

**Oral Statement  
of  
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Chairman  
Federal Deposit Insurance Corporation  
before the  
Subcommittee on Capital Markets, Securities  
and Government Sponsored Enterprises  
Committee on Banking and Financial Services  
United States House of Representatives  
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Mr. Chairman and members of the Subcommittee, I appreciate this opportunity to present the views of the Federal Deposit Insurance Corporation on financial modernization and related issues. I commend you, Mr. Chairman, and Congressman Kanjorski for placing a high priority on the need to modernize and strengthen the nation's banking and financial systems. Current restrictions on the financial activities of banking organizations are outdated. Their elimination would promote the efficient, competitive evolution of financial markets in the United States. One of the lessons of the 1980s is that geographic constraints and product restrictions do not insulate depository institutions from competitors, and can present safety and soundness problems because of the lack of diversification.

Congress eliminated many geographic constraints by enacting the Riegle-Neal Interstate legislation in 1994, but remaining product barriers limit the opportunities for financial institutions to diversify and to respond quickly and efficiently to changes in the marketplace. To maintain the safety and soundness of the financial system, institutions must be allowed to diversify. Expansion of bank and thrift powers must be accompanied by appropriate safeguards for the insurance funds. In addition, any proposal for financial reform must also be examined for its impact on small communities, small businesses, and customers of financial institutions.

Mr. Chairman, I have written testimony to submit for the record that examines financial modernization and related issues in detail. This morning, I want to concentrate on one of those issues, which threatens to drive our consideration of financial modernization -- the issue of whether banks receive a subsidy from the federal safety net.

Concerns have been expressed that the existence of the federal safety net -- deposit insurance, access to the Federal Reserve's discount window, and access to the payments system -- provides banks with funding advantages that could be passed on to bank subsidiaries, thereby resulting in the undesirable expansion of the safety net to activities for which it was not intended.

I have asked the FDIC staff to analyze whether such a subsidy, in fact, exists. The analysis is ongoing, but based on the evidence we have now, the FDIC staff has reached several conclusions.

It has long been widely accepted, and the FDIC agrees, that banks receive a gross subsidy from the federal safety net. However, banks also incur costs, both direct and indirect, that offset this gross subsidy. The relevant question, therefore, is not whether banks receive a gross subsidy, but whether banks receive a net subsidy, after taking account of offsetting costs and restrictions, that they could pass on to a subsidiary or affiliate engaged in nonbanking activities.

It is extremely difficult to measure directly whether banks receive a net subsidy. However, on balance, the evidence indicates that, if a net subsidy exists, it is very small.

In addition, during the 1990s, significant changes in law and practice have substantially reduced the gross subsidy that the safety net provides -- these changes include minimum risk-based capital standards, the "least cost" test for resolving bank failures, risk-based deposit insurance, and restrictions in the Federal Reserve's ability to lend to undercapitalized institutions through the discount window.

As my written testimony discusses in detail, while quantification of the gross subsidy and offsetting costs is very difficult, the evidence shows a gross benefit of about 10 basis points or less, and offsetting costs -- interest free reserve requirements, interest payments on bonds issued by the Financing Corporation, and other costs from regulation -- that, together, are considerably higher than 10 basis points. The costs of regulation for commercial banks alone has been estimated to amount to more than 30 basis points.

Practical evidence also argues that the net subsidy is small or nonexistent. Banking organizations often conduct activities in affiliates at the holding company level that could be conducted directly in a bank or in a bank subsidiary without any firewalls. Examples include mortgage banking, consumer finance and commercial finance. If there were a material net subsidy, a rational banking organization would not carry out these activities in holding company affiliates. It would carry them out in the bank or bank subsidiary.

Moreover, even if a small net subsidy exists, firewalls, such as those that require a bank's equity investment in a subsidiary to be deducted from the bank's regulatory capital, and the restrictions of Sections 23A and 23B of the Federal Reserve Act -- which among other things limit the investments by a bank in an operating subsidiary to 10 percent of the bank's capital -- serve to inhibit a bank from passing a subsidy either to a subsidiary or to an affiliate of the holding company.

These firewalls are not impenetrable under all circumstances. In times of stress, firewalls tend to weaken. Our experience is that in such times, funding pressures can be exerted on the insured bank by its holding company as well as by subsidiaries of the bank. Nevertheless, the available evidence indicates that both bank subsidiary and

holding company structures will work equally well in inhibiting a bank from passing a net subsidy to a subsidiary as long as appropriate safeguards are in place to protect the insured bank.

In addition, from the perspective of safety and soundness, there may be an advantage to the bank subsidiary model. Allowing a bank to put new activities in a bank subsidiary diversifies a bank's income stream. The bank benefits from the earnings of the subsidiary and, with appropriate firewalls, the downside risk can be limited to excess regulatory capital -- above well-capitalized levels -- with respect to investments in the subsidiary. In this way, the bank subsidiary structure can lower the risk to the insurance funds and may actually reduce any subsidy that arises from deposit insurance.

Given these facts, we have concluded that allowing banks to conduct financial activities in a bank subsidiary does not represent an undue expansion of the federal safety net. Therefore banking organizations should be free to choose how best to organize their activities according to their business judgments.

Because any subsidy from the federal safety net is, at most, de minimis, the subsidy argument should not drive financial reform.

Nor should the subsidy argument be used -- as it has been -- as justification for reducing federal deposit insurance coverage -- or for eliminating federal deposit insurance altogether through privatization. Such an argument diverts attention from the real issue of whether federal deposit insurance continues to serve the interests of the American people. As we learned the hard way in the banking crisis of the 1980s and early 1990s, federal deposit insurance assured the stability of the financial system when it was under great stress. Privatizing or reducing federal deposit insurance would diminish our ability to assure financial stability in times of stress and, therefore, would be detrimental to the American public we serve.

Reforms enacted by Congress in 1991 have added market discipline to the deposit insurance system, and the FDIC continues to focus on other reforms that would further reduce the costs of resolving bank failures.

Mr. Chairman and members of the Subcommittee, my written statement discusses several other important issues that I, in conclusion, want to note very briefly this morning.

We have significant concerns about the full-scale removal of the division separating banking and commerce. We support functional regulation of securities and insurance activities. We believe that regulation should be commensurate with risk -- no more and no less. We also believe that there is room for oversight supervision to prevent critical safety and soundness issues from falling into the cracks and to address potential systemic problems. That said, such oversight need not involve regular full-scope examinations of nonbanking subsidiaries where there is adequate functional regulation

nor activity-by-activity or investment-by-investment regulation of nonbanking subsidiaries.

In conclusion, eliminating current restrictions on the financial activities of banking organizations requires balancing public policy goals and building a sound supervisory structure for the future. I believe that we can achieve genuine reform while assuring a strong, competitive environment for financial services and, at the same time, addressing safety and soundness considerations. I applaud this Subcommittee for its attention to these issues. The FDIC stands ready to assist you in any way we can. I look forward to your questions.

Thank you.

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