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TESTIMONY OF

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Before the

COMMITTEE ON BANKING AND FINANCIAL SERVICES

of the

U.S. HOUSE OF REPRESENTATIVES

May 22, 1997

Statement required by 12 U.S.C. § 250:

The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

Mr. Chairman and members of the Committee, you have invited me here today to discuss modernization of the nation's banking laws, particularly those governing permissible bank activities and the corporate structure they may use in conducting them. I thank you for the opportunity to share with you my thoughts on this important topic. Specifically, you asked me to comment on three bills, H.R. 10, H.R. 268, and H.R. 669, all of which strive to adapt our nation's regulatory and supervisory structure to the realities of today's financial markets.

I commend you, Mr. Chairman, and the Committee, for your thoughtful work to foster dialogue on legislation to reform the Nation's banking laws. If the banking system is to remain strong, it is critical that bank regulators continue to use their authority under existing law to ensure that our regulation and supervision keeps pace with the changing marketplace. Nevertheless, regulatory changes are not a substitute for legislation to modernize the financial system.

In my testimony, I will first describe briefly the market changes currently affecting the financial services industry, discuss why those changes require action to modernize the legal and regulatory regime within which the industry operates, and review the principles I believe should guide financial modernization efforts. The essence of these principles is that true financial modernization will require providing financial services firms maximum flexibility in organizational structure and financial activities, consistent with safety and soundness and fair access to credit.

Next, I will comment on the three financial modernization bills the Committee is currently considering. All of these bills move the debate forward in that they would repeal the antiquated Glass-Steagall restrictions on affiliations between banks and securities firms for certain well-capitalized banks and permit banks to affiliate with companies engaged in a broader range of financial activities than is permissible under current law. However, I do have concerns about provisions of the bills that would unnecessarily limit organizational flexibility and, hence, banks' ability to choose the most efficient form for their operations. I am also concerned about certain provisions of the bills that would force some activities that banks now conduct safely and profitably outside the bank. Such restrictions on where banks could conduct activities and on what financial activities they could conduct would impair safety and soundness because they would limit a bank's ability to diversify and encourage the bank to take on greater risks to maintain earnings. They would adversely affect the goals of the Community Reinvestment Act (CRA) because they would push assets and earnings out of the bank into affiliates not subject to the Act.

The restrictions would limit a bank's ability to respond to changes in the marketplace and impose unnecessary costs that would hinder banks' ability to compete. As a result, these unnecessary restraints would harm consumers by limiting the benefits of improved services and greater innovation that result from increased competition. Ultimately, either the assets and income stream of the institution would diminish, or it would seek riskier lines of business

in order to attract capital and survive. Either way, these provisions would result in destabilized hollow banks that are less safe and sound and less able to meet the broad financial needs of their customers and serve our communities.

Finally, I will discuss the issues you raised in your letter of invitation: Firewalls and Safeguards, Commerce and Banking, Holding Company Regulation, and Thrift Charter Conversion.

The Changing Competitive Environment

The banking industry of the 21st century is being shaped by an unprecedented combination of pressures. Today's information-driven economy is decreasing banks' traditional, core, competitive advantage. The information needed to make prudent and profitable loans is now more easily available, and less costly to access, than ever before. As technological changes impact the production, packaging, and delivery of financial services, banks face competition not only from finance companies, mortgage bankers, and investment houses, but also from non-traditional competitors, such as telecommunications companies and software development firms. Moreover, banks' traditional, core customers--commercial and industrial firms--are increasingly bypassing insured depositories and accessing the capital markets directly.

Driven by technological change, economic globalization also has made financial services markets increasingly competitive. A 1994 Office of the Comptroller of the Currency (OCC) study of foreign banks operating in the United States reported that foreign banks' share of the U.S. commercial and industrial loan market grew from 16 percent in 1983 to 39 percent in 1993.[1]

In addition, the mix of products and services that consumers want and need has changed and will continue to change with increasing consumer sophistication and changing demographics. The aging baby boomer population understands it has a variety of investment options and opportunities for its retirement savings. Correspondingly, there has been a migration of savings from insured deposits to mutual funds that offer an array of investment and risk/reward profiles. Last year, for the first time in the history of the United States, assets held in mutual funds exceeded assets held in insured deposits. Furthermore, the percentage of household financial assets invested in bank deposits decreased from 36 percent in 1975 to 18 percent in 1995.

