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Testimony by

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I am pleased to appear before this Committee to discuss two important banking reform bills. The first, S.543, the Comprehensive Deposit Insurance Reform and Taxpayer Protection Act of 1991, was introduced by Chairman Riegle. The second, S.713, is the Treasury's proposed Financial Institutions Safety and Consumer Choice Act of 1991. These two bills have a significant degree of overlap and agreement about modifications to our deposit insurance system and our supervisory procedures.

Both bills propose similar reforms to reverse one of the fundamental causes of the problems facing our banking system today: an expansive safety net that creates incentives for our banks to take excessive risk with insufficient capital. The Treasury bill also addresses two other root causes of the present difficulties of the U.S. banking system: (1) the reduction in the value of the bank franchise associated with the ongoing technological revolution that has dramatically lowered the cost of financial transactions and expanded the scope of financial activities of bank rivals; and (2) a statutory and regulatory structure that impairs the competitiveness of U.S. banks by increasing their operating costs, discouraging geographic diversification, and limiting their ability to respond to financial innovations and the challenges posed by nonbank providers of financial services.

The coupling of the Riegle bill with the provisions of the Treasury bill on interstate branching and expanded activities for banking organizations would address these basic problems facing U.S. banks, and establish a particularly useful framework for congressional action. These broader reforms would make our banking system more efficient, better able to serve the public, and create an environment for a safe, sound, and profitable banking system.

Mr. Chairman, both bills contain a large number of detailed provisions. In the interests of both time and space, I have limited my comments to those portions of each bill that represent the core proposals relevant to basic reform, to those for which the Board may have a view contrary to others that you may have heard, and to those with which the Board has relatively strong reservations. I will, of course, respond to questions about those provisions on which I have not commented.

With so many provisions, it is not surprising that no Federal Reserve Board member supports all of them. Nonetheless, all members of the Board support a significant number of them, and a few provisions are opposed by some or all of us. Thus, when I say the Board supports or opposes any particular provision, I will be suggesting a majority or sometimes a unanimous position. In this sense, I can say that the Board strongly supports both bills in their

approach to deposit insurance and supervisory procedures, and similarly strongly supports the thrust of the Treasury bill to authorize new activities and interstate branching.

Prompt Corrective Action

The centerpiece of both bills is a capital-based prompt corrective action mechanism, under which entities with capital ratios below certain standards would be placed under prompt and progressively greater pressure to limit their dividends and their growth, and to modify management practices. As the degree of undercapitalization increases, the supervisory pressure would intensify. The principal objective of prompt corrective action is to change the behavior of bank management by modifying its risk-benefit calculations through the establishment of a presumption that supervisors will take specified corrective action as capital deteriorates. Moreover, by acting promptly, it is possible for the franchise values of the going concern to be maintained and to avoid the rapid declines in value that normally occur for insolvent banks. For the same reason, at some low, but still positive, critical level of bank capital, the bank would be placed in conservatorship or receivership and the stockholders provided only with residual values, if any. If the bank could not be recapitalized, it would be sold, merged, or liquidated; larger banks might be reduced in size over time before sale or liquidation.

Thus, prompt corrective action is designed to decrease the probability of failures, and, when they do occur, to minimize their cost to the FDIC. It thus would reduce the need to draw on the insurance fund and to limit that draw when resort to insurance funds is necessary. The Board strongly supports this approach and believes that it is an idea whose time has come for enactment. In this regard, we are struck by the many similarities between the specifics of the two bills. The Treasury proposal clearly draws heavily on the provisions of the earlier version of the Riegle bill, and likewise the Riegle bill has been adjusted in reflection of Treasury proposals.

Our suggestions do not call for significant modifications, but we nonetheless urge their consideration. For example, both bills, correctly in our view, base prompt corrective action on capital. Generally, capital is a leading indicator of the financial condition and future performance and solvency of a bank. It should thus be a major determinant in prompt corrective action. However, supervisory experience and economic research indicates that sometimes capital ratios alone do not always differentiate between banks posing high and low risk to the deposit insurance system. That is why the Treasury's proposal includes reference to "unsafe and unsound" conditions or operations in placing banks into zones lower than might be indicated by capital alone. We believe more

general language -- such as "other supervisory criteria" -- would be more useful. Operationally, this would mean that supervisors would be able also to consider asset quality, liquidity, earnings, risk concentrations, and judgmental information based on recent examinations, such as classified assets data. In short, a reduction in a bank's capital ratio requires that a close review for significant problems is required, but other variables should be considered as well.

These other indicators of the financial condition of a bank should not prevent categorization based on capital. They would, however, permit supervisors to act even if the criteria for bank capital were met. Indeed, we would suggest the proposed provisions for prompt corrective action be revised to indicate that supervisors could use other supervisory information to *downgrade* institutions relative to zones implied by capital alone. We believe this approach would greatly improve the overall effectiveness and fairness of a policy of prompt corrective action without jeopardizing the presumption that regulators would be required to act quickly, forcefully, and consistently in dealing with capital-impaired institutions. Nor would it eliminate the rigor that its supporters hope prompt corrective action policies would bring to the supervisory framework. In our view, noncapital considerations should only be allowed to reduce the category that capital alone

would call for, and never either to neutralize or raise the categorization of a bank based on capital.

Indeed, even with the supplemental authority provided by the Treasury and Riegle prompt corrective action proposals, the bank regulators must remain vigilant in detecting problems that do not immediately show up in capital ratios of banks, and must be aggressive in using existing enforcement authority to address these problems. Both bills would permit a systemic program of progressive restraint based on the capital of the institution, instead of requiring the regulator to determine on a case-by-case basis, as a precondition for remedial action, that an unsafe or unsound practice exists. This would provide a powerful and useful tool for addressing problems at banks, but would not replace the need for active supervision of other factors at banks.

The proposed Treasury legislation would authorize expedited judicial review to ensure that the supervisor had not acted in an arbitrary and capricious way, but would allow the supervisory responses to go forward without delay while the court was reviewing the process of capital measurement. Such a procedure is a necessary precondition for the "prompt" in prompt corrective action, but should be modified to include the other supervisory standards referred to above. We urge the incorporation of this concept of expedited judicial review in S.543.

The Riegle proposal has three categories of classification for prompt corrective action and the Treasury proposal has five. The Board prefers the larger number of categories because of the additional flexibility it provides. Both approaches require certain actions and permit supervisory discretion when deemed appropriate. In the Treasury approach, the number of required and the range of permissible actions expand as the capital ratio declines, but procedures are specified -- requiring explicit determination of public benefits -- that permit the supervisor to delay taking required actions. The Riegle approach permits no deviations from a small number of required actions, but has a wide range of permissible responses, a procedure that also provides flexibility to the supervisor. Both approaches thus blend flexibility with a mandate for prompt action. Both avoid inflexible, cookbook supervisory rules, while establishing a presumption of rapid supervisory action.

The adoption of prompt corrective action policies would represent a significant change in the supervisory framework for a large number of institutions. In order to avoid unintended impacts in credit markets and to provide banks with time to rebuild their capital positions and modify their policies, we would urge a delayed effective date. The Treasury legislation calls for a three-year delay and the Riegle bill for a nine-month lag after enactment.

We prefer the longer interval. Putting banks on clear notice of the coming supervisory framework at a certain date should provide for a smooth transition with minimal disruption.

A final technical note. Both bills call for the regulators to establish the specific capital ratios for each zone or category. The Treasury bill requires the agencies to set the critical capital level -- which would call for putting the bank in conservatorship or receivership -- at a point that generally permits resolution of troubled banks without significant financial loss to the FDIC. The Treasury bill provides that this measure may be no lower than 1.5 percent of the bank's assets. The Riegle bill indicates that the critical capital ratio should be set high enough that "with only rare exceptions" resolution would involve no cost to the FDIC, but does not specify a minimum critical capital level.

The very act of placing a bank into receivership or conservatorship significantly lowers its franchise value, thereby increasing FDIC resolution costs. It is unreasonable to impose such a haircut on operating banks. We would suggest, therefore, that the criterion be to "minimize" resolution costs. It is worth emphasizing that prompt corrective action will tend to reduce losses to the insurance fund, but a genuine fail-safe, no-losses-to-the-FDIC policy would require unrealistically high capital

levels. We also believe that it is appropriate for Congress to set a floor on the critical capital level that indicates that Congress recognizes the positive subsidy resulting from the federal safety net.

Deposit Insurance Reform

As I noted, prompt corrective action will ultimately make deposit insurance reform less pressing. Nevertheless, both bills propose a reasonable reining in of the safety net that the Board supports. Both bills call for limiting insurance coverage to $100,000 per individual per insured institution (plus $100,000 for retirement savings) and for eliminating coverage for all -- or in the case of S.543, most -- pass-through and brokered accounts. We believe this basic proposal would be consistent with the original intent of deposit insurance to protect the smaller-balance depositor.

It is worth noting that 1989 survey data suggest that only about 3-1/2 percent of households held accounts that, when combined for all household members, exceeded $100,000 at a single depository institution. However, 60 percent of these combined accounts were both less than $200,000 and held by households with husband and wife, each of whom could, under the provisions of both bills, open fully insured accounts at the same institution. With this adjustment, which excludes the additional coverage for retirement accounts proposed in both bills, only 1-1/2

percent of households would have held accounts with uninsured balances. These households had median net worth in excess of $2 million, hardly a family for which the safety net was designed.

Some observers would prefer a rollback in coverage. If we were rewriting history, few now would call for insurance coverage as high as $100,000 per individual per institution. But, as I noted last summer before this Committee, such insurance levels are now capitalized in bank stock values, in loan and deposit rates, and in the technology and scale of bank operations. A rollback could thus create disruptions that may well exceed its benefits.

The Treasury also proposes a study of longer-run efforts to limit coverage to $100,000 per individual across *all* institutions. The Board endorses the concept of a study in order to understand better the potential cost and intrusiveness of such a fundamental change in the scope of deposit insurance coverage.

Both bills would require the FDIC to establish a risk-based deposit premium assessment system. In principle, such a system has several attractive characteristics: it would link the cost of insurance to the risk that a bank poses to the insurance fund; it would reduce the subsidy to risky banks; and it would spread the cost of insurance more fairly across depository institutions. It could also be coupled with capital, reducing the premium for those banks

that held capital above the minimum levels adjusted for their risk profiles. Whatever these attractions might be in principle, the Board would urge caution at a time when premiums are already high, BIF resources are low, and the range of premiums necessary to reflect risk differences accurately, and to induce genuine behavioral changes, might be much wider than feasible. Risk-based premiums also would have to be designed with some degree of complexity if they were to be fair, and if unintended incentives were to be avoided. Moreover, the extent of potential benefits when risk-based premiums are imposed on top of the risk-based capital system, while likely positive, requires further evaluation.

Both bills would require the FDIC to resolve failed banks in the least costly manner, which generally means that uninsured depositors would receive only pro rata shares of residual values, if any. The Riegle bill, however, has no provision permitting consideration of systemic risks, and, after 1994, prohibits outright any financial assistance by the FDIC to an insured bank that would have the effect of preventing loss to uninsured depositors or creditors. To minimize the impact of a bank failure on other banks, this bill would require the Federal Reserve to develop and apply rules that limit interbank deposits and credits, including a prohibition on interbank deposits by banks not in capital compliance.

While the Board understands the desire to limit systemic risks through controlling interbank credit relationships, we strongly oppose this proposal because of the substantial disruption that could occur in the correspondent bank network from its implementation. We are, for example, concerned with the inducement to rapid withdrawals that would be associated with the message that a bank, whose capital has declined to just below minimum levels, was suddenly prohibited from taking interbank deposits. The payments system depends importantly on the interbank network, with large cross-border interbank balances held for payments purposes. Sudden changes in the ability to offer such balances would be associated with sudden shifts in payment patterns that could be quite disruptive.

The Treasury's bill is silent on interbank deposits and credits. However, it calls for an exception to the least costly resolution of failed banks in those situations in which the Treasury and the Federal Reserve Board, on a case-by-case basis, jointly determine that there would be bona fide systemic risk.

Like you, Mr. Chairman, no one -- including the Federal Reserve Board -- is comfortable with the exception procedures for addressing systemic risk, even though the Treasury proposal would tighten up the way such cases are handled. While, in principle, systemic risk could develop

if a number of smaller or regional banks were to fail, systemic risks are more likely to derive from th failure of one or more large institutions. Thus, the need to handle systemic risk has come to be associated with the too-big-to-fail doctrine. The disproportionate degree of systemic risk at larger banks highlights the tension between one of the main purposes of deposit insurance -- protecting smaller-balance depositors -- and the concern that the rapid withdrawals by uninsured depositors from larger banks perceived to be in a weakened condition could cause and spread significant disruptions that could, in turn, affect credit availability and macroeconomic stability. Whatever its macro benefits might be, too-big-to-fail has increasingly offended observers and policymakers alike because of its inequitable treatment of depositors and borrowers at banks of different sizes, and its tendency both to broaden the safety net and to undermine depositor and creditor discipline on bank risk-taking.

Despite the substantial concerns, the Board, like the Treasury, has reluctantly concluded that there may be circumstances in which all of the depositors of failing institutions will have to be protected in the interests of macroeconomic stability. In evaluating our conclusion, it is important to underline that we anticipate that there will also be circumstances in which large banks can fail with losses to uninsured depositors but without undue disruption

to financial markets. The Treasury's proposal in fact co..templates that the large-balance deposi.ors of these banks will not be protected. Moreover, since the exception proposal is designed to maintain the confidence of *depositors* in the system, its implementation does not call for protection of non-deposit creditors of the bank, its holding company, or its nonbank affiliates, and especially protection of the stockholders and senior management. These claimants and employees need not be protected to serve the objectives of the exception proposals.

In addition, I would emphasize again that other provisions of both bills should ultimately make the exception or too-big-to-fail issue less relevant. The greater emphasis on capital maintenance, more frequent on-site examinations, and policies of prompt corrective action can be expected to modify bank behavior and attitudes toward risk-taking. Indeed, the ultimate solution to the too-big-to-fail problem is to ensure that our policies minimize the probability of large banks becoming weak, and that when banks experience distress that regulators act promptly to limit FDIC costs. But reality requires that we recognize that substantial increases in capital and substantial reversals of policies cannot occur in the short run. Moreover, it would be taking a significant risk, we believe, to eliminate the long-run option to respond in a flexible way to unexpected and unusual situations. The Federal

Reserve alone cannot address this problem. We can add liquidity to the economy and we can direct liquidity to individual institutions in appropriate circumstances. But we cannot, under the Federal Reserve Act, nor should we, provide capital to any institution.

