TESTIMONY OF
DONNA TANOUE, CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION
ON
FINANCIAL MODERNIZATION
BEFORE THE
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE
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ROOM 534, DIRKSEN SENATE OFFICE BUILDING

Mr. Chairman, Ranking Member Sarbanes, and Members of the Committee, I appreciate the opportunity to testify on financial modernization and H.R. 10, the Financial Services Act of 1998. As you said last year, Mr. Chairman, when you introduced S. 298, "our laws must be updated to reflect modern times." H.R. 10 is the latest effort at modernizing the laws that govern our nation's financial system, a goal the Federal Deposit Insurance Corporation has long supported, and a goal that as the new Chairman of the FDIC, I strongly endorse.

As the deposit insurer, the FDIC brings a unique perspective to the analysis of financial modernization proposals. The FDIC operates the federal deposit insurance system that since 1933 has contributed to the health and stability of the banking industry by assuring depositors their insured funds are safe. In addition, the FDIC supervises 6,045 depository institutions for which it is the primary federal regulator. As both the deposit insurer and a banking regulator, the FDIC is concerned about the continued long-term profitability and competitiveness of the banking industry. Profitability and competitiveness depend in the first instance on safety and soundness. Consequently, the safety and soundness of the banking industry is our foremost concern.

This testimony will highlight the general ways in which H.R. 10 advances financial modernization and will discuss the FDIC's concerns with the legislation. Although H.R. 10 is a start toward modernizing the regulatory structure, we believe it has flaws. First, the proposed legislation unnecessarily favors the affiliate structure over the operating subsidiary structure as the means by which banking organizations could expand into new financial products and services. Second, in implementing a greater degree of functional regulation, the bill appears to curtail the FDIC's ability to monitor certain affiliates of banks and to reduce the authority of the federal banking regulators to determine the appropriate products and services of banks. Finally, the bill does not provide for a merger of the two deposit insurance funds, but only a study of the subject. The FDIC believes a merger of the funds is appropriate.

Before turning to H.R. 10, I want to emphasize the need for financial modernization legislation, and to note several considerations against which proposals should be measured.

Along with most of the economy, the banking and thrift industries are enjoying a period of extraordinary health. Earnings continue to set records. Financial institution failures are practically nonexistent. Notwithstanding the current good times, however, changes in the regulatory system for the financial industry are needed. These changes will be much easier to implement in a time of prosperity than in a time of crisis. The rapidly evolving financial marketplace is subject to the oversight of a regulatory structure that was formed when financial products, services, and organizations were well-differentiated. Today, many banking, securities, and insurance products and services overlap in purpose, effect, and appearance. The recent announcements of mergers between very large banking organizations and between banking organizations and other financial entities highlight the extensive changes taking place. To ensure that the oversight system for the financial industry is adequate for the task of maintaining stability while allowing orderly evolution, the system's statutory foundations require modernization.

Modernization should be guided by a variety of considerations. Statutory and regulatory restrictions on the marketplace should be no more than are necessary to ensure the stability of the financial system, ensure that small businesses and communities have access to financial resources, and provide for the protection of consumers. The restrictions should not prevent the financial system from evolving in response to competitive developments and technological advances. Also, the ability of participants in the marketplace to choose among alternative structures, products, and services should be recognized as an important contributor to both the evolution of the financial system and consumer interests, and consequently should be constrained only upon a showing of real need. For example, the ability of an organization to choose its corporate structure should not be limited, except to accomplish significant regulatory goals. Similarly, the products and services that an organization offers should be limited only for important public policy purposes, such as, in the case of the banking system, identifiable safety and soundness reasons.

Another consideration is that the authority of financial regulators should be adequate and effective. For example, one important tool is the ability of a regulator to monitor the transactions and relationships a regulated institution has with affiliates. Finally, statutory changes should be designed and implemented with concern about their effects on existing institutions and should not create any new competitive disparities. To the extent possible, forced restructurings of ongoing operations should be avoided.

