TESTIMONY OF

L. WILLIAM SEIDMAN
CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

ON

INTERNATIONAL TRENDS IN THE FINANCIAL SERVICES INDUSTRY

BEFORE THE

INTERNATIONAL COMPETITIVENESS TASK FORCE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
UNITED STATES HOUSE OF REPRESENTATIVES

11:30 AM
March 22, 1990
Room 2359-A, Rayburn House Office Building

Mr. Chairman and members of the International Competitiveness Task Force, I am pleased to be here today to discuss the Federal Deposit Insurance Corporation's views on the competitiveness of American banks in the global marketplace. We applaud the creation of this Task Force and look forward to a continuing dialogue on much-needed reforms to our own domestic financial services industry.

Banking is experiencing and will continue to experience rapid and critical changes, yet our current financial system was shaped in response to events which occurred over 50 years ago. This system is outdated, inequitable and inefficient. As a result, we believe that system now hampers the ability of our financial institutions to effectively compete in the marketplace.

Later in the testimony, we give some detail on the status of foreign laws, regulations and practices, in order to address concerns about the competitive position of U.S. banks in international markets. This summary also provides a comparison of permissible activities in other countries, as well as recent actions by other governments to modernize their domestic financial systems. It is time for our government to take action as well. Failure to enact needed reform to our financial system

now will only weaken the viability of our banking system and therefore, the economic strength of our nation worldwide.

What then, needs to be done? In our view, the overriding principle is that the banking system must become more efficient in order to become more competitive. A strong and more efficient banking system benefits our nation's industries, consumers and overall economony. With the proper safeguards in place to ensure that this system remains safe and sound, our financial institutions can prosper if they are free to attract capital and compete effectively, at home and abroad. The FDIC believes that structural reform of our entire financial system is necessary to permit banks to compete and prosper.

Four basic steps will help to achieve this goal:

First, banking laws that regulate the activities of nonbanking entities -- namely, Glass-Steagall and the Bank Holding Company Act -- should be dismantled and replaced with a system that provides regulation along functional lines. Other major countries currently allow banks to engage in a wider range of activities than is permitted by the U.S. We believe that liberalization is necessary in order to allow our banks to better diversify risk.

The FDIC believes that a piecemeal approach to restructuring is inefficient, and therefore dangerous. The dismantling of archaic statutes as part of a complete revision of our financial system has several advantages. One is that this approach allows financial restructuring to be a two-way street. Not only could banks affiliate with most corporate entities, but those corporate entities could own banks as well. Another benefit is that functional supervision eliminates the costly layers of regulation and supervision that exist when companies are subject to the jurisdiction of both the banking agencies and the appropriate functional regulators. No other country has such a costly regulatory system imposed on their banks.

The second major area is a recognition that the separation of commerce and finance is not necessary to protect the financial system from abuse. In fact, we would argue that it is necessary for commerce and finance to be combined in order to provide financial resources to the banking system. Time and again we have found that the most financially suitable buyers for depository institutions are commercial enterprises.

This is another area in which the U.S. is far more stringent than our trading partners abroad. The fact of the matter is that commerce and finance go hand in hand. In our 1987 study entitled Mandate for Change: Restructuring the Banking Industry, we noted that there has never been a complete separation of finance and

commerce in the history of American banking. Affiliations between commercial banks and nonbanking firms continued until 1956 when the Bank Holding Company Act became law, and there are still exceptions today. There is little evidence of any bank safety-and-soundness concerns, conflict-of-interest abuse or undue concentrations of resources from the interaction of banking and nonbanking activities either here, or abroad where much greater interaction has traditionally been permitted.

Third, geographic restrictions on bank expansion need to be revisited. These restrictions also have contributed to an overly-regulated and inefficient system for our banks, as well as to greater risk in the banking system due to lack of diversification. Moreover, some regional pacts specifically discriminate against institutions owned by non-U.S. citizens or firms. These laws conflict with our policy of national treatment and equality of competitive opportunity. They even may lead to barriers to entry for our financial institutions in foreign markets.

