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Charles E. Long
Executive Vice President

July 21, 1989

President George Bush
The White House
1600 Pennsylvania Avenue, N.W.
Washington, D.C. 20500

Dear President Bush:

On Thursday, July 13 John Reed, Chairman of Citicorp, testified before the Senate Banking Committee regarding the challenges and prospects facing the financial services industry in the coming years.

His testimony touches on a number of interesting and important themes that may be of interest to you, including the implications of the globalization of financial markets and Europe 1992, the problems with our deposit insurance system, and LDC debt.

I have enclosed a copy of his testimony for your information. I would be happy to discuss it with you at your convenience.

Sincerely,

C E Long

CEL:amh
Enclosure

Statement of

John S. Reed

Chairman, Citicorp

before the

Committee on Banking, Housing, and Urban Affairs

United States Senate

July 13, 1989

Good morning. I am John Reed, the Chairman of Citicorp. I am pleased to be here today to exchange views on the challenges and prospects facing the financial services industry in the coming years. I take the timing of this hearing and the care with which it has been organized as an indication that this Committee is ready to take the action necessary to move the financial services industry in the United States into the twenty-first century. The agenda of this Committee should be nothing less.

<u>The Revolution in Financial Services</u>

In recent years, this Committee has heard several witnesses discuss the profound changes that technology and globalization have brought about. The significance of these changes should not be underestimated. The vision of an integrated world economy is already a reality, but we are just at the beginning of an ongoing process. In the years to come, it is virtually certain that international trade will continue to grow faster than domestic economies and international banking and finance will continue to grow even faster than trade.

A global economy mandates global finance. The needs of financial services customers today are not limited by geographic boundaries nor by historical distinctions between financial products. Whether they seek to raise capital or invest it, their perspective is broad and it is global. This is true for multinational businesses which must fund operations in dozens of countries; it is true for investors who seek the advantages of global diversification; and it is true for ever more mobile individuals who desire access to their assets anywhere in the world.

More and more nations are restructuring their financial systems to make them more efficient and competitive internationally. They are doing so because it makes good economic sense. Job creation, physical investment and the efficient allocation of a nation's scarce capital all depend on well-functioning and cost-effective capital markets. Both Canada and the United Kingdom have recently completed significant restructurings, and further changes are on the horizon in Canada, Japan and Switzerland. But the significance of the efforts thus far is dwarfed by the momentous changes that will result from the European Community's 1992 project.

Financial services firms in the United States are justifiably concerned about the impact of the 1992 project on their own competitiveness in the global financial services market. But the stakes are much greater than that for the economy as a whole. The primary purpose of the 1992 project is to enhance the competitiveness of the European

Community in the world economy. The primary means to this end is the elimination of virtually all internal barriers that have limited competition and reduced economies of scale and scope in a broad range of industries. The financial services component of this effort is extensive. EC directives touch on virtually every aspect of financial services, including insurance, banking, securities, electronic payments and an important related area, telecommunications. The goal of these directives is not just a more competitive financial services market, it is a more competitive Europe.

In preparation for 1992, countries within the EC are rapidly dismantling the barriers between banking, securities and insurance. Universal banking, which permits full integration of securities and banking activities, is likely to become the norm. Three EC countries -- France, Germany, and The Netherlands -- already have universal banking, while in Belgium, the United Kingdom and Spain, banks may own securities and insurance companies, and these companies may own banks. These types of structures permit financial services organizations to attract management and capital, to balance risk, and to efficiently deliver a full range of banking, insurance and securities services to their customers. Regulation of these multiservice firms is on a functional basis, essentially the way American Express is regulated in the United States. In particular, there are generally no holding company capital requirements overseas, and few "firewalls" between banks and their non-bank affiliates, aside from simple lending limits.

There are many joint ventures and acquisitions now in the works by European companies. Banque Nationale de Paris, France's largest bank, and Union des Assurances de Paris, its largest insurance company are planning an alliance to boost cross-marketing of financial services products. Deutsche Bank, West Germany's largest bank, recently announced that it is getting into the life insurance business through a subsidiary. In the United Kingdom, a major clearing bank, Lloyd's, recently purchased Abbey Life, a top insurance company. And Europe's biggest insurance company, Allianz, recently announced a marketing arrangement with West Germany's second largest bank, Dresdner Bank.

