FDIC
Speeches

Restructuring the financial services industry:

Remarks By

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Before

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Thank you for the opportunity to meet with my distinguished co-panalist, and to take part in the Morin Center's symposium on "retructuring America's financial services industry."

Being here in Boston brings back memories I have from my time at the Harvard Law School.

In those disciplined old days it was customary for the stern scholar at the podium to gaze out into the classroom and announce, "Look to your left, look to your right, by the end of the year one of you will be gone from sight!"

Come to think of it, that sounds a bit like Texas bankers at their 1988 Convention.

Less than a year ago the FDIC issued an insurer's view of the need for restructuring the financial services industry, and called it "Mandate For Change." In the study we recommended fundamental changes to the banking industry's structure and regulation.

And we tried to follow Henry Ford's advice: "Don't [only] find fault; find a remedy."

An important finding of our study was that there is no strong historical basis for what some have called a fundamental tenet of American banking law -- the doctrine that banking and commerce <u>must</u> remain separately owned.

That determination raised a couple of central questions:

Why can't anyone own a bank?

Why exclude most of corporate America from owning banks?

Why, indeed -- we found no convincing answers.

So our report recommended:

First, <u>eliminate regulation of owners of banks</u>. Any honest individual or business that has the resources should be allowed to own a bank if antitrust and concentration considerations are satisfied. Bank owners should not be forced under any special regulatory structure because of bank ownership, any more than they should be regulated because they own a furniture factory.

Second, <u>create a supervisory firewall that separates insured depository institutions from owners and affiliates</u>, and requires arms length transactions between owners and their banks.

Third, <u>provide functional regulation where necessary for institutions affiliated with a bank</u>. For example, securities activities should be regulated by the SEC and insurance activities by state insurance regulators.

Firewalls can be made effective:

(1) by insuring the maintenance of separate corporate identities;

(2) and, by providing adequate governmental supervision to insure enforcement of the firewall's provisions.

This concept was developed by our FDIC examiners, the people on the front line of bank safety. This is a conservative group who pride themselves on not throwing caution to the wind.

Based on their practical, field experience, members of our Division of Bank Supervision said that this approach would work with increased supervisory personnel, and with only <u>minor</u> improvements in existing law.

Allowing bank affiliates or owners to be free of bank regulation allows institutions owning a bank a level playing field with other competitors in the financial service industry. Such freedom should improve profits and capital availability to the banking system.

Victor Hugo said "There is no force as powerful as an idea whose time has come." We said in the Mandate that ours was an idea whose time was coming. In fact, it is coming more quickly than we expected.

For example, these ideas are represented in the banking legislation that emerged from the Senate.

Although the Senate Bill did not remove many of the restrictions on bank holding companies, it would permit a company that owns a bank to also own a narrowly defined securities operation, as long as "firewalls" exist to separate these operations.

The Senate supported the idea of exempting certain securities firms from bank holding company capital regulation. But a full two-way street, in which banks can own securities firms and securities firms can own banks, is not yet proposed.

The FDIC is pleased that the Proxmire Bill provides the beginning of a financial restructuring based on functional regulation. It also emphasizes better supervision of banks and less control of holding companies.

We anxiously await what will emerge from the House. Will the useful progress made in the Senate be maintained?

Our current policies for handling bank failures also owes much to the work set forth in our study.

An unfortunate, but unavoidable, by-product of deposit insurance is that it inherently distorts the free marketplace. The FDIC seeks to limit this governmental intrusion to banks and only to the banks. Some ask why must the government supervise banks at all? One very good answer is because they can borrow <u>our</u> credit -- that is, the FDIC's credit -- and thus indirectly the credit of the U.S. government.

But the "safety net" provided by FDIC insurance need not extend beyond banks to bank holding companies, or their affiliates, to insure systemic safety and soundness.

