FULL STATEMENT

BY

WILLIAM M. ISAAC, CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

HEARINGS ON THE CONDITION AND STRUCTURE OF, AND COMPETITION WITHIN, THE DOMESTIC FINANCIAL SERVICES INDUSTRY

BEFORE THE

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

9:30 a.m.
Wednesday, April 27, 1983

Room SD-538, Dirksen Senate Office Building

Mr. Chairman, I appreciate the opportunity to appear this morning to discuss some of the many issues which we believe should be considered if financial deregulation is to move forward in a sound and responsible manner. We commend the Committee's efforts in addressing the complex questions posed by a rapidly-changing financial environment.

I would like to direct my comments to three principal areas: (1) expanding the permissible activities and geographic coverage of banking organizations, (2) modifying the deposit insurance system to foster a greater degree of market discipline, and (3) reorganizing the federal regulatory structure as it relates to financial institutions. There are some important interrelationships among these areas, and I believe they can be placed in better perspective by reviewing some aspects of banking history.

Commercial Banking: 1930s-Present

The 1930s was a period of great turmoil for both the banking system and the economy as a whole. Congress responded to the banking crisis by enacting major legislative reforms, primarily designed to discourage bank risk-taking and to ensure the safety and soundness of the commercial banking system.

As part of the Glass-Steagall Act, banks were prohibited from participating in what were perceived to be high-risk securities activities. Deposit interest rate ceilings were imposed to restrict competition and reduce the cost of bank deposits. It was intended that lower cost deposits would encourage banks to invest in less risky assets. The Federal Deposit Insurance Corporation was established to restore confidence in the banking system by providing partial protection to depositors in failing banks.

Deposit insurance discouraged bank runs and limited the extent to which failed banks brought down other banks. As the economy advanced slowly and unevenly in the mid-to-late 1930s, the number of bank failures declined. While the FDIC undoubtedly played a significant role in reducing failures, other factors (expansionary government policies, reduced unemployment, fewer bankruptcies and a more accommodative monetary policy) enhanced banking performance.

Although the banking legislation of the 1930s involved major reforms, its immediate impact on banking behavior was probably quite limited. Bankers, in an understandable reaction to the depression, were extremely conservative; thus, the level of risk-taking remained low. Market entry was restricted by the cautious behavior of regulators and by a still-depressed economy. In addition, competition from nonbank companies was very limited.

During and immediately after World War II, government financial policies and private sector restrictions produced an expanding, very liquid banking system. Bank failures declined significantly. Loan losses were practically nonexistent. In fact, many banks experienced sizable recoveries on previously charged-off loans.

During the next couple of decades banking behavior continued, by present standards, to be very conservative. Economic performance was favorable. Recessions were generally short; business failures and loan losses were low. Until about 1960 banks continued to operate in a very insulated, safe environment. In the 1960s banks took steps to expand what they could do. Branching restraints were liberalized, deposit interest rate ceilings were raised and banks once again began to venture into securities-related activities.

From the beginning of federal deposit insurance, some expressed concern that the presence of deposit insurance might limit market discipline. However, either because of their own conservative behavior, existing legislative constraints or the behavior of bank supervisors, most banks operated during much of this period at a level of risk where market discipline probably did not matter. There was occasional discussion about variable-rate premiums, but it was conceded that 1930s' experience might not be relevant, and bank failures and loan losses were too infrequent to provide the bases for any statistical analysis.

In more recent years, however, banking behavior has changed in many respects. Earnings have been more volatile and loan losses have risen dramatically. More and more bank funding has involved purchased money, even for moderate-sized banks. Demand deposit balances have become relatively less important and, in the case of the household sector, most of these now pay interest. Because of the deregulation of interest rate ceilings, most deposits have become more expensive. Activities and geographic markets have expanded and competition from financial conglomerates has increased. While some of these events represented sudden developments, more often they reflected a gradually changing regulatory and competitive environment.

The economy's performance during the past 10 years has not been very strong. Recessions have been more severe. The one from which the economy is just emerging is by far the most severe in the post-World War II period. Some high-flying sectors in the economy (real estate development in the mid-1970s, some energy activities more recently) have encountered serious difficulties, causing major loan problems. Business bankruptcies recently surpassed any level reached prior to the 1930s. A weak international economy, overly expansive policies of governments and overly aggressive lending policies by some U.S. banks have made our banks vulnerable to the performance and policies of foreign governments.

