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Remarks by

Eugene A. Ludwig
Comptroller of the Currency

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In January, I had the privilege of speaking before the Exchequer Club on a subject I felt strongly about at the time and feel strongly about today -- financial modernization and the challenges facing the banking industry as it moves into the 21st century. This afternoon, I want to continue the discussion I began earlier this year, because the momentum for addressing these issues has gained strength in 1996. I'm hopeful that in the months to come, Congress, the Administration, the regulatory community and the financial services industry can -- working together -- continue to move forward in responding to the challenges of financial modernization.

As you may recall, when we last met, I spoke about the need to view financial modernization broadly. While some remain focused on whether and how to break down the walls that the Glass-Steagall Act raised between banking and securities, the rapid development of technology and the globalization of the economy are continually and dramatically altering the landscape of financial services in fundamental ways. Consequently, a truly modernized legal and regulatory structure for financial services must take into account this changing financial services landscape.

In addition, financial modernization must preserve and refine regulation to help markets work efficiently, to ensure safety and soundness, and to protect consumers. Our legal and regulatory structure must not chill innovation or prevent financial service providers from responding to changes in the marketplace. Rather, it must offer banks and other financial services institutions the flexibility to develop new products and services in a prudent manner, and to adapt their organizational structures to serve an evolving economy and new consumer needs.

So when I talk about financial modernization I am referring to evolution in two areas:

-- the evolution of financial products and services consumers want and need -- offered in a competitive environment

-- and the evolution of the government's responsibility to reduce unnecessary burden and ensure safety and soundness of the financial system as a whole, including the banking

system.

Even those who share this broad view of financial modernization do not always appreciate the range of reasons why achieving it is so important.

Almost all observers recognize that financial modernization is good policy because it promotes competition and efficiency within the financial services industry, and increased competition and efficiency benefit consumers. As more providers compete to offer the same products and services, these products and services are likely to be offered at lower costs and offered to consumers who currently are not adequately served or perhaps not served at all. Increased competition also should drive innovation so that new products and services continually become available in the marketplace. Throughout this century, constant innovation has brought greater access to financial products and services for more American consumers and businesses, fueling the trend I've called the democratization of credit -- a trend we must continue in the coming century.

Further, financial modernization should mean greater flexibility for financial service providers to choose the organizational structure that makes the most business sense for their institution. This increased flexibility will reduce costs, and these savings can be passed on to consumers. In some cases, increased flexibility in structure may even enable organizations to offer products or services that they could not otherwise have offered, further benefitting the institution and the consumer. And importantly, greater flexibility in organizational form should work to the benefit of America's community banks, which have been and must continue to be valuable players in America's financial services industry.

But beyond the benefits of enhanced competition, expanded access and greater efficiency is a benefit many fail to recognize and the one I want to emphasize today -- what broad financial modernization can mean for safety and soundness.

A combination of forces at work in banking today is leaving banks with shrinking revenue opportunities from their traditional lines of business. I want to cite three examples of the forces affecting today's banks that have long-term implications for their vitality if we do nothing.

First, even without significant legal or regulatory change, developing technology and economic globalization has made the financial services market increasingly competitive. American banks face competition from non-U.S. banks and from domestic and foreign non-bank financial services companies, such as investment banks, securities houses, and insurance companies. Increasingly, competition comes even from companies that have not been traditional financial services providers, such as telecommunications companies and software development firms.

Second, the products and services that financial services customers want and need today have changed and will change

greatly in the future. For example, savers today apparently are less interested in insured deposits than in mutual funds and insurance. This year, for the first time in the history of America, assets held by savers in mutual funds will outstrip assets held in insured deposits.

Third, the core of banking's traditional lending business is fast disappearing. For the last several decades, more and more of the core business of commercial banking -- lending money to business -- has been taken away by the capital markets. And the portion of the business appropriated by the capital markets has been the industry's most creditworthy business.

To recap, a dwindling core business, increased competition, changing consumer needs, and -- most significantly -- a dynamic environment in terms of technological change and globalization means that banking cannot stand still.

If we deny banks the opportunity to evolve and grow into new financially-related activities they can engage in safely, banks will be pressed to squeeze more profit out of their dwindling traditional activities, either by moving further out on the risk limb or by shortchanging basic risk management systems and internal control mechanisms as they seek to cut costs without losing revenue. I believe that a prudent increase in permissible activities will enable banks to establish a more varied and more stable mix of activities, helping to balance and offset downturns in a bank's traditional lines of business. Stronger institutions with increased profits and asset growth will be better positioned to meet the credit needs in their communities and in the economy as a whole.

Despite these safety and soundness facts, financial modernization still remains unfinished business.

I have no doubt that the debate over financial modernization will continue, and I'm confident that new momentum will eventually move us forward. But "eventually" -- as history in this area has taught us -- can often be a very long time indeed. We cannot wait, because a failure to move ahead prudently in the current dynamic environment is likely to create safety and soundness problems for the banking industry.

Banking must move forward now, as best it can, and those of us charged with safeguarding the safety and soundness of the banking industry have a responsibility to act. Indeed, a regulator who identifies a safety and soundness issue -- whether an issue of immediate concern or one off on the horizon with long-term implications -- and does nothing is not doing his job or serving the public interest.

It was with keen awareness of this responsibility that two years ago we proposed a revision to Part 5, the section of the OCC's rules that establishes the process and procedures for OCC to consider corporate applications from national banks. We proposed to modernize and streamline our application process and to make more explicit the ability of banks to use subsidiaries to engage

in a broad range of activities that are part of or incidental to the business of banking.

