that the state's financing scheme violated both the state and federal constitutions. A new funding system, enacted by the legislature in 1977, provoked voter outrage, leading in 1978 to passage of Proposition 13, a referendum that applied a cap on taxes and effectively restricted state funding for *all* school districts. Funding to most districts in California is now roughly equal, but California ranks 46th among the 50 states in the share of state income that goes to public education, and its average class size is the largest in the nation. Meanwhile, Kozol notes, affluent school districts in California have created tax-exempt foundations to channel additional money into their local schools.

Kozol is a passionate writer, but he is neither a social scientist nor an education policy analyst. Throughout the book, he mentions and discounts many education policies and theories, such as magnet schools and teacher competency testing, but offers little evidence or explanation for dismissing them. The price Kozol will pay for his lack of analytical vigor and his use of a populist rhetoric is that his basically sound argument—that the financing structure for public schools is unjust and needs reworking—may fall on deaf ears. •

LIGHTS, CAMERA

Stephen Hess

LIVE FROM CAPITOL HILL! STUDIES OF CONGRESS AND THE MEDIA

Washington: Brookings Institution, 1991. 178 pp.

By Fuller Griffith

Given C-SPAN coverage of House and Senate proceedings, expanded local TV news broadcasts, and growing congressional press staffs, few people would dispute the importance of the media in American politics. Yet in *Live From Capitol Hill! Studies of Congress and the Media*, Stephen Hess, a Brookings Institution senior fellow and long-time media observer, debunks the myths surrounding the power of the sound bite.

Taking as his theme appearance versus reality, Hess makes a good claim for the relative "unimportance" of the press. Yes, an elite group of network anchors and newspaper columnists have become household names. But Hess persuasively argues that the press's aura of power is mostly an illusion, as demonstrated by the low status actually accorded congressional reporters. His strongest point is that both Members of Congress and reporters themselves overestimate the extent and significance of televised political coverage. While readers might not agree with Hess's conclusions, his thoughtful analysis does argue for a new view of the relationship between politics and the media.

Hess backs his contentions with voluminous, well-documented original research. Thirty-five tables sum up extensive survey work on the characteristics of press secretaries, Washington reporters, and television coverage of the Hill. The book's main shortcoming is structural; organized as a collection of six stand-alone essays plus a "postscript," it would have benefited from greater integration and smoother transitions. For example, chapter topics shift abruptly from an informative discussion of congressional press gallery oversight to a look at local television news coverage. In addition, Hess's most provocative idea—that Members of Congress turn to television primarily to satisfy a desire for celebrity—appears only in the last several pages of the book and begs for elaboration. But these concerns are minor.

Hess first looks at how reporters cover Congress, concentrating on Senate coverage. He details the resourceful ways in which press gallery reporters

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r news—for instance, by buttonholing legislators as they wait for elevators. Reporters seldom attend Senate floor proceedings, which are heavy on procedure and light on real debate. Instead, members of the Senate-supplied press gallery staff rotate through 45-minute shifts taking notes, posting them for use by all press gallery reporters.

Hess defends Hill reporters against charges that their stories uncritically reflect legislators' agendas and verge on "press release journalism." After surveying articles published by nine large newspapers and a national chain of 55 small papers during March 1985, he surmises that congressional reporters are an energetic lot, filing diverse stories with a professionally neutral tone. Their output, Hess concludes, demonstrates that "much of Congress is reported somewhere."

Hess also profiles the congressional reporter's counterpart—the House or Senate press secretary, described as typically young, underpaid, and fairly low in the Capitol Hill pecking order. These are the people who churn out the various vehicles of congressional publicity: videotapes, which are fed to local TV news stations (often by satellite); press releases, with their emphasis on self-promotion and credit-claiming; regular columns for small-circulation papers; and op-ed pieces. The op-ed piece, in particular, has become a potent political tool since its appearance 20 years ago in the *New York Times* in a space once reserved for obituaries.

Press secretaries often have the authority to speak for their bosses and even invent "quotes" for attribution. Most, however, lack the influence that other aides have on legislative or policy decisions. More often, they serve simply as gatekeepers of information. Reporters commonly end-run press secretaries and contact committee staff directly for substantive information.

Most Hill staff members know of offices in which the administrative assistant—often the real power broker on a congressional staff—has formally or informally assumed the mantle of handling the press. But Hess refers to this practice only in passing. Further, Hess touches only briefly on the post-Hill employment of press secretaries. As with many Members of Congress, press secretaries rarely seem to go back to their home states, instead linking up with Washington public relations firms, returning to journalism, or assuming another government post.

Hess hits his stride in analyzing television's relationship with Congress. During the 1980s, new technologies such as lightweight video cameras, tape, and satellite broadcast, coupled with the growing commercial profitability of local newscasts, seemed to portend an increase in Washington news coverage by local television stations. But that isn't what happened. Hess analyzed more than 18,000 Washington news stories produced by 10 Washington bureaus and two independent news services over a seven-year period ending in 1985, and found that many of these stories focused on Congress. But what local television stations actually pick up and air is another story. Sampling local broadcasts in 35 cities over 1987 and 1988, Hess found that Washington coverage often makes up only a small part of local newscasts.

Hess suggests that congressional stories are becoming even rarer. Three of the Washington bureaus that Hess studied in 1986 had closed by 1990. Interviewing news directors from more than 100 television stations, Hess learned that few of them wanted to expand Washington coverage. One news manager said bluntly, "Government news is boring to viewers. One thing Washington is full of is talking heads and meetings."

Local news coverage has been linked with the so-called incumbent advantage, and Hess admits that even trivial amounts of television coverage are "not irrelevant" to electoral success. Even fleeting images boost name recognition. But contrary to conventional wisdom, Hess asserts that the absence of coverage may actually benefit Members of

Congress. Through paid air time, incumbents can package themselves and their issues as they wish, while local television's indifferent approach to congressional coverage ensures that few news stories will produce conflicting images. During election seasons, Hess discovered, targeted campaign ads—not news stories—dominate the airways.

In an era when television has become the primary (if not sole) source of news for many Americans, the implications of its lack of congressional coverage are powerful. "No news may be bad for a member's ego, policy position, and chances of challenging a Senator," Hess writes, "but it's good for being returned to a House seat every two years."

So, if Congress is largely a print story, and if television appearances for rank-and-file incumbents have little effect on elections or policy, why do Members of Congress pursue broadcast coverage so relentlessly? According to Hess, getting on the air is an advantage, if slight, for which "the costs are small, both in time and money, and the money is provided by taxpayers or campaign contributions anyway." Further, the constant display of lights, cameras, and mikes on the Hill elicits a response by both Members of Congress and the press "to the presence of television rather than to its output."

Hess essentially argues that Congress pursues television for its own sake. More and more Members of Congress grew up in the Age of Television, and the attraction of air time for them may have less to do with political dividends than with the quest for celebrity. This notion—echoing McLuhan's judgment that "the medium is the message"—is intriguing, though based largely on anecdote and intuition; more direct empirical evidence would have been helpful. On the other hand, Hollywood personalities now appear at congressional hearings, and the glamour associated with many television journalists seems to owe more to Madonna than to Murrow. Few would argue that in Washington, a city popularly associated with ambition and ego, television has an allure all its own. •

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