STATEMENT ON

S. 2181, FINANCIAL SERVICES COMPETITIVE EQUITY ACT AND S. 2134, DEPOSITORY INSTITUTIONS HOLDING COMPANY ACT AMENDMENTS OF 1983

PRESENTED TO

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

BY

WILLIAM M. ISAAC, CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

9:30 a.m.
Wednesday, March 21, 1984
Room SD-538, Dirksen Senate Office Building

Mr. Chairman, we appreciate this opportunity to present the FDIC's views on S. 2181 and S. 2134. Our staff is preparing a more detailed comment on these bills, which will be forwarded to you promptly. We would appreciate your including that analysis in the official record.

The FDIC strongly supports the general framework for deregulation set forth in S. 2181 and its predecessor S. 1609, introduced last year at the request of the Administration. We commend you and your colleagues on the Committee for advancing the debate on the issue of deregulation of the financial-services industry.

Banks have held a very special place in our society and economy for at least the past 50 years. The American public has insisted that we maintain stability in the financial system, following the banking collapse of the 1930s. A principal means through which this has been achieved is the provision of federal insurance for deposits placed in banks. The public believes in the federal deposit insurance system and expects its government to maintain the strength and integrity of that system.

So my first premise is that we must do whatever is necessary to enable the deposit insurance system to continue protecting the public's savings deposited in banks, up to the insurance limit of $100,000.

My second premise is that the public desires a financial system that offers a broad range of services at competitive prices to the maximum extent consistent with stability and safety.

My third premise is that our deposit insurance system should not become a drain on the U.S. Treasury -- that is, it should continue to finance itself through bank assessments and interest earned on its investment portfolio.

My fourth premise is that whatever financial system evolves should be fair and equitable to both the general public and financial institutions.

With these thoughts in mind, let me offer for your consideration a definition of the term "bank" and then turn to a discussion of some of the issues presented by S. 2181 and S. 2134.

Definition of a Bank

A "bank," in our judgment, is an entity the public believes is or should be a safe-haven for its funds at least up to some specified amount. The key element, in terms of public perception, is whether an organization holds itself out to the public as a "bank" by using that term in its name. If an organization calls itself a bank, it ought to be required to be FDIC insured and regulated as a bank.* No entity may be FDIC insured unless it both accepts deposits and uses the term "bank" in its name.

*There would be an exception to the prohibition against the use, by non-FDIC entities, of the term "bank" for government organizations or entities that do not accept the public's funds.

This definition would close the "nonbank bank" loophole. It would also subject banks and thrifts that choose to look like banks to the same regulatory treatment. Finally, it would prevent a recurrence of tragedies like those we recently witnessed in Iowa and Tennessee, where uninsured banks failed causing thousands of people to lose their savings at entities that held themselves out to the public as "banks."

Greater Competitive Freedom for Banks

We believe banks should be authorized to engage in a broader range of financial activities for two principal reasons. First, it would be procompetitive. The American public -- including consumers, small businesses and farmers -- would be given a broader range of financial products at more competitive prices. Second, it would strengthen the banking system by allowing banks to be more competitive in the financial marketplace and develop new sources of income to help offset the cost of liability deregulation.

The question, in our judgment, is how far can we go without creating an undue risk to the deposit insurance system or creating a competitive climate that would be unfair to competitors of banks?

From the viewpoint of safety, we believe it appropriate to divide financial services into two categories: those that are offered in an agency capacity and those that are offered by a bank as principal. We believe

there is very little risk in a well-managed bank acting as an insurance, real estate or securities agent or broker, and we would authorize these activities to be conducted in the bank itself.

When it comes to underwriting insurance or securities or developing real estate, the risks are greater. Accordingly, we would authorize these activities only in affiliates of banks, coupled with other appropriate safeguards, such as requirements for separate capitalization and funding, different names and logos, and strict limits on interlocking management and directors. Safeguards such as these would insulate banks from the greater risks these activities entail and also promote fairness with respect to nonbank competitors.

