TESTIMONY OF
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ON
FINANCIAL MODERNIZATION AND H.R. 268,
THE DEPOSITORY INSTITUTION AFFILIATION
AND THRIFT CHARTER CONVERSION ACT
BEFORE THE
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS & CONSUMER CREDIT
COMMITTEE ON BANKING AND FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES
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Madam Chairwoman and members of the Subcommittee, I appreciate this opportunity to present the views of the Federal Deposit Insurance Corporation on financial modernization, H.R. 268, the Depository Institution Affiliation and Thrift Charter Conversion Act, and related issues. I commend you, Madam Chairwoman, and Congressman Vento for placing a high priority on the need to modernize and strengthen the nation's banking and financial systems. H.R. 268 represents a thoughtful approach toward meaningful reform that will serve us well in developing balanced, constructive legislation.

On behalf of the FDIC, I also want to express our sincere gratitude to you, to members of this Subcommittee, and to other members of the Congress for passing legislation providing immediate financial stability to the Savings Association Insurance Fund (the SAIF). The health and stability of the financial industry are in the interest of everyone -- participants, regulators, banks and thrifts. Sound deposit insurance funds contribute to that health and stability.

The Deposit Insurance Funds Act of 1996 (the Funds Act) capitalized the SAIF and solved its immediate financial problems. The Funds Act also recognized the need for a merger of the deposit insurance funds. The FDIC strongly supports a merger of the Bank Insurance Fund (the BIF) and the SAIF as soon as practicable. The SAIF insures far fewer, and more geographically concentrated, institutions than does the BIF, and, therefore, faces potentially greater long-term risks.

A merger of the BIF and the SAIF is a necessary component of a solution to long-term structural problems facing the thrift industry, and consequently the industry's deposit insurance fund. A combined BIF and SAIF would have a larger membership and a broader distribution of geographic and product risks; a combined fund would be stronger than the SAIF alone. Under the Funds Act, Congress has made the merger of the BIF and the SAIF contingent upon the creation of a common bank charter.

I am pleased to have this opportunity to testify on financial modernization against the backdrop of two fully capitalized deposit insurance funds and record bank earnings. Although final numbers are still being tabulated, early indications are that annual earnings for commercial banks surpassed $50 billion for the first time in 1996. Average equity ratios are at their highest levels in more than 50 years, and nonperforming assets are well under one percent of total assets, the lowest level in the 15 years that banks have reported nonperforming assets.

Private sector thrifts have earned more than $6 billion each year since 1991, when the industry returned to profitability. Thrift earnings in 1996 may have exceeded the record $7.6 billion of 1995 if thrifts had not paid a special assessment to capitalize the SAIF. Equity ratios remain near 40-year highs, and nonperforming assets are down to approximately one percent of total assets, the lowest level in the seven years that thrifts have reported nonperforming assets.

Only six insured institutions, with aggregate assets of $220 million, failed in 1996. Also, the number and aggregate assets of institutions on the FDIC's "problem" institution list have declined sharply over the past five years. At the end of 1991, there were 1,426 institutions with total assets of $819 billion on the "problem" list. This was the highest level of "problem" list assets in the history of the FDIC. Since 1991, the "problem" list has steadily declined. As of September 30, 1996, only 125 institutions, with assets of $15 billion, were on the list -- a fraction of the highest level.

From 1980 through 1994, 1,617 banks failed or received financial assistance from the FDIC. These banks accounted for almost three-fourths of the failures that have occurred since the inception of federal deposit insurance in 1933. These failed banks had combined assets of $317 billion, and cost an estimated $36.4 billion to resolve. The number of failures reached an annual record level of 221 in 1988, while the losses and combined assets of failed banks peaked in 1991. The five bank failures in 1996 were the fewest since four banks failed in 1974, and demonstrate the significantly improved financial condition of the banking industry.

