TESTIMONY OF
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ON
MERGERS IN THE FINANCIAL SERVICES INDUSTRY
BEFORE THE
COMMITTEE ON BANKING AND FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES
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ROOM 2128, RAYBURN HOUSE OFFICE BUILDING

Mr. Chairman and members of the Committee, I appreciate the opportunity to present the views of the Federal Deposit Insurance Corporation on the effect of mergers in the financial services industry. Recently announced proposed mergers are of two distinct types. One type consolidates already large banks and savings associations into still larger banks and savings associations.

The other type unites depository institutions, insurance companies, securities firms and other financial services providers in a single financial conglomerate. While these recently announced mergers are noteworthy due to their size, they exemplify long-standing trends in the financial services industry.

My testimony will first discuss the background behind recent merger activity and the FDIC's role as deposit insurer. I will then review the implications of these mergers for the deposit insurance funds. Next, my testimony will explore the effect on bank supervision and competition in the financial services market, including the role of community banks. Finally, I will discuss the possible effect on small business and consumers.

Background

Consolidation in the Banking Industry

Large mergers within the banking industry continue a long-term trend begun in the 1980s and accelerated by passage of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994. Strong earnings during the 1990s have enabled banks and thrifts to build their capital to the highest levels in more than 50 years. As a percentage of total assets, banks' equity capital rose from 6.45 percent at the end of 1990 to 8.33 percent at year-end 1997, during which time thrifts' average equity ratio climbed from 5.36 percent to 8.71 percent. Many institutions have used their capital to fund acquisitions, contributing to the ongoing consolidation in the banking and thrift industries. While the number of insured depository institutions has declined by more than one-third since 1985, primarily as the result of holding companies consolidating their operations, the number of offices serving the public has remained relatively constant, above 80,000. Mergers of banks, both interstate and intrastate, have resulted in a larger share of industry assets being held by a smaller number of organizations. While 41 banking companies held 25 percent of total domestic deposits in 1984, it took only 11 companies to account for the 25 percent share by the end of 1997. If these figures were adjusted to reflect the large mergers recently announced, just 7 banking companies would hold 25 percent of domestic deposits.

Financial Conglomerates

Financial conglomerates already exist. Non-bank banks and some industrial banks are owned by non-financial companies; national banks can sell insurance under certain geographic restrictions; bank holding companies and some banks are permitted to operate securities subsidiaries, subject to certain limits; and the thrift charter, via the unitary thrift holding company, has been an entry vehicle to the banking industry for financial service providers and non-financial firms.

Competitive pressures will continue to lead to financial conglomerates like the proposed merger of Citicorp and The Travelers Group. As the FDIC has testified several times, the existing prohibitions that prevent banks from affiliating with other financial service providers no longer achieve their goals and should be modernized.

Effect on the Deposit Insurance System

In the midst of these mergers and consolidations, the mission of the FDIC as deposit insurer remains central to the maintenance of financial stability. Throughout its history, the FDIC has played a critical role in assuring stability and public confidence in the nation's financial system, and in preserving liquidity in the national payments system. Deposit insurance has provided the secure foundation that has allowed the banking and financial system to weather storms that have created great instability in other nations. While I am confident that the deposit insurance system will continue to assure - as it has in the past - that no insured depositor will ever suffer a loss, we must continue to monitor industry developments carefully.

The FDIC has been studying the challenges to the deposit insurance funds presented by financial conglomerates and industry consolidation. To facilitate a thorough discussion of the role and nature of federal deposit insurance, the FDIC sponsored a symposium held on January 29, 1998. The symposium provided a forum for exploring the complex issues associated with maintaining an effective deposit insurance system. Since the symposium addressed many issues of concern to this Committee, the FDIC will forward a copy of the proceedings as soon as they are published.

The symposium addressed the issues related to deposit insurance and financial modernization, in light of the recent rapid pace of banking evolution and the prospect of newly permissible activities for banking organizations; the various deposit insurance reform proposals that would curtain the role of the federal government in protecting depositors; and the right balance between the pursuit of safety and soundness and the need to allow banks to compete and evolve. Participants considered the feasibility of measures that might further enhance the effectiveness of the deposit insurance system. The symposium concluded with a roundtable discussion of the deposit insurance issues raised by the previous panels.

