TESTIMONY OF
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FEDERAL DEPOSIT INSURANCE CORPORATION
ON
FINANCIAL MODERNIZATION
BEFORE THE
SUBCOMMITTEE ON FINANCE AND HAZARDOUS MATERIALS
COMMITTEE ON COMMERCE
UNITED STATES HOUSE OF REPRESENTATIVES
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Mr. Chairman and members of the Subcommittee, I appreciate this opportunity to present the views of the Federal Deposit Insurance Corporation on efforts to modernize the nation's banking laws and specifically on H.R. 10, the Financial Services Competition Act of 1997.

The FDIC brings a unique perspective to the analysis of financial modernization proposals. The FDIC is an independent agency that insures approximately $2.7 trillion in deposits at 11,368 commercial banks, savings institutions, and U.S. branches of foreign banks. These institutions hold assets totaling approximately $5.7 trillion. The FDIC insures deposits for up to $100,000 through two insurance funds, the Bank Insurance Fund (the BIF) and the Savings Association Insurance Fund (the SAIF). The FDIC also serves as the primary federal regulator for 6,308 state-chartered institutions that are not members of the Federal Reserve System. Since its inception in 1933, the federal deposit insurance system has contributed to the health and stability of the banking industry, and to the larger financial services industry, by providing assurance to depositors that their funds are completely safe.

Last year, in the Deposit Insurance Funds Act of 1996 (the Funds Act), Congress recognized the need to merge the deposit insurance funds. The SAIF insures far fewer, and more geographically concentrated, institutions than does the BIF, and consequently faces greater long-term structural risks. A combined BIF and SAIF would have a larger membership and a broader distribution of geographic and product risks and would be stronger than the SAIF alone. Because we believe that merging the funds is an important element of financial modernization, we strongly support the provisions in H.R. 10 that will merge the funds.

Today, the banking and thrift industries are experiencing robust earnings. Annual net income for commercial banks surpassed $50 billion for the first time in 1996. Thrift earnings in 1996 were $7.0 billion and would have exceeded the record of $7.6 billion set in 1995 if thrifts had not paid a special assessment to capitalize the SAIF, as required by the Funds Act.

Although banks have been earning record profits recently, bank performance has varied greatly over the past ten years. During this period, for example, the banking industry achieved both its highest annual return on assets (1.20 percent in 1993) and its lowest return on assets (0.10 percent in 1987) since 1934. Moreover, by some measures, the banking industry has been shrinking. For example, bank commercial and industrial loans represent a declining proportion of the credit market debt of nonfinancial corporations; bank loans now stand at 21 percent of corporate debt, down from 28 percent in 1985.

Modernization is essential if our nation is to achieve an efficient and competitive financial services industry capable of meeting the needs of a growing and changing economy. Financial markets have changed dramatically since many of our nation's laws governing financial services were enacted during the 1930s. Modernizing the financial system will benefit not just banks but also other financial businesses, such as insurance companies and securities firms. Equally as important, consumers should benefit from a wider array of products, services, and providers.

Events of the past decade have demonstrated how costly bank and thrift failures can be for the deposit insurance funds, for communities across America, and for our economy. The banking industry, through the BIF, spent approximately $36.4 billion to resolve failing banks from 1980 through 1994. The General Accounting Office has estimated that, from 1986 through 1995, the thrift crisis cost the thrift industry and taxpayers an estimated $160 billion to resolve (including tax benefits granted in connection with the crisis).

To help ensure that we learn from the banking and thrift crises of the 1980s and early 1990s and do not repeat them, the FDIC initiated a history project that we called the "Lessons of the Eighties." We have learned many lessons from this project. Two are particularly germane: (1) geographic and product constraints can result in inadequate diversification of income sources; and (2) rapid expansion into unfamiliar activities, without adequate supervision, can have undesirable consequences.

In the remainder of my testimony, I will first summarize principles that must govern any financial modernization legislation. Next, I will address several key issues raised by financial modernization proposals and H.R. 10. These are: the extent to which banking and commerce should be allowed to mix; the proper role of the proposed National Council on Financial Services; customer protection; and capital requirements.

