FDIC
FEDERAL DEPOSIT INSURANCE CORPORATION

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FDIC CHAIRMAN URGES BUSINESS EDITORS TO CAREFULLY REVIEW BANK RESTRUCTURING PROPOSALS

FDIC Chairman L. William Seidman today urged members of the business news media to make sure banking industry leaders and legislators answer the basic questions concerning the restructuring of the financial services industry as the effort to modernize laws governing the industry proceeds.

In remarks delivered to the American Society of Business Editors and Writers, Mr. Seidman said a wide ranging discussion of how best to restore the banking industry's capability to compete in the marketplace will ultimately produce benefits for both consumers of financial services and the nation's financial system. He commented that the task for business writers will be to "take a critical look at each proposal put forward. If it is based on untested assumptions, you should be asking why some of the old myths which have found their way into existing legislation and regulation remain unchallenged."

"To secure real benefits for consumers and the economy the discussion of reform should not be limited by conventional wisdom," Mr. Seidman commented. "Proposals which would be based on complex holding company structures need close scrutiny. Instead of creating new opportunities for regulatory expansion, participants in this discussion should seek simplicity and minimal government intervention in the private sector," he said.

"Our banking system is threatened by technological change, foreign competition, archaic government regulation, and its own inability to create legislative change. There is ample evidence change is needed, but we should

-more-make sure we avoid crafting a program which would establish an even more complicated and encompassing regulatory system than our present one. All too often our efforts to ease a stifling regulatory burden end up producing a heavier burden for the industry we are trying to help," Mr. Seidman commented.

The FDIC chairman noted supervisory barriers should preserve the safety of the financial system without impairing the system's ability to function.

"The potential for abuses will always exist. Dividend policies, controls on intercompany transactions and adequate public disclosure may be more appropriate tools for dealing with these potential abuses than designing a supervisory system which presumes all the industry participants are criminals," he commented.

Mr. Seidman said the key questions in the banking industry restructuring debate are:

* Can banks be effectively isolated for safety and soundness purposes from their owners, affiliates or subsidiary organizations?

* If isolation can be achieved, what are the characteristics of activities appropriate for banks to perform?

* Is there a need for constructing a regulatory system which protects against undue concentration of economic power or are there other ways to achieve this goal?

"All parties are interested in achieving a safe, competitive and prosperous banking system," Mr. Seidman said. "You should step back and take a good, hard look at the issues. If we pool our collective wisdom, I am convinced the result will be an improved banking system."

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Good morning and thank you for your kind introduction. As a former business page columnist (the Gazette in Phoenix), I have developed great respect and some fear of business page editors. Perhaps your stern guidance is why, as a long time observer, I find business sections continue to improve.

You perform a valuable service. The growth in the awareness and understanding of complex business and economic issues is a direct result of your efforts. But, there are still a few issues left to elucidation.

This morning, I seek to inform you about one of them. One of the most important long-range issues facing the American economy is the future structure of its banking and financial system.

Why is this subject important? Because the American banking system is threatened by technological change, foreign competition, archaic government regulation, and its own inability to create legislative change. The regulatory framework within which banks must operate today is obsolete.

Foreign bankers, investment bankers, even manufacturing and retail firms are all going after the banking business. Because of outmoded bank regulation, they can offer a bigger package of financial services than can a "full service" bank.

Thirty years ago, banks provided over 80% of U.S. corporations' short and intermediate term credit. Their share is now down to about 60%. Twenty percent of all commercial banks operated at a loss during 1986. Industry net income declined last year for the first time in 25 years. The trends are there and they are not good.

All of these facts point to the need for a review of where the financial institutions of the United States should be headed. So, any threat to the banking system must be taken most seriously.

