Remarks
By FDIC
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Good afternoon. It is great to speak to a roomful of independent bankers and bank directors.

We at the FDIC have great respect for the challenging job you have—competing in the marketplace, satisfying your regulators, responding to your customers, and succeeding on the bottom line. Every day, independent bankers are doing these things and making a difference in their communities.

Independent bankers walk in a different world than bankers who work in large financial conglomerates. You compete in different niches, serve your customers in different ways, and in many ways you are supervised and regulated differently. Yet your fortunes are in part linked to those of the large banks. Your competitive opportunities are influenced by how well large banks serve their customers and how they price their loans and deposits. Your options for creating value for your shareholders can be influenced by whether your bank is or should be a candidate for acquisition by a larger institution. And the industry as a whole has a collective liability to fund the costs of deposit insurance.

Because of these linkages, trends in the supervision and regulation of the largest banks can affect all banks. And we as banking policymakers must always be vigilant in preventing the cost of the federal banking safety net from running out of control, which is why ensuring appropriate supervision and regulation of large banks is of utmost concern.

As the financial services industry evolves, large bank supervision inevitably becomes subject to evolutionary pressures. In discussions of implementing Basel II for the largest U.S. banks, one sometimes hears reference to a “new paradigm” for regulation and supervision in which bank regulators, and holding company or consolidated regulators, will need to work together more seamlessly. Indeed, regulatory achievement of such a new paradigm is at the top of the wish list for many internationally active banks. With this in mind, some U.S. legislators have expressed interest in at least exploring whether our financial regulatory structure could be rationalized to keep pace with market evolution.

In short, significant questions are being asked, and it is critical that we as regulators respond thoughtfully to the challenges that financial evolution puts before us. Drifting with the current is a risky course—the history of financial regulation shows how often jagged rocks can lie just beneath the seemingly open waters. With respect to the regulation and supervision of large financial conglomerates, we at the FDIC are concerned that some of the plausible courses the regulators might steer would result in a significant expansion of the federal banking safety net.

In particular, it is imperative that we resolve the tension between two potentially incompatible realities. One, regulators' ability to control the costs of federal deposit insurance is based on the legal accountability that management and directors of insured institutions assume for the governance of their institutions. This accountability is the bedrock on which the possibility of effective bank supervision rests. Two, it is increasingly being said that financial conglomerates manage risk by line of business and not by legal entity. Yet if a movement toward enterprise risk management and consolidated supervision of conglomerates is inevitable, so are questions about how directors whose banks are owned by these conglomerates should balance their bank governance responsibilities with the demands and strategies of the broader organization.

There can be no ambiguity in the answer to this question. The duty to oversee the management of a bank rests solely with its directors. In practice, bank boards and holding company boards often share common members. What is critical for the sound operation of this potentially ambiguous situation is that when a holding company director sits on a bank's board, that director must wear his or her banking hat. As a bank director, he or she is required to act in the best interests of the bank, not of the holding company.

Recent trends towards the active and integrated management of financial conglomerates are likely to accelerate under Basel II, which in its complexity and extensive systems requirements, clearly provides a financial reward for companies that have centralized risk management. There is also an increasing tendency in recent policy discussions to relate the trend toward integrated risk management to a need for consolidated supervision. This is said to be needed both from a safety-and-soundness perspective and for the convenience of the regulated entities that do not wish to contend with the demands of multiple legal entity supervisors.

Consolidated supervision seems to offer a plausible model for regulating conglomerates. This model, however, poses a major unresolved issue—that of identifying and controlling the scope of the federal banking safety net. In the United States, we have chosen to provide federal deposit insurance to depository institutions, and not to other entities. The liabilities of holding company affiliates enjoy no federal guarantee. Yet, if we are trending towards a situation where banks are so closely linked to their affiliated entities as to be indistinguishable, or where they cannot measure and manage their own risk, then we are clearly also trending toward expanding the scope of the federal safety net to cover risks taken outside of banks.

Deciding the scope of federal safety net support, and what entities should be regulated and why, are the most important financial regulatory choices Congress can make. For a long time, we had some consensus about these issues, or at least about the reasons for doing what we did. Federal deposit insurance coverage was put in place to prevent bank runs and protect small savers. The need to contain the costs of deposit insurance added to a long list of reasons for regulating banks and erecting firewalls to insulate them from risks taken by affiliates. Supervision of bank holding companies was introduced in the 1950s, in part, to protect banks from being harmed by the activities of non-bank affiliates.

More recent policy discussions seem to reflect a movement away from a bank-centric rationale for holding company regulation. In the new vision, conglomerates will be asked to have comprehensive risk measurement and management systems, in order to assure compliance with a Basel II consolidated capital requirement. From the original idea of checking up on the holding company to help ensure it does not harm the bank, we seem to be evolving to the idea that the safety of the holding company itself is the major focus of regulatory activity.