PRINCIPLES OF FINANCIAL MODERNIZATION

Any financial modernization proposal must allow for equitable competition in an evolving marketplace while maintaining the safety and soundness of insured depository institutions. Financial modernization should also permit financial organizations to generate sufficient returns to attract capital essential for normal growth and expansion.

Moreover, any financial modernization proposal must be examined for its effect on small communities, isolated markets, and customers.

The FDIC believes that the following principles must govern any financial modernization effort:

Existing barriers preventing affiliations between banks and other financial service providers should be removed, but barriers between banking and commerce should be lowered cautiously and incrementally.

Banking organizations should be able to choose the organizational structure -- bank subsidiary or bank holding company affiliate -- that best meets their individual business strategies, as long as there are safeguards in place to protect the insured bank. The activities that banks themselves currently conduct should be left undisturbed. Functional regulation should not force organizations to restructure their financial operations and services by function rather than along strategic or market-based lines, or incur the costs of doing so which will be at least partly borne by their customers.

Federal regulators must be able to monitor the overall financial condition of an organization and coordinate supervision of -- and transactions among -- affiliates, but this monitoring and supervision need not involve activity-by-activity or investment-by-investment regulation.

Safeguards should prohibit inappropriate transactions between insured institutions and their subsidiaries and affiliates. Any financial modernization proposal should continue the safeguards of Sections 23A and 23B of the Federal Reserve Act as they apply to affiliates. The restrictions in Sections 23A and 23B are intended to safeguard the resources of federally insured banks against misuse for the benefit of an affiliate of the bank. Any financial modernization proposal should also apply the principles of these sections, as appropriate, to dealings between an insured bank and any subsidiary of the bank engaged in nonbanking activities. Further, investments by insured institutions in subsidiaries engaged in activities not permissible for the bank itself should be deducted from regulatory capital. Finally, a parent company involved in new financial activities should be required to keep insured banks well-capitalized.

These principles governed our analysis of the issues to which I now turn.

BANKING AND COMMERCE

Existing barriers that prevent banks from affiliating with other financial service providers should be removed. Competitive market pressures and technological advances have eroded the effectiveness of laws and regulations separating commercial banking from other financial activities, such as insurance and investment banking. Businesses and individual consumers alike want a full range of products from their financial service providers. If proper safeguards are in place to protect insured banks, bank affiliates and subsidiaries could provide a full range of nonbanking financial services without raising significantly the risk profile of the banking organization. We believe, however, that Congress should proceed with extreme caution in mixing banking and commerce, and we believe that as an initial effort H.R. 10 goes further than desirable in this area.

Both the benefits and risks of mixing banking and commerce are highly speculative. Proponents of such mixing have identified a number of potential benefits for both banks and the economy. First, a broader diversification of earnings may be possible -- if commercial activities are more likely to move counter-cyclically to bank earnings than other financial activities. This could also benefit the deposit insurance funds because the institutions they insure would be more broadly diversified. Second, new sources of capital would be available to the banking industry.

In addition, proponents contend, synergies may allow banks to realize economies of scope, and broadened activities may help banks adjust to changing markets. Whether synergies exist, however, is an open question. In addition, firewall restrictions between banks and their affiliates could limit any potential synergies.

Opponents of mixing banking and commerce assert that such combinations will foster undue economic power. In general, however, firms in the United States are subject to antitrust laws, which are designed to prevent problems caused by a lack of competition.

Conflicts of interest also are identified by opponents as a potential problem. These conflicts include: restricting credit to competitors, treating customers and suppliers more favorably, tying products and credit, making unsound loans to affiliates, and sharing customer information. In general, competition and existing safeguards can adequately control conflicts of interest. For example, a bank that denies credit to competitors of its commercial affiliates loses potential profits if those competitors finance their activities elsewhere. Further, firewalls -- such as those of Sections 23A and 23B -- are meant to prevent certain unsound transactions between a bank and its affiliates.

