TESTIMONY OF

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ON

REFORM OF THE FINANCIAL SYSTEM

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS SUPERVISION,
REGULATION AND INSURANCE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
UNITED STATES HOUSE OF REPRESENTATIVES

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Room 2128, Rayburn House Office Building

Good morning, Mr. Chairman and members of the Subcommittee. We are pleased that you have called these comprehensive hearings on a most important subject. It is said that there is nothing as powerful as an idea whose time has come and we believe this applies today to the subject of these hearings -- restructuring the financial system. The FDIC's views on financial services reform and the structure of the financial services industry are set forth in our study <u>Mandate for Change: Restructuring the Banking Industry</u>. This study is being submitted today as part of the official record. The Executive Summary at the front of our study lays out the principal issues and our recommendations for reform.

Financial markets and competitive forces, both domestic and international, have changed dramatically since 1933 when the Glass-Steagall Act first imposed a partial separation between banking and securities activities and since 1956 when the Bank Holding Company Act further limited the activities of bank affiliates. These changes are addressed at length in our study.

Existing restrictions on banking activities have handicapped the banking industry in today's rapidly changing financial environment. The effect of these restrictions on banks is amply demonstrated by the appended chart that compares the annual growth rate of banks between 1980 and 1986 to that of other financial services firms. Of particular importance is a comparison of banks' growth rate of approximately 8 percent during that period with that of mutual funds and securities brokers and dealers which grew at rates of approximately 33 percent and 28 percent, respectively. Our banks should mirror the vitality of our economy. It is clear they are not doing so.

For an insurer like the FDIC, this news about the economic strength of our nation's banks is disturbing. This disadvantageous situation slowly will lead to a less safe and sound banking system.

Why does this situation alarm the FDIC? Why are we concerned about banks and why does the government have an involvement in the banking system? The answer is because banks are special. They are special for two principal reasons. First, because of deposit insurance, banks essentially borrow funds on the credit of the United States Government. Second, the banking system provides a safe harbor for savers, reserve liquidity and the mechanism for transferring funds throughout our economy. Without these functions by the banking system our economy could not function. In sum, any threat to the banking system is a threat to the intermediation process, private-sector liquidity, the payments system and the United States economy.

Through the operations of a more efficient banking system, direct benefits also accrue to individuals and society as a whole. Specifically, enhanced economic efficiency results from increased competition among the providers of financial services and the possible realization of economies of scale and scope. Furthermore, an improved level of safety and soundness for the banking system is a public benefit that can be expected to result from product liberalization.

Because banks are special and essential to our economy, the government must maintain a safe and sound banking system. To be safe and sound, the system has to prosper. But, bank supervisors cannot order success. Prosperity can be achieved only if a fair competitive structure is in place. Thus, structural reform is necessary for banks to attract capital and to compete effectively, at home and abroad.

In developing our study on structural reform, the FDIC established a number of key objectives. Those objectives are:

- Maintaining the safety and soundness of, and public confidence in, the banking system.

- Enhancing banks' competitiveness and their ability to respond to technological advances, both at home and abroad.

- Finding the simplest and least-costly way to achieve financial restructuring.

- Promoting increased benefits for consumers by providing the freedom to innovate and increase efficiency, thereby giving consumers the best services at the least cost.

Given that banks and the banking system are special, we then need to ask what is the least burdensome way for the government to protect that system. If the bank itself can be made safe and sound by supervision, then supervision beyond the bank is neither necessary nor desirable. Bank regulation and safety supervision could be focused on the bank -- and on the bank alone. The bank's owners, affiliates and subsidiaries would not be subjected to unnecessary and costly regulation. Regulation could truly be on a functional and fair basis -- and the public would benefit from the efficiencies.

This leads us to THE PIVOTAL QUESTION: Can a bank be insulated from those who might misuse or abuse it? It focuses attention on the fundamental issue of financial restructuring: Can we create a wall around banks that insulates them and makes them safe and sound, even from their owners, affiliates and subsidiaries?

We at the FDIC believe that such a wall can be achieved and that supervising conflicts of interest is the key to an effective supervisory wall. Based on 54 years of supervisory experience, our professional supervisory staff believes that conflicts can be regulated appropriately to ensure the safety and soundness of banks. The tools needed for the "wall" are only a logical extension of safeguards that exist now to protect banks from insider abuse and conflicts of interest. The views of the FDIC professional staff with regard to the regulatory powers needed to supervise such abuses and conflicts are presented in our study. They are:

- First, retain the limitations on dealings with nonbank affiliates contained in Section 23A of the Federal Reserve Act and extend them to "nonbanking" subsidiaries of banks.

- Second, retain the new Section 23B, just passed by Congress, which specifies that all transactions with affiliates be conducted on an "arm's-length" basis. This Section also prohibits any action that would suggest that a bank is responsible for the obligations of its nonbank affiliates, and significantly restricts bank purchases of securities in which nonbank affiliates have an interest. Section 23B also should be extended to nonbanking subsidiaries.

