TESTIMONY OF

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CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

ON

H.R. 1062, "THE FINANCIAL SERVICES COMPETITIVENESS ACT OF 1995" AND RELATED ISSUES

BEFORE THE

SUBCOMMITTEE ON TELECOMMUNICATIONS AND FINANCE
AND THE
SUBCOMMITTEE ON COMMERCE, TRADE AND HAZARDOUS MATERIALS
COMMITTEE ON COMMERCE
U.S. HOUSE OF REPRESENTATIVES

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ROOM 2123 RAYBURN HOUSE OFFICE BUILDING

INTRODUCTION

Chairman Fields, Chairman Oxley and members of the Subcommittees, I appreciate and welcome this opportunity to present the views of the Federal Deposit Insurance Corporation on the Financial Services Competitiveness Act of 1995, and related issues. I commend you for placing a high priority on the need for structural reform of our financial system.

The FDIC supports a repeal of the Glass-Steagall restrictions on the securities activities of commercial banking organizations, provided that this is accompanied by the appropriate protection to the deposit insurance funds. In the financial and regulatory environment of today, the Glass-Steagall restrictions do not serve a useful public purpose. Repeal of the restrictions would strengthen banking organizations by allowing diversification of income sources and better service to customers, and would promote an efficient and competitive evolution of U.S. financial markets.

History demonstrates, however, that expansion of the activities of banking organizations must be accompanied by adequate safeguards. The controls that exist today to protect insured institutions from the risks of related nonbanking entities have generally proven satisfactory in the normal course

of business. When banking organizations have experienced severe financial stress, however, interaffiliate transactions have occurred that have resulted in material losses to the deposit insurance funds, although these have not been solely responsible for any bank failures. The FDIC has a special interest in the adequacy of safeguards to protect the deposit insurance funds. My testimony contains several specific comments in this area.

Financial markets have changed dramatically since 1933, when the Glass-Steagall Act first imposed a separation between banking and securities underwriting activities, and since 1956, when the Bank Holding Company Act further limited the activities of bank affiliates. To a greater extent than ever before, nonbanking firms now are offering financial products that were once the exclusive domain of banks. Improvements in information technology and innovations in financial markets make it possible for the best business customers of banks to have access to the capital markets directly, and, in the process, to bypass traditional financial intermediaries.

Large corporations meet their funding needs through the issue of commercial paper, debt securities, equity and through loans. The Glass-Steagall restrictions prevent most banking organizations from providing the full range of funding options to their customers. The shrinking role of banks in lending to business is illustrated by the declining proportion that bank

loans represent of the liabilities of nonfinancial corporations. This share declined from about 22 percent in 1974 to 13.7 percent at year-end 1994, the lowest proportion since these data were first collected in the early 1950s. Similarly, it is noteworthy that banks have grown much less rapidly than other financial intermediaries during the past ten years. For example, banking assets grew at an average annual rate of 4.8 percent, compared to growth rates of 26.7 percent and 14.1 percent for mutual funds and securities firms, respectively. Attachment A shows average annual growth rates of the assets of various types of financial institutions for the past ten years.

There is indirect evidence which suggests that as banks have lost their best business customers, they have to some extent turned to riskier ventures such as construction finance and commercial real estate loans. Although the banking industry has experienced record profits recently, the wide swings in past performance indicate increased risks in the industry. In the last ten years, the banking industry achieved both its lowest annual return on assets (approximately 0.09 percent in 1987) and its highest return on assets (1.20 percent in 1993) since the implementation of deposit insurance. As discussed in Attachment B, the volatile swings in the health and performance of the industry may result in part from constraints that limit alternatives for generating profits. Restrictions that resulted in the loss of many of their best corporate loan customers,

combined with the need to maintain profit margins and keep market share, led many banks to increase their concentrations in alternative high-yield assets. Some of these investments, such as construction and real estate development loans, loans to developing-country borrowers and loans to finance highly leveraged commercial transactions, carried higher, sometimes unfamiliar, credit risks. Other investments, including longer-term fixed-rate securities and home mortgage loans, as well as securities derivatives, increased the interest-rate risk of banks.

Some might ask whether we are forgetting the lessons of an earlier time -- the 1920s and 1930s. Congress imposed the restrictions of Glass-Steagall in reaction to the abuses of bank securities affiliates and the perception that the abuses contributed substantially to the banking crisis of the 1930s. Attachment C to my testimony describes the historical evidence on this subject. The evidence generally suggests that the concerns that bank securities activities played a major causal role in the banking crisis were overblown, and that remedies other than the Glass-Steagall restrictions would have addressed the abuses more effectively.

When the historical debate is finished, however, we come to this: we have in place today a regulatory structure of comprehensive banking and securities regulation that did not

exist in 1933, including restrictions on interaffiliate transactions. Moreover, the marketplace has moved well beyond the Glass-Steagall restrictions. Financial products, regardless of the labels, are converging. The Glass-Steagall Act stands like a dam in the middle of a mighty river that is finding other channels for its inevitable currents. On balance, I believe the risks of eliminating the Glass-Steagall prohibitions can be contained and that the benefits of an evolving marketplace outweigh the costs.

Finally, I would argue that an easing of the broad range of restrictions on activities of banking organizations beyond those that are financial in nature should proceed in a cautious, incremental manner. Banking organizations have expertise in managing financial risks. We should develop a body of experience to evaluate the safety-and-soundness implications of any new financial affiliations, before allowing broader affiliations with firms exposed to a different range of risks. Setting aside real estate development, the limited, but generally successful, experience of the affiliation of savings associations with commercial firms may provide a useful starting point for such an evaluation in the future. However, it does not provide a clear model for intermingling the more comprehensive risk profile of banking with commercial activities.

My testimony will first summarize the special concerns of the FDIC, as deposit insurer, with respect to expanded activities of bank subsidiaries and affiliates. Next, I will discuss the safeguards that are necessary to protect the deposit insurance funds and the financial system. I will then review the advantages and disadvantages of particular organizational structures with respect to the location of new securities activities. The balance of my testimony will focus on specific provisions of the Financial Services Competitiveness Act of 1995.

