TESTIMONY OF

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ON

FINANCIAL SERVICES REFORM LEGISLATION

BEFORE THE

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

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Room 538, Dirksen Senate Office Building

Good morning, Mr. Chairman and members of the Committee. We are pleased to testify today on the subject of financial services reform and on two of the bills recently introduced by members of this Committee. We would like to express our appreciation to you, Mr. Chairman and Senator Garn, as well as Senators Wirth, Graham, D'Amato and Cranston for advancing the reform process through the introduction of financial restructuring measures.

The Federal Deposit Insurance Corporation's views on overall financial services reform and the structure of the financial services industry are set forth in our study Mandate for Change: Restructuring the Banking Industry, a copy of which is being submitted today for the record. The major conclusions of that study will be described briefly at the beginning of my testimony, followed by the FDIC's views on the two bills on which we have been requested to testify. Because the bill sponsored by Senators D'Amato and Cranston was just introduced, it will not be addressed in this statement. We hope, however, that it will be considered seriously along with the other two measures.

Competitive forces and financial markets, 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 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 eight 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. Clearly, banks are not being permitted to keep pace with their competitors in meeting the challenges of the changing marketplace.

The inability of banks to compete effectively with other financial firms concerns the FDIC since the situation could lead to a less safe and sound banking system. Without a doubt, banks are special. Because of deposit insurance, banks essentially borrow on the credit of the United States Government. Moreover, the banking system provides a safe harbor for the savings of consumers, reserve liquidity and the funds transfer mechanism in this country -- all of which are essential to the United States economy. Thus, any threat to the banking system is a threat to the intermediation process, private sector liquidity, the payments system and our economy.

A strong and more efficient banking system benefits consumers as well. Increased competition and economies of scale and scope result in economic efficiency which, in turn, results in lower costs to banks and bank customers. The public also benefits from increased levels of safety and soundness in our nation's banks. But, the system must prosper in order to be safe and sound and prosperity can be achieved only if banks are free to attract capital and compete effectively, at home and abroad. The FDIC believes that structural reform of our financial system is necessary to permit banks to compete and prosper.

A number of key objectives should guide any structural reform effort. Those objectives are: a viable and competitive financial system and a safe and sound banking system, increased benefits for consumers through enhanced competition, and sufficient flexibility to respond to technological change. One final goal is to find the financial restructuring alternative that is the simplest and least costly to the economic system, consistent with these other objectives. Those objectives guided the development of our study. We believe that the same objectives should guide the Committee in considering financial reform and the two bills being addressed today.

FDIC RECOMMENDATIONS FOR STRUCTURAL REFORM

From our perspective as the deposit insurer, the most important issue in restructuring the banking industry is the appropriate role of banking safety supervision in the evolving financial services sector. THE PIVOTAL QUESTION to that issue is: Can a bank be insulated from those who might misuse or abuse it? Is it possible to create a supervisory wall around banks that insulates them and makes them safe and sound, even from their owners, affiliates and subsidiaries? If the answer is "yes," there is no reason to legislate the separation of commercial banking from securities activities and, for that matter, in the longer term from other financial and nonfinancial activities.

The conclusion of the FDIC study is that such a supervisory wall can be created and that supervising conflicts of interest is the key to an effective wall. That conclusion is based on 54 years of supervisory experience. The FDIC supervisory role has included effective supervision of the inherent

conflicts that arise when bank directors also are borrowers of the bank. It also has provided effective supervision of the relationship between the parent holding company, affiliated banks and the parent's nonbank subsidiaries. Satisfactory supervision of these conflicts reinforces the conclusion that any new conflicts can be regulated appropriately to ensure the safety and soundness of the banking system.

The tools needed for insulating banks and establishing the "supervisory wall" are only a logical extension of safeguards contained in existing law to protect banks from insider abuse and conflicts of interest. Those tools are discussed in detail in our study. They include (1) the transaction limitations contained in Sections 23A and 23B of the Federal Reserve Act, (2) the exclusion of investments in nonbanking subsidiaries in determining bank regulatory-required capital, (3) the authority to audit both sides of any transaction between a bank and its affiliates or subsidiaries, (4) flexibility for bank supervisors to collect financial data from affiliated nonbanking entities, to prohibit any transactions deemed to jeopardize the safety and soundness of banks and to require that activities which pose undue risk be housed outside the bank, and (5) additional penalties for those who violate the rules.