- Third, ensure authority to audit both sides of any transaction between the bank and its subsidiaries or affiliates.

- Fourth, to the extent necessary, authorize collection of certain financial data from nonbanking affiliates and subsidiaries.

- Fifth, provide clearly defined regulatory authority to require, from either a public-policy or risk standpoint, that any nonbanking activity be housed outside the bank, in either a separately capitalized subsidiary or affiliate.

- Sixth, require that nonbanking subsidiary and affiliate investments be excluded in determining bank regulatory-required capital.

- Seventh, provide authority to prevent any transactions between banks and their owners, subsidiaries or affiliates which are deemed to jeopardize the safety and soundness of the banks.

Reasonable individuals have disagreed on whether this type of insulation and an effective supervisory wall 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 kind of structure is in place. The issue is not whether supervision can provide complete protection for <u>every</u> bank, but whether it will keep the <u>system</u> safe and sound.

It is a fact of human behavior that a majority of the people play by the rules. However, a small percentage do not. Thus, the supervisory challenge in creating a "safety and soundness" wall is to identify and restrain the minority who will abuse the system. If, for example, 90 percent of all bankers obey the law, and 10 percent seek to beat it, then the clear supervisory challenge is to see that as few as possible of the errant 10 percent succeed. We believe bank regulators can meet that challenge and that bank supervision can ensure that the system is safe and sound.

The FDIC has been supervising conflicts of interest effectively over the last 50 years. The banking industry has inherent conflicts in that bank directors also are borrowers of the bank. Potential conflicts also are raised by the relationship between parent holdings and the parent's subsidiaries. In both cases, supervision has been effective in preventing the conflicts from jeopardizing the system.

Given that a better supervisory wall can be established which adequately protects banks from conflicts of interest and effectively insulates them from affiliated entities, major structural reform is possible. With such a "wall" in place, direct banking regulatory and supervisory authority over bank owners and nonbanking affiliates and subsidiaries is not necessary. Affiliates and subsidiaries could operate in the free market -- unregulated by banking laws and bank regulators -- subject only to regulation and supervision by the appropriate functional regulator. Thus, a supervisory wall would permit the dismantling of banking laws that regulate the activities of banks' related nonbanking entities -- namely, Glass-Steagall and the activity restrictions contained in Section 4(c)(8) of the Banking Holding Company Act -- and allow for functional supervision of those nonbanking entities.

The dismantling of such statutes, as opposed to a piecemeal approach to restructuring, allows financial restructuring to be a two-way street. In other words, not only could banks affiliate with most corporate entities, but those corporate entities could own banks as well. For example, if the affiliation restrictions of Glass-Steagall are eliminated (as opposed to the mere authorization of a few additional securities activities to bank affiliates), then theoretically securities companies could own banks. It should be recognized, however, that by eliminating only Glass-Steagall, a two-way street between banks and securities firms is not assured since many securities firms now are affiliated with companies engaged in activities not permitted to bank affiliates. Total competitive equality and a two-way street can be established only if the activity restrictions of the Bank Holding Company Act also are removed.

The dismantling of Glass-Steagall and the Bank Holding Company Act also attains the objective of functional regulation and supervision. Functional supervision eliminates the costly layers of regulation and supervision that exist when companies are subject to the jurisdiction of both the banking agencies and the appropriate functional regulators. Functional supervision also permits bank regulators to focus their attention on the bank -- which is where the focus should be.

With the establishment of a supervisory wall, bank regulators need only supervise the bank itself and the bank's dealings with its affiliates, subsidiaries and owners. Internally, bank operations would continue to be supervised to ensure that bank funds are handled in an appropriate manner and that the bank is being run on a sound business basis. Enhanced bank supervision also would see that the bank is not dealing preferentially with outsiders, conflict-of-interest rules are being observed and transactions with affiliates are at arm's length.

Structural flexibility is another benefit of the supervisory wall. The "wall" permits nonbanking activities to be undertaken either in subsidiaries or holding company affiliates of banks. There are approximately 4,500 banks that are not in holding companies. Such companies should not be forced to incur the additional corporate and regulatory costs of establishing a holding company in order to affiliate with nonbanking entities. Provided the "wall" is in place and it imposes the same conditions on banks' dealings with subsidiaries that apply to dealings with holding company affiliates, banks should be permitted to opt for the corporate structure that best suits their business plans.