In recent years, banks and thrifts have benefited from continued economic expansion and low inflation. These favorable conditions have produced strong loan demand and have contributed to wider net interest margins. The resulting growth in revenues has enabled banks and thrifts to reduce their inventories of bad assets while boosting profits.

Although banks have been making record profits recently, evidence suggests that increasing numbers have turned to somewhat riskier investments as they have lost business to competitors. Loan-loss rates in today's favorable environment remain significantly higher than in pre-1980 nonrecessionary periods. Bank performance has varied greatly during the past ten years. Figures 1 and 2 illustrate annual returns on assets and net charge-offs as a percentage of average loans since 1960. The volatility of earnings in the 1980s is readily apparent, as is the relationship between recessionary

periods and net charge-offs. In the past ten years, the banking industry achieved both its highest return on assets (1.20 percent in 1993) and its lowest annual return on assets (0.10 percent in 1987) since 1934.

As we consider financial modernization, current favorable economic conditions provide both an opportunity and a challenge. We have the opportunity to merge the deposit insurance funds at a time when both funds are fully capitalized. The challenge for us is to recognize that good times may not last forever. We must evaluate any financial modernization proposal by determining whether it will operate effectively during times of stress for financial institutions. As deposit insurer, the FDIC brings a unique perspective to the financial modernization question. Events of the past decade have demonstrated how costly bank failures can be for the insurance fund, for communities across America, and for our economy. The BIF and the banking industry 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 an estimated $160 billion to resolve (including tax benefits); approximately $132 billion of this amount was paid by the taxpayers. Thus, it is imperative that we learn from the past and proceed deliberately as we contemplate a substantial expansion of powers available to banking organizations.

Let me turn now to a discussion of the issues before us today. First, my testimony will briefly discuss the need for financial modernization. Second, I will outline lessons the FDIC has learned from studying the banking and thrift crises of the 1980s and early 1990s. And finally, I will suggest guiding principles for financial modernization.

THE NEED FOR FINANCIAL MODERNIZATION

Modernization of the financial system is necessary to achieve an efficient and competitive financial services industry able to meet current and future challenges. The financial markets have changed dramatically since the 1930s when many of our nation's laws governing financial services were enacted.

To a greater extent than ever before, businesses have been by-passing traditional financial intermediaries to access the capital markets directly. Large corporations now frequently meet their funding needs by issuing commercial paper, debt securities and equity, rather than by borrowing from banks. The shrinking role of banks in lending to business is illustrated by the declining proportion that bank loans represent of nonfinancial corporate debt. This share declined from about 28 percent in 1975 to 21 percent at year-end 1995.

In addition to their shrinking role as providers of traditional financial intermediation services, banks and thrifts also are experiencing increasing competition from nonbanking firms that now offer financial products that once were the exclusive domain of banks and thrifts. Banks have also grown much less rapidly than other financial intermediaries during the past 10 years. For example, from 1986 through 1995, banking

assets grew at an average annual rate of 5.7 percent, compared to growth rates of 19.0 percent and 8.5 percent for mutual funds and pension funds, respectively.

This relative decline in market share and relatively slower growth do not paint the complete picture. Traditional market share measures, which are based on asset holdings, generally do not reflect the growing importance of bank income from off-balance-sheet products and services. The rise in the noninterest income share of bank earnings indicates less reliance on traditional lending activities. It also indicates that banks, too, are innovating and adapting to a changing marketplace.

Nevertheless, banks have experienced a relative decline in market shares and relatively slower growth. Financial modernization should strengthen banking organizations by allowing diversification of income sources and better service to customers, which would promote an efficient and competitive evolution of the U.S. financial markets.

LESSONS FROM THE PAST

When I became FDIC Chairman, I initiated a project that I called the "Lessons of the Eighties" to answer the question, "Did we, as bank regulators, learn the correct lessons from the banking and thrift crises of the 1980s and early 1990s?" At the time the project began, the banking and thrift industries were recovering from the worst period of bank failures since the 1930s. It is essential that we thoroughly analyze and understand the factors that led to those crises in order to be prepared for the problems that could occur in the future.