Organizations and strategic alliances such as these, which have at their core a commercial bank, a fully integrated investment bank/securities operation, and an insurance company, can be expected to dominate global capital markets as the 21st century gets underway.

<u>The United States Is Lagging.</u>

In sum, the global competitive environment is changing rapidly. But while much of the developed world is busy laying the foundation for a financial system for the next century, the U.S. financial system is anchored firmly in the past. It is frankly appalling that European nations will have removed virtually all geographic and product-line barriers affecting financial services by 1992, while our system remains balkanized.

Less than half the states will be participating in full interstate banking by 1992. As for the activities and affiliations of depository institutions, the Bank Holding Company Act and the Glass-Steagall Act can only be characterized as protectionist -- if not in intent, at least in their consequences. Financial institutions perform a limited number of common functions -- they process transactions, serve as intermediaries, manage information, give advice and trade assets. That is why the common sense benefits from combining services are potentially so large. Yet current laws compartmentalize financial services in ways that are increasingly anachronistic. They are a source of risk and inefficiency.

A vivid example is the convergence of commercial banking and securities services, which are now so similar from a business standpoint and so closely intertwined from a customer standpoint that any distinction between them is artificial. The risks and the marketing procedures involved in loan syndications and private placements, for example, are fundamentally the same as those involved in underwriting and distributing securities. Yet loan syndications and private placements have been done by banks for years, while the strictly limited securities activities now permissible for bank holding companies can only be done in a separate subsidiary with separate capital, different people and duplicate support functions.

Another example is insurance. Amendments to the Bank Holding Company Act in 1982 almost completely separated banking and insurance. But the gains from permitting banking and insurance organizations to affiliate are potentially very large. These organizations both deal in risk-transfer, risk management and distribution. They both function as financial intermediaries, receiving funds from depositors or policyholders and investing them in comparable assets. The techniques they use for assessing and containing risk are often similar. The products they offer are in many cases functionally equivalent -- there is little difference, for example, between letters of credit and financial guarantees, or between the annuities offered by life insurers and the CDs offered by banks. With thousands of branches nationwide, banks would be cost-effective distributors of insurance products. In turn, many life insurance companies are interested in providing their agents with both life insurance and banking products to sell.

In sum, limitations on the nonbanking activities of bank holding companies and the clumsy "firewall" structure in the United States raise the cost of financial services to customers and make it difficult for financial services organizations to be responsive to their needs. They reduce the industry's ability to attract management and capital, and they inhibit the development of the type of innovative products, risk management techniques and distribution strategies that are now being developed by major European financial services providers.

Financial services customers have become very skillful in assessing their available alternatives on the basis of the quality of services and their cost. If they can not obtain the range and quality of services they need from providers in the United States, many of them will simply obtain them elsewhere -- from a foreign competitor, or maybe even from a foreign office of Citicorp. One of the great ironies of the present framework is that bank holding companies are permitted to offer services overseas that they are unable to offer at home. As a result, we as a nation are exporting jobs, capital, and know-how.

<u>What Needs to be Done.</u>

It is essential that we restructure our laws and regulations. In today's world, it is simply not possible for financial firms and financial markets in the United States to be more onerously regulated than in other financial centers and still be competitive. Our industry is the most innovative and resourceful in the world. Nonetheless, in rankings of institutions by size or by extent of cross-border activity, we are slipping further and further behind our foreign rivals. In addition, the problems of the savings and loans, the farm banks and the Texas banks are clear signs of failure to serve our own people and businesses. Unless the Congress can fashion a world-class legal framework for financial services, U.S. institutions will become increasingly less effective.

In 1988 the Senate passed banking legislation in an effort to modernize parts of the U.S. financial system. But the global competitive environment and domestic needs are changing rapidly. You and your colleagues in the Congress must now look beyond the compromises that were crafted then and take a bold approach to financial restructuring.

The Depository Institutions Affiliations Act, introduced in the Senate as S. 530, would be a step in the right direction. This legislation would permit any business to own a depository institution as a separately capitalized subsidiary of a holding company, regardless of its other business activities. It also contains new safeguards to protect the deposit insurance funds.

The Depository Institution Affiliation Act would go a long way, but not all of the way, toward meeting the industry challenge. In essence, we need a framework that: (a) permits firms intermediating global capital markets on behalf of their customers to do so efficiently, whether they are commercial or investment banks; (b) allows the integration of the traditional banking and savings and loan industries; (c) allows the integration of insurance and banking with appropriate industry safeguards and supervision; and (d) erases geographic barriers within our common market of the United States.