PERSPECTIVE OF THE DEPOSIT INSURER

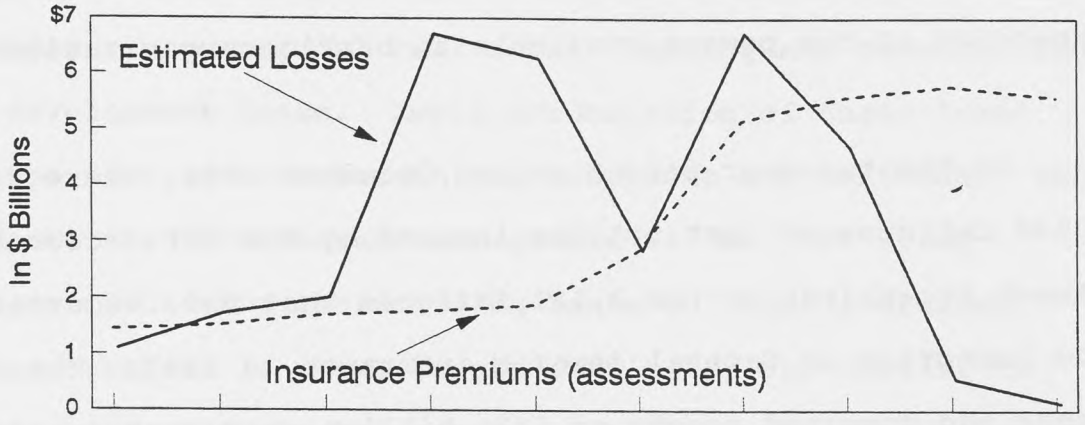
As the deposit insurer, the FDIC has a vital interest in the safety and soundness of insured institutions and the integrity of the deposit insurance funds. Events of the past decade have demonstrated how costly deposit insurance can be. The Bank Insurance Fund (BIF) and the banking industry have spent almost $33 billion to resolve failing banks in the period from 1985 to 1994 (see Figure 1). The thrift crisis, in contrast borne by the taxpayers, has been estimated to cost $150 billion.

We cannot attribute all of the insurance losses to economic events or poor management of depository institutions. A significant share of the responsibility must be assigned to poorly planned efforts to deregulate financial services and ineffective supervision in some areas. Thus, it is imperative

FIGURE 1

Deposit Insurance Cost - Ten Years Ending 1994

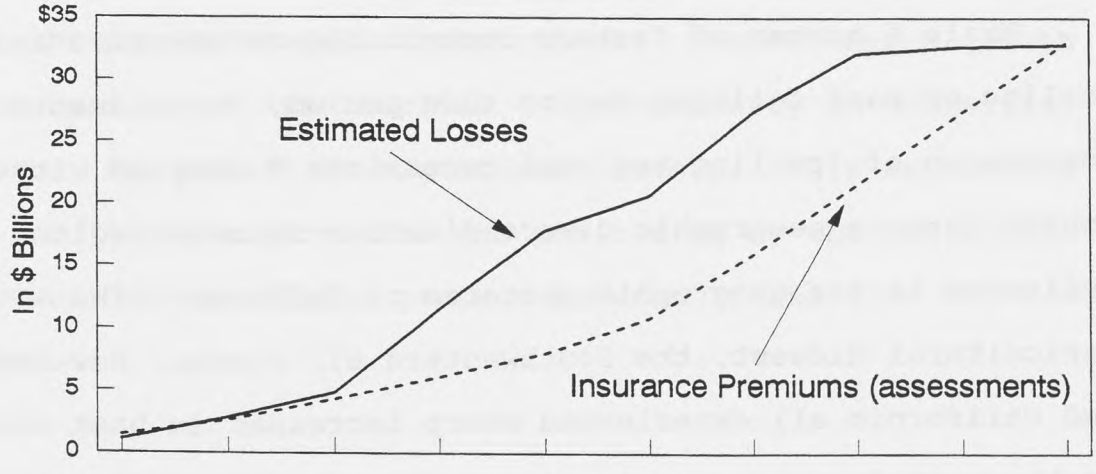
FDIC Bank Insurance Fund



(In $ Millions)	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994 *
Estimated Losses	1,099	1,722	2,007	6,721	6,273	2,856	6,739	4,695	570	139
Insurance Premiums (assessments)	1,433	1,517	1,696	1,773	1,885	2,855	5,161	5,588	5,784	5,591 *

Cumulative Deposit Insurance Cost - Ten Years Ending 1994

FDIC Bank Insurance Fund



(In $ Millions)	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994 *
Estimated Losses	1,099	2,821	4,828	11,549	17,822	20,678	27,417	32,112	32,682	32,821
Insurance Premiums (assessments)	1,433	2,950	4,646	6,419	8,304	11,159	16,320	21,908	27,692	33,283 *

* The 1994 figure reflects rebates to some institutions that appealed their 1993 assessments.

Sources: 1993 FDIC Annual Report and FDIC Failed Bank Cost Analysis, 1986 - 1993.

that we proceed deliberately as we contemplate a substantial expansion of the powers available to banking organizations.

In the ten-year period ending December 1994, there were 1,368 failures of institutions insured by the BIF, accounting for almost two-thirds of the 2,121 failures that have occurred since the inception of federal deposit insurance in 1933. These failed banks had combined assets of $236 billion, and cost an estimated $32.8 billion to resolve. The number of failures reached an annual record level of 221 in 1988, while the losses and combined assets of failed banks peaked in 1991. The 13 bank failures in 1994 were the fewest since ten banks failed in 1981, and speak to the significantly improved financial condition of the banking industry.

While a number of factors contributed to the rise and decline of bank failures during this period, two elements -- the phenomenon of "rolling regional recessions," coupled with constraints on geographic diversification in some regions -- are reflected in the geographic patterns of failures. The agricultural Midwest, the Southwestern oil states, New England, and California all experienced sharp increases in bank failures in the past decade, stemming in large part from regional economic downturns. In general, the largest losses to the FDIC occurred in those states where regional recessions have been most severe.

The most costly failures can be linked to excessive concentrations in commercial real estate lending and construction and land development loans. Rapid accumulation of these loans preceded the rise in failures in the Southwest and Northeast, the regions where the FDIC losses were greatest. An FDIC study published in 1990 found that failing banks in Texas increased their concentrations in these assets long after the decline in local real estate markets had begun. Failed savings banks in New England also had much higher proportions of their balance sheets invested in construction and land development loans, where they had little previous experience.