Bank failures have increased during the past decade and even more dramatically during the past year. In 1982 alone, the FDIC handled 42 bank failures. We expect the failure rate for 1983 to be at least as high. So far this year 15 banks have failed. It is difficult to determine how much of this is due to changing bank behavior or how much can be explained by the economic environment. Clearly both have been important. In any case, there is a greater sense of bank exposure and risk of failure that exists not just among those who regulate and follow banks but with the general public as well.

Risks have increased and the nature of competition has been altered. Competition has become more intense because of the removal of deposit interest ceilings, technological innovations, relaxation of geographic limitations and entry by nonbanks into previously sheltered product lines. The resulting pressures on profit margins are providing a strong incentive to banks to expand into new lines of business and to seek both higher returns on their traditional types of investments and new sources of noninterest income.

With this perspective in mind, let me now turn to the main issues before us.

Expanded Powers for Banks

As you know, in recent years, nonbank companies have increasingly entered traditional bank markets, in many cases by purchasing their own "bank" or thrift institution. However, depository institutions are prohibited from entering most of the nonbank markets in which these firms operate.

Thus, Merrill Lynch offers a cash management account that directly competes with banks and thrifts for the deposits of the general public. American Express owns a securities firm that, in turn, owns a federally-insured bank; but depository institutions are excluded from most securities market activities. Travelers Corporation plans to offer federally-insured money market accounts and Prudential-Bache has announced its intention to purchase a commercial bank; but in most states banks and thrifts cannot underwrite insurance. National Steel and Sears own S&Ls and Gulf & Western owns a federally-insured bank; yet depository institutions are excluded from the wide variety of activities in which these firms compete.

The result of all this has been an increasingly inequitable financial marketplace. While we do not automatically assume that the solution is to dismantle all the barriers that separate depository institutions from commercial enterprises, we do recognize that it is no longer possible to completely insulate banks and thrifts from the market pressures generated by a wide array of nondepository competitors.

We believe that banking should remain separate from general commerce. Otherwise, the risks to safety and soundness would be too great, conflicts of interest could not be avoided, and the potential concentration of economic power would be unhealthy. Let me give one example of a serious potential conflict. Imagine that the nation's largest bank were acquired by the nation's largest oil company and that a competing oil company needed financing. If the loan were turned down by the largest bank, an important source of credit would be denied. If the loan were granted, the bank would gain access to, and a degree of control over, the business plans and strategies of an important competitor of its parent. Once the line of credit were established, it would be extremely difficult to terminate it even for good cause without raising charges of foul play.

In order to maintain the separation between banking and general commerce, we need to recast the definition of a "bank." It seems clear that the current definition has lost meaning. The overriding characteristic that banks possess, which warrants that they be treated in a manner somewhat different from other types of institutions, is that banks accept deposits from the general public for which the federal government has assumed the responsibility of safeguarding. This responsibility necessitates that banks be subject to some federal regulation and supervision, from which nonbanks are exempt. With this in mind, it may be appropriate to define a bank as any institution that offers any type of federally-insured deposit. This would create a clear and useful distinction between banks and other types of financial institutions. S&Ls, which for all intents and purposes are commercial banks, would be defined as such. The current "loophole," which allows nonbank companies to acquire banks simply by divesting themselves of either the bank's demand deposits or its commercial loan portfolio, would be eliminated.

Beyond changing the definition of a bank, we need to reconsider the range of activities in which a bank or its affiliates may engage. In our opinion, a bank should be permitted to engage, either directly or through a bank subsidiary or holding company, in a full range of financial services. Activities in which banks are currently permitted to engage, or additional activities in which banks act as agent or sell services, should be permitted within the bank itself. Among the activities we would be inclined to include in this area are: brokerage activities related to securities, real estate and insurance; travel agency services; and data processing services. Riskier activities, such as underwriting securities, real estate development, and underwriting property, casualty and life insurance, should be placed in separate bank or holding company subsidiaries. In addition to placing the higher risk activities into separate subsidiaries, a number of safeguards would be needed to limit intercompany dealings, require independent capitilization and funding, minimize conflicts of interest, and limit the overall exposure of the banking organization.