Benefits of Financial Restructuring.

Consumers would benefit enormously from breaking down barriers to competition in financial services for a number of reasons. It would ensure that consumers get market rates on their savings and on their borrowings; it would generate new products and greater convenience; and it would extend the availability of credit. Our business community would also benefit from more competitive, responsive, and market-oriented finance. In the process, overall productivity, the use of capital and the competitiveness of the United States economy would be enhanced.

Nonetheless, some financial services providers have actively resisted the integration of banking with other lines of business. They raise the specter of anti-competitive practices, abusive tie-in arrangements and conflicts of interest. They say the safety and soundness of the banking system would be threatened. There is little support for these claims.

When consumers buy any number of complicated goods and services from refrigerators to VCRs, they face many of the same information problems they face in buying banking, insurance, securities and real estate services. They need to know whether the seller is offering a good product and whether the seller can be relied upon to stand behind it. How do consumers make these choices? The answer is that they often rely on the reputation of an established retailer to ensure that they get good quality for their money.

Late in the 19th century, organizations such as Marshall Field, J.C. Penney and Sears revolutionized retailing by staking their reputations on the quality and price of the goods that they sold. In addition to the convenience these retailers offered, the fact that they sold a broad range of items made them willing to go to great lengths to satisfy their customers. After all, their reputations were essential to their commercial success. This proved to be enormously beneficial to consumers.

Customers could go to a retailer offering a diverse product line, buy a complicated product they did not fully understand, and be confident that they were getting a fair value.

For the same reason, consumers would welcome the opportunity to buy financial services as part of a larger relationship in which the seller's incentive to provide the best service is especially strong. This is particularly true for non-routine transactions, such as acquiring a major insurance policy, in which complex information hurdles make it difficult for consumers to compare terms and costs. The incentive for a financial services organization like Citicorp to offer quality services to their customers is strong indeed for the simple reason that we want to keep our customers satisfied. We would not want to jeopardize an ongoing relationship in a single transaction.

In sum, breaking down financial barriers would result in significant consumer benefits, not consumer abuses. Some consumers are enjoying these benefits right now. Consumers in the United Kingdom, for example, now buy about 60 percent of their insurance through banks. Consumers in several midwestern states and, most recently, in California are also able to buy insurance from banks and many are doing so. These consumers obviously think they are getting a good deal either by virtue of lower price or greater convenience. The combination of banking and insurance activities has not been accompanied by claims of abusive selling practices. It has not threatened the solvency of any banks. And it has not eliminated the need for insurance agents.

Nor would breaking down barriers to competition inevitably lead to high levels of concentration and monopolistic practices. No one is worried that Sears Roebuck, with sixty million credit card customers, will end retail merchandising competition. No one is afraid that Merrill Lynch, with over seven million active customers and branch offices in forty-nine states, will gobble up its competitors and control everyone's financial assets. The concern that a small number of commercial banks would come to dominate the financial marketplace is equally unwarranted.

Deposit insurance Reform.

Would breaking down barriers to competition pose new risks to the safety and soundness of the banking system? It is instructive to note that only one U.S. bank holding company is rated AAA, and then only by a single rating agency, while there are at least seven European universal banks with that rating by both Moody's and Standard and Poor's. Four of these have grandfathered securities affiliates that are free to underwrite and to distribute securities throughout the United States without firewalls between the bank and the securities company.

Few universal banks operating without branching restrictions in their national markets have failed. By contrast, U.S. banks and thrifts have been failing at rates not seen since the 1930s. Most of these failures have occurred the old fashioned way -- as a result of loans that went bad or interest rate gambles that did not pay off. Geographic and product-line restrictions have contributed to high failure rates by limiting diversification opportunities, while in the S&L industry, fraud and overexpansion fueled by easy access to federally-insured funds have been factors. It is not readily apparent that our compartmentalized system is either safer or sounder.

The FSLIC crisis is an appalling example of the weaknesses in the deposit insurance system. Congress and the Bush Administration deserve credit for working toward a plan to restore discipline to the savings and loan industry by strengthening capital requirements. Nonetheless, in my judgement, these reforms do not go far enough.

