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Remarks by  
Eugene A. Ludwig  
Comptroller of the Currency

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Over the years, the Levy Institute has built a well-deserved reputation for thoughtful debate and research in economics and financial issues. Jerome Levy believed that the efficiencies and innovations of market economies mean opportunities for the citizens of this country and the world. This institute is a living, lasting legacy to that belief. So I am honored to join you this afternoon to share my thoughts about financial modernization for the 21st century.

Three years ago, Jim Barth and Dan Brumbaugh, writing for a Levy Institute public policy brief, entitled "Financing Prosperity in the Next Century," observed that: "... the bank regulatory environment is inconsistent with the evolving financial marketplace." Despite many attempts to move forward with financial modernization in the interim, that assessment, unfortunately, remains true today.

Whether or not we believe that the legal framework supporting America's financial services industry through the 20th century has served us well, this is a new era. And as the 21st century closes in on us, we can see more and more clearly that developments in the marketplace are beginning to undermine that framework and call into question the assumptions on which they rest.

Although it may not be a legislative reality, financial modernization is very definitely becoming a marketplace reality.

What are those 20th century assumptions that market developments are calling into question? In my mind, three are especially fundamental and perhaps no longer relevant:

First, the notion that geography -- the physical location of a financial services provider or a financial transaction -- forms the appropriate basis for determining what rules apply to the offering of financial services, and who applies those rules.

Second, the notion that certain legitimate financial activities -- specific products and services -- are in and of themselves simply too risky for financial institutions to engage in, and the idea that judgment can be responsibly made without regard to the strength or

sophistication of either the institution's own risk management systems, or the supervisory capacities of its regulator.

And finally, the related idea that -- again, without regard to the strength or sophistication of either a financial institution's own risk management systems, or the supervisory capacities of its regulator -- certain government-mandated organizational structures meaningfully address the risks of providing certain financial products and services.

We could spend an interesting afternoon on any of these issues, but today I want to focus our attention on that last question.

In the past twenty years, banking policy has come a considerable distance in the direction of greater competition. We've managed to come that distance by holding historic safety and soundness assumptions up to the light of contemporary realities. Compared to their predecessors of a generation ago, banks today have greater freedom to achieve geographic and product diversification ... diversification that enhances their risk management strategies and competitive positions -- and also their strength and stability.

But in the area of bank structure -- the corporate form of banking organizations -- the trend has been strangely backwards. As the ability of banking organizations to set their own mix of products and services has increased, their ability to decide upon the appropriate corporate structure for offering that mix has declined. I believe we are now overdue for a reexamination of the costs and supposed benefits of government-mandated corporate structures. Because the progress we've realized in our quest to make banks more competitive will be set back if we continue to force banks into structures that serve no clear public policy purpose.

In the absence of government intervention, businesses organize themselves in many different ways. Several different factors tend to drive their decisions regarding their corporate form -- factors such as the diversity and intensity of competition, advances in technology, and the need to achieve operating efficiencies.

But relative to their competitors in the marketplace -- foreign, domestic, financial and non-financial -- America's banking organizations are perhaps uniquely hamstrung in their ability to make ordinary business judgments about the corporate structures that work best for them.

Our 20th century legal framework sharply limits the ability of America's banking organizations to make independent decisions about their corporate structures. These limits are often justified in the name of safety and soundness. But the role they play in accomplishing this goal is questionable, and suggestions that their benefits outweigh the costs are unconvincing. Indeed, the reality is that some of these

limitations probably came into being precisely as devices to move certain activities out of the purview of bank regulators. But whatever their source, as the pace of competition continues to accelerate, these limitations are fast becoming a source of competitive inequity that are ultimately quite likely to have detrimental effects on the safety and soundness of the banking industry.

### Forces of Change

I believe three forces now at work in the marketplace will ultimately require the government to place less emphasis on mandated corporate structures and greater emphasis on effective supervision. These forces are industry consolidation, the evolution of the bank charter, and competition from non-depository businesses.

First, industry consolidation:

It's hardly a news flash to note that the banking industry is consolidating at breakneck speed.

Between 1980 and year-end 1995, the number of banks in this country dropped from 14,000 to about 10,000. In the same period, the number of banking organizations -- independent banks and bank holding companies -- dropped from about 12,300 to about 8,100. Numbers like these are cited routinely every time another merger makes the news.

