Oral Statement
of
Ricki Helfer
Chairman
Federal Deposit Insurance Corporation
before the
Subcommittee on Financial Institutions & Consumer Credit
Committee on Banking and Financial Services
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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; on H.R. 268, the Depository Institutions Affiliation and Thrift Charter Conversion Act; and on related issues. I commend you, Madam Chairwoman, and Congressman Vento for placing a high priority on the need to modernize 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.

Before turning to those topics, I want to express our gratitude to you and to other members of Congress for passing legislation providing immediate financial stability to the Savings Association Insurance Fund (SAIF). The legislation solved the immediate problems of the SAIF. The SAIF, however, has longer-term structural problems because it insures the deposits of far fewer -- and more geographically concentrated -- institutions. A merger of the SAIF with the Bank Insurance Fund (BIF) would address these problems and create a single, highly diversified, well-capitalized insurance fund. The FDIC strongly supports a merger of the two funds as soon as possible. The legislation capitalizing the SAIF made the merger of the BIF and the SAIF contingent upon the creation of a common bank charter that would include federal savings associations, and I hope these issues can also be addressed expeditiously.

Madam Chairwoman, I have written testimony that examines financial modernization in detail. This morning, I will discuss four important points.

Point Number One -- experience has shown us that product and geographic constraints on insured institutions have resulted in inadequate diversification of sources of income and have prevented the institutions from responding to changing market conditions. In the 1970s and 1980s, such restrictions became increasingly harmful. Product restrictions on savings and loan associations created the inherently unstable situation of these institutions borrowing short-term deposits to fund long-term mortgages, which helped lead to the collapse of the savings and loan industry. Commercial banks faced new competition -- in the commercial paper market and elsewhere -- that drove them

into the riskier activities, such as commercial real estate lending, that led to increased bank failures in the 1980s and early 1990s.

Point Number Two -- experience has also shown us that rapid expansion of insured institutions into unfamiliar activities -- without adequate supervision and monitoring by the regulators -- can have undesirable consequences. When many banks and thrifts aggressively expanded commercial real-estate lending in the 1980s, insufficient attention was paid to safeguards against risky behavior.

Point Number Three -- because the record earnings and favorable economic conditions that banks and thrifts now enjoy may not last forever -- no one has repealed the business cycle -- any financial modernization proposal must be examined and evaluated for its effects when financial institutions are under stress. Our current experience is extraordinary. In terms of profits, annual earnings for commercial banks last year probably surpassed $50 billion for the first time. Moreover, the number and aggregate assets of problem institutions are only a fraction of what they were only six years ago.

Point Number Four -- Any financial modernization proposal should balance a number of public policy goals. Those goals include: the safety and soundness of insured institutions, the integrity of the deposit insurance funds, and the need for depository institutions to generate returns sufficient to attract capital.

We believe that the following principles are critical components for a financial modernization proposal that balances public policy goals and safety and soundness concerns:

First, with limited exceptions discussed in my written testimony, financial organizations should be permitted to engage in any type of financial activity consistent with safety and soundness.

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.

Third, safeguards should prohibit inappropriate transactions between insured institutions and their subsidiaries and affiliates.

Fourth, regulation should be commensurate with risk -- no less, no more -- and should be along functional lines with no gaps between the functional lines.

Fifth, easing the broad range of restrictions on activities of banking organizations beyond those that are financial in nature should proceed cautiously.

In conclusion, it is imperative that we learn from the past as we contemplate a substantial expansion of powers available to banking organizations. I applaud this subcommittee for its substantial attention to these issues. The FDIC stands ready to

assist the Subcommittee with this important effort. I look forward to answering your questions.

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