CURRENT BANK AND THRIFT ISSUES

STATEMENT BY

L. WILLIAM SEIDMAN
CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION
WASHINGTON, D.C.

BEFORE THE

COMMITTEE ON BANKING, HOUSING,
AND URBAN AFFAIRS
UNITED STATES SENATE

10:00 a.m
Room SD-538 Dirksen Senate Office Building
January 21, 1987

Mr. Chairman, Members of the Committee:

We appreciate having this opportunity to speak with you about these issues important to the banking and thrift industries.

We have provided below our thoughts on each issue you have raised. At the outset, we also encourage a broad review of the financial services industry with the intent of achieving a proper competitive and supervisory balance. We hope such a review can take place in the near future.

FSLIC Recapitalization

The FDIC supports the proposal of the Administration and the Bank Board to recapitalize the FSLIC. Quick approval by Congress is important to maintain confidence in our financial system and reduce the ultimate cost of handling failing savings and loan associations.

Because of limited resources, the FSLIC has not been able to resolve problems in a significant number of failing savings and loan associations. This condition cannot be permitted to continue without seriously impairing confidence in the financial system. Moreover, delaying the closing of insolvent institutions increases the ultimate cost of failures. In some instances, imprudent management may succumb to the temptation to take excessive risks, to roll the dice in the hope that insolvency can be overcome. In addition, continuing operating losses add to the extent of insolvency and thus increase the ultimate cost of disposing of such institutions.

Failing savings and loans consistently pay above market rates for their funding. This not only adds to their cost, it puts pressure on the system as a whole, raising funding costs and cutting into earnings for competing, solvent institutions. For these reasons, we believe that delay is imprudent, destabilizing and costly. The FSLIC recapitalization plan should be enacted quickly; it should, in our view, be given the highest priority.

Regulators' Bill

The FDIC continues to request the enactment of this proposal. Emergency interstate acquisition powers will enhance our ability to handle failed and failing banks with a minimum of disruption to local economies and a minimum cost to the insurance fund.

Actions with respect to interstate purchases taken by a number of states have reduced the urgency of this legislation. Currently, 37 states have enacted legislation providing for some form of regional or national full-service interstate banking. (The current status of interstate-banking activity is discussed in Appendix A.) Of particular significance, several states that have had high failure rates are among

those that have adopted some form of interstate banking. We applaud these states' efforts. Unfortunately, several states with high bank failure rates have not changed their laws. (Refer to Appendix B.)

In 1986, 138 insured banks failed and another seven were given financial assistance to prevent failure. We expect a sizeable increase in the number of failures in 1987. Along with increased failures, the number of problem banks has also increased significantly. From just 200 banks in the spring of 1981, the number of problem banks has increased each year. The number reached 1,140 at the start of 1986 and climbed to 1,484 by year-end -- a growth rate of almost one bank a day. Weaknesses are likely to persist through next year or longer in energy, agriculture, and real estate. Parts of the banking system will continue to be hurt by these strains. Competitive forces also have made it more difficult for banks to improve profitability. Such problems are exacerbated by geographic restrictions which limit diversification possibilities for banks and can lead to excessive exposures to one source of risk.

Whenever possible, the FDIC attempts to arrange a purchase and assumption transaction (known as a P&A) to handle failed banks. In such transactions another institution purchases some of the failed bank's assets and assumes deposits and other liabilities. An acceptable P&A is less expensive to the FDIC. It is less disruptive to depositors because deposit arrangements of the failed bank are generally honored by the acquiring bank. Also, many assets of the failed bank are retained by the acquiring bank, minimizing disruption to the borrowers and reducing the FDIC's involvement in servicing and liquidating failed bank assets. Finally, a P&A is responsive to the question of fairness since we protect all depositors, thus treating all failed banks in a manner similar to that required in handling very large institutions.