Finally, the different types of financial products have tended to converge and different providers increasingly offer a similar array of products and services. There is no longer a sharp distinction between a syndicated loan and privately placed financial paper, between an

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[1] Nolle, Daniel E. "Are Foreign Banks Out-Competing U.S. Banks in the U.S. Market?" Economics and Policy Analysis Working Paper 94-5, May 1994.

interest-bearing NOW account and a money market mutual fund, or between a mutual fund and a variable annuity. Banks and thrifts are increasingly similar in their product mix. Banks sell mutual funds and other securities and underwrite a limited range of securities. Securities firms make and syndicate commercial loans and offer money market accounts with checking privileges. And, just a few weeks ago, several insurance companies announced that they are contemplating opening thrifts. In short, technological and financial innovation, together with market pressures to offer consumers a wider array of services, have eroded the traditional segmentation of the financial marketplace.

The Case for Financial Modernization

Changes in the financial marketplace, while more dramatic in recent years, are not a new phenomenon. Nonetheless, for sixty years our laws have remained frozen in the face of a dynamic market that is now driven by technological change. We need a broad reconsideration of the legal framework in order to promote a robust competitive marketplace, while maintaining safety and soundness, fair access to financial services, and vital consumer protections.

It is crucial that the plan Congress adopts for financial modernization be thoughtfully conceived. We should keep in mind that any agreements this Congress makes to reshape the landscape of the financial services industry could be as durable as the Glass-Steagall Act. Therefore, in creating a new paradigm for the financial services industry, Congress must allow for the change in the financial markets that is occurring at an increasingly rapid pace. We will not achieve the gains we desire unless legislation moves beyond shuffling the boxes into which we attempt to carve up various parts of the financial services industry. We must recognize that the marketplace will reject these artificial distinctions and that American consumers and the American economy are better served by providing financial service firms with sufficient flexibility in structure and activities to change with the evolving economy.

Principles for Financial Modernization

When I testified before the Financial Institutions and Consumer Credit and the Capital Market, Securities, and Government Sponsored Enterprises Subcommittees earlier this year, I outlined five principles that, in the context of this rapidly changing environment, should guide financial modernization efforts. In my view, modernization that does not adhere to the following five principles will do more harm than good.

Maintaining Safety and Soundness. First and foremost, financial modernization must ensure the safety and soundness of the banking system. Providing banks the ability to maintain strong earnings through prudently conducted financial activities is the essence of safety and soundness. At the same time, no safeguards can succeed without expert, on-site supervision.

Access to Financial Services and Consumer Protection. The second principle for financial modernization is that reform should promote broader access to financial services for all consumers. It is incumbent on us, as we pursue the modernization of our financial services industry, to guard against the possibility that the "haves" of our society will benefit, while the "have nots" are left farther behind.

Promoting Competition. The third principle is that financial modernization should promote competition and increase efficiency within the financial services industry as a whole-- including banks, securities firms, and insurance companies alike. This increased competition should benefit consumers and businesses through lower costs, increased access, improved services and greater innovation.

Role of Community Banks. The fourth principle is that financial modernization must not impose unnecessary structural requirements or activities limitations that would effectively preclude community banks and the customers they serve from reaping the benefits of modernization. Community banks are critical to meeting the needs of small businesses and farms and the Nation's small, rural communities.

Flexible Corporate Structure. The fifth principle is that financial modernization must ensure that financial services providers have the flexibility to choose, consistent with safety and soundness, the organizational form that best suits their business plans. This principle is essential because it is necessary for the full attainment of the other four principles.

Taken together, these principles support a legal and regulatory regime that provides financial services firms with broad flexibility, consistent with safety and soundness, fair access, and consumer protection, to conduct a full array of financial activities and to structure their businesses in the manner that best serves their business needs.

Comments on H.R. 10, H.R. 268, and H.R. 669

While I do have concerns about specific provisions in each of the bills that you have asked me to discuss, I commend their sponsors for advancing the debate on financial services modernization and for recognizing the need to enact legislation that would allow banks to become more competitive and meet the public's evolving financial services needs. All of the bills would repeal the antiquated Glass-Steagall restrictions on affiliations with securities firms for certain well-capitalized banks and would permit banks to affiliate with companies engaged in a broader range of financial activities than are permissible under current law.

My principal concern is that, to varying degrees, each bill would unnecessarily limit bank organizational choice and unnecessarily restrict the ability of banks to engage in activities they now conduct safely. There is no safety and soundness reason to limit banks' ability to use the operating subsidiary structure to house new activities or to force banks to move activities that they are now engaging in safely outside the bank.

My discussion of the bills before the Committee focusses on the two critical issues that this reform effort must address: what corporate structure is appropriate for the conduct of new activities and what activities are permissible for banks to conduct.

Corporate Structure

Business firms should be allowed to choose the organizational form that best serves their business needs, absent compelling public policy reasons--such as safety and soundness. Today, banking companies have two basic options for conducting expanded activities that may not be conducted in the bank--the holding company affiliate approach and the bank subsidiary approach. As I will discuss, there is no basis to limit bank choice to the holding company model.

