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Testimony by

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Financial Institutions Subcommittee

of the

Committee on Banking, Finance, and Urban Affairs

U.S. House of Representatives

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I am pleased to appear before this Committee to discuss three important banking reform bills: H.R. 6, the Deposit Insurance and Regulatory Reform Act of 1991, introduced by Chairman Gonzalez; H.R. 15, the Depositor Protection Act of 1991, introduced by Congressman Wylie; and H.R. 1505, the Treasury's proposed Financial Institutions Safety and Consumer Choice Act of 1991. These three bills all would modify our deposit insurance system in order to place limits on an expansive safety net that has created incentives for our banks to take excessive risk with insufficient capital. Both the Wylie and the Treasury bills would also increase the efficiency of our banking system, reducing its operating costs and increasing its diversification, by authorizing a true interstate banking system.

The Treasury bill addresses more broadly two other root causes of the present difficulties of the U.S. banking system: (1) the ongoing technological revolution that has dramatically lowered the cost of financial transactions and expanded the scope of financial activities of bank rivals, reducing the value of the bank franchise; and (2) a statutory and regulatory structure that impairs the competitiveness of U.S. banks by limiting their ability to

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

Modifications of the deposit insurance system are necessary, but the Board strongly prefers the comprehensive approach to banking reform that the Treasury bill offers, believing that it establishes a particularly useful framework for congressional action. These broader reforms would make our banking system more efficient and better able to serve the public, as well as create an environment for a safe, sound, and profitable banking system.

Mr. Chairman, the three 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 shall, of course, respond to questions about those provisions on which I have not commented.

With so many provisions, it is not surprising that there is some difference of opinion among the Board on some of them. 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 the thrust of the Treasury

bill to limit deposit insurance, authorize new activities and interstate branching, and modify supervisory procedures.

**Prompt Corrective Action**

Both the Treasury and the Gonzalez bills call for 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 value 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.

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.

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 thus should be a major determinant in prompt corrective action. However, supervisory experience and economic research indicate that 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 authorizes placing banks into zones lower than might be indicated by capital alone on the basis of "unsafe and unsound" conditions or operations. 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 data on classified

assets. In short, a reduction in a bank's capital ratio implies 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 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 Gonzalez 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 systematic 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 the Gonzalez bill.

Both the Gonzalez and Treasury approaches to prompt corrective action require certain supervisory steps as capital declines 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 that

permit the supervisor to delay taking required actions based on explicit determination of public benefits. The Gonzalez approach permits no deviations from a small number of required actions, and has other permissible responses in certain limited situations, a procedure that also provides some 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.

However, we prefer the Treasury bill provisions to those in H.R. 6. The latter would trigger supervisory action only at two capital levels or if an undercapitalized bank did not submit or adhere to its capital plan. The Treasury bill provides for more flexibility by creating five capital zones, each with different supervisory steps.

The adoption of prompt corrective action policies would represent a significant change in the supervisory framework for a large number of institutions. 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 after enactment, and the Gonzalez bill for a nine-month delay. We believe it would be advisable to enact 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. The Treasury and Gonzalez bills require the agencies to set the critical capital level that would call for putting the bank in conservatorship or receivership. The Treasury calls for that critical ratio to be at a point that generally permits resolution of troubled banks without significant financial loss to the FDIC, while the Gonzalez bill provides that the critical capital ratio should be set high enough so that "with only rare exceptions" resolution would involve no cost to the FDIC. For the Treasury, this should be no lower than 1.5 percent of bank assets and for the Gonzalez approach no less than 2 percent of tangible assets.

The very act of placing a bank into receivership or conservatorship significantly lowers its franchise value, thereby increasing FDIC resolution costs. To require that a bank be closed with capital high enough to assure that it could absorb all of the associated drop in values seems unreasonable. We would suggest, therefore, that the criterion be to "minimize" resolution costs. It is worth emphasizing that prompt corrective action would 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, the Wylie and Treasury 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). The Board supports these proposals to limit insurance coverage, as well as the types of limits on insurance for pass-through accounts called for in all three bills, and the elimination of insurance for brokered accounts in the Treasury bill. We believe these steps 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. In another 15 percent of households, funds could be fully insured at a

single depository institution if put into accounts of other members of the household. With both of these adjustments, which excludes the additional coverage for retirement accounts proposed in both bills, less than 1 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 (presumably plus another \$100,000 for retirement accounts), across all institutions. The Gonzalez bill would adopt that coverage limit without a study, rather than the per institution limits in the other two bills. 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 the Gonzalez and the Treasury 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.