The lessons we have thus far learned could be instructive to this Subcommittee in its deliberations on financial modernization. My testimony will focus on two broad lessons in particular: (1) geographic and product constraints on insured institutions can result in inadequate diversification of income sources; and (2) rapid expansion of insured institutions into unfamiliar activities, without adequate supervision, can have undesirable consequences. In the context of this hearing, what these lessons demonstrated to us is that we cannot attribute all the losses from the failures of financial institutions in the 1980s and early 1990s to economic events or to poor management of depository institutions. A significant share of the responsibility must be assigned to overly restrictive laws, changes in the law providing little time for adjustment, poorly planned deregulation and deficiencies of the supervisory process. Geographic and Product Constraints

Geographic and product restrictions have constrained the activities of U.S. depository institutions for much of their history. Although these restrictions insulated them, at least for a time, from competition, they also hindered banks from expanding their sources of income and from developing portfolios that reflected product and geographic diversity.

The impact of product restrictions is most notably seen in the experience of savings and loan associations. For years, thrifts were limited to providing only savings deposits and home mortgages to their customers. This created an inherently unstable situation -- of

borrowing short-term deposits to fund long-term mortgages -- that became apparent in the late 1970s and early 1980s when short-term interest rates rose above long-term rates. This was the beginning of the savings and loan crisis that in time led to the demise of the Federal Savings and Loan Insurance Corporation. Although banks provided a broader range of products, commercial lending was their primary focus and this market also came under pressure during this period. As the commercial loan market declined, and the commercial paper and junk-bond markets grew, banks were forced to find new sources of income since they were restricted in their ability to adapt to their customers' needs.

The impact of geographic restrictions is evident in the relatively high failure rates in states where branching was prohibited or severely restricted, such as Texas, Kansas and Illinois. This impact is also evident in the vulnerability of banks to regional economic problems. Because most U.S. banks serve relatively narrow geographic markets, regional and sectoral recessions have frequently had a severe impact on them. There were four major regional or sectoral economic downturns during the 1980s and early 1990s, and each resulted in increased bank failures. The first accompanied the downturn in farm prices in the early 1980s. Agricultural prices increased steadily during the boom years of the 1970s. This ended, however, in the late 1970s as interest rates soared, significantly increasing farm operating costs. At the same time, export demand decreased sharply due to worldwide competition. These events contributed to a collapse in real farm income in 1980. Then, as inflation declined, land values collapsed. Ultimately, this downturn took its toll on many agricultural banks. In 1985, these banks accounted for 48 percent of bank failures. The second downturn occurred in Texas and other major energy-producing states in the Southwest following the collapse of oil prices in 1981 and again in 1985. Texas banks, for example, had rapidly increased their commercial and industrial loans in the 1970s as strong worldwide demand for oil and OPEC-restrictions on supply brought on a sharp rise in oil prices. Following the oil-generated cycle were wide swings in real estate activity that contributed significantly to the downturn in the economies of Texas and other states in the Southwest and the sharp rise in bank failures in this region. The experience in Texas and certain other states was aggravated by the large number of new banks chartered during the 1980s, and by the fact that newer banks failed more frequently than existing institutions.

Boom and bust conditions in real estate activity also contributed to the third downturn, in the Northeast. In this regional recession, mutual institutions that had converted to the stock form of ownership failed with greater frequency than mutuals that had not converted. Of the mutuals that converted in the mid- and late-1980s, 21 percent failed during the period 1990 through 1994. This compared with eight percent of all mutuals that existed as of the end of 1989 and had not converted. The final downturn was a recession in California -- a state without geographic branching restrictions -- following defense cutbacks in the early 1990s. In this downturn we found higher failure rates among smaller and newer banks that were more closely tied to their local economies. The large California banks that operated statewide were less affected.