The increased numbers of bank failures, the geographic concentration of banking problems, and the relatively large size of some troubled banks are making it increasingly difficult to find purchasers for all failed banks. As recently as 1984, the FDIC was able to find buyers for P&As in 80 percent of bank failures. This percentage has declined to only 68 percent in 1986. Not only has the percentage of bank failures handled through P&As declined but the price paid by the acquiring banks in these transactions also has dropped. The average premium received in a P&A transaction has declined from 3.67 percent of deposits in 1984 to 0.87 percent of deposits in 1986. These trends have significant adverse implications for the FDIC insurance fund. Total purchase premiums received on P&As in 1986 were roughly $22 million less than in 1984 although the volume of failed bank deposits was more than double. The relative drop in premiums paid for failed banks translates into significant additional costs to the insurance fund.

In order to enhance the FDIC's ability to handle the growing number of failing banks, we continue to seek authority that would:

- Allow acquisition by an out-of-state institution of failed and failing banks;

- Extend the scope of interstate acquisition authority to include bank holding company systems when the failing bank represents a sizable part of the holding company system; and

- Provide the FDIC with authority to run a failed bank for a limited period of time to facilitate a more orderly disposal of the bank.

Allowing acquisition of a failed bank by an out-of-state bidder greatly expands the number of potential acquirers and enhances the chances of finding a purchaser for a P&A. Increased competition among an increased number of bidders will reduce costs to the FDIC. This is true regardless of the size of the failed bank. The Regulators' Bill required that the failed or failing bank have at least $250 million in assets before interstate bidding would be allowed. Today about 95 percent of problem banks are below that level with significant concentrations in states that do not allow out-of-state entry. This size requirement was intended to provide a transition from then current law. We now recommend that the threshold be eliminated. It should be noted that size limitations are rare among the many states that have enacted interstate legislation. The asset size of a failed bank is only one measure of significance -- and not a particularly good one in terms of assessing the impact on the community served if a P&A cannot be achieved and a payoff must be made. The liquidation of any bank reduces banking services in the community, increases local economic disruption, and increases costs for the FDIC. For these reasons our objective is to avoid payoffs of failed banks whenever possible. We are making progress toward this goal; the average amount of uninsured deposits in failures handled by payoff (including insured deposit transfers to another institution) has declined each of the last three years. (See Table 1.) Still, this is of little comfort to the unsuspecting depositors with uninsured funds in such banks.

Since the Regulators' Bill was first proposed, a number of states have passed laws which allow entry by out-of-state institutions under varying conditions. Such initiatives have materially expanded our options. During the past year, out-of-state institutions were invited to submit bids in 35 failed bank situations, and submitted the best offer in two instances. However, varying rules among states create administrative problems and uncertainty for both the FDIC and interested bidders. In addition, many of the states have incorporated reciprocity restrictions, expansion restrictions or other constraints that limit the attractiveness to many potential out-of-state bidders for failed banks.

The Regulators' Bill also would permit the interstate acquisition of failing banks. We support this because, once a bank has failed, its value to a potential acquirer can be substantially diminished. In such instances the FDIC's options are reduced and potential costs are materially increased. The Bill would also allow the interstate acquisition of an entire holding company when one of its significant bank subsidiaries is failing. This is important because the economic reality is that holding company banks are frequently managed and operated as a consolidated entity and not as independent individual banks. When

institutions are operationally and financially intertwined, it is difficult to separate a single failed institution from the rest of its family.

Last year's bill contained provisions that would not permit expansion in the state by the acquiring out-of-state institution until two years after the acquisition of the failing bank(s). The FDIC would prefer that there be no special delay for acquiring banks and that the new banks be given the same rights as their competitors. In acquisitions involving a failing bank, we continue to support a preemption of regional compact provisions that restrict bank expansion outside the compact.

If Congress should decide that the legislation proposed as the Regulators' Bill should not be passed then at least the expired interstate provision of Garn-St Germain should be renewed. This Act provided for interstate acquisitions of failed banks with assets of $500 million or more. That provision significantly increased the FDIC's options in several bank failures. For example, early in 1986 the interstate provision was used in a Florida failure and saved the FDIC a substantial sum.