Bank Insurance Fund (BIF) Recapitalization

While prompt corrective action and deposit insurance limits will reduce future exposure of the Bank Insurance Fund, the chairman of the FDIC has warned of the unfolding insolvency of BIF. In response, the Treasury has developed a proposal that would authorize the Federal Reserve Banks to lend up to $25 billion to the FDIC to absorb losses sustained by the BIF in resolving failed banks. While the liabilities of the BIF would be full faith and credit obligations of the U.S. Treasury, it is anticipated that they would be repaid from increased insurance premiums. Premiums could be increased to as high as 30 cents per $100 of assessed deposits -- 7 cents higher than the premium the FDIC has proposed to impose at midyear. In addition, the BIF could borrow from other sources up to $45 billion for "working-capital" purposes, i.e., to carry assets of failed banks pending their sale or liquidation. These loans would thus be self-liquidating. Total premium income would be used to pay interest on borrowings from the Federal Reserve and the Federal Financing Bank, cover

ongoing insurance losses, repay Federal Reserve loans, and rebuild the BIF fund.

In the current environment of intense competition and weak earnings, the Federal Reserve Board is concerned about the potential costs of further premium increases in terms of the soundness and competitiveness of our banking, financial, and economic system. It is extremely difficult to judge how high the premium could be raised before the costs outweigh the benefits in terms of added revenues for BIF. What is clear is that in reaching a judgment about the appropriate premium level we cannot ignore these potential costs simply because they cannot easily be measured. The premium level that maximizes BIF's premium revenues, or even the premium level that maximizes the net worth of BIF, could be substantially higher than the level that would be optimal if the potential adverse impact of higher premiums on our financial system and our economy could be precisely quantified. In light of these considerations, the Board supports the imposition of a 30 basis point premium cap, and urges caution in considering increases in premium costs beyond an amount equal to a 23 basis point on the current base.

The Board believes that any plan to recapitalize BIF must provide sufficient resources without imposing excessive burdens on the banking industry in the near term. The Board also believes that loans to BIF that would be

repaid with future premium revenues are the best means of striking this difficult balance.

However, an element of the Treasury's proposal that has troubled the Board is the use of the Federal Reserve Banks as the source of these loans. To prevent such loans from affecting monetary policy, the loans would need to be matched by sales from the Federal Reserve's portfolio of Treasury securities. Thus, in either case, the public would be required to absorb an amount of Treasury securities equal to the amount of loans to BIF.

The Board can discover no economic purpose that would be served by this indirect financing route. The implications for financial markets, the economy, and the federal budget would be identical if the Treasury made the proposed loans to BIF rather than the Federal Reserve Banks. Because the Federal Reserve would offset the loans with open market sales, there would be no impact on reserves, the federal funds rate, or the money supply. With respect to budgetary implications, neither FDIC outlays, net interest payments by the U.S. government, nor the budget deficit, would be any different. Finally, use of the Treasury rather than the Reserve Banks would have no implications for the Budget Enforcement Act.

Not only would use of the Reserve Banks for funding BIF serve no apparent economic purpose, it could create potential problems of precedent and perception for the

Federal Reserve. In particular, the proposal involves the Federal Reserve directly funding the government. Congress has always severely limited and, more recently, has forbidden the direct placement of Treasury debt with the Federal Reserve, apparently out of concern that such a practice could compromise the independent conduct of monetary policy and would allow the Treasury to escape the discipline of selling its debt directly to the market. Implementation of the proposal could create perceptions, both in the United States and abroad, that the nature or function of our central bank had been altered. In addition, if implementation of the proposal created a precedent for further loans to BIF or to other entities, the liquidity of the Federal Reserve's portfolio could be reduced sufficiently to create concerns about the ability of the Federal Reserve to control the supply of reserves and, thereby, to achieve its monetary policy objectives.

Mr. Chairman, BIF must be granted unquestioned access to the financial resources necessary to meet its obligations. And, the public must be reassured that, regardless of the solvency or insolvency of BIF, the U.S. government will make available whatever funds are necessary to protect federally insured deposits.

Whatever financial arrangements accomplish this objective, however, it is of critical importance that we adopt policies now to minimize the risk that such losses to

the insurance fund will ever occur again. The Board believes that both the Riegle and Treasury bills establish an approach that would accomplish that objective through prompt corrective action. But the Riegle bill does not address other issues that would strengthen banking organizations, issues that I would now like to discuss.

Expanded Activities and Interstate Branching

As the Committee knows, the Board believes that a significant part of the longer-run solution to the subsidy provided by the safety net is an increase in minimum capital standards. However, the condition of many banks suggests that a shorter-run restoration process must precede the increase in capital minimums. In the interim, the Board supports the Treasury proposal that would immediately reward those financial services holding companies with bank subsidiaries that have capital significantly above the minimum standards. Not only does such an approach create additional inducements for these organizations to build and maintain the banks' capital, it also addresses one of the most significant causes of weaknesses in the banking system by widening the scope of activities for holding companies with well-capitalized bank subsidiaries.

It is clear that some members of Congress are hesitant about authorizing wider activities for banking organizations at a time when taxpayers are being asked to pick up the costs for failed S&Ls that have unsuccessfully

taken too much risk, and when BIF recapitalization proposals raise the concern that taxpayer assistance for resolution costs of banks may also be necessary. Such hesitancy is understandable. However, two crucial differences exist between the expanded bank activities proposed by the Treasury and those previously allowed for S&Ls: the types of activities in which the institutions could engage, and the types of institutions that would be allowed to engage in the activities.

The wider activities proposed by the Treasury are all financial in nature; they involve the types of risk with which bankers are familiar, letting them build on their expertise. Thus, for example, the bill would not permit financial services holding companies to engage in real estate development or other nonfinancial activities. It is worth repeating that the new activities that would be authorized would be restricted to holding companies with well-capitalized and soundly operated bank subsidiaries. They are to be conducted in separately capitalized affiliates that would have limited access to bank funds; and they must be divested if the capital of the affiliated banks does not remain significantly above the minimum international capital standards. The proposal does not repeat the thrift experience of authorizing *all* institutions -- strong and weak -- to engage in new activities in the depository, financed by insured deposits. The proposed

approach is unlikely to expose the safety net to additional risk because it does not reflect a wholesale removal of restraints. Based on their current capital positions, we estimate that only about one-fourth of the largest 25, and about one-half of the largest 50, of our banking organizations would be permitted to engage in such activities if they were authorized today. Almost all of the next 50 largest bank holding companies have bank subsidiaries with capital high enough to permit the holding company to engage in these new activities.

The best protection for the insurance fund is to be certain that we have strong banking organizations. Authorizing wider activities for holding companies with well-capitalized bank subsidiaries would increase the efficiency of our financial system by permitting such organizations to respond more flexibly to the new competitive environment in banking here and abroad. It also would add to the incentives for increasing and maintaining bank capital, and it would make available better and cheaper services to customers of U.S. banks around the world.

Similar benefits involving even more banks and a larger proportion of the public would result from widening the geographic scope of bank activity. The Riegle bill excludes and the Treasury bill includes such provisions. The Treasury proposal would repeal the Douglas Amendment to the Bank Holding Company Act, to permit banking companies to

operate subsidiary *banks* in all states, and would amend the McFadden Act, to permit banks to operate *branches* of their banks in all states. The bill would thus eliminate an anachronism and permit full interstate banking by any vehicle that a banking organization chooses.

An interstate banking system has slowly evolved in this country through the holding company vehicle. Only Hawaii and Montana do not now have on the books legislation that permits -- or is scheduled to permit -- some form of interstate banking. But this approach, with separately capitalized bank subsidiaries, and with less than full nationwide banking authorized, still does not permit some banking organizations to enter some attractive markets and, most important, is unduly costly. True nationwide interstate branching would be much more flexible and efficient, achieving geographic diversification at lower cost. Simply by collapsing existing subsidiaries to branches, banks could eliminate the unnecessary costs of separate boards and extra management layers, as well as the costs of separately capitalizing each subsidiary. Authorization of interstate bank branching is, in effect, both a more efficient use of capital and a capital-building step by reducing banking costs.

The evidence from intrastate branching does not suggest it will be a substantial source of additional earnings to out-of-market banks. What interstate banking

promises is wider consumer choices at better prices and, for our banking system, increased competition and efficiency, the elimination of unnecessary costs associated with the delivery of banking services, and risk reduction through diversification. The Board continues to urge its prompt adoption.

Regulation and Examination

The holding company form is retained in the Treasury proposal as the best organizational vehicle for financial modernization. Under the Treasury proposal, each holding company subsidiary -- bank and nonbank -- would be separately capitalized and functionally regulated as if it were an independent entity: bank regulatory agencies would regulate banks, the SEC would regulate broker/dealers and mutual funds, and the states would regulate insurance companies.

In order to restrict the safety net to the insured bank, the proposal would apply Sections 23A and 23B of the Federal Reserve Act, which limits quantitatively the financial transactions between banks and their affiliates, and requires that such transactions be collateralized and conducted on market terms. However, to achieve the synergies that are the purpose of the proposal, the bill would not impose management, operations, or general marketing firewalls, though strong disclosure requirements would be required to protect the consumer. Among the

firewalls that would remain are restrictions on sales of affiliate liabilities at the bank, where they might be confused with insured deposits.

In the Treasury bill, the primary regulator of the largest bank subsidiary would become the umbrella supervisor of the financial services holding company. The Treasury bill contemplates that, with expanded permissible activities, the insured banking units often would account for a significantly smaller proportion of the consolidated assets of the financial services holding company than they are now of the bank holding company. As a result, the focus of the umbrella supervisor in the Treasury bill is to police and constrain threats to the bank, while limiting bank-like regulation of the holding company and its uninsured subsidiaries. The Riegle bill, in contrast, does not expand the scope of activities of banking organizations and thus retains the current bank-like regulatory focus on the consolidated holding company, whose assets are predominantly banks and subsidiaries whose activities are closely related to banking.

In their respective context, each of these approaches makes sense to the Board because they link regulation to the type of activity. Since the Board strongly supports a wider range of activities for banking organizations, we would also support the regulatory approach of the Treasury bill if such activities are authorized.

Under that approach, the umbrella supervisor's authority over the uninsured affiliates of well-capitalized banks would be limited. However, the umbrella supervisor would police financial transactions between the bank and its affiliates, could assess the risks to the bank posed by the activities of its nonbank affiliates, and could require divestiture of a nonbank affiliate posing a threat to the bank.

In order to assure that the bank is protected, the Board believes some minor modifications in the language of the Treasury bill are necessary to further clarify that the umbrella supervisor could examine the parent anytime it wishes to assure that it is not creating risk for the bank. Further clarity is also necessary to assure that, while the umbrella supervisor would not, as a matter of course, examine the nonbank affiliates on a regular basis, the umbrella supervisor would be permitted to examine nonbank affiliates whenever the supervisor believed the affiliate posed a risk to the banks, even when the banks' capital was above minimum levels; otherwise the supervisor's divestiture authority would be less meaningful. Balancing protection of the bank and limits on the spreading of the safety net with minimal regulation of nonbank affiliates requires careful legislative language.

The Treasury proposal calls for the imposition of bank capital standards on, and the application of many of

the regulations governing prompt corrective action for banks to, the consolidated holding company whenever the capital of the bank falls and remains below the minimum bank capital standard. This approach is designed to reinforce the protection of the banks from contagion by its parent or affiliates. While the Treasury bill provides the supervisor with examination authority over financial affiliates to determine compliance with these requirements, the Board believes that additional clarification is required to assure that the supervisor would have full examination powers over the consolidated financial services holding company when the banks' capital declined below minimum levels.

All of these clarifications are necessary to ensure that the umbrella supervisor would be able to act promptly and effectively to protect the bank. But the thrust of the modified provisions would still be to limit the bank-like regulation of the holding company and its uninsured subsidiaries, provided the bank affiliates are well capitalized. For example, the traditional consolidated bank holding company capital regulation would not be imposed, under the bill, as long as its insured depository subsidiaries were themselves capitalized above minimum levels. There are several reasons for this approach: it recognizes the practical infeasibility of regulators determining what the appropriate minimum capital should be for an organization that is not primarily a banking

organization but rather a true financial services company; it facilitates equitable treatment between holding company subsidiaries and independent firms; it avoids the inefficiencies of regulation; it creates an additional incentive to build and maintain a strong *bank* capital position; and it avoids even the appearance of extending the safety net.

It certainly is true that this would permit holding companies to rely without regulatory limit on debt markets to finance equity contributions to their bank and nonbank subsidiaries -- so-called double leverage. However, prompt corrective action would limit dividends and other payments that bank subsidiaries could make to their parent should the banks' capital decline. Such restrictions on dividends, as well as the strict limitation of the safety net protection only to the banks, are likely to make financial markets cautious about the quantity of debt it permits financial services holding companies to assume. Moreover, with the appropriate examination authority, the supervisor could take remedial corrective action if the holding company poses risk to the banks.

Our support for limits on bank-like regulation of holding companies, as I have noted, depends on banks becoming a less important component of the consolidated entity. Should permissible activities of bank holding companies remain unchanged -- and bank holding companies

remain predominantly in the banking business -- the Board would prefer to see the continuation of consolidated holding company supervision, regardless of the capital position of the subsidiary bank. In such a context, we would support the extension of the cross-guarantees to nonbank subsidiaries, as provided in the Riegle bill.

The Riegle bill does not address regulatory structure, while the Treasury bill makes the Board the primary regulator of state-chartered banks and a new federal agency the primary regulator of national banks and thrifts. Thus, both the Board and the Treasury believe that the Federal Reserve should have a significant role in the supervisory process.

The Board is convinced that the information flow obtained from the supervisory contact is of critical importance for the conduct of monetary policy and the maintenance of the stability of the financial system. In addition, the Board believes its supervisory policy benefits from the perspective of its responsibilities for macro-stabilization. Not only is it important that monetary and supervisory policies not work at cross-purposes, but I cannot emphasize enough how much we rely on the qualitative information we now obtain from bankers through our supervisory process to understand evolving developments in financial markets. We need a critical mass of coverage of banking markets to get an immediate sense of what lies

behind the data and, just as our responsibilities for macro stabilization bring a different prospective to our supervisory efforts, we use this feedback from the supervisory process both to help us develop our monetary policy and to evaluate its impact. For example, our understanding of the recent evolving problems with credit availability, the constrained flow of credit, and the impact on economic activity came importantly from our supervisory contact with banking organizations large and small.

