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Comptroller Warns that Senate Proposal Would Compromise Safety and Soundness of National Banking System

WASHINGTON -- Comptroller of the Currency John D. Hawke, Jr. told a Senate panel today that a legislative proposal requiring banks to conduct new activities in holding company affiliates "would have a profound long-term detrimental effect on the safety and soundness of the banking system."

The measure, contained in a legislative draft being considered by the Senate Committee on Banking, Housing and Urban Affairs "would mandate a format that would inevitably weaken banks, by forcing them to use their resources to capitalize and fund holding company affiliates, rather than husbanding those resources in the bank," he said. It would rob banks of their long-term vitality by depriving them of opportunities to diversify their base of activities and revenue.

"And when a bank gets into trouble, it would deprive the FDIC of the ability to cushion its losses by selling off profitable subsidiaries," he added in testimony before the Senate committee.

Mr. Hawke said Congress should not require banks to conduct new activities through either a holding company affiliate or an operating subsidiary. Instead banks should be given freedom of choice between the two formats, subject to exactly the same strong safety and soundness protections for the bank, and to the same limits on the bank's ability to provide funding for new activities.

"The fact is that there is not a penny's worth of difference in the exposure of the bank to the risk in new financial activities when those activities are conducted in bank subsidiaries as compared to holding company affiliates under the safety and soundness protections we have endorsed," Mr.Hawke said. "On the contrary, a proposal that would limit the ability of banks of all sizes to elect to conduct new activities in bank

subsidiaries would have seriously adverse safety and soundness implications."

The Comptroller pointed out a number of anomalies inherent in legislation that would force new financial activities out of the bank and into holding companies. For example:

- State banks are free to conduct through subsidiaries any activities authorized by their states with the approval of the FDIC. A number of activities, including underwriting securities and annuities, have been approved and the Senate discussion draft would not subject state institutions to the activities limits that would be imposed on national banks.

- Any U.S. bank can conduct activities abroad through subsidiaries subject to approval by the Federal Reserve and the Fed has consistently permitted securities underwriting as a permissible activity with no apparent concern for safety and soundness threats. The discussion draft would not subject foreign subsidiaries of U.S. banks to activity limits that would be imposed on national banks.

- Foreign banks can engage in a broad range of activities in the U.S. through bank subsidiaries. In fact, a significant percentage of the bank securities affiliates approved by the Fed have been direct subsidiaries of foreign banks. The discussion draft would not subject foreign banks to the same limits on subsidiary activities that would be imposed on U.S. national banks.

"In light of these precedents there is no justification for singling out national banks for discriminatory treatment," Mr. Hawke said.

Mr. Hawke also took issue with the argument, advanced by the Federal Reserve, that direct bank subsidiaries would unfairly benefit from a "safety net" subsidy. There is sharp disagreement among experts about whether such a subsidy exists, Mr. Hawke noted.

"More importantly, the question demanding a comprehensible answer is what difference organizational format makes as to whether entities related to the bank can benefit from any subsidy -- particularly given the constraints that would apply," Mr. Hawke said.

The Comptroller noted that the same protective firewalls would apply to the bank subsidiary as to the holding company affiliate. A bank would be unable to invest any more in a subsidiary than it would be able to pay in dividends to the holding company. Any such equity investments would be deducted from a bank's regulatory capital for the purpose of determining compliance with capital standards. Thus, the effect on regulatory capital would be exactly the same as payment of a dividend. And if the subsidiary failed and the bank's investment were wiped out, the bank would still remain at the highest level of regulatory capital.

Moreover, he said, if a subsidy does exist, funds do not need to move at all within the company to spread the advantage, since the existence of a subsidy at any place in the structure benefits the consolidated organization. However, real world experience demonstrates that banking organizations do not behave as though a subsidy exists.

The Comptroller said the most compelling argument for permitting banks freedom of choice is the importance of bank subsidiaries for the safety and soundness of the banking system.

"Why would we want to deny larger national banks and community banks owned by holding companies -- in total, over 80 percent of all national banks -- the safety and soundness benefits of diversification?" he asked. "Why would we want to make FDIC resolutions potentially more costly?

"How the Committee resolves this issue will leave a legacy for the future of banks of all sizes and for the long-term safety and soundness of the banking system," he concluded.

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