We have testified previously that brokerage or agency activities should be permitted within the bank itself and that underwriting activities should be permitted in bank subsidiaries rather than requiring all these activities to be placed in separate holding company affiliates. We have taken that position because we believe it would provide adequate protection to the bank while permitting the bank and its customers to directly benefit from the profits and capital base generated from the new activities. Moreover, it would allow people to avoid the expense and inconvenience of forming a holding company.

While we still believe very strongly in these principles and urge Congress to enact legislation along these lines, we recognize that legislation broadening the permissible activities of banking organizations is

essential. Consequently, we would not oppose legislation that requires the new activities to be conducted in a separate holding company affiliate if that is necessary to achieve a political consensus for reform.

We would encourage you to enact as broad a bill as possible with respect to permissible financial activities. For example, in the securities underwriting area, I would go further than S. 2181 and allow the underwriting of corporate securities.

The Glass-Steagall Act prohibits member banks from affiliating with investment banking firms. The law was enacted in response to the collapse of the banking system in the 1930s. We do not believe it was an appropriate response. There were abuses by securities firms during that period, but there is no evidence those abuses were more prevalent among bank-affiliated securities firms than among securities firms generally. Neither is there evidence those abuses caused significant problems in the banking system.

The banking system collapsed during the 1930s primarily because of overly restrictive fiscal and monetary policies during the course of a major recession and because thousands of banks were not able to avail themselves of the discount window at the Federal Reserve. Since then, we have established a federal deposit insurance system to reassure depositors, created the SEC to regulate securities firms, strengthened bank examination and regulation, and, through the Monetary Control Act of 1980, made the discount window available to all depository institutions.

In view of those reforms, we do not believe the Glass-Steagall prohibitions should be maintained. They serve principally to shield securities firms from competition at the expense of the American public. At the same time, we recognize that political reality may require a less ambitious reform. That, in our judgment, would be far preferable to no progress at all.

While the issue of broader powers for banks is sometimes characterized as a "big bank" issue, we could not disagree more. This issue should be of concern to banks of all sizes and their customers. For example, since permitted to do so in 1982, some 1,200 banks have begun offering the public discount brokerage services at commissions ranging from 40 to 60 percent lower than those available at full-service brokers. Similar benefits have been realized by life insurance purchasers in New England and New York where savings banks profitably underwrite and sell life policies at rates among the lowest available anywhere. Small banks without the managerial or financial resources to enter these new businesses alone are often able to do so through joint ventures or the purchase of packages assembled by others.

Competition, Safety and Concentration

To promote stability and competition in financial markets, we must have as many viable competitors as possible. In our judgment, the ideal system is not one in which 15,000 competitors are artificially preserved in small banking markets by protective laws. Nor is the ideal system one

in which only a handful of firms survive and operate in a giant, national arena. We favor a system without artificial barriers to lock firms into and out of markets, but one with much more vigorous antitrust enforcement than is possible under current laws.

For example, we believe it would be clearly procompetitive for one of the nation's largest banking organizations to enter a major new product or geographic market on a de novo basis or through a foothold acquisition. On the other hand, the competitive benefit would be nonexistent, or at least much less clear, if it were to enter by acquiring one of the large, established competitors in that market. Yet, current antitrust law largely ignores the long-range structural or concentration effects of an acquisition and would not, in all probability, preclude quite sizeable combinations.

We are concerned about this issue not only from the standpoint of competition, but also from the viewpoint of the safety of our insurance fund. Like any insurer, we want our risk diversified as much as possible and spread among as many institutions as is reasonable.

For these reasons, if artificial barriers to product and geographic expansion by banks are dismantled by the Congress, state legislatures or marketplace developments, we believe it essential that our antitrust laws be strengthened. The Judiciary Committee will likely have to address this subject to fashion a comprehensive, longer term solution. In the meantime, the Banking Committee could take care of short-term needs by placing tight restrictions on the permissible size of acquisitions or affiliations by

our largest banking organizations, say the top 25 or so. While S. 2181 addresses this issue, it appears it would not be particularly effective in restraining acquisitions or affiliations by or among the largest firms.