Under the Treasury proposal, however, the Federal Reserve would have umbrella authority only over state-chartered banks, which tend to be significantly smaller, on average, than national banks. We believe our ability to accomplish our monetary policy objective successfully would be seriously damaged without the intimate contacts derived from our supervisory responsibilities relating to large banking organizations. This theme was echoed in the 1984 Bush Task Force report, which assigned umbrella supervision of large bank holding companies to the Federal Reserve, even if it did not regulate the lead bank. We believe that the Federal Reserve must have hands-on knowledge of the operations of those large banking organizations, where potential problems could have systemic effects, if we are to perform the critical function of ensuring stability in the financial markets and payments systems. For example, it is difficult to imagine how we would administer our discount

window responsibilities and the associated collateral evaluations without the practical experience and knowledge derived from our supervisory responsibilities at the larger institutions.

Moreover, with the increasing globalization of banking, in the coming years the central banks of the world will need more than ever to coordinate responses to developments that may originate anywhere and impact not only foreign exchange markets but also the financial markets of their respective countries. In a world of electronic transfers, in which billions of dollars, yen, marks, and sterling can be transferred in milliseconds, and problems at a bank or other institution in any country can put such transfers -- and hence market stability -- at risk, central bank consultation and coordination on operating details and procedures are critical. Thus, in our view, it is essential that the Federal Reserve -- in order to conduct its stabilization policies -- have intimate familiarity with all banking institutions having a substantial cross-border presence.

Foreign Bank Activities in the United States

The Treasury bill would require a foreign bank that desires to engage in newly authorized financial activities to establish a financial services holding company in the United States through which such activities would have to be conducted. The bill also would require any foreign bank

that chooses to engage in such activities in the United States to close its U.S. branches and agencies and to conduct all of its U.S. banking business through a U.S. subsidiary bank. Under the bill, foreign banks would lose their grandfather rights for U.S. securities affiliates after three years and would be required to obtain approval from appropriate authorities to engage in underwriting and dealing in securities activities in the United States in the same way that a U.S. banking organization would. The Treasury bill would also allow foreign banks to establish interstate branches at any locations permitted to state or national banks. Foreign banks choosing to engage only in banking in the United States would not be required to form U.S. subsidiary banks and would be permitted to operate interstate through branches of the foreign parent bank.

The capital and other supervisory standards that would be the basis for authorizing affiliates of foreign banks to engage in newly authorized financial activities and interstate banking are the same as would apply to affiliates of U.S. banks. Such a policy appears appropriate and equitable. On the other hand, we question the need for the requirement that foreign banks close their U.S. branches and agencies and conduct their U.S. business in a separately capitalized U.S. subsidiary bank in order to take advantage of the expanded powers for activities and branching.

As the Treasury bill recognizes in advocating domestic interstate branching, a requirement that a banking business be conducted through separately incorporated subsidiaries rather than branches imposes substantial costs by not permitting a banking organization to use its capital and managerial resources efficiently. In most countries, U.S. banks have been permitted to enjoy the advantages inherent in competing in foreign markets through branch offices. In bilateral and multilateral discussions, U.S. authorities have correctly argued that a restriction against branching discourages the involvement of U.S. banks in foreign markets. It would be inconsistent not to acknowledge that foreign banks could also be discouraged from involvement in U.S. banking markets by requiring foreign banks to operate only through subsidiaries in order to engage in new activities. Moreover, by compelling a switch from branches, whose deposits now are largely uninsured, to U.S. subsidiaries, whose deposits would be covered by U.S. deposit insurance, we would be increasing the extent to which depositors would look to the U.S. safety net instead of to the foreign parent in the event of problems.

Foreign banks have made a substantial contribution to the competitive environment of U.S. financial markets and the availability of credit to U.S. borrowers. Currently, legal lending limits for U.S. branches and agencies of

foreign banks are based on the consolidated capital of their parent banks. By contrast, requiring a "roll up" of branches and agencies of a foreign bank into a U.S. subsidiary bank, whose capital is measured separately from the parent, might limit the extent to which foreign banks contribute to the depth and efficiency of markets in the United States.

We also have some reservations about the purpose that would be served by requiring a foreign bank to establish a holding company in the United States to conduct new financial activities. In particular, requiring foreign banks to operate through holding companies is not necessary to assure competitive equity for U.S. financial services holding companies or independent U.S. nonbank firms. First, we see no clear competitive advantages to foreign banks when they can engage in new activities only if the banks are well-capitalized. Second, branches of foreign banks possess no systemic funding advantages in the United States, and any cost advantage a foreign bank may have in its *own* home market would be available regardless of the structure of its U.S. operations. The requirement that a foreign bank conduct new activities only through a financial services holding company imposes additional costs on foreign banks without any obvious benefits. It also creates an inducement for foreign banks to conduct their banking operations in less costly environments outside the United States and for

foreign authorities to threaten reciprocal restrictions for U.S. financial firms abroad.

Commerce and Banking

The Treasury has proposed permitting commercial and industrial firms to own financial service holding companies. The Treasury report that preceded its legislative proposals focused on the need to widen and deepen capital sources, especially for failing banks, for which nonfinancial corporations might be willing to provide substantial capital in exchange for control. The Treasury proposal also seeks fairness for those financial firms that operate in markets banks would be authorized to enter under the proposal, but that would otherwise be prohibited from purchasing a bank because of their commercial parents. The Treasury report also stressed the desirability of additional management expertise and strategic direction from commercial firms, as well as the reduction in regulatory burden in distinguishing between financial and nonfinancial activities.

Those who hold a contrary view argue that our capital markets are so well developed that profitable opportunities in banking can attract capital from sources other than nonfinancial corporations seeking management control, provided that banks operate in a regime that permits them to be fully competitive. In addition, opponents are concerned about the implications of permitting

commercial and industrial firms to own -- even indirectly -- subsidiaries with access to special government protection.

On balance, the Board supports on a philosophical level the notion of permitting any institution the right to go into any business -- including banking -- with the proper safeguards. However, the Board believes it would be prudent to delay enacting the authority to link commerce and banking until we have gained some actual experience with wider financial ownership of, and wider activities for, banking organizations. We should reflect carefully on such a basic change in our institutional framework because it is a step that would be difficult to reverse, and for which a strong case for immediate enactment has not been made.

The Board would have no difficulty with those nonbanking *financial* firms wishing to affiliate with banks maintaining their *de minimis* pre-existing holdings in commercial or industrial firms. But, if banking and commerce connections remain prohibited, financial firms already owned by commercial and industrial firms would likely point out the inequity of their being prohibited from affiliating with banks, while their independent rivals were free to do so. Given the relatively small number of securities firms, insurance companies, finance companies, and thrifts that are owned by commercial and industrial firms, the Congress may wish to address this issue through appropriate limited grandfather provisions.

Accounting Standards

Both bills address accounting standards in banking. Timely and accurate financial information on depository institutions is critical to the supervisory process and to effective market discipline. Thus, it is important that financial statements and reports of condition accurately represent the true economic condition of firms.

The Riegle bill contains a number of provisions intended to strengthen regulatory accounting standards for insured depository institutions. While the Board shares the basic view that any deficiencies in accounting practices should be corrected, we are concerned that certain contemplated reforms may be counter-productive. In particular, I am referring to the provisions requiring that regulatory accounting standards move in the direction of market-value accounting.

The Riegle bill would direct the SEC, in consultation with the banking agencies, to "facilitate" the development of regulatory accounting principles that promote effective supervision and "accurately reflect -- at market value, to the extent feasible -- the economic condition of insured depository institutions." This provision apparently is intended to stimulate the development of market valuation techniques, leading, eventually, to the adoption of market-based accounting standards for banks and thrifts. A related provision would mandate that banks with total assets of more

than $1 billion disclose the aggregate market value of their assets and liabilities in Reports of Condition.

The Board recognizes the potential value of accounting research directed at improving the measurement of assets and liabilities. However, we are skeptical whether such research can successfully resolve fundamental problems regarding the applicability of market value accounting to all banking organizations. Consequently, at this time we believe that it would be premature to commit, even in principle, to the adoption of market value accounting either in whole or in part for banking organizations.

Our concerns are both practical and conceptual. Because most assets and liabilities of banks are not traded actively, their market values would have to be estimated. Inherently, such estimates would be highly subjective. For valid reasons, the economic value of an asset or a liability might differ according to the identity of the holder, reflecting differences in individual risk preferences, tax situations, informational and operating costs, and other idiosyncratic factors. Indeed, the value added by banks is partly attributable to their comparative advantage relative to other investors in evaluating, originating, or servicing illiquid loans, based on proprietary information, operating efficiencies, or special monitoring capabilities.

Owing to this subjectivity, market value estimates would be difficult to verify by auditors and examiners and

susceptible to manipulation. Thus, the adoption of market value accounting principles for illiquid assets could worsen rather than enhance the quality of information about the true condition of depository institutions. Technologies that reduce the underlying subjectivity of market value estimates generally do so by imposing standardized assumptions that may not be appropriate in all situations and would precisely fit none.

Even when assets are traded in liquid markets, market values may not be the best measure of underlying value. A growing body of evidence suggests that asset prices display substantial short-run volatility or noise that is unrelated to economic fundamentals. Under market value accounting, such noise could discourage depository institutions from making fixed-rate loans, whose market values would be especially subject to price changes. Market value accounting also could lead to greater fluctuations in bank earnings that might generate instability in the supply of credit to the economy through its impact on the volatility of capital positions and on public confidence. The latter problem could arise even if market value information were disseminated through supplemental disclosures.

While the adoption of market value accounting for investment securities may be technically feasible at this time, the Board strongly recommends against such a partial

approach that would mark only part of the balance sheet to market. Such a partial approach could create substantial measurement distortions that artificially distort bank behavior. Depository institutions often use investment securities to hedge interest rate risk present in other areas of their balance sheet. Thus, were investment securities marked to market, offsetting gains or losses on other assets and liabilities generally would not be recognized, leading to inaccurate measures of the true net worth and riskiness of the institution. Banks and thrifts, therefore, might be discouraged by accounting treatment from undertaking hedging transactions that are in their best interest. In addition, the partial approach would tend to undermine incentives to acquire and hold long-term securities and might encourage a trading mentality that could increase the overall level of risk in the portfolio.

We believe that the agencies and the SEC could productively focus on the improvement in supplemental disclosure and support the provisions of the Treasury bill that call for such efforts. However, at present we believe that there is rather limited scope for expanding supplemental disclosures by banks of market value information. For a number of years, a supplemental schedule to the Report of Condition has shown both the current book value and market value of each type of security held by banks. While these market values have not been included in

reported capital and earnings, they are publicly disclosed. In addition, assets that are expected to turn over relatively quickly are carried at market value, in the case of trading accounts, or at the lower of cost or market value, in the case of debt securities, mortgages, and other loans held for sale. The Report of Condition requires separate disclosure of the amount of debt securities and loans held for sale, with the latter going beyond what is mandated under GAAP. Perhaps the only significant area where additional supplemental disclosures of market value information may be appropriate is residential mortgages that are not held for resale and mortgage servicing rights. The active secondary market for these assets and related mortgage-backed securities could be used as a basis for disclosure of their market value.

Much can be done to reduce divergences between accounting and economic measures of financial condition within the current GAAP framework. The most important priority should be to improve the reporting of loan loss reserves and disclosures about loan quality and asset concentrations. Financial analysts typically cite these areas, rather than the lack of market value information, as the most problematical under current accounting standards. In this regard, on March 1, the Federal banking and thrift agencies recommended voluntary disclosures about the cash flows and other characteristics of nonaccrual loans held by

banking and thrift organizations. In addition, the Report of Condition was recently revised to collect detailed data on the participation by banks in highly leveraged transactions. Nevertheless, further disaggregated disclosures about the characteristics of loans and borrowers, as would be required under S.543, may be appropriate. Such disclosures could exert constructive market discipline on depository institutions to ensure adequate provisioning for loan loss reserves.

I would also note that the banking agencies currently are working to develop more comprehensive and uniform standards for examining loan loss reserves. Together with an at least annual full-scope asset quality examination of every bank, these standards should enhance the reliability of estimates of the allowance for loan loss reserves and their comparability across institutions.

Conclusion

Mr. Chairman, the bills before you address critical issues of fundamental importance. The Board strongly supports the provisions of the Riegle and Treasury proposals to rein in the safety net by limiting deposit insurance coverage and implementing prompt corrective action procedures. We believe, however, that the Riegle bill should be extended to cover the proposals in the Treasury bill to expand the range of permissible activities for organizations with well-capitalized banking subsidiaries and

to rescind inefficient restrictions on interstate banking. These steps would significantly and prudently limit subsidies to banks, reduce incentives for excessive risk-taking, and safely remove constraints that have limited the ability of banks to deliver wider services at lower costs. All of these actions, including assured funding for BIF, are required if we are to have a healthy and strong banking system capable of financing economic growth and providing American households and businesses with low cost state-of-the-art financial services.

Despite the need to develop procedures to assure that BIF has adequate resources, the Board urges the Congress to address the issues broadly and to avoid only partial solutions by separating into component parts the comprehensive proposals for reform such as those suggested by the Treasury. Despite our concerns about some of its proposals, we strongly support the thrust of the Treasury's approach because it addresses the issues within a framework that attacks the major root causes of the problems in our banking system.

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GREENSPAN TESTIMONY
DRAFT #3: 4/15/91

I am pleased to appear before this Committee to discuss two important banking reform bills. The first, S.543, the Comprehensive Deposit Insurance Reform and Taxpayer Protection Act of 1991, was introduced by Chairman Riegle and by Senators Dodd and Wirth. The second, S.713, is the Treasury's proposed Financial Institutions Safety and Consumer Choice Act of 1991. These two bills have a significant degree of overlap and agreement about modifications to our deposit insurance system and our supervisory procedures.

Both bills propose similar reforms to reverse one of the fundamental causes of the problems facing our banking system today: an expansive safety net that creates incentives for our banks to take excessive risk with insufficient capital. The Treasury bill also addresses two other root causes of the present difficulties of the U.S. banking system: (1) the reduction in the value of the bank franchise associated with the ongoing technological revolution that has lowered the cost of financial transactions and expanded the scope of financial activities of bank rivals; and (2) a statutory and regulatory structure that impairs the competitiveness of U.S. banks by increasing their operating costs, discouraging geographic diversification, and limiting their ability to respond to

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financial innovations and the challenges posed by nonbank providers of financial services.