Even with these or more stringent insulation mechanisms, abuse cannot be prevented in <u>all</u> cases. No matter what kind of structure is in place, abuses will occur. While most people play by the rules -- particularly if the rules are reasonable -- some will seek to avoid them. Thus, the supervisory challenge is to identify and restrain the minority who do not follow the rules. We believe that regulators can meet that challenge and, thus, ensure

that the system is safe and sound. While supervisors will seek to keep every bank safe, it must be emphasized that the primary objective is to keep the system safe and sound.

Given adequate supervisory insulation of the bank, direct banking regulatory and supervisory authority over bank owners and nonbanking affiliates and subsidiaries is neither necessary nor desirable. Bank regulation and safety supervision could be focused on the bank -- and on the bank alone. There would be INCREASED REGULATION AND SUPERVISION OF BANKS -- focusing regulation where the Government has an interest -- and any required regulation of the entities affiliated with that bank would be performed along functional lines. A supervisory wall would permit the dismantling of banking laws that regulate the activities of nonbanking entities -- namely, Glass-Steagall and much of the Bank Holding Company Act -- and would leave the regulation and supervision of these nonbanking entities to the appropriate functional regulator.

An appropriately insulated banking system also permits structural flexibility. In other words, it permits nonbanking activities to be undertaken either in subsidiaries or holding company affiliates of the insulated bank.

S. 1886

I would like to begin my comments on S. 1886 by expressing our appreciation to you, Chairman Proxmire and Senator Garn, for all of your efforts towards the introduction of this measure and thank you for considering

the views of the FDIC in that process. We view S. 1886 as a first step in enhancing the competitiveness of the financial services industry. We believe that ultimately all the activity restrictions contained in the Bank Holding Company Act, as well as Glass-Steagall, should be eliminated. However, we believe it is prudent not to do it all at once. A phaseout approach is appropriate. Thus, we agree that the repeal of Sections 20 and 32 of Glass-Steagall is a sound first step towards total financial reform.

We must recognize, however, that by eliminating only the Glass-Steagall restrictions, a fair competitive "two-way street" between securities firms and banks is not assured since many securities firms are affiliated with companies engaged in activities not permitted to bank affiliates. Total competitive equality between banks and securities firms can be established only if the activity restrictions and other portions of the Bank Holding Company Act also are removed from qualified securities firms. The Committee should consider adding exceptions to the Bank Holding Company Act activity restrictions for securities firms whose primary business is securities.

Our specific comments on S. 1886 will focus on (1) bank insulation, (2) functional regulation, (3) corporate structure, (4) activities permitted within the bank and (5) concentration limitations. In each case, the provisions contained in the bill have been evaluated by measuring them against the recommendations of our longer range goals for restructuring.

Bank Insulation. S. 1886 provides extensive insulation of banks from the activities of their securities affiliates. Investments in securities affiliates must be out of excess funds, over and above the amount of capital

required for bank holding companies by the Federal Reserve Board. The bill prohibits virtually all bank extensions of credit to, and purchases of assets from, securities affiliates. It also expressly prohibits extensions of credit to third parties in a number of instances in which the credit extension would facilitate transactions of a securities affiliate. Subject to a small bank organization exception and specific exceptions granted by the Federal Reserve Board, all officer and director interlocks between banks and their securities affiliates are prohibited. Finally, disclosure requirements reinforce the separation between banks and their securities affiliates and ensure that customers are aware that securities transactions are not covered by federal deposit insurance.

The FDIC believes that the insulation mechanisms provided in S. 1886 strike a good balance between adequately insulating banks on the one hand, and allowing banks and their securities affiliates to benefit from natural synergies on the other. Generally, the separation mechanisms seem to be appropriate and not too burdensome. We support the concept of requiring that the capitalization of securities affiliates be out of capital in excess of regulatory-required capital, although we believe at some point the Committee should consider whether, in fact, it believes holding company capital -- as opposed to bank capital -- should be regulated at all by bank regulators. We believe the disclosure requirements mandated by the bill are significant to adequate bank insulation and vitally important to customer protection. Since we believe that a total prohibition against interlocking officers and directors may not be necessary, we are glad to see that there are exceptions to that prohibition.

