TESTIMONY OF

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ON

DEPOSIT INSURANCE REVISION AND FINANCIAL SERVICES RESTRUCTURING

BEFORE THE

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Mr. Chairman and members of the Committee: We appreciate this opportunity to testify on the need for legislation to modernize the regulation of financial services. There is no doubt in our view that change is necessary to enhance the competitive position of financial institutions and reduce the exposure of the taxpayers to the costs of the federal safety net. In the invitation to testify, we were asked to focus on three interrelated issues. These are:

(1) How should the current system of Federal deposit insurance be reformed?

(2) What should be done to improve the current Federal regulatory structure? What changes in Federal supervision would be needed to deal with expanded powers?

(3) Should new powers be granted to banks or their affiliates? If so, what powers should be granted, when should they take effect, and with what protections for the deposit insurance fund? Should new powers be granted only to a bank's holding company affiliates, rather than to the bank or its subsidiaries?

Our testimony on these very broad, complex issues does not contain definitive recommendations. Along with the other federal banking agencies and the Office of Management and Budget, the FDIC is participating in the Treasury Department's comprehensive study of deposit insurance. This study was mandated by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989. Treasury intends to complete the study by the end of this

year.

Because the study will draw conclusions and make recommendations regarding the subject matter of this testimony, providing final conclusions and recommendations now would be premature. Since we are still studying these matters with our colleagues, our purpose in this testimony is to report on our thinking and define the important issues we believe are involved.

In laying out the issues, our testimony first reviews several general considerations that should be kept in mind when the topics of financial industry and deposit insurance reform are examined. Then issues involving structural reform of the deposit insurance industry are discussed. The topic of structural reform concerns obstacles to the maintenance of a healthy banking system. In the final analysis, a healthy deposit insurance fund depends on the viability of the banking industry itself.

Next, suggestions for reforms in the deposit insurance system are considered. Although the deposit insurance reforms are important, the point needs to be emphasized that in the long run they would be ineffective if the structural problems of the industry are not addressed. The United States has operated for far too long with an economically irrational financial structure. Financial institutions need freedom, subject to adequate supervision, to respond and adjust to changes in the competitive environment.

The testimony concludes with a brief look at the topic of changes in the federal regulatory structure.

BACKGROUND

To say that the last decade or so has been a period of change and turmoil in the financial industry is, if anything, an understatement. Secondary evidence of the volatile environment and its effects on various segments of the financial industry can be found in the actions of this very body. Since 1978, Congress has passed an extraordinarily large number of far-reaching laws pertaining to depository institutions.

These laws include: The Financial Institutions Regulatory and Interest Rate Control Act of 1978 (FIRIRCA); the International Banking Act of 1978; the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA); the Bank Export Services Act of 1982; the Garn-St Germain Depository Institutions Act of 1982; the International Lending Supervision Act of 1983; the Competitive Equality Banking Act of 1987 (CEBA); and most recently the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA).

What is the point of this mind-numbing recitation? The point is to emphasize the many rapid changes that have taken place in the financial environment, changes considered serious enough to warrant action by Congress. Never before in the nation's history, not even during the legislatively prolific years of the 1930s, have such a large number of important banking laws been passed in such a relatively short period of time.

And many contend that an appropriate point for a legislative

hiatus has not yet been reached.

In hindsight, some of the actions--both legislative and regulatory--taken during the last decade appear unwise. As a general matter, the deregulation of the savings and loan industry was not accompanied by a concurrent strengthening of capital standards and the industry's supervisory structure. This contributed to the S&L crisis, a financial disaster of major portions.

Among the lessons that should be absorbed from the S&L debacle is that adequate supervision is necessary to the maintenance of a safe and sound system of depository institutions. Regulation--the mere promulgation of rules--is no substitute for supervision because the rules must be enforced. And the nature of the business of depository institutions is such that enforcement requires judgement and hands-on efforts by competent, trained examiners.

In determining what additional banking laws should be added to the prodigious output of the recent past--either to cope with problems that have not yet been adequately handled or to correct prior efforts--several considerations need to be kept in mind. These are: (1) the changing nature of the banking industry in the nation and the world; (2) the uniqueness of the problems in the S&L industry; and (3) the misunderstandings concerning the Too Big To Fail concept.

A Changing Industry

Reform of the deposit insurance system must begin with reform of the antiquated legal structure burdening the financial industry in general and the banking industry in particular. Reform of this structure is necessary because the competitive environment within which banks operate is changing significantly. Banks and other financial institutions have been hampered in their ability to adjust to the changes.