Expansion of bank powers will result in important benefits to the general public by providing more services at competitive prices. It is our view that these benefits outweigh concerns that banks will be exposed to higher levels of risk. This does not mean that we intend to allow bank risk-taking to go unchecked. The FDIC is currently considering a number of policy changes, which I will address shortly, that will enable both ourselves and the private sector to better control excessive risk-taking by commercial banks.

We do not believe any of these new powers need to be placed in a holding company subsidiary as opposed to a bank subsidiary. The arguments for such a separation -- that the bank will be better insulated from additional risk or potential conflicts of interest and that competition will be on a more equal basis -- are not persuasive. Past experience has shown clearly that banks cannot be insulated altogether from the risks of their affiliates. A bank subsidiary can be structured to provide just as much protection as a holding company subsidiary; indeed, it might be better if these activities were offered through a direct bank subsidiary where the bank regulatory agencies would be better able to monitor them.

Many banks and thrifts do not currently have holding companies, and we perceive no social or economic justification for encouraging their formation (indeed, thrifts organized in mutual form cannot do so). A bank subsidiary can be required to have separate funding sources and capitalization and can be regulated in the same manner as a holding company subsidiary.

A principal reason we favor expansion of bank powers is to permit banks to offer their customers a wider range of financial services. The banks will presumably use the new sources of income to help offset the pressures nonbank competitors are placing on their traditional sources. A separate holding company subsidiary would, in effect, take income from the bank by cross-selling bank customers. We would much prefer that income to be generated in a direct subsidiary of the bank where it would enhance the bank's earnings and capital.

Once it is determined what new powers are to be extended to depository institutions, it follows that any company engaged in such activities should be permitted to own or affiliate with a bank or thrift institution and that any company engaged in impermissible activities should not. Nonconforming companies already affiliated with banks or S&Ls could be given 10 years to either conform or divest. This will ensure that the boundary lines, once drawn, are fairly and consistently applied to all firms, banks and nonbanks alike.

An expansion of banking powers might increase the risk involved in banking. However, it should be noted that not all restrictions (including some developed specifically to protect depository institutions, <u>e.g.</u>, rate ceilings, branch restrictions and asset restrictions) have necessarily reduced bank risk. Nonetheless, we should keep in mind that determining what institutions can do and where they can do it should not be determined solely (or principally) by risk considerations. More relevant are such considerations as improved services to the public and a more efficient allocation of resources. Risk can be controlled by proper insulation of the activities and through capital standards and other financial policies.

You have also asked for our views on geographic expansion by banks. In many respects we already have nationwide competition for most financial services. The wholesale banking market has long been a national one. On the retail lending side, we have national firms, some of which are bank affiliates, making consumer and real estate loans on virtually a nationwide basis. The only major remaining geographic restriction relates to the taking of deposits, and even here we can list a lot of exceptions. There are grandfathered situations in which individual banks or holding companies operate on an interstate basis. In addition several savings and loan associations branch interstate and some savings banks have acquired savings and loans in other states.

Several states permit selective out-of-state entry and there is pending legislation in several others that would expand the list. Several bank holding companies have acquired minority stock positions in depository institutions in other states, essentially positioning themselves for the time when either the Douglas or McFadden restrictions are removed.

The Garn-St Germain Act permits interstate acquisitions of failing depository institutions if they meet size and other criteria. In a few states legislation is pending that would permit interstate acquisitions to accommodate selected problem situations.

Even without interstate branching or the control of depository institutions on an interstate basis, retail deposit markets have become less insulated from out-of-state competition. Money market funds showed us that retail money could be attracted through the mail when rates offered were high enough, and the deregulation of deposit rate ceilings has increased the ability of depository institutions to penetrate deposit markets without a physical presence.

All of this suggests that geographic restrictions are becoming less important and currently play much less of a role in insulating local markets from competition than they have in the past. There are inequities in present arrangements. In some instances devices to get around geographic restrictions or efforts by institutions to position themselves for the future are probably wasteful.