THE FINANCIAL SERVICES ACT OF 1998

In important respects, H.R. 10 would update the nation's system of financial regulation to keep pace with the changes in the marketplace. The provisions of the Glass-Steagall Act that restrict banks from affiliating with securities underwriters would be repealed. The Bank Holding Company Act would be amended to allow banking organizations to engage in a range of financial activities through a new type of holding company, the financial holding company (FHC). For the permissible activities of FHCs, the bill would

use a "financial in nature" standard rather than the "closely related to banking" standard that currently restricts the activities of bank holding companies.

The FDIC has long advocated eliminating the unnecessary marketplace constraints inherent in the Glass-Steagall and the Bank Holding Company Acts. These restrictions were designed originally to protect the financial system. Over the long term, however, the restrictions have hampered institutions in diversifying their products and services and thus in diversifying their risks. Unnecessary constraints also are harmful to the consumer. Competition motivates the producers of financial products and services to continually improve their offerings and to price them to attract customers. By limiting the competitive incentives to improve products and services, we reduce efforts that can ultimately contribute to consumer welfare.

Under the proposed legislation, depository institutions within an FHC would have to be well-capitalized and well-managed before the FHC could engage in the financial activities beyond those permitted bank holding companies. In addition, an FHC would have to assure that depository institution subsidiaries were adequately insulated from financial and operational risks within the FHC. Depository institution subsidiaries would be further protected by the requirement that the FHC have reasonable policies and procedures to preserve the separate corporate identities and limited liability of its various organizational components. The FDIC supports the inclusion in the bill of these safeguards for depository institutions. Despite favoring the general thrust of the bill and supporting elements of it that serve to safeguard depository institutions, the FDIC has several concerns, discussed below.

OPERATING SUBSIDIARIES

H.R. 10 would limit the ability of national banks to conduct through subsidiaries activities not permissible for banks themselves. The bill does not address generally the activities of subsidiaries of state-chartered banks, but it would appear to preclude new entry by such subsidiaries into securities underwriting. We believe that both national and state-chartered banks should have the choice of conducting activities in either a holding company affiliate or in an operating subsidiary of the bank, provided the operating subsidiary structure has certain safeguards. Those safeguards include: (1) applying principles such as those contained in Sections 23A and 23B of the Federal Reserve Act to transactions between a bank and its operating subsidiary, with the appropriate principles to be determined by each federal banking agency for the institutions within its jurisdiction; (2) requiring that the bank's investment in the operating subsidiary be deducted from regulatory capital; and (3) requiring that after this deduction the bank be well-capitalized.

Some have argued that banks have a lower net marginal cost of funds than nonbanks due to a perceived federal subsidy from deposit insurance and access to the federal payments system and the Federal Reserve discount window. Thus, the argument continues, activities conducted in bank subsidiaries are subsidized, resulting in an expansion of the federal safety net. For well-capitalized banks, the evidence shows that

if a net marginal funding advantage exists at all, it is very small. Moreover, even if a small net marginal funding advantage exists, there is no difference in a bank's incentive, and ability, to pass this advantage to both holding company affiliates and bank subsidiaries. Regulatory safeguards for operating subsidiaries, however, such as those discussed above, and existing safeguards for affiliates, such as Sections 23A and 23B of the Federal Reserve Act, serve to inhibit a bank from passing a net marginal subsidy either to a direct subsidiary or to an affiliate of the holding company. Any leakage of a net marginal subsidy from the insured bank to a subsidiary or an affiliate is likely to be the same and would be de minimis.