The lesson we draw from these events is that attempts to ensure the safety and soundness of insured institutions by limiting market competition ultimately fail. In the long run, geographic constraints and product restrictions do not insulate depository institutions from competitors, who will eventually find ways to enter markets.

Congress eliminated many geographic constraints by enacting the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994. Slowly, over the years, Congressional action, agency initiatives and court decisions have removed some product constraints. Nevertheless, barriers, such as the Glass-Steagall Act, that prevent financial organizations from diversifying -- and from responding quickly and efficiently to changes in the marketplace -- remain. To maintain the safety and soundness of the financial system, institutions must be allowed to diversify.

Use of Expanded Powers and Supervision

In response to the deepening crisis in the thrift industry, the early 1980s were dominated by actions to deregulate the product and service powers of insured depository institutions. The resultant rapid expansion of insured institutions into unfamiliar activities without adequate supervision resulted in significant losses for the industry. For example, many banks and thrifts adopted a highly aggressive posture with respect to commercial real estate lending. Large increases in the early 1980s in real estate investment produced a boom in commercial construction and in bank and thrift commercial real estate lending. Further stimulus was provided by legislation that greatly enhanced the after-tax returns on real estate investment and by the expansion of nonresidential lending powers of savings and loan associations implemented through banking legislation.

Other factors led to increased risks in the 1980s as well. During this time, chartering standards were lowered, the inappropriate use of brokered deposits increased, and capital standards were reduced for thrift institutions.

Relaxed chartering policies led to approximately 3,300 new banks being chartered from 1980 through 1990. Of these new institutions, 15 percent subsequently failed; this compared with a 7.7 percent failure rate for banks in existence as of year-end 1979. The influx of new charters created markets that were overbanked, which created more competition for good loans. This, in turn, created incentives for banks to loosen underwriting standards and take on more risk. The increase in charters also diluted the available management talent necessary to operate a sound institution.

Insolvent thrifts were allowed to use brokered deposits to stay in operation and, indeed, to grow their assets or engage in new activities that could not have been funded through traditional sources. At the same time, regulatory accounting standards for thrifts were adopted allowing many to exist with little or no capital. These institutions, with little or no capital on the line, and access to fully-insured brokered deposits, in many cases took extraordinary risks that resulted in large losses to the old Federal Savings and Loan

Insurance Corporation fund, which was not managed by the FDIC, and, ultimately, to taxpayers.

While powers were being expanded, insufficient attention was being paid to safeguards against risky behavior. In the late 1970s and early 1980s, regulators increased their reliance on off-site monitoring and prioritized examinations to focus primarily on problem banks. This was attributable in part to efforts to limit the size of the federal government. As a result, intervals between examination cycles for healthy banks increased on average from annually to as long as three years, and even longer for some institutions, and the number of examiners was reduced. From 1979 to 1984, examination staffs declined by nearly 20 percent at the FDIC and the Office of the Comptroller of the Currency, while the Federal Reserve's examiner staff increased slightly. Additionally, state examiner ranks declined 12 percent during this period. These actions ultimately resulted in weakening the ability of bank supervisors to detect and to respond to problems as failure rates began to soar.

The lesson we learned from these events is that deregulation must be accompanied by adequate safeguards and strong supervision and monitoring by the regulators. Unfortunately, in the 1980s this did not occur. In addition, during that period, legislation was passed in a crisis situation without a full understanding of the consequences of the changes being undertaken.

Diversification of income sources by depository institutions remains a desirable goal and will contribute to stronger, more competitive financial markets. With these lessons in mind -- and in the absence of crisis conditions -- we have the opportunity to design an appropriate analytical framework that addresses competitive as well as supervisory issues.