Finally, some have argued that mixing banking and commerce will result in safety and soundness problems. Little conclusive evidence exists, however, that safety and soundness will be compromised by mixing banking and commerce as long as safeguards are in place. In this regard, we note that H.R. 10 would specifically prohibit a bank from lending to a commercial affiliate. The risks created by banks undertaking new and unfamiliar activities can be better controlled with a go-slow incremental approach to the expansion of activities conducted by banking organizations. The Federal Reserve has used an incremental approach in permitting securities underwriting and dealing for nonbank subsidiaries of bank holding companies. Additionally, the potential for a bank to bail out an affiliate, to pass bad assets to (or receive bad assets from) an affiliate, or to pay excessive dividends and fees are currently controllable through firewalls and other restrictions. We advocate that these safeguards remain in place.

Any easing of the broad range of restrictions on the activities of banking organizations should proceed cautiously. While there is no hard evidence, either here or abroad, that combinations of banking and commerce are harmful, there is no hard evidence that they are beneficial, either. Experience with mixing banking and commerce in the United States has been limited. Since changes in public policy sometimes result in unintended consequences, caution dictates that we go slow in mixing banking and commerce. This go-slow approach would allow banks time to adjust to a new competitive environment and would allow regulators and others to assess the actual benefits and risks of allowing banking and commerce to mix.

H.R. 10, as adopted by the House Banking Committee, sets out two approaches to mixing banking and commerce -- a basket approach and a reverse basket approach. The basket approach would allow QBHCs to wholly own commercial firms as long as aggregate commercial revenues do not exceed 15 percent of the QBHC's gross domestic revenues. In principle, I endorse the basket approach in the proposed legislation. However, based on the desire to exercise caution, I favor a smaller basket -- with revenues from commercial firms amounting to no more than 5 percent of a QBHC's gross domestic revenues. As discussed below, this would permit most major securities and insurance companies to affiliate with banks in QBHCs without divesting nonfinancial or commercial activities.

Basket Approach. The basket approach allows insurance companies, investment banks, and other financial services companies that have controlling interests in commercial firms to affiliate with banks without having to divest their commercial activities. To evaluate whether such an approach would accomplish this objective, FDIC staff analyzed the most recent publicly available data on 28 brokerage, insurance, and diversified financial services firms.

The results were striking. FDIC staff found that most firms fall into one of two distinct categories: either they are overwhelmingly concentrated in financial services, or they have significant commercial activity. Of the 28 firms surveyed, 21 derived 95 percent or more of their revenue from financial services. Three firms derived between 85 and 95 percent of their revenue from financial services and four firms derived less than 80 percent of their revenue from financial services. Moreover, these calculations did not include the pro-forma effect on revenue of adding a bank. The percentage of revenue attributable to financial services would be even higher for a merger of any of these companies with a bank.

Based on these analyses, I believe that a 5-percent-of-revenue basket approach would be sufficient to allow most financial services firms to affiliate with banks without having to divest their commercial affiliates. A 5-percent-of-revenue basket approach also would allow QBHCs and regulators time to gain experience with this new environment on a smaller scale, and thus would be consistent with a go-slow approach. A 15-percent-of-revenue basket may allow too much to happen too fast. For example, based on data presented by House Banking Committee Chairman James A. Leach last March, a 15-percent-of revenue basket would allow the largest QBHC to acquire a commercial firm with $10.2 billion in annual revenue. Nonetheless, to avoid the need for subsequent legislation to change the size of the basket, some flexibility could be built into this legislation. Language could be added that would allow federal banking regulators to increase the limit on the revenue basket once experience is gained with this approach -- provided that no problems occur. This would be similar to the approach the Federal Reserve has taken with Section 20 companies.

Reverse Basket Approach. H.R. 10 also would allow a commercial firm to control a QBHC with one small bank -- that is, a bank with $500 million or less in assets -- without the commercial firm becoming a bank holding company (and thereby becoming subject to bank holding company regulation and supervision). Such ownership would be predicated on the reverse basket approach, whereby the gross domestic revenues of the bank could not exceed 15 percent of the consolidated gross domestic revenues of the commercial firm. Again, in principle, I do not oppose this provision in the proposed legislation. However, I would urge a smaller basket -- with gross domestic revenues of the bank not greater than 5 percent of the consolidated gross domestic revenues of the commercial firm.