Finally, as banks continue to operate across borders, we must reach an agreement with our counterparts in other countries on two issues we are currently grappling with here. These are the method used to handle the failure of large banks, and the need to reduce the risk exposure of taxpayers via the federal deposit insurance system. These issues involve not only safety

and soundness concerns, but also competitiveness. Our banks are facing increasing costs in the next few years. Banks operating in other countries face much lower costs in comparison, but a wide variety of insurance systems currently exist. Therefore, we are planning to meet with officials from the major financial centers around the world later this year to trade experiences on financial crises and to attempt to coordinate international policies on the provision of deposit insurance and otherwise ensuring the stability of the banking system. We feel that the measures I have outlined today will enable our financial institutions to compete in the emerging global marketplace.

OVERVIEW

As you know, foreign banking institutions are playing an increasingly important role in both U.S. and foreign markets. At mid-year 1989, there were 281 foreign banks operating 697 branches in the United States. Assets at these banks totalled $696 billion at June 30, 1989, or 22.6 percent of total U.S. bank assets. Moreover, foreign banks hold an even larger share -- 28.5 percent -- of the commercial- and industrial-loan component of bank assets. Much of the recent growth in foreign bank assets in the U.S. can be attributed to Japanese banks, who now account for 53 percent, or $372 billion of total foreign banks assets in the U.S.

Similarly, Japanese banks have also become predominate in international banking markets, where they control nearly 40 percent of the assets. Much of this growth has been at the expense of U.S. banks, the second largest group, who controlled less than 15 percent of international bank assets at the end of 1988, a sharp decline from the 22 percent market share they held three years earlier. While market share is only one view of competitive strength, the FDIC is concerned that a declining presence of U.S. banks in international markets may signal an inability to compete as a result of the regulatory restrictions imposed on their activities.

In recent years the financial services industry has undergone rapid change worldwide as a result of technological advances, deregulation of markets, and product innovation. Most major countries have modified their financial systems in order to adapt to internal and external pressure for change. Changes in domestic financial markets, in turn, affect the banking operations of foreign institutions. I would now like to discuss some of the recent developments in the regulation of financial markets in other countries, specifically those which may affect the ability of U.S. banks to compete in the international arena.

Of particular importance are developments in Japan and the emerging single market of the European Community ("EC") in 1992, as well as our own 1989 free-trade agreement with Canada. After

discussing these topics in turn, we will describe the overall actions the FDIC believes are necessary to meet the challenges presented by today's rapidly changing financial environment.

The Japanese Financial System

Overview. Following World War II, Japan segregated its financial system into groups of institutions designed to specialize in certain types of activities. Divisions of permissible activity were drawn both between long-term and short-term financing, and between banking and securities activities. This system provided a smooth and orderly allocation of the limited amount of funds available to rebuild Japan's economy, among the needs of various industry sectors. Clearly, this system was successful in helping to support Japan's postwar period of rapid economic expansion.

In recent years, however, economic growth in Japan has stabilized and its financial institutions, supported by the traditionally high domestic savings rate, have found themselves with excess liquidity. At the same time, Japan's consumers have sought more profitable and more flexible financial products, while its corporate sector has shifted the bulk of its funding needs from bank loans to securities. These changes in Japan's economy have occurred during a period of increased innovation in financial products, and worldwide trends toward deregulation and integration of financial markets. All of these factors have

contributed to accelerated pressure for change in Japan's current financial system.

Deregulation. The pace of interest rate deregulation in Japan has been very slow in comparison with international trends. Currently, about 60 percent of Japan's domestic deposits are still subject to interest rate regulation. This slow pace has provided Japanese banks with a stable and low-cost source of funds which has given them a competitive edge against foreign banks operating in deregulated markets. This issue has continued to be an area of concern for other players in the international financial markets.

However, this slow pace also has caused anger among Japanese consumers, who feel that their savings have contributed to large profits for the banks. As a result, they have fled to other financial institutions offering higher returns, and caused a virtual halt in the establishment of new domestic bank branches in Japan. It is hoped that interest rate deregulation in Japan will soon accelerate as a result of these forces.

Changes in Permissible Activities. In the early 1980s, Japan began to restructure its financial markets by relaxing some of the restrictions in Article 65 of its Securities and Exchange Law, which generally prohibits banks from underwriting, selling, dealing in or brokering stocks and corporate bonds. In 1984, major Japanese banks began dealing in government bonds which

comprise the largest portion of the Japanese bond market. Japan permitted domestic banks to underwrite and deal in commercial paper in November of 1987.