The FDIC was created to protect insured bank depositors, and in fulfilling that role, it has an obligation to help maintain a safe and sound banking system. A safe and sound system is necessary if the insurance fund is to be viable.

Historically, we have handled bank failures in a manner that has protected over 99 percent of all bank depositors, because this action provided the lowest cost to the insurance fund.

Unfortunately, the FDIC has on occasion extended the "federal safety net" to bank holding company creditors and even to shareholders as the lowest cost, or most practical, way of handling an individual situation.

The Board of the FDIC has recently stated that its policy today is that the safety net should not, and does not, extend to holding companies -- shareholders and creditors alike.

To paraphrase Harry Truman, our message is: "The safety net stops here...with the bank."

In the past, regulators have often applied a double standard in the supervision of banks owned by individuals and those held by large holding companies. If a bank is owned by an individual, and it is capital deficient, regulators forbade funds from moving out of the banks by way of dividends or other means. This "firewall" has not always been enforced where bank holding companies are involved.

The firewall collapses when a bank is short on capital and profits, but its holding company continues to take dividends from the bank, just as though the bank was in good health.

Nine of the ten largest bank failures since 1972 were part of holding companies. In these cases, even at the point of failure, at least half of these subsidiary banks were still upstreaming dividends to their parent holding company. In cases such as these, dividends paid to the holding company frequently came right out of the insurance fund's pocket.

Current problems of the larger holding companies in Texas illustrate the need for restricting the federal "safety net" to banks.

Several weeks ago the FDIC announced it had advanced one billion dollars to subsidiary bank of First RepublicBank Corporation of Dallas to bring stability back to the system.

This advance was guaranteed by First RepublicBank Corporation, the holding company, and by all its affiliate banks. The advance was also collateralized by a pledge of certain assets of the holding company.

While the FDIC guaranteed that all depositors and other general creditors of First Republic's banks will be fully protected, the FDIC made it clear that these guarantees DO NOT extend to the holding company creditors or shareholders.

Since our funding was protected by the guarantee of all the banks, the debt held by the creditors of the holding company should not be protected by the federal security net. Moreover, our Bridge Bank Authority makes this limitation of the FDIC's guarantee more easily enforceable.

We now seek a private sector longer-term solution for First Republic. And, we should be in a position to put a plan in place without extending the "safety net" beyond the banks. The "safety net" must leave the holding company behind.

The FDIC's treatment of holding company owners and creditors tests the viability of the "firewall" concept, and the prudence of expanded powers and services that concept could facilitate.

If holding companies are to move into new services, then we must insure that the federal "safety net" does not extend to those new non-bank activities. If the "safety net" is not limited to the banks, the level playing field is again askew, and government intrusion in the marketplace is greatly increased.

Thus, our BOTTOM LINE -- The focus of bank regulators should be BANK REGULATION, not HOLDING COMPANY REGULATION. Preventing the "safety net" from extending to holding companies is an integral part of that equation. Such a limitation is essential if bank owners are to be allowed to engage in new activities. Then, as Rhett Butler might have said, "Frankly, I don't give a damn who owns a bank!"

In closing, I might note that the number of recent bank failures has people predicting collapse of the financial system.

Books that predict the collapse of the economic and banking system are more popular than ever.

Paul Erdman, in particular, has made a good living coming out with books with the title "The Crash Of...".

I was interested in something contained in a recent interview Mr. Erdman gave, which I think should be encouraging to anyone concerned with the future of America's banking system.

The interviewer asked Mr. Erdman about his own investment practices -- how did he squirrel away all those $7,500 lecture fees he gets?

Does "Dr. Disaster" convert his money to rubies, gold ingots, or Japanese Yen?

No, it turns out, he doesn't.

He keeps his money in what he must consider among the safest of all investments, that is in bank certificates of deposit!

Our hope is that sound banking retructuring, as set forth in our "Mandate", will be put in place to further enhance the faith in the system.

On that hopeful note for the future of our financial system, I thank you.