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STATEMENT ON

S. 1609, FINANCIAL INSTITUTIONS DEREGULATION
ACT AND RELATED MATTERS

PRESENTED TO

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

BY

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Room 538 Dirksen Senate Office Building

Mr. Chairman, members of the Committee, thank you for giving us this opportunity to present our views on S. 1609.

The FDIC is a strong proponent of deregulation in the financial services area. Many of the current restrictions on competition were enacted 50 years ago. Whether or not they were appropriate then, they no longer benefit the public nor are they necessary to the maintenance of safety and soundness in our financial system. We are also convinced that our regulatory structure and our deposit insurance system are in need of substantial reform. Limited, stop-gap measures, such as the proposed moratorium legislation, are not what is needed now. What is called for is comprehensive legislation that addresses head-on the structural, competitive and regulatory anomalies in the current financial services picture. We recognize the magnitude of this undertaking, and we assure you of our full and continuing support and cooperation.

Enactment of S. 1609 would be a significant step in modernizing laws affecting our depository institutions. It recognizes the many changes that have occurred in our financial markets and the need for our depository institutions to be freed from many legal, but no longer useful, barriers. It also addresses in a limited way the need for uniformity in the regulation of financial institutions by recognizing the desirability of functional regulation.

We have, however, some specific concerns about S. 1609. First, we object to the requirement that the expanded activities be conducted through a bank holding company affiliate. We see no reason to force people to incur the expense of forming a holding company -- indeed, thrifts organized in mutual form may not be able to realistically do so. The purposes of requiring a subsidiary are to insulate the bank from risk, assure uniform regulation, and provide for separate capitalization and funding. We support those purposes. All of them can be achieved through a bank subsidiary just as effectively as through a bank holding company subsidiary. Moreover, to better insulate the bank itself, we would consider strict limits on the use of common names and logos and interlocking officers and directors, which S. 1609 does not do.

The principal reasons we are urging that depository institutions be given expanded powers are to provide a broader range of financial services to the American public at more competitive prices and to enhance the earnings of banks and thrifts. Why, in view of the latter objective, should we require that the subsidiary be structured so that the profits generated from bank customers flow to the holding company, not directly to the bank, and so that the capital base of the subsidiary directly protects holding company creditors, not bank depositors? We submit no sound rationale has been offered for such a requirement.

Second, we are concerned about the provisions of Section 10 of the bill, which would authorize bank holding companies to engage in insurance underwriting and brokerage without restriction and would authorize real estate brokerage and real estate investment and development, subject to a limit of five percent of capital. In our judgment, brokerage of both insurance and real estate -- and securities, for that matter -- is clearly a financial service that entails virtually no risk. It should be permitted for banks and thrifts as well as their holding companies or in subsidiaries of either.

Underwriting insurance and securities and real estate investment and development clearly involve greater risks. Accordingly, we believe that organization of these activities in a separate subsidiary should be required and that other safeguards, such as separate capitalization and funding requirements, should be imposed.

It should be recognized that permitting affiliations among banks, insurance companies, investment banking houses and real estate developers represents a substantial departure from the status quo, and raises a number of issues and potential problems, some of which are anticipated in S. 1609, some of which may not be. The FDIC recently commenced a rulemaking proceeding to gather information and public comment on bank involvement in these various areas. We will be pleased to share the results of this effort with the Committee.

Although we are proponents of well-conceived deregulation, some aspects of S. 1609 are difficult to

rationalize. For example, why is real estate investment limited to five percent of capital, particularly when insurance underwriting has no limits at all? Why should banks be permitted to affiliate with a casualty insurer but not an underwriter of corporate securities?

Another related matter requires attention. The Glass-Steagall Act as currently written prohibits affiliations between securities underwriters and member banks but not nonmember banks or S&Ls. Although the FDIC has pending a second rulemaking proceeding to consider some regulation of securities activities by nonmember banks, there nevertheless remains a substantial competitive inequity among member and nonmember banks and S&Ls which S. 1609 fails to address.