Geographic restraints have in the past served as a proxy for antitrust enforcement; that is, by limiting the areas in which banks were permitted to expand, the restraints fostered a larger number of competitors. As the restraints are dismantled, there will be a tendency toward greater concentration of financial resources in fewer hands.

Although some additional concentration would not be alarming, we believe significant additional concentration should be avoided. It would not only be philosophically objectionable to have the bulk of our nation's financial resources controlled by a handful of institutions, it would pose significant risks to the insurance system as exposures become larger and less diversified.

Although a persuasive argument can be made that the country would be better served if Congress acted to remove geographic restraints on the activities of depository institutions, the FDIC's official and unofficial position on this score is one of neutrality. Current antitrust laws appear inadequate to deal with potential concentration in the financial services industry, particularly if the geographic barriers should be dismantled. We are required to focus entirely on narrow geographic and product markets; overall concentration and the structural effects of combinations are not adequately considered. Too often this results in a rigid posture with respect to the merger of two small banks in the same community while, at the same time, we permit the nation's largest financial conglomerates to make one major acquisition after another. We believe this situation should be corrected.

Control of Excessive Risk Taking

Since the FDIC is an insurance agency and, therefore, bears the direct cost of excessive risk taking, some would argue that we should minimize our exposure to risk by restricting what banks can do. We disagree.

It is clear that the banking environment has undergone a dramatic change over the past decade. Recessions have been more frequent and severe, and interest-rate volatility has been high relative to historical standards. Deposit interest rate controls have been almost completely dismantled in response to market pressures. Product distinctions among banks, S&Ls and other intermediaries are barely discernible. Restrictions on entry and expansion have been eased.

Such changes bring to the forefront a critically important set of questions. How, in the absence of rigid, government-imposed restrictions on competition, do we control destructive competition and excessive risk-taking? How do we insure that deposits flow to the vast majority of banks that are prudently operated rather than to the marginal banks that are willing to make the highest risk loans and pay the highest rates for deposits?

There are two options. We can adopt countless new laws and regulations to govern every aspect of bank operations and hire thousands of additional examiners to monitor and enforce compliance. Or, we can seek ways to increase marketplace discipline.

The FDIC clearly prefers the latter approach. Let me outline some steps we are considering or implementing to achieve this objective.

Charges for Additional Examinations

Currently the FDIC does not charge banks for the cost of examinations. In a sense, however, all banks directly bear part of the cost of examinations since any supervisory expenses are reflected in lower premium rebates. Thus, to the extent that problem institutions require more frequent examination, an unfair burden is placed on all banks.

We feel it would be appropriate to charge banks for any above-normal cost of supervision. In addition to being more equitable, such a plan would create a small incentive for banks to promptly correct their problems.

Risk-Related Deposit Insurance Premiums

In addition to charging for extra exams, it would be desirable to price deposit insurance to reflect the risk of individual banks. This is why we have recommended (in the insurance study mandated by the Garn-St Germain Depository Institutions Act of 1982) adoption of risk-related deposit insurance premiums.

The current system of flat-rate assessments has two major flaws. First, it does nothing to discourage risk-taking, thereby forcing bank regulators to issue explicit regulations designed to control bank risk. Second, it is simply not fair that prudently managed banks should pay the same price for deposit insurance as those banks that pose a much greater threat of failure.

We have suggested that banks be divided into three risk classes based upon various well established measures of bank risk. The premium structure would be altered by changing the method by which we calculate our assessment rebates. Banks rated high risk would receive only half of their normal rebate and the very high risk banks would get no rebate. For those banks rated normal -- and this would include the vast majority of all banks -- nothing would change; they would receive their entire rebate.

This proposal is a modest one. The variation in premiums between the high risk and normal banks will be relatively small. It is not likely this system will go very far toward discouraging risk-taking; however, it is more equitable, and it is a step in the right direction.

Once we institute a premium structure based upon risk, through experience we may discover ways to refine it and make it more effective. While we are in favor of adopting and implementing a risk-related premium system, information and data problems will likely prevent us from ever measuring risk so precisely that we can set insurance premiums to entirely compensate for the level of risk exposure in a particular institution. Therefore, if we are to properly control risk without the issuance of excessive regulations, we must rely upon sources of discipline outside the FDIC.

