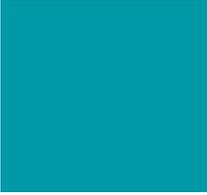


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# Featured Speaker

## Introduction

*John Bovenzi, Director*

*Division of Resolutions and Receiverships, FDIC*

I would like to introduce our afternoon speaker, and my understanding is that after his remarks he is willing to take some questions. Let me introduce John Heimann, who is the Chairman of Global Financial Institutions for Merrill Lynch & Company, a member of the firm's Office of the Chairman and Executive Management Committee. Mr. Heimann came to Merrill Lynch in 1984 as Vice Chairman of Merrill Lynch Capital Markets. He served as Chairman for the Executive Committee for Merrill Lynch European/Middle East from 1988 to 1990, and became Chairman of Global Financial Institutions in 1991. He served as U.S. Comptroller of the Currency from 1977 to 1981 and as a member of the FDIC's board of directors. You'll notice if you look later at his biography in your program that John Heimann has accomplished quite a lot. I won't go through all of it, but it's impressive and suffice to say we are very pleased that he was willing to take time from his busy schedule to be with us today. So, would you please join me in welcoming John Heimann.

**John G. Heimann**  
**Chairman, Global Financial Institutions**  
**Merrill Lynch & Company**

Thank you very much. I am an investment banker that morphed into a supervisor. I was first Superintendent of the Banks of New York State and then came to Washington as Comptroller of the Currency to return to the investment banking industry. So, the best

introduction I've ever received was from Alan Greenspan who said, this is John Heimann—he's a poacher, turned gamekeeper, turned poacher. I wish that fate for all of you—I really do.

I'm really very pleased to be with you today at this symposium. When I was asked to join you, the organizers gave me the wonderful brief to "talk about anything that interests me." That is generous, but it does cause one to reflect and think about what would you really want to say to so sophisticated and knowledgeable an audience? I decided I would discard those matters which would be a regurgitation of comments made by myself and others on a number of well-worthy subjects such as Glass-Steagall. What will Congress do? Will it make any difference and how did we ever get into this ridiculous situation with a Congress struggling with self-interested turf battles while the financial intermediary system in the United States and the rest of the world steams ahead and redesigns itself?

I suspect that the future will be filled with very learned doctorate theses, dissecting the history of Glass-Steagall, from its hurried enactment to its protracted reform. Since I have been an active participant in this issue, having first testified for the repeal of Glass-Steagall as New York State Superintendent of Banks 23 years ago (I must have been very persuasive right?) I will leave objective dissection of this issue in the hands of interested academics of the future.

Nor will I address in the body of my talk the future of the financial services industry. Anyone with eyes, ears, and common sense can easily determine the future shape of the financial services industry. It has been apparent for the past decade and I have again written and spoken to the subject so many times that I thought I would spare myself, and others, a repetition of the obvious. Nor will I dwell on the suitability of deposit insurance. It is thoroughly apparent that deposit insurance is a key, if not the key element, in any banking system. To debate its importance is questionable use of valuable time. Deposit insurance is a bedrock for stability. In a positive sense, we know that from the U.S. experience, and in a negative sense, we know that from the Asian experience. Yes, of course, there is room for debate on the extent of coverage under deposit insurance, and yes, there is room for debate whether deposit insurance should be privately funded or supported in the final analysis by an implicit government guarantee. Unquestionably, there is need for far more debate on the issue of moral hazard and its flip side, too big to fail, than has taken place to date.

But, I shall pass on all of that, even though I have strong views on these related subjects, not only as it affects the United States' financial system, but also how it impacts the international activities of the International Monetary Fund. On these subjects during question and answer, if you want to bring them up, that is fine with me.

But, in light of the globalization of the financial services industry, which combines banking, securities, and in many countries, insurance, and the recent spate of mergers in the United States and elsewhere, for example, Nations Bank and Bank of America, which we were involved in, Bank One/MBD which I was involved in, CIBC/Toronto Dominion Bank in Canada, Credito Italiano and Unicredito in Italy.