From a safety and soundness perspective, both the bank operating subsidiary and the holding company structures can provide adequate protection to the insured depository institution from the direct and indirect effects of losses in nonbank subsidiaries or affiliates. Some have argued otherwise-that the bank holding company structure provides greater safety and soundness protection than does the operating subsidiary structure. As deposit insurer, we have examined this issue closely and we disagree. The properly insulated operating subsidiary structure and the holding company structure can provide similar safety and soundness protection when the bank is sound and the affiliate/subsidiary is financially troubled. When, however, it is the bank that is financially troubled and the affiliate/subsidiary is sound, the value of the subsidiary serves to directly reduce the exposure of the FDIC. Thus, the subsidiary structure can provide superior safety and soundness protection. An appendix to the testimony contains an analysis of this issue.

Finally, forcing banks to conduct insurance and securities activities through holding company affiliates might be particularly burdensome to small banks that may not have holding companies. These banks would be required to set up a holding company structure in order to conduct new activities or in some cases to continue to conduct existing activities. With increased competition in the banking industry, we need to be especially cautious about putting unnecessary regulatory burdens and costs on community banks.

FUNCTIONAL REGULATION AND REGULATORY AUTHORITY

The bill contains a number of provisions that provide for greater regulation by function and for some degree of umbrella oversight. Properly implemented, greater regulation by function is likely to result in more consistent regulation of similar products and services across differing types of institutions. And the complexity of today's financial organizations combined with the growing use of risk-control strategies that view the activities of an organization in totality argue for some form and degree of umbrella oversight.

In striving for greater regulation by function, however, we must take care not to cause an artificial restructuring of financial operations and services on functional rather than on strategic or market-based lines. Such an artificial reshaping of financial operations and services would undermine the flexibility in corporate structure that should be among the

goals of financial modernization. Concerning umbrella oversight, the FDIC believes no formal "umbrella" regulatory or supervisory structure is needed to protect the deposit insurance funds, provided appropriate safeguards are in place and the FDIC has the ability to monitor both the effectiveness of the safeguards and the financial health of other parts of the conglomerate. Some measure of umbrella oversight, however, may be necessary to address concerns regarding the stability and liquidity of the financial system. The provisions in H.R. 10 regarding functional regulation would result in some shifts in regulatory responsibilities. As I have indicated, the FDIC believes that properly structured functional regulation has a role in the regulatory system. We have concerns about three of the bill's provisions in this area, however. One provision would restrict the ability of the FDIC to obtain information necessary to fully assess the risks to the deposit insurance funds. This provision would make the Securities and Exchange Commission (SEC) the sole federal agency with authority to examine or inspect any registered investment company that is not a bank holding company. We are concerned about this only as it relates to insured banks and the deposit insurance funds. This provision could be interpreted to narrow the authority of the FDIC under Section 10(b) of the Federal Deposit Insurance Act to examine relationships or transactions between insured institutions and their affiliates and to determine whether the affiliates pose a risk to the insured institutions. The FDIC has used this authority sparingly and only after careful analysis. The very fact the authority exists, however, gives us the leverage to obtain necessary information that might not otherwise be available or forthcoming. The experiences of the 1980s suggest the vital importance of the insurer's ability to monitor in a timely and effective manner the relationships a depository institution has with its affiliates, especially during a period of major changes in the marketplace and the law.

A second matter of regulatory authority that causes concern for the FDIC involves possible impediments to the evolution of products and services in the banking industry. H.R. 10 would narrow the exemptions banks have from registering as brokers or dealers under the securities laws to nine specific categories of activities, plus a de minimis exception. If doubt existed about whether an activity fell within an exemption, the SEC would make the final regulatory determination and could use its enforcement authority to require registration. Thus, the SEC would have discretion to determine whether a bank needed to register as a broker or dealer and be subject to the regulatory requirements resulting from that status. Moreover, although one of the categories for exemption is effecting transactions in traditional banking products, the bill would authorize the SEC to determine whether "new banking products" were securities and thus subject to SEC regulation.

Consequently, a nonbanking regulator would be given considerable authority over the activities of banks, a situation that could inhibit the evolution of banking products and services.