In Appendix I, a number of tables and graphs are used to identify three interrelated trends: banking is becoming a riskier, more volatile business; banks are encountering greater degrees of competition; and what constitutes the business of banking itself is undergoing a rapid evolution.

One way to summarize what is happening is to say that the banking industry's monopoly on financial information has been eroding. Credit histories are more widely available. The ability to acquire and analyze economic and financial data has become as ubiquitous as the personal computer. The development of complex financial instruments and strategies is being accomplished internally by an ever greater number of corporations. Consequently, banks and the traditional intermediary function they perform are no longer as necessary as they once were.

S&L Crisis Versus Bank Problems

The savings and loan industry crisis and the difficulties facing the banking industry should not be confused. A unique

situation and a particular series of events combined to produced the multi-billion dollar S&L disaster.

For many decades, S&Ls performed successfully the task of funding long-term assets with short-term liabilities. The underpinning of this process eroded in the latter half of the 1970s, however, when interest rates rose to unprecedented heights. As the high rates persisted, the total interest expense of many S&Ls grew to exceed their total interest income, the interest expense rising because of the reliance on short-term liabilities.

In an attempt to mitigate the growing difficulties facing the S&L industry, the federal government and several states relaxed restrictions on the activities the institutions could engage in. Most unfortunately, however, little attention was paid to supervising the exercise of the expanded powers. The results are well known. A number of S&Ls went on the institutional equivalent of a bender, and the nation will be paying the tab and nursing the hangover far into the future.

There were, of course, additional factors that contributed to the S&L debacle. One among them was that the federal S&L supervisor, the Federal Home Loan Bank Board, was not just a "policeman." It was also something of a "cheerleader" for low cost home financing and for the S&L industry, having been given the mandate to encourage local thrift and home financing and to promote, organize, and develop thrift institutions. The incompatibility of the two functions may have hindered the

FHLBB's ability to act objectively as the industry's troubles mounted.

A related problem was that there was in effect no separation between the federal chartering and deposit insurance responsibilities for S&Ls. The federal deposit insurer, the Federal Savings and Loan Insurance Corporation, was under the supervision of the FHLBB. This substantially reduced the possibility that a second independent supervisory agency might apply the objective oversight that was neglected by the first agency.

The closeness between the regulators and the regulated in the S&L industry probably contributed to the ill-advised efforts to protect institutions as the problems deepened. An example of these ill-advised efforts was the relaxation of accounting standards to forestall the recognition of losses. The deviation from proper accounting practices only compounded the developing troubles.

Banks do not have the maturity mismatching problems that S&Ls had in the late 1970s. No change in the banking system has required a large increase of supervisory resources in a short period. The chartering and deposit insurance responsibilities for the banking industry are separate. And although some aspects of bank accounting have been criticized, banks have been required to adhere to generally accepted accounting principles. Thus the difficulties facing the banking industry today are not comparable to the situation that produced the S&L crisis.

The banking laws enacted during the 1980s, particularly FIRREA in 1989, made a number of beneficial changes in the supervisory structure of the bank and thrift industries and added a number of weapons to the arsenals of the supervisors. For example, enforcement powers have been strengthened. Generally accepted accounting principles and higher capital levels have been mandated for thrift institutions. And the federal chartering and deposit insurance functions for S&Ls have been separated.

In summary, the point to be emphasized is that although banking industry structure and the deposit insurance system are in need of reform, the problems are not the same problems that brought the S&L industry to its knees. Consequently, the measures that have been taken regarding the S&L industry should not necessarily serve as a blueprint for legislative action for the banking industry.

Too Big To Fail

Too Big To Fail is an imprecise term that has received considerable attention lately. It concerns one of the more important things that must be understood before meaningful deposit insurance reform can be addressed: deposit insurance reform proposals that do not acknowledge the perception of large banks being Too Big To Fail could result in a shift in the competitive balance between big banks and small banks. The latter would suffer. This would be the case even though the FDIC does not in fact have a Too Big To Fail policy.

The term "Too Big To Fail" is used in referring to troubled banking organizations that supposedly are too large for the government to handle by closing the bank and paying off deposits up to the $100,000 insurance limit. There are many nuances in the resolution methods for troubled banks that are not handled through a liquidation and deposit pay off. To generalize, if the deposit pay off method is not used, a troubled bank resolution is accomplished either by arranging for the bank's liabilities, both insured and uninsured, to be acquired by another institution, or less often by providing direct financial assistance.

