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TESTIMONY OF

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of the

COMMITTEE ON BANKING AND FINANCIAL SERVICES

of the

U. S. HOUSE OF REPRESENTATIVES

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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.

Madam Chairwoman and members of the Subcommittee, I appreciate this opportunity to testify on financial modernization. Over the past several decades, numerous reform proposals have failed to succeed for a variety of reasons, and as a consequence, our Nation's banks continue to be constrained by an antiquated legal and regulatory framework. I commend you for fostering a dialogue on these critical issues. H.R. 268, the Depository Institution Affiliation and Thrift Conversion Act, raises many of the central issues that Congress must consider if it is to truly modernize our Nation's financial services system.

In your letter of invitation, you asked for my views on the need for financial modernization and on ways to achieve it while preserving the safety and soundness of the financial system. As you may know, the Department of Treasury is developing a comprehensive framework for financial modernization. While Treasury continues to develop this framework, I want to discuss today my perspective on why financial modernization is needed and what financial modernization must entail to be meaningful.

Historically, the federal government has pursued a strategy of regulating banks to achieve key policy goals. These goals, which Congress has established through legislation, include ensuring the stability and integrity of the payments system; creating a safe haven for small savers; providing an adequate flow of credit to homeowners, small businesses, and farmers; protecting consumers; and, ensuring appropriate investment in local communities. While some may debate the merits of some of these goals, it is clear their attainment depends on a vibrant banking system. Without effective modernization, banks will not be competitive financial services providers, thus undermining basic public policy goals.

As we develop a plan for financial modernization, it is important to proceed thoughtfully. Too much of the debate in the past has focused on competitor protection. Financial modernization will deliver benefits to consumers and the economy if it is founded on sound principles. I believe there are five principles that should underlie any efforts to modernize our financial services system. First, we must ensure that banks remain safe and sound. Second, financial reform must help promote fair access to financial services for all, including low- and moderate-income individuals and others that the current system may under-serve. Third, a newly remodeled system should encourage healthy competition that will benefit all users of financial services. Fourth, financial modernization should not proceed in a way that unfairly burdens smaller banks, which provide critical services to important sectors of the economy. Fifth, we must not place unneeded restrictions on the form in which banks conduct their business.

In the remainder of my testimony, I will first discuss the need for financial modernization. Next, I will describe in greater detail the five principles that should guide financial modernization. Last, I will offer some observations regarding the blending of banking and commerce, an issue you raised in your letter of invitation.

Need for Financial Modernization

The increasing pace of change in the financial sector has important implications for banks, their supervisors, and policymakers. Banks are facing competition not only from nonbank financial services companies, such as GE Capital, Merrill Lynch and General Motors Acceptance Corporation to name a few, but also from firms that traditionally have not offered financial services, such as telecommunications and computer companies.

At the same time, the products and services that financial services customers demand have changed and will continue changing in the future, most likely at an increasing pace. For banks to be relevant market participants, they will have to be able to offer many, if not all, of these new products and services.

In recent years, the nature of banks' lending business has also changed in significant ways. For the last several decades, large corporations increasingly have been accessing the capital markets directly, rather than using banks as an intermediary to raise funds.

Banks also face greater competition for retail funding, as consumers have a growing array of alternatives for their savings. Mutual funds have become the preferred savings option for millions of households. Last year for the first time, total mutual fund assets surpassed total deposits of the commercial banking system. As of the third quarter of 1996, net assets of mutual funds were $3.4 trillion compared with $3.1 trillion in deposits in FDIC-insured commercial banks.

Clearly, consumers and businesses in many communities would benefit if banks were allowed to engage in a wider range of activities. Yet, today, the ability of banks to satisfy a customer's changing financial needs is limited. For example, a bank that wants to offer securities underwriting to its customers must establish a section 20 affiliate, an inefficient alternative that can be both difficult and costly to establish. In other instances, customers are deprived of the benefits of price and product competition from banks that would otherwise seek their business. The lack of full competition translates into increased financing costs, and limits the development of innovative financing approaches for businesses. Forcing U.S. banks to operate within this inefficient structure impedes their ability to compete both domestically and internationally.

