

For Release Upon Delivery
July 17, 1997, 10:00 a.m.

Summary of Statement of
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Mr. Chairman and members of the Subcommittee, I appreciate this opportunity to discuss the financial modernization legislation you now have under consideration. The issues you face are exceedingly difficult. The financial services marketplace has changed significantly since Congress last enacted legislation as comprehensive as the proposal now before you. The challenge is to design a new framework that gives the financial services industry true flexibility to evolve with a changing marketplace and respond to consumer needs, but preserves the successful elements of our current system. I commend you, Mr. Chairman and members of the Subcommittee, for grappling with this difficult but very important challenge.

In recent years, the Office of the Comptroller of the Currency has undertaken regulatory and supervisory actions that I believe are necessary to ensure the long-term safety and soundness of the National Banking System and ensure that national banks are able to fulfill the role that Congress envisioned for their support of the American economy. These actions include our approach toward insurance sales by banks and our revised Part 5 regulation, which details the process by which banks can apply to engage, through operating subsidiaries, in activities that are part of or incidental to the business of banking. But actions by regulators are not, and cannot be, a substitute for legislation that accomplishes meaningful financial modernization.

The House Banking Committee has made a significant effort to design a new regime to govern the financial services industry. However, in my view, the proposed legislation falls short in certain critical areas. I am concerned that it would lead to increased regulatory burden, restrict organizational flexibility, and limit competition by imposing unnecessary restrictions on firms. Therefore, I believe that further efforts are required to arrive at a proposal that truly promotes the interests of the American consumer and economy.

One of my principal concerns with H.R. 10 is that it will create unnecessary regulatory burden and redundancies. In particular, the bill would establish a Financial Services Council whose members would have sweeping authority over the banking system and bank supervision, even though most of them would have no responsibility for federal supervision of the banking industry. The council represents an additional, unnecessary layer of regulation on top of the activities of existing supervisory agencies.

In addition, H.R. 10 would impose unnecessary and costly restrictions on organizational choice. It would not allow bank subsidiaries to engage in the same range of new financial

activities permitted for bank holding company affiliates, even though it would subject them to all the safeguards necessary to protect a bank's safety and soundness from any new risks that could result from new types of activities conducted in a subsidiary. This imbalance in permitted activities would make the bank operating subsidiary an inferior structure for financial modernization and would create incentives for banking organizations to shift growing, new activities to holding company affiliates.

Forcing new lines of business that are responding to the newest customer needs to be conducted in holding company affiliates has troubling long-term ramifications for the health of banks generally. Either the assets and income stream of the bank itself will dwindle away, or the bank will reach farther out on the risk curve. In either case, what will result is a destabilized hollow bank that is less safe and sound. Furthermore, if growth and new lines of business in banking organizations are forced to occur in holding company affiliates and not allowed in bank operating subsidiaries, that growing base of activities and earnings is not available to support a bank's CRA efforts. Over the long term, the requirement to conduct more profitable activities outside the bank is likely to cause a significant reduction in the relative portion of assets in the banking industry that are available to support the CRA.

Rather than promoting true modernization that enhances competition, H.R. 10 would limit competition by imposing unnecessary restrictions on insurance activities of national banks. It would freeze the ability of national banks to provide insurance as principal as of January 1, 1997 and endanger their ability to provide future banking products if they were labeled "insurance" by a state regulator. In addition, the current authority of national banks and their subsidiaries to sell title insurance would be terminated. Finally, a new self-regulatory organization, the National Association of Registered Agents and Brokers" (NARAB), would be created if a majority of the states did not adopt uniform licensing standards for insurance sellers within 3 years. NARAB would have authority to set licensing standards that discriminate against banks. These discriminatory standards would have full force and effect even if they prevented banks from selling insurance as explicitly authorized under current law.

H.R. 10 would also diminish safety and soundness. For example, the reported bill provides that an insurance company that owns or is affiliated with a bank could not be required to provide financial support to that bank if the bank's state insurance regulator objected. Thus, the bill puts protection of the insurance company above protection of the federal deposit insurance funds.