Who is aided in the various resolution methods varies. In the past, uninsured depositors and creditors of the troubled bank were benefitted in most cases in which a resolution method other than the deposit pay off method was used. Stockholders and management of the institution were benefitted much less frequently. The FDIC's pro rata power--which was legislatively endorsed in FIRREA and in recent years has been considered for use more frequently--enables it to distinguish between categories of uninsured depositors and creditors under all methods of resolving failing banks.

The Too Big To Fail concept came into prominence with the 1984 assistance package arranged for Continental Illinois National Bank and Trust Company. As a result of the assistance package, both the creditors of the holding company and the uninsured depositors and creditors of the bank itself were benefitted. The actions of the banking supervisors in the

Continental case and in a number of subsequent cases involving large troubled institutions have been widely interpreted as the product of a Too Big To Fail policy.

It bears repeating, however, that there is no such explicit policy. Continental and subsequent cases need to be put in the context of the FDIC's longstanding preference for handling troubled bank situations in the most expeditious, least disruptive way possible. Furthermore, in those subsequent cases the FDIC has not only been much less willing to include holding company creditors and equity holders in rescue efforts that benefit the uninsured depositors and creditors of a subsidiary bank. It has also not automatically adopted a resolution method that fully protects all of the bank uninsured depositors and creditors themselves.

Of more general significance, however, is the fact that Too Big To Fail is much more than a problem of the deposit insurance system. Altering the present regulatory structure in an attempt to eliminate the perception of large banks being Too Big To Fail would merely shift responsibilities. The possible failure of a large financial organization presents macroeconomic issues that some arm of the government must consider. The evaluation of the economy-wide ramifications of the demise of a big bank is a government duty.

To put the matter another way, Too Big To Fail as an issue would exist even in the absence of an explicit deposit insurance program. And the result of protecting large institutions is to

provide 100 percent insurance for the deposits in such institutions. Past experience in all major countries supports the contention that a Too Big To Fail policy exists, de facto if not de jure.

Therefore, the possibility that a failing large bank will be handled in a way that results in losses to uninsured depositors and creditors cannot be guaranteed. Many participants in the financial marketplace conclude based on past practices that large banks are safer than small banks. If changes in the deposit insurance system resulted in this view being more widely adopted, many marketplace participants might move funds to large banks regardless of any explicit policy requiring large bank depositors and creditors to suffer losses. The explicit policy would simply not be believed.

Thus the effectiveness of depositor discipline put in place by deposit insurance reforms designed to impose losses on uninsured depositors and creditors in all cases of bank failure is a difficult question. The stability of the system under such conditions must be evaluated.

INDUSTRY STRUCTURE

A healthy deposit insurance system depends ultimately on the existence of a healthy banking system. The discussion in Appendix I shows that the health of the banking system has been deteriorating. To halt this deterioration and give banks the opportunity to compete and remain viable in a fast-changing world

should be the goals of efforts to reform the structure of the banking industry.

Structural reform of the banking industry primarily concerns three topics:

1. The Glass-Steagall Act;
2. The ownership and product limitations of the Bank Holding Company Act; and
3. Geographic barriers to bank expansion.

In 1987, the FDIC considered in detail the first two of these topics. The results were set forth in Mandate for Change: Restructuring the Banking Industry. The events of the interceding three years have not detracted from Mandate's conclusions that the Glass-Steagall Act and many of the restrictions of the Bank Holding Company may be not only unnecessary but also actually harmful to the banking industry. As is discussed in the Background section and Appendix I of this testimony, the financial environment has been changing to the detriment of the traditional banking business. The laws constraining the business have not changed, however.

Two of the conclusions reached in Mandate were that product limitations on bank holding companies and regulatory or supervisory authority by bank regulators over nonbanking affiliates of banks are not necessary to protect either the deposit insurance system or the payments system. Banking

organizations should be free to offer a wide range of products and services, with the major caveat being that many of the products and services should be in uninsured subsidiaries or affiliates of a bank rather than in the bank itself. In addition, the FDIC in 1987 could discern no valid reason to limit the type of entities that can own or be affiliated with banks.

To carry the conclusions of Mandate a step further, there might be substantial benefits from eliminating the current ownership and activity restrictions. Risks could be diversified. Cross-marketing activities could enhance the profitability of the overall organization, although there would have to be restrictions on the use of insured funds to support uninsured activities. And the U.S. system for governing depository institutions could be brought into alignment with the systems of most of the other industrialized nations.

Regarding the last point, it is worth noting that the nations of the European Community, which is rapidly removing internal barriers to the movement of goods and services, have nothing that is comparable to the U.S. Bank Holding Company Act. Bank supervisory systems in Europe are aimed at the bank rather than at both the bank and any corporate owners.