In short, because they are restricted by a system of antiquated laws, banks have been unable to fully diversify their activities to provide efficiently the range of products and services that modern consumers and businesses are demanding. There are two potential consequences of these developments which policymakers must address. First, in order to preserve profitability, banks may increase their level of risk in those limited areas allowed to them. We have learned difficult lessons from the banking sector's past experiences with lending to lesser-developed countries, real estate development lending, and lending to finance highly leveraged transactions. These lessons have taught us that limiting banks to only traditional core businesses -- in a dynamic and highly

competitive environment -- can have unintended results for safety and soundness. Second, banks may shrink as nonbank competitors, who are not constrained by these laws grow.

Either consequence raises significant public policy concerns. If the level of risk in our banking system increases, bank failures may increase. Increased failures could pose a direct threat to the deposit insurance funds. Further, bank failures are not without cost to uninsured depositors and bank customers who may have established lines of credit or other relationships with the failed bank. Bank funds diverted from the banking business to replenish or sustain the deposit insurance system will also reduce the amount of capital that could otherwise be used by the bank for more productive purposes. And, regulatory attempts to offset bank risk through higher capital requirements will likewise reduce the ability of banks to lend and assist in the growth of our economy.

If the size of the banking sector is forced to shrink, the country will lose a valuable tool for effectuating many of the important public policy goals that banks are designed to accomplish. As noted before, these goals include providing a secure system of payments, a safe haven for small savers, and providing credit to important sectors of the economy, including low- and moderate income consumers, small businesses and farmers. As the size and importance of the banking sector diminishes, the ability to use banks to accomplish these and other important public purposes likewise shrinks.

Principles of Financial Modernization

While it is unquestionably in the public interest to permit banks to compete in our current financial world, it is also important to lay out some guiding principles to govern our efforts to modernize our financial laws. I believe those efforts should adhere to five basic principles.

Maintaining Safety and Soundness

First and foremost, any proposals for financial modernization must ensure the safety and soundness of the banking system. As national banks move increasingly into new or non-traditional lines of business, supervisors need to understand the risks that banks are taking. Last year, the OCC adopted Supervision by Risk, a forward-looking approach that identifies and focuses our examination resources on those areas that pose the greatest risk to the bank. Under Supervision by Risk, our examiners assess the quantity of risk exposure across the entire spectrum of a bank's activities and bank management's ability to identify, measure, monitor and control risk. We provide extensive training to examiners to continually improve their ability to supervise those risks.

I have also created a position for a Deputy Comptroller for Risk Evaluation, who serves as our national risk expert and as my principal advisor on risks facing the national banking system. And in recognition of the growing technical sophistication of banks' risk management systems, two years ago I created a division

dedicated to risk assessment. This division is staffed with Ph.D. economists with technical expertise in quantitative methods and who can evaluate the economic assumptions underlying banks' risk management systems. These economists regularly participate in examinations of large banks and help our examiners to evaluate banks' risk measurement methods for interest rate risk, trading, and credit activities.

We monitor developments in the industry and assess risk by gathering information from examinations, surveys, industry comparisons with nonbank competitors, and reports on the entire banking industry. We continually review and update our examination procedures to ensure that our examiners have up-to-date methods for assessing bank products and are able to identify and respond to risk. In addition, we inform our examiners through training and revised examination procedures, educate the industry by issuing guidance, and develop regulations as appropriate. For instance, last year, we began to put together a banking technology unit to identify the risk associated with emerging electronic money and banking technologies.

