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FEDERAL DEPOSIT INSURANCE
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STATEMENT ON THE

EFFECTS OF "NONBANK" CHARTERING

PRESENTED TO THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
SUPERVISION, REGULATION AND INSURANCE

OF THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

BY

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WASHINGTON, D.C.

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Mr. Chairman, members of the subcommittee, we appreciate this opportunity to address the subject of "nonbank banks." As you know, a "nonbank bank" is an FDIC-insured bank that escapes the purview of the Bank Holding Company Act by not offering checking accounts or by not making commercial loans. Because a nonbank bank is not subject to the Bank Holding Company Act, it may be owned by an industrial company or other type of firm that would not be permitted to own a full-service bank, and it may be owned by a bank holding company across state boundaries despite the Douglas Amendment to the Bank Holding Company Act.

A number of bills have been introduced to redefine the term "bank" and close the so-called loophole in the Bank Holding Company Act. We believe it is important at the outset to define the perceived issue or problem the subcommittee intends to address through legislation. Only after this type of analysis is it possible to arrive at a suitable definition of a "bank" and determine the types of firms with which a bank should be permitted to affiliate.

Some people contend that nonbank banks are a threat to the safety and soundness of the banking system. No one has had more experience dealing with banking problems than the FDIC, and no one has a bigger stake in maintaining the strength and stability of the system. It is always the FDIC that is called upon to pick up the pieces and absorb the losses when things go awry in the banking system. In our judgment, nonbank banks do not -- let me repeat, do not -- represent a serious safety and soundness hazard.

It is important to recognize that, despite all the attention they have received of late, nonbank banks are not a recent phenomenon. The FDIC began granting deposit insurance to nonbank banks owned by securities and other nonbanking firms as early as 1969. Over the years, we have approved deposit insurance applications and allowed changes of control for some 29 nonbank banks. In addition, the Comptroller of the Currency has approved at least preliminarily charters for 304 nonbank banks. None of these institutions has failed and not one has even been accorded problem bank status subsequent to its acquisition by a nonbanking firm. The owners of nonbank banks have generally been strong, responsible corporate citizens. Any potential concerns we would have had in this area were greatly alleviated in 1978 when -- thanks in large part to the efforts of the chairman of this subcommittee -- Congress passed the Change in Bank Control Act. This law affords the agencies the opportunity to review the financial strength and managerial competence and integrity of potential purchasers of FDIC-insured institutions, including nonbank banks.

In addition to these institutions, there are many other, very similar institutions which Congress has chosen to exempt from the restrictions of the Bank Holding Company Act. For example, as recently as 1982, the Garn-St Germain Act authorized the FDIC to insure deposits of qualified "industrial banks," a rather broadly defined class of state-chartered institutions that accept funds from the public and engage in various lending activities. With FDIC insurance, these entities are practically indistinguishable from nonbank banks.

Since enactment of that law on October 15, 1982, the FDIC has granted deposit insurance to 53 industrial banks. Many engage in activities, either directly or through affiliates, which range far afield from anything contemplated under the most liberal interpretations of the Bank Holding Company Act. For example, one of the earliest applications was from a firm in Hawaii which had two subsidiaries, one in the auto parts business and the other a glass distributorship. Many industrial banks are owned across state lines by major bank holding companies and other financial conglomerates.

With close review of the managerial and financial factors at the time of acquisition, appropriate conditions in the approval orders to safeguard against potentially dangerous practices, and careful supervision, industrial banks simply do not pose a significant risk to the insurance fund. Indeed, none has failed and not one has even been designated as a problem bank following receipt of FDIC insurance.

There is another type of institution that looks very much like a bank that Congress has seen fit to exempt from the Bank Holding Company Act. It is federally insured, accepts virtually the full range of deposits, makes most types of loans and has liberal investment powers. It calls itself a "savings and loan association" or, with increasing frequency, a "bank" with the initials "F.S.B." following its name. Its charter is so attractive and its accounting and capital rules so liberal that a number of "real" banks converted to that form of organization in the past year or so, all with Congressional blessing. Apart from the forum shopping engaged in by institutions searching for more lenient prudential standards, we perceive no serious safety and soundness issue in these applications.

There is a notable problem highlighted by nonbank banks of all manner and description, Mr. Chairman, but it is not safety and soundness. Rather, it is that our 50-year old statutory scheme is completely out of step with the times and is terribly inequitable. We do not approve of banking by loophole. The ground rules should be spelled out clearly and fairly, and they should be enforced strictly and consistently. The advantage should go to the best competitor, not the one with the most ingenious lawyer or the most influential lobbyist.

