

Statement of John D. Hawke Jr.
Comptroller of the Currency
before the
Committee on Banking, Housing and Urban Affairs
United States Senate
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Mr. Chairman, Senator Sarbanes, and members of the Committee, I appreciate the opportunity to be with you today. With your permission, if my entire prepared statement may be included in the record, I would like to focus on the issue that remains pivotal to the enactment of good financial modernization legislation. Some say that new financial activities of banking organizations must be conducted only in holding company affiliates. We disagree. We believe institutions should have the freedom to choose between the affiliate or bank subsidiary format, in either case 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.

Mr. Chairman, the February 16th Staff Discussion Draft tackles some of the most contentious issues that have stalled financial modernization in previous years, and I want to commend you for bringing forth a proposal early in this Congress that contains many advances over previous bills. I respectfully regret to say, however, that the Discussion Draft's treatment of bank subsidiaries, if enacted, would have a profound long-term detrimental effect on the safety and soundness of the banking system. By failing to allow banks of all sizes the ability to diversify their financial activities through subsidiaries, the proposal would compromise the long-term vitality and safety and soundness of our banking system. There is no clearly defined, compelling governmental interest justifying this result.

The Anomalies

Let me start by pointing out the anomalies inherent in legislation that would force new financial activities of national banking organizations into holding companies:

- o First, state banks today are free to conduct through subsidiaries any activities (other than insurance underwriting) authorized by their states, subject only to FDIC approval. A number of states have already authorized such activities as securities and annuities underwriting, and the FDIC has approved these activities. State banks would not be made subject to the same limits on subsidiary activities that the draft would impose on subsidiaries of national banks. It should be noted that by extending section 21 of Glass- Steagall to include bank subsidiaries, the bill would explicitly divest state banks of their present ability to engage in securities underwriting through subsidiaries.
- o Second, any U.S. bank can conduct activities abroad through

subsidiaries, subject to Fed approval, and the Fed has consistently permitted securities underwriting as a permissible activity -- with no apparent concern for safety and soundness threats or "subsidy" policy. Foreign subsidiaries of U.S. banks would not be made subject to the limits on subsidiary activities that would be imposed on domestic subsidiaries of national banks.

- o Third, foreign banks can engage in a broad range of activities in the U.S. through subsidiaries. For example, a significant percentage of the so-called "Section 20" affiliates routinely approved by the Fed are, in fact, direct subsidiaries of foreign banks, and such subsidiaries, according to Fed data, presently hold assets exceeding \$450 billion. Foreign banks would not be made subject to the limits on subsidiary activities that the draft would impose on subsidiaries of national banks.

In light of these precedents there is no justification for singling out national banks for discriminatory treatment.

The "Subsidy"

The reason offered by the Federal Reserve to justify the anomalous and discriminatory treatment of national banks is that banks generally benefit from a safety net subsidy, the benefit of which can be passed to a subsidiary, but not to a sister company. There is sharp disagreement among experts as to whether any net subsidy exists.

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:

- o First, the same firewalls would apply to each format. The bank could not lend to a subsidiary on any more favorable basis than to an affiliate.
- o Second, any equity investment by the bank in a subsidiary could be no more than the bank could pay upstream to its parent holding company by way of dividends.
- o Third, any such equity investment would be deducted from the bank's regulatory capital, and after the deduction the bank would still have to be well-capitalized. Thus, the effect on regulatory capital would be exactly the same as the 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.

In fact, if a subsidy does exist, funds don't need to move at all within the company to spread the advantage. The existence of a subsidy at any place in the structure benefits the consolidated organization. The organization can allocate the benefit of that subsidy in a variety of ways, to whatever element of the organization it chooses, with no actual transfer of funds, and it all washes out

on the consolidated books of the holding company.

It is simply not correct, in light of these facts, to say that the choice of format is a choice between financing new activities "by the marketplace," as opposed to "instruments backed by the sovereign credit of the United States." The funding options are virtually identical in either case, and, organizational format is wholly irrelevant.

Real world experience demonstrates, moreover, that banking organizations have not been acting as if such a subsidy exists. Such activities as mortgage banking, commercial and consumer finance and data processing are presently conducted both through holding company affiliates and bank subsidiaries, as evidenced in a table I would like to submit for the record.

Safety and Soundness

Let me turn now to what I think is the most compelling argument for permitting freedom of choice -- the importance of bank subsidiaries for the safety and soundness of the bank. The most troubling aspect of legislation that would mandate the holding company format in the name of guarding against the spread of some ethereal "subsidy" is that it would compromise bank safety and soundness.

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. 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.

- o It 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.
- o It would divert revenue flows to the holding company where they would be unavailable to the bank.
- o It would deprive banks of the opportunity to diversify their income stream by capturing the benefits of business opportunities generated by their day-to-day banking activities.
- o And when a bank gets into trouble, it would deprive the FDIC of the ability to cushion its losses by selling off profitable subsidiaries.

Why would we want to deny larger national banks and community banks owned by holding companies -- in total, over 80% of all national banks -- the safety and soundness benefits of diversification? 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.□