I just thought I would like to talk about the future of the structure, not of the industry, but of the system that supervises the industry in its broadest sense—the financial regulators. Now, I know that this is a complicated subject. It is one that is bound to raise considerable controversy. But, I thought it would be unfair of me to come down here without setting the cat amongst the pigeons, and when I say cat amongst the pigeons, that's what I mean. I don't mean every man for himself as the elephant said to the chickens. I mean cat amongst the pigeons—to discuss this subject.

It has been discussed, by the way, on an international basis by the Group of 30 study, which many of you may have seen, of which I co-chaired on financial supervision and national limitations. The subtitle of that study is “The Inherent Contradiction of National Supervision of Global Firms and Global Markets.” Any of you who haven't seen that study, if you will give me your card after this is over, I would be delighted to send it to you because it is a first rate piece of work. I know that is immodest, but that is what the FT said. That is the Financial Times and the Wall Street Journal. But, it is really worth your reading if you're concerned in this area of activity.

Now, financial supervision is predicated upon the correct belief that the real economy should be isolated from the repercussions of systemic failure in the financial intermediary system. I will always use that phrase. I don't mean the banking system. I don't mean the securities system. I don't mean insurance. I mean the financial intermediary system. Those institutions that intermediate the savings of the nation and put them to productive use.

Financial crises, particularly those that occur in the banking system, have dramatic economic consequences in the societies which they intermediate. Innocent savers, small businesses and others are perversely affected through no fault of their own. The financial supervisors' main task, therefore, is to prevent the unintended consequences of financial institutional failure. And, they do that through the supervision and regulation of individual institutions which, taken together, make up the financial intermediary system. That is not to say that financial institutions cannot disappear. A dynamic system that constantly evolves to meet the needs of the customers or clients will always include those who cannot adjust or those who make poor judgments. When that occurs, and it always does, but when that occurs, these institutions must be and inevitably are weeded out. That is not only permissible, it is desirable. But, the process of disappearance must be managed to prevent the problem of one institution being transmitted to others.

As a sidebar, and we won't discuss this at any length now, but one need only look at what has happened in the Japanese financial system to understand how not to manage this type of problem.

But, before tackling the issue of supervisory instruction, there are three principles that need to be observed. Number one is independence. Banking supervision, in fact all financial supervision, must be independent and not subject to the passing political whims and fancies of the legislative and executive body. By that I mean the financial supervisory structure should be so designed that the supervisor can take actions he or she deems necessary in the public interest, free from parochial, political pressures. Supervisors' powers

are great—I heard a bit of that before when I was listening. In the granting of charters, they bestow economic advantage. Conversely, in the closure of an institution, they take away economic advantage. To be independent, the supervisory agency must be free of undue short term influence from either the administration or the Congress. Therefore, the supervisory agency should not rely upon the appropriations process for its funding. Furthermore, the person or persons who run that supervisory agency should receive term appointments and be subject to rule only through a Congressional process. These twin requirements keep the supervisor free of direct Congressional and Executive Branch pressure. That is the case today for the banking regulatory agencies, but not for some of the others. But, of course, it is understood that the agency must be responsive to the parliamentary body that created it and that is done through Congressional oversight.

In my view, the model for the United States today is the newly-created Financial Services Authority in the United Kingdom which combines all the functions of the financial regulatory powers covering banks, building societies (we call them thrifts), securities activities and insurance. Even though it is totally independent, the linkage between the FSA and the central bank is strong and reciprocal, as it should be since the central bank is responsible for the provision of liquidity without which financial crises could easily blossom. In my view, the FSA is the prototype for the entire world.