The last item regarding regulatory authority that concerns us involves certain potential disputes between federal banking regulators and state insurance regulators. For these disputes, H.R. 10 would eliminate the deference usually accorded federal agencies' interpretations of their statutes. We question whether this curtailment of the ability of

federal banking regulators to determine the scope of the permissible products and services of banks is necessary or desirable. The concept of judicial deference recognizes an agency's expertise in interpreting any vagueness in federal legislation for which the agency has overall responsibility. We do not believe it is wise to begin a process that could erode the sound public policy reasons for providing deference. Concerning the particular focus of these provisions of the bill, the elimination of the deference usually accorded the decisions of the federal banking regulators could, over time, produce a number of state-by-state differences in the treatment of the insurance-related activities of banks. Maintaining a degree of national uniformity in the area of the financial arena where insurance and banking meet would appear to be the preferable course.

BIF-SAIF MERGER

An omission in H.R. 10 of considerable concern to the FDIC is the lack of provision for a merger of the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF). The bill directs the FDIC to conduct a study of a possible merger of the BIF and the SAIF. In the study, the FDIC would have to address several issues: (1) the safety and soundness of the deposit insurance funds and the adequacy of reserve requirements in light of the mergers and consolidations taking place in the industry and the affiliations that would be permitted under the bill; (2) the concentration levels of the funds, including the number of members in each fund, the geographic distribution of each fund's members, and the extent to which either fund is exposed to higher risks due to geographic concentrations of members or an insufficient membership base relative to the members' sizes; and (3) issues related to a merger, including the cost of merging the funds and the distribution of such costs among fund members.

These issues are certainly important, and they are among the topics that the FDIC is giving high priority in its ongoing evaluation of risks to the industry and the deposit insurance funds. Some of the items are operational and would have to be addressed when the funds were merged. But none of the issues warrant a delay in enacting legislation that would require a merger of the funds. The arguments for a merger are persuasive, and the administrative and logistical steps required to bring it about are not complicated or difficult. 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 risks, and would be stronger than either fund alone. Both funds are fully capitalized, and currently their members are healthy and profitable. The BIF and SAIF reserve ratios are very close to one another and should remain so throughout 1998. Thus, merger of the two funds at this time would not result in a material dilution of either. The Deposit Insurance Funds Act of 1996 (the Funds Act), which capitalized the SAIF, recognized the need for a merger. The FDIC believes that merger of the two insurance funds should not be delayed.

Prompt Congressional action to merge the funds would also alleviate a pending problem regarding the SAIF. The Funds Act created a "SAIF Special Reserve." If, on January 1,

1999, the reserve ratio of the SAIF exceeds the designated reserve ratio (DRR), currently 1.25 percent of insured deposits, the amount of the excess will be placed in a special reserve account. The most recent projections by FDIC staff are that the SAIF reserve ratio will range from 1.37 to 1.45 percent on December 31, 1998, which would result in a SAIF Special Reserve between $883.6 million and $1.35 billion on January 1, 1999. This SAIF Special Reserve account cannot be accessed unless (1) the reserve ratio of the SAIF is less than 50 percent of the DRR and (2) the FDIC expects the SAIF reserve ratio to remain at less than 50 percent of the DRR for each of the next four calendar quarters.

Absent a merger of the funds, the FDIC recommends repeal of the SAIF Special Reserve provision. By eliminating any cushion above the DRR, the creation of the SAIF Special Reserve will increase the likelihood that the SAIF could fall below the statutorily required DRR of 1.25 percent. If the SAIF falls below the DRR because of savings association failures or because of faster-than-expected growth in insured funds, the FDIC would be required to raise SAIF premiums, creating a premium differential between the SAIF and the BIF. Differing assessment rates for SAIF- and BIF-insured deposits existed before the Funds Act was enacted, and the result was the shifting of deposits between SAIF- and BIF-insured institutions. Such market distortions have an economic cost as institutions devote resources to countering artificial statutory distinctions. The problem of the SAIF Special Reserve could be solved through a merger of the insurance funds. If a merger is not authorized for the immediate future, the requirement that the FDIC create the SAIF Special Reserve on January 1, 1999, should be repealed.