The subsidiary structure offers important operational advantages and attendant public policy benefits. For example, use of bank operating subsidiaries allows banking organizations to focus their capital and earnings strength on their banks, or a lead bank, rather than removing capital and channeling earnings to non-bank affiliates. Use of operating subsidiaries also allows the benefits of activities diversification to flow to the bank and strengthen it. For community banks, use of operating subsidiaries can be simpler and less costly than relying on the holding company structure to provide new products and services.

The structure allowed for new bank activities also has important implications for the application of the Community Reinvestment Act. The CRA only applies to insured depository institutions. It does not apply to holding companies or to nonbank subsidiaries of a holding company. This is an important distinction because earnings from a bank subsidiary can flow up to the bank, thereby increasing the ability of a bank to undertake CRA activities. Moreover, when regulators assess the capacity of the bank to serve its community, they consider the bank's total assets, which, under generally accepted accounting principles, include the assets of the bank subsidiaries. By contrast, earnings of a holding company subsidiary flow to the parent holding company, not the bank, and are not available to support directly the bank's CRA activities. Also, regulators do not consider the assets of the holding company affiliate when assessing the bank's capacity to serve its community.

Therefore, if growth and new lines of business in banking organizations are forced to occur outside of the bank, there will be a growing base of activities and earnings that will not be subject to CRA requirements. This is more than a theoretical argument. The increased attention the OCC has given CRA in recent years has had concrete results, providing new opportunities for many to participate in the American dream of home ownership: home mortgage loans to low- to moderate-income census tracts increased 22 percent from 1993 to 1995, more than twice the 10 percent increase across all census tracts.[2] Reducing the base of

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[2] Source: Home Mortgage Disclosure Act (HMDA) data.

resources banks have available to

invest in their communities will deny real people the opportunity to share in this dream in years to come.

Bank subsidiaries as a structural option are not new. They have been used in the United States and abroad for many decades. As shown in Table 1 below, U.S. banks have, for many years, successfully engaged in a variety of financial services abroad directly in their branches and in bank subsidiaries. Under longstanding authority of the Federal Reserve Act and other banking laws and regulations, bank subsidiaries can and do conduct a variety of activities overseas, such as equity underwriting, leasing, insurance activities, dealing and investing in corporate debt securities, and making certain limited investments in other types of enterprises. Less than a year ago, Congress increased the amount that U.S. banks were permitted to invest in foreign subsidiaries that conduct these activities.[3] And, not only have bank subsidiaries proven to be a safe and sound way for banks to conduct these new activities, but also notably, overseas subsidiaries have outperformed the domestic operations of their companies in each year from 1990 through 1995.

In addition, as shown in Table 2 below, banks in most G-10 countries,[4] with the notable exceptions of the United States and Japan, have long engaged in a broad range of financial services activities, including underwriting and brokering securities and insurance, directly in the bank or in subsidiaries of the bank.[5] This broader range of activities has not impaired bank safety and soundness. On the contrary, foreign bank supervisors have told me that income from non-traditional activities has been a key support for the safety and soundness of certain banks during periods of financial stress.

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[3] Section 2307 of the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (enacted on September 30, 1996) increased from 10 to 20 percent of capital the maximum amount that a national bank can invest in an Edge Act or Agreement Corporation, provided the Federal Reserve determines that the additional investment would not be unsafe or unsound. This provision is codified at 12 U.S.C. 618.

[4] The G-10, or Group of Ten, includes the governments of nine countries and the central banks of two others for a total of 11 members. The members are the governments of Belgium, Canada, France, Italy, Japan, the Netherlands, Switzerland, the United Kingdom, the United States, and the central banks of Germany and Sweden.

[5] Because of the organizational flexibility that other countries give their financial services companies, forcing U.S. banks into a holding company structure is particularly problematic as the financial services marketplace is increasingly globalized. The holding company approach may disadvantage U.S. banks as they compete with many foreign banks, which enjoy the cost advantages of being able to structure their activities in whatever manner they find most efficient.

Table 1
Subsidiaries of U.S. Banks Operating Abroad

Selected Activities	# of Subsidiaries	Total Assets ($ million)	Net Income ($ million)
Insurance Agency & Brokerage	7	1,341	70
Insurance Underwriting	11	2,728	92
Securities Underwriting & Brokerage	75	94,222	353
Investment & Merchant Banking	55	76,176	362
ALL ACTIVITIES	1,236	405,408	5,588

(Source: Report of Condition for Foreign Subsidiaries of U.S. Banking Organizations, FR2314
Data as of December 31, 1995 for subsidiaries with total assets above $1 million)

Insurance activities include:

- Selling all forms of insurance as agent
- Underwriting life, annuity and pension-fund related insurance

Securities activities include:

- Underwriting and dealing in debt securities
- Underwriting and dealing in equity securities (subject to volume limits)
- Underwriting foreign government securities (subject to capital limits)
- Sponsoring mutual funds

Profits and Assets

- These subsidiaries earned a profit in every year between 1990 and 1995, and, on average, had higher returns than the U.S. banks themselves.
- In 1995 total assets in these activities accounted for 17 percent of the consolidated assets of the respective holding companies.

