TESTIMONY

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ON

DEPOSIT INSURANCE REVISION AND FINANCIAL SERVICES RESTRUCTURING

BEFORE THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
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Mr. Chairman and members of the Committee: We appreciate the opportunity to testify on the topic of deposit insurance reform. The nation's deposit insurance system is being buffeted as never before in its history. Underlying the problems of the deposit insurance system are the problems of the banking industry itself. Significant changes in both the system and the industry are called for, in part to reduce the exposure of the taxpayer to the costs of the federal safety net.

Supervision, capital, risk: these are the foremost topics that must be addressed in arriving at measures to restore the deposit insurance system and the banking industry to health. Supervision must be strengthened. Capital must be increased. Risk must be limited. We will discuss these three imperatives in our testimony today.

The Chairman of this Committee is to be commended for his foresight over the years regarding troubles in the financial industry, and in particular for his recent proposal from the House floor concerning the current problems. Our testimony will include some initial reactions to the Chairman's proposal. We have also included, as an appendix to the testimony, answers to the questions that were posed in the invitation to testify.

Because the FDIC is currently participating, along with the other federal banking agencies and the Office of Management and Budget, in the Treasury Department's comprehensive study of deposit insurance, some of our testimony is preliminary in

nature. That study was mandated by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 and is required to be completed by early next year. The study will draw conclusions and make recommendations on a broad range of topics concerning difficulties in the financial industry.

But even though some of what we say is preliminary, there is much that can be said with certainty. Some obvious truths can be emphasized. Some fundamental problems can be highlighted. Some underlying considerations can be pinpointed.

Our testimony begins with a review of the changing, and in many ways deteriorating, state of the banking industry. This is followed by a discussion of the three imperatives: supervision, capital, risk. Then we turn to the structural obstacles to the maintenance of a healthy banking system.

To be effective, deposit insurance reform must embrace these structural problems. Deposit insurance reforms that do not deal with the structural problems will produce few lasting improvements in the deposit insurance system and will not materially reduce the ultimate exposure of the taxpayer to difficulties among banks and thrifts. The purpose of deposit insurance reforms should not be to hold together an antiquated banking industry.

Lastly, we examine deposit insurance reform in the context of Chairman Gonzalez's recent proposal.

A CHANGING INDUSTRY

Banks are operating in a competitive environment that is changing significantly. Because of the legal restrictions that control the structure of the financial industry, banks and other financial institutions have been hampered in their ability to adjust to the changes.

The changes may be characterized as consisting of 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 is undergoing a rapid evolution.

Probably the most pervasive piece of evidence that banking is a riskier business is the number of failed banks. Between 1943 and 1981, the greatest number of banks that failed in any one year was 17, in 1976. Annual failures increased dramatically in the 1980s, however, reaching a peak of 206 in 1989. Also increasing in the industry in the 1980s were net loan chargeoffs, which reached a peak of 1.15 percent of total loans in 1989.

Regarding the increase in competition, a greater variety of players are offering a wider variety of products and services. As a consequence, the banking industry's share of financial sector assets fell from 33 percent of the total in 1980 to 27 percent in 1987. The growth of the commercial paper market is an oft-cited example of a specific inroad into the banking industry's bailiwick. The amount of commercial paper outstanding grew from approximately 10 percent of bank commercial and industrial loans

in 1960 to almost 80 percent in 1989.

As for the changing nature of the banking industry, both the proportion of loans in bank portfolios and the composition of the loan portfolios have changed. The loans to assets ratio for the banking industry has steadily climbed. The ratio was 22 percent for the decade of the 1940s, 38 percent for the 1950s, 51 percent for the 1960s, 54 percent for the 1970s, and 58 percent for the 1980s.

Among the changes in the composition of portfolios, the proportion of real estate loans has increased over the years as the proportion of C&I loans has decreased. At year-end 1989, real estate and C&I loans accounted for 38 percent and 31 percent, respectively, of total loans.

Both of these types of changes have increased the riskiness of the banking business. Loans are riskier than the securities they have replaced, and many types of real estate loans pose risks not found in other types of loans.