There are two lessons to be drawn from these experiences. First, inadequate diversification of income sources is dangerous for banking organizations. This is an argument in favor of the repeal of the Glass-Steagall restrictions. Second, rapid growth in lending by insured institutions -- particularly in unfamiliar activities -- can result in significant losses. This emphasizes the need for strong supervision and monitoring by the regulators using adequate safeguards to protect insured financial institutions.

The Demise of the FSLIC

The experience of the thrift industry in the 1980s serves as an even stronger reminder of the importance of maintaining safety-and-soundness standards. The highlights of the experience bear repeating as we consider the expansion of activities of banking organizations. In the early 1980s, most of the thrift industry was economically insolvent due to interest-rate-induced losses from lending longer term at lower interest rates and borrowing short-term at higher interest rates. Rather than address the problems directly, the political and regulatory response was to relax capital and accounting standards, forbear from closing insolvent institutions, and expand the powers available to thrifts.

Federal legislation in the early 1980s significantly liberalized the permissible assets of thrifts. By 1982, thrifts could make commercial mortgage loans of up to 40 percent of assets, consumer loans up to 30 percent of assets and commercial loans and leases each up to 10 percent of assets. By midyear 1983, the Federal Home Loan Bank Board (FHLBB) allowed federally chartered savings and loan associations to invest up to 11 percent of their assets in high-risk bonds. Direct equity investments in real estate, equity securities and in subsidiary service corporations were permitted up to 3 percent of assets. Several states permitted state-chartered institutions

significantly greater scope for direct investments. The attempt by many troubled institutions to use the new powers to "grow themselves out of their problems" added substantially to the cost of the thrift crisis.

Some might argue that the experience of thrifts in the 1980s is irrelevant today. I would disagree. Wherever there is a government guarantee, there will be some who attempt to exploit it inappropriately. Mechanisms must be in place to contain these risks. In addition, the supervisory staff that has been trained to detect losses from traditional activities will need to become familiar with the risks and potential losses associated with the new activities.

We also must keep in mind the extent to which a strong deposit insurance system depends on a sound regulatory structure as we eliminate the Glass-Steagall barriers. Securities activities of banking organizations should be subject to the regulation of the Securities and Exchange Commission (SEC). As securities activity increases in the banking industry, so will the role of functional regulation and the need to coordinate the distinct regulatory approaches. Supervision has been the keystone of the regulation of commercial banking, while disclosure and market discipline have been the key elements of securities regulation. The challenge will be to combine these approaches in a seamless fashion that permits no gaps that might

threaten the insurance funds, and yet avoids burdening banks with regulatory overlap.

Finally, as banking organizations enter new activities, care should be taken to confine deposit insurance protection appropriately. Securities markets in the United States are dynamic and innovative; they have expanded the growth potential of the economy and have become the envy of the world. Our securities markets do not need the backing of the deposit insurance guarantee, nor do they need the added requirements of bank regulation that come with it. To promote the continued efficiency of securities markets, as well as to protect the insurance funds from undue risk, it is critical to separate the insured entity from the securities units of the banking firm. This will be addressed more extensively in the following discussion of necessary safeguards to the insurance funds and the appropriate structure for the conduct of new activities by banking organizations.

PROTECTION FOR THE INSURANCE FUNDS

My testimony has emphasized that in expanding the securities activities of banking organizations, we must not lose sight of the need to maintain the safety and soundness of insured institutions. This requires protection against inappropriate

transactions between insured institutions and their securities subsidiaries and affiliates.

In general terms, there are two areas of concern from an insurance standpoint with respect to transactions between an insured institution and a related securities firm. The first involves the inappropriate use of an insured institution to benefit a related securities firm in the course of business. A second arises when an insured institution is in danger of failure. In the latter situation, there is an incentive for the owners and creditors of the related entities to extract value from the insured entity prior to its failure in order to maximize the share of losses borne by the FDIC and minimize their own losses. The FDIC's experience suggests useful lessons regarding necessary protections for the insurance funds in both areas.

There are numerous ways an insured institution could benefit a related securities firm in the course of business. These include: direct equity injections to a securities subsidiary; upstreaming of dividends to a parent that are used to inject equity to a securities affiliate; purchasing of assets from, or extensions of credit to, the related firm; issuing a guarantee, acceptance or letter of credit for the benefit of the related firm; extending credit to finance the purchase of securities underwritten by the related firm; and extending credit to the issuers of securities underwritten by the related firm for

purposes of allowing the issuers to make payments of principal, interest or dividends on the securities.

There are three main dangers in such transactions from the standpoint of the deposit insurer. First is the danger that the consolidated entity will attempt to use the resources of the insured institution to promote and support the securities firm in a way that compromises the safety and soundness of the insured institution. An equally important concern is that the business relationship between the insured entity and the securities firm will create a misperception that the investment products of the securities firm are federally insured. Finally, there is the danger that the business and operating relationship will cause the courts to "pierce the corporate veil" -- that is, to hold the insured entity responsible for the debts of the securities firm in the event the securities firm fails.

Current law provides a number of safeguards against these dangers. Attachment D provides a summary of some of the major provisions. We must be concerned with how well these safeguards will work after Glass-Steagall restrictions are lifted. The experience with the involvement of banks with securities activities has to this point been limited, but generally favorable. Since 1987, the Federal Reserve has allowed limited securities activities in so-called "Section 20 subsidiaries" of bank holding companies. The Federal Reserve indicates that there

have been no instances in which a Section 20 subsidiary adversely affected an affiliated bank. There are currently 36 bank holding companies that have Section 20 subsidiaries; these subsidiaries range in size from a few million dollars in assets to tens of billions of dollars in assets. There has been one failure of an insured institution affiliated with a Section 20 subsidiary. The Section 20 subsidiary played no role in causing the failure.

U.S. banks also are permitted to engage in securities activities overseas within various limitations. Typically these activities are conducted by subsidiaries of Edge Corporations, which, in turn, are generally subsidiaries of U.S. banks. Federal Reserve staff indicate that these activities have not posed any significant safety-and-soundness problems for U.S. banks.