CONCLUSION

The regulatory system for the financial industry needs updating. Technology and the marketplace have created a much more diverse and complex financial arena than existed when the various components of the system were put into place. H.R. 10, as passed by the House, is a step toward modernizing the regulatory system, although the FDIC believes the bill has flaws. We stand ready to work with the Committee in crafting a better bill.

APPENDIX A

Holding Company Affiliates and Operating
Subsidiaries: Safety-and-Soundness
Considerations

In considering financial modernization, two alternative organizational structures have been proposed. One, which is reflected in H.R. 10, would require that new activities such as securities or insurance underwriting be placed in a holding company affiliate. Under H.R. 10, in order to own such an affiliate, the holding company would have to be well-capitalized. The other, which is reflected in the Treasury proposal, would give banks the option of also housing new activities in a bank operating subsidiary. Under

the Treasury proposal, this operating subsidiary would be subject to certain safeguards. These safeguards include: application of the principles of Sections 23A and 23B of the Federal Reserve Act to transactions between a bank and its operating subsidiary so that loans made by the bank to the operating subsidiary would be fully collateralized and at market rates; requiring that the bank's investment in the operating subsidiary be deducted from regulatory capital; and requiring that the bank be well-capitalized after the capital deduction.

Safety-and-soundness issues arise in two situations: when the bank is healthy and the affiliate/subsidiary is financially troubled; and conversely, when the affiliate/subsidiary is healthy and the bank is financially troubled. Each is discussed below. We conclude that the affiliate and operating subsidiary structures offer similar protections when the bank is healthy and the affiliate or subsidiary is troubled, but that the operating subsidiary structure provides greater protection when the affiliate/subsidiary is healthy and it is the bank that is in financial trouble.

Bank Healthy-Affiliate/Subsidiary Troubled

There are a number of safety-and-soundness concerns that arise when a bank is financially strong but its affiliate or subsidiary is financially troubled. First, the bank might transfer funds to the subsidiary in an attempt to save its (or its parents) investment. However, both the affiliate structure and the operating subsidiary structure provide the same limits on such exposure. In particular, the application of the principles of Section 23A and 23B of the Federal Reserve Act to operating subsidiaries ensures that any extension of credit by a bank to its operating subsidiary would have the same limitations and safeguards as would apply to extensions of credit by the bank to its holding company affiliate. With respect to equity contributions, the bank might downstream capital to its subsidiary or it could upstream funds to its parent, which could then downstream the funds to the troubled affiliate. However, since the bank's investment in an operating subsidiary is deducted from regulatory capital and the bank would have to be well-capitalized under both the affiliate and operating subsidiary structures, equity transfers are limited to capital in excess of the well-capitalized threshold.

Of course, a bank might risk sanctions and illegally transfer funds to its affiliate or subsidiary in violation of Sections 23A and 23B, or even though it would fall below the well-capitalized level. Such a transfer also might go undetected by regulators until it was too late. But, it is important to remember that banking organizations seek to maximize the return to their shareholders; thus, they have the same economic incentive to improperly transfer funds to an affiliate as to a subsidiary. As for the ability of a regulator to detect improper capital transfers, bank regulators would presumably have similar access to operating subsidiaries and holding company affiliates, and similar mechanisms could be used to monitor capital flows between a bank and its operating subsidiaries and between a bank and its parent or affiliates. In short, banks may occasionally break the rules, and for a short time go undetected, but neither their incentive nor ability to do so is affected by organizational structure.