Table 2
International Comparison:
Corporate Form in Which Bank Activities are Most Often Conducted

Country	Securities Activities	Insurance Activities	Real Estate Activities
SOMEWHAT RESTRICTED BANK POWERS			
Italy	Bank	Bank sub[1]	Bank sub
Sweden	Bank	Bank sub	Prohibited
Canada	Bank sub	Bank sub	Bank sub
Greece	Bank sub	Bank sub	Bank sub
WIDE BANK POWERS			
Finland	Bank	Bank sub	Bank sub
Germany	Bank	Bank sub	Bank sub
Luxembourg	Bank	Bank sub	Bank sub
Portugal	Bank/Bank sub	Bank/Bank sub	Bank sub
Spain	Bank/Bank sub	Bank sub	Bank sub
VERY WIDE BANK POWERS			
Austria	Bank	BHC sub	Bank
Switzerland	Bank	Bank sub	Bank sub
United Kingdom	Bank/Bank sub /BHC sub	Bank sub[2]	Bank/Bank sub /BHC sub
Netherlands	Bank	BHC sub	Bank sub /BHC sub

SOURCE: OCC using information provided by bank supervisory authorities in the respective countries.

ACTIVITIES: Securities includes underwriting, dealing and brokering all kinds of securities and all aspects of the mutual fund business. Insurance includes underwriting and selling insurance products/services as principal and as agent. Real estate includes investment, development and management.

NOTES: (1) Insurance activities must be conducted by insurance companies. Banks usually act as an agent of insurance companies.
(2) With the exception of selling insurance as an agent, which is commonly conducted directly in the bank.

Here in the U. S., use of operating subsidiaries to conduct a broad range of activities is also not new. Many, if not most, States already authorize their banks to engage in a variety of activities not permissible for national banks, either directly or through a bank subsidiary. It is most interesting to note in this regard that the Conference of State Bank Supervisors (CSBS) has testified that requiring new activities to be performed in bank holding company subsidiaries would "strike at the heart of the dual banking system."[6] The CSBS has explained that such a requirement would inhibit the State's ability to authorize new powers and products in the most cost-effective ways, which is often in bank subsidiaries.

Based on the experience of State banks with operating subsidiaries, current and former Federal Deposit Insurance Corporation (FDIC) Chairmen alike have agreed that, from a safety and soundness perspective, allowing banks to conduct new activities in an operating subsidiary is at least as safe and sound as allowing banking companies to conduct these activities in an affiliate. Chairman Helfer noted in recent testimony that the FDIC's experience with the activities of bona fide securities subsidiaries of insured nonmember banks has not raised safety and soundness concerns.[7] Likewise, former FDIC Chairman L. William Seidman testified before Congress, "if banks are adequately insulated...then from a safety and soundness viewpoint it is irrelevant whether nonbanking activities are conducted through affiliates or subsidiaries of banks."[8] In discussing the bank subsidiary option, William M. Isaac, also former Chairman of the FDIC, stated that, "[c]ertainly there's no more risk than would be present if the activities were conducted in a holding company affiliate."[9] In discussing the advantages of the bank subsidiary approach, Chairman Helfer stated in recent testimony that "[w]ith appropriate safeguards, having earnings from new activities in bank subsidiaries lowers the probability of failure and thus provides greater protection for the insurance fund than having the earnings from new activities in bank holding company affiliates. The reason for this is that diversification often leads to less volatile earnings. ... Thus, on average, allowing a bank to put new activities in a bank subsidiary lowers the probability of failure and provides greater protection to the insurance

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[6] Testimony of James Hansen, Chairman, Conference of State Bank Supervisors, at hearings on H.R. 1062, The Financial Services Competitiveness Act of 1995, Glass-Steagall Reform, and Related Issues (Revised H.R. 18)--Part 4, before the Committee on Banking and Financial Services. U.S. House of Representatives, April 1995.

[7] See testimony of Ricki Helfer, Chairman, FDIC, on financial modernization before the Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises, Committee on Banking and Financial Services, U.S. House of Representatives, March 5, 1997.

[8] Hearings before the Senate Committee on Banking, Housing, and Urban Affairs, December 3, 1987.

[9] American Banker , December 19, 1996.

funds. For the FDIC as deposit insurer, this is an extremely important benefit of the bank subsidiary structure."[10]

In light of this extensive experience with operating subsidiaries and because we believe that flexibility in corporate structure does not raise safety and soundness concerns and will benefit consumers and underserved communities, the OCC recently amended its rules at 12 C.F.R. Part 5 to put in place a process for national banks to seek approval to engage in activities that are part of or incidental to the business of banking but that are different from those the bank may engage in directly. I believe it is critical that any financial modernization legislation retain the operating subsidiary option contained in Part 5.