Reducing De Facto Insurance Coverage

Although the explicit coverage under our deposit insurance system is limited to $100,000, in practice we have for years been providing implicit 100 percent coverage for depositors and other creditors at most banks, particularly the larger ones. This has resulted from our practice of merging failed banks into other banks. Under current law, we are required to make all general creditors whole when we arrange a merger (or a purchase and assumption transaction).

We have had a strong preference for handling bank failures through mergers. It is ordinarily the least expensive and least disruptive method. We nevertheless abhor the side effect of providing 100 percent deposit insurance coverage; we are convinced it has eroded marketplace discipline and provided larger banks a substantial competitive advantage.

Prior to the failure of Penn Square National Bank, many believed the FDIC would never pay off depositors in a bank larger than $100 million. That episode has obviously caused people to raise their estimate of the size limit, but most still believe there is a limit beyond which we will not go.

As a practical matter, they may be right. It is not, as some people think, a matter of cost. The percentage of insured deposits in most large banks is comparatively modest and paying them off would not be prohibitively expensive. The problem is that billions of dollars of uninsured funds would be tied up for years in a bankruptcy proceeding, possibly causing severe repercussions throughout the economy.

In order to provide uninsured depositors and other creditors with the proper incentive to monitor bank risk, their risk exposure must be increased. We would suggest two methods whereby this can be accomplished.

Modified Payoff. Under this plan, the FDIC would take two actions upon a bank's closing and the establishment of a receivership. First, insured depositor claims would be satisfied as rapidly as possible as is the current payoff practice. Second, an "advance" of additional funds to all remaining valid claimants would be made, equivalent to the FDIC's estimate of the total value of bank assets to be recovered in liquidation.

This plan would have the beneficial effect of facilitating a payout, especially for larger institutions, since the potentially large volumes of assets and uninsured creditors will not be frozen in bankruptcy proceedings for a long period of time. Additionally, since it is envisioned that the insurance deposit settlement and the additional "advance" of other funds could be transfered to an operating institution, most of the benefits of the traditional purchase and assumption transaction could be retained.

Coinsurance. A variation of the modified payoff approach would be to provide coinsurance on deposits over the present insured limit. For example, balances up to $100,000 would be fully insured, with amounts above the limit provided 75 percent coverage (i.e., the depositor provides "coinsurance" on 25 percent of the excess balance). The workings of this system would be basically the same as the modified payoff alternative discussed above, except that depositors would know the proportion of uninsured funds that would be immediately available if the bank should fail.

Both approaches -- the modified payoff and the coinsurance plan -- would expose large depositors to some risk of loss (in the typical case they might ultimately lose 10 percent or so of their balances over $100,000), but would make most of the funds immediately available so as to limit the economic repercussions of the failure. Depositors would be given an incentive to select a bank on some basis other than its size or the rate of interest it pays on deposits. Depositors would begin to inquire about such matters as capital adequacy, risks in the loan portfolio, insider dealings and liquidity.

Depositor Preference

In addition to the modified payoff there are other things that can be done to enhance market discipline. At the present time, depositors are considered general creditors in bank liquidations except in a few states in which their claims on the assets of a failed state-chartered bank are specifically preferred over those of other general creditors. Significant benefits would derive from statutorily providing for a depositor preference from the standpoint of increasing market discipline since the potential loss exposure of selected creditors would be increased. In addition, it would facilitate the use of the modified payoff option in handling bank failures.

Thus, if depositors were preferred to general creditors, the latter would have to be more concerned about with whom they do business. We believe that such increased concern would be appropriate and would act as a check on bank risk in some areas.

Should this approach be adopted, however, it would be necessary to spell out carefully through legislation who would be preferred. On balance, we believe it would improve the fairness of the system and increase market discipline.

Capital Standards

Finally, we may wish to reexamine our capital adequacy standards. Economic and financial events of the past several years have demonstrated the importance of a sound net worth position to a firm's ability to withstand protracted adversity and uncertainty. To the extent deregulation increases uncertainty, the need for a strong capital base in financial institutions takes on even greater significance. Subordinated debt, while not contributing to a bank's solvency, could play an important role in not only protecting depositors but in increasing market discipline.