The coupling of the Riegle bill with the provisions of the Treasury bill on interstate branching and expanded activities for banking organizations would address these basic problems facing U.S. banks, and establish a particularly useful framework for congressional action. These broader reforms would make our banking system more efficient, better able to serve the public, and create an environment for a safe, sound, and profitable banking system.

Mr. Chairman, both bills contain a large number of detailed provisions. In the interests of both time and space, I have limited my comments to those portions of each bill that represent the core proposals relevant to basic reform, to those for which the Board may have a view contrary to others that you may have heard, and to those with which the Board has relatively strong reservations. I will, of course, respond to questions about those provisions on which I have not commented.

With so many provisions, it is not surprising that all members of the Board support a significant number of them, no member supports all of them, and a few provisions are opposed by some or all of us. Thus, when I say the Board supports or opposes any particular provision, I will be suggesting either a unanimous or majority position. In

this sense, I can say that the Board strongly supports both bills in their approach to deposit insurance and supervisory procedures, and similarly strongly supports the thrust of the Treasury bill to authorize new activities and interstate branching.

Deposit Insurance Reform

Both bills would rein in the safety net by limiting insurance coverage to $100,000 per individual per insured institution (plus $100,000 for retirement savings) and by eliminating coverage for all -- or in the case of S.543, most -- pass-through and brokered accounts. The Board supports the basic proposal to limit insurance coverage. We believe such a step would be consistent with the original intent of deposit insurance to protect the smaller-balance depositor.

It is worth noting that 1989 survey data suggest that only about 3-1/2 percent of households held accounts that, when combined for all household members, exceeded $100,000 at a single depository institution. However, 60 percent of these combined accounts were both less than $200,000 and held by households with two spouses, each of whom could, under the provisions of both bills, open fully insured accounts at the same institution. With this adjustment, only 1-1/2 percent of households would have held accounts with uninsured balances. These households had

median net worth in excess of $2 million, hardly a family for which the safety net was designed.

Some observers would prefer a rollback in coverage. If we were rewriting history, few now would call for insurance coverage of $100,000 per individual per institution. But, as I noted last summer before this Committee, such insurance levels are now capitalized in bank stock values, in loan and deposit rates, and in the technology and scale of bank operations. A rollback could thus create disruptions that may well exceed its benefits. However, drawing explicit limits and requiring the least costly method for resolving the financial problems of banks -- another common provision of both bills -- would bring additional discipline to bear on bank management and limit the taxpayer's exposure for the safety net guarantees.

The Treasury also proposes a study of longer-run efforts to limit coverage to $100,000 per individual across *all* institutions. The Board endorses the concept of a study in order to understand better the potential cost and intrusiveness of such a fundamental change in the scope of deposit insurance coverage.

Both bills would require the FDIC to establish a risk-based deposit premium assessment system. In principle, such a system has several attractive characteristics: it would link the cost of insurance to the risk that a bank poses to the insurance fund; it would reduce the subsidy to

risky banks; and it would spread the cost of insurance more fairly across depository institutions. It could also be coupled with risk-based capital, reducing the premium for those banks that held capital above minimum levels. Whatever these attractions might be in principle, the Board would urge caution at a time when premiums are already high, BIF resources are low, and the range of premiums necessary to reflect risk differences accurately, and induce genuine behavioral changes, might be much wider than feasible. Risk-based premiums also would have to be designed with some degree of complexity if they were to be fair, and if unintended incentives were to be avoided. Moreover, the extent of potential benefits when risk-based premiums are imposed on top of the risk-based capital system, while likely positive, require further evaluation.

[The Riegle bill incorporates a proposal of Senator Dixon that would permit the FDIC to rely more on private deposit insurers to establish premiums and to assume part of the liability for coverage. The Treasury bill proposes a demonstration project along the same lines. The Board believes there are significant practical and conceptual difficulties with private deposit insurance, and initiatives in this area should be taken with care. To be willing to participate, private insurers would likely require that all relevant supervisory information -- most of which is now confidential -- be shared with them. The provision of such

information would create a substantial potential for conflicts of interest. For while private insurers might be placed under obligation to use the information only to evaluate risk in providing depositor insurance, there would be an obvious opportunity to use the information for other purposes, such as deciding how to allocate their own portfolio assets. Moreover, with closure decisions presumably remaining in the hands of FDIC, the private insurers would likely adjust their premium upward to reflect the risk associated with the uncertainty regarding when the FDIC might close a troubled institution.

Private insurance and public responsibility unfortunately are not always compatible. It is clearly unreasonable to impose on private insurers any macro-stability responsibilities in their commercial underwriting of deposit insurance. Nonetheless, private insurers' withdrawal of coverage in a weakening economy, or their unwillingness to forebear in such circumstances, while understandable, would probably be counterproductive to broader national interests. Moreover, an inability of private insurers to meet their obligations would be disruptive at best and potentially necessitate a backstop role for the Treasury and taxpayers.]

Both bills require the FDIC to resolve failed banks in the least costly manner, which generally means no funds to cover uninsured deposits. The Riegle bill, however, has

no provision permitting consideration of systemic risks, and, after 1994, prohibits outright any financial assistance by the FDIC to an insured entity that would have the effect of preventing loss to uninsured depositors or creditors. To minimize the impact of a bank failure on other banks, this bill would require the Federal Reserve to develop and apply rules that limit interbank deposits and credits, including a prohibition on interbank deposits by banks not in capital compliance.

While the Board understands the desire to limit systemic risks through controlling interbank credit relationships, we believe that the Committee and the Congress should be sensitive to the substantial disruption that could occur in the correspondent bank network from such a proposal. We are particularly concerned with the inducement to rapid withdrawals that would be associated with the message that a bank, whose capital has declined to just below minimum levels, was suddenly prohibited from taking interbank deposits.

The Treasury's bill is silent on interbank deposits and credits. However, it calls for an exception to the least costly resolution of failed banks in those situations in which the Treasury and the Federal Reserve Board, on a case-by-case basis, jointly determine that there would be bona fide systemic risk. While depositors would be protected in such cases, it is important to emphasize that

stockholders and nondeposit creditors of these large insolvent banks and their holding companies would not be, and their senior management could be replaced. For the purpose of controlling systemic risk, it is only necessary to ensure that depositors retain confidence in the banking system, and for this purpose other claimants need not be protected.

Nevertheless, like you, Mr. Chairman, no one -- including the Federal Reserve Board -- is comfortable with the exception procedures for addressing systemic risk, even though the Treasury proposal would tighten up the way such cases are handled. While, in principle, systemic risk could develop if a number of smaller or regional banks were to fail, systemic risks are more likely to derive from the failure of one or more large institutions. Thus, the need to handle systemic risk has come to be associated with the too-big-to-fail doctrine. The disproportionate degree of systemic risk at larger banks highlights the tension between one of the main purposes of deposit insurance -- protecting smaller-balance depositors -- and the concern that the rapid withdrawals by uninsured depositors of weak larger banks could cause and spread significant disruptions that could, in turn, affect credit availability and macroeconomic stability. Whatever its macro benefits might be, too-big-to-fail has increasingly offended observers and policymakers alike because of its inequitable treatment of depositors and

borrowers at banks of different sizes, and its tendency both to broaden the safety net and to undermine depositor and creditor discipline on bank risk-taking. Despite the substantial concerns, the Board, like the Treasury, has reluctantly concluded that there may be circumstances in which all of the depositors of failing institutions will have to be protected in the interests of macroeconomic stability.

I would emphasize that other provisions of both bills should ultimately make this issue less relevant. The greater emphasis on capital maintenance, more frequent on-site examinations, and policies of prompt corrective action can be expected to modify bank behavior and attitudes toward risk-taking. Indeed, the ultimate solution to the too-big-to-fail problem is to ensure that our policies reduce the probability of large banks becoming weak, and that when banks experience distress that regulators act promptly to limit FDIC costs. But reality requires that we recognize that substantial increases in capital and substantial reversals of policies cannot occur in the short run. Moreover, it would be taking a significant risk, we believe, to eliminate the long-run option to respond in a flexible way to unexpected and unusual situations. The Federal Reserve alone cannot address this problem. We can add liquidity to the economy and we can direct liquidity to individual institutions as long as they remain solvent. But

we cannot, under the Federal Reserve Act, nor should we, provide either capital or liquidity to insolvent institutions.

Prompt Corrective Action

The centerpiece of both bills is a capital-based prompt corrective action mechanism, under which entities with capital ratios below certain standards would be placed under prompt and progressively greater pressure to limit their dividends and their growth. As the degree of undercapitalization increases, the supervisory pressure would intensify. The principal objective of prompt corrective action is to change the behavior of bank management by modifying its risk-benefit calculations through the establishment of a presumption that supervisors will take specified corrective action as capital deteriorates. Moreover, by acting promptly, it is possible for the franchise values of the going concern to be maintained and to avoid the rapid declines in value that normally occur for insolvent banks. For the same reason, at some low, but still positive, critical level of bank capital, the bank would be placed in conservatorship or receivership and the stockholders provided only with residual values, if any. If the bank could not be recapitalized, it would be sold, merged, or liquidated; larger banks might be reduced in size over time before sale or liquidation.

The Board strongly supports this approach and believes that it is an idea whose time has come for enactment. In this regard, we are struck by the many similarities between the specifics of the two bills. The Treasury proposal clearly draws heavily on the provisions of the earlier version of the Riegle bill. Our suggestions do not call for significant modifications, but we nonetheless urge their consideration.

In both bills it would be desirable, we believe, to make clear that supervisory standards other than capital may also be used to categorize depository institutions. Our supervisory experience and the economic research conducted at the Board and elsewhere strongly indicate that capital ratios *alone* do not always adequately differentiate between banks posing high and low risk to the deposit insurance system. Capital clearly is a key factor -- indeed the single most important factor -- indicating the financial condition and future performance and solvency of a bank. It should thus be the major determinant in prompt corrective action. Nonetheless, other information reflecting asset quality, liquidity, earnings, and risk concentrations is also relevant. Practical experience and research also suggest that judgmental information based on recent examinations, such as classified assets data, would enhance the accuracy and timeliness with which high-risk banks are identified. In short, the flexibility to use other

supervisory information is needed because circumstances can and do arise where other factors -- such as rapid growth or increasing concentration of assets -- are better indicators of a bank's current and future financial condition than its current GAAP capital ratio. A reduction in a bank's capital ratio requires that a close review for significant problems is required. But, we believe that it should be recognized that a system based on capital alone may sometimes be unacceptably tardy in its reaction time and, as a result, other variables should be considered as well.

These other indicators of the financial condition of a bank should not prevent categorization based on capital. They would, however, permit supervisors to act even if the criteria for bank capital were met. Indeed, we would suggest the proposed provisions for prompt corrective action be revised to indicate that supervisors could use other supervisory information to *downgrade* institutions relative to zones implied by capital alone. We believe this approach would greatly improve the overall effectiveness and fairness of a policy of prompt corrective action without jeopardizing the presumption that regulators would be required to act quickly, forcefully, and consistently in dealing with capital-impaired institutions. In our view, noncapital considerations should only be allowed to reduce the category that capital alone would call for, and never either to neutralize or raise the categorization of a bank

based on capital. The Treasury's proposal includes reference to unsafe and unsound conditions or operations in placing banks into lower zones, but more general language would, we believe, be useful.

Indeed, even with the supplemental authority provided by the Treasury and Riegle prompt corrective action proposals, the bank regulators must remain vigilant in detecting problems that do not immediately show up in capital ratios of banks, and must be aggressive in using existing enforcement authority to address these problems. Both bills would permit a systemic program of progressive restraint based on the capital of the institution, instead of requiring the regulator to determine on a case-by-case basis, as a precondition for remedial action, that an unsafe or unsound practice exists. This would provide a powerful and useful tool for addressing problems at banks, but would not replace the need for active supervision of other factors at banks.

The proposed Treasury legislation would permit expedited judicial review to ensure that the supervisor had not acted in an arbitrary and capricious way, but would allow the supervisory responses to go forward without delay while the court was reviewing the process of capital measurement. Such a procedure is a necessary precondition for the "prompt" in prompt corrective action, but should be modified to include the other supervisory standards referred

to above. We urge the incorporation of this concept in S.543.

The Riegle proposal has three categories of classification for prompt corrective action and the Treasury proposal has five. The Board prefers the larger number of categories because of the additional flexibility it provides. Both approaches require certain actions and permit supervisory discretion when deemed appropriate. In the Treasury approach, the number of required and the range of permissible actions expand as the capital ratio declines, but procedures are specified -- requiring explicit determination of public benefits -- that permit the supervisor to delay taking required actions. The Riegle approach permits no deviations from a small number of required actions, but has a wide range of permissible responses, a procedure that also provides flexibility to the supervisor. Both approaches thus blend flexibility with a mandate for prompt action. Both avoid inflexible, cookbook supervisory rules, while establishing a presumption of rapid supervisory action.

A final technical note. Both bills call for the regulators to establish the specific capital ratios for each zone or category. The Treasury bill requires the agencies to set the critical capital level -- which would call for putting the bank in conservatorship or receivership -- at a point that generally permits resolution of troubled

banks without significant financial loss to the FDIC. The Treasury bill provides that this measure may be no lower than 1.5 percent of the bank's assets. The Riegle bill indicates that the critical capital ratio should be set high enough that "with only rare exceptions" resolution would involve no cost to the FDIC. The Riegle bill does not set any minimum critical capital level itself.

The very act of placing a bank into receivership or conservatorship significantly lowers its franchise value, thereby increasing FDIC resolution costs. It is unreasonable to impose such a haircut on operating banks. In both bills, therefore, we would suggest that the criterion be to "minimize" resolution costs. It is worth emphasizing that prompt corrective action will tend to reduce losses to the insurance fund, but a genuine fail-safe, no-losses-to-the-FDIC policy would require unrealistically high capital levels. We also believe that it is appropriate for Congress to set a floor on the critical capital level that indicates that Congress recognizes the positive subsidy resulting from the federal safety net.