In Mandate, the FDIC presented an order of precedence for the elimination of the excessive controls and regulation imposed by the Glass-Steagall Act and the Bank Holding Company Act. The first step would entail the enactment of the necessary legislation or the promulgation of the necessary regulations to

ensure that the bank supervisors have adequate tools to police banks under the new regime.

Specifically, if the Glass-Steagall and Bank Holding Company Acts were substantially altered, the following controls should be part of the new supervisory system:

1. Restrictions relating to dividend payments and general loan limits should be uniform for all banks, whether chartered by the state or federal government;

2. The interaffiliate restrictions of Sections 23A and 23B of the Federal Reserve Act should cover transactions not only between banks and their affiliates but also between banks and their subsidiaries;

3. Equity investments in subsidiaries should be excluded from the determination of banks' required levels of capital;

4. Bank supervisors should have the authority to audit both sides of any transactions between a bank and its affiliates or subsidiaries and to require reports as needed from the affiliates and subsidiaries;

5. Bank supervisors should have broad explicit authority to determine which activities can be performed in the bank and which have to be conducted in affiliates or subsidiaries; and

6. The legal and financial separateness of the insured bank from subsidiaries and affiliates should be fully disclosed and criminally enforced.

Controls such as these are designed in large measure to insulate a bank from difficulties in affiliates and subsidiaries. Can separateness be effectively established between the banking and nonbanking portions of a banking organization so that the bank's capital and the federal deposit insurance fund are not endangered by the nonbanking activities? The FDIC argued in Mandate that such separateness can be achieved. The suggested restrictions and limitations would merely be extensions of existing safeguards to protect banks from insider abuse, conflicts of interest, and the risks of certain types of endeavors. Where they have been adequately enforced by bank supervisors, such safeguards have worked well.

A case in point concerns the operation of life insurance programs by savings banks in Massachusetts. While the insurance programs and other programs within a bank have shared common names and quarters, there has been no commingling of assets or funds. The insurance programs have been separate and distinct from the other operations of the bank. No significant problems with the provision of life insurance by Massachusetts' savings banks have arisen.

The second step suggested in Mandate to bring about a new regime of bank supervision would be to eliminate the Glass-Steagall restrictions on banking organizations. A gradual phase-out of those restrictions would appear to be unduly cautious. For one thing, many securities activities would have to be conducted in subsidiaries or affiliates of banks, and these subsidiaries or

affiliates would be subject to supervision and regulation by securities industry regulators.

For another thing, securities firms should be allowed to enter the banking business at the same time that banking organizations are given the right to conduct a full range of securities activities. Such an equitable removal of Glass-Steagall restrictions might be difficult under a gradual phase-out approach.

Some use of phasing, however, might be appropriate for Mandate's third step in a move away from excessive control over bank holding companies--the elimination of the ownership and activities restrictions of the Bank Holding Company Act. If these eliminations were legislated, affiliations with financial firms should probably be allowed to take place on a faster schedule than affiliations with nonfinancial businesses. Other than this broad guideline, the exact timetable would probably not be important. What would be important is that certainty be part of the process. There should be a specific sunset date when all limitations on affiliations would terminate.

The third topic regarding structural reform was not discussed in Mandate, but it is related to the bank holding company concept. To put the matter simply, the time may have come to allow unfettered nationwide banking. This means removing all restrictions on the establishment of bank branches across state lines. In this regard, the FDIC is pleased to note the initiative just taken by Senator Dodd in introducing a bill to bring about

full interstate banking by 1994.

Interstate banking exploded in the 1980s, but the explosion was at the holding company level. Moreover, it came as the result of state rather than federal action. First in New England, then in the Southeast, and finally in all geographic regions, state legislatures moved to permit some form of interstate banking. The result is a bewildering variety of reciprocity laws, regional reciprocity laws, failing institution laws, and the like.

The states were responding to the imperatives of the marketplace. Halting the banking business at state boundaries was becoming more and more economically inefficient. In the Douglas Amendment to the Bank Holding Company Act, the states had a means to rectify matters. The Douglas Amendment permits the Federal Reserve Board to allow a bank holding company to acquire a bank outside its home state if the laws of the target bank's state authorize such an acquisition.

Unfortunately, the free market ideal of no geographic restraints on the banking business has still not been achieved. The mishmash of state laws imposes substantial restrictions on interstate expansion by bank holding companies. Just working one's way through the maze of state interstate banking laws requires a high-priced legal team. But more important, what is often the most economical way to expand geographically--by branching--is not readily available.

The 1927 McFadden Act severely restricts the ability of national banks and state banks that are members of the Federal

Reserve System to branch across state lines. There is no such federal constraint on state banks that are not members of the Federal Reserve System, but very few states have opened their borders to branches from out-of-state banks.