But beyond the simple fact that consolidation is occurring lie some very interesting statistics about how it is occurring. These statistics tell a story of how government imposed structure forces the industry in one direction and -- when allowed to do so -- how the market moves the industry toward simpler, more competitive structures. Consider this. In 1980, there were only 16 multistate, multibank holding companies, and they controlled only about \$80 billion in assets, or barely 4 percent of industry assets. By the middle of 1995, however, there were approximately 250 multistate, multibank holding companies. And these entities controlled nearly 75 percent of industry assets. This growth was a reflection of the fact that government required the industry to adopt a holding company structure to do business across geographic barriers and on a regional basis.

But consider what market forces are doing today. In 1986, the typical interstate holding company had 12 bank affiliates, by the middle of 1995, affiliates had been reduced by half.

And when we compare the number of bank affiliates to the number of states in which each company operates, you see further evidence of the market's preference for organizational simplification. The mean banks-to-state ratio for the 250 interstate companies in 1995 was a little over two -- compared to five a decade ago -- and we see a similar trend with smaller, single-state holding companies.

So, today, we are seeing a clear market trend for bank holding companies to consolidate their operations into the minimum number of charters possible when they are empowered to do so in response to increased competitive pressure.

A second force that will lead government to place less emphasis on mandated corporate structure is the recently established legal framework that allows the bank charter to respond to new circumstances.

Last year's VALIC case laid the foundation for a more competitive, more contemporary banking model when the Supreme Court unanimously upheld the OCC's legal interpretation that national banks could sell annuities. But the importance of the Supreme Court's decision went well beyond the sale of annuities. VALIC confirmed that national banks are not limited to the specific powers and activities spelled out in the National Bank Act. And it directed the courts to give "controlling weight to a reasonable construction of the powers of national banks by the Comptroller."

The importance of VALIC cannot be overstated, particularly given the system of wild card statutes -- in place in over 30 states -- that automatically grant state chartered banks the same authority held by national banks. Taken together, VALIC and the state wild card statutes establish a legal framework in which the bank charter can continue to evolve to meet the needs of the marketplace.

The Supreme Court's recent unanimous ruling in the Barnett case realized the promise of VALIC by affirming the right of national banks in towns of less than 5,000 to sell insurance. The Barnett decision is yet another significant advance toward a more competitive banking industry and more competitive banking law and policy. As a direct consequence of that decision, greater numbers of consumers will enjoy the benefits of competition in the insurance marketplace.

Banks will gain a greater ability to engage in a line of business that is both profitable and relatively low-risk. These benefits are long overdue.

As an aside, it is noteworthy that in 1996 the ability of many banks to sell insurance depends on a statute Congress enacted in 1916 -- eighty years ago. It speaks well of our judicial system and our legal traditions that a statute enacted so long ago, at a time when the business of banking and the marketplace for financial services were so different than they are today, can still hold meaning for us today. I might add that Barnett is also a bit of a vindication for those of us in the regulatory community who struggle to find meaning in old statutes so that the institutions we supervise can continue to provide competitive products and services to their customers.

A third factor creating pressure on the government's desire to set organizational structure is competitive pressure from nonbank institutions that do not face the same sorts of costly

organizational constraints as banks do today.

With intensifying competition and the need to stay ahead of the technological curve, you can bet that banks will continue to search for ways to reduce costs. Certainly, the first place where many in the industry urge us in Washington to begin is to reduce regulatory burden and eliminate costly structural constraints. This need fueled the Riegle-Neal bill's drive through Congress and its enactment into law. But the need hasn't gone away. The numbers I gave you a little while ago clearly show that the banking industry continues to drive toward simpler organizational structures when the law permits.

It should surprise nobody if, when the industry has wrung all the efficiencies it can out of the Riegle-Neal legislation, the same need for increasingly more efficient corporate structures forces reconsideration of other government-imposed mandates on the corporate form of banking organizations.

Today, most of us view Riegle-Neal as a post hoc ratification of the marketplace trend toward industry consolidation. My guess is that we will someday look back on it as the first effort by policy makers to loosen some of the government-imposed limitations on the corporate form of banking organizations.

#### Costs and Benefits of Structure Constraints

Limits on structure exact a cost -- both from banks and from their customers. The key question for policy makers is whether the safety and soundness benefits of those limits are worth the costs they exact. In the absence of a clear, affirmative answer to that question, I believe the policy justification for government intervention is inadequate.