If there remains a justification for the Bank Holding Company Act, following enactment of the Change in Bank Control Act, it is to guard against undue concentrations of economic power by limiting interstate banking and by maintaining a separation between banking and other industries. I believe these objectives could be achieved more efficiently through less anticompetitive, more targeted means such as much stronger antitrust laws than currently exist. As Congress is unlikely to choose that path in the near term, we will need a new definition of the term "bank."

Of all the definitions advanced to date, the one we prefer is contained in H.R. 916 introduced by Congressman Cooper. Simply stated, it says that if you call your institution a "bank" and accept deposits from the general public, you must be insured by the FDIC and regulated as a bank, including abiding by the Bank Holding Company Act. This definition would resolve a number of inequities. It would slam shut the nonbank bank loophole. It would greatly assist in avoiding the public misunderstandings which have led to the recent tragedies in Iowa, Nebraska, Tennessee and Ohio where people have lost or may lose their life savings in high-flying institutions that held themselves out to the public as banks. It would also prevent savings and loans from calling themselves banks while operating under vastly more lenient prudential standards, which encourages forum shopping and competition in laxity among regulators. At the same time, this definition would leave room for the states to charter other forms of financial firms. Institutions, including bank holding companies, could provide such financial services as they wish, insured or not as they wish.

While redefining the term "bank" in this fashion would be a very significant step forward, it would not resolve all of the pending issues. Congress would still need to address the issue of what services a bank or its affiliates may offer and where they may be offered. It is no secret that we favor a substantial liberalization of the existing rules. They are harming consumers by denying them the fruits of a more competitive financial marketplace, and they are harming the banking system by retarding sensible and profitable opportunities for expansion.

We frequently hear or read these days commentary about the hazards of deregulation. Deregulation, we are told, led to the failure of a modern-day record of 79 banks last year, the near failure of Continental Illinois and even the recent crisis in Ohio. Nothing could be further from the truth. The 79 banks that failed last year were the victims of mismanagement or insider abuse brought to the fore by a very difficult economic environment, including more than a decade of accelerating inflation, followed by high and volatile interest rates, two back-to-back recessions and then deflation in certain sectors such

as energy and agriculture. Continental Illinois was the victim of these same forces plus archaic restrictions on its ability to attract a strong and diverse deposit base. The Ohio crisis was due to ineffective supervision and an inadequate insurance system; it could just as well have occurred ten or twenty years ago -- indeed, a similar problem did arise in Mississippi in 1976.

The fact is that almost no deregulation has taken place at the federal level apart from deposit interest rate deregulation. Remember all the dire predictions during the Congressional debate on that subject? Congress was told that bankers were incompetent and could not be trusted to handle interest rate deregulation sensibly. There would be cutthroat, senseless competition. The reality is that, after the novelty wore off a few months into interest rate deregulation, bankers handled it remarkably well. Banks and thrifts stopped the erosion of their marketplace share dead in its tracks, and consumers and smaller businesses reaped tens of billions of dollars in additional income. The only significant negative effect from the entire process was the impetus it gave to money brokers to perpetrate their gross abuses of the deposit insurance system, something Congress could rectify overnight if it would choose to heed our pleas.

That leads me to the final subject I want to touch upon: the urgent need for deposit insurance reform. Mr. Chairman, in 1982 Congress recognized the link between deregulation and deposit insurance reform. The FDIC and the FSLIC were directed, in the Garn-St Germain Act, to submit studies to Congress on how to reform the deposit insurance system in a deregulated environment. Both agencies poured enormous resources into the project and responded within the six-month deadline with remarkably similar recommendations. The FDIC submitted legislative language within six months thereafter and the FSLIC has since done likewise. Our major proposals have been endorsed by the Bush Task Group, a working group for the Cabinet Council on Economic Affairs and the American Bankers Association. There is virtually no meaningful opposition. The time for enactment is now -- in this session of Congress. We need your help.

In sum, we favor a redefinition of the term "bank," but we believe that other equally, if not more, important issues are on the table. We favor a comprehensive package to continue the half-completed task of deregulation and to reform our system of deposit insurance. The lack of action on these parts of the package is a far greater threat to financial stability than nonbank banks could ever conceivably become.

Thank you, Mr. Chairman, for this opportunity to testify. I will be pleased to respond to any questions.

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