My second principle is integration. As the recent announcement of Citicorp and Travelers highlights and others around the globe, the melding of banking, securities and insurance is the design of the future. This structure exists in most European nations. With the disappearance of Article 65 in Japan—that is their Glass-Steagall law which has disappeared—we will continue to seek commingling of banking and securities activities in that country. In fact, with the broad exemptions granted under Section 20 by the Federal Reserve, the amalgamation of banking and securities activities in the United States is broadly operative. Therefore, considering those realities of now and in the future, we must expect that we will see more and more of these activities housed in one operating entity. It hardly makes sense to have a variety of different supervisors involved in overseeing that operation.

As it stands today, we have three national banking supervisory agencies—the Federal Reserve, the Office of the Comptroller of the Currency and the FDIC. Thrifts are regulated by the Office of Thrift Supervision; credit unions by the National Credit Union Administration. On top of this, there are 50 state banking supervisors. In the world of securities, we find the Securities Exchange Commission. We have the Commodities Futures Trading Commission. And of course, when it comes to insurance, there is no national supervision, as that is vested in the 50 state insurance commissioners.

Now, how do we integrate all of this into an efficient and effective supervisory system which simultaneously permits innovation and forward movement? To me the answer is obvious—it's the same answer that has propelled the U.S. banking system forward since the founding days of the republic, and it's the dual banking system which clearly must be protected for those states which are willing to appropriate the necessary resources to properly supervise state-chartered institutions.

So, integration means bringing together all of the activities that modern financial institutions offer to the public, and under the supervisory umbrella of one entity. Obviously, today's supervisory bodies have very special areas of expertise developed over the years. To use these talents effectively, many have argued for functional regulation, a concept with which I am in total agreement. To do otherwise I think would be foolish. In H.R.10, this concept is promulgated. But that still leaves the issue of the lead supervisor who always sees the whole and works closely with the functional regulators.

Regardless of the specifics of the present bill, it is my contention that the supervisory structure in the United States needs a major overhaul so that it brings together the various banking and securities regulators in one body. Insurance should be a part of this, but until there is some Congressionally-authorized role for national insurance company supervisors, this will have to remain outside the new structure.

We should create a financial services supervisory body which would preserve functional regulation, and simultaneously, would permit state-chartered institutions to flourish.

The third point is integrity, and by integrity I mean the process which combines independence and integration, and that is critical.

In short, the overseer of the diversified financial enterprise should be capable of viewing the totality of operations from a safety and soundness viewpoint and it should not be subject to undue political pressures. Additionally, it means the integrity of the process by which it makes its judgment, and that its goals and responsibilities are clearly stated and understandable to the public.

In recent months, we have witnessed some unseemly squabbles amongst the regulators, over what can charitably be called turf. It is understandable that private interests will engage in adversarial politics in consideration of their economic self-interest. However, it is hard to justify self-interest for agencies of the government responsible to the people. These battles do not serve the public interest and undoubtedly will continue until the supervisory system is rationalized. In light of the rapid globalization of finance, delay in resolving our dilemma will prove to be as expensive as it is unnecessary.

One of the major arguments against a single federal regulator is that it would put too much power in a single regulatory body, that it would stifle innovation, and that it would be slow to move as it would become exceedingly bureaucratic. Many of these concerns would be solved, as I pointed out before, if we not only preserve but increasingly support a strong and effective dual banking system. My experience in New York State and then from my years here is that many of the real innovations that have taken place in banking did, in fact, start at the state level. They were not created in Washington, but they were created in one of the states by an imaginative superintendent or commissioner with the support of the banking community in that state.

So, my proposal fundamentally is to create a federal financial commission which would combine the banking supervisory activities of the Federal Reserve, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Deposit Insurance Corporation, and the National Credit Union Administration. Additionally, the Securities and Exchange Commission and the Commodities Futures Trading

Commission would also be members. Each existing agency would continue its functional responsibility in order to preserve their expertise and to avoid unnecessary duplication. The commission's board would consist of the heads of the agencies named above, slightly overweighted in favor of the Fed, which would have two board members for a total of nine. There is a legitimate argument on the part of the Fed that they have to know what is going on in the financial system as part of their duties and responsibilities as the central bank.