Despite the sound history, some observers have criticized the operating subsidiary option. They have expressed the concern that banks benefit from a safety net subsidy that allows them to borrow at lower rates than competitors. Those with this point of view insist that this alleged subsidy should not be allowed to spread to new activities conducted within the banking organization. They argue that the supposed subsidy can be transmitted to an operating subsidiary, but not to a bank holding company affiliate. Thus, government should prescribe organizational form, imposing costs on banks and consumers in order to maintain the integrity of access to the federal safety net.

The attached paper responds to these concerns in detail. To summarize, there simply is no evidence of a net subsidy. Any benefit to banks that may have existed from access to the safety net has declined in value over the past decade. The value of any benefit is offset by capital requirements, forgone interest on sterile reserves, examination fees, risk-based deposit insurance premiums, and other costs of regulation.[11] Even using conservative assumptions with respect to cost estimates, the estimated net "subsidy" received by banks is negative. Evidence cited as proof of a subsidy is readily attributed to other factors. Most important, banks do not behave as if they enjoy a subsidy.

In light of the operational and public policy benefits that can ensue when banks are given the ability to choose the organizational form that best suits their needs, the OCC has substantial concerns about provisions in H.R. 10, H.R. 268, and H.R. 669 that would restrict organizational flexibility. H.R. 268, particularly, fails to offer banks any room to choose how to structure their operations.

I am encouraged that H.R. 10 contains express provisions that incorporate the basic concept contained in the OCC's Part 5 rule that national bank operating subsidiaries may engage in activities that are different from those permitted for the parent bank, with specific

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[10] op. cit.

[11] Whalen, Gary, "The Competitive Implications of Safety Net-Related Subsidies," Economics Working Paper 97-7, April 1997.

safeguards in place. However, H.R. 10 would impose practical restrictions that would greatly reduce banks' ability to use the operating subsidiaries option. And those restrictions are not necessary to ensure safety and soundness. For example, under H.R. 10, special operating subsidiaries may not engage in all of the activities that would be permissible for a securities affiliate of a financial services holding company. There is no prudential reason to treat a special operating subsidiary any different from a securities affiliate.

The provisions in H.R. 10 and H.R. 669, to the extent that they authorize banks to conduct activities in operating subsidiaries, are more likely than H.R. 268 to advance safety and soundness by allowing prudent diversification and to enhance industry resources available to support CRA. The provisions in H.R. 268 that would force new securities activities to be conducted only in a subsidiary of a holding company would limit the bank's ability to diversify and shift resources to entities that are not directly subject to CRA requirements.

H.R. 268 and H.R. 669 would also impose unnecessary costs by forcing banks seeking to conduct new activities as provided by the bills to form a financial services holding company, which could make it too expensive for smaller banks to offer the broader range of products their customers desire. The restrictions contained in these bills and, to a lesser extent in H.R. 10, are not only unnecessary, but, as I mentioned before, they can lead to a less safe, less sound banking system. Forcing activities into a holding company affiliate will lead banks either to shrink or to take on greater risks to maintain earnings, and the result will be destabilized hollow banks. Markets for banking services will be less competitive, and fewer resources will be available to banks to meet community needs. Bank customers will face higher fees, reduced services, and fewer choices. The many sectors of the economy that depend on community banks will be denied the benefits of modernization. And, in a world in which financial institutions compete globally, and money can move rapidly, cost disadvantages due to excessive regulation may cause financial activities to move off-shore, weakening U.S. financial services institutions.

Permissible Activities

There is considerable evidence both internationally and within the U.S. to suggest that an appropriate expansion of permissible activities can provide benefits to consumers and increase the efficiency of the banking system.[12] Banks gain from the ability to diversify their

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[12] Evidence suggests that Section 20 affiliates increase average returns, lower costs and reduce risk for their bank holding companies. See Elijah Brewer, "Relationship Between Bank Holding Company Risk and Nonbank Activity," *Journal of Economics and Business*, Vol. 41 (November), pp. 337-353; Myron Kwast, "The Impact of Underwriting and Dealing on Bank Return and Risks," *Journal of Banking and Finance*, Vol. 13, pp.101-125; Vincent P. Apilado, John G. Gallo, and Larry J. Lockwood, "Expanded Securities Underwriting: Implications for Bank Risk and Return," *Journal of Economics and Business*, Vol. 45, pp. 143-158; Simon H. Kwan, "Securities Activities by Commercial Banking Firms' Section 20 Subsidiaries," Federal Reserve Bank of

sources of income and thereby reduce risk. In that context, misguided attempts to shield banks from the downside of what are incorrectly labeled as riskier activities will prevent the industry from taking advantage of the upside of a broader and more diversified range of activities.