The FDIC permits institutions it supervises to engage in securities activities through "bona fide subsidiaries" -- that is, subsidiaries that meet certain criteria designed to ensure corporate separateness from the insured banks. A detailed description of the bona fide subsidiary structure and the FDIC's regulatory safeguards in place to insulate the insured institution is included in Attachment D. More limited activities are permissible to subsidiaries that do not meet the "bona fide" subsidiary test.

The experience of banking organizations conducting securities activities through such subsidiaries has been limited. Currently, only one FDIC-supervised institution owns a subsidiary actively engaged in the full range of securities activities permitted by the FDIC. There are, however, over 400 insured nonmember banks that have subsidiaries engaged in more limited securities-related activities. These include management of the bank's securities portfolio, investment advisory activities, and acting as a broker/dealer. With one exception, none of these activities has given cause for a significant safety-and-soundness concern.

There has been one failure of an insured institution supervised by the FDIC that conducted securities activities through a subsidiary. While not the sole cause of the failure, the business relationship with the securities subsidiary added to the cost of the failure. The bank made a substantial unsecured loan that was used to benefit the securities subsidiary. This transaction was in compliance with the restrictions on affiliate transactions of Section 23A of the Federal Reserve Act because Section 23A does not specifically apply to transactions between a bank and its subsidiary. Given the Federal Reserve's residual rulemaking authority with respect to Sections 23A and 23B, we will work with the Federal Reserve to determine whether the provisions of Sections 23A and 23B should be extended to apply to

these subsidiaries. We would also support an amendment to the legislation to assure coverage of these kinds of transactions.

The experience with bank-sponsored mutual funds has also been free of substantial safety-and-soundness concerns. Nevertheless, this experience demonstrates that the mixing of banking with securities activities is not without risk. Within the last year, 12 banking organizations have elected to provide financial assistance to their proprietary money-market mutual funds. The assistance has ranged from $1 million to about $83 million. The decisions to provide assistance presumably reflected business judgments that weighed the cost of the assistance against the loss of reputational capital that these organizations would have sustained if investors in their mutual funds had suffered losses.

None of these episodes posed any serious safety-and-soundness concerns to the insured entities. In all but two cases, the assistance was provided by the holding company rather than the bank, and in no case did the assistance exceed approximately one percent of the consolidated capital of the holding company. Nevertheless, the instances serve as a reminder that banking organizations can have an incentive to manage their businesses as a unit, and the result may involve the transfer of resources among affiliates that can adversely affect the insured entity.

The affiliation of banking and securities activities as it currently exists in both bank subsidiaries and bank affiliates has, in general, not presented significant safety-and-soundness concerns. This experience suggests that current safeguards are for the most part adequate and that any reform of Glass-Steagall should include similar safeguards against dealings between the insured bank and a securities affiliate.

Although the experience thus far has been generally positive, it has been limited. As mentioned above, we have not seen the combination of a failed or severely distressed bank that was associated with significant securities activity. This is important from the perspective of the deposit insurer because the past decade provided examples where distressed banks breached statutory or regulatory protection of the insured bank to the detriment of the FDIC.

While none of the interaffiliate transactions were solely responsible for the failure of any insured institutions, there were a number of instances where "deathbed transactions" were proposed or consummated that served to advantage the holding company or an affiliate at the expense of the insured bank. The transactions often involved sums in the tens of millions of dollars. Not all of these transactions required regulatory approval. The regulators often, but not always, denied those that did.

Unpaid tax refunds arose as an issue in more than one case. Bank holding companies generally receive tax payments from and downstream tax refunds to their banking subsidiaries, acting as agent between the bank and the Internal Revenue Service. The FDIC has observed that in some cases unpaid tax refunds accumulated on the books of failing bank subsidiaries, leaving the cash with the holding company. This practice occurred without regulatory approval.

Consolidation of nonbank activities at the parent level is another way to transfer value away from insured bank subsidiaries. One notable case involved the consolidation of trust operations at the subsidiary banks into a single parent-owned company that was later sold at a profit. When service company affiliates carry out data processing or other activities for banks, the issue of intercompany pricing also is raised. In one case the FDIC observed a large and retroactive increase in charges by an asset management company to troubled bank affiliates. In other cases, service company affiliates failed to provide promised overhead reimbursement for the use of bank premises.

Linked deals involving the sale of purchased mortgage servicing rights have in some cases been used either to subsidize the sale of a holding company asset or to allow the bank subsidiary to book an accounting gain. The effect of a linked

deal may be to either transfer value to the parent or delay the closing of a subsidiary without the benefit of needed fresh capital.

Finally, there have been instances of "poison pills" created by interaffiliate transactions. In one case, key bank staff were transferred to the holding company payroll, apparently to reduce the attractiveness of bringing in an outside acquirer. Interaffiliate data processing contracts also have been structured so as to limit the availability of information to the FDIC or an acquirer after the bank was closed, thereby making regulatory intervention more costly.

To summarize, factors other than interaffiliate transactions typically have caused the failure of FDIC-insured subsidiaries of bank holding companies. However, such transactions were used in several cases to extract value from the insured bank just prior to its failure at the expense of the deposit insurance fund. This generally did not come about through excessive dividends or the transfer of blatantly misvalued assets. They more often occurred through the pricing of services traded between affiliates, early retirement of subordinated debt and linked deals involving third parties. These transactions probably added tens of millions of dollars to the losses realized in resolving these large banking organizations.

Some of the most spectacular examples of inappropriate intercompany transactions come from the thrift industry in the 1980s. Thrifts have traditionally spawned a variety of subsidiary service corporations to perform tasks such as mortgage servicing, brokerage, title insurance and other types of insurance. With the liberalization of federal and state restrictions on direct real estate investment in the early 1980s, the real estate development subsidiary became a common vehicle for these activities. However, while federally chartered institutions in the early- to mid-1980s were limited to investing 3 percent of assets in these activities, state-chartered institutions in California and Texas could make virtually unlimited direct investments.