The Wylie bill is silent on the failure resolution procedure of the FDIC, while the Treasury and the Gonzalez 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

value, if any. The Gonzalez 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. The Gonzales bill also contains a provision intended to limit Federal Reserve discount window lending to undercapitalized institutions, where lending to such institutions is not just for very short-term liquidity purposes. The Federal Reserve is sympathetic to concerns about failing bank use of the discount window to fund the flight of uninsured creditors, potentially raising the cost of resolution to the FDIC. The Federal Reserve would prefer not to lend to insolvent institutions unless the failure to do so might have systemic implications. However, we are concerned that the Gonzales bill would seriously handicap the Board's ability to ensure the stability of the banking system and might prematurely close off liquidity support to viable institutions.

The Treasury bill calls for an exception to the least costly resolution of failed banks when the Treasury and the Federal Reserve Board, on a case-by-case basis, jointly determine that there would be bona fide systemic risk. 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 and other short-term creditors 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, other short-term creditors, 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 and short-term creditors 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 and creditors but without undue disruption to financial markets. The Treasury's proposal in fact contemplates that the large-balance depositors of these banks will not be protected. Moreover, the exception proposal does not call for protection of all creditors of the bank, its holding company, or its nonbank affiliates, and especially protection of the stockholders and senior management. These claimants and employees should not be protected.

In addition, I would emphasize again that other provisions of the Treasury and the Gonzalez 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 (also included in the Wylie bill), and 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.

**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.

**Increase in BIF Premiums.** In the current environment of both 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 charge 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.

Congressman Wylie's bill would assist banks in paying the higher premiums in two ways. The first would

authorize both larger reductions in reserve requirements than possible under existing law and the transfer of imputed earnings on reserve balances to the insurance funds.

In fact, the Federal Reserve still has room under existing law to reduce reserve requirements further, but is concerned about the effects of such reductions on the clearing of payments, on money market volatility, and on the conduct of monetary policy. Further reductions in reserve requirements, in any event, would not benefit those banks whose account balances would have to be maintained for clearing purposes. Moreover, if reserve requirements were not reduced, the imputed interest payments would not be returned to the banks, but the distorting effects of the reserve requirement tax would continue to fall on particular types of deposits. The Board favors a more straight-forward approach of paying explicit interest on required reserve balances, which the banks could use to offset higher premiums. Such an approach would end the tax involved in this monetary policy and payment systems tool.

The second way the Wylie bill would assist in paying higher premiums is to require the retirement of Federal Reserve stock, freeing up \$2.5 billion of assets at national and state member banks which they could then invest in different ways; the additional earnings they could realize above the statutory 6 percent risk-free return on Federal Reserve stock probably is modest at this time, but

could be more significant in other environments.

Presumably, the Reserve Banks would rebuild their capital from this distribution by withholding some of their earnings from the Treasury.

While ownership of Federal Reserve stock clearly does not confer any control over policy to member banks, there are clear benefits to the existing legal regime. Stock ownership, with local boards of directors, helps greatly to strengthen significant elements of the structure of the Federal Reserve System. By providing for private ownership of the Reserve Banks insulated from political control, present stock holding arrangements help insure the independent role of the Federal Reserve within the government. The stock ownership by area industry participants contributes importantly to the cooperative atmosphere that is vital to the effective and efficient day-to-day operation of our monetary system. What appears to some to be an institutional quirk or an anachronism may in fact be a critical and important element in helping to insure an independent U.S. Central Bank drawing on the regional resources of the financial community to make national policy. Rather than retiring this stock, we would prefer to see amendments to the Federal Reserve Act to provide that the dividend on the stock reflect a more appropriate rate of return, perhaps, for example, a rate linked in some way to the return on the Federal Reserve

Bank's portfolio. We understand the motivation to return funds to the banking system during this period of pressure on the insurance fund, but we would urge Congress not to ignore the important policy implications inherent in the structure of the Federal Reserve involved in this proposal.

Congressman Gonzalez's bill would seek to augment BIF balances, and to limit the increase in BIF premiums on most banks, by including the deposits of foreign branches of U.S. banks in the FDIC's assessment base. We understand the sense of fairness that motivates this proposal, especially given a policy that some banks may be "too large to fail." However, there are countervailing reasons for great caution in levying assessments on the foreign branch deposits.

The judgment that charging premiums on foreign branch deposits would raise significant amounts of revenue for the FDIC rests on the assumption that depositors would continue to hold these deposits in the face of relatively large FDIC premiums. However, at least some, if not all, of the premium increases would likely be reflected in lower offering yields on the deposits subject to premiums. Because depositors at foreign branches appear to be among the most sensitive to yield differentials among money market instruments, they are likely to shift funds out of U.S. banks should the yield differential on U.S. bank deposits decline vis-a-vis alternative money market instruments, such as deposits at foreign-based banks and commercial paper.

Thus, larger U.S. banks would likely be faced with the choice of either trying to pass additional assessments on to deposit and loan customers in highly competitive markets, possibly suffering further erosion of their competitive positions, or absorbing assessments and suffering associated reductions in earnings and equity values during a difficult banking period. In any event, the revenue increase from BIF assessments on foreign branch deposits of U.S. banks will be smaller -- we believe considerably smaller -- than initial calculations would suggest, once adjustment is made for the reduced demand for lower yielding deposits in the Euro markets.