The simple fact is that regulations peculiar to banking, in conjunction with changes in technology that have eroded banks' informational advantage in corporate lending, have greatly reduced the profitability of what was once banks' bread-and-butter lending activity. Banks have shown considerable ingenuity in finding new and profitable activities to replace those in decline, in particular by expanding the range of guarantees, derivatives, and other off-balance-sheet activities that they offer. However, ingenuity is no substitute for legislation that would allow banks greater freedom to diversify by engaging in a full line of financial activities, a freedom that their counterparts in many other countries have long enjoyed.

As I have noted, it is also apparent that consumers of financial services can benefit from expanding bank activities. Consumers will benefit directly in that they will be able to obtain a greater variety of services from a single source. Nonbank financial service providers have been offering an ever wider range of services because consumers can benefit in terms of lower cost and greater convenience. Consumers will also benefit from the lower costs to banks and increased competition in the financial services industry.

Allowing banks to enter the insurance market, in particular, holds the promise of improved service, lower prices, and greater convenience for consumers. Recent studies of efficiency in both the banking and the insurance industry have shown that both industries harbor widespread inefficiency, as measured by the unit costs of most firms in each industry relative to those of firms adhering to the best practices.[13]

Given the need for banks to diversify further, it is especially distressing, therefore, that H.R. 10, H.R. 268, and H.R. 669 contain activities restrictions that would prohibit banks from directly engaging in new activities, as well as certain activities that they now conduct and have conducted safely. In so doing, those restrictions would decrease the opportunities for

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San Francisco, Working Paper, Janurary 1997.

[13] Andrew M. Yuengert, "The Measurement of Efficiency in Life Insurance: Estimates of a Mixed Normal-Gamma Error Model," *Journal of Banking and Finance*, vol. 17 (April 1993), pp. 483-96, found that the typical firm in the life insurance industry had costs 35-50 percent higher than the best-practice firms. Lisa A. Gardner and Martin F. Grace, "X-Efficiency in the US Life Insurance Industry," *Journal of Banking and Finance*, vol. 17 (April 1993), pp. 497-510, reported a mean efficiency estimate of 17 percent for their sample of 561 life insurance companies; truncating the distribution to reduce the effect of luck and observation error raised this only to 42 percent. Similarly, Allen N. Berger and Loretta J. Mester, "Inside the Black Box: What Explains Differences in the Efficiencies of Financial Institutions," forthcoming, *Journal of Banking and Finance*, Vol. 21, 1997, found that "13.2 percent of costs are wasted on average relative to a best-practice firm."

banks and their customers to benefit from diversification without any offsetting safety and soundness gain. For example, H.R. 10 and H.R. 268 (under some circumstances) would make it more expensive for banks to conduct their existing brokerage activities by subjecting banks to increased regulatory burden, including Securities and Exchange Commission (SEC) net capital rules. H.R. 669 would completely prohibit banks affiliated with a financial services holding company from engaging in securities brokerage. In addition, H.R. 10 and H.R. 268 would bar banks associated with a securities affiliate from underwriting asset-backed securities and from dealing in or underwriting any securities other than bank eligibles. Under H.R. 268, subsidiaries of banks are subject to the same activities restrictions. H.R. 10 would repeal the exemption in the securities laws for banks that act as investment advisers to mutual funds and H.R. 268 would repeal that exemption for banks that are affiliated with financial services holding companies. Also, H.R. 669 would prohibit banks controlled by financial services holding companies from continuing to underwrite or deal in some securities that are permissible under current law. Banks have historically engaged in all these activities, and they have not posed safety and soundness concerns.

In addition, the OCC has significant concerns with the limitations that H.R. 10 would impose on national banks' insurance activities. In effect, H.R. 10 would roll back preemption standards that have been clearly established by the courts. By limiting the test applied to State regulation of a national bank's insurance agency activities to whether State regulation "prevents or significantly interferes" with the national bank's exercise of its powers, H.R. 10 would supersede the traditional preemption test reaffirmed by the Supreme Court in Barnett Bank v. Nelson. The Court in the Barnett decision recognized that there may be other bases on which to determine that State law is preempted by Federal law and that the test is not limited to prevention or significant interference. H.R. 10 would also prohibit national banks from providing any new products either as agent or principal that are regulated as "insurance" by State authorities after January 1, 1996. If Congress wants the Barnett standard to apply to the OCC, no legislation on this issue is necessary, since Barnett is currently the law of the land. Any attempt to codify it will, by necessity, result in changing the standard.

I will now turn to a discussion of the specific issues, Mr. Chairman, that you requested we address in your letter of invitation.