The goal of the reverse basket approach appears to be to provide a two-way street for financial modernization: if banks can own commercial companies, then commercial companies should be allowed to own banks. By allowing commercial companies to own banks without themselves being regulated as bank holding companies, the reverse basket approach creates a situation similar to those of thrifts owned by commercial firms through a unitary savings and loan holding company. Other examples include the few banks owned by commercial firms grandfathered under the 1970 Amendments to the Bank Holding Company Act (BHCA), some of the nonbank banks grandfathered under the Competitive Equality Banking Act of 1987, those industrial loan companies (industrial banks) owned by commercial firms, and some limited purpose banks.

Our experience with the mixing of banking and commerce under these forms of organization has been limited. In general, the thrifts and grandfathered nonbank banks owned by commercial firms have not engaged in full-scale banking activities, although for thrifts permissible activities have expanded considerably. Recently, some of the commercial firms owning thrifts and grandfathered nonbank banks have given up their charters. A number of commercial firms have begun to charter limited purpose banks that appear to operate mainly as credit-card banks.

The entities that are most likely to resemble what we might expect a priori if commercial firms are allowed to own banks are the banks grandfathered under the 1970 Amendments to the BHCA and the industrial loan companies. As a result of the 1970 Amendments to the BHCA, a number of commercial firms that owned banks found that they would subsequently be regarded as bank holding companies. The 1970 Amendments, however, provided exemptions for these companies if they met certain criteria. Ultimately, the Federal Reserve granted hardship exemptions to 12 companies. While most of the banks have since been sold to other banks, a few continue to be owned by commercial firms.

As with the basket approach, our limited experience argues for a go-slow approach here -- we do not know if problems will develop. I believe we need to take this opportunity to gain experience with a "controlled" mixing of banking and commerce before we proceed further. Therefore, based on the desire to exercise caution, I believe a 5-percent-of-revenue reverse basket would be a prudent starting point. Again, language could be added to the proposed legislation that would allow federal banking regulators to increase the limit on the reverse basket once experience is gained with this approach.

NATIONAL COUNCIL ON FINANCIAL SERVICES

H.R. 10 would establish a new National Council on Financial Services (NCFS). The NCFS was originally intended, we believe, to be a consultative, coordinating body as to what activities are considered financial. The NCFS would see that all regulatory approaches are taken into consideration to ensure, among other things, that there is a consistent approach to regulating the offering of similar financial services by different types of providers.

We have serious concerns about the NCFS as currently presented in H.R. 10. The NCFS would add a layer of unnecessary bureaucracy, burden and delay, doing little to resolve important public policy issues and, in fact, making their resolution more difficult. If Congress determines that a council is appropriate, we recommend that it be advisory in nature only.

H.R. 10 puts the NCFS in a role that goes far beyond a consultation, coordination, and information-sharing role. The council ultimately would determine what activities are and are not financial in nature. In addition, it would be empowered to issue regulations and orders directed at classes of institutions as well as individual companies, institutions, or affiliates. As drafted, H.R. 10 would authorize the NCFS to issue an order against banks, their subsidiaries and affiliates, and QBHCs and their affiliates, including an insurance company, a securities firm, or a commercial enterprise, although its absolute authority in this area is unclear in the bill.

A financial services provider seeking to offer a new or modified product or service already faces possible scrutiny by multiple regulators. The existence of the NCFS would add another multilayered and uncertain process that would make it more difficult and time-consuming for financial services providers to respond to the needs of consumers as markets and technology evolve. In this regard, the NCFS provisions conflict with the rest of H.R. 10 that places emphasis on streamlining regulation and regulatory approvals. Before providing a new product or service, a financial service provider would not only have to obtain the approval of its primary regulator but also would have to comply with any orders, regulations, or conditions imposed by the NCFS.

In summary, if Congress determines that a council is appropriate, we recommend that its role be an advisory one. Moreover, the FDIC feels strongly that the various federal regulators of the financial industry should retain their current authority to determine the appropriate activities of the organizations they regulate.