In general, Japan has been slow to deregulate their domestic money markets and to allow the introduction of new financial instruments. Thus, in order to meet the increasingly complex needs of their clients, Japanese banks have tended to expand their commercial banking activities abroad. This activity began in Great Britain and the U.S., where the largest financial centers were located. However, certain features of our banking markets--particularly the availability of diversified and sophisticated financial instruments--and the traditional openness of our banking markets to foreign investors, have provided attractive opportunities for Japanese banks to operate and expand in the U.S. Recent figures suggest that at mid-year 1989, Japanese banks controlled about $370 billion, or 14 percent of total U.S. bank assets.

Our government has responded to this trend by encouraging the Japanese government to modernize its financial system. In 1984, the Yen/Dollar Agreement was implemented which led to continued communication between our Treasury Department and the Japanese Ministry of Finance. In general, these talks have helped to accelerate the pace of liberalization in Japan's domestic capital markets, and removed many of the barriers to

foreign entry into its domestic financial services industry.

Improvements for U.S. Banks in Japan. Recent changes in Japanese financial markets and their competitive implications for U.S. banks were reported in a 1988 study completed by the GAO at the request of the House Banking Committee. In summary, this report concluded that Japan has made several changes in its financial system which provide foreign institutions greater opportunities to compete in its domestic markets. For example, foreign concerns over access to the Tokyo Stock Exchange ("TSE") appear to have been addressed to the satisfaction of most foreign firms seeking membership.

In two other areas, however, U.S. financial institutions were still concerned about their ability to compete with the Japanese. The first is the amount of foreign participation in the Japanese government bond market, particularly the important market for 10-year government bonds. Japanese government bonds are issued through one of three methods: an auction, an underwriting syndicate, or direct placement with certain official accounts. The 1988 GAO report noted that, while most maturities for Japanese government bonds were sold and priced through auction, the syndicate procedure remained in place for 10-year bonds. Of the 800 financial institutions in this consortium, 12 U.S. banks and 12 U.S. securities firms were members in April of 1987, when the Japanese government increased foreign firms' share

of the bonds allocated from 0.3 to 1.5 percent. In November 1987, the Japanese introduced a limited auction for 20 percent of each 10-year issue. More recently, in April 1989, Japan allowed 40 percent of new 10-year government bonds to be auctioned, with the remainder sold through the syndicate.

The remaining area of frustration for U.S. banks operating in Japan has been difficulty in providing the full range of products that they may offer in other markets. While this is also a source of frustration for domestic Japanese banks, it has competitive implications for U.S. banks that are more experienced in some of the new and innovative financial products such as futures and options. Japan opened its first financial futures market in October 1985, by listing government bond futures contracts on the Tokyo Stock Exchange. In September of 1988, Japan began to permit the trading of stock index futures on the Tokyo and Osaka Stock Exchanges.

Summary. The GAO report concluded that, in general, Japan has more quickly liberalized its international financial market than its domestic market, which remains relatively underdeveloped. The rigidities of the regulated Japanese markets affect the ability of U.S. firms to compete, for a variety of reasons. These include difficulty for foreign firms to fund themselves in Japanese money markets, stiff competition from domestic firms with access to low-cost deposits, and relatively

low demand for commercial loans in Japan. Notwithstanding recent efforts by the Japanese to open their financial markets to foreign competitors, U.S. banks today control only about $30 billion of bank assets in Japan.

In one respect, however, U.S. banks have broader powers in Japan than do Japanese banks: affiliates of seven U.S. banks have been granted licenses to engage in securities activities. In effect, according to the GAO, these banks receive "super-national treatment" because domestic banks in Japan, as in the United States, are currently restricted from engaging in similar activities.

Entry guidelines for securities affiliates of U.S. banks are the same that apply to European banks: the Japanese unit must be a branch of an off-shore subsidiary that is not more than 50 percent owned by the parent foreign bank. The Japanese government's decision to permit U.S. banks additional securities powers apparently stemmed from their treatment of European universal banks operating in Japan.

European Community -- 1992

Background. The European Economic Community, which currently includes 12 Member States, was established in 1957 for

the purpose of creating an internal market characterized by the free movement of goods, services, labor and capital. One of the principal organizational bodies comprising the EC is the European Commission ("Commission") which proposes and prepares legislation, typically in the form of individual "directives." Another organizational body, the Council of Ministers, decides whether a directive becomes "Community Law." The Council of Ministers, which includes one voting delegate for each Member State, can amend a Commission proposal, but only by unanimous vote.