The fundamental problem is that the deposit insurance system now extends protection far beyond what was originally intended. Through increases in explicit coverage and the failure resolution policies of the deposit insurance agencies, safeguards that were originally designed to protect small savers are being applied to financially sophisticated professionals capable of making their own credit judgments about the banks with which they do business.

As a result, our system of depository institutions has become far too dependent on deposit insurance. The sad fact of the matter is that hundreds, perhaps thousands, of depository institutions could not survive without the federal deposit insurance sticker on the door. Extensive deposit insurance protection has had a corrupting influence on the entire financial system -- directly because it does not reward prudence and sound judgment, and indirectly because it forms the justification for burdensome government regulations that reduce the efficiency of the financial system. It is in this sense that the deposit insurance problem is also a competitiveness problem.

In my judgment, this situation will only change when deposit insurance coverage is limited to $100,000, <u>de facto</u> as well as <u>de jure</u>. Better still, coverage should be rolled back. I personally favor subjecting all deposits in excess of some basic amount to a ten to fifteen percent "haircut" in the event of a failure.

Protecting the stability of the financial system does not require full federal protection for all the liabilities of depository institutions. It does require timely intervention by regulators when an institution gets in trouble and better enforcement and supervision. Federal regulators have tools, such as bridge banks and modified payoffs, to expose large depositors and other creditors to losses when a failure occurs, while preserving the liquidity of deposit accounts. They can safely apply those tools to banks and S&Ls of all sizes. No bank is too big to be reorganized.

Other solutions have been proposed. For example, some have advocated "narrow banking," which would require banks to invest only in perfectly safe securities and spin off all other activities, such as commercial lending into separately capitalized affiliates. While this approach would surely solve the deposit insurance problem, it is also much more costly to society. Commercial banks around the world have been combining commercial lending with deposit taking for hundreds of years without the major systemic problems we are witnessing in the S&L industry. These problems are the result of many contributing factors, but they are not the result of combining lending and deposit-taking in the same organization.

Others have proposed risk-based deposit insurance premiums and further refinements of risk-based capital requirements. In my judgment, these are fine-tuning measures. They do not address the core problem, and they are extremely difficult to implement effectively.

<u>LDC Debt.</u>

I would be remiss in not saying a few words about the debt problem of the lesser-developed countries. The current situation has to be seen in the proper perspective. We have made progress in the past few years and we are working very hard see that it continues.

There is a widespread notion that the banks and the LDCs are adversaries. This notion is untrue. We have a common interest in the economic and democratic viability of the LDCs. I myself grew up in Latin America. I speak the language. I know the people and many of their leaders. As a company, Citicorp has been in Latin America for nearly 100 years. We plan to stay there and to grow with these nations. The last thing we want to see is the economies of these countries grinding to a halt. Instead we are anxious to see confidence restored and capital flight reversed.

Right now, negotiations with Mexico are at an extremely sensitive stage. It would be improper for me to discuss any details. I am confident, however, that we are close to an agreement. Once an agreement with Mexico is completed, we will then be in a better position to assess the Brady Plan and its prospects for dealing with other debtor nations.

Let me add a word of caution. The LDC debt problem is not a problem that is well-suited for a legislative solution. The situation in each of the debtor nations is different and must be approached on a case-by-case basis. Moreover, only a third of the creditor banks are based in the United States, and these banks hold less than 30 percent of the total debt. Nothing is gained by applying pressure only to the U. S. participants in these negotiations. It is certainly not in the interest of the United States to disadvantage its own banks relative to creditor banks in Europe and Japan.

<u>Conclusion.</u>

A major restructuring of our financial system is necessary. Restoring the United States financial system to world-class status is important for the health of the financial services industry. But more importantly, it is crucial for the U.S. economy as a whole. The United States will be unable to maintain its leadership of the world economy without vigorous and healthy financial markets. The decisions made by this committee, and by your colleagues on other important committees in the Congress, will materially determine whether or not the United States continues to be a leader in the world economy going into the 21st century, or whether it sinks into secondary status.

I would be happy to work with Committee members in any appropriate way to achieve these goals.

SUMMARY OF TESTIMONY

JOHN S. REED
CHAIRMAN, CITICORP

JULY 13, 1989

A major restructuring of our financial system is necessary. Restoring the U.S. financial system to world-class status is crucial not just for the health of the industry, but more importantly, for the economy as a whole. Decisions made by this committee will materially determine whether our nation continues to be a leader in the world economy going into the 21st century, or whether it sinks back to secondary status.