Lending by the Reserve Banks. Irrespective of the level of insurance premiums or methods of assisting banks to pay them, an element of the Treasury's proposal to recapitalize BIF that has troubled the Board is the use of the Federal Reserve Banks as the source of loans to BIF to cover its losses on failed bank resolutions. 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, rather than the Federal Reserve Banks, made the proposed loans to BIF. 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 removed the authorization for, 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 help 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 Gonzalez and Treasury bills establish an approach that would help accomplish that objective through prompt corrective action. But the Gonzalez bill does not address other issues that would strengthen banking organizations, and the Wylie bill only partially addresses them. I would like to turn to these issues now.

#### **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 them.

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 the entities engaging in these new activities 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 institution itself, 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.

Congressman Wylie's bill would permit bank holding companies to engage in activities beyond those presently authorized where the activities are "of a financial nature," provided they are either in response to technological innovations in the provision of banking and banking-related services or are substantially identical to products and services offered by nonbank competitors. The Wylie bill offers a constructive option that, while more limited than the Treasury bill, would address one of the fundamental restraints on the ability of banking organizations to remain competitive in an ever changing marketplace. However, unless the Glass-Steagall Act is repealed and certain provisions of Section (4)(c)(8) of the Bank Holding Company Act are rescinded, the Wylie bill would not permit banking organizations to engage in securities activities beyond Section 20 subsidiaries or to engage in insurance underwriting or sales. In remaining financial markets, it would focus on responding to the innovations developed by their nonbank competitors rather than permitting banking organizations to originate their own innovations for the delivery of financial services. The Board thus prefers the broader approach proposed in the Treasury bill.

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 Treasury and Wylie bills 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 and related statutes, to permit banks to operate branches of their banks in all states. These bills 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 laws that permit -- or are 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 that interstate branching 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.

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. In this context, 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. In contrast, the Gonzalez bill does not expand the scope of activities of banking organizations and the Wylie bill expands powers only marginally. Thus, both retain the current bank-like regulatory focus on the consolidated holding company, whose assets are predominantly banks and subsidiaries whose activities are bank-related.

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.

To ensure 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 ensure that it is not creating risk for the bank. Further clarity is also necessary to ensure 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 these affiliates whenever the supervisor believed they 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 bank from contagion from 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 ensure 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 still would 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 they permit 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.

As for regulatory structure, the Treasury bill would make the Board the primary regulator of state-chartered banks and a new federal agency the primary regulator of national banks and thrifts; the Gonzalez bill would create a single new agency as the primary federal regulator of all banks and thrifts. The Board is convinced that the information flow it now obtains from its supervisory contact with banks 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 perspective 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, and, under the Gonzalez bill, we would have no supervisory responsibilities at all. We believe our ability to accomplish our monetary policy objectives successfully would be seriously damaged without the intimate contacts derived from our supervisory

responsibilities relating to large banking organizations. This view was echoed in the 1984 Bush Task Force report, which Congressman Wylie's bill would have studied for the feasibility of implementation; that report also would have made the Federal Reserve the primary regulator of all state banks and the umbrella supervisor of their holding companies, but, in addition, it would have made the Federal Reserve the umbrella supervisor of the holding companies of large banks, even if those banks had a national charter and, hence, another primary regulator. 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 affect 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 ensure 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 systematic 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 the Gonzalez and the Treasury 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 Gonzalez 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 Gonzalez bill would direct the new single banking agency it creates to "prescribe regulations which require that all assets and liabilities of insured depository institutions be accounted for at fair market value unless the agency makes a determination that such a method of accounting is inappropriate in the case of a particular asset or liability or class of assets or liabilities." The Board has significant concerns 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 banks' 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 for auditors and examiners to verify and would be 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 support the provisions of the Treasury bill that call for efforts to improve supplemental disclosure. I

would note that 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. Although these market values are publicly disclosed, they have not been included in reported capital and earnings. We continue to believe that this accounting treatment is appropriate in light of the role played by the investment portfolios at most banking organizations.

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 may be appropriate. Such disclosures could exert

constructive market discipline on depository institutions to ensure adequate provisioning for loan losses.

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 Wylie and Treasury proposals to rein in the safety net by limiting deposit insurance coverage and to rescind inefficient restrictions on interstate banking. The Board also strongly supports the provisions of the Gonzalez and Treasury bills implementing prompt corrective action procedures. We believe, however, that both the Gonzalez and Wylie bills 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. Limiting deposit insurance, modifying supervisory procedures, introducing true interstate banking, and authorizing wider activities for strong organizations 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 ensure that BIF has adequate resources, the Board urges the Congress to address the issues broadly and to avoid partial solutions that separate 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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