PRINCIPLES OF FINANCIAL MODERNIZATION

Any financial modernization proposal must balance numerous public policy goals. Financial reform must ensure the safety and soundness of insured depository institutions and the integrity of the deposit insurance funds. It also must allow insured depository institutions to generate sufficient returns to attract new capital essential for normal growth and expansion into new areas. To achieve these goals, insured depository institutions must be able to compete on an equitable basis with other businesses, and to evolve with the marketplace, consistent with safety and soundness. Equally important, concerns about the potential for credit judgments to be made on preferential terms to affiliated companies or other conflicts of interest between banking and nonbanking affiliates and the effects of undue concentration in the economy must be addressed. Moreover, any financial modernization proposal must be examined for its effect on small communities, isolated markets, and customers of insured depository institutions.

The FDIC has a vital interest in the safety and soundness of insured depository institutions and the integrity of the deposit insurance funds. It is from the perspective of

insurer of U.S. bank and thrift deposits that we evaluate the proposals for financial modernization. We believe the following principles are critical components in achieving a financial modernization proposal that balances the public policy goals.

Activities

First, with limited exceptions, an insured institution should be permitted to engage in any type of financial activity, whether banking, securities, or insurance. The exceptions would consist of those activities that: (1) pose significant safety and soundness concerns; (2) represent an unwarranted expansion of the federal safety net provided by deposit insurance, access to the Federal Reserve's discount window, and Federal Reserve oversight of the payments system; or (3) harm consumers or small businesses.

Structure

Second, a financial institution should have flexibility to choose the corporate or organizational structure that best suits its needs, provided safeguards protect the insurance funds and prevent expansion of the federal safety net. If an activity raises safety and soundness concerns or would unduly expand the federal safety net, the activity should be confined to a subsidiary or an affiliate.

With respect to expansion of the federal safety net, there is no question that federal deposit insurance, the discount window, and access to the payments system continue to provide banks with a gross funding subsidy -- a funding advantage before taking account of offsetting costs. However, the relevant question for purposes of organizational structure is not whether banks receive a gross subsidy. The relevant questions are whether banks receive a net subsidy -- a funding advantage after taking account of offsetting costs such as reserve requirements, regulatory expenses, and regulatory restrictions -- and whether banks could pass on a net subsidy to a bank subsidiary or holding company affiliate given restrictions that protect the safety and soundness of the insured bank and inhibit undue expansion of the safety net.

There are two organizational structures with which we have experience in the United States that can be used to combine traditional commercial banking with new activities. These are: (1) conducting each activity in separate organizations owned and controlled by a common "parent" organization (the "bank holding company" model); and (2) conducting each activity in a separate organization, one of which owns and controls the other entity (the "bona fide subsidiary" model). A third model -- the conduct of both activities within the same entity (the "universal banking" model) -- has been used in some other developed countries, although not with unmitigated success in recent years. We believe that universal banking is not a model that would best fit the dynamic financial marketplace in the United States or provide sufficient protection for the deposit insurance funds against the effects of potential conflicts of interest between banking and nonbanking functions in an insured entity or prevent the unwarranted expansion of the federal safety net.

The Bank Holding Company Model. Since the adoption of the Bank Holding Company Act of 1956, one of the primary methods of expanding permissible activities beyond those associated with traditional commercial banking has been through formation of affiliated entities under the bank holding company umbrella. Within this framework, banking organizations have been permitted to engage in an increasing array of financial and related services, including securities, mutual funds and insurance.

In terms of the criteria for safeguards set forth earlier, the bank holding company model has considerable merit. The advantages include:

Providing a good framework for monitoring transactions between insured and non-insured affiliates and for detecting transfers of value that could threaten the insured institution; and
Maintaining a meaningful corporate separation between insured and non-insured organizations to assure that the insured bank is not held responsible for the losses from uninsured activities.
The disadvantages of the bank holding company model include:

In distressed situations, the parent will have the incentive to transfer or divert value away from the insured bank, leaving greater losses for the FDIC if the bank ultimately fails; and
The holding company model requires bank owners to establish and maintain an additional corporation. This may add costs, inefficiencies, complexity and, in some cases, an additional regulator.
Bona Fide Subsidiary Model. The FDIC has permitted bona fide subsidiaries of insured nonmember banks to engage in securities activities since December 1984 (12 CFR 337.4). A "bona fide" subsidiary of an insured nonmember bank must be adequately capitalized. Its operations must be physically separate and distinct from the operations of the bank. It must maintain separate accounting and other corporate records, and observe corporate formalities such as separate board of directors meetings. It must share no common officers or employees with the bank and must compensate its own employees. A majority of its board of directors must be composed of persons who are neither directors nor officers of the bank. It must conduct business in a way that informs customers that the subsidiary is separate from the bank and that its products are not bank deposits and are not insured by the FDIC, nor guaranteed by the bank. Additionally, restrictions are placed on loans, extensions of credit and other transactions between an insured bank and its securities subsidiary.

From a practical perspective, there has been much less experience with the "bona fide" subsidiary form of organization than with the bank holding company form. However, the experience discussed later in this testimony supports the view that direct ownership of a nonbank firm by an insured bank need not be significantly different from the bank holding company model in terms of affording protections to the deposit insurance funds, and may have some additional advantages.

Analytically, there are several factors that make this approach different from the bank holding company model. The advantages of the bona fide subsidiary approach include:

The residual value of the subsidiary accrues to the bank, not the holding company; and
The bank, rather than the parent, controls the allocation of excess capital of the organization. This may mean that in making corporate investment decisions, greater weight will be given to the needs of the insured bank. Financial investments will be structured to diversify the risks of the bank's portfolio, while investment in systems and physical capital will benefit the operations of the bank.
However, on the negative side:

While corporate separateness theoretically can be maintained regardless of organizational structure, in practice, a bank holding company structure may be a more effective vehicle for this purpose; and
Inappropriate wealth transfers may be more easily executed if made directly to a subsidiary, rather than indirectly to the parent and then to an affiliate.
Securities Activities Under the Bona Fide Subsidiary Model. While the experience of the FDIC with bona fide securities subsidiaries of insured nonmember banks has been limited, these subsidiaries generally have not posed safety and soundness concerns. Only one FDIC-supervised institution owns a subsidiary actively engaged in the full range of securities activities permitted by the FDIC, but over 400 insured nonmember banks have subsidiaries engaged in more limited securities-related activities. These activities include management of the bank's securities portfolio, investment advisory services, and acting as a broker-dealer. With one exception, none of these activities has given cause for a significant safety-and-soundness concern.

There has been one failure of an insured institution supervised by the FDIC that conducted securities activities through a subsidiary. While not the sole cause of the failure, the business relationship with the securities subsidiary added to the cost of the failure. The bank made a substantial unsecured loan that was used to benefit the securities subsidiary.

It is clear that there are advantages and disadvantages to both the bank holding company and the "bona fide subsidiary" models. Legislation based on a progressive vision of the evolution of financial services need not mandate a particular structure, as long as the insured bank is protected.

Moreover, activities that banks currently conduct should be left undisturbed. To require that these activities be moved to a subsidiary of either the bank or the holding company, in the absence of compelling public-policy reasons, could cause unnecessary disruption and contribute to market inefficiencies. Moreover, if banks have historically conducted the activities in the insured institution with minimal negative consequences, there is no compelling safety and soundness reason to require that such activities be conducted in

a subsidiary or affiliate. A combination of flexibility and sound regulation has contributed to the successful development of the U.S. financial system, and these key elements should be present in any proposal for reform.