Third, we endorse the concept of parity between unitary and multiple S&L holding companies and bank holding companies. As thrifts and commercial banks are clearly in competition today for both deposits and loans, uniform treatment is in order. We would require uniform reports of condition and public disclosures by both banks and thrifts. We would not object, however, to a provision exempting unitary S&L holding companies from the affiliation rules if the S&L is almost exclusively engaged in the origination of residential mortgage loans.

Mr. Chairman, inherent in this entire exercise is the question of where to properly draw the line between "banking" or "financial services" and "commerce." In deciding where to draw the banking/commerce line, Congress should avoid the

temptation to grandfather existing relationships. If, for example, it is decided that retailers or manufacturers should not in the future provide depository services, then we see no reason for institutions currently engaged in such activities to be permanently grandfathered. If a combination is undesirable from the public policy viewpoint, it is undesirable regardless of when it was commenced. Once the line is drawn, those whose activities do not conform should be required to divest in a timely and reasonable manner.

Mr. Chairman, let me now turn to certain issues that are not addressed in S. 1609.

Deregulation has increased head-to-head competition between banks and thrifts. It has also increased the ability of depository institutions to gather funds from nonlocal sources so that local markets are no longer insulated from regional and national market competition. At the same time, money funds and diversified financial service companies have become more important competitors for banks and thrifts. Because of these occurrences, standards previously used to evaluate the competitive impact of mergers -- I have in mind the concept of commercial banking as a line of commerce and narrow geographic market definitions, sometimes as small as a single county -- are rapidly losing meaning. There is much less reason for the banking agencies or the Justice Department to be concerned about the merger of two small banks. At present, antitrust standards discourage or prevent such mergers

even though the result might be a stronger institution, better able to serve customers and withstand the pressure of changing, more competitive financial markets.

On the other hand, we will need to look more closely at the implications of mergers between large banks and large financial service institutions. If bank holding companies move into life insurance or other fields (or vice versa) largely through de novo entry or through the acquisition of small firms, competition will be increased. However, mergers among large institutions can adversely affect competition. While banks do not currently compete directly with insurance companies when it comes to providing insurance products, major banks and insurance companies do compete in various lending areas. The same can be said for investment banking firms which play a major role in financing real estate projects, municipal and corporate debt and corporate equity issues.

Mergers among large organizations would not only lessen potential competition, they could also lessen competition that exists today. This has not been of overriding concern in the past because legal barriers have prevented the combination of banks, insurance companies and investment banking firms and the merger of banks across state lines. If Congress should decide to remove these barriers, in our judgment the current antitrust law would be inadequate to prevent excessive concentration in the financial services industry.

A second vital issue not addressed by S. 1609 concerns the deposit insurance system. There are various ways we can handle a failing institution, ranging from a payoff of depositors to a variety of ownership transfers that essentially maintain the status quo in the public perception. We are well aware that the deposit payoff is frequently the most expensive and disruptive option so, other considerations being equal, we have traditionally attempted to effect a merger or purchase and assumption transaction. While we believe this is appropriate, it has had the unfortunate side effect of eroding market discipline by providing de facto 100 percent insurance of all accounts regardless of size. We believe this has also created a perception that works to the disadvantage of smaller institutions, whose customers are less sanguine about the prospects for a merger as opposed to a deposit payoff.

We believe our recommendation for a 25 percent coinsurance risk for large depositors, on balances exceeding the insurance limit of \$100,000, would have a major corrective influence in this regard. At the same time, steps should be taken to limit the rapidly growing practice of money brokers placing large deposits in banks and thrifts in fully insured segments of \$100,000.

We have also recommended a risk-related insurance premium in our study submitted to you last spring. While we do not believe it is costly enough to create a significant deterrent to "go-go" bank or thrift managers, it would be a

step in the right direction to recognize banks and thrifts that pursue sound management practices. We would hope that with experience it could be made more effective.