Finally, H.R. 10 would create an uneven playing field in the financial services arena. Specifically, bank holding companies that are predominantly financial would be subject to Federal Reserve oversight, but bank holding companies that are predominantly commercial would not -- even though the risks to

the deposit insurance fund would be at least as great from commercial companies that own banks. In addition, the Federal Reserve could set different capital standards for different types of holding companies -- even if these differences disadvantaged companies engaged predominantly in one type of financial activity.

Insurance firms would be permitted to own banks as subsidiaries, but banks would not be allowed to own insurance firms as subsidiaries. Existing thrifts and their holding companies could continue to engage in activities they now conduct even though the activities would be prohibited for other banks and their holding companies. And state thrifts would continue to exist and could have broader powers and activities than state and national banks. These competitive inequities between different segments of the financial services industry are precisely the kinds of constraints on full and effective competition that financial services modernization is designed to eliminate.

The issues presented by financial modernization are exceedingly difficult. Often, they can become quite contentious. I commend the Banking Committee for its efforts to address and resolve these issues. Unfortunately, I must conclude that H.R. 10, in its current form, does not adhere to the principles that I believe are essential for financial modernization. Moreover, the bill does not further the safety and soundness of the National Banking System so that it may continue to serve the citizens, communities and economy of the United States. I realize that drafting legislation of this magnitude is a formidable task, and I appreciate your continued efforts to ensure that these concerns are addressed.

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July 17, 1997, 10:00 a.m.

TESTIMONY OF
EUGENE A. LUDWIG
COMPTROLLER OF THE CURRENCY
Before the
SUBCOMMITTEE ON FINANCE AND HAZARDOUS MATERIALS
of the
COMMITTEE ON COMMERCE

of the
U. S. HOUSE OF REPRESENTATIVES

July 17, 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 Subcommittee, I appreciate this opportunity to discuss the financial modernization legislation you now have under consideration. The issues you face are exceedingly difficult. The financial services marketplace has changed significantly since Congress last enacted legislation as comprehensive as the proposal now before you. The challenge is to design a new framework that gives the financial services industry true flexibility to evolve with a changing marketplace and respond to consumer needs, while preserving the elements that have been critical to the success of our current system. Actions by regulators are not, and cannot be, a substitute for legislation that accomplishes that formidable task. I therefore commend you, Mr. Chairman, and members of the Subcommittee, for grappling with the difficult but crucial issues presented by modernization legislation.

I will begin my testimony by discussing some of the regulatory and supervisory changes undertaken by the Office of the Comptroller of the Currency (OCC) in recent years, because I recognize that members of the Subcommittee have expressed interest, and, in some cases, concerns, about these changes. A brief summary of these developments should illustrate that careful regulatory and supervisory changes can enhance the long-term safety and soundness of the National Banking System and ensure that national banks are able to fulfill the role that Congress envisioned for their support of the American economy. Next, as you requested, I will offer my comments on the financial services modernization legislation currently under consideration. The House Banking Committee made a significant effort to design a new regime to govern the financial services industry. As I will discuss, however, the proposed legislation falls short in certain critical areas. I am particularly concerned that it would lead to increased regulatory burden, restrict organizational flexibility, and limit competition by imposing unnecessary restrictions on firms. Therefore, I believe that further efforts are required to arrive at a proposal that truly promotes the interests of the American consumer and economy.

Ensuring Safety and Soundness in a Changing Environment

The financial services business is changing with increasing

rapidity, resulting in new challenges to the long-term health of the industry. Advances in technology are fundamentally changing how information is created, processed and delivered -- the heart of what banks do. These advances have allowed new participants to compete in the banking arena and have blurred differences among existing financial services products. Firms in different sectors of the financial industry offer products to their customers that are functionally comparable, but bear different labels. 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.

Although the business of banking has changed greatly since Congress created the OCC in 1863, the mission of the OCC has remained constant: to charter, regulate and supervise national banks to ensure a safe, sound and competitive National Banking System that supports the citizens, communities and economy of the United States. The National Currency Act of 1863, revised and renamed the National Bank Act in 1864, was based on the belief that a safe, stable system of national banks was indispensable to our country's economic future. Consistent with that belief, Congress provided that the details of what national banks could do would evolve with a changing environment. Thus, the law endowed the Comptroller with a large measure of discretion in regulating the system under his care, which four recent Supreme Court decisions have reaffirmed. These decisions reflect the understanding of Congress, embodied in the National Bank Act, that failure to change would make banking less relevant to the needs of the economy and would also make bank supervision and regulation less effective in assuring safety and soundness.