In addition, there would be two public members appointed for a five-year term, one of whom would be the chairman and both appointed by the President with the advice and consent of the Senate. The commission would then have 11 voting members, and as noted before, it would be funded by fees charged to the regulated institutions to keep it free from the day-to-day hassle with the appropriations process, though obviously the commission would be responsive to federal legislative oversight.

However, I know that is the perfect plan. But, I think it is a step too far. I know it has been right for years, but it's not going to work obviously—too many turf battles involved here. But yet we still need to do something. So, if Congress does not see in its wisdom to create a federal commission, then it seems to me that an acceptable alternative would be for the commission to be part of the Federal Reserve which is independent, according to the standards I set forth previously. In that case, the Fed would need only one member of the board on the commission and public members would be reduced to one, the chairman of the board, for a total commission membership of nine. The state superintendents of banks would relate directly to the commission through the FDIC. The FDIC would remain the insurer of the system as it is today, but its structure would need to be adjusted so that it can more directly represent the states. This could be accomplished by a restructuring of the FDIC board to include one or more state representatives. Importantly, it should be noted that the existing structure of all agencies would remain as they are today, that is, there would be no change in the governance structure in the Fed or the SEC, the FDIC, the CFTC and so forth. The governance does not affect those agencies that have a single person regulator such as the OCC and the OTS.

Now, I realize that bringing all of these agencies together would be difficult. Winston Churchill said don't argue the difficulties—they argue themselves. But, it seems to me that we must, in the United States, adapt our system to the growing reality of international financial competition. We have to do that in a way which takes care of the unique situation of the United States in terms of the spread of our financial system. It is unlike any other nation and therefore we have to adjust accordingly. Nevertheless, that should not be the excuse for doing nothing. That merely says we have to be imaginative in its design. I think that we can do that. I don't think we want to wait for circumstances to force us to change because whenever that happens, it is usually the result of crisis which costs the taxpayers a heck of a lot of money.

So, with that I would like to close my remarks and open it up to questions, except to say one thing. I want to take this opportunity—this is totally off the subject—but I

want to take this opportunity to commend in this audience Skip Hove. The reason I want to do that is, I think he is one of the unsung heroes of financial supervision in the United States. He has been Acting Chairman of the FDIC—I'm not sure he's here so I'm not saying this for his benefit in his presence. He has been Acting Chairman of the FDIC three times and I don't think he's ever gotten the credit he deserves for the extraordinary job he's done standing in for one of the great agencies that was left leaderless. I just wanted to say Skip Hove is a treasure and we're all lucky that he is here.

**Question:** With either your new financial organization or the current regulators, what types of qualitative performance standards would you be applying to see if they're successful, especially in light of the Government Performance Results Act?

**Heimann:** That is a very good question. I think financial supervision has to change quite dramatically from where it's been in the past 20 years. When you have a giant organization that you have to oversee, and to make sure they are not getting themselves into financial difficulty, whatever that means, you can't do it the old fashioned way. It can no longer be examined as looking at loan files or questioning transactions. There is only one way you can oversee an organization of 50,000 to 100,000 people with a couple of hundred billion dollars in assets, with offices and activities in 40 nations, 50 nations, 80 nations—I don't know how many. How are you going to do that? You are all professionals—how are you going to do that? Are you going to put one guy in the head office—is he going to do it? No. Are you going to send in 10,000 examiners? We don't have 10,000 examiners. Are you going to send in 10,000 examiners to look at that and take a snapshot, and what good is a snapshot. When you can change your balance sheet in nanoseconds, so to speak, if you're so inclined, by pressing buttons on a computer and increasing your risks substantially through the use of just trading derivatives, etc., what good is a balance sheet analysis?