However, effective supervision by itself is not enough to ensure a safe and sound banking industry. Ensuring that banks have the flexibility to adapt to changes in the marketplace is also critical. Limiting banks' activities is likely to increase their risk profiles for two reasons. First, it deprives banks of the benefits of diversification. Requiring banks to put all of their eggs in one basket leaves them prey to the vagaries of one market, one set of risks. One of the lessons learned from losses in commercial real estate and agricultural lending in the 1980s is that excessive concentration in a particular market segment is risky. Although any new financial activity entails risk, prudent diversification can lower an institution's overall risk exposure. Second, as the opportunities for profit in banks' traditional lines of business decline with changes in the marketplace, banks have incentives to take greater risks within those traditional areas to maintain profitability.

The empirical evidence supports the supposition that bank involvement in new financial activities will enhance rather than threaten bank safety and soundness. For example, U.S. banks, through foreign branches and subsidiaries, as well as holding company affiliates, have successfully engaged in a variety of financial services abroad for many years. These institutions can engage in equity underwriting, as well as dealing and investing in corporate debt securities. The authority provided in the Federal Reserve Act and other banking laws and regulations for these activities is longstanding.

In addition, banks in most G-10 countries(1) have been engaging in a broad range of financial services activities for many years. Almost all G-10 countries, with the notable exceptions of the United States and Japan, allow a wide range of activities, including underwriting and brokering securities and insurance, to be conducted either directly by a bank or a direct subsidiary of a bank, rather than through a holding company structure. This broader range of activities has not impaired bank safety and soundness. On the contrary, foreign bank supervisors have told me that income from non-traditional activities has been a key support for the safety and soundness of certain banks during periods of financial stress. To the extent that banks in these countries have experienced safety and soundness problems, the problems have primarily arisen in traditional lines of business, such as through excessive concentrations in commercial real estate lending or inadequate internal controls.

Further, non-traditional activities can improve a bank's performance by enhancing its ability to manage risks and increase profitability. For instance, studies show that banks can reap significant diversification benefits from involvement with some insurance products.

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(1) The G-10, or Group of Ten, includes the governments of nine countries and the central banks of two others for a total of 11 members. The members are the governments of Belgium, Canada, France, Italy, Japan, the Netherlands, Switzerland, the United Kingdom, the United States, and the central banks of Germany and Sweden.

In particular, these studies have found that cash flows from many insurance activities provide an important cushion during downturns in profits from bank lending activities.(2)

Research also lends support to the conclusion that commercial and investment banking can be combined safely through a separate subsidiary or affiliate. Scholars have found that the Glass-Steagall Act's (Act) separation of commercial and investment banking was not justified either on safety and soundness grounds or as a response to bank failures in the 1930s. In fact, banks with securities affiliates failed less frequently than other banks. A path-breaking 1986 study by Eugene White of Rutgers University found no convincing historical evidence that any of the 9,000 banks that failed between 1930 and 1933 did so as a result of their investment banking activities. It seems that the separation between commercial and investment banking largely reflected the continued faith of legislators and regulators in the now-discredited Real Bills Doctrine, which held that making short-term loans for productive purposes and secured by real goods was the only appropriate lending activity for commercial banks. The immediate impetus for passage of the Act came from a serious misdiagnosis of the causes of the banking collapse in the 1930s, together with resentment toward bankers involved in underwriting and distributing corporate securities.

Access to Financial Services and Consumer Protection

The second principle for financial modernization is that reform should promote broader access to financial services for all consumers. Banks play a special and vital role in the development and prosperity of all communities, particularly those encompassing lower and middle-income Americans. In addition to providing credit and other basic consumer financial services, banks often serve as the primary source of economic development financing and investment. Greater access to banking services is a key element in the rehabilitation of economically disadvantaged communities, as well as the provision of community development finance and investment. In recent years, the banking industry has made significant progress in expanding access to financial services for low- and moderate-income consumers and communities. Any financial modernization proposal must build on this success.

(2) Peter S. Rose, "Diversification of the Banking Firm," The Financial Review, vol. 24 (May 1989), pp. 251-280.

One potential outcome of financial modernization is that the "haves" of our society will benefit and the "have nots"will be left farther behind. It is incumbent on us, as we pursue the modernization of our financial services industry, to guard against making that possibility a reality. Financial modernization must neither erect new barriers to, nor erode current protections for, consumer access to financial services and the provision of credit to all sectors of our society.