In its 1985 White Paper, the Commission identified 300 non-tariff 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 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. Many of the directives already have become Community Law. Of particular importance to this hearing is the Second Banking Directive, which was formally adopted by the Council of Ministers in December, 1989.

Second Banking Directive. The key components of the Second

Banking Directive are as follows: (1) a single banking license will be granted to institutions that will entitle them to offer a wide range of financial services anywhere in the EC, if they are permitted to do so by their home country; (2) the home country of an institution will be responsible for the institution's regulation and supervision; and, (3) mutual recognition of each others' regulatory arrangements will be observed by the governments of all of the Member States.

Before discussing how the Directive will treat non-EC banks, we would like to touch on the core list of permissible activities and some related supervisory developments. First, it is noteworthy that the Directive focuses upon financial products rather than institutions. By any standard, the range of permissible products is quite comprehensive: all forms of lending, leasing, foreign-exchange services, financial futures, portfolio management and advice, and securities trading. The fact that insurance activities are missing from the list is not as significant as might first appear. Many of the major European countries already permit their banks to engage, at a minimum, in insurance agency activities.

The core list of permissible activities was not drawn up without due regard to supervisory considerations. The Directive also sets standards for solvency ratios for banks, disclosure of "major" shareholders and limits on banks' holdings in

nonfinancial companies. Earlier this year the Council of 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).

Effect on Non-EC Banks. How does the Second Banking Directive treat non-EC banks? Subsidiaries of third-country financial firms will be governed by the Directive and will 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 domestic 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.

Implications for U.S. Banks. The implications of "Europe 1992" for U.S. banks are enormous. By definition, the creation of a new economic superpower whose GNP and population would rival or exceed those of the United States will create both

opportunities and challenges. Moreover, these opportunities and challenges will impact U.S. banks of all sizes -- not just the money-center institutions.

The European markets for retail and wholesale financial services are diverse and thus present potential profit opportunities for U.S. banks possessing the requisite marketing strategy and expertise. The retail markets, in particular, hold promise. For example, credit cards, which currently are not popular in West Germany, are a great potential market if 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 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 January 1, 1993.

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 U.S. 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 treatment. However, the EC has indicated that it is interested in seeing the elimination of Glass-Steagall and McFadden Act restrictions. If the EC elects to hold our feet to the fire on these or other issues, which remains a possibility, then the opportunities created by "Europe 1992" might be foreclosed to U.S. banks.

Another major issue is whether the U.S. regulatory environment will restrict the ability of U.S. banks to compete in the European market. European banks have begun a process of consolidation and expansion that may put U.S. banks at a significant disadvantage. Already, the United States does not have a bank in the top 25 in the world, in terms of deposit size. Glass-Steagall and Bank Holding Company Act restrictions

ability of U.S. banks to compete on both a domestic and global basis.

The Canadian Financial System

Overview. Traditionally, Canada has segregated the activities of banks, trust companies, insurance companies, and securities dealers. However, in 1986, the Canadian government published a policy paper titled "New Directions for the Financial Sector", more commonly referred to as the "Blue Paper." A major conclusion of this report was that while the segregation of the four categories of financial activities should continue, each entity should be allowed to enter into the activities of other entities through subsidiaries.

The first revision of Canadian banking law allowed banks, and other financial institutions, to establish subsidiaries engaged in the securities business. Subsequent revisions of the law will allow the fields of activity for individual financial institutions to expand, as well. For example, trust companies are expected to be granted full consumer and commercial lending powers.

As with the EC's Second Banking Directive, these changes were not made without due consideration of safety-and-soundness concerns. For example, strict limits have been established

regarding commercial capital's ownership of financial institutions. Other measures include prohibitions against self-dealing transactions, stronger provisions against conflicts of interest, and an improved deposit insurance system.

U.S.-Canada Free Trade Agreement. Like the EC's plan to achieve economic integration by 1992, the U.S.-Canada Free Trade Agreement, which became effective January 1, 1989, sets up a concrete model for lowering barriers to international trade in services and international investment. It is expected that nearly all existing barriers to trade and investment between the two countries will be removed by the end of the 20th century, thereby creating the largest internal market in the world. The purpose of this agreement, like that in the EC, is to stimulate economic growth and enhance consumer welfare in the two countries through more efficient resource allocation.

