FDIC
FEDERAL DEPOSIT INSURANCE CORPORATION

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STATEMENT ON

LEGISLATIVE RESPONSES TO CHANGES
IN FINANCIAL SERVICES

PRESENTED TO the Senate

COMMITTEE ON BANKING, HOUSING, AND
URBAN AFFAIRS
UNITED STATES SENATE

BY

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10:15 a.m.
Wednesday, May 8, 1985
Room SD-538, Dirksen Senate Office Building

Mr. Chairman, last year the Senate voted overwhelmingly in favor of the banking bill reported out of this Committee. Due to the circumstances well known to you, however, it did not become law. You have asked that we now comment on current conditions that might dictate changes in that bill. I am pleased to have the opportunity to do so.

In recognition of the need for deregulation of bank liabilities to be accompanied by commensurate liberalization of assets and services, last year's bill had as its basic theme enhanced investment opportunities for commercial banks. Although it did not go nearly as far as we would have liked, the bill would have provided new earning opportunities for banks by permitting them somewhat greater freedom to compete in financially related services. The American public would have been served by the improved competitive climate.

The events of the last year are fairly well known to members of this Committee. I will merely give you my assessment of their significance and how I think they might affect your legislative priorities.

A. Bank Failures. Bank failures have continued at a high level by historical standards, reaching 79 in 1984. During 1985, they will almost certainly exceed that level. Most have been smaller institutions. However, the near failure of Continental Illinois demonstrated once again that large banks are not immune to problems, particularly where unit banking laws limit the ability to establish a strong base of core deposits. Many of the small bank failures, particularly in agricultural states that restrict branching, are due in some measure to their inability to diversify their portfolios.

B. Thrift Problems. A number of mutual savings banks remain in critical condition and are dependent on net worth certificates for their survival. We have no serious objection to the renewal of this program for thrifts, provided thrifts are mandated to conform over time to the capital standards and accounting rules applicable to banks. We strenuously oppose any extension of the net worth certificate program to shareholder-owned commercial banks for reasons set forth in testimony before Senator Gorton's Subcommittee two weeks ago.

The failure of Home State Savings and Loan in Ohio and the subsequent holiday imposed by Governor Celeste on 71 state "insured" savings and loans raise another question -- namely, is it in the public interest to continue allowing state deposit insurance companies to function? We believe public confidence, both here and abroad, has been shaken by the Ohio episode. Many innocent people in Ohio, Tennessee and Nebraska have lost or may well lose their life savings as a result of failures of non-federally insured institutions in the past two years. In addition, an uninsured institution that held itself out to the public as a bank failed recently in Iowa, victimizing thousands of people.

We favor a new definition of the term "bank." Simply put, our preferred definition would provide that if an institution holds itself out to the public as a "bank" by using that word in its title and accepts deposits from the public, it must be insured by the FDIC, regulated as a bank and subject to the Bank Holding Company Act. Not only would this

provision help prevent a recurrence of the recent tragedies in Ohio, Iowa, Nebraska and Tennessee, it would close down the nonbank bank loophole and reduce the incentive for forum shopping by institutions seeking to avail themselves of the more liberal prudential standards applicable to savings and loan associations while still calling themselves banks.

C. Court Decisions. Recent court decisions have adversely affected our efforts to control some risks that we consider very serious threats to the deposit insurance fund. Although insured brokered deposits have greatly increased losses in failed banks, our effort to limit this abuse by regulation has been struck down by the courts, though we intend to pursue all avenues for appeal.

The FDIC has never considered letters of credit as deposits, but in two recent lawsuits, most notably the "Philadelphia Gear Case," the courts have found the FDIC liable for letters of credit as deposits. This poses multiple problems for the FDIC and banks. The FDIC fund will be exposed to substantial potential liabilities. Banks will see a significant increase in their deposit insurance premiums.

D. State Initiatives. The states continue to lead the way in updating laws governing the financial services industry. Apparently the conflicting lobbies that immobilize the Congress do not have the same impact on some state legislatures. A number of states have authorized new investment powers for banks and thrifts. Regional compacts to authorize limited interstate banking have been enacted, or are under active consideration, in many areas. Lacking any Congressional direction, the FDIC has proposed rules regarding the exercise of new powers by insured banks. The proposed rules are designed to protect consumers as well as to contain risks to the insurance fund from possible unsafe and unsound practices. These rules will be reissued for further comment in the near future.

Any consideration of developments in the financial services markets would be incomplete without recognizing market developments that are taking place without the benefit of any legislation. Interstate ATM networks are spreading everywhere, providing consumers with banking services twenty-four hours a day, at home and away. Money market mutual funds continue to compete for savers' funds, and investment bankers compete fiercely for IRA and Keogh funds on a fully insured basis. I could go on.

What this means is that the only financial intermediaries constrained in any way by the Glass-Steagall Act, the Bank Holding Company Act or the McFadden Act are bank holding companies and commercial banks. One has to wonder why commercial banks, which are so essential to the delivery of financial services, cannot provide a full range of financial services or must resort to uneconomical legal devices in order to provide them.