From the standpoint of market discipline, subordinated debt affords certain advantages over deposits. Subordinated lenders are apt to be more sophisticated and comfortable in evaluating credit risk. Whereas most uninsured deposits mature within a few months or can be withdrawn on demand, subordinated lenders typically are in a very different situation. Once having made the loan or investment, they generally cannot flee during adversity. They have to view borrower (bank) operations from a longer-term perspective.

Banks could be required to maintain a minimum protective cushion to support deposits, which could be met by the use of a combination of equity and subordinated debt. Smaller banks that already have a high equity ratio or might have limited access to debt markets might choose a higher proportion of equity to meet the minimum. Larger banks that are well-rated might be able to obtain as much as one half of this cushion from debt markets in the form of subordinated funding. As banks grow they would be required to add proportionally to their "capitalization." Rapidly growing banks would have to go to the market frequently to expand their cushion and to refinance maturing issues. Thus, they would be exposed periodically to the results of their performance and, possibly, to the reactions of rating services.

Depositors would be significantly insulated because of the increased size of the protective cushion. Yields on issues traded in the secondary market would also provide them with information on the market's valuation of their institution. Large institutions with good internal controls and audits and a reasonable degree of agency monitoring should provide a sufficient cushion so that significant depositor losses would not occur frequently, even when banks fail.

The FDIC is not prepared to endorse this concept at this time. A number of details would have to be worked out before it could be implemented, but it appears to warrant consideration in addition to, or in lieu of, the modified payoff and coinsurance proposals considered above.

Public Information

Irrespective of the methods used to enhance market discipline, it is clear that the marketplace cannot perform its proper function without an adequate amount of information. Thus, we have decided to make public the new call report data on interest-rate sensitivity and nonperforming loans, and we are considering additional disclosures covering such matters as insider-lending practices and enforcement actions. This should help turn the spotlight on marginal, high-risk banks. We believe this will deter unsound banking practices and destructive competition. If problems nonetheless arise, troubled banks will either correct them promptly or fail more quickly, causing less damage.

It may seem harsh, but we cannot coddle marginal banks. To do so would undermine the vast majority of banks that are operating prudently by making sound loans, maintaining adequate capital ratios and paying reasonable rates for their deposits.

Regulatory-Supervisory Structure

Before concluding, Mr. Chairman, I would like to make some comments about the future structure of depository institution regulation. An examination of the current regulatory system reveals many disparities and anomalies. For example, state banks are burdened by two layers of regulation while national banks operate with only one. Savings and loans operate under vastly different rules from those applicable to commercial banks even though they now have commercial lending and checking account authorities. In our opinion, financial institutions with essentially the same powers should be regulated in essentially the same way.

Parent bank holding companies are examined and regulated by the Federal Reserve System while the lead bank is usually examined and regulated by a different agency. This results in needless duplication of effort and makes effective supervision more difficult.

There appear to be inconsistencies and needless duplication in other areas of bank regulation. Mergers are subject to antitrust review by both the banking agencies and the Justice Department. The banking agencies enforce the securities laws with respect to banks while the Securities and Exchange Commission has responsibility for bank holding companies and other businesses. Also, the banking agencies enforce Truth-in-Lending and other consumer laws with respect to banks, while the Federal Trade Commission oversees nonbank firms.

Merging the FDIC and the FSLIC Insurance Funds

An important first step toward the rationalization of the regulatory system would involve the merger of the FDIC and the Federal Savings and Loan Insurance Corporation. Similarities of objectives and functions for the deposit insurance agencies and a growing similarity in banks and thrift institutions support the notion of a single fund as a logical alternative to the present framework. The future of the financial services industry will require a larger, better-diversified insurance fund and greater flexibility in dealing with troubled or failed institutions, including cross-industry takeovers. Interindustry mergers can be expected to increase as banks and thrifts seek access to each other's markets. Loose affiliations between banks and savings and loans are becoming more and more common, making effective supervision difficult.

Merging the funds will provide for less public confusion and greater public confidence in the deposit insurance system, and foster more uniformity of supervision, particularly with respect to capital adequacy and disclosure requirements. Additionally, a merger of the insurance funds would facilitate the separation of the role of deposit insurance from chartering and regulation.