While we doubt the need for a total prohibition against virtually all transactions between banks and their securities affiliates and between banks and third parties that involve the securities affiliate, it may be the conservative place to start. Sections 23A and 23B already impose stringent transaction, collateral and arm's-length requirements on transactions between banks and their affiliates. Moreover, both of those sections already apply to transactions by a bank with any third party if the proceeds of the transaction "are used for the benefit of, or transferred to, [an] affiliate." Thus, such third party transactions are subject to the quantitative limitations and collateral requirements of Section 23A and the arm's length requirements of Section 23B. Furthermore, the arm's-length requirements of Section 23B also specifically apply to any transaction with a third party "if an affiliate has a financial interest in the third party or if an affiliate is a participant in such transaction."

In view of the protections now in place, including the enhanced protections of the new Section 23B, we question the need for imposing an across the board, blanket prohibition against all transactions. Still at the outset it may be prudent to over-insulate and over-protect the bank to insure insulation from conflicts of interest.

Functional Regulation. The FDIC believes that functional regulation is critical to any repeal of Glass-Steagall and all further financial restructuring measures. We applaud the significant movement in that direction reflected in S. 1886. Functional regulation avoids the layers of regulation and duplication that result from subjecting companies to the jurisdiction of multiple agencies. In addition, functional regulation is fundamental to

providing competitive equality among all securities firms, irrespective of whether they are affiliated with a bank.

For the most part, S. 1886 houses the regulation and supervision of bank securities affiliates in the appropriate functional regulator -- the Securities and Exchange Commission. For example, implementation and interpretation of the disclosure requirements imposed on securities affiliates would be solely the responsibility of the SEC. The SEC would be responsible for determining the adequacy of the financial and managerial resources of securities affiliates. In addition, securities affiliates would be subject only to capital requirements established by the SEC. In this regard, we believe there should be an explicit prohibition against the Federal Reserve Board requiring extra capital in a holding company based on its affiliation with a securities firm.

Another extremely important provision that furthers the goal of functional regulation is the exception from FRB examination, reporting and capital requirements provided to bank holding companies that are 80 percent engaged in securities activities, on a consolidated basis. We support that as a wise exception. We believe that a similar standard should be added to exempt companies that are primarily engaged in securities from the Bank Holding Company Act and, thus, provide a two-way competitive street between banks and securities firms.

Corporate Structure. S. 1886 requires that new securities activities be undertaken through holding company affiliates and prohibits them from being conducted by direct subsidiaries of banks. As described earlier and as

outlined in detail in the FDIC study, if banks are adequately insulated -- and we believe the insulations contained in S. 1886 are more than adequate -- then from a safety and soundness viewpoint it is irrelevant whether nonbanking activities are conducted through affiliates or subsidiaries of banks.

If the risks and exposure are the same -- which we believe they are -- banks should be permitted to opt for the corporate structure that best suits their business plans. They should be able to elect to undertake new securities activities in direct subsidiaries, as well as in holding company affiliates. Small banks would benefit, since there are about 4500 banks that are not in holding companies. These companies should not be forced to incur the additional corporate and regulatory costs of establishing a holding company in order to affiliate with a securities firms. Moreover, by depriving banks of this corporate option, the bill infringes on the rights of the states to determine permissible activities for state-chartered banks.

Further, Mr. Chairman, we respectfully disagree with your view expressed to us in writing, that this issue should decide whether a bill repealing Glass-Steagall provisions is supportable. We support the bill despite the fact that we believe its provisions in this respect are unwise in principle and discriminatory with respect to small banks in practice.

Activities Permitted Within The Bank. S. 1886 would authorize national banks to (1) underwrite municipal revenue bonds, (2) sponsor and underwrite unit investment trusts that consist solely of securities that national banks are permitted to underwrite and (3) sell -- but not sponsor, manage or control -- mutual funds. The latter two activities, however, are permitted to

national banks only if the national bank is not affiliated with a securities company. We strongly support the addition of these new activities to those permitted for national banks, but see no reason to prohibit them within the bank merely because the bank has a securities affiliate. If the risks and competitive dynamics associated with those activities are such that the activities are appropriate within the bank, that determination should not be affected by the bank's affiliation with any other company. In keeping with that position, we were very pleased to see that other securities activities already permitted to national banks are no longer required to be removed to a securities affiliate within one year of the establishment of such a company.