Two factors made this liberalization of powers particularly conducive to creating losses for the Federal Savings and Loan Insurance Corporation (FSLIC) and later the Resolution Trust Corporation (RTC). First, under regulatory accounting practices, direct investments in subsidiaries were carried on the books of the parent thrift at historical cost, instead of their market value, which was often considerably lower. Second, thrift regulators as a rule neglected to conduct detailed examinations of subsidiary operations. Under these conditions, thrift managers were free to invest in residential and commercial real estate development activities with which they had little experience, and when these projects became problematic they could

use a variety of transactions to hide the losses. The thrift could make unsound loans to help sell new properties built by the subsidiary. In some cases the thrift would sell the note to the subsidiary, removing it from the balance sheet for a period.

Our review of the examples described above suggests that, for the most part, the problem has not been that the existing protections were inadequate. Instead, it appears that the regulatory community has been reluctant at times to enforce these protections. This reluctance is understandable to some extent, given the considerable uncertainties that surround banks in distress and the desire to mitigate market pressures that may unnecessarily aggravate the plight of those banking organizations that have a chance to survive.

What steps can be taken to encourage more vigilant enforcement of protections? First, the enforcement of safeguards against transactions between an insured bank and its securities affiliates should allow for few exceptions. Congress should consider whether the perspective of the FDIC as insurer would be useful in identifying, through guidelines or other means, those limited areas where exceptions to the safeguards may be beneficial without creating the potential for losses to the insurance funds. In addition or in the alternative, it may be useful to develop an interagency codification of the standards for enforcing Sections 23A and 23B of the Federal Reserve Act, so

that insured financial institutions and all regulatory agencies will have clear notice and fuller understanding of the nuances of these safeguards. Second, while sound business judgment should dictate when healthy, well-capitalized banks provide support to related entities, such support should come through the transfer of excess bank capital -- beyond the capital required for a well-capitalized bank -- not through the relaxation of safeguards such as those discussed earlier. For bank holding companies, this means the well-capitalized bank could provide dividends that allow the parent to provide support to nonbank subsidiaries. For banks conducting activities in subsidiaries, the bank could make additional equity investments in the subsidiary and those investments should be deducted from bank capital before determining whether the insured bank meets the standard of being well-capitalized.

In addition, bank regulators may want to consider whether to require prompt reporting of intercompany transactions under certain conditions, as the SEC does in some contexts. These requirements may be tied to the capital level of the bank, the size of the transaction, or other relevant factors.

As the deposit insurer, it is the FDIC's responsibility not only to protect depositors when a bank fails, but also to learn from the failure of that bank. The FDIC is prepared to provide information and analysis to fellow regulators where there is

evidence that intercompany transactions have contributed to the failure of, or increased the cost of resolving, an insured institution. Such reports would contribute to an increased understanding and awareness of these issues, and we believe ultimately would promote improved enforcement of the safeguards.

STRUCTURAL ISSUES

An important consideration in the deliberations concerning the possible combination of traditional commercial banking and securities activities is the organizational structure under which such combinations would be permitted. The perspective of the deposit insurer focuses on two issues: the ability to insulate the insured bank from the risks of the securities underwriting activities and the burdens and inefficiencies associated with a particular regulatory structure. The following analysis addresses these issues.

There are two organizational structures with which we have experience in the United States that can be used to combine commercial and securities underwriting activities. These are: (1) the conduct of each activity in separate organizations owned and controlled by a common "parent" organization (the "bank holding company" model); and (2) the conduct of each activity in a separate organization, one of which owns and controls the other entity (the "bona fide subsidiary" model). A third model -- the

conduct of both activities within the same entity (the "universal banking" model) -- has been used in some other developed countries. For reasons discussed in Appendix B, I believe that universal banking is not a model that would best fit the dynamic financial marketplace in the United States or provide sufficient protection for the deposit insurance funds against the effects of potential conflicts of interest between banking and nonbanking functions in an insured entity.

The Bank Holding Company Model

Since the adoption of the Bank Holding Company Act of 1956, one of the primary methods of expanding permissible activities beyond those associated with traditional commercial banking has been through formation of affiliated entities within the bank holding company umbrella. Within this framework, banking organizations have been permitted to engage in an increasing array of financial services. Most recently, some bank holding companies have been permitted by the Federal Reserve to engage in corporate securities underwriting activities through so-called "Section 20" subsidiaries. Attachment E describes in detail the prohibitions and restrictions on securities activities that are imposed by Section 20 of the Glass-Steagall Act and by the Bank Holding Company Act.

In terms of the criteria for safeguards set forth earlier, the bank holding company model has considerable merit. The advantages include:

- Provision of a good framework for monitoring transactions between insured and non-insured affiliates and for detecting transfers of value that could threaten the insured institution; and

- Maintenance of a meaningful corporate separation between insured and non-insured organizations to assure that nonbank affiliates have no competitive advantages from the insured status of the bank.

The disadvantages of the bank holding company model include:

- In distressed situations, the parent will have the incentive to transfer or divert value away from the insured bank, leaving greater losses for the FDIC if the bank ultimately fails; and

- The holding company model requires bank owners to establish and maintain an additional corporation. This may add costs, inefficiencies, complexity and, in some cases, an additional regulator.

Bona Fide Subsidiary Model

From a practical perspective, there has been less experience with the "bona fide" subsidiary form of organization than with the bank holding company form. However, the experience discussed earlier in this testimony supports the view that direct ownership of a securities firm by an insured bank need not be significantly different from the bank holding company model in terms of affording protections to the deposit insurance funds, and may have some additional advantages.

Analytically, there are several factors that make this approach different from the bank holding company model. The advantages of the bona fide subsidiary approach include:

- The residual value of the subsidiary accrues to the bank, not the holding company; and

- The bank, rather than the parent, controls the allocation of excess capital of the organization. This may mean that in making corporate investment decisions, greater weight will be given to the needs of the insured bank. Financial investments will be structured to diversify the risks of the bank's portfolio, while investment in systems and physical capital will benefit the operations of the bank.

However, on the negative side:

- While corporate separateness theoretically can be maintained regardless of organizational structure, in practice, a bank holding company structure may be a more effective vehicle for this purpose;

- Inappropriate wealth transfers may be more easily executed if made directly to a subsidiary, rather than indirectly to the parent and then to an affiliate; and

- Consolidated earnings of a bank that includes a fully consolidated securities firm may exhibit more volatility than the bank alone. This may be negatively perceived by the market, and might inhibit the ability of banks to raise capital or attract funds at market rates.