Thus the banking industry, and the financial marketplace in general, have been undergoing significant changes. Volatility and risk have been on the increase. Because of the outdated restrictions governing what banking organizations can and cannot do, the industry has had trouble adjusting to the changes.

THE THREE IMPERATIVES

Much needs to be done to reverse the decline in the fortunes of the banking industry and to restore the health of the deposit insurance system. But three needs stand out. Supervision must be strengthened. Capital must be increased. Risk must be limited.

Supervision. The essence of prudent banking is to avoid making bad loans and investments. Unfortunately, all the rules and regulations in the world are not going to prevent bankers from making unwise lending and investing decisions. Adequate supervision, however, can restrain, although not entirely prevent, such decisions. Adequate supervision is built upon hands-on efforts by competent, trained examiners.

Indeed, in many ways supervision is superior to regulation. A number of industrialized nations have been highly successful in governing their depository institutions through systems that rely almost solely on supervision as opposed to regulation.

In the United States, there is a partiality toward written rules and regulations. Fairness is viewed as requiring explicit publicly-known standards. Such explicitness, however, can produce a false sense of security. A law is passed, a regulation is promulgated, and a problem is considered solved. Meanwhile, unnoticed events are occurring that will lead to future difficulties.

Thus supervision must occupy a central position in the structure for governing the nation's depository institutions. The

FDIC is spearheading an effort, in conjunction with the other banking supervisors, to improve and enhance the supervision of U.S. banks. This effort can proceed independently of the deliberations on banking and deposit insurance reform. Indeed, a strengthened supervisory effort is necessary to protect the insurance fund and the taxpayers during the period when appropriate reforms are identified and implemented.

Among the measures being actively pursued are: a policy of conducting on-site examinations of all banks no less than once a year; assignment of permanent resident examiners to all of the larger banks; a uniform dividend policy that would apply to all banks encountering difficulties; and a common approach to the evaluation of loan underwriting standards.

Capital. While the degree of risk in the banking system has increased since the 1940s, the proportionate amount of capital has remained relatively static. In the 1980s, this adverse change in the relationship between the degree of risk in the banking industry and the level of capital support was joined by--perhaps even contributed to--soaring numbers of bank failures. These failures in turn produced a fall in the ratio of the deposit insurance fund to insured deposits to the lowest level in the FDIC's history, 0.70 percent. The FDIC believes that the amount of capital--the safety cushion--in the banking industry should be increased.

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.

The federal banking supervisors recently reached agreement on a minimum capital ratio for banks. This is only a minimum, however. Over the long term, more capital is needed. How much more is hard to say, but the amount should depend on the riskiness of the activities insured banks are allowed to conduct. In addition to higher capital ratio requirements, an increase in the amount of capital for new bank charters may be called for. This might help improve the staying power of new banks, which historically have experienced a relatively higher failure rate than have longer established institutions.

Although the FDIC believes an increase in capital requirements is necessary, the increase should not be imposed in isolation. Higher capital requirements should be accompanied by industry structural reforms. These structural reforms concern the product and ownership limitations of the Glass-Steagall and Bank Holding Company Acts and the geographic restraints of the McFadden Act, and are discussed later in this testimony.

<u>Risk.</u> The level of risk in the banking industry has increased over the years because, as noted earlier, the banking business itself has become riskier. In addition, many bankers

with less aversion to risk have appeared on the scene.

Regarding the latter point, by the time the financially exciting years of the 1980s arrived, the numbers of bankers who remembered the devastating times of the 1930s and the cautious times of the 1940s and 1950s were few. The field of finance became an arena for the robust, the daring, the adventuresome. Concern about risk was not high on their agenda.

Perhaps the events of the last few years have restored a healthy appreciation for, and fear of, the perils inherent in financial activities. If not, additional excruciating lessons might have to be endured. The ease of entry into the banking industry can produce a degree of pessimism in this regard as there is a steady influx of individuals who must relearn old truths.

But assuming that the human aspect of the banking industry's risk problem has been mitigated somewhat, the problem of a generally riskier business still remains. The best way to approach this problem appears to be to limit the types of activities that can be supported with insured deposits. In other words, what can be done in a bank should be restricted. If a banking organization wants to engage in riskier activities, it should do so in nonbanking affiliates adequately separated--both legally and financially--from the bank. This view is elaborated upon in the discussion of structure in the next section of this testimony and was first put forward by the FDIC in its 1987 study, Mandate for Change: Restructuring the Banking Industry.