In my testimony today, I will describe two developing areas of bank supervision and regulation that are of particular interest to this Subcommittee as it considers financial modernization legislation: insurance sales by banks and the OCC's revised Part 5 regulation, which details the process by which banks can apply to engage, through operating subsidiaries, in activities that are part of or incidental to the business of banking.

Insurance

It is important to recognize that national banks' authority to sell insurance is long-standing. In 1916, Congress authorized national banks to act as general insurance agents from places of fewer than 5,000 people under 12 U.S.C. § 92. In addition, under 12 U.S.C. § 24(Seventh), national banks are authorized to engage in activities that are part of or incidental to the business of banking, which includes selling credit-related insurance and annuities.

There are good public policy reasons for Congress' decision to allow banks to sell insurance. Not only the OCC, but others, including the General Accounting Office (GAO), believe that insurance sales are a low-risk business that complements other

financial products and services offered by banks and gives consumers greater choice and convenience. For example, in 1990, the GAO concluded that "[e]xpanded bank sales of insurance underwritten by unaffiliated insurance companies would not endanger bank safety and soundness." Ultimately, increased competition can be expected to lower insurance costs to consumers and increase availability of insurance products to more sectors of our economy.

Courts have repeatedly recognized the authority of national banks to engage in insurance activities. In *Barnett v. Nelson*, the Supreme Court found that a State law that prohibited national banks from exercising their insurance powers authorized under 12 U.S.C. § 92 had to yield to national banks' authority under federal law. Other appellate judicial decisions have made clear that there is no geographic limitation on the scope of a national bank's insurance activities under § 92. In January 1995, the Supreme Court unanimously upheld the Comptroller's determination that all national banks may act as an agent in the sale of fixed and variable rate annuities as part of or incidental to the business of banking.

The OCC does not dispute that State laws apply to national banks' sales of insurance. As a result of the *Barnett* decision, there recently has been considerable discussion concerning whether State law is preempted for national banks. It is the OCC's position that generally applicable, non-discriminatory State laws regulating the business of insurance apply to national banks. For example, generally applicable, non-discriminatory State laws regulating solvency, competence, fair dealing, and personnel training and qualifications of insurance providers apply to national banks.

On the other hand, if State law is above this "waterline," that is, if it has special features that single out banks for additional requirements, the law may impair the ability of national banks to exercise their Federally authorized powers. If so, under judicially developed preemption principles elucidated by the courts over the last century, that State law may be preempted. The key will be whether the special impact on banks reaches a level above the "waterline" that significantly interferes with their ability to exercise powers authorized under federal law. Although the OCC, upon request, may issue advisory opinions or interpretive rulings regarding preemption issues, the courts have always been--and remain--the ultimate arbiters of whether State law is preempted in a particular area.

The OCC cooperates with State insurance regulators. We have worked hard to develop effective working relationships with State insurance regulatory authorities, who administer and oversee compliance with State laws that apply to national banks. For example, District Deputy Comptrollers and District Counsel have met with the insurance regulators in all 50 States. In addition, the OCC is engaged in ongoing and constructive discussions with the National Association of Insurance Commissioners (NAIC) to address issues that pertain to sales of insurance in all States, including working towards establishing

a protocol for sharing consumer complaint information.

The OCC enforces anti-tying statutes and has adopted policies to provide for consumer protection. National banks are required to adhere to certain consumer protections in the sales of insurance products. For example, 12 U.S.C. § 1972 prohibits the tying of credit, property, or services with obtaining other credit, property, or services. The Comptroller's Handbook includes procedures for examiners to use in determining whether a bank has violated 12 U.S.C. § 1972.

In addition, in October 1996, we issued an Advisory Letter to National Banks on Insurance and Annuity Sales Activities that provides guidance to national banks to ensure that they conduct insurance and annuities sales in a safe and sound manner that protects the interests of their customers. The advisory letter applies to sales of all types of insurance and annuities by bank employees, bank subsidiary and affiliate employees, and third parties operating from bank premises. The advisory letter emphasizes that banks must take appropriate steps to ensure that customers are not confused about the nature of the insurance product offered and understand that they are not required to obtain insurance from the bank as a condition of obtaining credit. It also highlights other issues that banks should consider, including evaluating the products they sell, ensuring salespersons are adequately qualified and trained, avoiding recommendations that are inappropriate for the customers, monitoring and resolving customer complaints, ensuring advertising is accurate, maintaining customer privacy, clearly communicating to consumers third party arrangements, and ensuring that commissions do not create excessive pressure to sell.