Based on these observations, it is clear that there are advantages and disadvantages to both models. Furthermore, the safeguards that are necessary to protect the insured bank and ultimately the insurance funds can be similar for either structure. If these safeguards are in place and enforced, either approach will work. If safeguards are inadequate or there is not a strong commitment to enforcing them, the deposit insurance

funds, the financial system and the public will suffer, regardless of which model is used.

In the final analysis, I favor allowing financial institutions to choose the model that best suits their business needs, as long as strong safeguards are in place to protect the insurance funds. Legislation based on a progressive vision of the evolution of financial services need not mandate a particular structure. A combination of flexibility and sound regulation has contributed to the successful development of the U.S. financial system, and these key elements should be present in any proposal for reform.

COMMENTS ON THE FINANCIAL SERVICES COMPETITIVENESS ACT OF 1995

I want to commend the Subcommittee Chairmen again for holding this hearing to serve as a focus for debate on how best to achieve financial services reform. The Financial Services Competitiveness Act of 1995, as reported from the Committee on Banking and Financial Services ("the bill"), is designed to enhance competition in the financial services industry by providing a prudential framework for the affiliation of banks and securities firms. It accomplishes this by eliminating current statutory restrictions on these affiliations and establishing a comprehensive framework for affiliations within a holding company

structure overseen by the Federal Reserve with functional regulation of securities activities by the SEC.

As discussed earlier in my testimony, the protections against inappropriate intercompany transactions provided in the bill are sound. I would expect that any exceptions to these restrictions that could be made pursuant to the legislation would be structured to protect the deposit insurance funds from potential losses. Moreover, provided the appropriate protections are in place, I would support an approach that allows a commercial bank the flexibility to conduct securities activities in an affiliate of its holding company where the bank has a holding company or wishes to organize one, or in a subsidiary of the bank where that approach more effectively conforms to the business plan of the organization. I recognize, however, that the bill would permit additional securities activities to be conducted only under the holding company structure. While I do not believe the advantages of the bank holding company structure are so pronounced as to justify imposing additional costs on the banking system by mandating a particular structure, I support the bill as a reasonable balancing of the competing considerations of safety and soundness and additional flexibility for banking organizations.

Criteria for Approval

Turning to a more detailed discussion of the bill, any expanded authority may be exercised only through a financial services holding company structure and only when the Federal Reserve has concluded that certain procedural safeguards have been met. The criteria outlined in the bill are sensible and appropriate.

Only financial services holding companies that are adequately capitalized are eligible to acquire a securities affiliate. For purposes of determining whether a financial services holding company is adequately capitalized, the holding company's capital and total assets are reduced by the holding company's equity investment in any securities affiliate, and further reduced by certain extensions of credit to any securities affiliate.

The lead bank within the holding company must be well-capitalized before the holding company is eligible to acquire a securities affiliate. Moreover, 80 percent of the aggregate total risk-weighted assets of the holding company's depository institutions must be controlled by well-capitalized institutions, excluding certain recently acquired depository institutions. All subsidiary depository institutions controlled by the holding company must be well-capitalized or adequately capitalized.

Well-capitalized financial services holding companies may elect alternative capital treatment, however. A financial services holding company and its depository institution subsidiaries will be deemed to have satisfied the capital requirements prescribed by the bill if the holding company files a notice of its election for alternative capital treatment with the Federal Reserve; all of the holding company's depository institutions are at least adequately capitalized; and the holding company is well-capitalized and would continue to be well-capitalized immediately after the acquisition of the securities affiliate. Any holding company that elects such alternative capital treatment will be liable for any loss incurred by the FDIC in connection with the default of any insured depository institution controlled by the holding company.

We support these provisions. I believe these provisions help to preserve a strong capital cushion for the bank and the financial services holding company as a possible source of strength for its banking subsidiaries. It is appropriate to impose losses incurred by the FDIC on holding companies that elect the alternative capital treatment described above.

The bill properly provides an incentive to financial services holding companies and their depository institutions to maintain adequate capital levels after they have been allowed to affiliate with a securities company. In the event the lead

depository institution drops below the well-capitalized category, or if well-capitalized institutions cease to control 80 percent of the aggregate total risk-weighted assets of the depository institutions within the holding company, the holding company must execute an agreement with the Federal Reserve to meet the prescribed capital requirements within a reasonable period of time or to divest control of the depository institution within 180 days (or such additional period of time as the Federal Reserve may determine is reasonable). If the holding company fails to execute such an agreement or fails to comply with such an agreement, the securities affiliate cannot agree to underwrite or deal in any securities starting 180 days after the capital deterioration, with limited exceptions. While there are certainly instances where, as provided for in the bill, the securities affiliate should be barred from agreeing to underwrite or deal in any securities, such a blanket prohibition may not be prudent in all cases. For example, a profitable securities affiliate may serve as a source of strength to a holding company and its bank subsidiary.

At the same time, however, we note that the bill gives the Federal Reserve the authority to waive the capital safeguards for up to two years if the financial services holding company submits a recapitalization plan for the banks. We have an interest in assuring that a waiver will be granted only in situations where greater safety and soundness can be expected to result and losses

to the insurance fund are not likely to be increased. For that reason, we want to work with the Federal Reserve on an interagency basis to develop guidelines on when waivers of these safeguards would be appropriate.

In addition to capital conditions, the bill imposes a broad array of managerial safeguards and internal controls. The holding company and all of its depository institutions must be well-managed. The financial services holding company must have the "managerial resources" necessary to conduct the securities activities safely and soundly. The holding company must have adequate policies and procedures in place to manage any potential financial or operational risks. In addition, the holding company must have established adequate policies and procedures to provide reasonable assurance of maintenance of corporate separateness within the financial services holding company. Finally, the acquisition must not adversely affect the safety and soundness of the financial services holding company or any depository institution subsidiary of the holding company. These operational safeguards, particularly the emphasis on maintaining corporate separateness, are well-designed to insulate federally insured banks from the risks of securities activities.