The FDIC believes that it would be appropriate for the Committee to assess whether other activities should be considered "banking" and thus be authorized specifically for national banks. In our opinion, certain activities such as the underwriting and sponsorship of mutual funds and the underwriting of commercial paper and securitized assets also could be included.

Concentration Limitations. S. 1886 would prohibit affiliations between banking firms with assets greater than $30 billion and securities firms with assets greater than $15 billion. We agree that the antitrust laws may not be sufficient to deal with such interindustry affiliations. In fact, we are in the process of analyzing and developing our own recommendations for addressing any such concentrations. At this time, we would have no conceptual objection to the approach taken in S. 1886. We would suggest, however, that there is a need to consider the international aspects of concentration as well.

S. 1891

We also want to thank Senators Wirth and Graham for furthering the prospects for financial reform through the introduction of a measure which reflects a different approach to financial restructuring. S. 1891 would permit banks to affiliate with all types of financial firms and we support that as an ultimate goal. In fact, we believe that with the proper insulation, banks should be permitted to affiliate with commercial enterprises as well, which S. 1891 specifically forbids.

While we concur with the goal of permitting banks to affiliate with firms engaged in all forms of financial activities, we believe that S. 1891 moves in the wrong direction in attempting to achieve that goal. S. 1891 would establish a Super Agency to regulate all companies that are engaged in any type of financial activity, thereby, embracing all financial corporations. Instead of developing the simplest and least costly structure, consistent with maintaining a safe and sound banking system, S. 1891 would establish a new megabureaucracy that would have authority not only over the banking industry, but most of financial America.

We believe that the essence of financial restructuring should be to construct a supervisory wall around banks that adequately insulates them from the activities of their nonbanking subsidiaries and affiliates. Given such a wall, regulation and supervision of those nonbanking entities along other than functional lines is unnecessary. This view of financial restructuring, as expressed in our study, generally is supported by the Barnard Committee

Report, the American Enterprise Institute study, the American Bankers Association's Chase study and the approach in the bill introduced by Senators Proxmire and Garn.

Finally, S. 1891 would establish a new transfer system corporation to be owned by large users and the Federal Reserve. We believe there is no need for another federal agency to oversee the nation's payment system. Appropriate regulation of the banking system can do the job.

MISCELLANEOUS MATTERS

Prior to concluding my testimony, a couple of additional matters should be mentioned. First, irrespective of whether the Congress has made progress on financial restructuring legislation, the FDIC opposes any extension of any part of the moratorium which is scheduled to expire on March 1, 1988. In view of the rapidly changing marketplace, we believe it would be inappropriate to continue to hinder banks' ability to respond to those changes within the limits of the law as it existed prior to the moratorium.

Second, the financial institution regulatory agencies recently forwarded to the Committee a proposal to amend the enforcement statutes to improve the agencies' ability to address instances of insider abuse, misconduct and fraud at our nation's depository institutions. In brief, the proposed amendments clarify some of the enforcement powers of the agencies, codify current administrative interpretations of our powers and address certain anomalies created by a recent U.S. Circuit Court of Appeals decision. For example, the amendments would (1) clarify that the agencies may require affirmative action