The U.S.-Canada Free Trade Agreement contains a financial services section that removes many discriminatory practices previously encountered by U.S. financial institutions in Canada. For example, U.S. banks in Canada are now exempt from the Canadian limitation on foreign banks' market share to 16 percent of total bank assets. Similarly, the Agreement abolished for U.S. firms the Canadian "10/25 rule" regarding foreign ownership of Canadian financial institutions. This law limits ownership to 10 percent for any individual nonresident, and 25 percent for all

nonresidents together, in any Canadian financial institution.

As a result of these recent changes, all U.S. financial institutions are allowed to acquire securities firms and federally-regulated insurance and trust companies. However, as noted earlier with respect to the implications of "Europe 1992," U.S. banks will be faced with corresponding competition from Canadian banks seeking to enter the larger, and more profitable, U.S. market. At mid-year 1989, Canada was already the third largest "foreign" country operating in the U.S. banking industry, with assets of $42.4 billion.

Conclusions and Recommendations for Change

It seems clear that recent changes affecting the provision of financial services have led all of the major industrial nations to revise certain laws governing their financial institutions and, in some cases, to restructure their entire domestic financial systems. Moreover, there is a clear tendency for convergence in permissible activities for banks, primarily in the area of securities underwriting and brokering.

As banking activities have become more globalized, each country has looked to developments in foreign markets to ensure compatibility of activities, and hence, the competitiveness of its domestic institutions. At the same time, regulators seek to

ensure safety and soundness without unnecessarily impeding the free flow of capital. Moreover, the development of truly international capital markets requires increasing coordination in supervisory oversight and in individual countries' regulatory practices.

This process already has begun as evidenced by the recent international agreement on capital regulation, to which the United States is a participant. As noted earlier, the EC already has adopted this risk-adjusted standard. Japan also has agreed in principle to this regulation, and most of its major banks have largely completed the process of complying with increased capital standards.

Another regulatory area that will receive much attention in the near future is the insurance of bank deposits. As a result of the large number of commercial bank and savings and loan failures in recent years, our banks soon will be paying among the highest annual premiums for deposit insurance coverage. Although a wide variety of systems exist in other countries to protect depositors, many of these are new and have yet to be tested. The FDIC has begun to take a closer look at foreign deposit insurance schemes and intends to address this matter in conjunction with the Treasury Department review of the deposit insurance system currently being conducted.

Having addressed some of the implications of restructured international markets, the next question is: Where do we go from here? First, it is imperative that the U.S. financial system, its regulators and the Congress think in global terms. The creation of this Task Force is a good first step. Second, we need to consider whether existing financial laws in the U.S. 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 U.S. and foreign markets. Their growing market share has increased largely at the expense of U.S. commercial banks. As we have indicated, one reason is that foreign banks are exempt from many of the regulatory restrictions imposed on U.S. banking activities. The study stressed that if banking companies are to maintain the earnings potential fundamental to their viability, they must have the opportunity to offer products and services necessary to compete on even terms with their international competitors.

To improve viability, two fundamental alternatives are available: maintain strict regulatory constraints, but allow banking companies to offer a wider variety of products; or remove the constraints and allow banking organizations to compete in

markets that, in the individual judgement of management, makes good business sense. The removal of constraints is appropriate if we can isolate banking entities from the risks associated with nonbank affiliates, without spinning a regulatory web around the entire organization.

The major conclusion of Mandate for Change is that insulation through the creation of a supervisory wall can be achieved. The tools needed for insulating banks and establishing the "supervisory wall" are only a logical extension of safeguards that exist today to protect banks from inside abuse and conflicts of interests.

The public-policy implication of this conclusion is that the Glass-Steagall Act and certain provisions of the Bank Holding Company Act -- including those that limit the activities of bank affiliates -- should be abolished. Such restructuring would be accompanied by a strengthening of the supervisory and regulatory restrictions on banks. The prudent supervision of banks would become more important, along with the need to monitor and limit risks posed by any new activities conducted in the bank.

If all this sounds familiar, it is because Mandate for Change mirrors the thinking that produced the Second Banking Directive adopted by the European Community's Council of Ministers last December. In fact, if the recommendations in the FDIC's study were adopted, the thorny problems presented by

reciprocity might largely disappear.

As stated at the outset, along with the dismantling of these archaic laws, public policy officials concerned over U.S. competitiveness must overcome unfounded trepidation over the separation of finance and commerce, prevail over the temptation to continue geographic restrictions that create market inefficiencies and find internationally compatible solutions to the issue of deposit insurance.