Even with interstate powers there can be situations where options may still be very limited. We have encountered situations involving both larger and smaller banks, where material uncertainties precluded bidders from making informed and intelligent bids. In these situations, putting together a satisfactory P&A was very difficult or impossible in the short time available.

What is needed in these circumstances is a method to "bridge" the gap between the failed bank and an orderly purchase and assumption transaction -- a fallback position for the FDIC. The FDIC seeks authority to operate a full-service bank on a transition basis for a limited period of time. The objective would be to return the failed bank's assets to the private sector in an orderly manner. Bridge banks are not intended to be used frequently. The FDIC has no desire to be in the banking business. However, in exceptional circumstances, this power could be an invaluable aid in minimizing economic disruption and reducing FDIC costs, particularly in handling major failures in the banking system.

As a part of the Regulators' Bill, the FDIC continues to seek Congressional confirmation that it and the Office of the Comptroller of the Currency are exempt from budget apportionment by OMB. We strongly urge Congress to include language to that effect in the Regulators' Bill. Particularly during these troublesome times, we believe the FDIC must maintain the flexibility to cope speedily and innovatively with the problems in the banking industry. OMB is attempting, for the first time, to apply 36 year-old legislation to control the FDIC's funds. There is no justification for suddenly trying to do this now!

On a related issue I would like to strongly recommend passage of S. 288 recently introduced by Senator Riegle. This bill recognizes the importance of attracting and maintaining high caliber examiners during these increasingly challenging times. Comparable legislation was passed by a large margin (340 to 49) in the House last year and merits a full hearing and passage by the Senate this year.

Nonbank Banks

Nonbank banks are the outgrowth of a loophole in the Bank Holding Company Act, in which Congress narrowed the definition of "bank" to those institutions that both accept demand deposits and engage in commercial lending. By offering only one of these services, the nonbank bank can carry out most of a bank's principal activities without coming under the restrictions and regulations of the Bank Holding Company Act. Such an institution is eligible for federal deposit insurance.

This is an attractive option for nonbanking firms and for bank holding companies alike, as they can access new sources of funds and new lending markets that, within the current regulatory framework, are not available to banks. Through the use of the nonbank bank, nonbanking firms can enter the business of banking without becoming a bank holding company and therefore need not divest themselves of business activities not "closely related to banking." In addition, bank holding companies can avoid the Douglas Amendment to the Bank Holding Company Act and overcome geographic restrictions against interstate banking.

Nonbank banks became increasingly popular in the early 1980s, with applications for about 400 charters submitted to the Comptroller of the Currency. Nonbank banks have become increasingly controversial as well. There is concern that nonbank banks pose a threat to the safety and soundness of the banking system. Also, many bankers argue that nonbank banks create inequities in the financial system because they enjoy an unfair competitive advantage over "real" banks.

With regard to safety and soundness concerns, we do not believe nonbank banks, if subjected to prudential regulation and supervision, should pose any major risks to the system. Our experience is consistent with this observation. The FDIC began insuring nonbank banks as early as 1969. None of these institutions has failed and less than two percent are on our problem bank list. This compares to a problem bank ratio of about 10 percent for commercial banks.

Nonbanking activities of bank affiliates can bring the benefits of financial product diversification to the system. Increased diversification and earning power will reduce risk and increase earnings in banking organizations, thereby strengthening the overall banking system. Such activities also can lead to increased competition in securities, insurance and other markets, reducing costs to consumers.

Currently nonbank banks do not control a significant proportion of banking resources. Available data indicate that they play a comparatively small role in the system. The total deposits held by FDIC-insured nonbank banks, using the broadest definition of nonbank banks, are only about $12 billion, about 0.6 percent of total domestic deposits. Thus, at current levels nonbank banks are not a serious threat.

Nonetheless, we believe that the present statutory system is highly inequitable and detrimental. Allowed to grow, nonbank banks can weaken the real banks by competing in an unfair contest in the market place. We

believe that, within the financial system, institutions must be treated fairly. We need a set of ground rules that are consistent and equitable, not only because this is right but because it will strengthen the system. The rules should be spelled out clearly, and they should be enforced. The question facing us, then, is how a fair and equitable system can best be achieved.