Determining the activities that could be conducted in the bank--and consequently that would be supported by insured deposits--is no mean task. The FDIC is taking a hard look at the issue. One attractive possibility is to limit the bank to making short and intermediate term loans that have no attributes of equity instruments. All loans would be with recourse. Other activities, including some activities that banks now engage in, would have to be moved to affiliates.

In such a system, a distinction might need to be drawn between larger banks and smaller banks. The difficulties that smaller institutions would encounter in setting up holding companies or separate subsidiaries, and the lesser danger they pose to the deposit insurance system, might justify fewer restrictions on their activities.

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Supervision, capital, risk: these are the three imperatives that must be dealt with if the present troubles engulfing the deposit insurance system and the banking industry are to be overcome. The next topic in this testimony is industry structure, a topic in which the interplay of those imperatives is particularly pronounced.

INDUSTRY STRUCTURE

It was stated previously that because of the outdated restrictions governing what banking organizations can and cannot do, the industry has had trouble adjusting to the many environmental changes that have occurred. The outdated restrictions are the Glass-Steagall Act, the product and ownership limitations of the Bank Holding Company Act, and the geographic barriers imposed by the latter act and the McFadden Act. 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.

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 than can own or be affiliated with banks.

Events in the three years since the publication of Mandate have not vitiated these conclusions. Indeed, developments in other areas of the world, particularly in the European Community as it implements its 1992 program of reduced barriers to the

movement of goods and services, have served to emphasize the uniqueness of the banking structure in the United States. The U.S. bank holding company concept is virtually unknown in most other countries, and bank supervisory systems are focused on banks rather than on any corporate owners.

Dissatisfaction with the product and ownership limitations of the Glass-Steagall and Bank Holding Company Acts seems to be fairly widespread among industry members, supervisors, and legislators in the United States. There is less agreement, however, on how the limitations should be altered.

One view, exemplified by Mandate, is that the supervisory effort should be concentrated on banks and not on affiliates and parent holding companies. Moreover, appropriate separations between banks on one hand and affiliates and parent holding companies on the other would permit banks to be part of larger financial, perhaps even non-financial, organizations without the necessity of subjecting those organizations to close supervisory scrutiny. Riskier activities could be conducted in affiliates or subsidiaries of the insured bank without exposing insured deposits to unacceptable risks.

The contrary view is that any relaxation in the restrictions of the Glass-Steagall and Bank Holding Company Acts should be accompanied by strong supervision of both the banking and nonbanking sides of resulting organizations. Underlying this view is the argument that establishing adequate separation between a bank and its affiliates and parent holding company is not

feasible. Consequently, the entire organization needs to be supervised. Moreover, affiliates and parent companies of banks should be limited to certain types of financial activities, and there should be no mixing of banking and commerce.

In Mandate, the FDIC came down on the side of focusing on the bank and reducing the control over the holding company and nonbank affiliates. The FDIC still believes that this is the preferable approach.

The third structural obstacle to a healthy banking industry consists of geographic barriers. Despite actions by the states allowing, in various forms, interstate expansion by bank holding companies, 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 bank holding company interstate expansion. And the 1927 McFadden Act severely restricts the ability of national and state banks that are members of the Federal Reserve System to branch across state lines.

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

To summarize, structural reform of the banking industry is

long overdue. To enable banking organizations to function in the changing environment, the obstacles presented by the Glass-Steagall Act, the Bank Holding Company Act, and the McFadden Act should be critically examined. With appropriate changes in the legal underpinnings of industry structure, banking organizations would be in a better position to adjust to the ongoing revolution in the financial marketplace.

DEPOSIT INSURANCE REFORM

Assuming the enactment of structural changes that remove impediments to the pursuit of reasonable profits by the banking industry, reforms in the deposit insurance system should be designed to ensure that the industry and its customers bear the appropriate costs of the government safety net.

