For release on delivery
10:00 A.M. EST
JANUARY 28, 1991

Testimony by

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before the

Subcommittee on Financial Institutions Supervision,
Regulation and Insurance

of the

Committee on Banking, Finance and Urban Affairs

U.S. House of Representatives

February 28, 1991

It is my pleasure to appear before this subcommittee with such a distinguished panel to discuss H.R. 192, the proposed "Financial Industry Reform and Capital Enforcement Act." Financial industry reform is one of the most pressing and important issues facing the Congress and the nation. The Federal Reserve Board, like this subcommittee, believes that this topic should be placed high on the Congressional agenda.

H.R. 192 highlights two of the basic problems that need to be addressed in reforming the financial services industry. First, institutional developments and technological change have altered the competitive environment and made obsolete the statutory and regulatory framework in which banks currently operate. Competition in banking has become more intense as a result of the technological revolution in information transmission and processing. These innovations have led to an increased volume of transactions made directly between lenders and borrowers, fostered new institutions offering bank-like claims and granting bank-like credit, and permitted old banking rivals to become more bank-like as well. In this environment, outdated laws increasingly are hindering the ability of many banks to service their customers' needs. But most significantly, American consumers are being denied the benefits of a more efficient financial system. These developments all call for expanding the activities banking organizations are authorized to deliver and--just as important--relieving them from the costly prohibition of interstate branching.

The second problem is the potential liability of the taxpayer for losses that banks may incur. Over the years, moral hazard has created a threat to the deposit insurance system, as expanding deposit

insurance guarantees have greatly reduced the market discipline imposed by depositors on bank risk-taking. Consequently, some insured depository institutions have been encouraged to take excessive risks and to operate with eroded capital ratios that may not provide sufficient insulation for the insurance fund. Tragically, these developments have exposed American taxpayers to liability for the insurance guarantees in the thrift industry. Thus, we need to develop legislation to limit the size of potential taxpayer exposure for deposit insurance in the commercial banking industry. The pressing need to enhance the ability of commercial banking organizations to compete by expanding the range of their permissible activities only increases the need to avoid extending the safety net guarantees to whatever additional risks may be present in these new businesses.

With these concerns in mind, the Federal Reserve Board supports H.R. 192's objective of expanding bank activities and permitting affiliations of banking and other financial firms. This reform directly addresses the first problem: the need for banking organizations to modernize their delivery systems. But the defense of the safety net is not addressed as fully as we would like in the bill. We are concerned that certain provisions of the bill spread the safety net under a wider variety of risks and thereby increase the exposure of the insurance fund.

To protect the safety net, H.R. 192 focuses on the regulation of the bank subsidiaries of depository institution holding companies, supplemented by an "early intervention" requirement that relies on the parent maintaining the capital of the bank subsidiary. Failure of the

parent to maintain the bank's capital would result in dividend restrictions on the bank and ultimately divestiture of undercapitalized banks or imposition of a conservatorship. Such an approach is generally consistent with the Board's proposals last summer for a policy of prompt corrective action.

The Board is concerned, however, that other features of the bill may not provide sufficient supervisory authority to safeguard the insurance funds. The bill does not provide for an umbrella supervisor for the parent and its nonbank subsidiaries, nor any control over the capital of these units. It will, I am sure, come as no surprise to you, Mr. Chairman, that the Board believes that a federal supervisor should have the overall authority to look at the whole enterprise that contains an insured deposit-taking unit. Our experience has reinforced our view regarding the complexities of inter-company relationships within a holding company and the conviction that firewalls alone cannot insulate a bank from the problems of its parent or affiliates. We have seen that pressures on the parent holding company or nonbanking affiliates may well affect the costs and availability of funding of affiliate banks.

While H.R. 192 looks to the parent to maintain the capital of its bank affiliates, it does not give the supervisor the examination and reporting tools to closely monitor or supervise the financial condition or operations of the parent. In addition, no realistic and timely means are provided to ensure that the activities or financial condition of the organization as a whole do not pose additional risk to the insured deposit taker and through it, to the financial system or the safety net.