Part 5

Another action the OCC has taken to keep our regulation in pace with the evolving environment is revision of Part 5 of our regulations, the section which governs corporate applications.

Part 5 is a component of the OCC Regulation Review Project. The goal of this review, initiated in 1993, was to identify changes that would maximize the efficiency of our rules and regulations and minimize their burden. A specific objective of our Part 5 review was to devise a risk-based approach to the OCC's corporate application process.

Consistent with our risk-based approach to bank supervision, the regulation employs different application procedures depending upon the level of risk of the proposed activity and the financial strength and operational capability of the applicant institution. In this context, Part 5 provides a mechanism for banks to apply to engage through operating subsidiaries in activities that are part of or incidental to the business of banking, including activities that differ from those a national bank can conduct directly.

Part 5 does not authorize any mixing of banking and

commerce. Nor does Part 5 authorize any new activity; rather, it provides a framework within which the OCC will consider applications case-by-case and based on public comment if the applications involve new activities. We included in Part 5 explicit safeguards to maintain safety and soundness and protect bank customers. Part 5 is a modest, incremental step in the direction of a modern financial services industry structure. The rule provides important benefits. Creating a process through which banks can prudently respond to new marketplace demands for products and services will enable them to achieve balance and offset downturns in their traditional lines of business. Controlled activities diversification can have important benefits. For example, former Federal Deposit Insurance Corporation (FDIC) Chairman Helfer stated recently that allowing a bank to put new activities in a bank subsidiary "lowers the probability of failure and provides greater protection to the insurance funds." Stronger institutions with increased profits and asset growth will be better positioned to meet the credit needs in their communities and support the economy as a whole. In addition, Part 5 holds potential benefits for consumers in danger of becoming disadvantaged by changes in the financial services industry. It provides community banks with the flexibility to use the least costly corporate structure to offer new products and services. Finally, because activities conducted in subsidiaries can provide an income stream to support a bank's Community Reinvestment Act (CRA) efforts, whereas those conducted in affiliates do not, Part 5 increases the potential pool of resources available to support disadvantaged communities.

New approach to operating subsidiaries. Part 5's risk-based approach allows well-run banks to establish subsidiaries to conduct specified non-complex activities that the OCC has previously approved with a simple, after-the-fact notice. Another category of activities, also previously permitted by the OCC, is eligible for an expedited application process (but not after-the-fact notice). And, under a new feature of the operating subsidiary rule, certain well-managed and well-capitalized banks can apply for a subsidiary to engage in activities that are part of the business of banking or incidental to banking -- but different from what is permitted for the parent bank. If the OCC has not previously approved the activity, the proposal will be published in the Federal Register, and we will invite public comments. We will carefully consider the impact of the activity on the bank's safety and soundness. And we will take a cautious and judicious approach to reviewing and deciding any requests made through this new process.

Safeguards. This new portion of Part 5 contains important, explicit corporate and supervisory safeguards to ensure that all new activities of this type are conducted safely and soundly. Furthermore, the OCC will impose additional safeguards application-by-application as warranted by the particular activities the subsidiary proposes to conduct.

Specific safety and soundness safeguards that apply to all

operating subsidiaries engaging in activities not permissible for the bank include an extensive set of corporate separation and independence requirements. Part 5 imposes additional safety and soundness restrictions --including deduction of the capital invested in the subsidiary when calculating regulatory capital, deconsolidation of the assets and liabilities of the subsidiary from those of the bank, and application of sections 23A and 23B of the Federal Reserve Act -- if the subsidiary conducts activities as principal, to reflect the added risk the bank undertakes when its subsidiary acts in this capacity. These safeguards are detailed in Tables 1 and 2 of Appendix I.