Several industry restructuring proposals already have been offered -- including those by the NY Federal Reserve's Gerald Corrigan, the Association of Bank Holding Companies, and Federal Reserve Board Member, Robert Heller. All of these proposals are a fine contribution to the examination of the problem. However, all contain assumptions that need close examination. For example, almost every proposal assumes the best way to expand bank competitive powers is through expanding the holding company structure. Take a close look at that model; check the foundation assumption on which it is built.

Contrary to standard practice in Washington, I shall resist the temptation to appear to return from the mountain with an engraved table providing the plan for bank restructuring.

Instead, I would like to offer you some suggestions that are designed to be of aid in evaluating the many plans in existence, as well as those yet unborn. Here are some important queries you might find useful when you evaluate these various proposals. Of course, I won't be able to resist slipping in a few conclusions that I hope you might reach in your deliberations.

By way of background, let me assert a fundamental fact about the present banking system. Deposit insurance, in combination with a responsive Federal Reserve discount window policy, has gone far in eliminating systemic risk in the banking system. Specifically, I am referring to the risk of a loss of public confidence -- a panic, that would seriously threaten our economy.

The existence of this Federal safety net means deregulation is possible. Individual bank managers can be permitted a wider range of business judgments, including the opportunity to make mistakes. Unfortunately, some bankers will always accept this opportunity.

Hopefully, the cost of mistaken business judgments, both to the industry and to the government, will be more than offset by increased efficiency and benefits to bank customers and the public at large.

In crafting reform, judgment must be exercised to assure a sound balance between an enlightened deregulatory approach that promotes maximum individual flexibility, and the need to ensure the safety and soundness of the system. This argues for gradual rather than for radical change in the system.

Now to your questions, first with respect to what the proposed change will accomplish. Does the proposal enhance:

1. Safety and Soundness: Are we confident that the system will not fail depositors, users of the transfer system, and borrowers and traders?

2. Competitiveness: Will it allow banks to compete in the world marketplace?

3. Simplification: Is it the simplest way to achieve our goal?

4. Consumer Orientation: Does it provide the freedom to innovate and increase efficiency, which can provide the customers with the best of services at the least cost?

5. Monetary Control: Will it provide for effective implementation of monetary policies?

THE CONCEPTUAL FRAMEWORK

In trying to achieve a simple, efficient consumer and monetary oriented, yet safe and sound system, several questions with respect to banking structures should be asked.

1. Why should the government be regulating depository institutions? Even Adam Smith recognized a special relationship between government and the banking system. Banking is vital to the economy.

However, my friend Bill Simon, the Ultimate Market Man, believes that free Marketer Adam Smith had not gone far enough. He asserts that Smith's "invisible hand" was an unwarranted interference in the marketplace.

2. Can banks be effectively insulated, for safety and soundness purposes, from their owners or affiliates, or subsidiary or parent organizations? This is the $64,000 question.

3. What are the characteristics of activities appropriate for banks to perform? The answer to this judgmental question will be an evolving one.

4. Should bank structuring be designed to protect against undue concentration? Is structure the appropriate means of controlling undesirable economic concentration?

Let me now provide some background designed to help focus these questions.

WHY SHOULD THE GOVERNMENT BE REGULATING DEPOSITORY INSTITUTIONS?

Banks do play a special role in our economy. They are one of the major actors in the intermediation process, and the primary private-sector source of liquidity. They participate in a payments system that transfers literally billions of dollars each day within the United States and abroad. They also provide a liquid safe haven for the savings of the public at large. They are the major conduit through which monetary policies are implemented.

Since banks are at the heart of the economic system, their continued functioning is necessary for the system to function.

Through the Government's guarantee of deposits, involvement in the transfer system, and the Fed discount window, the government is positioned in the heart of the financial system. Any suggestion for change must be tested to insure that the government's ability to carry out its responsibility is not jeopardized.

CAN A BANK BE INSULATED?

Having asserted the Government regulatory role, we then need to ask what is the least burdensome way for it to regulate. If the bank itself can be made safe and sound by regulation, then regulations beyond the bank are not needed or desirable. Can a bank be insulated from those who might misuse or abuse it? Can a supervisory "wall" be erected around a bank to provide an adequate level of protection for the system? What kind of wall could do the job?