The mergers that are the focus of today's hearing are occurring while the deposit insurance funds are financially very sound. The current balances of the deposit insurance funds are higher than the statutorily mandated Designated Reserve Ratio (DRR) of 1.25 percent. As of December 31, 1997, the balances of the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF) were $28.3 billion and $9.4 billion, respectively, or 1.38 percent and 1.36 percent of estimated insured deposits. As strong as the funds are, a combined BIF and SAIF would be stronger than either fund alone. A combined BIF and SAIF would have a larger membership and a greater diversification of risks. For these reasons, I urge you to address the issues related to a merger of the BIF and the SAIF as expeditiously as possible.

Statutory Enhancements Statutory changes over the last decade have provided the FDIC with tools to meet the challenges presented by financial conglomerates and consolidation in the banking industry. The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) instituted prompt corrective action to strengthen the hand of regulators to force banks to address problems earlier. While prompt corrective action has yet to be tested in times of stress, it should help avoid situations encountered in the last decade, where losses built up, value left the bank, and in extreme cases, management took excessive risks.

The risk-based premium system introduced by FDICIA provides another important mechanism to complement regulatory efforts. Institutions that pose a greater risk to the deposit insurance funds pay higher deposit insurance premiums than well-capitalized, well-managed institutions. This provides an economic incentive for financial institutions to manage risk prudently. The deposit insurance symposium that the FDIC held in January highlighted many of the issues raised by these mergers, including the potential failure of very large institutions and whether current methods of assessing risk can keep pace with the complex and evolving nature of the institutions. The symposium included a panel discussion of ways to enhance the assessment system, such as methods to incorporate market assessments of risks.

In addition, the enactment of the national depositor preference statute in 1993 can limit the losses borne by the deposit insurance funds from a bank or thrift failure. Under depositor preference, once the costs of managing a receivership are paid, the claims of the deposit insurance funds and uninsured depositors are paid from the failed institution's unencumbered assets before other claims may be paid. Large banks tend to have a smaller proportion of funding from deposit liabilities than do small banks.

FDICIA greatly expanded the FDIC's ability to offset losses through regular and emergency special assessments on insured institutions. While the capital of insured institutions available to pay assessments can fluctuate depending on the financial condition of the industry, capital currently is substantial, totaling approximately $450 billion as of year-end 1997. If the reserve ratio were to fall below the DRR, the FDIC is required by FDICIA to set semiannual premiums on financial institutions to lift the fund's ratio to the DRR. Our staff has analyzed the sufficiency of the deposit insurance funds and has concluded that the resources available to the federal deposit insurance system are sufficient to withstand several years of failures at the highest historic levels experienced by banks. The resources of the funds also appear sufficient to handle the failure of a large insured institution. Unprecedented failures of a number of very large financial institutions simultaneously would be more problematic, but it is questionable whether it would be appropriate to maintain insurance funds that are large enough to address a worst-case scenario.

FDICIA also limited the scope of deposit insurance and placed appropriate restrictions on the use of the deposit insurance funds in resolving failing insured institutions. Under current law, the FDIC must use the resolution method that is least costly to the deposit insurance funds. Any decision to depart from this standard due to the potential systemic effect of a failure requires a joint determination by the FDIC and the Board of Governors of the Federal Reserve, and the Secretary of the Treasury in consultation with the President. A systemic risk determination would result in either a determination not to place a large, troubled institution in receivership or a determination to extend protection in a failed-bank resolution beyond insured deposits. In addition, unlike pre-FDICIA "too-big-to-fail" determinations, the additional costs associated with using the systemic risk exception are to be recovered through special assessments on insured institutions, generally based upon total liabilities. As a result of these statutory provisions, determinations of systemic risk in the future are likely to be rare and pose less of a threat to the taxpayers than prior to FDICIA.

Consolidation in the Banking Industry

Consolidation of banks serving different markets can diversify risk and decrease earnings volatility, thereby decreasing the likelihood of failure. Regional recessions and sectoral downturns contributed to many of the bank and thrift failures in the late 1980s and early 1990s. Many of the institutions that failed or were troubled tended to have either geographic or product concentrations. Broader diversification of risks through mergers of institutions serving different markets can moderate the effect of economic downturns on these institutions.

Consolidated banking organizations also may be able to reduce duplicative back office and other administrative costs, although the actual value of these cost savings remains uncertain. The resources and broader array of activities of these banks should also enable them to compete more effectively in international markets.