The present system whereby chartering, regulation and supervision are used to promote all aspects of an industry (individual institutions, housing and depositors), while at the same time these vehicles are used to protect an insurance fund, involves inherent conflicts. A consequence could be the subordination of safety and soundness considerations to those of promotion. The responsibility of an insurer is, and should be, singular -- stability of the system through the safe and sound operation of individual institutions and the prompt resolution of problems.

There frequently is, and should be, a healthy tension between the insurance and regulatory functions. The best way to achieve this is through a legal separation of the agencies performing these distinct functions. While having the chartering and insurance functions housed in a single agency may provide some flexibility for dealing with crises, such as have been experienced in the thrift industry during the past two years, it removes the discipline provided by a system of checks-and-balances. During the past two years, the FDIC has handled more than 60 bank and thrift failures. These failures were dealt with swiftly and effectively, notwithstanding the absence of a chartering power. Indeed, the fact that the handling of those failures was subjected to review by a separate chartering authority imposed an important discipline on the insurer with respect to both identifying and resolving the problems.

<u>Supervisory Framework</u>

A merger of insurance funds has implications for the structure of the supervisory framework and should be viewed as part of a comprehensive plan to more rationally define the federal insurance and regulatory process.

The federal financial regulatory structure could be consolidated to combine the functions of the Federal Home Loan Bank Board, the Federal Reserve and the Comptroller into a single independent agency headed by a board. That agency would issue charters, act on corporate applications, and supervise all federally-chartered banks and thrifts and holding companies. These functions would remain with the states for state-chartered banks and thrifts.

The FDIC would have the authority to conduct examinations, require reports, and take enforcement actions with respect to any insured institution or its affiliates, although it would focus its attention on problem and near-problem institutions. The FDIC would not have regulatory authority with respect to branches, mergers, trust powers and the like. An examination could be made by the FDIC whenever necessary to determine the condition of an institution for insurance purposes. Under this program, the FDIC would concentrate on financial institutions with safety and soundness problems and examine well-rated institutions infrequently -- under a sampling program that would cover perhaps ten percent per year. The examination of a portion of well-rated institutions would provide the FDIC with information to judge the effectiveness of the chartering agencies' supervision and rating systems, provide training for new examiners, and diminish the automatic assumption that an institution is in trouble because of the FDIC's presence.

Other regulatory activities currently lodged in the banking agenices and the Federal Home Loan Bank Board could be reorganized along functional lines. For example, the Securities and Exchange Commission could be given exclusive jurisdiction over all securities matters relating to banks and thrifts (it now exercises such jurisdiction over holding companies); the Justice Department could assume sole responsibility for antitrust enforcement; and the Federal Trade Commission could enforce compliance with consumer laws such as Truth-in-Lending.

Reorganizing the federal regulatory framework would result in administrative cost savings in the form of reduced support staffs and consolidated regional offices. This consolidation should reduce travel expenses and diminish some of the informational problems that exist today. More important than any cost saving, however, is the fact that supervision of federally-insured banks and thrifts would be vastly improved.

The fact is that the current, fractionalized system of regulation and insurance for banks and thrifts is increasingly inefficient, ineffective, and inequitable. Assuming it was justified when created 50 years ago, events have passed it by and it has outlived its usefulness. The system is in urgent need of a major overhaul.

The overall supervisory structure that might be formed as a result of the reorganization of the federal regulatory system has implications for the proper role of the Federal Reserve. In general, the issue is whether the regulation of banks and bank holding companies is necessary to conduct monetary policy. The argument that the Federal Reserve needs general supervisory authority over 1,000 commercial banks (out of a total of some 14,400) and needs to regulate and supervise bank holding companies to augment or enforce monetary policy is not persuasive. Indeed, many informed observers perceive the potential for serious conflicts between bank supervision and the conduct of monetary policy.

The Federal Reserve could continue to have access to bank data and information through representation on the Board of Directors of the FDIC and the new regulatory agency and, through this, would gain more direct access to data on other financial institutions, an increasingly significant factor as thrifts begin exercising more bank-like powers.