Reasonable men have disagreed on whether this insulation can be achieved. Disagreement has centered on the question of how effective supervision of a bank can be.

As the GAO recently reported, it will be impossible to stop abuses in all cases no matter what banking structure is in place. Human nature is, after all, human nature. One has only to look at what's been happening on Wall Street these past few months to realize that the potential for abuse always exists. However, we should not design a system that assumes all the industry participants are criminals. The issue is not whether supervision can provide complete protection for every bank, but whether it will keep the system safe and sound.

This is a question for regulators and supervisors. They have the experience and professional training necessary to make a meaningful evaluation.

FDIC supervisory professionals, as well as my own experience as a CPA, tell me that we can move toward a system that will provide the required insulation of the bank. We can then protect the system. To do so, FDIC supervisors say they will need the ability to:

1. Prohibit excessive dividend policies, or other ways of jeopardizing bank capital;

2. Regulate inter-company or affiliate transactions--that is, set reasonable lending restrictions and enforce an "arm's length" requirement;

3. Look at both sides of any inter-company or affiliate transaction;

4. Require clear consumer oriented public disclosure of the lack of Federal Deposit Insurance protection of affiliates. And more generally, make it clear to all that the Government's goal is insulation. Real study to improve a bank only supervisory system is warranted.

Let me say, however, that no one can now prove that such insulation is achievable. So, prudence would dictate that we proceed cautiously toward this goal.

WHAT ARE THE CHARACTERISTICS OF APPROPRIATE BANKING ACTIVITIES?

Given an approach to an insulated bank, what activities should be performed inside the bank? Which ones belong outside?

As a start, I suggest four criteria that could be examined in answering these questions.

FIRST CRITERION: Is the activity too risky? This is not an easy question to answer. I think that, from a pure risk point of view, a good case can be made that any legitimate business activity should be available to banks; after all, we have all learned that appropriate diversification is the most effective risk-reduction device. Remember, today's problems--oil, farm land, and commercial real estate--were yesterday's prime investments. Still, a judgment on risks can and must be made--inexact as it may be. To the extent practical, higher-risk activities are best kept outside of the bank's wall.

ANOTHER CRITERION: Would the activity in question represent an appropriate use of federally enhanced funding? Should insured deposits be limited to financial services? Should they be limited to "socially acceptable" activities? Most people probably would argue that certain activities simply should not be supported by Government subsidized funding--that a judgment be debated.

A THIRD CRITERION: What is the difficulty of exercising supervisory authority over the activity? It is my experience that it is more difficult to "supervise" a gambling casino than a mutual fund. Some businesses seem in-appropriate for supervision. Where do we draw the line?

FOURTH: Is the activity needed to provide diversification and actually enhance safety and soundness?

FINALLY: Is the activity needed to allow the bank to prosper? Banks are not charitable organizations; they are businesses that must earn an acceptable return to attract and retain capital.

DOES BANK RESTRUCTURING HAVE TO PROTECT AGAINST UNDUE CONCENTRATION?

My final question concerns the relationship between structure and a potentially undesirable concentration of financial resources. There always has been a legitimate and fundamental concern in the United States about undue concentration of financial powers. This concern has been an important factor in the current regulatory pattern.

In other business areas, the anti-trust laws and unfair competitive rules are considered sufficient to address such concerns. Banks have been singled out for a special structure safeguard with regard to ownership. Increased competition through free entry in the field of finance would seem to offer at least as much promise for success.

I could continue and answer all the questions with a detailed plan for the future of banking. Perhaps I should, but recently I spoke at a meeting where a gentleman picked up the gavel and threw it at the speaker, who ducked. It hit a lady and floored her. When they asked if she was okay, she said, "Hit me again. I can still hear him."

So I'll close by thanking you for your attention!