Consolidation in the banking industry does pose certain risks. The deposit insurance funds face larger potential losses from the failure of a single large consolidated institution. Insurance is based on the concept of diversifying risk. If an institution gets too large relative to the industry as a whole it becomes increasingly difficult to diversify risk. Larger institutions also are more complex and tend to be involved in more non-traditional activities as well. Large banks also pose challenges when they fail. As I speak, the FDIC is hosting a symposium on the various aspects of asset disposition and financial institution resolution options used during the crises of the 1980s and early 1990s. Mergers that create larger banking companies increase the economic impact should the new institution fail and may raise the possibility of a systemic risk determination, although, as discussed earlier, the statutory changes over the last decade have improved our ability to address these issues. Despite these areas of concern, I believe these enhancements, together with effective supervisory oversight, should assure the financial integrity of the insurance funds.

Financial Conglomerates

Mergers between banks and other financial services providers can benefit banking organizations and the deposit insurance funds in several ways. These combinations can bring new capital and additional management expertise to banking organizations, and enhance the ability of U.S. financial services companies to compete in an increasingly global economy. In addition, financial service company mergers offer banking organizations new opportunities to generate profits and to diversify their sources of income by expanding the activities that they can conduct.

Financial service company mergers, however, raise significant issues for the industry and regulators. Merging large banking organizations with large, non-bank providers of financial services creates a potential for expansion of the federal safety net to non-banking activities. Enforcement of safeguards to separate the insured institution from other parts of the organization - like the principles contained in Sections 23A and 23B of the Federal Reserve Act - are the keys to containing expansion of the safety net beyond the insured bank or thrift. The absence of adequate safeguards also may complicate the resolution of the insured institution and create the potential for additional losses to the deposit insurance funds. During the symposium on deposit insurance held by the FDIC, many participants emphasized the importance of establishing and enforcing effective safeguards.

Regulatory Issues

Consolidation in the Banking Industry

The sheer size and complexity of larger institutions and their involvement in more non-traditional activities can create challenges for regulators and management. Regulators must ensure that management of the combined entity has sufficient commitment and resources to control risks effectively. Bank managers must consolidate operations efficiently. For example, management must ensure the compatibility of information systems while addressing the problems associated with the Year 2000, maintain strong internal controls and develop appropriate risk management systems.

The recent implementation of risk-focused examinations by the federal banking agencies and the programs already in place for coordinated oversight of large, complex institutions provide a strong foundation for addressing the challenges of industry consolidation. Regulators ensure that proper controls and practices are in place and assess management's ability to identify, measure, monitor and control risk within an institution. Going forward, we will determine whether examiners need additional training to address new activities and whether our supervisory programs need to be modified.

The FDIC and the other bank and thrift regulators also coordinate examinations and conduct unified examinations to identify the riskiest activities, to more efficiently allocate staff, and to share information. We also have developed sophisticated analytical tools over the past few years, providing the ability to stress test and forecast potential risks to both individual institutions and to the industry as a whole. As we gain more experience with banks operating nationally and internationally, we may find that we need to develop additional ways to cooperate and share information with other federal and state regulators.

The model of supervision for community- and regional-based banks has been a point-in-time examination followed by Call Report trend analysis and other off-site supervision until the next on-site examination. This model has worked well in smaller institutions. Nationwide banks are subject to market dynamics that move much more quickly than quarterly financial information is able to track. Effective supervision of a nationwide bank or a bank with worldwide operations requires continual monitoring.

Regional recessions in the Southwest in the mid-1980s, and in New England a few years later, led to substantial losses to the federal deposit insurance funds. In 1995, the FDIC established the Division of Insurance (DOI) to monitor trends, including regional trends, in both the financial services industry and the economy more effectively. DOI has regional analysts who work with our examiners to assess risk exposures for individual banks and groups of banks. This information is particularly significant for monitoring community banks and thrifts that are more closely tied to their local economies than are the larger interstate organizations.

Banks and thrifts, including those with multi-state operations, report financial results based on their main-office location, regardless of the location of their branches and customers. Thus, with more and larger institutions operating on an interstate basis, bank Call Reports and Thrift Financial Reports are now less useful in identifying regional or statewide trends. Mindful of the reporting burden of altering bank Call Reports and Thrift Financial Reports, and as part of a broader evaluation of the FDIC's future information needs, we are currently investigating alternative sources and collection methodologies to improve the ability to monitor industry developments on a less aggregated basis. As part of this effort, the FDIC also is seeking to improve its ability to monitor lending concentrations by industry. Commercially available products, surveys of examiners and other uses of existing information are being explored as less burdensome alternatives to expanded data collections from insured institutions, although the latter cannot be ruled out.

Consolidation of the industry underscores the importance of the current reexamination of capital standards. It is possible that nationwide and worldwide banks should have different capital standards than community and regional banks. Many of the nation's largest banks have balance sheet structures in which borrowed money provides major parts of their funding. We need to explore whether and how these liability structures could provide greater degrees of both market discipline and depositor protection.