Safeguards

The third principle of financial modernization is that safeguards should prohibit inappropriate transactions between insured institutions and their subsidiaries and affiliates. If these safeguards are inadequate or the resources are unavailable to enforce them, the deposit insurance funds, the financial system, and the public could suffer. Transactions between an insured institution and a related firm pose several risks. First, an insured institution may be used to benefit a related firm inappropriately, for example, through unwarranted fees paid to an affiliate or subsidiary, or through excessive direct equity injections to a subsidiary, or perhaps upstreaming of excessive dividends to a parent that are used to inject equity to an affiliate. Second, when an insured institution is in danger of failure, the owners and creditors of related entities may try to extract value from the insured entity to minimize their own losses, thereby increasing losses to the deposit insurance funds. The past decade has provided examples of a number of instances where transactions were proposed or consummated that served to advantage a holding company or an affiliate at the expense of a failing insured bank.

Third, the business relationship between the insured entity and its subsidiary or affiliate may create a misperception that the products of the subsidiary or affiliate are federally insured. Finally, there is the danger that the business and operating relationship will cause the courts to "pierce the corporate veil" -- that is, to hold the insured entity responsible for the debts of a subsidiary or affiliate in the event the subsidiary or affiliate fails.

Sections 23A and 23B of the Federal Reserve Act place certain restrictions on transactions between banks and their affiliates. These restrictions are intended to safeguard the resources of federally insured banks against misuse for the benefit of an affiliate of the bank. Section 23A was designed to prevent a bank from risking too large an amount in affiliated enterprises and to ensure that if a bank extends credit to an affiliate, the collateral behind the extension of credit is sufficient to ensure recovery by the bank. Section 23A, therefore, regulates certain "covered transactions" with affiliates of an insured bank and does so primarily in two ways.

First, the section places limits on the dollar amount of loans a bank may make to, or investments it may make in, any individual affiliates, and to or in all affiliates. Second, it requires that the loans or extensions of credit meet certain standards as to collateral. In addition, banks generally may not purchase low quality assets from affiliates.

Section 23B essentially expands section 23A. Section 23B requires that certain transactions between a bank and its affiliate must be carried out "at arms length," under terms and conditions comparable to the terms of similar transactions between unaffiliated entities. The transactions subject to this comparability requirement include:

certain sales of securities or other assets by a bank to its affiliate; payments or provision of services by a bank to its affiliates under a contract; and certain transactions between a bank and a third party where an affiliate acts as a broker or agent.

Any financial modernization proposal should continue the safeguards of Sections 23A and 23B and apply them to dealings between an insured bank and any subsidiary of the bank engaged in nonbanking activities. Exceptions under these safeguards should be allowed rarely. While there should be room for supervisory discretion and the exercise of good business judgment in determining whether a healthy bank may support an affiliate, such support should be provided through transfers of excess capital -- beyond that required for a well-capitalized bank -- not through relaxations of restrictions on intercompany transactions. Existing restrictions on intercompany transactions as defined by Section 23A and 23B should not be relaxed.

In addition, we believe that any financial modernization proposal should require that an insured institution's capital adequacy be determined after deducting the institution's investment in subsidiaries. Consideration also should be given to requiring timely reporting of intercompany transactions, as the Securities and Exchange Commission currently requires.

Functional Regulation

The fourth principle for financial modernization is that regulation should be commensurate with risk -- no less and no more. With this principle in mind, the FDIC believes that regulation along functional lines may be preferable to the current practice of regulating individual banking entities based on charter or corporate structure. Properly implemented, functional regulation could avoid the layers of regulation and duplication that may result from subjecting financial institutions to the jurisdictions of multiple agencies. It also ensures that the appropriate degree of expertise is brought to bear on each activity. However, functional regulation will add to the regulatory burden of financial institutions if it becomes solely additive.

Functional regulation must be seamless, permitting no gaps that might threaten the insurance funds, and yet must avoid burdening banks with regulatory overlap. Caution will need to be exercised to ensure that functional regulation does not result in an artificial restructuring of banking operations and services based on function, rather than historical practice or along strategic or market-based lines. Such artificial restructuring of banking operations would undermine the flexibility in corporate structure that efforts at financial modernization should strive to achieve.