CUSTOMER PROTECTION

As the federal deposit insurer, the FDIC has a special interest in making sure that customers are adequately informed regarding the differences between FDIC-insured deposits and other investment products sold through insured institutions. Failure to present adequate disclosures is unfair to customers of financial institutions and could lead to a loss of public confidence in the deposit insurance system. Current proposals for financial modernization, including H.R. 10, will permit banks and thrifts to engage in additional business activities -- and the FDIC supports this expansion of the marketplace for financial services. Along with the participation by insured depository institutions in this broader marketplace we must ensure that customers receive equivalent disclosures about the comparative risks posed by nondeposit investment products and protections from unscrupulous practices -- whether the non-deposit investment products are purchased from an insured depository institution or from a registered broker/dealer or an insurance agency.

Before discussing some of the steps that the FDIC and other banking regulators have taken to protect customers and help ensure that they have the necessary information, I should point out a few important facts. First, banks and thrifts and the federal banking regulators have considerable experience with the federal securities laws and in cooperating with securities regulators to ensure that customers have full and accurate information before purchasing nondeposit investment products, such as securities, annuity contracts, and life insurance policies. Banks and thrifts already underwrite some securities directly and broker securities and mutual funds -- and conduct these activities in a manner consistent with safety and soundness and investor protection. Consequently, while we support the general concept of functional regulation, we oppose provisions that would impose unnecessary additional burdens upon insured depository institutions engaged in providing a wide range of financial services to their customers.

Second, the vast majority of insured institutions already use registered broker/dealers for sales of non-deposit investment products. Recent surveys, including the FDIC's 1996 survey of nondeposit investment product sales practices, have found that very few banks -- less than 300 out of 10,000 -- sell such products using their own employees under the present exemption from registration as a broker/dealer. Thus, most of those selling nondeposit investment products at banks and thrifts already are registered representatives of broker/dealers subject to the regulatory oversight of the Securities and Exchange Commission and securities industry self-regulatory organizations, such as the National Association of Securities Dealers (NASD).

In fulfilling our responsibilities to the public, the FDIC and the other federal banking regulators have implemented important investor safeguards. To help ensure that customers of banks and thrifts receive the information they need to understand fully the risks involved with nondeposit investment products, the federal banking agencies issued the Interagency Statement on Retail Sales of Nondeposit Investment Products (Interagency Statement) in 1994. The Interagency Statement is designed to ensure that a customer at a bank or thrift receives sufficient information to distinguish between an FDIC-insured deposit and a mutual fund, annuity, or other nondeposit investment product. The Interagency Statement provides that banks, thrifts, and affiliated and third party broker/dealers should ensure that three essential disclosures are made: (1) that a nondeposit investment product is not insured by the FDIC; (2) that the product is not a deposit or other obligation of the bank or thrift or otherwise guaranteed by the bank or thrift; and (3) that the product is subject to investment risk, including possible loss of the principal amount invested. The Interagency Statement also gives comprehensive guidance on other sales practices that are designed to ensure that customers receive clear and accurate written and oral explanations of the risks from a particular nondeposit investment product.

After issuing the Interagency Statement, the FDIC and the other federal banking regulators issued bank examination procedures that evaluate compliance with the sales practices outlined in the Interagency Statement. In 1995 and 1996, the FDIC conducted a survey of industry-wide sales practices by selecting a random sample of banks and thrifts for review and made the survey report available to Congress and the public. The survey revealed that banks and thrifts, and registered representatives of broker/dealers, all need to improve their disclosures to customers. Moreover, given the fact that more than 80 percent of the investment representatives surveyed were NASD members, the results of the Survey suggest that, NASD membership and SEC oversight alone do not assure that accurate disclosures are given to investors.

The FDIC has recently implemented a number of initiatives to enhance the protection of investors. For example, the FDIC has developed new consumer complaint procedures, which utilize the FDIC's existing toll-free telephone hotline. The FDIC recently implemented new examination procedures that emphasize the Interagency Statement's disclosure requirements. Examiners are directed to evaluate carefully consumer complaints and resolutions. The examiners designated as specialists in this area received intensive instruction on the new procedures in May 1997, and those specialists have now begun training the national examiner staff. In addition, the FDIC has enhanced its data systems to more effectively analyze the results from nondeposit investment product examinations. Further, the FDIC has produced nondeposit investment product training materials for bankers. In cooperation with the American Bankers Association and the Independent Bankers Association of America, the FDIC presented ten seminars across the country for bankers that addressed nondeposit investment product guidelines, the Interagency Statement, and the FDIC's new examination procedures.