Strong antitrust enforcement, in addition to protecting the public and the deposit insurance fund, would promote competitive equity between banks and their nonbank competitors. An obvious element in that fairness equation would be to permit nonbank financial firms to affiliate with banks to the extent banks are permitted to affiliate with nonbank financial firms. It should be a two way street, open to all competitors. For firms that do not conform to the new rules, whatever they may be, we would require divestiture of nonconforming activities within a reasonable period of time, perhaps 10 years as was required under the Bank Holding Company Act Amendments of 1970. We do not believe in permanent grandfathering. Either there is a problem with certain affiliations or there is not. If there is not, they should be permitted. If there is, they should be prohibited across-the-board. The date an affiliation was created should be irrelevant except possibly in determining the length of time permitted for divestiture.

Deposit Insurance Reforms

Mr. Chairman, the fundamental premise upon which we at the FDIC are operating is that the public wants stability in the banking system. The cornerstone of that stability is the deposit insurance system. In considering the issue of deregulation, we must also address the measures necessary to maintain the vitality of our federal deposit insurance system.

Last year you introduced legislation -- S. 2103 -- designed to do just that. The thrust of the bill is to foster a greater degree of marketplace discipline in the banking system, while also strengthening our supervisory powers. These steps are essential if we are to maintain stability in the absence of rigid government controls on competition such as Regulation Q, which has been almost completely phased out.

S. 2103 would authorize the FDIC to replace the present system of fixed-rate deposit insurance premiums and rebates with a system in which the rebates vary according to bank risk. It also proposes that banks be charged for all above-normal costs of supervision, such as the more frequent examinations that problem banks require. Requiring problem banks to pay more for deposit insurance and supervision, instead of spreading the cost among all banks as we do now, would provide an incentive for banks to correct their problems promptly and would certainly be more equitable than the present system. These are not drastic proposals, but they represent steps in the right direction.

S. 2103 would also provide the FDIC the tools it needs to limit its exposure to loss in problem banks by granting the FDIC the authority to take the full range of enforcement actions against any bank it insures. Today we have that authority only with respect to state nonmember banks which, due to their generally small size, present the least exposure to the insurance fund.

I might note that we recently entered into cooperative examination programs with the Comptroller of the Currency and the Federal Home Loan Bank Board for federally chartered banks and thrifts insured by the FDIC. These programs will be of tremendous benefit in helping us to monitor our exposure in banks we insure and to prepare in an orderly way for their failure where it cannot be avoided. These two agencies are to be commended for putting the overall good of the system ahead of interagency political concerns. It is our hope that a similar arrangement can be worked out with the states and/or the Federal Reserve for state member banks.

We believe that one of the most effective ways to control destructive competition and excessive risk-taking in a deregulated environment is to expose banks to the discipline of the market, an ingredient that the working of the deposit insurance system has tended to stifle. A promising potential source of market discipline is large depositors, those with deposit balances in excess of the $100,000 insurance limit. Although we refer to them as "uninsured" depositors, in practice we have for years provided them de facto 100 percent coverage in most failures, especially failures of larger banks.

This results from our practice of merging failed banks into other banks. Currently, uninsured depositors, particularly at the larger commercial banks, do not feel they are at risk since they recognize the FDIC prefers to handle these failures through mergers. If uninsured depositors are to have sufficient incentive to monitor bank risk, this perception by uninsured depositors must be altered.

One way this could be done is for the FDIC to pay off insured depositors in all failed banks. However, paying off a large bank can pose significant problems. Most notably, uninsured depositors typically must wait several years before they receive any significant payment on their claims. This could prove very disruptive to the payments system when a large bank is involved.

To alleviate these problems, the FDIC has tried a procedure under which a payoff was accomplished by transferring insured deposits to another bank for a premium, and a cash advance was made nearly simultaneously to uninsured depositors and other general creditors based on the present value of anticipated collections by the receivership. Under this type of transaction, disruptions in the financial markets are kept to a minimum while exposing uninsured depositors to some risk of loss. As a result, the depositors have a strong incentive to select the soundest institutions, rather than simply the largest ones or those paying the highest interest rates. We have not completed our evaluation of this new procedure. If it proves successful, we will provide ample public notice before implementing it as a matter of course.

