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STATEMENT ON

DEREGULATION AND BANK SUPERVISION

PRESENTED TO The

COMMERCE, CONSUMER, AND MONETARY AFFAIRS SUBCOMMITTEE of the
House COMMITTEE ON GOVERNMENT OPERATIONS
~~HOUSE OF REPRESENTATIVES~~

BY

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Mr. Chairman, members of the subcommittee, I am pleased to have this opportunity to present the FDIC's views on the adequacy of our current banking laws. Your initiative to evaluate the fundamental premises underlying much of our present banking legislation is commendable.

I. Background

As a starting point, I believe that we must continue to accept the proposition that banks, as providers of insured deposits and as key participants in the nation's payment system, play a "special" role in our economy. First, there is a strong demand by depositors for institutions that can provide security for their hard-earned savings. The existence of federal deposit insurance at our nation's banks for deposits up to $100,000 provides this security. This, in turn, necessitates a supervisory presence to protect the insurer. Second, it is also clear that the failure of our banking system could have severe implications for our nation's economy and indeed for much of the world economy.

By accepting the view that banks are "special" in these two ways, we implicitly acknowledge that banks or, more generally, depository institutions, require some level of government regulation and supervision from which nondepository institutions are exempt. The primary objectives of such regulation and supervision should be to provide a safe place for the funds of savers, to provide an efficient financial resource system, and to assure the continued soundness and stability of the financial system. Additional secondary objectives include controlling conflict-of-interest abuses, ensuring adequate levels of consumer protection, and maintaining vigorous and equitable competition.

While there may have been certain inadequacies in our banking laws, until recently the system has been stable and there was little pressure for legislative reform. Our more recent experience has been quite different. Significant changes in our financial environment are putting a great deal of pressure on our nation's banks. Technological advances in computers and communications and changing economic conditions have allowed many nondepository institutions to provide bank-like services. These new nonbank providers have stimulated competition among financial institutions and contributed to the development of a financial marketplace that is much more responsive to consumer preferences.

New developments have benefited the general public and investors. Small savers, who for years were forced to subsidize borrowers by accepting artificially low interest rates on their deposits, now receive market rates of return. Investors now have a much wider range of investment opportunities available to them. For example, the so-called "securitization" of bank loans has provided a mechanism through which financial institutions can spread risks, reduce costs, and facilitate the flow of funds from savers to spenders. Many formerly illiquid assets, such as mortgage and automobile loans, are now being packaged and sold to investors in a form that suits their needs. In turn, these new investors provide financial institutions with greater liquidity and enlarge the pool of funds available in those markets. As a result, financial institutions enjoy reduced risk and lower costs and the general public benefits from expanded investment opportunities.

We fully recognize that new market opportunities also create risks for some banks. Thus, we must proceed carefully in assessing possible new deregulatory initiatives. We should adopt a measured pace, proceeding one step at a time. We must also place a premium on bank supervision, in order to forestall excessive risk-taking and insider abuses that could threaten stability in the banking system. As FDIC Chairman, I intend to give our supervisory mission high priority. This is not reregulation -- it is safety supervision of a partially deregulated system.

II. New Powers

New powers for banks can improve the system. We believe that banks should be allowed to exercise limited new powers in order to remain viable competitors in the financial services marketplace.

The new powers we propose would authorize banks to underwrite and deal in mortgage-backed securities, commercial paper, and municipal revenue bonds. We also believe banks should be allowed to sponsor mutual funds. These new powers are a "natural fit" for banks.

Authorizing banks to underwrite and deal in mortgage-backed securities would afford banks greater flexibility in an area where they have developed significant expertise. It is a natural extension of writing home mortgage loans to package those loans and sell them to interested investors. Banks, however, are largely prohibited from underwriting and dealing in mortgage-backed securities.

Banks also should be permitted to underwrite and deal in commercial paper. Increasingly, the larger and more creditworthy business firms choose to raise funds by issuing their own commercial paper rather than by borrowing from banks. Banks' efforts to compete in this area have been challenged by the securities industry. If banks are excluded from this potentially lucrative and safe activity, they must attempt to stimulate loan demand in other, perhaps more risky, areas.

Today, banks are unable to sponsor mutual funds. This makes it increasingly difficult for them to compete in the growing IRA and Keogh markets. Banks can act as agents in joint ventures with securities firms to sell mutual funds, and while this helps, banks are effectively prevented from obtaining a full share of income from this lucrative activity.

Moreover, banks should be permitted to underwrite and deal in municipal revenue bonds. The most likely reason why banks were not given explicit authority under the Glass-Steagall Act to underwrite and deal in such bonds is that they were virtually nonexistent at that time. Banks are permitted to underwrite and deal in general obligation bonds and some revenue bonds issued by states and municipalities. However, over the years, general obligation bonds have comprised a smaller and smaller portion of the municipal bond market. As revenue bonds have grown in importance, banks increasingly have been left behind.