Events of the past few years clearly point to the need for improvements in the deposit insurance system. I can report to you that we have done a number of things administratively to improve our operations.

We have implemented new reporting requirements and improved information retrieval systems to enable us to spot developing problems with our off-site monitoring system. We imposed new disclosure requirements so investors and bank customers can assess the quality of their banks.

We have issued a greater number of supervisory actions to correct unsafe practices, we have increased capital requirements, and we have successfully gotten hundreds of banks off the troubled bank list and back to a state of reasonable health. But that is not enough. While we have worked to increase market discipline to help provide the incentive for sound management, the high level of deposit insurance and the high percentage of failures handled as mergers make effective depositor discipline hard to attain. Even higher capital standards, which would include subordinated debt, could result in imposition of the necessary discipline by suppliers of capital.

However, there is only so much we can do administratively. We have submitted to you our Federal Deposit Insurance Improvements Act. It would provide us with new tools such as the authority to implement risk-related insurance premiums, which would be far more equitable than the present system and would provide an incentive to sounder management. Our bill would also authorize us to charge troubled banks for the extra supervisory effort they require and would enable us to move promptly against officers engaging in abusive practices. Our bill also deals with the letter of credit problem alluded to earlier, and it would make permanent the emergency interstate takeover provisions of the Garn-St Germain Act that are scheduled to sunset this year. Events of the past year clearly call for priority attention to this legislation.

One problem we have tried to cope with so far, with little success, is brokered deposits. Our attempts to deal with this by regulation were struck down in the courts. Though we are still pursuing the case, the problem could easily be addressed through legislation. With today's technology, a banker so inclined can gather millions in brokered deposits so rapidly it defies regulatory detection until after the problem has become severe. The weakest banks are the worst abusers of this market and their failures have cost us hundreds of millions of dollars. Our potential liability runs to the billions, as we had over $9 billion of brokered deposits in troubled banks at last report. There is no problem more threatening to the deposit insurance fund.

E. Conclusion. Mr. Chairman, I have now served over seven years with the FDIC, nearly four as Chairman. This will probably be my last appearance before you in that capacity. I have come to appreciate a number of things in that time.

I appreciate the importance of deposit insurance and the FDIC's role in helping to maintain stability in both our domestic and international financial markets. The handling of Continental Illinois Bank represented an effort to avoid what would almost certainly have been an international financial crisis. Not a single tax dollar was

involved in that effort. But I also appreciate the need for substantial changes and improvements in a system created 51 years ago to deal with an entirely different set of problems and environment.

I appreciate the innovativeness of our American financial services industry. Most Americans welcome the opportunity to avail themselves of the new services that have been developed. But I am also aware of the fact that a minority opposed to change -- or increased competition -- can seemingly paralyze the Congress.

Mr. Chairman, I have heard you say more than once that the banking issues before the Committee today have been before it since you first came to the Senate. Indeed, many of them have, and we applaud your tireless efforts to resolve them. Last year's bill was a good beginning, and the vote on that bill showed that most members of this body are eager to see an end to the unproductive interindustry bickering which has stymied resolution of these issues for so many years. We understand the political pressures that have made progress so difficult, but would like to conclude with a plea for even broader action than you took last year.

The time is long past when we can view commercial banking in a vacuum. Those who would argue that commercial banking is unique because deposits are insured deliberately overlook the fact that thrifts, credit unions, and, increasingly, even investment banking firms offer federally insured deposits accessible by check or other transfer mechanisms. Thrifts have more liberal authorities, both regarding investments and geographic expansion, than do commercial banks or their holding companies, while both stock and mutual associations are exempted from prudential standards applied to commercial banks. Because the time has passed when these institutions are constrained by law to serve only a limited credit market, or clientele, and because so many thrifts are wisely turning to stock ownership as a means of raising capital, we believe the time has come to phase in higher standards of capitalization, accounting and disclosure. We urge you to address these issues in any legislation you consider this year.

This Committee also has a unique opportunity -- I might even say responsibility -- to consider how the public can best be served by the broader spectrum of commercial and investment banking services. Your jurisdiction, unlike that of the House Banking Committee, covers both. You can address the disparities in geographic boundaries and product offerings between these two sectors of our financial services industry and reconcile them in the public interest. We feel very strongly that if our commercial banking industry is to remain a vigorous competitor serving the public, it must be accorded as much freedom as its major rivals. We hope you will address this in legislation this year.

Last, but certainly not least, we urge your attention this year to deposit insurance and regulatory reform. There should be no misunderstanding. Our urging expanded opportunities for commercial banks to offer new services in broader geographic areas -- termed "deregulation" -- does not imply less supervision of these activities. We firmly believe

we must upgrade the quality of supervision and enforcement and find new ways to obtain greater discipline from the marketplace. We stand ready to work with you to develop 20th Century solutions to the problems of safety and soundness. We believe our Federal Deposit Insurance Improvements Act, S. 760, represents a good starting point for your consideration. Its major provisions, such as risk-related deposit insurance premiums, have been endorsed by the American Bankers Association, the Bush Task Group and a working group of the Cabinet Council on Economic Affairs. The time for action is now.

Thank you. I will be pleased to respond to any questions.

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