The bill provides that a holding company's acquisition of a securities affiliate must not result in an undue concentration of resources in the financial services business. The bill also

provides that the lead depository institution subsidiary as well as the depository institutions controlling at least 80 percent of the aggregate total risk-weighted assets of all depository institutions controlled by the holding company must have achieved a satisfactory record of meeting community credit needs during the most recent examination. We support these provisions.

The bill also places several interaffiliate safeguards on the relationship between a securities firm and its affiliated bank or parent holding company. For example, a depository institution affiliated with a securities affiliate is prohibited from extending credit to the securities affiliate, issuing a guarantee, acceptance, or letter of credit for the benefit of the securities affiliate or, with certain exceptions, purchasing assets of the securities affiliate for its own account. I support these safeguards. In moving from a framework based on prohibition to one based on regulation, prudential safeguards such as those set forth in the bill will avert the hazards Glass-Steagall was intended to prevent.

In addition, the bill provides for some exceptions to the safeguards for well-capitalized banks. For example, a well-capitalized institution may extend credit for the purpose of enhancing the marketability of a securities issue underwritten by its securities affiliate but only if the depository institution has adopted limits on its exposure to any single customer whose

securities are underwritten by the affiliate and the transaction is on an arm's-length basis. This appears to be a reasonable exception to the safeguards. The FDIC would like to work with the Federal Reserve to assure that in practice, any additional exceptions to the safeguards will not present substantial risks to the deposit insurance funds.

Some may argue that the safeguards provided for in this bill would hamper the ability of a financial services holding company to compete against non-regulated entities and would impede its ability to realize business synergies. The potential for risks associated with the conduct of such activities by an entity affiliated with insured depository institutions, however, carries with it the need for some protections for the insured institution. The bill draws an appropriate balance between these competing considerations.

I also support the additional safeguards for director and senior executive officer interlocks. Finally, I support the various public disclosures included in the bill. In particular, I strongly support the requirement that customers be informed that the securities offered or sold by securities affiliates of insured banks are not federally insured deposits. This is an important protection for these customers and for the deposit insurance funds.

Existing Bank Securities Activities

The bill provides that, subject to discretionary determinations by the SEC or the Federal Reserve, banks could continue to conduct some existing securities activities within the bank. Some of these activities must be moved to a Separately Identifiable Department (SID) and some activities must be moved to an affiliate -- both of which would be functionally regulated by the SEC.

While there is no separate capital requirement for SIDs, the risk associated with the activities conducted through the SID is included currently in the assessment of the bank's overall capital adequacy. In addition, bank regulators are in the process of developing a proposed amendment to more formally incorporate market risks associated with underwriting and dealing activities into their capital adequacy requirements.

Concerns have been raised about the provisions of the bill that provide for discretionary determinations of the SEC and the Federal Reserve with respect to what is a security or a bank product and where such activities can be conducted. Such determinations could result in limitations or unnecessary regulatory burdens on activities that have been conducted within the bank for many years without posing significant safety-and-soundness problems. We believe that there may be some room for

further refinement of these provisions in order to avoid unnecessary organizational or regulatory burdens.

Functional Regulation

With respect to regulation, the bill calls upon the banking agencies and the SEC to work together to ensure compliance with the securities laws. As I mentioned earlier in my statement, functional and supervisory regulation must be seamless to be effective. By calling for the banking agencies and the SEC to share information, the bill promotes this goal by facilitating coordination among the regulatory agencies. Further refinement may need to be made to the provisions of the bill with respect to SEC and Federal Reserve discretion in order to avoid the possibility of duplicative supervisory and reporting burdens.

Securities Firms

The bill creates the possibility for securities firms to become affiliated with banks by acquiring an insured bank and becoming a financial services holding company. In circumstances where more than 50 percent of a company's business involves securities activities, the bill allows the company five years, with the possibility of an additional five-year extension, to divest its nonfinancial activities. In addition, such a company could be permitted to continue holding any subsidiaries engaged

in financial activities that the Federal Reserve has not authorized if the company acquired the subsidiaries more than two years prior to its becoming a financial services holding company and the aggregate investment by the company in these subsidiaries does not exceed 10 percent of the total consolidated capital and surplus of the company. The company would not be permitted to engage in any new activities not otherwise authorized by the bill once it becomes a financial services holding company. This means that some securities companies that become financial services holding companies could be permitted to engage in activities not otherwise permitted generally to financial services holding companies.

I support in general the approach of the bill with respect to the affiliation of a securities firm with an insured institution. If it is understood that prudential restrictions may be imposed by the Federal Reserve where necessary to protect the safety or soundness of an insured institution with respect to a grandfathered affiliate's activities, I see no reason to go further and require divestiture. Further, it should be clear that each of the banking agencies should be able to apply the full panoply of enforcement powers, ranging from cease-and-desist actions to deposit insurance termination, in order to protect an insured bank and the deposit insurance funds.

Wholesale Financial Institutions

The bill provides the additional option of an "investment bank holding company" (IBHC) that would be allowed to engage in a broader range of financial activities and could conduct banking activities through a "wholesale financial institution" (WFI). WFIs would be uninsured state member banks that could, with certain exceptions, only take initial deposits over $100,000. This provision allows for a wholesale banking operation to conduct a broader range of financial services activities without exposing the deposit insurance funds to the risks of these activities.

The IBHC concept may prove attractive to some financial firms and may even cause some FDIC-insured banks to consider terminating their deposit insurance. The proposed IBHC appears to the FDIC to be sound as long as there is clear disclosure to the public of the uninsured nature of commercial bank operations and the exceptions for initial deposits of $100,000 or less are appropriately limited and clearly defined for public disclosure purposes.

Holding Company Supervision

The bill provides a different supervisory structure for holding companies engaged primarily in nonbanking activities. Certain financial services holding companies and investment bank holding companies, that have relatively smaller percentages of consolidated risk-weighted assets in depository institution assets, would be under limited reporting and examination requirements and minimal approval requirements for new activities. As insurer, the FDIC finds this approach reasonable, and adequate, to provide for the identification of risks associated with nonbanking activities. Capital requirements and guarantee provisions protect the insured depository institutions and maintain a degree of supervision that while appropriate, does not unduly disadvantage financial services holding companies or investment bank holding companies with respect to unregulated entities.