A significant regulatory focus on entities outside the federal safety net has a number of implications. Most obviously, it has tended to constrain marketplace choices about affiliations between banks and other entities. If a corollary of allowing a bank and a commercial firm to affiliate is to impose consolidated supervision on the commercial firm, then there is the possibility that the commercial activities would then be guided less by market forces and more by financial sector style regulation. A number of policymakers have argued based on safety-and-soundness considerations that this regulatory quid pro quo should be a necessary condition for allowing such affiliations. Yet there is another side to this debate, that under a consolidated supervision model that downplays the importance of the bank's separate legal status and separate governance responsibilities, the danger of commingling the bank with the rest of the organization might, in fact, be greater.

What are the dangers of an erosion of the corporate separateness of banks that are part of conglomerates? To the extent holding companies are actively managing the affairs of a subsidiary bank, they may cease to enjoy limited liability with respect to that bank. While piercing the corporate veil might have the effect of reducing costs to the insurance funds in a world where legal entity risk management becomes less robust, it could also inhibit capital formation in financial companies.

Other costs of eroding corporate separateness of banks are more concrete. The FDIC has gone into failing banks where employees did not know whether they were bank employees or holding company employees, and where the performance of vital bank functions by affiliates increased significantly both the complications, and the cost, of the receivership. We have seen banks paying dividends to support troubled non-bank affiliates. At times, the ability of bank regulators to prevent the payment of such dividends may be constrained by a fear that the bank could not survive a default by its parent. In these and other ways, the federal safety net can be stretched when the commingling of bank and conglomerate activities goes too far.

We dwell on such scenarios at the FDIC because we have had considerable experience with them. What needs to be asked is whether regulation is heading in a direction that will make such scenarios more likely in the future, when the size and scope of financial conglomerates will raise the stakes much higher than they have been in the past.

To operate credibly and effectively over a long period of time, a policy on the supervision and regulation of conglomerates must be informed by, and consistent with, clear decisions on the scope of the federal safety net. In this respect, a number of choices are available.

The essential question relates to the scope of federal safety net support in situations where a bank is part of a conglomerate. One vision would be to explicitly expand the scope of federal guarantees to include not just the bank subsidiaries, but the entire conglomerate. In this vision, consolidated regulation would seem to be the only viable way to control the costs of providing those guarantees.

Another approach would be to reject expanding the federal safety net, but without insisting on robust legal-entity risk-management of subsidiary banks. In this case, Congress might consider resolving these two incompatible ideas by simply cutting the insured entities in these conglomerates off from deposit insurance. These banks would then become in law what some would argue that they are in fact—integrated components of a larger company whose risk-exposure as legal entities is of secondary importance.

A third approach would seek to prevent an expansion of the federal safety net by ensuring that banks in conglomerates are effectively insulated from potential problems in the affiliates. This approach would place much less emphasis on detailed and comprehensive oversight of an entire conglomerate and much more emphasis on holding insured banks' management and directors accountable for the effective governance of their institutions.

The approach I refer to, of course, is traditional bank supervision. To insulate banks from problems in affiliates, bank supervisors rely on, among other things, regulatory limits on bank exposures to affiliates, reviews of transactions with affiliates, the application of Prompt Corrective Action standards for capital adequacy, the ability to conduct special examinations of affiliates when needed to determine the nature and effect of the bank's relationships with those affiliates, and the ability to take enforcement actions against affiliates.

Not only is the traditional bank supervision model an effective approach to containing the cost of deposit insurance for banks that operate within conglomerates, it is sufficiently flexible to work with alternative regulatory philosophies with respect to those conglomerates. As a notable example, the bank supervision model has worked well for a number of industrial banks and non-bank banks whose parent companies are commercial firms that are not subject to federal financial institution regulation.

The bank supervision model can also work well in the presence of a layer of holding company regulation. Federal holding company regulation today comes in a number of flavors. In addition to the well-known supervision powers of the Federal Reserve, the Office of Thrift Supervision and, more recently, the Securities and Exchange Commission have substantial consolidated supervision powers. Whatever name is used—holding company supervision, umbrella supervision or consolidated supervision—these additional layers of supervision work best when they rely on the bank regulator for bank supervision and address their efforts to the non-bank portions of the organization.

It seems to me that the seamless regulatory cooperation that both we and our supervised banks seek is most readily achieved when supervisory responsibilities are both clearly identified and non-overlapping. Conversely, if the provider of the additional layer of supervision does not stop outside the door of an insured bank, and succumbs to the temptation to downplay the importance of that bank's ability to manage its own risk, then the additional layer of supervision may simply be counterproductive and increase the costs of the federal banking safety net.

The policy choices I have described are not the only choices. They are not the direction that the most vocal proponents of consolidated supervision seemingly are urging us to take. But financial evolution will continue to give us reason to ask the question of what we are regulating and why, and where the federal safety net begins and ends. It is better for all of us to address such questions before events force them on us, and before the stakes become significantly higher.

Thank you.

Congress created the Federal Deposit Insurance Corporation in 1933 to restore public confidence in the nation's banking system. The FDIC insures deposits at the nation's 9,079 banks and savings associations and it promotes the safety and soundness of these institutions by identifying, monitoring and addressing risks to which they are exposed. The FDIC receives no federal tax dollars – insured financial institutions fund its operations.

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