So, the whole form of supervisory oversight will have to change if it is to be effective in the future. It's going to have to combine very great knowledge, of not just banking per se. What is a bank today? Banking in the traditional sense—certainly capital markets—the banking system has been disintermediated by the capital markets. The banks all want to be in the capital market. I don't blame them for that one bit. So, you need people who understand traditional commercial banking, capital markets activities, and obviously insurance would be another element of it.

I wonder what happened to Daiwa? When the examiners from Japan came to New York to look at Daiwa, it was the banking examiners who came from the banking bureau. They didn't know beans about securities and of course the problem was in the securities side of Daiwa. Would it have been curtailed or controlled if it had been the securities guys from the securities bureau of the Ministry of Finance? I don't know. But it seems to me it would have been far more logical if those two sets of talents had been combined when they looked at Daiwa. The point in all this is you have to combine the talents.

So, the next question is are you going to have every agency duplicate things? Is the Fed now going to have a whole bunch of capital markets people? Is the FDIC going to have a whole bunch of capital markets people? Is the SEC now going to have a whole

bunch of bank examiners and the costs for all of that? That doesn't make any sense. It is not fair to the public. It is simply unfair to the consumer, if nobody else.

So, how are we going to measure it? I think we're going to measure it by a number of ways going into the future. Obviously—I'm going to have to divert for a minute. We do have a dual banking system in the United States, but it is not what everybody calls the dual banking system. When in my remarks I was talking about state supervision and federal supervision—we have a dual banking system in the United States which are the big banks and the little banks. We have had that dual banking system for many years. The rules of the game are different. I happen to be a strong supporter of the community banking system and I think it has enormous value in this country and some of the community bankers are the smartest bankers around by far. But, having said that, you can examine and supervise a bank of \$100 million or \$500 million, or up to a billion quite differently than one that is \$250 billion or greater than that.

So, we do have a dual banking system and we're going to have to adjust. That is why I feel so strongly about the state superintendents and state banking commissions. We have to adjust our systems so that there is an entity on a national level that can look at the big multinational problem and then you have the capacity simultaneously to deal with the domestic institutions.

How will it be measured? Well, more and more it's going to be measured by disclosure, transparency and by the markets themselves. As the systems grow, the markets are going to be the most severe judges of these institutions in terms of their share price. They have been in the past, but I don't think people have appreciated that so much. If you had looked at outfits like Franklin National or First Pennsylvania, just to name a few at different periods of time, Continental Illinois—all the different periods of time, you'll see their share prices were declining, long before the problem became a public problem. And, so in my view, for the larger institutions it's transparency and disclosure. More and more, I think the banking supervisors have begun to understand that following the share prices of these institutions is a wonderful early warning signal and pay attention to what the broad public is saying about a financial institution. How will it be measured? I think that is how it will be measured. That will be the reality of it.

This also brings up the other question about too big to fail, and I don't know if you want to get into that and I'll pass on that. But, I would have to say that of course there are institutions that are too big to fail. Why are we kidding ourselves? Can you imagine what would happen to the financial system of the world if you name the institution—I don't want to pick any one out—but forget the United States—if the Deutsche Bank closed its doors. They must be involved with financial institutions everywhere in the globe, as are our larger banks. So, it is not an issue of too big to fail.

We in the United States have found an answer to that and importantly the FDIC had a really lead role in finding that answer. It first happened with First Pennsylvania and then it went on—Continental Illinois, etc. We have designed a neutron bomb to take care of financial institutions that have been badly managed. We wipe out the shareholders. We sue the members of the board and management. But, the building still

stands. It still continues to function. So, too big to fail is a meaningless phrase if the shareholders are wiped out and management is changed. So, I think we have to revise our lexicon when we discuss these subjects.

Finally, I would say yes, institutions must disappear. As I said in my remarks, there will be numbers of institutions that simply are sufficiently badly managed that they will come on hard times and they deserve to be wiped out. That doesn't mean just closing it down, but certainly the shareholders, the board of directors, the managers, etc. have to pay the penalty for their mismanagement. So, I think that is another system that will be very effective.