Interstate banking restrictions have contributed to the increase in risk in the nation's banking industry and to the decrease in banks' competitive capabilities. Banks have been hampered in attempting to lower risk through diversification. And banks have been constrained in expanding operations to match the expansion of banking markets that has been caused by technology and economic growth.

The nation's archaic geographic banking restrictions will become even more obvious and unpalatable in the near future as the European Community eliminates restrictions on branch banking. While European banks, and U.S. banking organizations with subsidiaries in Europe, make growth decisions based on market opportunities, banks operating in the United States will make growth decisions based to a large extent on what statutory loopholes can be found by the aforementioned teams of high-priced legal talent.

To summarize, the FDIC believes that deposit insurance reform should start with reform of banking industry structure. And structural reform should begin by identifying and examining the underlying obstacles to a competitive and viable banking industry. Topics that should be considered in this process are the Glass-Steagall Act, the product and ownership limitations of

the Bank Holding Company Act, and interstate banking restrictions.

DEPOSIT INSURANCE REFORM

Given a viable and competitive banking industry, the deposit insurance system should be designed to ensure that the industry--both the institutions that provide products and services and their customers--bears the appropriate costs. The deposit insurance system should not result in a subsidy to the banking industry, particularly a subsidy that eliminates the penalties the marketplace imposes on reckless conduct.

It is easy to lose sight of the fact that any system of supervisory controls creates costs and benefits. Some sectors of the economy receive implicit subsidies, and other sectors pay implicit taxes. A complete tabulation of these costs and benefits is extremely difficult. The issue sometimes comes to the fore only when changes in the supervisory system are considered, or when a disaster such as the S&L crisis sheds light on the costs and benefits.

Regarding the S&L crisis, taxpayers were surprised, and not pleasantly, at the amount of the costs they had unknowingly accrued over the years.

One charge that has been made is that the banking industry has received a benefit from underpriced deposit insurance. The banking business has become riskier. The cost of deposit insurance, however, has not kept pace with the increased risk. As

a result, the ratio of the bank insurance fund to insured deposits is at its lowest level in the FDIC's history (Figure 1). At year-end 1989, the fund, at $13.2 billion, amounted to 0.70 percent of insured deposits.

Increasing what banks pay for deposit insurance could be done directly, by increasing the insurance premiums, or assessments, that banks pay, as was done in FIRREA. The increase could be equally applicable to all banks, or it could be based on the level of risk in a bank's operations.

Imposing higher costs on banks for deposit insurance could also be done in a variety of indirect ways. One such way would be to increase required capital levels. Another way would be to reduce what is covered by the deposit insurance system, thus shrinking the amount of insured deposits, and perhaps the banking industry itself.