Voluntary Termination of Insured Status

In order to facilitate transition by existing insured depository institutions to WFI status, the bill adds a new section governing voluntary termination of deposit insurance and repeals certain provisions of the FDI Act with respect to such termination. The bill would permit an "insured State bank" or a national bank to voluntarily terminate its status as an insured

depository institution upon six months' written notice to the FDIC, the Federal Reserve, and the institution's depositors. Before a bank may terminate its insurance under this provision, the deposit insurance fund must equal or exceed the fund's designated reserve ratio (DRR) of 1.25. In addition, the FDIC must confirm that the insurance fund will continue to equal or exceed the fund's DRR for the two semiannual assessment periods following notification of the institution's intent to terminate insurance. If the insurance fund does not meet its DRR, the bank must pay an exit fee and obtain the approval of the FDIC and the Federal Reserve. The FDIC is required to prescribe procedures for assessing any such exit fee by regulation.

The FDIC currently has in place procedures governing the termination of insurance. The legislative provisions described above appear to be intended to prevent the dilution of the fund for which coverage would be terminated. However, because a termination of insurance has the effect of increasing, not decreasing, the reserve ratio of the affected fund, Congress may wish to reconsider this provision. Moreover, the requirement that the FDIC confirm that the insurance fund would not fall below the DRR for one year following notification of the intent to terminate insurance would be very difficult to satisfy. Thus, the provision could have the unintended effect of precluding the transition of insured institutions to WFI status and of preventing voluntary terminations of insured coverage where no

disadvantage to the deposit insurance fund would necessarily result.

Savings associations as well as insured depository institutions excepted from the Bank Holding Company Act definition of "bank" would no longer be eligible voluntarily to terminate insured status. We believe these institutions, which are presently authorized under the law to leave the federal deposit insurance system, should continue to have that option.

The primary purpose of this provision of the bill is presumably to protect depositors when insured institutions convert to non-insured status. We agree that depositor protection must be paramount when any insured institution voluntarily relinquishes its insured status.

Under current law, an insured depository institution must obtain prior written consent of the FDIC before it may convert to non-insured status. The FDIC weighs several factors prescribed by statute in deciding whether to grant or withhold such consent. The bill does not amend or repeal these provisions; the FDIC's power to disapprove any institution's conversion from insured to non-insured status would continue without change. The voluntary termination procedures specified in the bill, however, differ somewhat from these consent requirements found elsewhere in the FDI Act. Consequently, it would be appropriate to clarify the

bill to assure consistency of the various termination provisions. The bill could in part be clarified by including a provision that the bill does not override the provisions of Section 18(i) of the FDI Act.

The bill provides that a depository institution that voluntarily elects to terminate its insured status shall no longer receive insurance of any of its deposits after the specified transition period. It also should be made clear that this provision is not intended to bar a formerly insured institution from reapplying for federal deposit insurance.

Under the bill, any institution that voluntarily terminates its status as an insured depository institution is prohibited from accepting deposits unless the institution becomes a WFI. If the institution becomes a WFI, it may not accept any initial deposit that is $100,000 or less other than on an incidental and occasional basis. These prohibitions limit the flexibility non-insured institutions now have under federal law. It is not clear why the law should compel institutions that have voluntarily terminated insurance to obtain WFI status so that they can accept deposits where state law permits other kinds of uninsured entities. The flexibility non-insured institutions enjoy under current federal and state laws should not be diminished without good cause. The bill can be improved by clarifying the termination provisions along the lines I have

outlined. The FDIC will be pleased to work with members of Congress in making reasonable modifications to these provisions to avoid unintended consequences.

In conclusion, on balance the bill represents a thoughtful approach to easing the restrictions between commercial and investment banking. It provides for prudential safeguards and appropriate restrictions designed to insulate insured institutions from the risks inherent in investment banking activities. It is an important foundation for considering the most effective and efficient approach by which appropriate financial services reform can be achieved.

CONCLUSIONS

The restrictions of the Glass-Steagall Act do not serve a useful purpose. Their repeal would strengthen banking organizations by helping them to diversify their income sources, and would promote the efficient, competitive evolution of financial markets in the United States. History demonstrates, however, that a significant expansion of the powers available to insured institutions must be accompanied by appropriate safeguards for the insurance funds. Chairman Leach and other members of the House Committee on Banking and Financial Services have recognized the need for such safeguards in the bill.

Existing experience with the combination of banks and securities firms suggests that, in general, current safeguards have been adequate to prevent significant safety-and-soundness concerns in the normal course of business. This experience has been limited, however; in particular, we have not seen a severely distressed banking organization that had significant securities activities.

The experience of the FDIC has been that in times of financial stress, banking organizations may attempt to engage in transactions that transfer resources from the insured entity to the owners and creditors of the parent company or nonbanking affiliates. In some cases the FDIC has suffered material loss as a result of such transactions. We seek to assure that reform of Glass-Steagall is not the vehicle for more such episodes.

My general comments on the safeguards against inappropriate intercompany transactions in the proposed bill are as follows. First, exceptions to the safeguards should be allowed only after taking account of potential losses to the insurance funds. While there should be room for supervisory discretion and the exercise of good business judgment in determining whether a healthy bank may support an affiliate, such support should be provided through transfers of excess capital -- beyond that required for a well-capitalized bank -- not through relaxations of restrictions on intercompany transactions. Second, it could be useful to develop

an interagency codification of the standards for enforcing Sections 23A and 23B of the Federal Reserve Act. To promote improved enforcement of the safeguards, the FDIC is prepared to provide information and analysis to fellow regulators on instances where intercompany transactions contributed to the failure of, or increased the cost of resolving, an insured institution.

There are two United States models for conducting the new securities activities within banking organizations -- the holding company model and the bona fide subsidiary model. There are advantages and disadvantages both to housing the securities activities in bank subsidiaries, and to housing the activities in holding company affiliates. On balance, I do not believe the case for either approach is strong enough to warrant dictating to banks which approach they must choose.

In general, I believe that banks should be able to chose the corporate structure that is most efficient for them, provided adequate safeguards are in place to protect insured financial institutions and the insurance funds. H.R. 1062 is a sound and constructive approach to evaluating how best to reform our financial system. The FDIC stands ready to assist the Subcommittees with this important effort.