A preference for the holding company model rests on certain beliefs that need to be more fully considered:

First, the belief that new financial activities are riskier than traditional activities. That may arguably be true of some new activities, like some exotic derivatives, but it is certainly not true of others, like insurance sales.

Second, the belief that allowing banks to engage directly in these activities increases their risk of failure. But we all know both that, as a general proposition, a broader range of assets and activities diversifies risk and reduces the probability of failure and that, in specific cases, one cannot measure the riskiness of an activity in isolation from the systems in place to manage the risks.

And third, holding company proponents believe that the cost of imposing the holding company model on banking organizations, with all the restrictions associated with that model, is not particularly consequential. But, in fact, the statistics I have already presented regarding

the trend toward simplicity in many banks' corporate form clearly show that, left to its own devices, the market reaches a very different conclusion.

Long-held beliefs must be held up to real world experiences. For example, it's often suggested that the holding company structure promises safety and soundness by insulating the institution from risk. But holding companies with troubled affiliates don't walk away from their problems. In the 1970s, for instance, several large bank holding companies bailed out their failing real estate investment trust affiliates. More recently, several bank holding companies came to the rescue of troubled affiliated money market mutual funds.

And there's a simple business reason for that.

Corporations that walk away from the problems of their affiliates face the risk of diminished public confidence in their financial strength and damage to their reputations. In a business largely dependent on such confidence, responsible business persons will go to great lengths to avoid that risk. We've seen virtually no instances where aiding affiliates has put a bank at risk, and in scores of cases, banks have benefitted from the profits of subsidiaries and affiliates.

Banking organizations in virtually all other major industrialized countries enjoy much greater latitude than U.S. banks in selecting their organizational structures. In countries that give bank management the power to choose between the bank model and the holding company model, one rarely sees voluntary adoption of a meaningful holding company structure.

The overseas activities of U.S. banks also provide practical evidence that should give us doubts about whether the American preference for the holding company model rests on a solid footing. Overseas, U.S. banks may engage in securities underwriting and other activities not permitted domestically. In general, they are not permitted to engage in these activities through their foreign branches but must use either a bank subsidiary, Edge Act corporation, or a holding company subsidiary.

Roughly 85 percent of the assets of all foreign subsidiaries controlled by U.S. banking organizations are either directly bank-owned or controlled through Edge Act subsidiaries. To date, there is little evidence that the bank parents have been harmed by these activities.

Indeed, in 1994, 80 percent of the large direct and indirect subsidiaries of banks were quite profitable, with aggregate profits of \$4.7 billion.

For all these reasons, pending legislation that would deepen and affirm our commitment to a bank holding company model seems to fly in the face of marketplace dynamics and public policy needs. It amounts to a vote of no confidence in bank management.

Further committing ourselves to the holding company model at a time when the marketplace is moving in the other direction will very quickly reduce the competitiveness of U.S. banking organizations and could ultimately undermine their safety and soundness.

In other industries, such as telecommunications, we're seeing overdue sea changes as the market is increasingly shaped -- not by lawyers and legislators -- but by the forces of competition and innovation. The regional Baby Bell structure, for example, arbitrarily created in the wake of the AT&T divestiture, no longer serves a clear public policy purpose or the country's homes and businesses in the most efficient way possible. The telecommunications industry is moving away from a regulatory regime and an industry structure that made sense in an age of telephones and telegraphs, but are questionable in the high-tech, computerized and highly competitive world of today.

Similarly, the regulatory regime and structure of financial institutions should not be bound by 20th century conventional wisdom or legalistic creations of the past. In our zeal to modernize we must not lock the banking industry into one way of thinking ... particularly a mind set that could stifle innovation and the efficient -- and safe -- delivery of financial products and services.

The need for safety and soundness in the financial system will not go away in the 21st century. Neither will the need to protect consumers and taxpayers. But in this day and age, corporate separateness requirements are a highly questionable means to those ends -- indeed, such requirements may actually frustrate our public policy objectives.

We have the ability -- and the responsibility -- to do better. Modern risk assessment and risk management techniques make it possible for supervisors to protect the public policy interests at stake in the banking system scrupulously while giving banking organizations a great deal more of the freedom most other businesses already have -- the freedom to decide for themselves which corporate form best suits their business needs. The marketplace clearly prefers simpler corporate structures for a number of legitimate reasons, and management deserves the right to choose. The policy rationale for government-mandated complexity in the structure of banking organizations is at best unclear. I'm convinced we can achieve our policy objectives with far less in the way of such government-mandated complexity and cost.

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