We have waited some time before finalizing this rule in deference to the efforts of the last Congress to pass legislation in this area. During this same time period, the Supreme Court has made clearer than ever before that President Lincoln and Secretary Chase, in creating the national bank charter, granted a broad range of powers to national banks that were meant to evolve over time. The Court's four unanimous decisions in the past three years represent an extraordinary reaffirmation of their original vision that the nation's economic vitality is dependent in large part upon a strong and ever-adapting national banking system.

Part 5 will effectively improve the way in which we can achieve that vision of a vibrant, market-driven banking system -- allowing financial modernization in a prudent, orderly and public fashion. Since we proposed our revision to Part 5, we have carefully reviewed our proposal and the many thoughtful comments we received to make certain that, as we streamline the regulation, we maintain the highest safety and soundness standards and protect the interests of America's consumers and communities.

After this careful consideration, and mindful both of the responsibility that led us to propose these revisions two years ago and of our obligation not to restrict the rights granted national banks by their charters as reaffirmed by the Supreme Court, this morning I approved the final version of Part 5 for publication in the Federal Register.

Part 5 is the capstone to our regulatory review project, a comprehensive review and revision of all OCC regulations. Part 5 represents a fundamental rethinking of our corporate application procedures. Building upon our risk-based approach to supervising today's banks, the rule employs different application procedures depending upon the level of risk of the proposed activity as well as the financial strength and operational capabilities of the institution.

Part 5 also applies this risk-based approach to the activities permitted for subsidiaries of national banks. It allows well-run banks to establish subsidiaries to conduct certain specified activities with a simple, after-the-fact notice and other activities after an expedited review process. Further, under the new 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 potentially different from what the bank may engage in directly.

This provision establishes a process by which the OCC may consider whether to permit certain activities for a bank subsidiary that we have not previously allowed. But this provision does not authorize any particular activity. The OCC will publish notice and seek comment before we reach a decision on any specific proposal to conduct an activity in a subsidiary that could not be conducted in the bank itself. We will carefully consider whether the activity could lower the bank's safety and soundness. And we will take a very cautious and judicious approach to reviewing and deciding any requests made through this new process.

The two central components of Part 5 provide the broad range of benefits from financial modernization that I described earlier. First, the streamlined application procedures promote safety and soundness because they provide a powerful incentive for banks to ensure that they are well managed and well capitalized so they can take advantage of expedited processing. They enhance competitiveness and efficiency by reducing the paperwork that must be filed in connection with many applications and simplifying the process for charter conversions, consolidations, mergers, and corporate reorganizations.

Further, the streamlined procedures promote access to credit. For applications subject to CRA, we have combined expedited processing with a rapid response approach to adverse CRA comments. When appropriate, we will conduct targeted examinations during the application process to assess the significance of CRA issues raised during the comment period and modify our response to the application if warranted.

The second component of Part 5 -- the operating subsidiary provision -- promotes safety and soundness by opening up the possibility of a prudent increase in the range of financially-related activities that banks, through their subsidiaries, can conduct. And the rule contains important safeguards to ensure that any new activities are conducted safely and soundly. These safeguards include required internal controls, provisions to ensure the separate corporate identities of the parent bank and its subsidiary, limitations on transactions between the bank and subsidiary, and restrictions on the bank's ability to count its investment in the subsidiary toward regulatory capital requirements. The OCC will impose additional safeguards that may be warranted by a particular activity if we approve an application for that activity.

The operating subsidiary provision has the potential to increase competition in the financial services industry because bank subsidiaries will be able to join non-banks in offering a wide array of financial products and services that meet customer needs. The provision further promotes competition and enhances efficiency because it gives banking organizations an increased choice of how to structure their operations. For community banks, operating subsidiaries may provide the only realistic option for diversifying their activities to stay competitive.

Finally, by enabling banks to operate more efficiently and tap new profitable opportunities, the operating subsidiary provision has the potential to increase the resources banks have available to help meet credit needs in the communities in which they operate. Under the CRA regulation, the community development activities of a bank's operating subsidiary can be counted in the bank's CRA assessment. I wouldn't be surprised to see banks creating operating subsidiaries to further support their community development activities, such as subsidiaries that bring new products and services into underserved neighborhoods.

This recitation of the benefits of Part 5 is not intended to suggest that this rule provides answers to all the difficult issues posed by the prospect of financial modernization. Like so many advances in this area, Part 5 is a small step forward. But Part 5 does hold the promise of significant progress, and it can be a powerful tool for expanded business opportunities, greater efficiencies, enhanced safety and soundness, and a broader and less expensive array of financial services for America's communities and consumers -- goals that should be shared by all supporters of financial modernization.

As we've learned, when banks are afforded new ways to take one step forward, there will be voices calling for other changes that would push them two steps back. I'd like to think that Part 5 will be an exception to that rule -- because it strengthens our financial system and provides broad public benefits. But I'm enough of a realist to know otherwise.

We know our Part 5 process will have its critics. It's probably safe to say that monopolists and protectionists will not be cheering us on. So it will be up to those of us who believe this is an important move toward needed financial modernization to make the case that Part 5 is both crucial for America's banks to remain competitive in the financial services marketplace and in the general public interest. I look forward to working with those of you who share this belief and our desire to prepare banking and financial services for the 21st century.

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