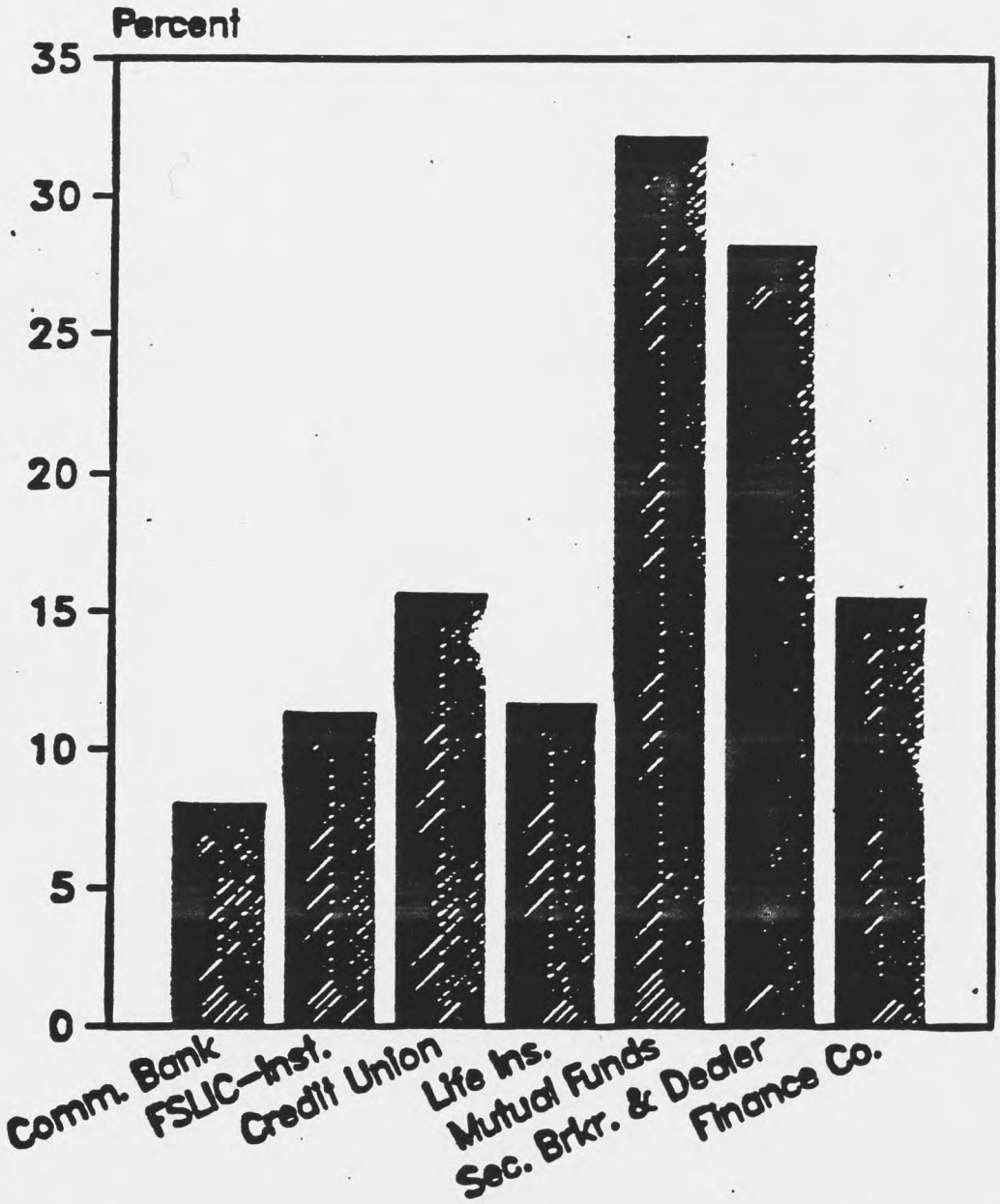
in cease-and-desist orders to correct the conditions which resulted from unsafe or unsound banking practices, (2) specifically allow the agencies to place limitations on the activities of an individual at a bank without having to completely remove the individual from banking and (3) make certain that termination of employment by a bank-related person does not affect the agencies' authority to bring appropriate actions against that person for improper conduct. We would hope that this package of amendments that was produced by all five of the federal agencies would be incorporated into any bill reported out of this Committee.

CONCLUSION

The banking industry is experiencing and will continue to experience rapid and critical changes. The existing system is inequitable and inefficient. Long-range financial services industry restructuring should be undertaken. S. 1886 provides a first step toward that end. On balance, and with the reservations stated, we can support S. 1886 as enhancing the safety and soundness of the banking system. We believe, however, that S. 1891 moves the regulatory system in the wrong direction and, thus, we cannot support it.

We will be pleased to work with the Committee in its important deliberations on these bills.

Annual Growth Rates of Finanical Institutions
1980 - 1986



Source: Federal Reserve Bulletin, New York Stock Exchange