Financial Conglomerates

Supervision of financial conglomerates requires that banking regulators ensure that the capital of insured banks and thrifts is not impaired or diluted through interaffiliate relationships. As I stated earlier, statutory restrictions, like the principles contained in Sections 23A and 23B, play a vital role in preventing additional risks to insured banks and thrifts from non-banking affiliates. On-site examination and off-site monitoring of the insured institutions in these conglomerates continue to be vital to ensuring that banks and thrifts effectively manage their risks. Equally important is the examination of interaffiliate transactions. As deposit insurer, the FDIC must continue to have authority to examine, as appropriate, all insured banks and thrifts to be able to assess risk to the deposit insurance funds. In addition, the FDIC must continue to have the authority to obtain all the information it deems necessary to fully assess its risk.

Mergers need to be reviewed to ensure that they do not result in undue market power in any line of business. Banks, brokerage firms and insurance companies are generally in complementary, rather than competing, businesses. Certain lines of business, however, such as municipal bond underwriting and commercial real estate financing, do involve direct competition between these organizations.

The convergence of financial services providers and products, domestically as well as globally, again points to the need to revisit capital adequacy standards. The blurring of lines between providers and products presents new challenges to financial services supervisors in the determination of capital sufficient to protect against the various risks associated with a growing mix of activities. Supervisors must think ahead to what kind of capital framework may make sense in a global and integrated financial services market.

Implications for Community Banks and the Market for Financial Services The trend toward consolidation within the banking industry and combinations of depository institutions and different financial services providers must be carefully reviewed to evaluate the potential effect on the marketplace for financial services. Unlike many other nations, the U.S. banking system is characterized by a large number of small, community-based institutions. Despite the trend toward consolidation, smaller banks and thrifts still account for the majority of depository institutions and have demonstrated an ability to compete in their markets.

Community banks generally tend to have considerably less than $1 billion in assets. While the number of community banks may have decreased in recent years, they still account for more than 90 percent of the number of banks and thrifts. In fact, as of December 31, 1997, nearly two out of three commercial banks and savings institutions had less than $100 million in total assets. Although a few of the very largest interstate financial institutions in the country may operate in over 1,000 communities, community banks operate in over 4,000 communities in which there are no offices of larger banks, providing essential financial services to consumers and businesses. Community banks continue to serve as a key source for credit for small businesses and farms. They are often more aware of the financial health and credit needs of local businesses and can use this knowledge to profitably originate loans that might not be made by a larger, multistate institution.

Many have raised concerns that the trend towards larger institutions will adversely affect the viability of community banks. However, there are many reasons to believe that community banks will continue to play a critical role in the financial system.

First, smaller banks have competed effectively in states, such as California, New York, North Carolina and Virginia, where statewide branching has long been allowed. Second, new community banks continue to be chartered. Since the beginning of 1995, more than 450 new financial institutions have been chartered with 200 of those being chartered during 1997. Many of the newer banks are targeting specialized niches, or products and services to satisfy the needs of communities not being met by larger institutions.

Third, community banks continue to share in the extraordinary profits achieved by the industry over the past six years. In each of these six years, depository institutions with under $100 million in assets have recorded an average return on assets (ROA) above 1 percent, the recognized industry benchmark for strong profitability. In 1997, small institutions earned an average ROA of 1.14 percent. Also, institutions with less than $100 million in total assets have the lowest rates of net loan charge-offs and the highest capitalization levels of any asset-size group.

Finally, community banks also compete effectively on prices and services. The Federal Reserve Board's most recent Annual Report to the Congress on Retail Fees and Services of Depository Institutions (June 1997) concludes that average fees charged by multi-state organizations are "significantly higher" than those charged by single-state organizations. Anecdotal evidence suggests that smaller banks and thrifts can gain customers when a local competitor is acquired by an out-of-area organization. Computerized communications may be leveling the field on which small and large banks compete by enabling smaller banks to contract for off-site back-office support and to offer products and services from remote vendors.

While these facts demonstrate the continued vitality of smaller community banks, these institutions do face strong competitive challenges from larger institutions. Economies of scale and other efficiencies available to larger institutions serving regional or national markets enable larger institutions to provide a wide range of competitively priced traditional products and services, including savings and checking accounts and loans. In addition, financial conglomerates are better positioned to provide one-stop financial services, which also may include insurance of all types, mutual funds, stocks, financial planning, and other services. These institutions can target and market these services, enabling them to advantageously expand into new markets and identify likely customers. On balance, smaller banks, focused on service to a particular local community and taking advantage of competitive strengths resulting from that focus, should continue to have a place in the banking industry.