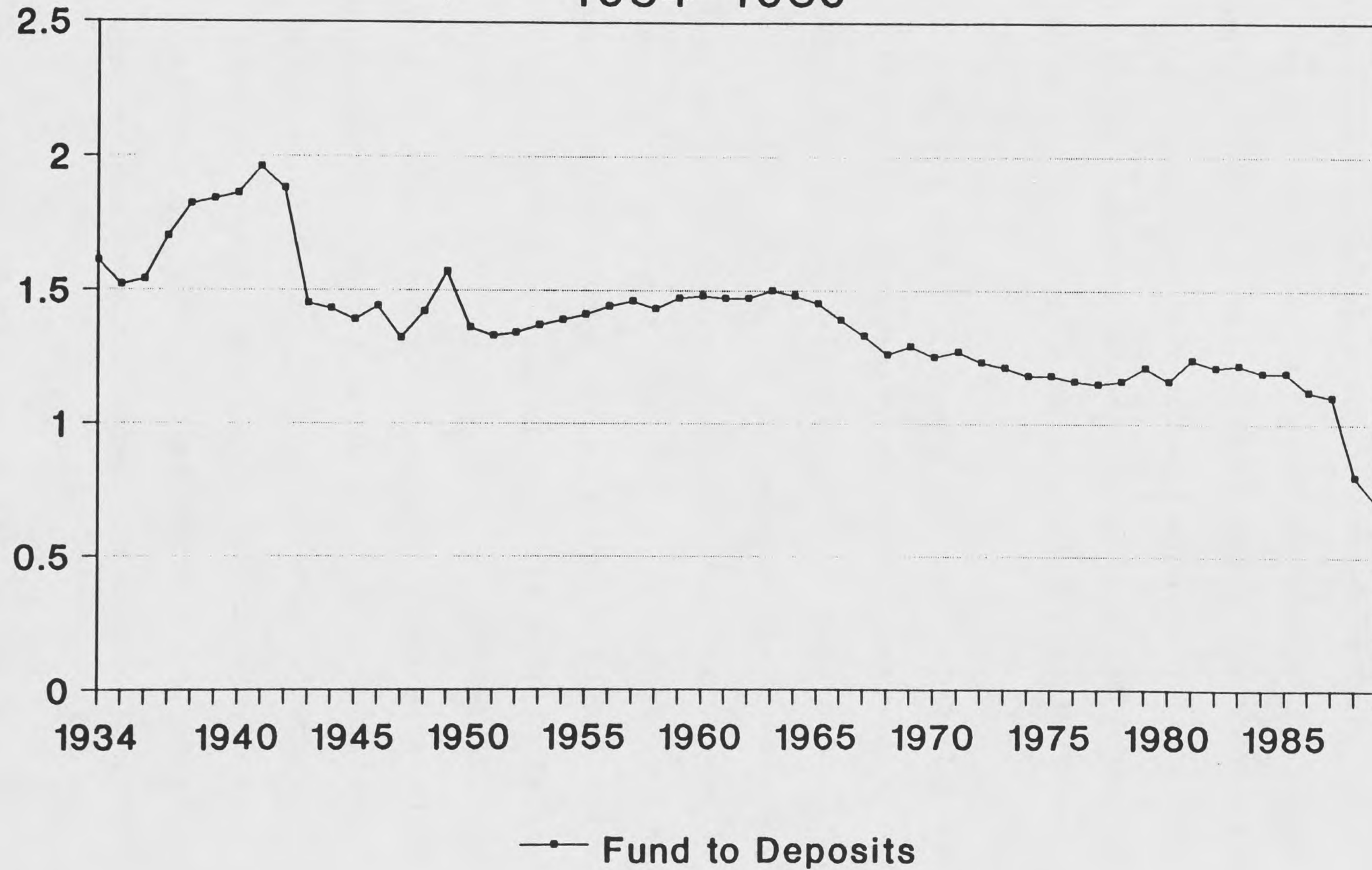
The mere mention of these possibilities highlights the fact that changes in the deposit insurance system, and the bank supervisory structure in general, entail shifts in costs and benefits. Such shifts are not painless.

In the remainder of this section, the topic of deposit insurance reform is examined under three headings. The headings are: liabilities, assets, and capital and structure.

<u>Liabilities</u>

Many proposals to reform the deposit insurance system concentrate on the liabilities side of the balance sheet. These

Figure 1: State of the Bank Deposit Insurance Fund
Ratio of Fund to Insured Deposits
1934-1989



Source: FDIC Annual Reports

proposals have the goal of limiting government's exposure by restricting or curtailing the amount of liabilities guaranteed.

Among the proposals--several of which are examined in greater detail in Appendices II and III--are the following: reduction in the statutory coverage limit from the current $100,000; limitation of coverage for each individual to a maximum of $100,000 per institution, across all institutions, or per lifetime; and limitation of coverage according to type of liability.

A particularly noteworthy proposal is the American Banker's Association coinsurance mandatory "haircut" proposal. Under this proposal, all uninsured depositors would suffer a loss in a bank failure. The loss would be based on the FDIC's average rate of recovery of assets in past failure resolutions. Since this average has been in the 85 to 95 percent range, uninsured depositors would suffer losses in the 5 to 15 percent range. The proposal envisions that even the largest banks could be successfully liquidated.

The FDIC is in favor of reducing its exposure to loss. However, limiting the cost of banking industry difficulties to the deposit insurance fund will entail tradeoffs, such as increased risk of instability in banking markets and the resulting possible adverse economic effects. This in turn could lead to reduced international competitiveness on the part of U.S. banks.

Such tradeoffs are likely to be more pronounced if a

component of any alteration in the deposit insurance system is a reduction in the FDIC's options regarding failing institutions. That is, the less flexibility the FDIC is allowed in handling a troubled institution, the more likely it will be forced to select a more costly, more disruptive approach to resolving the situation.

Although one benefit of these types of proposals would be to increase the incentives for depositors to monitor more closely bank operations, it must be realized that there is currently a significant amount of market discipline in the banking system. The stock market, credit rating agencies, large depositors, all are sources of discipline. The fact that banking organizations in trouble do lose access to funding--Continental in 1984 and First Republic in 1988 are two examples--shows that considerable discipline already exists.