Closing the nonbank bank loophole may arguably reduce or eliminate some of the problems and inequities associated with nonbank banks. However, if that is the only reform adopted, additional problems will likely arise. For example, a thrift loophole would still exist, which will insure that inequities associated with nonbank banks continue to exist through unitary-thrift holding companies. Indeed, one such institution, owned by a large automobile manufacturer, has deposits of approximately $10 billion, a figure that is not substantially less than the deposits of all FDIC-insured nonbank banks.

Grandfathering of existing nonbank banks also leaves inequities in place. As is currently the case, individual ownership of any combination of bank, nonbank bank or other business would remain possible. Simply closing the nonbank bank loophole will not provide us with a financial system that is both fair and consistent.

With regard to the so-called "South Dakota loophole," we find this statute objectionable and paradoxical in that it authorizes banks chartered in South Dakota to underwrite insurance in any state but South Dakota. It should be noted, however, that no banks in South Dakota are currently underwriting insurance while several major insurance companies own FDIC-insured depository institutions. Once again, the solution to existing inequities may lie in the direction of expanding ownership relations rather than trying to stamp out loopholes.

If we truly desire to level the playing field, a broader approach is needed. We must examine more than just the nonbank bank or South Dakota loophole in isolation. We must also address the broader questions of bank ownership and bank powers, in conjunction with a redefinition of the term "bank." We believe that all institutions enjoying the privilege of federal deposit insurance should operate under the same regulatory rules and ownership restrictions. If restrictions are appropriate for one, they are appropriate for all. Only when those who elect to have deposit insurance also elect to operate under common rules and regulations can the system operate fairly and efficiently.

New Powers for Banks

This brings us to the subject of additional powers for banks. Currently a limited set of new bank powers is under discussion. These powers include the authorization to underwrite and deal in mortgage-backed securities, commercial paper and municipal revenue bonds and to sponsor mutual funds. If granted, these new powers could improve the system and allow banks to remain, or once again become, viable competitors in the financial marketplace.

These activities are not unlike many of the activities pursued by banks today. Indeed, they appear to be natural extensions of banking skills and expertise, and probably would expose banks to less risk than direct credit transactions.

Underwriting and dealing in mortgage-backed securities is a natural extension of writing home mortgage loans. The ability to package and sell such loans would provide banks with greater flexibility. The power to underwrite and deal in municipal revenue bonds is increasingly important as these instruments (which were virtually nonexistent when Glass-Steagall was written) continue to play a larger role in the municipal bond market. At the time Glass-Steagall was adopted, this market was dominated by general obligation bonds, in which banks were given permission to deal. Banks are being increasingly and unfairly forced from municipal underwriting. Morever, as more creditworthy firms choose to raise funds by issuing their own commercial paper, banks must increasingly look for other, perhaps riskier, loan customers. We believe these new powers pose no significant additional risk, and can be housed safely within banks.

In addition to these powers, we believe that banks should be permitted to sponsor mutual funds. The mutual fund market has seen considerable expansion in recent years -- expansion from which banks have been excluded. Allowing banks to offer and manage mutual funds will increase their ability to recapture business lost to nonbanking competitors in recent years. This activity, too, is a natural fit for banks. Their experience with common trust funds and commingled investment funds has provided them with the necessary skills. And, as in the case of such trust activities, we see no evidence of excessive risk or loss associated with the sponsoring of mutual funds.

We believe mutual funds could be housed within the bank, provided restrictions similar to those currently placed on trust activities are required. Banks should be required to provide adequate disclosure that these funds would not be federally insured and that customers would be exposed to risk.

In the interests of competitive equity and safety and soundness, it is essential that banks be accorded new powers. It also is essential that adequate supervision and safeguards be integrated into the system. We feel that the list of new powers under discussion today does not represent a comprehensive list of powers that could safely be granted to banks.