Bank subsidiaries as a structural option are not new. The bank subsidiary structure has been used safely in the United States and abroad for decades. Notably, as shown in Table 3 in Appendix I, U.S. banks have, for many years, successfully engaged in a variety of financial services abroad in both branches of the bank and in separate subsidiaries. Furthermore, State banks have been authorized to engage domestically in activities through operating subsidiaries, including securities brokerage, municipal securities underwriting, real estate brokerage, real estate equity participation, real estate development, and insurance brokerage.

As shown in Table 4 in Appendix I, banks in most G-10 countries, 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. In sum, non-traditional activities have been and today are conducted safely and soundly by bank operating subsidiaries. This is not a matter of theory, but experience. As former FDIC Chairman L. William Seidman testified nearly a decade ago, "[i]f 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."

No evidence of a safety net subsidy. Some have expressed concern that banks benefit from a safety net subsidy that can be transmitted to an operating subsidiary and is best contained by the bank holding company structure. We have analyzed this issue very carefully and have published our economic analysis. The attached paper (Appendix II) discusses this issue in detail. To summarize, there simply is no evidence of a net subsidy. Legislation has reduced significantly any benefit accruing to banks from access to the safety net, and the value of any benefit is more than offset by regulatory costs. Even using conservative cost estimates, regulatory costs exceed benefits from the safety net. Evidence cited as proof of a subsidy is readily attributed to other factors. Most important, experience shows banks do not behave as if they enjoy a subsidy.

Even if a subsidy were to exist, the appropriate response would be to contain it with carefully constructed regulations -- similar to the safeguards we have developed for operating subsidiaries -- rather than to impose organizational constraints

on banking companies. If organizational constraints were the answer, then banks should be prohibited from having holding companies, affiliates, or subsidiaries engaged in activities different from those permitted for the bank itself. There is no reason to single out bank subsidiaries as a unique source of subsidy leakage. In fact, under current rules, the bank subsidiary structure is actually superior to the holding company structure for containing any alleged subsidy. If the safeguards of sections 23A and 23B are applied to direct transfers between a bank and its subsidiaries and a bank and its affiliates, transmission of any subsidy by these transactions is equally contained whether the transactions are with subsidiaries or with affiliates. But a bank can also pay dividends to its holding company -- a transfer of funds which is not subject to sections 23A and 23B. Those funds may then, in turn, be down-streamed to a holding company affiliate.

Comments on Proposed Legislation

As I noted earlier, the initiatives I have just discussed, although necessary to keep OCC supervision and regulation relevant in a rapidly changing environment, are not substitutes for legislation to modernize the financial services industry. When I testified before the House Banking and Financial Services Committee earlier this year, I outlined five principles that, in the context of this rapidly changing environment, should guide financial modernization efforts. In my view, legislation that does not adhere to these principles will do more harm than good.

First and foremost, financial modernization legislation 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. Second, 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. Third, financial modernization should promote competition and increase efficiency within the financial services industry as a whole -- including banks, securities firms, and insurance companies alike -- in order to increase choices and lower costs for consumers. Fourth, financial modernization must not impose unnecessary structural requirements or activities limitations that would effectively preclude community banks, which are critical to meeting the needs of small businesses and farms and the Nation's small, rural communities, from reaping the benefits of modernization. Finally, 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. 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.

H.R. 10 Falls Short in a Number of Important Areas

On June 3, the Treasury Department submitted to the Congress a progressive legislative proposal that would have provided for the modernization of our financial services industry. However, the bill reported by the House Banking Committee on June 20th, the "Financial Services Competition Act of 1997" (FSCA), diverges from the Treasury proposal in a number of significant ways.

H.R. 10 would increase regulatory burden and redundancies. H.R. 10 would establish a 10-member Financial Services Council that would include the Secretary of the Treasury (who would chair the Council), the Chairman of the Federal Reserve Board, the Chairman of the FDIC, the Comptroller of the Currency, the Chairman of the Securities and Exchange Commission (SEC), the Chairman of the Commodity Futures Trading Commission (CFTC), one current or former State securities regulator, two current or former State insurance regulators, and one current or former State bank regulator.

I find it particularly troubling that individuals with no responsibility for federal supervision of the banking industry would have sweeping authority over the banking system and bank supervision. The authorities given this new body would be broad, and, as a result, the Council would provide an additional layer of regulation, superimposed on the activities of existing supervisory agencies. For example, the Council would be authorized to decide if a new product is a banking product or an insurance product (with the result that if it is an "insurance product," the product would become impermissible for national banks to provide). The Council could also decide what new types of activities are "financial," adopt new conditions and restrictions on transactions and relationships among depository institutions and their affiliates and subsidiaries, and promulgate consumer protection and disclosure requirements in addition to the requirements imposed by the bank regulators.