Implications for Small Business

While larger banks hold a significantly smaller share of their portfolios in small business loans than do smaller banks, this does not mean that the dollar volume of their loans is less or that small businesses do not have access to bank credit. The Small Business Administration's Office of Advocacy reports that in 1997 the 57 largest bank holding companies accounted for 37 percent of small business loans. The 373 commercial banks with more than $1 billion in total assets accounted for over 82.9 percent of the dollar volume of all small commercial and industrial (C&I) loans in 1997 and 28.4 percent of the dollar volume of all agricultural loans to small farms.

There are a number of reasons to believe that small businesses will continue to have access to credit even with industry consolidation. First, data indicate that small businesses, in general, appear to be well served by the banking industry. As of June 30, 1997, FDIC-insured commercial banks held more than $400 billion in loans to small farms and businesses - an increase of 20 percent over the last three years. That total included $198 billion in C&I loans and $56 billion in agricultural loans. In addition, there were $163 billion in loans outstanding on commercial properties.

Second, as discussed earlier, small community banks remain a healthy and energetic segment of the nation's banking system despite the advent of interstate banking and the ongoing consolidation of the industry. In 1997, small community banks held 18 percent of all small farm and small business loans, which was proportionately greater than their 5 percent share of all industry assets.

Finally, although commercial banks have traditionally been the principal providers of financing to small businesses, they are not the only source. Data from the 1993 National Survey of Small Business Finances indicated that small businesses obtained almost 40 percent of the dollar amount of small business credit outstanding from non-bank sources. It is likely that non-banks will continue to be a major source of credit.

Implications for Consumers

Large interstate mergers should benefit consumers who desire to take advantage of additional choices and opportunities. These consumers will be able to make deposits or withdrawals at their own financial institution even when they are travelling in another state or region of the country. Customers of these national institutions may be able to use more ATMs without being levied a surcharge. Consumers also may be able to obtain new credit and deposit services from these larger institutions that have not been available from the institutions previously serving those markets.

Customers and communities may suffer if large mergers result in branch offices being closed, particularly if these branches serve low-and moderate-income areas. A closed branch, however, may offer smaller community banks an opportunity to increase services. As consolidation of the industry continues, bankers and regulators will be challenged to ensure that banking services and credit remain available throughout communities.

Combinations of large financial institutions allow the bundling of products and services. Consumers will benefit if they can choose bundled products and services at a discount. Consumers will be harmed if they are forced to accept one product or service to obtain another. Existing anti-tying laws need to be examined to ensure that consumers can benefit from bundled, discounted products and be protected from arrangements that require them to purchase an unwanted product or service to obtain the product or service they want.

While cross-marketing can benefit consumers through lower prices and new products, some consumers have expressed concern that one company in a financial conglomerate may provide a customer's personal financial or other information without their permission to help an affiliate cross-market. Amendments to the Fair Credit Reporting Act that became effective last fall established a mechanism for sharing customers' financial information among affiliates of banks and bank holding companies. If the consumer objects, the information cannot be shared with other affiliates. Although the amendments require disclosure to consumers of information sharing arrangements and give each consumer an opportunity to "opt out" of any such sharing arrangement, this mechanism has not been tested long enough to assure consumers that it can adequately protect the privacy of their personal financial information.

The federal and state regulatory system has provided effective safety and soundness oversight and protection for consumers under separate regulatory structures for banks, securities brokers, and insurers. The existing regulatory system has worked well in an environment of relatively well-defined distinctions between banking, securities, and insurance products. This new world of multi-product financial conglomerates poses substantial challenges to federal-state and interagency cooperation and coordination. Nonetheless, close coordination between federal and state regulators will continue to provide effective oversight and protection of the public.

Conclusion

The deposit insurance funds are sound and well prepared to continue their historic role in providing stability for the financial system. Financial conglomerates and bank consolidations, while not new, raise significant issues for the industry and regulators. These mergers are driven by the increasing competition in the financial services marketplace. Financial modernization legislation is necessary to provide a rational framework for this market evolution. However, we believe that statutory changes over the last decade have placed the FDIC in the best position in our history to manage the risks created by market developments and to assure the stability of the deposit insurance system.

Thank you for the opportunity to present the views of the FDIC today. I now stand ready to answer any questions you may have.

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