Moreover, deposit insurance reform proposals that are designed to increase depositor oversight of banks through the monitoring of deposits have their limitations. Only a small proportion of depositors have the resources and ability to make informed judgments about the condition of a bank. Even the best regulators, Wall Street types, and financial gurus have a very poor record of foreseeing banking problems much in advance.

Assets

Various proposals would approach deposit insurance reform from the asset side of the balance sheet. The idea behind these

proposals is to limit what government insured deposits can be used to fund. The basic approach is to limit government risk by restricting the types of activities funded with insured deposits to those with the least risks. This approach has both promise and problems, as do all of the proposed changes.

One subset of these proposals focuses on a "narrow bank" concept. A "narrow bank" would be limited to investing in high quality, mostly government, securities.

The difficulty with the "narrow bank" idea--and indeed with any proposal that would reduce the type of assets that banks are currently allowed to hold--is the unpredictable effect it would have on the major beneficial function of banks: the provision of credit and liquidity to the private sector, which results ultimately in economic growth. Limiting deposit insurance protection to deposits that are only invested in the highest quality securities could well result in less credit and liquidity being provided to the private sector, and less economic growth.

Another subset of asset-related proposals would expand what banking organizations can do but limit use of insured deposits to a small part of the total operations. If the banking industry were given increased powers--primarily through relaxations in the restrictions of the Glass-Steagall and Bank Holding Company Acts--a major issue is where the new powers would be exercised: in banks themselves, in bank subsidiaries, or in bank affiliates.

This is a question for which there is no readily apparent precise answer. As a general guideline, traditional credit-

granting functions could continue to be funded with insured deposits. Other financial activities could be performed in subsidiaries. And the most risky financial activities, along with nonfinancial activities, could be confined to bank affiliates.

Bank size could be a factor in the determination of whether activities would be conducted in the bank or in subsidiaries or affiliates. Small banks would most likely have less desire to engage in nonbanking activities. The costs of setting up subsidiaries or affiliates would not vary much by bank size, thus making it relatively more expensive for small banks to establish separate nonbanking entities. Difficulties in a single small bank pose less danger to the banking system than do difficulties in a single large bank. And small banks are easier to supervise. Therefore, a requirement to conduct some types of activities in subsidiaries or affiliates could be limited to banks above a certain size, say $100 million in assets.

Regulatory discretion would be necessary to implement a banking system freed from the restraints of the Glass-Steagall and Bank Holding Company Acts. For example, the development of the appropriate degree of separateness among banks, their subsidiaries, and their affiliates to achieve a balance between prohibiting improper use of insured funds and permitting economic synergies would require the capability of making a number of incremental decisions.

Capital and Structure

While the level of risk in the banking system has increased since the 1940s, the proportionate amount of capital has remained static (see Appendix I). In addition, failures in the banking industry increased dramatically in the 1980s, and the ratio of the deposit insurance fund to insured deposits is at the lowest level in the FDIC's history (Figure 1). Thus it seems appropriate that serious consideration should be given to phasing in higher capital requirements for banks.

Capital serves to protect both individual banks and the deposit insurance system. An adequate commitment of capital on the part of the owners of a bank can curtail the temptation to take excessive risks with the bank's funds. Curtailment of risky activity at individual banks would result in a more stable banking system and a healthier deposit insurance fund.

In addition, capital encourages more efficient and equitable pricing for the banking industry's products and services. One of the undesirable effects of deposit insurance is to enable banks to offer some products and services at prices below those that would prevail in an uninsured banking industry. Capital can serve to mitigate this subsidization effect. All other things being equal, more capital would require a bank to earn more revenue in order to maintain its return on equity. The requirement for more revenue would reduce the bank's ability to underprice.

Phasing in higher capital requirements would not be a painless process, however. Moreover, a general increase in

capital requirements should probably not take place in isolation. Any such increase should depend on banking industry structural reforms, such as the alterations that were discussed earlier concerning the restraints of the Glass-Steagall and Bank Holding Company Acts. Then, as capital requirements for banks were raised, banking organizations would have various options regarding the movement of activities to uninsured affiliates or subsidiaries. The banking regulators would mandate the capitalization of banks, but the marketplace would determine the capitalization of the overall company.

Some proposals would alter the structure of the deposit insurance system by either eliminating deposit insurance or placing some exposure on private-sector insurance companies. The private insurance alternatives range from a totally private system with little, if any, governmental presence to partially private systems where the private and public sectors coordinate and share the insurance function. The basic premise is that the integration of private insurers into the deposit insurance system would lead to greater efficiencies in terms of pricing, risk monitoring, and closure of insolvent institutions.