In this regard, it is important to note that authorizing new activities to be conducted in a subsidiary of a bank in addition

to an affiliate offers the possibility of enhanced resources available for Community Reinvestment Act (CRA) activities. This is so for two reasons. First, earnings from a bank subsidiary flow up to the bank, and thus increase the ability of the bank to undertake CRA activities. By contrast, earnings of a holding company subsidiary flow to the parent holding company, and therefore are not available to directly support the bank's CRA obligations. Second, the asset size of a bank, including its subsidiaries, is generally part of the performance context in which regulators evaluate the bank's CRA performance. Assets in other affiliates are not considered in determining the bank's capacity to perform under CRA.

Ensuring fair access also encompasses ensuring the protection of consumers who use banking services. New bank activities may offer customers greater convenience and greater choice, but banks must take appropriate steps to educate their customers. At a minimum, proper disclosures must be made to ensure that customers understand that certain products are not FDIC-insured, and that they are fully aware of what risks the new activities entail. Customers must have all necessary information to make intelligent and well-educated decisions. In addition, bank employees must follow appropriate and fair sales practices when marketing and selling these products.

Promoting Competition

Properly conceived, financial modernization should promote competition and increase efficiency within the financial services industry. If we remove barriers to more vigorous competition, we can expect firms to offer products and services , such as insurance and mutual funds. The increased competition provided by banks in these markets should both lower costs to customers and increase (or in some instances create) access to the capital markets for businesses. In turn, market access can spur economic development. The benefits of promoting competition and reducing regulatory barriers are significant. Based on analysis of the effect of removing geographic restrictions on the banking system, research economists have found that banks have become more cost efficient following the entry by out-of-state banks.(3) In increasingly competitive local banking markets, such savings will likely be passed on to consumers as lower prices and/or better services. Research by others finds that expansion via branch banking leads to lower prices. (4) Entry by out-of-state banks can also be a catalyst for new banks to enter local markets.(5)

Nonbank providers of financial products and services also are likely to benefit from an expanding market and from the innovation spurred by competition. Years ago the securities industry raised concerns about bank sales of mutual funds. But as banks have established a foothold in mutual fund sales, the market for mutual funds has continued to grow. While the dramatic increase in the mutual fund market is due to a variety of factors, I believe bank

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(3) Adkisson, J. Amanda, and Donald R. Fraser, "The Effect of Geographical Deregulation on Bank Acquisition Premiums," Journal of Financial Services Research 4: 45-155, 1990; Calem, Paul S. and Leonard I. Nakamura, "Branch Banking and the

Geography of Bank Pricing," Federal Reserve Board, working paper 95-25, 1995; Laderman, Elizabeth S. and Randall J. Pozdena, "Interstate Banking and Competition: Evidence from the Behavior of Stock Returns," Federal Reserve Bank of San Francisco, Economic Review no.2: 32-47, 1991; Savage, Donald T., "Interstate Banking: A Status Report," Board of Governors, Federal Reserve Bulletin 79: 601-630, 1993; DeYoung, Robert, Iftekhar Hasan, and Bruce Kirchoff, "Out-of-State Entry and the Cost Efficiency of Local Commercial Banks," Draft Working Paper, Office of the Comptroller of the Currency, 1997..

(4) Laderman and Podeza, 1991; Marlow, Michael L, "Bank Structure and Mortgage Rates: Implications for Interstate Banking," Journal of Economics and Business, pp. 135-142, 1982; Calem, Paul S. and Leonard I. Nakamura, "Branch Banking and the Geography of Bank Pricing," Federal Reserve Board, Working paper 95-25, 1995.

(5) Thomas, Christopher R., "The Effect of Interstate Banking on Competition in Local Florida Banking Markets," Working paper, University of South Florida, 1991.

involvement in this market has helped the industry reach a broader customer base and thereby has promoted greater access for consumers to the securities markets.

