TESTIMONY OF

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ON

THE EFFECTS OF THE EUROPEAN COMMUNITY'S 1992 PROGRAM ON U.S. FINANCIAL INSTITUTIONS

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS SUPERVISION,
REGULATION AND INSURANCE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
UNITED STATES HOUSE OF REPRESENTATIVES

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Room 2128, Rayburn House Office Building

Good morning, Mr. Chairman and members of the Subcommittee. We appreciate the opportunity to discuss the impact of the European Community's 1992 economic integration program on United States financial institutions. Your decision to hold these hearings, Mr. Chairman, addresses the complaints of critics who have charged that Congress virtually has ignored this important issue.

The rapidly changing financial environment represented by developments such as "Europe 1992" offer enormous possibilities for U.S. banks to expand their markets, lower their costs and strengthen their financial position. However, equally plausible is the possibility that outdated restrictions on U.S. banking activities will threaten the ability of our banks to remain competitive players globally. Two key points should be emphasized. First, the European Economic Community ("EC") has indicated that barriers to competition will be lowered for countries that equitably reciprocate in opening or leaving open their own markets to outside competition. However, there is enough uncertainty on this point that we cannot take it for granted that U.S. banks will be allowed to compete on an equal basis. The United States must maintain its efforts to ensure the EC encourages free trade. Second, we must look at our own banking laws and regulations to make sure we are not unwisely

In its 1985 White Paper the Commission identified 300 nontariff barriers that needed to be removed in order to achieve economic integration. The 1992 selected target date for eliminating these barriers subsequently was ratified by the parliaments of all of the Member States of the EC. The 1985 White Paper called for the drafting of about 20 proposals dealing with banking and securities activities. Technical working groups have largely completed the task of drafting the necessary directives and have submitted them to the Commission for consideration. Some of the directives already have become Community Law.

For purposes of this hearing we would like to focus on the Second Banking Directive. This Directive is the cornerstone of the EC's efforts to open its banking markets. Formal adoption of the Directive by the Council of Ministers is projected by the end of this year.

The key components of the Second Banking Directive are as follows:

- A single banking license would be granted to institutions that would entitle them to offer a wide range of financial services anywhere in the EC if they were permitted to do so by their home country.

Ministers approved a separate directive that specifies capital adequacy for banks doing business in the EC (eight percent of a bank's risk-adjusted assets).

How does the Second Banking Directive treat non-EC banks? Subsidiaries of third-country financial firms would be governed by the Directive and be entitled to the single banking license. They will qualify for an EC license if their home governments let EC banks operate on the same terms as local ones. Where EC banks are being discriminated against, then the application for an EC banking license in the reverse direction will be delayed or suspended.

The Second Banking Directive does not apply to branches of third-country banks. Thus, a branch of a U.S. bank (without a subsidiary of the same bank within the EC) would be prohibited from offering its services across borders to the rest of the EC. Moreover, branches of a U.S. bank (without the aforementioned subsidiary) in different EC countries might be subject to regulation by each country.

Earlier drafts of the Second Banking Directive called for mirror-image reciprocity with respect to authorization of new subsidiaries and access to the single banking license. The reciprocity provisions subsequently have been softened and now call for reciprocal arrangements based on the national treatment

consumer attitudes change. United States banks have a proven track record in the credit-card business. Profit opportunities also abound in the "underdeveloped" life insurance markets in France, Spain and Italy. These and other profit opportunities will likely prompt U.S. banks to restructure their European operations. As noted earlier, subsidiaries and branches of third-country banks will be subject to disparate treatment after the Second Banking Directive takes effect.

On our own side of the Atlantic, U.S. banks will encounter new challenges in the form of increased competition from EC banks operating in the United States. To date, developments associated with "Europe 1992" have touched off a wave of merger and acquisition activity involving EC financial institutions. Mergers between institutions which have or will have representation in the United States mean that the resultant institutions will have an expanded asset base and greater economic power with which to challenge our banks.

"Europe 1992" raises several important public-policy issues in the financial-services area. The most immediate of these issues relates to whether U.S. banks will have access to the European markets even though banking operations in the United States remain more restrictive. As noted earlier, the Second Banking Directive calls for consideration of applications by third-country banks based on the concept of national

Recommendations

We have addressed some of the implications of "Europe 1992" for United States financial institutions. The next question is: Where do we go from here? First, it is imperative that the United States financial system, its regulators and the Congress think in global terms. As an advertisement in a financial publication recently stated: "Yesterday, globalization was a word. Today, it's a reality." Second, we need to consider whether existing financial laws in the United States enable our institutions to compete effectively in a global economy.

In a 1987 FDIC study entitled Mandate for Change: Restructuring the Banking Industry, we noted that foreign banking institutions are playing an increasingly important role in both United States and foreign markets. Their growing market share has been gained largely at the expense of United States commercial banks. One reason is that foreign banks are exempt from many of the regulatory restrictions imposed on U.S. banks' activities. The study stressed that if banking companies are to maintain the earnings potential fundamental to their continued viability, they must have the opportunity to offer the products and services necessary to compete on even terms with their international competitors.

activities either before or after passage of the Glass-Steagall and Bank Holding Company Acts.

The safety and soundness of the banking system can be preserved by insulating banks from their nonbanking affiliates and subsidiaries. Financial firewalls such as restrictions on financial transactions between banks and nonbanking affiliates and subsidiaries and separate capitalization of nonbanking subsidiaries and affiliates would limit such concerns. Strong enforcement of these restrictions would ensure that while individual problem situations may arise, overall risk to the system could be controlled.

Given adequate supervisory insulation of the bank, direct regulation and supervision by the bank regulatory agencies of bank owners and nonbanking affiliates and subsidiaries is neither necessary nor desirable. Bank regulation and safety supervision could be focused on the bank -- and on the bank alone. There would be INCREASED REGULATION AND SUPERVISION OF BANKS -- focusing regulation where the Government has an interest -- and any required regulation of the entities affiliated with that bank would be performed along functional lines. A supervisory wall would permit the dismantling of banking laws that regulate the activities of nonbanking entities -- namely, Glass-Steagall and much of the Bank Holding Company Act.

organizations should not proceed without strong supervision.

The EC's bold initiative to reduce trade barriers between its Member States heightens the concerns related to outdated U.S. banking laws. Restructuring these outdated banking restrictions will encourage more open international competition, which benefits all countries. United States banks will have the opportunity to remain competitive with nonbanking financial firms in the United States and with financial firms throughout the world. Attracting new capital into the banking industry and allowing a properly supervised combination of banking and nonbanking activities within the same organization will better enable U.S. banks to remain financially sound. There is no better way to ensure that taxpayers are "never again" forced to pay for huge financial industry losses than by building a framework that leads to a financially sound banking system.

We would be pleased to respond to questions from the Subcommittee.