

The Implications of Financial Modernization for Community  
Development

Remarks by Julie Williams  
Chief Counsel  
Office of the Comptroller of the Currency

Before the

Third National CDFI Institute  
Washington, DC

January 29, 1998

Freedom and opportunity are at the heart of a healthy, vibrant democratic system. In particular, economic opportunity -- the chance for all people to make the most of their lives, attain good jobs, live in decent homes and develop their own businesses -- is essential to the strength and long-term vitality of our society. But, unfortunately, economic opportunity has not always been available to all on equal terms, and when and where it has been thwarted, as in the case of many disadvantaged communities across the nation, special efforts are needed to nurture economic opportunity and growth so that these communities may thrive. This is a vital role performed by the community development financial institutions that you lead and represent here today.

I am pleased that the CDFI Institute recognizes the link between ongoing changes in the financial services industry and the growth of the CDFI sector. Your success, and the success of others striving to foster economic opportunity through various community development initiatives, may be substantially affected by federal legislation that seems quite distant from your immediate goals. However, the course of so-called "financial modernization legislation" can have a profound impact on the avenues and incentives available for private sector financial institutions to support community development and economic revitalization.

For starters, what exactly is "financial modernization"? Generally that term today is understood to mean eliminating the existing restrictions that prevent banks, securities firms and insurance companies from owning, or freely affiliating with, each other.

The potential benefits of financial modernization have been variously described as increased competition, lower prices, increased product innovation and increased consumer access and convenience. On the other hand, critics of financial modernization express concern that it will produce an unhealthy concentration of economic power in gigantic financial conglomerates, to the detriment of community development, small businesses and the farm sector.

For purposes of our discussion here today, however, there is

another, equally important perspective on financial modernization -- whether it will have a meaningful positive or negative effect on low and moderate-income communities and the poor.

What I will try to do here is frame several issues that, from the perspective of community development and economic revitalization, should be key considerations in constructing any new "modern" framework for financial institutions.

#### Role of Financial Institutions in Community Development

It is becoming increasingly clear that the marketplace is ignoring the artificial legal barriers that once separated the banking, securities and insurance industries. Banks, securities firms and insurance companies all perform many of the same financial functions, albeit sometimes in different ways. Is it important to pay particular attention to how "financial modernization" affects any one of these types of financial institutions? Should we care whether financial modernization enhances or undermines the relative role of banks in the financial services marketplace?

Banks are subject to standards -- some would say regulatory burdens -- that do not apply to other types of firms that perform the same types of financial activities as banks. For example, banks are comprehensively and frequently examined to assure their financial stability and their compliance with applicable laws. They are a safe place to store money. In fact, some have argued that the safety and soundness of them makes insured banks the preferred issuer of electronic money.

Banks are also subject to certain specific types of obligations, such as the consumer protection requirements under the Truth in Savings Act or the obligation to serve their entire community that arises under the Community Reinvestment Act. These obligations do not apply to other types of financial firms.

Banks shoulder these obligations, even though other financial services providers that are not subject to these obligations also enjoy significant public benefits. For example, "savings" accumulated in certain types of pension funds are guaranteed by the Pension Benefit Guaranty Corporation, and securities firms, like banks, have access to the Federal Reserve's "discount window."

Where banks and other financial firms are subject to the same standards -- e.g., Truth in Lending, Fair Housing and Equal Credit Opportunity -- other types of financial firms do not have assigned examiners that regularly check to make sure they are in compliance with these standards.

#### Impact of Financial Modernization on Community Development

Financial modernization could diminish or enhance the extent to which these bank characteristics are present in the financial

system. It can enhance the presence of these characteristics either by enabling banks to be robust players, or by causing other types of financial firms to assume the same characteristics of banks in these respects. It can diminish the presence of the characteristics, on the other hand, by limiting the business of banks and encouraging current and future functions of financial institutions to be performed in entities that do not have these characteristics.

In the current debate in Congress regarding financial modernization legislation, three factors are crucial to whether banks will emerge as robust financial service providers in the 21st century:

- 1) Whether banks and their subsidiaries are allowed to engage in a broader range of financial and financially-related activities to the same extent as subsidiaries of holding companies;
- 2) The extent to which "wholesale financial institutions" are authorized in the legislation and the extent to which they are subject to the same prudential regulation and other obligations, such as CRA, that apply generally to insured banks; and
- 3) The degree to which activities that are currently permissible for banks to conduct directly are required or encouraged to be "pushed out" of the bank.