There have been no shortage of proposals regarding deposit insurance reform. Some proposals focus on the asset side of the bank balance sheet. Others focus on bank liabilities. Still others focus on the difference between assets and liabilities--capital. And many approaches combine actions on all three balance sheet categories.

Rather than review the many different ideas that have been espoused, the remainder of this testimony sets forth some initial reactions to the recent proposal by the Chairman of the House Banking Committee. The goal of that proposal is to strengthen the deposit insurance system by: providing and enforcing adequate

capital standards; limiting insurance coverage and requiring realistic pricing for that coverage; unifying the regulatory system and making it independent; requiring regulators to act promptly and decisively when an insured institution begins to weaken; and making holding companies responsible for losses their insured institutions incur. Each of these topics is considered in turn.

Capital. The need for more capital in the banking industry has already been emphasized. Indeed, it is an imperative that activities funded with insured deposits be backed by adequate capital. Capital is a source of protection for the individual bank and a bulwark for the deposit insurance system as a whole.

An increase in the capital requirements for activities funded with insured deposits should take place in conjunction with action on the structural obstacles to the restoration of a competitive and viable banking industry. The product and ownership limitations of the Glass-Steagall and Bank Holding Company Acts and the geographic restrictions of the McFadden Act should be reduced or eliminated.

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.

Insurance Coverage and Pricing. There is merit to many of the proposals that would limit insurance coverage in one fashion or another. But most of the proposals would also entail administrative difficulties, some of them significant. The costs of reporting burdens on individual institutions and recordkeeping requirements on the FDIC should be considered before the adoption of any proposal that would limit insurance coverage. Also requiring consideration are the security and privacy issues that would be raised if another extensive system of records were necessary.

Administrative difficulties are only one area of concern, however. Two other factors regarding the insurance limitation proposals have more importance. First, reducing or limiting insurance coverage might lead to increased instability in banking markets. This in turn could result in reduced international competitiveness on the part of U.S. banks.

Second, due to a widespread belief in the Too Big To Fail concept--a better term is too big to allow a default on deposits--a reduction or limitation in insurance coverage 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.

What the FDIC does have regarding Too Big To Fail is the

belief that the possible failure of a large financial organization presents macroeconomic issues of considerable significance. These issues can transcend the normal considerations in a failing bank situation, leading to a decision to prevent the bank from going under. A by-product of that decision can be to provide 100 percent insurance for the deposits in the institution.

The macroeconomic considerations cannot be legislated away. 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. Consequently, many participants in the financial marketplace have concluded that large banks are safer than smaller banks. Reductions or limitations in insurance coverage that purport to apply to all banks but in practice only apply to smaller banks might exacerbate this discrepancy in perception, leading to a flight of deposits from smaller banks to larger banks.

Regarding proposals on the pricing of deposit insurance, one suggestion would base deposit insurance premiums on the riskiness of an institution's assets. The FDIC is required by FIRREA to conduct a study of risk-based premium assessments and to report the findings to Congress by January 1, 1991. The FDIC is in the process of conducting this study. Although the ultimate recommendation may well be to institute a system of risk-based insurance premiums, it should be realized that any such system will pose difficult, complex problems concerning the measurement

of risk.

Regulatory Structure. Regulatory structure reforms are important, but they are subsidiary to issues of industry structure and to questions concerning the deposit insurance system. Issues of regulatory responsibility and supervisory authority should not be allowed to obscure the more important need to rejuvenate the health and competitiveness of the banking industry. Nor should issues of regulatory structure be the determining 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, assorted peripheral federal entities, and a variety of regulators in the fifty 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. One guiding principle should be regulatory independence. Financial regulators and insurers should have a degree of insulation from the effects of the latest political fad or from the pressures of powerful

economic interests. In addition, banking supervisors should not be subject to a conflict of interest by also being responsible for other important functions and objectives, such as monetary policy, international economic stability, or revenue production.

Further considerations are the preservation of the state-federal dual banking system and the separation of chartering and deposit insurance functions.

A more uniform, more efficient system is possible. But a streamlined structure would make it even more important to keep supervision insulated from political pressures and other public concerns.