I don't mean to suggest that new powers for commercial banks are a panacea that pose no additional risks. As the links between various types of financial services are expanded, there is more opportunity for abuse. It is essential that banks be granted new powers. Competitive equity and safety-and-soundness concerns demand this. However, it is also essential that, as new powers are granted to banking organizations, adequate levels of bank supervision and appropriate safeguards are put in place.

III. Role of Supervision and Safeguards

Let me turn first to supervision. As deregulation proceeds and as the links between banks and the providers of other types of financial and commercial products grow, the need for adequate levels of bank supervision increases rather than decreases. One of the byproducts of a competitive marketplace is that not all firms achieve financial success. There are winners and there are losers. It seems likely that there will be more problem banks and more failed banks than in years past when banks were insulated from competitive pressures. This alone suggests a need for increased levels of bank supervision. Not only must regulators take steps to help a problem institution regain its profitability, they must monitor the bank's actions much more closely. This increased level of supervisory attention is necessary because owners of a bank experiencing financial difficulties will have a greater incentive to engage in self-dealing or other forms of dishonest behavior. To the extent that a problem bank has links to other financial or commercial enterprises, there will be an even greater potential for abuse.

Of course, the discipline of the marketplace imposes its own form of supervision on banks. Shareholders have an incentive to monitor management performance, in order to prevent self-dealing and related abuses that could destroy the value of their stock. The disclosure provisions of the Securities Act of 1933 and the Securities and Exchange Act of 1934 enhance the effectiveness of shareholder monitoring. Government supervision should complement, not supplant, such market-based discipline.

In sum, as deregulation proceeds, and as various types of financial activities become more intertwined, we will need increased levels of bank supervision and more sophisticated supervisors. However, if bank supervision is to keep pace with fast changing events, it is essential that the bank supervisory system remain independent. After 36 years, the Office of Management and Budget has suddenly asserted new (and we believe unfounded) jurisdiction over the FDIC, the Comptroller of the Currency, and the Federal Home Loan Bank Board under the Antideficiency Act of 1950. The Congress should move immediately to exempt the three Federal institutions from asserted OMB control in order to maintain independence, competence, and flexibility in the regulators' operation. In doing so, the Congress is well aware that the regulatory agencies are self-funded and do not require taxpayer dollars. Oversight of agency budgets should remain under the Congress.

Let me now address some of the safeguards that may be needed as banks are granted new powers. In some instances, the FDIC has already implemented safeguards for banks that wish to conduct new activities. Nonmember banks engage in some securities activities prohibited to member banks under the Glass-Steagall Act. State-chartered banks often have much broader authority to engage in activities such as real estate investment and insurance underwriting. As a general rule, the FDIC has sought to segregate the nonbanking activities of banks in separate subsidiaries, subject to separate capital requirements and other restrictions. Bank participation in these new activities is beneficial to the general public and enables banks to compete fairly with their nonbanking rivals. At the same time, we believe that a certain degree of insulation between the bank and its nonbank activities is desirable to help reduce risk and safeguard against abuse.

Separating the bank from its nonbanking activities does not eliminate all risk or potential for abuse, but it is an important safeguard. Safety-and-soundness concerns are reduced by such separation and it is easier for the appropriate regulatory authorities to monitor bank activities. Limits can be placed on the financial dealings between banks and their subsidiaries or affiliates. In part, these limits can be used to ensure that the banking organization remains adequately diversified. If structural safeguards are to work well, Congress must give regulators greater enforcement powers to help deter abuses. Finally, the laws should also guarantee that there is adequate disclosure of information with which to assess a company's financial activities.

IV. Emergency Interstate Acquisitions

Before closing, I will briefly highlight one more area where legislative reform is necessary. Just as our changing environment necessitates new powers for banks, it requires additional authorities for bank regulators. Specifically, we propose broadening the bank acquisition provisions of the recently-extended Garn-St Germain Act of 1982.

Our proposal would do four things. First, it would lower the size threshold of a bank eligible for acquisition from $500 million to $250 million. Second, it would permit the acquisition of failing as well as failed commercial banks. Third, it would extend the scope of the provision to include bank holding company systems as well as banks. Fourth, it would require equal treatment for acquiring banks in the state of acquisition.

The specifics of our proposal -- which is supported by all of the bank regulatory agencies -- are set forth in my April 9, 1986 written testimony before the Subcommittee on Financial Institutions of the House Banking Committee. I refer you to that testimony for a more detailed analysis of this initiative.

V. Conclusion

At some point in the future, Congress may wish to consider more far-reaching deregulatory changes. It may wish to evaluate research which suggests that safety and soundness would not be undermined by the relaxation of Glass-Steagall Act, McFadden Act, and Bank Holding Company Act restrictions.

Those issues are not, however, before you today. What we need here and now is action on two far more modest, cautious, narrowly-crafted reforms -- increased powers and emergency interstate acquisitions. I strongly urge Congress to move forward swiftly in those two areas.

Thank you very much.