Bank Insurance Fund (BIF) Recapitalization

The Treasury proposal would authorize the Federal Reserve Banks to lend up to $25 billion to the FDIC to absorb losses sustained by the BIF in resolving failed banks. While the liabilities of the BIF would be full faith

and credit obligations of the U.S. Treasury, it is anticipated that they would be repaid from increased insurance premiums. Premiums could be increased to as high as 30 cents per $100 of assessed deposits -- 7 cents higher than the premium the FDIC has proposed to impose at midyear. In addition, the BIF could borrow from other sources up to $45 billion for "working-capital" purposes, i.e., to carry assets of failed banks pending their sale or liquidation. These loans would thus be self-liquidating. Total premium income would be used to pay interest on borrowings from the Federal Reserve and the Federal Financing Bank, cover BIF fund losses, repay Federal Reserve loans, and rebuild the BIF fund.

In the current environment of intense competition and weak earnings, the Board is concerned about the potential costs of further premium increases in terms of the soundness and competitiveness of our banking, financial, and economic system. No one can be certain how high the premium could be raised before the costs outweigh the benefits in terms of added revenues for BIF. What is clear is that in reaching a judgment about the appropriate premium level we cannot ignore these potential costs simply because they cannot easily be measured. The premium level that maximizes BIF's premium revenues, or even the premium level that maximizes the net worth of BIF, could be substantially higher than the level that would be optimal if the potential

adverse impact of higher premiums on our financial system and our economy could be precisely quantified. [In light of these considerations, the Board supports the imposition of a 30 basis point premium cap, and urges caution in considering increases in premium costs beyond an amount equal to a 23 basis point on the current base.]

Irrespective of the premium rate, the Board has some difficulty understanding the value and purpose of using the Federal Reserve Banks as financial intermediaries in funding BIF losses. The implications for the financial markets, for the economy, and for budget scoring all would be the same whether the Treasury -- or the Federal Financing Bank -- directly financed the BIF, rather than the Reserve Banks. In both cases, the public must absorb more Treasury securities, since, for monetary policy purposes, the Federal Reserve would have to offset the impact on reserves of its BIF note purchases by selling Treasury securities from its portfolio. Recorded FDIC outlays, net interest payments of the U.S. government, the measured deficit, and the level of interest rates would all be the same regardless of whether the Reserve Banks are, or are not, used as intermediaries in this process. The only difference between the two approaches is that the Federal Reserve portfolio becomes more illiquid if the Federal Reserve Banks are participants, perhaps causing some changes in perceptions around the world

about the ability of the U.S. central bank to achieve its policy objectives.

Mr. Chairman, the BIF fund needs to be either recapitalized or to have unquestioned access to resources to meet its obligations, obligations that have cumulated from decisions and policies of the past that cannot be shirked. We should be careful, however, that we are not misleading ourselves into thinking that anything is being accomplished by using Reserve Banks in the process. The financing mechanism does not change the nature of the financial flows required and, under present law, cannot change the impact on the measured federal deficit.

The losses to BIF that have already occurred or will be booked in the period immediately ahead reflect credit decisions and portfolio and funding choices already made by banks. They cannot be changed. Regardless of the current or anticipated state of the deposit insurance fund, [the Congress in 1987 reaffirmed, in the Competitive Equality Banking Act, that the deposit insurance guarantee is backed by] the full faith and credit of the U.S. government [up to] [will back] the statutory $100,000 limit on federal deposit insurance. And, it is imperative that whatever decision the Congress reaches on the funding mechanism must credibly eliminate any vestigial uncertainty about how the funding will be arranged and its costs allocated. These issues need to be resolved, and the

publicity surrounding them eliminated, so that depositors can be confident that the government's guarantee will be implemented, and banks -- and the suppliers of capital -- will be able rationally to plan the costs and profit opportunities in banking.

However the costs incurred in the past and the immediate future are allocated, what is fundamental is that we must adopt policies now to minimize the risk that such losses to the insurance fund will ever occur again. The Board believes that both the Riegle and Treasury bills establish an approach that would accomplish that objective through prompt corrective action. But the Riegle bill does not address other issues that would strengthen banking organizations, issues that I would now like to discuss.

Expanded Activities and Interstate Branching

The Treasury proposal does not call for an increase in the minimum international capital standards that would be fully phased-in by the end of next year. The Board still believes that a significant part of the longer-run solution to the subsidy provided by the safety net is an increase in minimum capital standards, but it understands the shorter-run restoration process that must precede it. In the interim, the Board supports the Treasury proposal that would immediately reward those financial services holding companies with bank subsidiaries that have capital significantly above the minimum standards. Not only does

such an approach create additional inducements for these organizations to build and maintain the banks' capital, it also addresses one of the most significant causes of weaknesses in the banking system by widening the scope of activities for holding companies with well-capitalized bank subsidiaries.

It is clear that some members of Congress are hesitant about authorizing wider activities for banking organizations at a time when taxpayers are being asked to pick up the costs for failed S&Ls that have unsuccessfully taken too much risk, and when BIF recapitalization proposals raise the concern that taxpayer assistance for resolution costs of banks may also be necessary. Such hesitancy is understandable. However, two crucial differences exist between the expanded bank activities proposed by the Treasury and those previously allowed for S&Ls: the types of activities in which the institutions could engage, and the types of institutions that would be allowed to engage in the activities.

The wider activities proposed by the Treasury are all financial in nature; they involve the types of risk with which bankers are familiar, letting them build on their expertise. Thus, for example, the bill would not permit financial services holding companies to engage in real estate development or other nonfinancial activities. It is worth repeating that the new activities that would be

authorized would be restricted to holding companies with well-capitalized and soundly operated bank subsidiaries. They are to be conducted in separately capitalized affiliates that would have limited access to bank funds; and they must be divested if the capital of the affiliated banks does not remain significantly above the minimum international capital standards. The proposal does not repeat the thrift experience of authorizing *all* institutions -- strong and weak -- to engage in new activities in the depository, financed by insured deposits. The proposed approach is unlikely to expose the safety net to additional risk because it does not reflect a wholesale removal of restraints. Based on their current capital positions, only about one-fourth of the largest 25, and about one-half of the largest 50, of our banking organizations would be permitted to engage in such activities if they were authorized today. Almost all of the next 50 largest bank holding companies have bank subsidiaries with capital high enough to permit the holding company to engage in these new activities.

The best protection for the insurance fund is to be certain that we have strong banking organizations. Authorizing wider activities for holding companies with well-capitalized bank subsidiaries would increase the efficiency of our financial system by permitting such organizations to respond more flexibly to the new

competitive environment in banking here and abroad. It also would add to the incentives for increasing and maintaining bank capital, and it would make available better and cheaper services to customers of U.S. banks around the world.

Similar benefits involving even more banks and a larger proportion of the public would result from widening the geographic scope of bank activity. The Riegle bill excludes and the Treasury bill includes such provisions. The Treasury proposal would repeal the Douglas Amendment to the Bank Holding Company Act, to permit banking companies to operate subsidiary *banks* in all states, and would amend the McFadden Act, to permit banks to operate *branches* of their banks in all states. The bill would thus eliminate an anachronism and permit full interstate banking by any vehicle that a banking organization chooses.

An interstate banking system has slowly evolved in this country through the holding company vehicle. Only Hawaii and Montana do not now have on the books legislation that permits -- or is scheduled to permit -- some form of interstate banking. But this approach, with separately capitalized bank subsidiaries, and with less than full nationwide banking authorized, still does not permit some banking organizations to enter some attractive markets and, most important, is unduly costly. True nationwide interstate branching would be much more flexible and efficient, achieving geographic diversification at lower

cost. Simply by collapsing existing subsidiaries to branches, banks could eliminate the unnecessary costs of separate boards and extra management layers, as well as the costs of separately capitalizing each subsidiary. Authorization of interstate bank branching is, in effect, both a more efficient use of capital and a capital-building step by reducing banking costs.

The evidence from intrastate branching does not suggest it will be a substantial source of additional earnings to out-of-market banks. What interstate banking promises is wider consumer choices at better prices and, for our banking system, increased competition and efficiency, the elimination of unnecessary costs associated with the delivery of banking services, and risk reduction through diversification. The Board continues to urge its prompt adoption.

Regulation and Examination

The holding company form is retained in the Treasury proposal as the best organizational vehicle for financial modernization. Under the Treasury proposal, each holding company subsidiary -- bank and nonbank -- would be separately capitalized and functionally regulated as if it were an independent entity: bank regulatory agencies would regulate banks, the SEC would regulate broker/dealers and mutual funds, and the states would regulate insurance companies.

In order to restrict the safety net to the insured bank, the proposal would apply Sections 23A and 23B of the Federal Reserve Act, which limits quantitatively the financial transactions between banks and their affiliates, and requires that such transactions be collateralized and conducted on market terms. However, to achieve the synergies that are the purpose of the proposal, the bill would not impose management, operations, or general marketing firewalls, though strong disclosure requirements would be required to protect the consumer. Among the firewalls that would remain are restrictions on sales of affiliate liabilities at the bank, where they might be confused with insured deposits.

In the Treasury bill, the primary regulator of the largest bank subsidiary would become the umbrella supervisor of the financial services holding company. The Treasury bill contemplates that, with expanded permissible activities, the insured banking units would account for a significantly smaller proportion of the consolidated assets of the financial services holding company than they are now of the bank holding company. As a result, the focus of the umbrella supervisor in the Treasury bill is to police and constrain threats to the bank, while limiting bank-like regulation of the holding company and its uninsured subsidiaries. The Riegle bill, in contrast, does not expand the scope of activities of banking organizations and thus

retains the current bank-like regulatory focus on the consolidated holding company, whose assets are predominantly banks and subsidiaries whose activities are closely related to banking.

[In their respective context, each of these approaches makes sense to the Board because they link regulation to the type of activity. Since the Board strongly supports a wider range of activities for banking organizations, we would also support the regulatory approach of the Treasury bill if such activities are authorized.] Under [that] [the Treasury bill's] approach, the umbrella supervisor's authority over the uninsured affiliates of well-capitalized banks would be limited. However, the umbrella supervisor would police financial transactions between the bank and its affiliates, could assess the risks to the bank posed by the activities of its nonbank affiliates, and could require divestiture of a nonbank affiliate posing a threat to the bank. In order to assure that the bank is protected, the Board believes some minor modification in the language of the Treasury bill are necessary to make clear and explicit that the umbrella supervisor could examine the parent anytime it wishes to assure that it is not creating risk for the bank. Clarity is also necessary to assure that, while the umbrella supervisor would not, as a matter of course, examine the nonbank affiliates on a regular basis, the umbrella

supervisor would be permitted to examine nonbank affiliates whenever the supervisor believed the affiliate posed a risk to the banks, even when the banks' capital were above minimum levels; otherwise the supervisor's divestiture authority would be less meaningful. In addition, it should be clarified that the supervisor would have full examination powers over the consolidated entity when the banks' capital declined below minimum levels. Balancing protection of the bank and limits on the spreading of the safety net with minimal regulation of nonbank affiliates requires careful legislative language.

[All of these clarifications are necessary to ensure that the umbrella supervisor would be able to act promptly and effectively to protect the bank. But the trust of the modified provisions would still be to limit the bank-like regulation of the holding company and its uninsured subsidiaries, provided the bank affiliates are well capitalized. For example, the traditional consolidated bank holding company capital regulation would not be imposed, under the bill, as long as its insured depository subsidiaries were themselves capitalized above minimum levels. There are several reasons for this approach: it recognizes the practical infeasibility of regulators determining what the appropriate minimum capital should be for an organization that is not primarily a banking organization but rather a true financial services company;

it facilitates equitable treatment between holding company subsidiaries and independent firms; it avoids the inefficiencies of regulation; it creates an additional incentive to build and maintain a strong *bank* capital position; and it avoids even the appearance of extending the safety net.

It certainly is true that this would permit holding companies to rely without regulatory limit on debt markets to finance equity contributions to their bank and nonbank subsidiaries -- so-called double leverage. However, prompt corrective action would limit dividends and other payments that bank subsidiaries could make to their parent should the banks' capital decline. Such restrictions on dividends, as well as the strict limitation of the safety net protection only to the banks, are likely to make financial markets cautious about the quantity of debt it permits financial services holding companies to assume. Moreover, with the appropriate examination authority, the supervisor could take remedial corrective action if the holding company poses risk to the banks.]

It is worth underlining that if the capital of the banks falls and remains below minimum standards, the Treasury proposal calls for the imposition of bank capital standards on, and the application of many of the regulations governing prompt corrective action for banks to, the holding company on a consolidated basis. This approach is designed

to reinforce the protection of the banks from contagion by its parent or affiliates.

Should permissible activities of bank holding companies remain unchanged -- and bank holding companies remain predominantly in the banking business -- all of us at the Board would prefer to see the continuation of consolidated holding company supervision, regardless of the capital position of the subsidiary bank. In such a context, we would support the extension of the cross-guarantees to nonbank subsidiaries, as provided in the Riegle bill.

The Riegle bill does not address regulatory structure, while the Treasury bill makes the Board the primary regulator of state-chartered banks and a new federal agency the primary regulator of national banks and thrifts. Thus, both the Board and the Treasury believe that the Federal Reserve should have a significant role in the supervisory process.

The Board is convinced that the information flow obtained from the supervisory contact is of critical importance for the conduct of monetary policy and the maintenance of the stability of the financial system. In addition, the Board believes its supervisory policy benefits from the perspective of its responsibilities for macro-stabilization. Not only is it important that monetary and supervisory policies not work at cross-purposes, but I cannot emphasize enough how much we rely on the qualitative

information we now obtain from bankers through our supervisory process to understand evolving developments in financial markets. We need a critical mass of coverage of banking markets to get an immediate sense of what lies behind the data and, just as our responsibilities for macro stabilization bring a different prospective to our supervisory efforts, we use this feedback from the supervisory process both to help us develop our monetary policy and to evaluate its impact. For example, our understanding of the recent evolving problems with credit availability, the constrained flow of credit, and the impact on economic activity came importantly from our supervisory contact with banking organizations large and small.

Under the Treasury proposal, however, the Federal Reserve would have umbrella authority only over state-chartered banks, which tend to be significantly smaller, on average, than national banks. We believe our ability to accomplish our monetary policy objective successfully would be seriously damaged without the intimate contacts derived from our supervisory responsibilities relating to large banking organizations. This theme was echoed in the 1984 Bush Task Force report, which assigned umbrella supervision of large bank holding companies to the Federal Reserve, even if it did not regulate the lead bank. We believe that the Federal Reserve must have hands-on knowledge of the operations of those large banking organizations where

potential problems could have systemic effects if we are to perform the critical function of ensuring stability in the financial markets and payments systems. For example, it is difficult to imagine how we would administer our discount window responsibilities and the associated collateral evaluations without the practical experience and knowledge derived from our supervisory responsibilities at the larger institutions.