**Question:** Mr. Heimann, you've concentrated your remarks on how to reform the federal regulatory system. What would you do to improve market discipline in the system? You spoke a little bit about disclosure and transparency and touched on too big to fail. Is that your answer, or is there more we could do?

**Heimann:** I think that is a good question. Market discipline—that is something that is broached about by everyone. What is market discipline? There can be no market discipline without full information being made public. You just can't have market discipline without that. How is the market going to know?

One other thing about deposit insurance—I remembered this debate while I was here. That was we should rely on market discipline—we don't need deposit insurance. I have this picture of a hundred million Americans sitting around staring at half-baked balance sheets of banks, trying to understand whether the bank was strong or weak, and in many of the banks, they are so small they put out material once a year or twice a year. This just doesn't make any sense. We're not going to have market discipline in those cases.

We have market discipline where you have security analysts following the individual institutions. They issue reports and there is full information. I think part of the answer is market discipline certainly. But there has to be full information, which raises the most important question that people don't like to talk about—what about CAMEL ratings? Should they be made public? Isn't that a way for the public to find out? Isn't that a way to have market discipline? Shouldn't they know that the supervisors have looked at ABC institution and given it a four—because if it's a five it's not a problem—they're gone. But, giving them a four? What will that do? It is the same basic theory as having a variable rate deposit insurance. That is all part of market discipline in the broadest sense of the word.

I happen to believe, after all of this time that I've been around this system, and that has been a long time it seems like, that the CAMEL ratings should be made public. That is the way to create market discipline.

Now you say, that is a terrible thing to do—look at the problems you cause the regulators because up until now they could put any rating they want on it and they can't get sued or blamed for a run. But, I think that creates discipline and it creates discipline not only in the financial system but it creates a certain kind of discipline amongst the financial regulatory organizations, that they have to defend the ratings.

This brings me to another subject. I don't know how many people fundamentally get to the concept that all supervisory, certainly on loans and credit, questions are subjective.

They are not objective. But, as anyone knows if you're looking at a loan, it depends on the assumptions you apply to that loan. If it's a building in downtown Washington and you assume that the U.S. economy is going to grow by 2.5 percent in real terms, your valuation of that building in downtown Washington will be somewhat different than if you assume it will be a one percent negative growth in real terms. Therefore, the heart of supervision is subjective.

**Question:** Are the Japanese authorities moving in any way toward a solution?

**Heimann:** Well, I'm a great admirer of the Japanese and I think they've done a fantastic job since the end of World War II, and they surely have done that. There is a cultural question here that the Japanese government really has to deal with. There are a couple cultural questions. Number one, when they were recovering from the ravages of the war in the Pacific, the Japanese authorities felt it was their responsibility, and quite correctly so, to protect their industry, and the Ministry of Trade and Industry and the Ministry of Finance saw it as their primary responsibility to help build these indigenous corporations and financial institutions and they did a terrific job. There is no question about it. And Japan became a true economic power in the world, second only to the United States today, and assuming that the European Monetary Union (EMU) works as they think it will, Europe will be one of the three economic giants and powers of the world.

The problem, as I've seen it, and I've expressed this concern for the last five to ten years was that for whatever reason, the bureaucrats, and you can use that word in Japan with much more meaning than you can in the United States and we use it in the United States a lot, but in Japan the bureaucrats have enormous power and influence. They continue to protect the system and manage it in a way that we would never dream of in the United States. So, the financial system, if you look at it, was protected for many years on the philosophy of the lowest common denominator. It was considered anathema in Japan that a financial institution should fail or close, or disappear. Therefore, their rules and regulations and the standards they have set were the lowest common denominator—not those that were necessarily correct, but those which when implemented would not cause the disappearance or the failure of one of their financial institutions. Japanese are like Americans—they've got good bankers and they've got bad bankers. We have the same thing—good bankers and bad bankers. But, it was part of the Japanese cultural philosophy to protect everyone—it was called the convoy effect.