Firewalls and Safeguards

Mr. Chairman, in your letter of invitation you asked that I comment on firewalls and safeguards, and particularly those contained in H.R. 10. The firewalls in H.R. 10 that apply to banks and securities affiliates generally follow the firewalls the Federal Reserve now applies to Section 20 affiliates. Under H.R. 10, the Federal Reserve would have broad authority to modify the firewalls or impose additional restrictions on transactions among depository institutions, their affiliates and their customers.

H.R. 10 would apply the firewalls, together with the Federal Reserve's regulatory

authority, to a national bank and its special operating subsidiary if the subsidiary is engaged in the securities activities permissible for a securities affiliate. It would also give the Comptroller the authority to modify or impose additional requirements with respect to certain corporate separateness requirements.

While I believe that it is necessary to impose adequate safeguards so as to ensure that banks' financial soundness is protected and special operating subsidiaries operate as independent legal and corporate entities, I do not support creating a separate regulatory scheme for special operating subsidiaries that would vest another Federal agency, in addition to the OCC, with overlapping regulatory authority to set and modify firewalls. This would be confusing and would not achieve any safety and soundness purpose. For national banks to be able to take full advantage of the special operating subsidiary option, their operations must not be burdened with additional regulatory requirements that serve no purpose and may artificially limit the subsidiary's activities or make it unfeasible for the subsidiary to conduct the activity.

I feel strongly that it is the responsibility of the OCC, as the bank's primary supervisor, to establish the appropriate safeguards that apply to transactions between the bank and its subsidiary. The OCC has the regulatory authority to approve the establishment of the special operating subsidiary, the responsibility to examine the bank and the subsidiary, and enforcement authority.

The OCC has established a set of minimum firewalls that apply under Part 5 to special operating subsidiaries that are engaging in activities that are different from those in which the bank may engage directly. These firewalls are illustrative of the strong, hard-wired firewalls that must be applied to ensure that these activities are conducted in the subsidiary in a safe and sound manner. Under Part 5, the firewalls apply if a national bank subsidiary is engaged in any activities that are different from those permitted for the parent bank, not just if it is engaged in securities activities that are not permissible for the bank.

If the subsidiary engages in activities as principal that are different from the permissible activities for the bank, additional firewalls apply. The bank must reduce capital and total assets by an amount equal to the bank's equity investment in the subsidiary, and may not consolidate the subsidiary's assets and liabilities with its own in determining its capital ratio. The bank must be well capitalized before and after commencing the activity. Also, the bank must have a CAMEL rating of 1 or 2. In addition, the bank cannot be subject to an administrative enforcement action unless the OCC grants an exception. In addition, the OCC will apply the standards of §§ 23A and 23B of the Federal Reserve Act to the transactions between the bank and the subsidiary.

The OCC will impose those basic firewalls if a national bank subsidiary engages in activities that are different from those that are permissible for the parent bank. The OCC also has the authority to condition its approval on compliance with further safeguards that may be

appropriate for a particular activity and a particular bank engaging in that activity to ensure that the bank and subsidiary operate in a safe and sound manner, and risks are adequately identified, managed, and controlled.

Commerce and Banking

In your letter of invitation, you also asked for my views on affiliations between banks and nonfinancial entities. This is a complex issue on which many people have strongly held views. My view is that the health of the financial system is much less dependent upon wide-ranging combinations between banks and commercial firms than on eliminating harmful and unnecessary impediments to affiliations among providers of financial services. Indeed, I do not favor the unfettered mixing of banking and commerce at this time. Interestingly, there does not seem to be a particularly strong market interest in affiliation between insured depositories and commercial firms. In fact, the unitary thrift holding company, which provides a means for mixing banking and commerce, has not been widely used by commercial firms to affiliate with insured depositories.

Having said that, I am concerned that we do not approach this issue in such a rigid manner that we prevent the natural evolution of the banking industry. We must recognize that the line separating banking from commerce has shifted over the past two centuries, and our views of what is a banking activity and what is a commercial activity will continue to change over time. The evolving nature of the business of banking is most evident in the technology area. In recent years, we have come to recognize that computer technology and information management are integral to the provision of financial services, even though at one time many felt they were clearly commercial activities.

Holding Company Regulation

Mr. Chairman, you also asked for my comments on another critical issue addressed in many modernization proposals, and one on which there is no emerging consensus--the mechanism for the supervision of banking companies with affiliates that engage in a wide range of activities. The bills the Committee is considering would increase the ability of banking companies to affiliate with other providers of financial services. This could have important practical implications for the regulation of financial products and services.

The prospect of wider affiliations among banks and other providers of financial services has generated much debate over the concepts of umbrella regulation versus functional regulation. In addressing this issue, it is important that we clarify the type of regulation that is appropriate for a modernized financial system. We need to define clearly what we mean by umbrella regulation.