Moreover, with the increasing globalization of banking, in the coming years the central banks of the world will need more than ever to coordinate responses to developments that may originate anywhere and impact not only foreign exchange markets but also the payments system and financial markets of the United States. Thus, in our view, it is essential that the Federal Reserve -- in order to conduct its stabilization policies -- have intimate familiarity with all banking institutions having a substantial cross-border presence.

Both the Bush Task Force and the current Treasury proposal have noted the needless complexity for banking organizations that now have an umbrella supervisor for holding companies that is often different from the primary bank regulator of the bank subsidiaries. Thus, both would make the umbrella supervisor the same agency as the primary regulator of the largest bank in the holding company. Both nevertheless would still permit different regulators of

different parts of the same banking organization if there were state and federally chartered bank subsidiaries of multibank holding companies.

The Board sees no relevance in charter class for the economic issues related to regulation. It is difficult to understand why two similar banks -- be they small banks in a rural community or global giants in New York City -- should be subject to different regulators solely because of the level of government that granted their charter. The Board, thus, urges that, if the regulatory structure is modified, each banking organization should have the same regulator of the holding company and *all* of its bank subsidiaries, regardless of charter class.

Foreign Bank Activities in the United States

The Treasury bill would require a foreign bank that desires to engage in newly authorized financial activities to establish a financial services holding company in the United States through which such activities would have to be conducted. The bill also would require any foreign bank that chooses to engage in such activities in the United States to close its U.S. branches and agencies and to conduct all of its U.S. banking business through a U.S. subsidiary bank. Under the bill, foreign banks would lose their grandfather rights for U.S. securities affiliates after three years and would be required to obtain approval from appropriate authorities to engage in underwriting and

dealing in securities activities in the United States in the same way that a U.S. banking organization would. The Treasury bill would also allow foreign banks to establish interstate branches at any locations permitted to state or national banks. Foreign banks choosing to engage only in banking in the United States would not be required to form U.S. subsidiary banks and would be permitted to operate interstate through branches of the foreign parent bank.

The capital and other supervisory standards that would be the basis for authorizing affiliates of foreign banks to engage in newly authorized financial activities and interstate banking are the same as would apply to affiliates of U.S. banks. Such a policy appears appropriate and equitable. On the other hand, we question the need for the requirement that foreign banks close their U.S. branches and agencies and conduct their U.S. business in a separately capitalized U.S. subsidiary bank in order to take advantage of the expanded powers for activities and branching.

As the Treasury bill recognizes in advocating domestic interstate branching, a requirement that a banking business be conducted through separately incorporated subsidiaries rather than branches imposes substantial costs by not permitting a banking organization to use its capital and managerial resources efficiently. In most countries, U.S. banks have been permitted to enjoy the advantages inherent in competing in foreign markets through branch

offices. In bilateral and multilateral discussions, U.S. authorities have correctly argued that a restriction against branching discourages the involvement of U.S. banks in foreign markets. It would be inconsistent not to acknowledge that foreign banks could also be discouraged from involvement in U.S. banking markets by requiring foreign banks to operate only through subsidiaries in order to engage in new activities. Moreover, by compelling a switch from branches, whose deposits now are largely uninsured, to U.S. subsidiaries, whose deposits would be covered by U.S. deposit insurance, we would be increasing the extent to which depositors would look to the U.S. safety net instead of to the the foreign parent in the event of problems.

Foreign banks have made a substantial contribution to the competitive environment of U.S. financial markets and the availability of credit to U.S. borrowers. Currently, legal lending limits for U.S. branches and agencies of foreign banks are based on the consolidated capital of their parent banks. By contrast, requiring a "roll up" of branches and agencies of a foreign bank into a U.S. subsidiary bank, whose capital is measured separately from the parent, might limit the extent to which foreign banks contribute to the depth and efficiency of markets in the United States.

We also have some reservations about the purpose that would be served by requiring a foreign bank to establish a holding company in the United States to conduct new financial activities. In particular, requiring foreign banks to operate through holding companies is not necessary to assure competitive equity for U.S. financial services holding companies or independent U.S. nonbank firms. First, we see no clear competitive advantages to foreign banks when they can engage in new activities only if the banks are well-capitalized. Second, branches of foreign banks possess no systemic funding advantages in the United States, and any cost advantage a foreign bank may have in its own home market would be available regardless of the structure of its U.S. operations. The requirement that a foreign bank conduct new activities only through a financial services holding company imposes additional costs on foreign banks without any obvious benefits. It also creates an inducement for foreign banks to conduct their banking operations in less costly environments outside the United States and for foreign authorities to threaten reciprocal restrictions for U.S. financial firms abroad.

Commerce and Banking

The Treasury has proposed permitting commercial and industrial firms to own financial service holding companies. The Treasury report that preceded its legislative proposals focused on the need to widen and deepen capital sources,

especially for failing banks, for which nonfinancial corporations might be willing to provide substantial capital in exchange for control. The Treasury proposal also seeks fairness for those financial firms that operate in markets banks would be authorized to enter under the proposal, but that would otherwise be prohibited from purchasing a bank because of their commercial parents. The Treasury report also stressed the desirability of additional management expertise and strategic direction from commercial firms, as well as the reduction in regulatory burden in distinguishing between financial and nonfinancial activities.

Those that hold a contrary view argue that our capital markets are so well developed that profitable opportunities in banking can attract capital from sources other than nonfinancial corporations seeking management control, provided that banks operate in a regime that permits them to be fully competitive. In addition, opponents are concerned about the implications of permitting commercial and industrial firms to own -- even indirectly -- subsidiaries with access to special government protection.

[On balance, the Board supports on a philosophical level the notion of permitting any institution the right to go into any business -- including banking -- with the proper safeguards. However], the Board believes it would be prudent to delay enacting the authority to link commerce and banking until we have gained some actual experience with

wider financial ownership of, and wider activities for, banking organizations. We should reflect carefully on such a basic change in our institutional framework because it is a step that would be diffficult to reverse, and for which a strong case for immediate enactment has not been made.

The Board would have no difficulty with those nonbanking *financial* firms wishing to affiliate with banks maintaining their *de minimis* pre-existing holdings in commercial or industrial firms. But, if banking and commerce connections remain prohibited, financial firms already owned by commercial and industrial firms would likely point out the inequity of their being prohibited from affiliating with banks, while their independent rivals were free to do so. Given the relatively small number of securities firms, insurance companies, finance companies, and thrifts that are owned by commercial and industrial firms, the Congress may wish to consider grandfathering these entities for a time, permitting them limited entry into banking through their financial affiliates as a controlled experiment, after which Congress could review the issue.

Accounting Standards

Both bills address accounting standards in banking. Timely and accurate financial information on depository institutions is critical to the supervisory process and to effective market discipline. Thus, it is important that

financial statements and reports of condition accurately represent the true economic condition of firms.

The Riegle bill contains a number of provisions intended to strengthen regulatory accounting standards for insured depository institutions. While the Board shares the basic view that any deficiencies in accounting practices should be corrected, we are concerned that certain contemplated reforms may be premature and counter-productive. In particular, I am referring to the provisions requiring that regulatory accounting standards move in the direction of market-value accounting.

The Riegle bill would direct the SEC, in consultation with the banking agencies, to "facilitate" the development of regulatory accounting principles that promote effective supervision and "accurately reflect -- at market value, to the extent feasible -- the economic condition of insured depository institutions." This provision apparently is intended to stimulate the development of market valuation techniques, leading, eventually, to the adoption of market-based accounting standards for banks and thrifts. A related provision would mandate that banks with total assets of more than $1 billion disclose the aggregate market value of their assets and liabilities in Reports of Condition.

The Board recognizes the potential value of accounting research directed at improving the measurement of assets and liabilities. However, we are skeptical whether

such research can successfully resolve fundamental problems regarding the applicability of market value accounting to all banking organizations. Consequently, at this time we believe that it would be premature to commit, even in principle, to the adoption of market value accounting either in whole or in part for banking organizations.

Our concerns are both practical and conceptual. Because most assets and liabilities of banks are not traded actively, their market values would have to be estimated. Inherently, such estimates would be highly subjective. For valid reasons, the economic value of an asset or a liability might differ according to the identity of the holder, reflecting differences in individual risk preferences, tax situations, informational and operating costs, and other idiosyncratic factors. Indeed, the value added by banks is partly attributable to their comparative advantage relative to other investors in evaluating, originating, or servicing illiquid loans, based on proprietary information, operating efficiencies, or special monitoring capabilities.

Owing to this subjectivity, market value estimates would be difficult to verify by auditors and examiners and susceptible to manipulation. Thus, the adoption of market value accounting principles for illiquid assets could worsen rather than enhance the quality of information about the true condition of depository institutions. Technologies that reduce the underlying subjectivity of market value

estimates generally do so by imposing standardized assumptions that may not be appropriate in all circumstances.

Even when assets are traded in liquid markets, market values may not be the best measure of underlying value. A growing body of evidence suggests that asset prices display substantial short-run volatility or noise that is unrelated to economic fundamentals. Under market value accounting, such noise could generate instability in the supply of credit to the economy through its impact on the volatility of capital positions and on public confidence. The latter problem could arise even if market value information were disseminated through supplemental disclosures.

While the adoption of market value accounting for investment securities may be technically feasible at this time, the Board strongly recommends against such a partial approach. By exempting from market value accounting major categories of assets and liabilities, this action could create substantial measurement distortions that could artificially distort bank behavior. Depository institutions often use investment securities to hedge interest rate risk present in other areas of their balance sheet. Thus, were investment securities marked to market, offsetting gains or losses on other assets and liabilities generally would not be recognized, leading to inaccurate measures of the true

net worth and riskiness of the institution. Banks and thrifts, therefore, might be discouraged by accounting treatment from undertaking hedging transactions that are in their best interest.

We believe that the agencies and the SEC could productively focus on the improvement in supplemental disclosure and support the provisions of the Treasury bill that call for such efforts. However, at present we believe that there is rather limited scope for expanding supplemental disclosures by banks of market value information. For a number of years, a supplemental schedule to the Report of Condition has shown both the current book value and market value of each type of security held by banks. While these market values have not been included in reported capital and earnings, they are publicly disclosed. In addition, assets that are expected to turn over relatively quickly are carried at market value, in the case of trading accounts, or at the lower of cost or market value, in the case of debt securities, mortgages, and other loans held for sale. The Report of Condition requires separate disclosure of the amount of debt securities and loans held for sale, with the latter going beyond what is mandated under GAAP. Perhaps the only significant area where additional supplemental disclosures of market value information may be appropriate is residential mortgages that are not held for resale and mortgage servicing rights. The

active secondary market for these assets and related mortgage-backed securities could be used as a basis for disclosure of their market value.

Much can be done to reduce divergences between accounting and economic measures of financial condition within the current GAAP framework. The most important priority should be to improve the reporting of loan loss reserves and disclosures about loan quality and asset concentrations. Financial analysts typically cite these areas, rather than the lack of market value information, as the most problematical under current accounting standards. In this regard, on March 1, the Federal banking and thrift agencies recommended voluntary disclosures about the cash flows and other characteristics of nonaccrual loans held by banking and thrift organizations. In addition, the Report of Condition was recently revised to collect detailed data on the participation by banks in highly leveraged transactions. Nevertheless, further disaggregated disclosures about the characteristics of loans and borrowers, as would be required under S.543, may be appropriate. Such disclosures could exert constructive market discipline on depository institutions to ensure adequate provisioning for loan loss reserves.

I would also note that the banking agencies currently are working to develop more comprehensive and uniform standards for examining loan loss reserves.

Together with an at least annual full-scope asset quality examination of every bank, these standards should enhance the reliability of estimates of the allowance for loan loss reserves and their comparability across institutions.

Conclusion

Mr. Chairman, the bills before you address critical issues of fundamental importance. The Board strongly supports the provisions of the Riegle and Treasury proposals to rein in the safety net by limiting deposit insurance coverage and implementing prompt corrective action procedures. We believe, however, that the Riegle bill should be extended to cover the proposals in the Treasury bill to expand the range of permissible activities for organizations with well-capitalized banking subsidiaries and to rescind inefficient restrictions on interstate banking. These steps would significantly and prudently limit subsidies to banks, reduce incentives for excessive risk-taking, and safely remove constraints that have limited the ability of banks to deliver wider services at lower costs. All of these actions, including assured funding for BIF, are required if we are to have a healthy and strong banking system capable of financing economic growth and providing American households and businesses with low cost state-of-the-art financial services. Despite the pressing need to assess BIF-funding questions, the Board urges the Congress to address the issues broadly and to avoid only partial

solutions by separating the components of the broad proposals for reform such as those suggested by the Treasury.

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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

March 29, 1991

ALAN GREENSPAN
CHAIRMAN

The Honorable Donald W. Riegle, Jr.
Chairman
Committee on Banking, Housing, and
Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

Thank you for your letter of March 18, inviting me to testify before the Senate Banking Committee at a hearing on current banking legislation, including deposit insurance reform, recapitalizing the Bank Insurance Fund, regulatory restructuring, interstate banking, and permitting banks to be affiliated with other financial companies or with commercial companies.

I will be pleased to appear before the Committee on Tuesday, April 23, 1991, at 10:00 a.m.

Sincerely,

For Files
S. Russell

DONALD W. RIEGLE, JR., MICHIGAN, CHAIRMAN
ALAN CRANSTON, CALIFORNIA
PAUL S. SARBANES, MARYLAND
CHRISTOPHER J. DODD, CONNECTICUT
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United States Senate
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
WASHINGTON, DC 20510-6075

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Chairman Alan Greenspan
Chairman, Board of Governors
of the Federal Reserve System
Federal Reserve Board
20th and C. Streets, N.W.
Washington, D.C. 20551

March 18, 1991

Dear Chairman Greenspan:

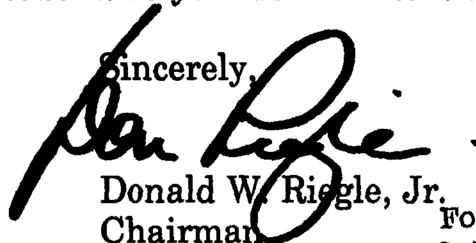
Thank you for agreeing to testify at the Committee's April 23 hearing on current banking legislation, including S. 543 and the Administration's proposal. We would appreciate hearing your views on deposit insurance reform, recapitalizing the Bank Insurance Fund, regulatory restructuring, interstate banking, and permitting banks to be affiliated with other financial companies or with commercial companies.