Our efforts to encourage more discipline in the banking system will be undermined if nothing is done to limit the practice of brokers sweeping the nation for funds and placing them in banks that pay the highest rates of interest irrespective of the condition of the banks. Competition in banking should not be based solely on the rate of interest paid. Consideration should also be given to such factors as capital adequacy, asset quality,

the degree of insider lending, competence of management and the quality of service. Brokers and their investor clients have little reason to consider these other factors because the existence of the FDIC guaranty interferes with the normal working of the marketplace by eliminating risk.

As a consequence, the FDIC and the Federal Home Loan Bank Board have jointly proposed changes in our insurance regulations to limit the federal guaranty on brokered deposits. The rule, if adopted in final form, will be effective October 1, 1984, in order to allow a reasonable transition period.

Our proposed regulation will not be a panacea. There will be ways for some entities to bypass it. For example, a credit union with $2 million to invest could, rather than going through a broker, place the funds directly in the 20 banks that pay the highest interest rates and obtain full insurance in the process. Our proposed regulation would make this more difficult and less efficient, but not impossible. Moreover, our proposed regulation would do nothing to limit the insurance coverage on trusteed deposits placed by organizations such as the Bureau of Indian Affairs in problem banks throughout the country. Our lawyers are currently considering additional regulatory or legislative solutions to curb these outright abuses and misuses of the deposit insurance system. If we conclude legislation is necessary to address these problems, we will promptly submit an amendment to S. 2103.

There are several other provisions in S. 2103 that we consider important. Rather than addressing each item individually, let me just say that we believe reform of the deposit insurance system is tied inextricably

to the issue of bank deregulation. We do not believe the two topics can or should be separated. In the strongest possible terms, we urge Congress to consider our proposals for reform of the insurance system in S. 2103 right along side S. 2181 and S. 2134.

Miscellaneous Provisions

There are other collateral issues that are raised by S. 2181 and S. 2134. Because our testimony is already more lengthy than we desire and our views on the additional matters are reasonably well known, I will simply highlight a few of them. Interest on all reserves maintained at the Federal Reserve should be paid at market rates, in our judgment. We would recommend a phase-in to cushion the federal budget impact. Banks and thrifts should be authorized to pay interest on checking accounts, but only if this action is taken in the context of an acceptable comprehensive bill. We believe that if we are to maintain a separate regulatory and insurance system for thrifts, the definition of a "thrift" must be tightened through adoption of a strict asset test based on mortgage lending activity. We also believe that the FDIC and FSLIC should be directed to adopt uniform capital standards and accounting rules for federally insured banks and thrifts, to be phased in over the next several years to allow thrifts an opportunity to recover from their severe losses in recent periods. Assuming Congress is not able to address the McFadden and Douglas restraints at this time, we would support legislation to sanction reciprocal interstate banking pacts entered into by the states, and we would not "sunset" this provision. Finally, we would

support legislation to prohibit the states from empowering their banks to engage in activities outside the state that are banned or limited within the state.

Conclusion

Mr. Chairman, in preparing this testimony I gained a new appreciation for the problems you and your colleagues face in attempting to deal with the subject of bank deregulation legislatively. It is a vast and complex subject. There are no clearly right answers or solutions.

The process requires that we balance a number of factors. We have attempted in our testimony to identify those factors and give our judgment about where to strike the balance. We recognize that others with different or perhaps more focused perspectives would strike a different balance. We will be as flexible as possible in accommodating our views to those held by others. We want legislation, and we want it as soon as possible.

Except for moratorium legislation, it is hard to imagine the Congress adopting any bill that would be worse than the status quo. The marketplace is deregulating, and, try as one might, it cannot be stopped.

As a practical matter, our choice is not between deregulation and re-regulation. Our choice is between unplanned, helter-skelter deregulation and more orderly deregulation in which Congress acts to protect the public interest. As difficult as the legislative process is certain to be, we owe it to the American public to travel that route.