One view of umbrella regulation envisions the role of an umbrella regulator primarily as ensuring adequate information exchange and coordination to enable regulators to assess the

consolidated operations of a financial institution. This could be accomplished most efficiently by allowing regulators with the necessary experience and expertise to have the responsibility for supervising particular activities.

A different approach to the umbrella regulator concept would involve centralized risk oversight. Supporters of this approach believe that it will render an important public policy benefit of improving safety and soundness supervision. However, I am concerned that such an approach could lead to a substantial concentration of regulatory power over all financial activities or lead to an increasingly redundant regulatory system--particularly with respect to the regulation of the insurance and securities activities of diversified financial services firms--without producing any additional safety and soundness benefits.

While I am keeping an open mind and plan to evaluate carefully any concrete proposal, my view at present is that our regulatory goals can best be accomplished through a system that ensures the proper exchange of information among regulatory agencies responsible for particular activities. I believe that we should be very cautious before moving toward a model of a single umbrella regulator with substantially expanded powers to supervise all large financial institutions.

One of the arguments frequently advanced for a powerful umbrella regulator is that this kind of entity is necessary to respond to a systemic financial crisis. I agree that our regulatory structure must effectively protect against and respond to systemic problems. I am not certain, however, that an additional overarching layer of regulation will help achieve this goal. The four bank and thrift regulatory agencies, the SEC, and the Treasury Department, all have played important roles in dealing with systemic issues in the past and all are keenly aware of their responsibilities to protect against systemic problems in the future. I believe our system of multiple financial regulators provides checks and balances necessary to have the broad perspective that responses to systemic threats require. We should be careful that, in any regulatory restructuring, we do not lose the important contribution that the current system provides.

In sum, I recognize that supervisors must remain vigilant in preserving safety and soundness, and that will be even more important as the range of activities banking companies conduct expands. As the financial services industry continues to change, we must have an approach that allows appropriate regulatory oversight of the consolidated operations of complex financial institutions. At the same time, we need to guard against unproductive overlaps in regulatory authority and/or excessive concentrations of regulatory authority over the entire financial industry. Before adopting any approach, we must ascertain whether the costs and burdens it would add would be offset by clear benefits.

Thrift Charter Conversion

The final issue you raised in your letter of invitation--merging the bank and thrift charters--also raises policy issues that require thorough consideration. Reconciling the differences between bank and thrift powers is one important issue. For example, thrifts have broader powers than banks in areas such as insurance and real estate development. Unitary thrift holding companies are subject to different standards than bank holding companies. And national banks are not currently authorized to be organized in mutual form. In addressing these differences, both H.R. 10 and H.R. 268 contain similar thrift charter conversion provisions.

I have several general observations that I would ask Congress to consider before it moves to combine the bank and thrift charters. As I have emphasized repeatedly in my testimony, safety and soundness must be a primary consideration in fashioning financial services modernization legislation. This principle equally applies to thrift charter conversions.

Forcing thrifts that convert to national banks to cease activities that they have conducted in a safe and sound manner would undercut the viability of the converting institutions and is not necessary for safety and soundness. Moreover, permanent grandfathering of these nonconforming thrift powers would institutionalize different classes of national banks, which would be anti-competitive.

To maintain a level playing field, I urge that national banks be permitted to engage in whatever activities that are permissible for Federal thrifts at the time of enactment. Meaningful financial services modernization must give banks the ability to offer a broad range of financial services, making them competitive with other providers.

Conclusions

While all three bills advance the debate on financial services modernization, I have concerns about the particular provisions of the bills that would unnecessarily restrict banks' ability to choose the corporate structure that best suits their individual needs and force them to move outside the bank activities that they already conduct safely within the bank. There is no safety and soundness reason for such provisions, and, if enacted, they would lead to a banking system that is made up of destabilized hollow banks that are less safe and sound and less efficient. Banks' ability to provide services to consumers, including those segments of the population that are generally underserved by non-banking providers, would be diminished. In addition, the bills would create a structural framework that would reverse the gains attributable to reform of the CRA regulation.

I am also concerned about applying the firewalls and safeguards contained in H.R. 10 to special operating subsidiaries. While I support the imposition of adequate safeguards to

protect banks' financial soundness and to ensure that special operating subsidiaries operate as separate legal and corporate entities, I cannot support creating a different regulatory scheme for special operating subsidiaries that would vest another Federal agency, in addition to the OCC, with overlapping regulatory authority to set and modify firewalls. If enacted, such a scheme would be inefficient and confusing, and it would not convey any safety and soundness benefit. It should be the purview of the OCC, as the bank's primary supervisor and the one that is closest to the bank, to establish the appropriate safeguards that apply to transactions between the bank and its subsidiary.

I look forward to working with you, Mr. Chairman, and other members of the Committee as we continue the debate on these critical issues.