While the number of banks engaging in bank direct brokerage activities appears to be extremely small, the federal banking agencies are taking steps to ensure that bank employees selling securities to retail customers are subject to the same types of requirements that broker/dealers must meet. Our proposed Professional Qualifications Regulation, which was published in December of 1996, establishes qualification, registration, testing, reporting, and continuing education requirements that are virtually identical to those in the securities industry.

The FDIC urges the Committee and Congress to carefully review H.R. 10 to ensure that the law promotes adequate disclosures to investors and provides adequate consumer protection without imposing additional restrictions on depository institutions or unnecessary or duplicative regulatory burdens.

CAPITAL REQUIREMENTS

While I fully support the application of appropriate investor protection rules to the securities activities of banks, a bank's capital requirements should not be set by any standard other than the capital guidelines currently applicable to the banking industry. The level of a bank's capital is a critical tool in assessing an appropriate, and sometimes legislatively mandated, regulatory response. I have considerable concern over application of the SEC's net capital rules to institutions that already must comply with the capital requirements of their primary federal banking regulator.

The FDIC believes that all banking institutions should be subject to the bank capital guidelines that have been developed in coordination with international bank supervisory bodies. To the extent that such rules are inapplicable to broker/dealer activities or are in need of further refinement, the financial institution regulators should consult and develop appropriate uniform standards and guidelines. Bank regulatory capital standards are continually revised as new financial instruments and activities emerge. For example, capital standards have been adapted to include not only credit risk but also the market risk that stems from the trading activities of large banks. A bank uses its internal model to determine the risk profile of its portfolio. Recently, the SEC amended its capital calculation methodology for listed options, implementing a form of the internal model approach used in the banking industry. It is our belief that bank regulatory capital standards can apply well to the circumstances presented in an era of financial modernization. We do not support applying capital rules applicable to other institutions to a banking institution.

H.R. 10 requires a bank that must register as a broker/dealer to move from one set of capital adequacy guidelines to another. Such a move would be triggered by a change in the level of earnings derived from securities activities or by a decrease in capital levels. Transitional rules to implement this requirement would likely be complex and difficult to apply and enforce.

Other provisions of H.R. 10 appropriately address capital considerations, such as the requirement that an insured bank's direct investment in a securities underwriting subsidiary be deducted from the bank's capital. Under the bill, a well-capitalized bank may have one or more subsidiaries that engage in a full range of financial activities permitted to bank affiliates under a holding company structure (except that the bill specifically prohibits subsidiaries of national banks from engaging in real estate investment and development, insurance underwriting, or merchant banking). For purposes of compliance with applicable capital standards, the bank's equity investment in a subsidiary engaged in nonbanking activities would be deducted from its assets and tangible equity, and the assets and liabilities of the bank and subsidiary would not be consolidated. We believe these are appropriate standards.

CONCLUSION

Current restrictions on financial activities are outdated, and their elimination would strengthen banking and other financial organizations by helping them diversify their income sources, and would promote the efficient, competitive evolution of financial markets in the United States.

I am generally supportive of the approach H.R. 10 takes to financial modernization. I do have several concerns, however. I believe that caution dictates that we should take a slower path towards easing the restrictions on mixing banking and commerce. In particular, I believe that a 5-percent-of-revenue basket would be sufficient to allow a two-way street between banking organizations and other financial services firms, and at least as a first step would allow both banking organizations and regulators to gain experience with commerce on a smaller scale. A reverse basket is also consistent with this go-slow approach if, as in H.R. 10, the commercial firms are initially limited to acquisitions of a single bank with under $500 million in assets, and if the reverse basket is initially limited to 5 percent of revenues.

Other provisions of H.R. 10 that I am concerned about include the extent of the authority given to the proposed National Council on Financial Services, the possibility of duplicative and burdensome customer protection measures, and the treatment of the capital requirements applicable to banks required to register as broker/dealers.

I hope my comments today will prove helpful to the Subcommittee as it continues its examination of the bill and as it considers the many difficult issues arising in the financial modernization debate. The FDIC is ready to assist the Subcommittee in this regard.

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