The hearing will be held in Room 538 of the Dirksen Building, beginning at 10:00 a.m.

The Committee's rules require you to deliver at least 150 copies of your written statement to Room 534 of the Dirksen Building at least 24 hours before the hearing. You should also submit a brief summary of your statement. Early submission of your statement and the summary will enable Committee Members and staff to review your statement before the hearing.

Your full written statement will be included in the record. If you have any questions about the hearing, please have your staff contact Richard S. Carnell (224-5787).

Sincerely,



Donald W. Riegle, Jr.
Chairman

For Files
S. Russell

Chairman Gr

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date March 1, 1991

To Board of Governors

Subject: Testimony on Treasury Reform Proposals

From Ed Ettin

While we do not yet have a date, Chairman Greenspan is expected to be asked to testify in a week or two on the Treasury proposals. Attached is a draft of that testimony on which I would appreciate your comments. Among other things, your views on inclusion or exclusion of bracketed material and the options on pages 14-18 would be appreciated. The last two pages provide--for the Board's information--some statistics on various regulatory proposals.

Could you please send your comments to me by close of business Monday. Thanks.

Attachment

Similar testimony subsequently requested by the Senate (rather than House) Banking Committee. Testimony was redrafted and referred to 4/17/91 Board agenda.

DRAFT #5: 3/1/91
ETTIN/KWAST

Testimony
Chairman Alan Greenspan
before the
Financial Institutions Subcommittee
of the House Committee on Banking
March ?, 1991

[NOTE: BRACKETED MATERIAL OPTIONAL]

I am pleased to appear before this subcommittee today to discuss the wide ranging proposals of the U.S. Treasury for modifications to our nation's deposit insurance system, to the structure and regulation of the banking system, and to that system's scope for delivering financial services to the public. The Congress showed great wisdom in asking for the study that led to these proposals. The Board hopes that the Congress will now consider these and the other proposals before it and proceed promptly to enact legislation to ensure a strong, safe, flexible, and competitive banking system to take us into the 21st century.

Discussions of these reform proposals might best be conducted within a framework that focuses on the fundamental causes of the problems that face our banking system. In brief, they are (1) an expansive safety net that induces our banks to take excessive risk with insufficient capital; (2) a technological revolution that has lowered the cost of financial transactions and expanded the scope of financial activities of bank rivals, undermining the economic value of the bank franchise; and (3) a regulatory structure that

impairs the competitiveness of U.S. banks by increasing their operating costs, discouraging geographic diversification, and limiting their ability to respond to financial innovations and the challenges posed by nonbank providers of financial services. Despite these factors, the vast majority of our banks remain strong, safe, profitable, and well capitalized. Nevertheless, too many of them are under considerable stress, and the positions of the others are likely to erode over time unless the underlying causes are addressed. The Treasury proposals, the Board believes, are a useful road map for the Congress to follow in developing reforms, and we strongly support their thrust, with certain reservations I'll note later.

An important Treasury recommendation is the reining in of the safety net. Expanding deposit insurance has been among the major factors underlying the willingness of depositors to allow banks to operate with lower capital ratios. At the same time, they have induced banks to take portfolio risks that the market would not have permitted without the government guarantee of bank deposits. The Board concurs with the Treasury proposal to limit individual coverage to $100,000 per insured institution (plus $100,000 for retirement savings), and to eliminate coverage for brokered and pass-through accounts. These would be appropriate steps that are consistent with the original

intent of deposit insurance to protect the unsophisticated depositor.

Some observers would prefer a rollback in coverage. If we were writing on a blank sheet of paper, few now would call for insurance coverage of $100,000 per individual per institution. But, as I noted last summer before the full Committee, such insurance levels are now capitalized in bank stock values, in loan and deposit rates, and in the technology and scale of bank operations. A rollback would thus create disruptions that may well exceed its benefits. However, drawing explicit limits at current levels and requiring the least costly method for resolving the financial problems of banks would put larger depositors at risk, bring additional discipline to bear on bank management, and limit the taxpayers' exposure for the safety net guarantees.

While a study of longer-run efforts to limit coverage to $100,000 per individual across all institutions is desirable, the Board is hesitant to endorse such limitations at this time. We feel the need to understand better the potential cost and intrusiveness of such an effort.

There will always be a tension between the goals of protecting only unsophisticated small depositors and maintaining a degree of market discipline by adhering rigidly to insurance limits, on the one hand, and the

concern about the systemic risks that would result from rapid withdrawals of balances by uninsured depositors and creditors at weak banks, on the other. These latter concerns have led to the so-called too-big-to-fail policy, which seeks, through purchase and assumption transactions, to protect all depositors at some institutions in order to protect financial markets and the economy. Like most others, the Board has become increasingly uncomfortable with this policy because of its inequitable treatment of depositors and borrowers at banks of different sizes, its tendency to broaden the safety net, and its undermining of depositor and creditor discipline for bank risk-taking. But, like the Treasury, we reluctantly conclude that there may be circumstances in which all of the depositors of failing institutions will have to be protected in the interests of macroeconomic stabilization.

The Treasury proposal, which we support, calls for the Treasury and the Federal Reserve to determine jointly those special cases of bona fide systemic risk in which more flexibility should be permitted for resolving problem banks. While depositors would be protected in such cases, it is important to emphasize that stockholders and nondeposit creditors of these large insolvent banks and their holding companies would not be, and their senior management could be replaced.

The Treasury proposal suggests that the extra costs of resolving these special cases be funded in the short run by the Federal Reserve, with the advance ultimately repaid from industry insurance assessments. Of course, the Congress is aware that Federal Reserve funding is, in effect, an appropriation of public funds that results, regardless of the accounting, in more Treasury securities being held by the public. Since such appropriations are currently the responsibility of the Congress, the Board suggests that the Congress should review the proposal in this light. In addition, the Board finds considerable merit in recent arguments by the banking industry that the cost of the public benefit from avoiding systemic risk should be borne by the public, not the industry. In an environment of large federal deficits this conclusion is unlikely to be popular with the Congress, but the Board is receptive to shifting the costs of avoiding systemic risk from the industry to the Treasury.

The Board is driven to this conclusion in part by the appeal of linking public benefits with public costs, and in part by a realistic appraisal of the limits on the additional costs that the banking industry can effectively absorb. More generally, our support for public funding of the benefits of avoiding systemic risk, as well as retention of deposit insurance limits of $100,000, reflects other facets of the Treasury proposal that should make insurance

coverage an increasingly less important and less relevant issue. The greater emphasis on capital maintenance, more frequent on-site examinations, and policies of prompt corrective action can be expected to modify bank behavior and attitudes toward risk taking. Indeed, the ultimate solution to the too-big-to-fail doctrine in the end, perhaps the only one, is to assure that our policies reduce the probability of large banks becoming weak.

The Board is strongly in favor of the Treasury report's emphasis on capital-based supervision. Entities with capital ratios below certain standards would be placed under prompt and progressively greater pressure to limit their dividends and their growth. As the degree of undercapitalization increased, the supervisory pressure would intensify. The principal objective of prompt corrective action is to change the behavior of bank management by modifying its risk-benefit calculations. Moreover, by acting promptly, it is possible for the franchise values of the going concern to be maintained and to avoid the rapid declines in value that normally occurs for insolvent banks. For the same reason, at some low, but still positive, critical level of capital, the bank would be placed in conservatorship and the stockholders provided only with residual values, if any. If the bank could not be recapitalized, it would be sold, merged, or liquidated; larger banks might be reduced in size over time before sale

or liquidation. No bank, it is worth noting, would be too large for prompt corrective action, including ultimate sale or liquidation.

Prompt corrective action properly places limits on the discretion of supervisors. However, some proposals before the Congress would legislate the specific responses that must be taken. The Board believes it important to underline the real risks of inflexible rules; bank supervision should not be applied in cookbook fashion. The Treasury proposal strikes an appropriate balance by providing procedures for supervisors to deviate from mandatory steps when such deviations are deemed to be in the public interest. But it should be emphasized that, under prompt corrective action, the presumption would be shifted toward rapid supervisory action, with delay requiring affirmative steps by the regulatory agency. Indeed, a decision by the supervisor to delay at the low critical capital level would, under the Treasury proposal, call for concurrence by the chairman of the FDIC. [?]

[The proposed legislation would blend flexibility with a mandate for prompt response. Under current law, the supervisors' actions are discretionary and conditional on a showing of unsafe or unsound conditions or a violation of law. Implementation of remedial action can be delayed and extended over a protracted period when the bank contests the regulator's determination. The Treasury legislation would

permit a systematic program of progressive action based on the capital of the institution, instead of requiring the regulator to determine on a case-by-case basis, as a precondition of remedial action, that an unsafe or unsound practice exists. The proposed legislation permits judicial review of the supervisor's capital measurement, but would allow the supervisory responses to go forward without delay, even while the court was reviewing the process of capital measurement.]

The Treasury proposal does not call for an increase in the minimum international capital standards that would be fully phased-in by the end of next year. The Board still believes that the longer-run solution to the subsidy provided by the safety net is an increase in the minimum capital standard, but understands the shorter-run restoration process that must precede it. In the interim, the Board applauds the Treasury proposal that would immediately reward those banking organizations whose bank subsidiaries have capital significantly above the minimum standards. Not only does such an approach create additional inducements for higher bank capital, it also addresses one of the most significant causes of the weakness in banking by widening the scope of activities for holding companies with well-capitalized bank subsidiaries.

It is clear that some members of Congress are hesitant about authorizing wider activities for banking

organizations at a time when taxpayers are being asked to pick up the failure costs for entities that have unsuccessfully taken too much risk. Such hesitancy is understandable. However, the proposed wider activities are all financial in nature; they involve the types of risk with which bankers are familiar--letting them build on their expertise; they are to be conducted in separately capitalized affiliates that would have limited access to bank funds; and they must be divested if the capital of the affiliated banks declines to--not below, but to--the minimum international capital standards.

It is worth repeating that these new activities can be conducted only by holding companies with well capitalized bank subsidiaries and that they would be required to be conducted outside the bank. The proposal does not repeat the thrift experience of authorizing *all* institutions--strong and weak--to engage in new activities in the depository, financed by insured deposits. The proposed approach is unlikely to expose the safety net to additional risk because it does not reflect a wholesale removal of restraints. Based on their current capital positions, only about one-fourth of the largest 25, and about half of the largest 50, of our banking organizations would be permitted to engage in such activities if they were authorized today. Almost all of the next 50 largest bank holding companies

have bank subsidiaries with capital high enough to permit the holding company to engage in these new activities.

The best protection for the insurance fund is to be certain that we have strong banking organizations. Authorizing wider activities for holding companies with well-capitalized bank subsidiaries would strengthen the long-run viability of healthy banks by permitting them to respond to the new competitive environment in banking here and abroad. It also would add to the incentives for increasing and maintaining bank capital, and, it is often forgotten, it would make available better and cheaper services to customers of U.S. banks around the world.

Similar benefits involving even more banks and a larger proportion of the public would result from widening the geographic scope of bank activity. An interstate banking system has slowly evolved in this country through the holding company vehicle. Thirty-three states now permit full interstate banking through holding company subsidiaries, and another fourteen permit some form of interstate holdings in this way. But this approach, with separately capitalized bank subsidiaries, is unduly costly. Interstate branching would be much more flexible and efficient. Simply by collapsing subsidiaries to branches, banks could reduce their costs and increase their profits and achieve geographic diversification at lower cost. Authorization of interstate bank branching is, in effect, a

capital-building step and the Board continues to urge its prompt adoption.

The holding company form is retained in the Treasury proposal as the best organizational vehicle for financial modernization. Under the Treasury proposal, each holding company subsidiary--bank and nonbank--would be separately capitalized and functionally regulated as if it were an independent entity: bank regulatory agencies would regulate banks, the SEC would regulate broker/dealers and mutual funds, and the states would regulate insurance companies. Financial transactions between banks and their affiliates would be limited quantitatively, would have to be collateralized, and would be conducted on market terms as called for by Sections 23A and 23B of the Federal Reserve Act. To achieve the synergies that are the purpose of the proposal, management, operations, and most marketing firewalls, however, would be eliminated.

The primary regulator of the largest bank subsidiary would be the umbrella supervisor of the holding company. That supervisor would examine the parent, police the financial transactions between the bank and its affiliates, and could examine *any* affiliate posing a risk to the bank. If the umbrella supervisor concluded that the activities of a nonbank affiliate were posing a threat to the bank, it could require the holding company to divest the affiliate or the banks. It is worth emphasizing that the

umbrella supervisor of the holding company has only one function: to police and constrain threats to the bank.

While the umbrella supervisor would be authorized to act to protect the bank, the oversight mechanism is designed to limit as much as possible the bank-like regulation of the holding company and its uninsured subsidiaries. nonbank subsidiaries of the holding company would be examined *only* if the umbrella supervisor had reason to believe they were operating in a way that posed a risk to their bank affiliates. In addition, the holding company would be exempt from capital regulation as long as its insured depository institution subsidiaries were themselves capitalized above minimum levels. There are several reasons for the exemption: it facilitates equitable treatment between holding company subsidiaries and independent firms; it avoids the inefficiencies of regulation; it avoids even the appearance of extending the safety net; and recognizes the practical infeasibility of regulators determining what the minimum capital should be for an organization that moves away from being primarily a banking organization to a true financial services company. It certainly is true that this would permit holding companies to rely without regulatory limit on debt markets to finance equity contributions to their bank and nonbank subsidiaries--so-called double leverage. However, with the limit on dividends and other payments that undercapitalized bank subsidiaries can make

under the prompt corrective action proposal, as well as the general thrust of bank and only bank coverage of the safety net, the market is likely to be cautious about the quantity of debt taken on by financial services holding companies.

While a holding company with well capitalized bank subsidiaries is free of capital regulation, if the capital of the banks falls and remains below minimum standards, the *bank* capital standards and *bank* prompt corrective regulations would become applicable to the holding company on a consolidated basis. This approach is designed to reinforce the protection of the banks from contagion by their parent or affiliates.