Supervisory Promptness and Decisiveness. The FDIC agrees that promptness in dealing with banking organizations in trouble is extremely important. For the most part, the federal bank supervisors have not failed to act promptly once troubles in an institution become known. The difficult problem is determining when a bank is in fact in trouble. This determination requires an adequate supervisory program. As was noted in the discussion of the three imperatives, the FDIC is working with the other banking supervisors to improve supervision.

As for the necessity to act decisively, the FDIC again agrees. Some commentators contend, however, that because the bank supervisors have a certain amount of discretion regarding how banks in trouble can be handled, there is a lack of decisiveness. The S&L crisis is pointed to as a situation where too much

discretion resulted in ineffective or no action and a consequent compounding of the original problem.

There is no doubt that the S&L crisis has given supervisory discretion a bad name. It should be remembered, however, that the federal S&L supervisor, the Federal Home Loan Bank Board, was much more a captive of its industry than are any of the three federal banking supervisors. The FHLBB's lack of objectivity resulted in large measure from the fact that it was required by law to be something of a cheerleader for low cost home financing and the S&L industry. Its mandate was to encourage local thrift and home financing and to promote, organize, and develop thrift institutions.

Reducing the current discretion they have regarding troubled institutions would curtail the ability of the bank supervisors to seek the least costly or least disruptive way of handling bank difficulties. Supervisors are not perfect in their reaction to troubled bank situations, but supervisory discretion has contributed enormously to the stability of the financial system. Supervisory discretion in the 1980s enabled the banking agencies to avoid widespread financial and economic disruptions while dealing with troubles in hundreds of institutions, including nine of the ten largest banks in Texas and two of the three largest in Oklahoma.

Moreover, reducing or eliminating supervisory discretion would not, as some commentators contend, obviate the Too Big To Fail problem. As previously indicated, that problem is much more

than a problem of the deposit insurance system. The possible failure of a large financial institution presents macroeconomic issues that some arm of the government must consider.

There is a caveat to the FDIC's view that a certain amount of supervisory discretion is desirable. Regarding banks that it does not directly supervise, the FDIC needs to be more involved and to have the final say on who is to be protected by the deposit insurance fund. This requires an increase in the FDIC's statutory powers.

In summary, although promptness and decisiveness are essential attributes of an adequate supervisory system for the banking industry, it is unrealistic to mandate in advance precisely how each troubled bank situation should be handled and exactly who should suffer losses.

Source of Strength. The FDIC has concerns about making parent holding companies and nonbank affiliates of banks responsible for bank losses. This so-called source of strength doctrine suggests that all units within a financial holding company are effectively part of a single corporate entity. An implication is that bank regulation and supervision should extend throughout the entire holding company to include not only the bank or banks but also the holding company itself and any nonbank subsidiaries of the holding company.

In Mandate, the FDIC argued that if there is adequate regulation and supervision at the bank level, and if effective

separation exists between the banks and the nonbanking entities of an organization, there is no need for regulation and supervision at the holding company level or of nonbank affiliates.

A doctrine that puts nonbank affiliates at risk for bank failures has many implications for the nation's financial system. If there is no effective insulation between banks and nonbank affiliates, bank holding companies would be impeded in their ability to expand into nonbanking areas because their investments in nonbanking affiliates would always be in jeopardy.

Further, nonbanking firms might be inhibited from entering the banking industry if all preexisting activities and investments were at risk. This situation would reduce market efficiency, restrain the ability of banks to be viable competitors in the financial marketplace, and limit the ability to obtain new capital for the banking industry.

CONCLUSION

Supervision, capital, risk; these are the areas in which actions to attack the troubles of the deposit insurance system and the difficulties of the banking industry are imperative. Beyond these actions, a number of reforms regarding the legal foundations of the nation's banking industry are needed. A danger of the current difficulties facing the industry is that pressing fundamental reforms regarding the industry's structure will be neglected in favor of changes that either do not deal with

underlying long-term problems or that exacerbate them.

Both the immediate needs--the imperatives--and the long-term requirements must be attended to. In addition, the interrelationships among industry structure, the deposit insurance system, and regulatory responsibilities must be kept in focus. Only an integrated approach will enable the appropriate changes to be made, changes that will attack the causes of the decline in the soundness of the deposit insurance system and deal with the related underlying problems facing the banking industry.