Another safety-and-soundness concern arises when an affiliate/subsidiary fails. Despite limited liability, theoretically, the corporate veil may be pierced to make the bank accountable for the liabilities of its affiliate or subsidiary. First, it is important to note that piercing of the corporate veil is very rare. Second, corporate veils can be pierced both upward to a parent and sideways to an affiliate. The critical issue is not organizational structure, but whether the bank so controls and dominates its affiliate or subsidiary so that they are held out to the public or operated as integrated entities. Under both the affiliate and operating subsidiary structures, there are certain straightforward steps a bank would be required to take to ensure that its affiliate or subsidiary are in fact separate from the bank. These steps include having separate management and record keeping for the two corporations, and not having identical boards of directors. With some basic safeguards such as these, the legal separation of both subsidiaries and affiliates can be reasonably assured.

A third safety-and-soundness concern that could arise from a troubled affiliate or subsidiary is contagion or reputational risk. That is, despite the fact that the bank may be legally insulated from the financial troubles of its affiliate or subsidiary, the troubles of the affiliates/subsidiaries may extend to the bank because they could undermine public confidence in the organization as a whole. This risk is real, but it depends largely on public perception, not organizational structure. If regulators strictly enforce firewalls, there will be less contagion risk. If, on the other hand, regulators encourage banks to bail out troubled nonbank subsidiaries or affiliates, then contagion risk will be a larger problem for operating subsidiaries and affiliates alike.

Bank Troubled-Affiliate/Subsidiary Healthy

Safety-and-soundness considerations also arise when it is the affiliate/subsidiary that is healthy and it is the bank that is financially troubled. As noted earlier, banking organizations seek to maximize the return of shareholders. Thus, if a bank is in danger of failing, banking organizations have an incentive to shift resources from the bank to healthy nonbank affiliates. Since operating subsidiaries are an asset of the bank, no such incentive exists to shift resources out of a troubled bank into a healthy operating subsidiary. Of course, firewalls exist to protect the bank from an improper transfer of funds when a bank is near failure, and regulators monitor troubled banks very closely. Nonetheless, in the case of a troubled bank, there is less reason to be concerned with breeches in the firewalls between a bank and its subsidiary than between a bank and its affiliate.

A second safety-and-soundness consideration, when the bank is in trouble and the affiliate/subsidiary is sound, involves the support that the healthy affiliate or subsidiary gives to the bank, and hence, indirectly to depositors and the insurance fund. Since, as noted above, an operating subsidiary is an asset of the bank, the earnings, or sale proceeds, of a subsidiary might prevent a bank from failing. If the bank does fail, earnings or sale proceeds prior to failure will lower the insurance losses of the FDIC. If the subsidiary has not been sold prior to failure, then the subsidiary becomes an asset of the receivership and directly serves to limit the losses of the insurance fund.

The Federal Reserve's "source of strength" doctrine provides some of the same support for banks from bank affiliates but not as completely and not as well as outright ownership. First, the source of strength doctrine has never been fully litigated, and bank holding companies have occasionally successfully balked at meeting the Federal Reserve's demand for capital injections into their insured banks. Second, even when bank holding companies have injected capital into banks that subsequently failed the FDIC has twice been sued to recover some of those funds. In the First Republic failure, the recovery of funds downstreamed to the bank was one of several issues in a suit eventually settled out of court. A suit by the Bank of New England trustee to recover funds and assets downstreamed by the holding company into the bank prior to failure is pending. Finally, despite the source of strength doctrine, once a bank fails, the depositors and the FDIC have no claim whatsoever on the nonbank assets of the holding company. This differs markedly from an operating subsidiary, which, as noted earlier, would become an asset of the receivership and whose full value would accrue to depositors and the FDIC.

Conclusion

The operating subsidiary structure and the holding company structure provide similar safety-and-soundness protection when the bank is sound and the affiliate/subsidiary is financially troubled. However, when it is the bank that is financially troubled but the affiliate/subsidiary is sound, the operating subsidiary structure has a safety-and-soundness advantage.

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