A majority of the Board supports the Treasury approach to holding company supervision, but some members are concerned about the holding company exemption from capital regulation, even when the bank subsidiaries are well-capitalized. These members are not convinced that the market will enforce reasonable minimum capital standards on these banking organizations with insured subsidiaries, and believe that a low-equity parent can quickly endanger even its well-capitalized bank subsidiaries. They also believe that if the capital of the bank subsidiary declines substantially, it may be very difficult for a highly levered parent to raise equity promptly to meet its suddenly imposed regulatory requirement. Thus, some Board members believe that, to maintain the financial integrity of the bank and

the banking system, at least minimum bank tier 1 capital standards should apply to the holding company at all times. These members believe that the parent should have at least a plan, acceptable to the umbrella supervisor, that demonstrates how the holding company would meet its regulatory capital requirement if the capital of its bank subsidiaries fell below their regulatory minima.

NOTE: AT THIS POINT WE PRESENT TWO OPTIONS FOR THE BOARD POSITION ON THE REGULATORY STRUCTURE. BOTH OPTIONS CALL FOR MORE CENTRAL BANK SUPERVISION OF LARGE BANKS THAN THE TREASURY PROPOSED. OPTION A ALSO IMPLIES OUR INTEREST IN EITHER ALL STATE BANKS OR SOME SMALL BANKS TO SUPPLEMENT OUR LARGE BANK INTEREST. OPTION B IMPLIES THE LARGE BANK CARVE OUT DISCUSSED EARLIER THIS YEAR.

[**OPTION A**: Both the Board and the Treasury believe that the Federal Reserve should have a significant role in the supervisory process. We believe that the information flow obtained from the supervisory contact is of critical importance for the conduct of monetary policy and the maintenance of financial system stability. The qualitative information we now obtain from bankers through the supervision of organization of all sizes is critical in our understanding of evolving developments in financial markets. Not only does it give us an immediate sense of what lies behind the data, but we use the feedback from our supervisory contact to help us develop our monetary policy

and to evaluate its impact. For example, our earliest indication of the recent evolving problems with credit availability, the constrained flow of credit, and the impact on economic activity came from our supervisory contact with banking organizations large and small.

However, information from just the small state-chartered banks, which tend to be significantly smaller, on average, than national banks would, we fear, be insufficient for these purposes. As a central bank...**END OF OPTION A. NOW SKIP TO LINE 3 OF PAGE 17**]

[**Option B**: Both the Board and the Treasury believe that the Federal Reserve should have a significant role in the supervisory process. But most Board members have some difficulty with the Treasury's proposed allocation of bank regulatory responsibilities at the federal level. We view the proposed criteria for allocating such responsibility between the Federal Reserve and a new Federal Banking Agency as being based on legalistic rather than economic grounds: their charter class rather than the size or the nature of their activity. Banking is not the same business at all entities and can be roughly divided into community, regional, national, and internationally active banks. To a substantial degree, banks in each of these groups face different markets and different rivals, and have different problems, but, within groups, the economic issues are very similar. It is difficult to rationalize why two similar

banks--be they community banks in the same town, or world class banks headquartered in New York City--should be regulated by two different federal agencies only because they have different charters. Nor is it desirable that a bank be able to shift from what it perceives to be the more stringent of two regulators by the simple act of changing its charter.

Under the Treasury proposal, the Federal Reserve would significantly increase its direct regulatory authority over banks from about 1,000 to almost 8,300 banks. But, the Board believes, its access to the information flow needed for the conduct of monetary policy and the maintenance of financial system stability would decline as our supervisory contact with the larger banking organizations were sharply curtailed. I cannot emphasize enough how much we rely on the qualitative information we now obtain from bankers through the supervisory process to understand what is evolving in financial markets. We need a critical mass of coverage of banking markets to get an immediate sense of what lies behind the data and we use this feedback from the supervisory process both to help us develop our monetary policy and to evaluate its impact. For example, our earliest indication of the recent evolving problems with credit availability, the constrained flow of credit, and its impact on economic activity came from the large banking

organizations with which we have had long-term supervisory relations. **END OF OPTION B]**

As a central bank charged with anticipating or dealing with financial disturbances and crises, the Federal Reserve requires intimate familiarity with the operations of significant banking organizations of the kind that can be derived only from direct, substantial involvement in bank supervision. To perform the critical function of ensuring stability in the financial markets and payments systems, the central bank must have hands-on knowledge of the operations of those large depository institutions where potential problems could have systemic effects. For example, it is difficult to imagine how we would administer our discount window responsibilities without the practical experience derived from our supervisory responsibilities at the larger institutions. Moreover, with the increasing globalization of banking, in the coming years the central banks of the world will need more than ever to coordinate responses to developments that may occur anywhere. The U.S. bank supervisor that deals with international supervisory problems should be one with established expertise and experience in a full range of related fields, from the connection between financial markets and economic activity to operations in domestic financial and foreign exchange markets to the payments system.

In short, the central bank is responsible for contributing to macroeconomic stability through its actions in domestic and international financial markets. We believe our ability successfully to accomplish this objective would be seriously damaged without the intimate contact with [both small and]large banking organizations that come from supervisory responsibilities.

Both the Bush Task Force and the Treasury have noted the needless complexity for banking organizations that now have an umbrella supervisor for holding companies that is often different from the primary bank regulator of the bank subsidiaries. Thus, both would make the umbrella supervisor the same agency as the primary regulator of the largest bank in the holding company. Both nevertheless would still permit different regulators of the same banking organization if there were state and federally-chartered bank subsidiaries of multibank holding companies, and the Bush Task Force assigned umbrella supervision of large bank holding companies to the Federal Reserve, even if it did not regulate the lead bank. The Board sees no relevance in charter class for the economic issues related to regulation. It therefore urges that, if the regulatory structure is modified, each banking organization should have the same regulator of the holding company and *all* of its bank subsidiaries, regardless of charter class.

The Treasury has proposed permitting commercial and industrial firms to own financial service holding companies. The Treasury report focuses on the need to widen and deepen capital sources, especially for failing banks, for which corporations might be willing to provide substantial capital in exchange for control. It also seeks fairness for financial firms in businesses that banks may enter under the proposal but that would otherwise be prohibited from purchasing a bank because of their commercial parents. And it asserts the desirability of additional management expertise and strategic direction from commercial firms. Those that hold a contrary view argue that our capital markets are so well developed that profitable opportunities in banking can attract capital from other sources, and, if there are no profitable opportunities in banking, investment by commercial firms is unlikely to occur. There is also concern about the implications of permitting commercial and industrial firms to own--even indirectly--protected subsidiaries with access to special government protection. [Conflicts of interest might be controlled by firewalls and regulations, and concentration of power by anti-trust laws, but both of these issues remain unsettled.]

On balance, the Board supports on a philosophical level the notion of permitting any institution the right to go into any business--including banking--with the proper

safeguards. However, we believe it would be prudent to delay enacting the commerce-banking authority until we have gained some actual experience with wider financial ownership of, and wider activities for, banking organizations. We should reflect carefully on such a basic change in our institutional structure that would be difficult to reverse, and for which a strong case for immediate enactment has not been made. However, the Congress will have to consider whether [the two] securities and the other financial firms already owned by commercial and industrial firms [mostly captive finance companies and xx thrifts] should be prohibited from affiliating with banks while their independent rivals are free to do so, or whether, perhaps, they should be grandfathered, at least for a time. The latter approach may give us a controlled experiment for a few years, after which Congress could review the issue. [We would have no difficulty with those nonbanking financial firms wishing to affiliate with banks maintaining any prior *de minimus* holdings in commercial or industrial firms.]

Mr. Chairman, although I have spent some time on those areas where the Board has difficulties with the Treasury's proposals, it is important to underscore that we agree with most of what the Treasury advocates and certainly with the broad thrust of their reforms. Their proposal would begin to pull back the safety net, develop a capital-based supervisory process, widen the range of activities for

organizations with well-capitalized banking subsidiaries, and above all rescind costly restrictions on interstate branching. These steps would significantly and safely limit subsidies to banks and incentives for excessive risk-taking and safely remove constraints that have limited the ability of banks to deliver wider services at lower costs. All of these actions are required if we are to have a healthy and strong banking system capable of financing economic growth and providing American households and businesses with low cost state-of-the-art financial services. However, we have suggested some important modifications that we think would improve the proposals which we also urge for your consideration.

FR Coverage
Bush Task Force Proposal*

	Number regulated by FR		Assets regulated by FR (Bil. of $)		Percent of Assets	
	BHCs	Banks	BHCs[1]	Banks[2]	Banking assets in BHCs regulated by FR to total banking assets in BHCs [1]	Banks regulated by FR[2]
1. Lead bank is state-chartered (Treasury Plan)	3,943	8,278	1,102.9	1,317.4	35.62	39.96
2. Others with foreign nonshell branches or subs abroad	24	--	1,070.5	--	34.58	--
3. Other large entities accounting for						
a. 1/2% of all BHC assets[3, 4]	15	--	348.2	--	11.25	--
b. 3/4% of all BHC assets[3, 4]	10	--	274.6	--	8.87	--
c. 1% of all BHC assets[3, 4]	3	--	111.6	--	3.60	--
4. Others that are U.S. subs of foreign banks	10	--	20.5	--	0.66	--
TOTALS						
1 + 2 + 3a + 4*	3,992	8,278	2,542.1	1,317.4	82.11	39.96
1 + 2 + 3b + 4	3,987	8,278	2,468.5	1,317.4	79.73	39.96
1 + 2 + 3c + 4	3,980	8,278	2,305.5	1,317.4	74.46	39.96

1. Assets are banking assets only. (U.S. assets for foreign bank holding companies)
2. Consolidated domestic and foreign assets of U.S. banks (including subs of foreign banks but excluding U.S. branches and agencies of foreign banks).
3. For purposes of grouping bank holding companies by share of aggregate bank holding company assets, asset totals inclulde both banking and nonbanking assets.
4. Bush Task Force suggested 1/2 percent.

* **Bush Task Force Proposal:**

(1) FR supervises all state–chartered banks *and* their holding companies if a state–chartered bank is the lead bank.

(2) FR supervises holding company *only* if:

- **Subsidiary bank has nonshell branch or subsidiary bank abroad**
- **Subsidiary bank is U.S. sub of a foreign bank.**
- **The *holding company* accounts for 1/2 percent or more of all BHC assets.**

FR Coverage
Summary of Proposals
June 30, 1990

	Number regulated by FR		Banking assets regulated by FR (Bil. of $)		Share of assets regulated by FR (percent)		
					Banking assets in FR regulated holding companies[1]		
	BHCs	Banks	BHCs[1]	Banks[2]	Ratio to toal bank assets in all HCs	Ratio to total bank assets	Banks directly regula ted[2]
Current[3]	5,818	1,013	3,096.2	563.6	100.00	93.9	17.10
Treasury[4]	3,943	8,278	1,102.9	1,317.4	35.62	33.4	39.96
Bush Task Force[5]	3,992	8,278	2,542.1	1,317.4	82.11	77.1	39.96
FR proposal 12/90[6]	87	347	1,561.3	1,561.3	50.40	47.4	47.40
FR proposal 11/90[7]	111	651	2,031.0	2,031.0	65.60	61.6	61.60

1. Assets are banking assets only (U.S. assets for foreign bank holding companies).
2. Consolidated domestic and foreign assets of U.S. banks (excludes $348 billion of U.S. branch and agency of foreign bank assets that are affiliated with banks under FR coverage).
3. FR has *all* BHCs and state member banks.
4. FR has *all* state banks and those BHCs where lead bank is state chartered.
5. FR has *all* state banks, and the BHCs of those organizations where the lead bank is state chartered, the subsidiary banks have nonshell foreign branches or subs abroad, the subsidiary banks are subs of foreign banks, and the *BHCs* total bank and nonbank assets account for $^{1}/_{2}$ percent or more of total BHC assets.
6. FR has BHC and *all* bank subs of those BHCs with a bank sub that is "internationally active" (i.e., bank has foreign offices other than shell Caribbean office that on a consolidated basis have more than $500 million in international loans or have gross futures, forward, and derivative f/x contracts outstanding greater than $5 billion). Includes U.S. subs of foreign banks.
7. FR has BHC and *all* bank subs of those BHCs with (1) lead bank sub in the largest 50 by assets; (2) any foreign assets and total assets of $15 billion or more; and (3) nonshell branches abroad. Includes U.S. subs of foreign banks.

NOTE: All totals *exclude* 224 foreign banks with $227 billion of U.S.assets that are represented in U.S. *only* by branches and agencies. These would, however, be under FR jurisdiction in all FR proposals.

Board Circulation Tally Sheet

Memorandum circulated for:
___ vote
___ review
✓ comment
___ other ________

MONTH: March 1991

NUMBER: 2

From Ed Ettin   Date 3/1/91

Subject Deposit insurance system -- proposed statement by Chairman Greenspan before the Financial Institutions Subcommittee of the House Banking Committee.

Distribution Board + Mr. Wiles, ~~Mr. Johnson~~, ~~Mr. Lowrey~~, Miss Jones, ~~Mr. Scott~~, ~~Mr. Coyne~~,

(all staff copies distributed by Mr. Ettin's office, per J. Johnson)

Date: Friday, Mar 1, 1991

Time:

DUE DATE Mon, Mar 4

Response:		Change	Date	Remarks
Greenspan	Comments discussed orally		3/5/91	
Mattingly (partly illegible)				
Seger				(RESIGNED 3/11/91)
Angell	Comments submitted		3/5/91	
Kelley	Comments submitted		3/4/91	
LaWare	Comments submitted		3/4/91	
Mullins	Comments submitted		3/4/91	

Vote Results ________ On ________
Action and vote / Date

Review cycle completed on ________
Date

Comment cycle completed on March 5, 1991
Date

Other ________

without Governor(s) Seger

Referred to Board by Governor(s) ________

Final Disposition

Similar testimony subsequently requested by the Senate (rather than House) Banking Committee. Testimony was redrafted and referred to 4/17/91 Board agenda.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date March 1, 1991

To Board of Governors

From Ed Ettin

Subject: Testimony on Treasury Reform Proposals

While we do not yet have a date, Chairman Greenspan is expected to be asked to testify in a week or two on the Treasury proposals. Attached is a draft of that testimony on which I would appreciate your comments. Among other things, your views on inclusion or exclusion of bracketed material and the options on pages 14-18 would be appreciated. The last two pages provide--for the Board's information--some statistics on various regulatory proposals.

Could you please send your comments to me by close of business Monday. Thanks.

(Comments discussed orally) 3/5/91

Attachment

CHAIRMAN GREENSPAN

For ~~Notation Voting~~ **COMMENT**

by MAR 4 1991

done

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

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GOVERNOR ANGELL

For ~~Notation Voting~~ COMMENT

by MAR 4 1991

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OF THE
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Governors Kelley and LaWare - Comments submitted 3/4/91