Care must also be taken to ensure that key transactions between insured banks and their affiliates and subsidiaries activities can be reviewed by regulators as part of the regular examination process for insured banks. Because organizations under stress have strong incentives to circumvent restrictions on intercompany transactions, any regulatory structure must assure that these transactions can be properly reviewed. Finally, functional regulation must assure that an insured institution maintains adequate

capital to guard against the risks posed by each activity and by the combination of all activities.

Banking and Commerce

Fifth, easing the broad range of restrictions on activities of banking organizations beyond those that are financial in nature should proceed cautiously. Banking organizations have expertise in managing financial risks, but little or no experience in some of the activities that would be permissible under H.R. 268. The affiliation of savings associations with commercial firms under the unitary savings and loan holding company umbrella has been limited, although beneficial in adding capital to thrift affiliates during the period of the thrift crisis. Few large commercial firms have established long-term relationships in this fashion. Consequently, the experience of savings and loan holding companies containing commercial firms may not provide a clear model for the immediate merger of banking and commercial activities, although it is a starting place for analysis. H.R. 268 offers an incremental approach, which is one option that should be considered.

First and foremost, financial reform must ensure that the safety and soundness of insured depository institutions and the integrity of the deposit insurance funds and other elements of the safety net will not be compromised. Additionally, a decision to grant expanded access to the federal payments system should be reviewed to assure that the implications and ramifications are well understood.

Attached is a copy of my letter of December 16, 1996 to Chairman Roukema that provides comments on a previous version of H.R. 268. I would note that there have been changes to the bill since my letter. We would be happy to provide the Subcommittee with additional comments.

CONCLUDING SUMMARY

Current restrictions on the financial activities of banking organizations are outdated. Their elimination would strengthen banking organizations by helping them to diversify their income sources, and would promote the efficient, competitive evolution of financial markets in the United States. However, we should proceed cautiously in easing the broad range of restrictions on activities of banking organizations beyond those that are financial in nature. History demonstrates that an expansion of the powers available to insured institutions must be accompanied by appropriate safeguards for the insurance funds.

Any financial modernization proposal should permit financial organizations to engage in any type of financial activity, whether banking, securities, or insurance, unless the activity poses significant safety and soundness concerns, represents an unwarranted expansion of the federal safety net or harms consumers or small businesses.

A financial institution should have flexibility to choose the corporate or organizational structure that best suits its needs, provided safeguards protect the insurance funds and prevent undue expansion of the federal safety net. If an activity raises safety and soundness concerns for the insured bank, the activity, if otherwise prudent, should be confined to a subsidiary or an affiliate.

There are two organizational structures with which we have experience in the United States that can be used for engaging in new nonbanking activities -- the holding company model and the bona fide subsidiary model. There are advantages and disadvantages to each model. On balance, from a safety and soundness perspective, I do not believe the case for or against either approach is strong enough to warrant dictating to banks which approach they must choose, provided adequate safeguards are in place to protect insured institutions and the deposit insurance funds.

Any financial modernization proposal should continue the safeguards of Sections 23A and 23B of the Federal Reserve Act and apply them to dealings between an insured bank and any subsidiary of the bank engaged in nonbanking activities. We believe that any financial modernization proposal should require that an insured institution's capital adequacy be determined after deducting the institution's investment in subsidiaries. The experience of the FDIC has been that in times of financial stress, banking organizations may attempt to engage in transactions that transfer resources from the insured entity to the owners and creditors of the parent company, nonbanking affiliates, or to subsidiaries of the bank.

The FDIC believes that regulation along functional lines may be preferable to the current practice of regulating individual banking entities based on charter or corporate structure. We must ensure, however, that functional regulation is seamless and does not result in duplicative regulation or in the artificial restructuring of banking operations and services. We must also take care that key transactions between insured banks and their affiliates and subsidiaries activities can be reviewed by regulators as part of the regular examination process for insured banks.

H.R. 268 is a constructive approach to evaluating how best to reform our financial system. The FDIC stands ready to assist the Subcommittee with this important effort.

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