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Statement of the Shadow Financial Regulatory Committee

on

Principles of Bank Reform: Guidelines for Assessing Pending Legislative Proposals

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Two proposals to modernize the banking system and its associated regulatory structure are now before the Congress: H.R. 1062 (the Leach Bill) and S. 337 (the D'Amato Bill). Choosing between these proposals, which contain important differences, requires that we be clear about what we want financial reform to achieve. The Shadow Financial Regulatory Committee ("Committee") has identified five key principles that should, from the standpoint of FDIC and taxpayer-consumers, guide reform.

1. There should be no limitations on banks' permissible activities and owners so long as they demonstrably satisfy prudential regulations. Permitting banks and other financial institutions to diversify their activities can enhance economic efficiency and competitiveness. The potential risks associated with nontraditional activities will not undermine the soundness of the banking system so long as banks and their regulators meet prudential rules on adequate capital, prompt corrective action and least cost resolution.

2. If some activities are not permitted to the bank itself, because they are viewed as too difficult to monitor, it is preferable from the standpoint of maintaining the financial strength of banks to conduct them in "bank-subsidiaries" (wholly-owned, separately-incorporated and separately-capitalized subsidiaries of the

bank) rather than in bank-affiliates (subsidiaries of the bank's holding company). Compared to allowing banks to engage in such activities directly (through the bank itself), the bank-subsidiary structure better insulates the bank from losses associated with its nonbank activities while at the same time preserving the potential benefits of a more diversified earnings structure. Compared to a bank holding company structure, the bank-subsidiary approach captures the gains for the bank and avoids the costs of having to operate as a holding company. Finally, a bank-subsidiary approach facilitates functional regulation of bank subsidiaries where so required.

3. There is no reason to have consolidated supervision or an "umbrella" regulator responsible for regulatory oversight of banks and all their nonbank subsidiaries. The jurisdiction of the appropriate bank regulator should be limited to the bank entity and to concerns related to the safety and soundness of the bank -- including a valuation of the bank's investment in any subsidiaries. Nonbank subsidiaries should be regulated by the appropriate functional regulator, depending on their activities.

4. Reform should lower the costs and facilitate both entry into and exit from the banking industry and other financial services. As technological change occurs, it is important that the reallocation of capital both within and between industries not be impeded. In particular, as regulatory protection and subsidies to the banking industry are reduced, exit from the industry must be made easier.

5. The Committee endorses reducing regulatory estrictions when such actions will not increase the risk of taxpayer loss. Under the current regulatory system, both insured deposits and access to the discount window and to the Fedwire for payments clearance entail implicit subsidies and guarantees to participating banks that must be constrained or bounded by regulation. So long as such subsidies and guarantees continue, the Committee believes that all banks (even those with only uninsured deposits) must continue to be subject to a degree of prudential regulation.

In the Committee's view, neither proposal before the Congress fully satisfies this set of fundamental principles of reform, although the D'Amato Bill clearly comes closer to doing so than does the Leach Bill. The D'Amato Bill provides for broader powers and facilitates both entry and exit.