Even if the potential for trouble is detected, the agencies would have no specific cease and desist authority over the holding company and its nonbanking affiliates.

It is true that the bill authorizes the bank regulator to require divestiture of the depository institution when it is being endangered by the activities or condition of an affiliate, but corporate structures are often complicated, and without regular supervisory oversight, discovery may be difficult. More importantly, the possibility of administrative and judicial challenges, the one-year divestiture period, and the difficulties of proof under the proposed statutory standard eliminate the ability of the bank supervisor to use this divestiture provision in a timely fashion to protect the bank and the insurance fund.

Moreover, it is not clear whether the holding company could avoid the obligation imposed by H.R. 192 to maintain the capital of subsidiary depository institutions. For example, could the holding company simply turn over a troubled bank to a conservator, passing the losses to the deposit insurance funds and potentially to the taxpayer? Any reliance on the holding company to recapitalize its subsidiary banks would be greatly undermined if the holding company retained that option.

H.R. 192 wisely recognizes that certain risky nonbanking activities, such as real estate investment and development, should not be conducted directly by a federally insured depository institution. The Board is concerned, however, that the bill does not adequately address the equally important issue of the conduct of such activities

through subsidiaries of state-chartered institutions (where permitted by state law) and the concomitant exposure of the safety net. In our view, banks should not use federally insured funds to engage directly in such risky activities or to acquire or finance subsidiaries engaged in these activities. Experience has demonstrated that the market expects insured banks to support their subsidiaries. Even when an insured bank wishes to assert corporate independence from its subsidiaries, all losses experienced by these units are reflected directly in the income statements and balance sheets of the parent bank and reduce the bank's capital. Thus, unlike holding company affiliates, a subsidiary of a bank may directly reduce the bank's ability to use its own capital as a buffer protecting the bank's depositors and the insurance fund.

We are also concerned that the proposed amendments to sections 23A and B of the Federal Reserve Act could increase the bank's exposure to its affiliates. The bill fragments the existing unified rulemaking authority under section 23, giving each bank regulator the authority to adopt its own rules and interpretations and to exempt institutions or transactions from section 23A and section 23B limits. In addition, the bill amends existing law to allow depository institutions to lend to customers of affiliates in order to purchase the affiliates' products and services without regard to the quantitative and collateral limits of section 23A--a troublesome exemption since, under the bill, commercial firms may own or be affiliates of banks.

I should note that H.R. 192 places no limits on who may own a depository institution holding company or what business the bank affiliates may conduct, or on cross-marketing of financial or commercial

products and services. This mix of banking and commerce, which would raise serious issues in any context, is further complicated by the weakening of 23A and B firewalls and the absence of umbrella supervision. Before the Congress takes what will amount to an irreversible step, the Board believes that the issue of commerce and banking should be carefully studied and that if Congress decides to authorize commercial connections, it should be done in a carefully supervised and phased-in manner with adequate protection of the public interest.

The Board strongly objects to that provision of H.R. 192 which apparently would limit the Federal Reserve's ability to control its risk exposure from depository institution access to the Federal Reserve's payment services. This provision would deny to the Federal Reserve the discretion that it and all lenders have to make credit judgments based on all relevant factors. Further, in an era of electronic payments where trillions of dollars change hands daily, the bill would prevent the Federal Reserve from acting promptly to deal with troubled institutions accessing daylight credit from the Federal Reserve. These limitations could result in substantial losses to the Federal Reserve that could be reflected in reduced Federal Reserve payments to the Treasury.

In sum, we support the principle of wider activities for banking organizations that is the centerpiece of H.R. 192, and applaud its contribution to the financial reform debate. This objective, however, needs to be accompanied by safeguards to address the risks to the safety net of new activities and to limit the transfer of the safety

net subsidy to noninsured entities. We would also hope that any banking reform legislation would promptly authorize interstate branching. Revising these outdated limitations would be extremely helpful in reducing both bank costs and their risk profiles.