Another issue of concern relates to the payment of interest on demand deposits. Through action taken by the Depository Institutions Deregulation Committee, the process of time and savings deposit deregulation is well along. But it is not clear the DIDC has authority to permit the payment of interest on demand deposits. Chairman St Germain has introduced legislation in the House which would accomplish this task. We support this initiative as part of a comprehensive reform measure. Certainly there would be transitional costs to depository institutions; however, the benefits to consumers -- particularly small businesses -- and the flexibility it would provide banks and thrifts clearly makes this a worthwhile proposition.

Enhanced competition also necessitates a change in our views toward the holding of non-interest-earning reserves against deposit balances. As deregulation continues and as banks and thrifts compete more and more with firms not subject to reserve requirements, this is becoming a pressing issue of competitive equality. How can we justify the imposition of 12 percent reserve requirements on transaction accounts at depository institutions when their direct competitors can offer an almost identical product without this considerable burden?

We believe this problem should be addressed through either a significant reduction in reserve requirements or the payment of interest by the Fed on reserve balances, or both.

Another issue not addressed by S. 1609 concerns the regulatory structure. The regulatory system is in a state of disarray. Five different regulatory agencies plus the SEC and the Antitrust Division of the Department of Justice are responsible for regulating the affairs of insured depository institutions at the federal level alone. To cite but two examples, Citicorp is currently regulated by the Federal Reserve, its lead bank by the Comptroller of the Currency, and its California savings and loan by the Federal Home Loan Bank Board. It proposes to acquire a bank in South Dakota (presumably to engage in the insurance business, among other things), and an insured industrial bank in Utah, both of which apparently will be regulated by the FDIC. In addition, numerous state agencies, the Justice Department and the SEC play various roles. The Butcher organization also illustrates the problems inherent in the current regulatory scheme. In that case, some 40 affiliated banks, savings and loan associations and an industrial bank were regulated by seven different state and federal agencies, making accurate identification and assessment of the problems extraordinarily difficult.

In our study on deposit insurance we recommended the merger of the FSLIC and FDIC insurance funds and the reorganization of regulation along functional lines. We continue to believe these reforms are necessary and desirable and feel strongly that Congress should address them in conjunction with S. 1609.

Another matter of concern is the failure of the bill to address the problem posed by recent legislation in South Dakota. Section 14 of the bill preempts the states' rights to prohibit any affiliation between a national banking association and a company engaged in any of the activities authorized by Sections 10, 11 and 12 of the bill. In our judgment, this section should be amended to also prohibit any state from authorizing insured banks within its borders to engage in activities outside its borders that are not permitted within the state.

Finally, the Committee may wish to examine the interstate banking issue. While, as I have stated previously, the FDIC remains neutral on this question, we recognize that de facto interstate banking already exists in large measure and it is only a matter of time before it becomes de jure. I have long felt that an appropriate way to deal with this issue initially would be to allow the states to enter into reciprocal arrangements, possibly on a regional basis. A number of states are moving in this direction but their efforts are clouded by legal questions which the Congress might be able to resolve through enabling legislation.

My conclusion, Mr. Chairman, is not new to you or this Committee. The financial services industry is undergoing a major transition. The worst possible thing Congress could do is to interfere with that transition by enacting some kind of moratorium. In our judgment, a moratorium would only serve to perpetuate the current inequities, reward those who have exploited the weaknesses of the existing statutory framework and further delay attempts to come to grips with urgently needed reforms. We understand the difficulty of addressing the issues we have discussed today, but order must be brought by hard resolutions that will keep all financial institutions in a position to serve the needs of the public, businesses of all sizes and our government units, local and national. We commend your efforts to do this and urge others to join you in what must be a bipartisan effort if it is to succeed.

Thank you again for this opportunity to appear. I will be pleased to respond to any questions you or members of the Committee may have.