The global competitive environment is changing rapidly. More and more nations are restructuring their financial systems to make them more efficient and competitive internationally. But the significance of the moves thus far is dwarfed by the momentous changes that will result from the "1992 project" in Europe. Financial services firms in the U.S. are justifiably concerned about the impact of the 1992 project on their own international competitiveness. But the stakes are much greater than that for the U.S. as a whole. The European Community is eliminating virtually all internal barriers that have limited competition and reduced economies of scale and scope in a broad range of industries. The financial services component of this effort is extensive. The goal is not just a more competitive financial services market, it is a more competitive Europe.

As the 21st century gets underway, organizations and strategic alliances which have at their core a commercial bank, a fully integrated investment bank/securities operation, and an insurance company can be expected to dominate global financial markets.

<u>The U.S. Is Lagging.</u>

While much of the developed world is busy laying the foundation for a financial system for the next century, the U.S. financial system remains anchored firmly in the past. Less than half the states will have full interstate banking by 1992. As for the activities and affiliations of depository institutions, the Bank Holding Company Act and the Glass-Steagall Act can only be characterized as protectionist -- if not in intent, at least in their consequences. These laws compartmentalize financial services in ways that are becoming increasingly anachronistic. They are a source of risk and inefficiency in the system.

Limitations on the nonbanking activities of bank holding companies and the clumsy "firewall" structure raise the cost of financial services to customers and make it difficult for financial services organizations to be responsive to their needs. In addition, they reduce the industry's ability to attract management and capital, and they inhibit the development of the type of innovative products, risk management techniques and distribution strategies that are now being developed by major financial services providers overseas.

<u>What Needs to be Done.</u>

In today's world, it is simply not possible for U.S. financial services organizations and U.S. financial markets to be more onerously regulated than in other financial centers and still be competitive. Unless the Congress can fashion a world-class legal framework for financial services, U.S. financial services providers will become increasingly less effective.

The "Depository Institution Affiliation Act" combined with the repeal of laws intefering with interstate operations would be a step in the right direction. This legislation would permit any business to own a depository institution as a separately capitalized subsidiary of a holding company, regardless of its other business activities. It also contains new safeguards to protect the deposit insurance funds.

In essence, we need a framework that: (a) permits firms intermediating global capital markets on behalf of their customers to do so efficiently, whether they are commercial or investment banks; (b) allows the integration of the traditional banking and savings and loan industries; (c) allows the integration of insurance and banking with appropriate industry safeguards; and (d) erases geographic barriers within the United States.

<u>Deposit insurance Reform.</u>

The FSLIC crisis is an appalling example of the weaknesses in the deposit insurance system. Congress and the Bush Administration deserve credit for working to restore discipline to the S&L industry by strengthening capital requirements. Nonetheless, these reforms do not go far enough.

The fundamental problem is that the protection provided by the deposit insurance system now extends far beyond what was originally intended. Safeguards designed to protect small savers are being applied to financially sophisticated professionals. This has had a corrupting influence on the entire financial system -- directly because it does not reward prudence and sound judgment, and indirectly because it forms the justification for burdensome government policies that reduce the efficiency of the financial system.

In my judgment, this situation will only change when deposit insurance coverage is limited to $100,000, de facto as well as de jure. Better still, coverage should be rolled back.

Federal regulators have the tools to expose large depositors and other creditors to losses when a failure occurs, while preserving the liquidity of deposit accounts. They can safely apply those tools to banks and S&Ls of all sizes. No bank is too big to be reorganized.

LDC Debt.

The current LDC debt situation has to be seen in the proper perspective. We have made some progress in the past few years. There is a widespread notion that the banks and the LDCs are adversaries. This notion is false. We have a common interest in the economic viability of the LDCs. Citicorp has been in Latin America for nearly 100 years. We plan to stay there and to grow with these nations.

Right now, negotiations with Mexico are at an extremely sensitive stage. Once an agreement with Mexico is completed, we will than be in a better position to assess the Brady Plan and its prospects for dealing with other debtor nations.

The LDC debt problem is not a problem that is well-suited for a legislative solution. The situation in each of the debtor nations is different and must be approached on a case-by-case basis. Moreover, U.S. banks hold less than 30 percent of the debt. Nothing is gained by applying pressure only to U.S. participants.