The three main private insurance proposals are: private cross-guarantees of deposits; private insurance guarantees for deposits in excess of the statutory $100,000 limit; and reinsurance. Under the cross-guarantee proposal, deposit insurance would be mandated by the government but capitalized and operated by the private sector. Banks would be required to

purchase deposit guarantees from insurance syndicates comprised of other banks. Additionally, banks could act as insurers by investing their capital in one or more of the syndicates. The government, at least implicitly, would be the backup insurer.

Under the excess insurance proposal, private insurers would offer voluntary insurance for deposits in excess of the statutory $100,000 limit. Prices for the excess coverage would become, in theory, market-based, thus capturing the efficiencies of a competitive market. In the reinsurance scheme, the FDIC would, as primary insurer, sell to private insurers part of the risk it has underwritten in the form of deposit guarantees.

These proposals have some degree of merit. Each of the proposals, however, entails pricing and administrative difficulties. Moreover, in the final analysis each fails in the ability to cope with systemic risk. If the banking industry encounters deep troubles, it is unlikely that a private insurance system could handle the situation. The government would remain the ultimate risk-bearer.

Additionally, private insurance most likely would not reduce the Government's supervisory responsibilities and the moral hazard problem. Any lessening of the need for the Government to supervise banks could be offset by the need to supervise the insurer or insurers. Indeed, it is unlikely that any private insurance system would impose more effective supervisory restraints on imprudent conduct by banks than does the present system. Detailed supervision is largely what controls improper

activity and the moral hazard problem now, and detailed supervision is what would be necessary under any replacement system.

There are other useful ideas that could help the deposit insurance system. One type of proposal would convert deposit insurance to a risk-based system. Deposit insurance assessments would be determined by certain indicators of risk in a bank. The FDIC has been examining this topic for some time, and is required by a provision of FIRREA to report its conclusions to Congress by the end of the year.

Market-value accounting is also a concept that could have useful application in bank supervision. The market values of some types of assets, such as securities, can be ascertained without too much difficulty. Requiring such assets to be carried at their market values could result in more realistic financial statements for banking organizations.

REGULATORY STRUCTURE

Regulatory structure reforms should not be the tail that wags the dog. The issue of regulatory structure should be addressed only after the problems of structural reform of the industry and changes in the deposit insurance system are considered. How the regulatory structure should be altered will depend on how the problems of industry structure and deposit insurance reform are handled.

To put the matter another way, issues of regulatory

responsibility and supervisory authority should not be allowed to obscure the more important need to rejuvenate banking industry competitiveness and viability. Nor should issues of regulatory reform be the predominant factors regarding changes in the deposit insurance system.

Once reforms concerning banking industry structure and the deposit insurance system are agreed upon, the difficult task of improving the rationality and efficiency of the regulatory structure can be tackled. That structure currently consists of three federal bank regulators, one federal thrift regulator, one federal credit union regulator, and a variety of regulators in the 50 states. Responsibilities are often overlapping and redundant. The concept of functional regulation takes second place to the concept of institutional regulation. The elimination of many of the outdated aspects of this structure would appear to be possible.

As a general guideline, experience indicates that the independence of financial regulators and insurers is essential to accomplishing the task of supervising the financial system without bowing either to the current political fad or to potentially large economic pressures. Further, banking supervisors should not be put in a conflict of interest by also being responsible for other important functions and objectives, such as monetary policy, international economic stability, and revenue production.

Supervision can be more uniform than it is today. More

uniformity, however, would make it even more important that supervision be kept independent of other public concerns and political pressures.

CONCLUSION

The banking system has been undergoing significant changes. One way to characterize the changes is to say that the banking industry's monopoly on financial information has been eroding. Other players in the financial arena have been gaining ever greater access to financial information and consequently are relying less upon banks and the intermediary function they perform. Where these changes are leading is certainly one of the more intriguing economic questions of the Twentieth Century's last decade.

To enable banks to function in the changing environment, a number of alterations in the industry's structure appear to be needed. The major topics for examination are the Glass-Steagall Act, the Bank Holding Company Act, and the McFadden Act. When the appropriate changes are made, banks should be better able to adjust, under proper supervision, to the ongoing revolution in the financial marketplace.

Certain reforms in the deposit insurance system should probably accompany any changes in the legal underpinnings of the banking industry's structure. A number of such reforms have been suggested, many of them mentioned in this testimony. In the months ahead, the FDIC will be continuing its evaluation of these

and other proposals.

The proposals cannot be looked at in isolation, however. A piecemeal approach to financial industry reform will not succeed. An overview is needed, an overview that recognizes the many interrelationships among industry structure, the deposit insurance system, and regulatory responsibilities.