Role of Community Banks

My fourth principle concerns the role of community banks. These banks profitably serve the financial needs of small businesses and farms and are thus a critical part of the banking industry.(6) I believe that there will be continuing need for the services that community banks provide to local depositors, small businesses, and farmers.

Many community bankers are concerned that they will be disadvantaged because financial modernization will introduce a bias in favor of structures or activities that are economical only for larger institutions. To date, much of the debate on financial modernization has focused on permitting large financial institutions to engage in a broader range of activities through holding company affiliates. However, we must not allow smaller banks to get lost in the shuffle.

Hence, the fourth principle is that financial modernization must not impede community banks from competing in a changing financial services landscape. Reform proposals should not impose restrictions designed for large banks that do not make sense, or are too costly, when applied to small banks. For example, community banks should not be required to establish a holding company in order to engage in broader activities, since operating subsidiaries offer community banks a more cost-effective alternative.

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(6) In four of the six OCC supervisory districts, aggregate return

on assets (ROA) for commercial banks with assets of less than $1 billion have consistently exceeded aggregate ROA for commercial banks with assets of greater than $1 billion since 1990. Nationwide, ROA for commercial banks with assets of less than $1 billion also out-paces that for commercial banks with assets of greater than $1 billion.

Flexible Corporate Structure

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. Today, banking companies have two basic options -- the holding company affiliate approach and the bank subsidiary approach. Absent clearly demonstrable safety and soundness considerations, financial modernization should not impose one of these organizational forms for the purpose of supervisory convenience. Rather, it must offer banks and other financial services institutions the flexibility to develop new products and services in a safe and sound manner, and to adapt their organizational structures to serve an evolving economy and new consumer needs.

Supervision, combined if necessary with corporate restrictions that are tailored to each activity, can deliver safety and soundness benefits that are superior to those derived from reliance on structural constraints alone. This approach allows regulators to tailor their supervision to the specific circumstances and the particular risks facing a bank. As banks develop new products and new ways to manage risks, the regulator can then adapt its supervisory practices to marketplace developments. Such action can enhance effective supervision and at the same time limit regulatory burden. An example of this approach is the recent extension of risk-based capital standards by the OCC and other federal banking agencies to capture market risk. In devising this capital standard, we departed from previous approaches to regulatory capital that rely on simple "one-size-fits-all" formulas for assessing the level of risk and amount of needed capital. Rather, the capital standard uses the results of banks' own sophisticated value-at-risk measurement systems, subject to qualitative standards and quantitative parameters specified by supervisors. This approach provides supervisors with a more accurate assessment of a bank's risk, avoids the burden associated with a regulatory model, but also ensures appropriate safety and soundness safeguards.

Funding Concerns. Some banking industry observers contend that allowing banks to participate in new financial activities could lead to an inappropriate expansion of the federal safety net. In particular, some observers allege that banks have a lower weighted average cost of funds because of access to the federal safety net including federal deposit insurance. They argue that this lower weighted average cost of funds may be down-streamed to bank

subsidiaries, thereby giving the subsidiaries an advantage over nonbank companies. Proponents of this argument believe that it is necessary to house non-traditional activities within a bank holding company structure to prevent transmission of this subsidy.

I believe that this argument should be rejected. Despite a large amount of empirical work on the subject, there remains considerable doubt as to whether any subsidy exists. And although rating agencies rate bank holding company debt issues lower than comparable bank issues -- which leads to a difference between the cost of funds for a bank and its parent holding company of between 4 and 7 basis points (7) -- that difference in ratings does not reflect a subsidy. Rather, Standard & Poor's explains that the difference in its ratings is attributable to the fact that bank regulators can restrict payments to the holding company in times of distress. In any event, to the extent any funding subsidy does exist, it is probably more than offset by the costs of regulations that banks must bear. Thus, banks actually face higher costs than other financial service providers when the costs of examinations, reserve requirements, and safety and soundness and compliance regulations are considered.