#### Corporate Structure of a "Modern" Financial Firm

Let me turn first to the question of whether bank subsidiaries and bank holding company subsidiaries should both be able to engage in a broader range of financial activities. This may seem to many to be an esoteric legal question. Let me assure you it is not. There is currently a vigorous debate about the extent to which banks and bank subsidiaries should be allowed to conduct the same range of newly authorized activities as holding company affiliates. Embedded in this debate is the issue of how broadly the obligations and regulatory oversight now applicable to banks will be applicable in the future financial services industry. If financial modernization limits the new business of banks, while encouraging new business in companies that are simply affiliated with banks, then the reach of bank regulatory standards will be reduced, and indeed, the bank itself will become a less stable enterprise.

For example, the activities conducted in bank subsidiaries can increase the resources a bank has available to perform its obligations under CRA; activities conducted in bank affiliates do not. It is true that a banking organization, at its option, can elect to have specific activities conducted in its affiliates or subsidiaries to be counted for CRA credit. But it does not have to. From the organization's perspective, therefore, it is something like a "heads I win, tails you lose" proposition because bank regulators have no leverage over the performance of affiliates of a bank that are not subject to any

CRA obligations.

We must not lose sight of a fundamental point: CRA is only as strong as the institutions that are subject to it. Stronger institutions, with diversified sources of income and potential for growth are better positioned -- and have more resources available -- to help meet the financial services needs of their communities and support the economy as a whole, than are deflated institutions that have been deprived of new growth businesses.

In assessing the composition of the "modern" financial services industry, it is probably also important to pay attention to the way various financial services firms typically deliver their products and services, e.g., via telephone or now Internet, rather than through face-to-face customer contact. We should also care about the extent to which those delivery systems are accessible and readily useable by those who are economically disadvantaged.

"Woofies"

The second factor that will influence the extent of bank participation in the financial services industry -- and their ability to continue supporting community and economic development -- is the creation of "wholesale financial institutions," called "Woofies". The authorization of "Woofies" would allow investment banking firms as well as existing bank holding companies to have specialized wholesale banks. A "Woofie" would be a new type of bank that (i) could not accept insured deposits; (ii) would not have to pay deposit insurance premiums; (iii) could accept uninsured wholesale deposits (i.e., those with an initial deposit over \$100,000); (iv) would have direct access to the payments system; and (v) would generally be subject to a lower level of regulatory burden than insured banks. This could prove to be an attractive vehicle for financial firms to conduct wholesale lending and funding activities.

If Woofies are not subject to CRA, a potentially huge amount of financial system assets will not be covered -- including assets that are today subject to CRA because they are part of a single insured bank. And even if Woofies were not exempt from CRA, as "wholesale banks," they would be subject to a community development standard under the CRA regulations, rather than the general lending, services and investment criteria applicable to insured banks. Thus, their CRA obligations could end up being satisfied through targeted investments rather than through community-oriented lending.

Deflating Banks by Activities "Push-Outs"

A third factor that will affect whether banks are robust participants in the financial services industry is the outcome of the debate about "functional regulation" of activities

conducted by banks. Again, this debate may appear to be somewhat arcane, but it translates into the very practical question of whether certain types of activities -- most notably securities activities -- that are currently conducted directly by banks and are stable sources of bank revenues, will be forced out of the bank into bank affiliates. The activities in question are not esoteric. They include loan participations, underwriting certain government securities, securitizing loans, acting as a custodian for managed accounts, offering self-directed IRAs, arranging private placements, engaging in certain financial contracts, and offering employee and shareholder benefit plan services.

Profits of activities that are forced out of a bank will not of course, be available to support the activities and obligations of the bank. Nor will the "pushed-out" activities be subject to the comprehensive preventive regulation and regular on-site supervision that is typical of the bank supervision process.

"Push-outs" are another means by which a bank is deflated, to the detriment of its safety and soundness as well as its ability to meet the credit needs of its community and support the economy as a whole.

#### Conclusion

I hope this overview has been helpful to flag key issues in the financial modernization debate that could significantly impact future private sector support for community development and economic revitalization initiatives. I thank you for the opportunity to spotlight these very important concerns.

# # #

The OCC charters, regulates and supervises more than 2,600 national banks and 66 federal branches and agencies of foreign banks in the United States, accounting for 56 percent of the nation's banking assets. Its mission is to ensure a safe, sound and competitive national banking system that supports the citizens, communities and economy of the United States.