The increased regulatory burden that would result from the Council's duplicative regulation would increase costs for the financial services industry and limit flexibility. Redundant regulation is contrary to the principles of financial services modernization and the interests of consumers and the economy.

H.R. 10 would impose costly restrictions on organizational choice. The bill reported by the House Banking Committee would not allow bank subsidiaries to engage in the same range of new financial activities permitted for bank holding company affiliates, even though it would subject them to all the safeguards necessary to protect a bank's safety and soundness from any new risks that could result from new types of activities conducted in a subsidiary. This imbalance in permitted activities would make the bank operating subsidiary an inferior structure for financial modernization and would create incentives for banking organizations to shift growing, new activities to holding company affiliates. I believe that

dynamic would have negative consequences for banks, the communities they serve, and the deposit insurance fund.

Conducting activities through bank operating subsidiaries allows banking organizations to focus their resources on their banks, or a lead bank, rather than removing capital and channeling earnings away from the bank. Use of operating subsidiaries also allows the benefits of activities diversification to flow to the bank and strengthen it. Forcing new lines of business that are responding to the newest customer needs to be conducted in holding company affiliates has troubling long-term ramifications for the health of banks generally. Either the assets and income stream of the bank itself will dwindle away, or the bank will reach farther out on the risk curve. In either case, what will result is a destabilized hollow bank that is less safe and sound.

Moreover, modernization that relies on holding company affiliates at the expense of bank subsidiaries could have profound implications for the future efficacy of the Community Reinvestment Act. As Allen Fishbein, General Counsel of the Center for Community Change, recently noted, "...it is also important to understand that [the operating subsidiary option] provides a potentially important means for increasing the resource base for CRA-related activities." If growth and new lines of business in banking organizations are forced to occur in holding company affiliates and not allowed in bank operating subsidiaries, that growing base of activities and earnings is not available to support a bank's CRA efforts. Over the long term, the requirement to conduct more profitable activities outside the bank is likely to cause a significant reduction in the relative portion of assets in the banking industry that are available to support the CRA.

The subsidiary option can help banks of all sizes compete more effectively. For large and mid-size banks, competition is increasingly global. Most of the foreign banks with which U.S. banks compete are able to engage in broad securities, insurance and other activities, which they provide efficiently and conveniently through operating subsidiaries (or in some cases directly through the bank). The subsidiary structure is particularly notable in the European Community, where many formidable financial conglomerates are taking shape. For U.S. banks that must compete against these firms, the subsidiary option gives them an organizational mode that puts them on more equal competitive footing. Cost disadvantages from restrictions on organizational flexibility and other unnecessary regulation could cause financial activities to move offshore, weakening U.S. financial services institutions.

For community banks, use of operating subsidiaries is often a simpler, less costly structure for providing new products and services. Community banks today face multi-faceted competition. Community banks need to be able to choose the organizational form that enables them to compete most effectively to meet these challenges so that they can continue to serve their customers. If community banks cannot compete, certain consumers,

particularly those in smaller towns, will be disadvantaged. Diversification through operating subsidiaries may be their best means of survival in an increasingly competitive marketplace.

H.R. 10 would diminish safety and soundness. The reported bill also raises significant safety and soundness issues. For example, it provides that an insurance company that owns or is affiliated with a bank could not be required to provide financial support to that bank if the State insurance regulator objected. This limitation on an insurance company's liability effectively would treat insurance companies differently from other bank holding companies. This provision would nullify current law that requires companies that own insured institutions to provide a limited guarantee of a subsidiary institution's performance under a capital restoration plan if the institution becomes undercapitalized. Under the bill, the insurance company may be able to walk away from a failed insured depository institution and shift the total liability to the taxpayers. Thus, the bill puts protection of the insurance company above protection of the taxpayer-backed Federal deposit insurance funds.