Unfortunately, that is still, in many ways, in action. It is true the Japanese authorities have closed a bank and they have closed a securities company—Yamaichi. Yet, with the money that the Diet granted for support of the banks, they put \$100 million into every one of the banks, regardless of what was weak and what was strong. The reason they did that is they said if you put it into bank "A" and not to bank "B," the public would assume that bank "A" was in trouble and they would cause a run on the bank.

I'm a great believer in deposit insurance. That solves a lot of these kinds of problems. Nevertheless, the Japanese have a way to go in terms of structuring their financial system so it's not only competitive, but it is competitive in the world arena and it should

be because it is a very historically strong economy and people are savers and hard workers, and they deserve a financial system which does represent the best of their country rather than some hangover from the past, which is no longer effective.

Will they get it right in the long run? The answer is yes, because they are very smart. Their political system is vastly different from ours. I think they'll get it right in the long run, but they're going to have to go through this kind of turmoil and concern as it affects their people. You will notice in the paper today that Japan just had the largest jump in unemployment in the last 10–12 years. The publicly announced unemployment numbers in Japan are not real because they have sort of make-do employment, so the unemployment numbers are actually higher than the 4.6 percent that they announced today. Our analysts in Japan say it is about 7.2 percent.

The Japanese also—the problem is for 50 years people were trained and taxed to save. Interest was tax-free. Consumption was taxed. That helped build the nation. No question about it. But, today what they need is consumption because retail sales are falling off the cliff. They really have to get their economy going again and they can't export their way out of the problems. They're going to have to do it through domestic consumption. That means changes in the tax laws which have been proposed. But, once again, there is a problem because they proposed temporary tax relief—not permanent tax relief. Savers, people who are sitting there seeing the economy in the doldrums, seeing people getting laid off for the first time in the post-World War II period, and getting 0.2 percent on their savings—they're not about to start spending a lot of money unless they think the tax cut is something they will have for a long period of time. I think Japan will come out of it. It still has a way to go, and I don't understand the politics of that country well enough to know how they're going to resolve the issue. But, for the good of the Japanese people and for the good of Asia and for the good of the world, I hope they do.

**Question:** Returning to your comment before about making CAMEL ratings public. What do you think of the private sector attempts at emulating a rating system—do you think that is a suitable substitute for market discipline?

**Heimann:** Well, you mean the rating agencies?

**Question:** Yes, and those people that do ratings on banks and thrifts using call report data.

**Heimann:** They don't have the insight that the supervisors do. What is the great strength of the supervisory system? Are the bank examiners smarter than everybody—no. They are as smart as everybody in a cross-section of the public. They have something that nobody else has—that is, they go into a series of banks and they can compare. They can see what is happening inside of those institutions. They can see who is doing a good job and who's not. They can see whose risk controls work better than others. It is very hard for outsiders to see that. You see it in the end when things go awry, but until they go awry, it is very hard to see that.

For example, you know that there was a study done called the Derivatives Policy Group Report that was done for the SEC and the CFTC of which I was co-chairman. At the beginning we went around with 50 banks and asked who had independent risk

management, and 50 hands went up in the air. Everybody had independent risk management. So, you started to poke at it, and what did they mean by independent? Of course, some were really independent and others reported to the CFO, who had a treasury department that was a profit center. That is not independent. I won't go through all of those war stories, but you have to be able to get inside. No one can do that like the bank examiners.

I'm not suggesting that the confidential sections of bank examination reports be made public. I don't mean that at all. I'm just talking about the ratings. Obviously, it wouldn't make sense to publish all the ratings tomorrow. I think you would have to prepare the public to understand what they meant. So, this would be a process that would take place over years.

As far as the rating agencies are concerned, Asia proved yet, once again, that the rating agencies are a lagging indicator.

If there are no other questions, let me once again thank you for doing me the honor of having me visit with you today. Again, anyone who wants the Group of 30 Report, and I do recommend it to you, should just give me their card.

Thank you very much.