Activities not permitted for banking organizations in the United States in securities and other areas have been performed by affiliates of U.S. banks in the United Kingdom and elsewhere in the world for some time. These activities have contributed to profitability and they generally have not posed safety and soundness problems.

On the whole, we feel that banks should be permitted to offer financial and financially related services within the bank so long as

such activities can be properly supervised, and do not expose the bank and the deposit insurer to inordinate risk. Additional activities that may involve greater risk should be permitted for subsidiaries or affiliates of banks and bank holding companies with adequate insulation of the bank provided by law. As long as regulators can take the actions necessary to insulate the banks from the operations of a subsidiary or of the bank's owners, we feel there is room for greater expansion of the permissible activities of bank owners and affiliates. A thorough study of this matter should explore the possibility that any corporation be permitted to own banks.

Check Holding Practices

The FDIC supports efforts to ensure that bank deposits be made available within reasonable timeframes. We already have taken action to achieve this objective. In early 1984, the FDIC, along with other federal regulators, issued a joint policy statement encouraging depository institutions to review their current policies, to reduce delays in funds availability where feasible, and to provide adequate disclosure of their policies. We also adopted a program for reviewing and monitoring response to the joint policy statement.

We believe these efforts have proven productive and note that funds availability account for under two percent of all consumer complaints processed by the FDIC. Surveys conducted by the FDIC indicate most banks give immediate credit to established customers, with delayed availability applied only on an exceptional basis. Also, a number of states have passed or are considering laws that would require disclosure of availability policies and/or establish fixed availability schedules. (See Table 2.)

The FDIC believes considerable progress has been made to address concerns about funds availability and that abuses are the exception rather than the rule. Nevertheless, we support federal legislation in order to establish a national policy and provide a means for dealing with abusive practices. Federal legislation would also reduce inconsistency caused by varying state laws.

The Fair Deposit Availability Act (S. 1841) proposed in the last Congress would have required depository institutions to provide written disclosure to customers of its funds availability policies. We strongly support this goal and believe such disclosures would enable market forces to work more efficiently. We also support the requirement that a depository institution must start computing interest on funds deposited by check or similar instrument to an interest-bearing deposit as soon as it receives provisional credit for the deposit. We believe this would be fair and present negligible credit risk to the depository institution.

The proposed law also would have required that deposits of U. S. Treasury checks by established customers be made available for withdrawal as soon as the depositing institution received provisional credit for such checks. This approach seems fair and reasonable. It would be

particularly beneficial for persons who must rely upon government checks as their main source of income. Generally, delayed availability complaints about government checks involve senior citizens, where the financial hardship is likely to be the greatest.

We do not agree with all provisions of S. 1841. The proposal would have required the Federal Reserve Board to impose a precise funds availability schedule on deposits. Given the diversities in this country with respect to geographic location, transportation facilities, use of technology, and structure of financial institutions, imposing a single uniform availability schedule could prove inequitable and burdensome. Moreover, the cost of imposing a quick availability requirement on all deposits would ultimately be borne by all depositors, regardless of the need for it.

The proposal also would have established an "Expedited Availability Council" to consult with the Federal Reserve Board on funds availability matters. We see no need for creating another regulatory council or assigning the Federal Reserve an oversight role. A more practical and efficient approach would be to give the responsibility directly to the respective regulatory agency.

Conclusion

The topics before this Committee are of the utmost importance to the stability and well-being of the Nation's financial system. I urge you to give the highest priority to recapitalizing the FSLIC, providing more flexibility to the FDIC to deal with current and future problems within the industry and increasing investment options available to commercial banks.

Although these are important issues that need to be dealt with expeditiously, the long-term viability of the Nation's banking and financial system is dependent upon a critical and thorough analysis of the current laws and regulations that govern banks and other financial institutions. It is clear that current rules were developed in a much different economic and legal environment and are no longer appropriate. The FDIC stands ready to assist the Committee, in any way possible, in developing a sensible and fair set of standards that will guide the future development of the system.