Another provision in the reported bill could permit any company that engages in predominantly nonfinancial activities to own a bank through a qualified bank holding company, provided that the revenues generated by the bank were 15 percent or less of the total revenues of the consolidated company. The parent company would escape all holding company regulatory requirements. In other words, a parent company that was engaged in predominantly nonfinancial activities that qualified for this benefit would not be subject to holding company regulatory oversight or examination, or to capital requirements, but the company could engage in any commercial or financial activity. There would be no assurance that the company had adequate capital to affiliate with an insured depository institution and no opportunity to evaluate the company's risk management tools and policies.

H.R. 10 would also direct the agencies to develop guidelines and procedures to assure that insured institutions are not subject to criticism or sanction for "prudently" concentrating in real estate acquisition, development, residential mortgage finance and residential mortgage and housing production lending. This requirement would place an extra burden on the agencies to justify any criticism or sanction imposed on banking organizations that were directly involved in activities such as commercial and residential real estate development and acquisition, commercial and residential real estate lending, and other areas that have traditionally been considered very risky when done directly in a bank or thrift. In addition, the provision would create a new standard and require the agency to prove that the concentration was not prudent, rather than that the concentration violated established legal standards of safety and soundness. As a result, the provision is likely to result in protracted litigation and might even discourage a banking agency from taking appropriate enforcement action.

H.R. 10 would limit competition by imposing unnecessary restrictions on insurance activities of national banks. Rather than promoting true modernization that enhances competition, H.R. 10 would diminish competition by freezing the ability of national banks to provide insurance as principal as of January 1, 1997, and endangering the ability of national banks to provide future banking products if they were labeled "insurance" by a State insurance regulator. Competitors of national banks would not be subject to comparable restrictions on their ability to develop and provide new products. Prohibiting banks from providing future products that are deemed "insurance" by the States deprives consumers of the benefits that would be expected to result from increased competition, including lower prices, product innovation, and increased offerings in a greater number of communities, including underserved areas.

The current authority of the OCC to determine the permissible activities of national banks under the National Bank Act also would be severely undercut by H.R. 10 as reported because the National Council would resolve questions whether a new type of product is a prohibited "insurance" product or a permissible "banking" product. As discussed above, giving this broad authority to the Council would increase regulatory burden.

Also, the current authority of national banks and their subsidiaries to sell title insurance would be simply terminated. Sales of this insurance raise no safety and soundness concerns, and there is no evidence that sales of this type of insurance have created any problems for banks. This provision would result in a loss of virtually risk-free earnings for the national banks and deprive consumers of the benefits of competition in title insurance sales, including reduced prices.

Finally, the results of the Supreme Court's Barnett decision could be erased with respect to insurance agency activities conducted by banks. A new self-regulatory organization, the National Association of Registered Agents and Brokers" (NARAB), would become operative 3 years after enactment of the legislation (unless a majority of the States adopt uniform licensing standards for insurance sellers as determined by the National Association of Insurance Commissioners, a non-government professional organization of State insurance commissioners). NARAB would be authorized to set nationwide licensing standards for sellers of products that any State labels as "insurance." The effect of NARAB membership is that the member would be licensed in each State in which the member pays the licensing fee.

The authority of NARAB is set forth in such a way that NARAB could set licensing standards that discriminate against banks. Under H.R. 10, NARAB has the express authority to establish separate classes and categories of membership and impose separate criteria for the different classes. As a result, NARAB could establish separate criteria for bank membership that discriminate against banks and bank affiliates as compared with other providers of insurance. Since NARAB will

be operating under Federal authority, these discriminatory provisions would have full force and effect even if they prevented banks from selling insurance as authorized under U.S.C. § 92.

H.R. 10 would result in uneven treatment of banking organizations. H.R. 10 would create an uneven playing field in the financial services arena and would result in some segments of the industry having unfair competitive advantages over other segments. A "qualified bank holding company" predominantly engaged in financial activities would be allowed to engage in a "basket" of commercial activities, and all the operations of the holding company would be subject to the oversight and regulation of the Federal Reserve. In contrast, if a predominately nonfinancial company owned a bank, and the bank's revenue did not exceed 15 percent of the nonfinancial company's consolidated revenues, the parent holding company would not be subject to capital, examination, or other regulatory oversight by the Federal Reserve. In addition to the safety and soundness concerns that I mentioned earlier, this exemption from oversight would bestow a significant competitive advantage on those nonfinancial companies.