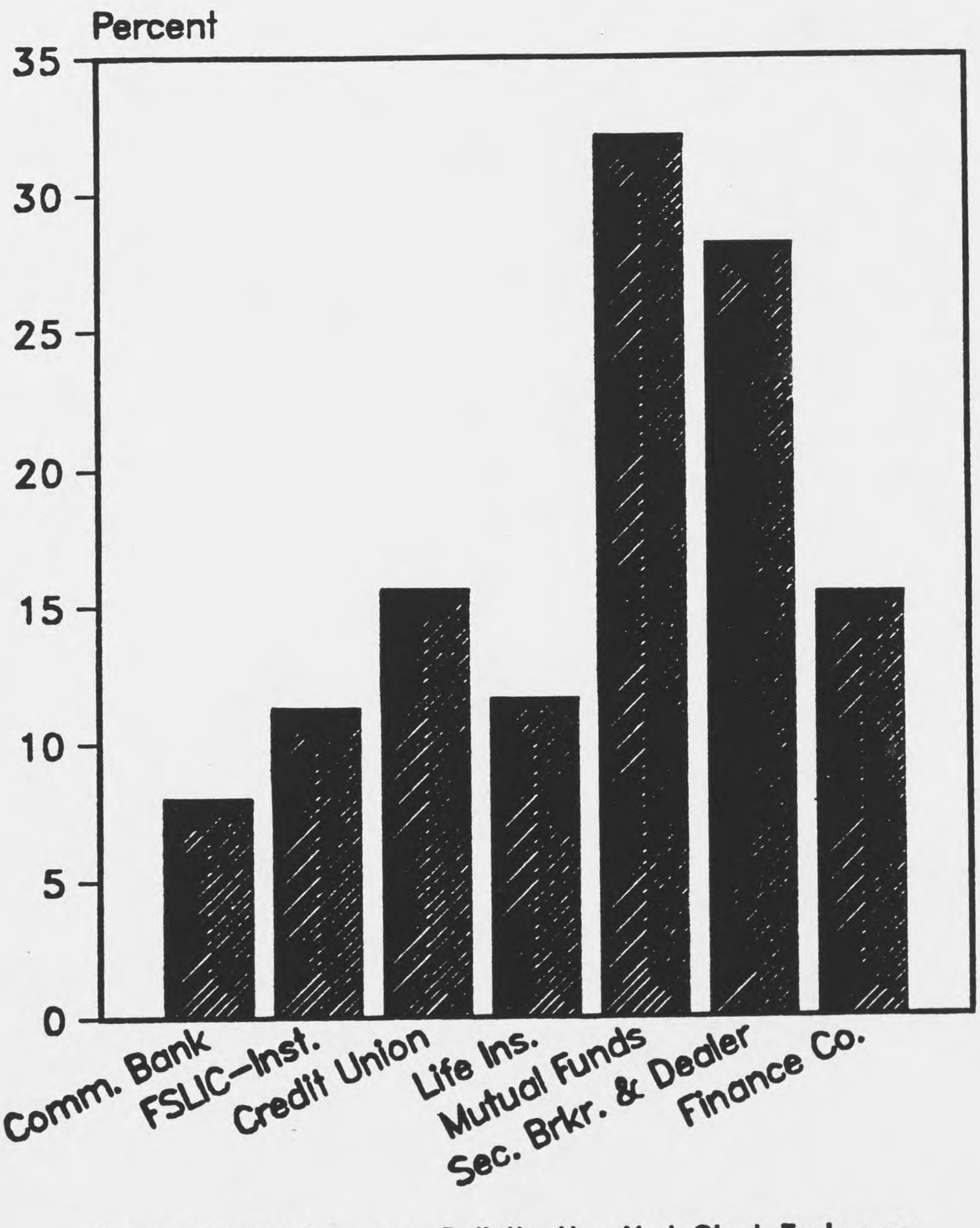
Furthermore, there are advantages to the bank subsidiary structure. Earnings of a bank subsidiary flow through the bank. In addition, if the bank runs into financial difficulty, the subsidiary can be sold to raise capital for the bank. If the subsidiary runs into difficulty, the bank has control over divestiture of the subsidiary.

Once the basic framework is established Congress also would have to reassess what activities should be considered "banking" and thus be allowed inside the wall. These decisions involve both risk and competitive equality considerations. Congress may wish to provide an outline of the types of activities that may be conducted inside the wall. In the absence of such guidelines, Congress should designate federal regulators to make the decisions regarding appropriate bank activities. The FDIC believes that certain activities such as mutual funds, commercial paper, securitization and municipal revenue bonds are "banking" and should be permitted within the bank.

To conclude, I would like to stress that banking is experiencing and will continue to experience rapid and critical changes. The existing system is inequitable and inefficient. Government's presence must be modernized. Long-range financial services industry restructuring should be undertaken to improve competitiveness, reduce regulatory costs and provide increased safety and soundness for the financial system. The FDIC has detailed in the accompanying study its views on the action needed. We will be pleased to work with your Subcommittee in its important deliberations.

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

Annual Growth Rates of Finanical Institutions
1980 - 1986



Source: Federal Reserve Bulletin, New York Stock Exchange Fact Book.