Further, there is no meaningful evidence that banks act as though they believe there is a funding subsidy for the bank. If one assumes banks benefit from a subsidy, one would expect to see banks uniformly issue debt at the bank level. Instead, we find a mix of bank and holding company debt issuances. By the same token, if a funding advantage did exist, we would expect banks to organize themselves in a particular way to capture the benefits. But we do not find such patterns when banks have room to choose. For example, banks can locate their mortgage banking operations in a bank, a bank subsidiary, or in a subsidiary of a holding company. Of the top twenty bank holding companies, six conduct mortgage banking operations in a holding company subsidiary, nine conduct mortgage banking activities in the bank or bank subsidiaries, and five conduct mortgage lending through a combination of the bank and holding company.

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(7) See, for example, Tania Padgett, "Chase, Citi Debt Gets Extra Boost from Thompson," American Banker, November 12, 1996, p. 40.

Finally, even if a subsidy exists, appropriate regulatory safeguards can be established to restrict the transfer of any subsidy between a bank and its affiliates, regardless of whether those affiliates are subsidiaries of the bank or the bank holding company.

Banking and Commerce

In your letter of invitation, you asked me to comment on the question of the concentration of financial power that could result from a financial services company having large commercial affiliations. Permitting increased affiliations between commerce and banking is a complex issue requiring careful deliberation.

Changes in the law regarding such affiliations should be undertaken carefully, but we should keep in mind that there is no bright and unyielding line between banking and commerce.

The line separating banking from commerce has constantly shifted over the past two centuries. The original rationale for a narrow definition of bank powers was that banks, as quasi-public institutions, should not be permitted to use their special relationship to the state to compete unfairly with the private sector. Thus, in the early 19th century, many bank charters explicitly forbade dealing in merchandise or otherwise exceeding the powers expressly granted.

However, there were numerous exceptions to this rule. Some states, taking the quasi-utility logic a step further, required banks, as a condition of their charters, to serve public functions, even where these conflicted with a narrow definition of banking. Companies created to promote the building of canals and railroads were sometimes endowed with bank powers to help finance them. In 1799, the Bank of the Manhattan Company (later the Chase Manhattan Bank) was chartered to build and operate a water system for New York City. The Chemical Bank was chartered in 1823 to produce chemicals and to finance its operations through lending and note issuing. Banks continued to combine banking and commercial functions well into the 20th Century. It was not until the Bank Holding Company Act of 1956, that Congress prohibited commercial firms from combining with more than one bank.

Even after 1956, combinations of nonfinancial businesses and a single bank persisted. Banks shifted to a one-bank holding company structure for a variety of reasons, including the ability to continue to engage in a broad range of activities. The 1970 amendments to the Bank Holding Company Act eliminated the one-bank holding company exemption and gave the Federal Reserve the authority to decide which activities were properly incidental to banking. However, banking and commerce are still mixed today in unitary thrift holding companies.

As Congress deliberates, it might be useful to consider the experience prior to the 1956 enactment of the Bank Holding Company Act and the period from 1956 to 1970 prior to enactment of amendments to the Act, as well as experiences of unitary thrift holding companies. It also would be important to consider the fact that changes in the economy, particularly in the field of technology, will blur the line between banking and commerce. For example, computer technology and information management are now widely acknowledged to be integral to the provision of financial services, even though at one time they seemed to be clearly commercial activities.

Conclusion

Congress has passed extensive legislation affecting banks to promote important policy goals--protection of the payments system, maintenance of a safe haven for small savers, and providing an adequate flow of credit to critical sectors of the economy. The attainment of those goals has depended on the maintenance of a

strong banking system. To continue to attain those goals, therefore, we need to ensure that the banking system continues to be vibrant, and to remove any legal barriers that constrain competition in financial services.

I recommend that financial modernization reform reflect the five principles I have outlined in my testimony: safety and soundness, fair access and consumer protection, promoting competition, protecting the role of community banks, and maintaining a flexible corporate structure. I believe these principles can provide the foundation for true reform.