In addition, H.R. 10 would authorize the Federal Reserve to set different capital standards for different types of holding companies and thus a holding company with predominantly banking activities could be subject to more stringent capital requirements than a holding company predominantly involved in other types of financial activities.

The structural options in H.R. 10 are also uneven: although insurance firms would be permitted to own banks as subsidiaries, banks would not be allowed to own insurance firms as subsidiaries.

Also, the bill would provide for a permanent protection for companies that currently control only one thrift institution (unitary savings and loan holding company). Unlike bank holding companies, these companies could engage in any activity without restriction. Under the bill, the subsidiary thrift would be required to convert to become a bank, but the parent company would be able to continue to engage in any activity indefinitely, including new nonbanking activities.

Finally, the bill provides that most of the powers that a federal thrift had before it converted to a national bank would be continued after it converts, even if the activity is otherwise impermissible for national banks. Moreover, investments held by a federal thrift at the time of enactment of the bill would be regulated and supervised as if the institution were still a federal thrift, even after it converts to a national bank. State-chartered thrifts would not be eliminated at all and could have broader powers and activities than State and national banks. These powers and activities would be reviewed by the FDIC only if a State thrift sought to engage as principal in an activity that is not permissible for a national bank.

These competitive inequities between different segments of the financial services industry are precisely the kinds of constraints on full and effective competition that financial services modernization is designed to eliminate.

Summary and Conclusions

As I said at the outset of my testimony, the issues presented by financial modernization are exceedingly difficult. Often, they can become quite contentious. I commend the Banking Committee for its efforts to address and resolve these issues. Unfortunately, for the reasons I described above, I must conclude that H.R. 10, in its current form, does not adhere to the principles that I believe are essential for financial modernization. Moreover, the bill does not further the safety and soundness of the National Banking System so that it may continue to serve the citizens, communities and economy of the United States. I realize that drafting legislation of this magnitude is a formidable task, and I appreciate your continued efforts to ensure that these concerns are addressed.

Appendix I

Tables 1-4

Table 1

Firewalls Applicable to All Operating Subsidiaries

The bank and subsidiary must have:

Separate offices

Separate marketing materials

Separate names

Separate books and records

Separate policies and procedures

Separate board meetings

Internal controls to manage risks

Arms-length terms for any contract for services

In addition the subsidiary must:

Be adequately capitalized under appropriate industry standards

Have a board of directors at least 1/3 of whom are independent

Table 2

Additional Firewalls Applicable to Operating Subsidiaries
Acting as Principal

Capital computation:

Bank and subsidiary must state their assets separately

Bank may not count investment in subsidiary as an asset

Bank must subtract from its capital its investment in the subsidiary

Restrictions on transactions between bank and subsidiary ("Sections 23A and 23B" restrictions):

Qualitative restrictions--

- Arms-length terms
- Consistent with safe and sound banking practices
- No transfer of a low-quality asset
- Cannot suggest bank is responsible for subsidiary's obligations

Quantitative restrictions--

- Transactions with any one subsidiary limited to 10 percent of bank capital and surplus

- Transactions with all affiliates limited to 20 percent of bank capital and surplus

- Minimum collateral requirements (collateral required to exceed loan amount)

Condition of the bank--both before and after subsidiary operations begin, the bank must:

Be well capitalized

Be rated CAMEL "1" or "2"

Have a CRA rating of at least "Satisfactory"

Not be subject to an enforcement order

Table 3
Subsidiaries of U.S. Banks Operating Abroad
With Total Assets Above \$1 Million

Selected Activities	# of Subsidiaries	Total Assets (\$ million)	Net Income (\$ million)
Insurance Agency & Brokerage	8	1,616	75
Insurance Underwriting	11	3,482	103
Securities Underwriting & Brokerage	63	125,579	387
Investment & Merchant Banking	50	94,795	953
ALL ACTIVITIES	849	491,806	7,797

(Source: Report of Condition for Foreign Subsidiaries of U.S. Banking Organizations, FR2314 Data as of December 31, 1996)

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 4

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

Country	Securities Activities	Insurance Activities	Real Estate Activities
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SOMEWHAT RESTRICTED BANK POWERS

Italy	Bank	Bank sub1	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 sub2	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.

Related Link

- [Appendix 2](#)