

Testimony

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TS-012 - Retsinas Testimony, Before the Subcommittee on Financial Institutions and Consumer Credit, on Financial Modernization

Testimony

of

Nicolas Retsinas, Director

Office of Thrift Supervision

concerning

Financial Modernization

before the

Subcommittee on Financial Institutions and Consumer Credit

United States House of Representatives

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Office of Thrift Supervision

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Summary of Financial Modernization Testimony
Nicolas Retsinas, Director
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Before the
SUBCOMMITTEE ON FINANCIAL
INSTITUTIONS AND CONSUMER CREDIT
United States House of Representatives
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Regardless of what policies we ultimately adopt to deal with financial modernization, financial modernization will occur in some form. This is because powerful forces such as technology and globalization are driving changes in the financial services marketplace.

In framing the debate about the form of our future financial services industry, four principles should be followed when considering legislation:

1. Ensure that insured depository institutions, which for generations have protected America's savings and provided a critical source of funding to America's families and businesses, have the flexibility to compete effectively in today's dynamic financial services marketplace.
2. Minimize needless transitional and regulatory burdens imposed on insured institutions, consistent with safety and soundness, to allow institutions the flexibility they need to react in the marketplace.
3. Avoid substituting the federal government's judgment about the proper role of the financial services industry for that of the marketplace, absent a compelling safety and soundness concern.
4. Maintain a structure that does not hinder or impede the ability of insured institutions to continue to provide community-based financial services.

Applying these principles to whatever reforms we consider will help our insured depository institutions to compete effectively in the future. Several key issues must be addressed in order for financial modernization to take place, such as: holding company powers; operational and charter flexibility for insured institutions; minimizing transitional and regulatory costs for existing institutions; and maintaining and promoting the viability of community-based lending institutions.

Holding Company Powers: Perhaps the most controversial aspect of the financial modernization debate is the extent to which the powers of existing bank holding companies ("BHCs") should be expanded. Notwithstanding the concern expressed by many that banking and commerce should not mix, insured savings associations have for years affiliated with, and been owned by, a myriad of commercial entities. Our experience has been that affiliations with commercial firms do not involve inherently greater risk to a thrift than affiliations with more traditional "financial services" companies.

The thrift holding company model is useful because it demonstrates how the system can accommodate, from both a capital standpoint and an operational perspective, the intermingling of banking and commerce. Although unitary savings and loan holding companies ("SLHCs") are not generally subject to activity restrictions, nor capital requirements, the interaction and relationships between the subsidiary thrift institutions, the SLHC and its affiliates are monitored closely.

Based on the capitalization and earnings of a savings association, we impose restrictions on the extent to which institutions may make capital distributions to their holding companies. We also impose stringent affiliate transaction restrictions on a thrift's dealings with its holding company and affiliates. If a SLHC (or affiliate) is engaged in non-permissible BHC activities,

the restrictions on an affiliate savings association are even more stringent -- it may not make *any* loans or extensions of credit to the SLHC (or affiliate). In addition to these restrictions, we take an umbrella supervisory approach to the SLHC as a whole. This allows us to accurately assess how risks to an insured institution may be affected by risks in the other components of the holding company structure.

Operational and Charter Flexibility: Institutions should be permitted to engage in any activities related to their financial intermediary functions that do not otherwise pose an undue safety and soundness risk to the federal deposit insurance funds. Enhancing the business opportunities and, therefore, the market competitiveness of insured institutions, while providing the best service possible to consumers, is the fundamental objective of financial modernization.

Minimizing Transitional and Regulatory Costs: Although a certain amount of disruption is inevitable when attempting to implement changes of the magnitude we are now discussing, we must be vigilant to do all within our power to minimize governmental interference with the business operations of existing insured institutions. Financial modernization should not undermine the very objective it is intended to achieve -- making insured institutions more competitive. We must resist imposing unnecessary procedural requirements that drive up compliance costs; statutory provisions that disproportionately impact one group of institutions to the advantage of others; and inflexible reforms that interfere with the business operations of institutions, their holding companies and affiliates. These burdens translate into higher costs and thus decreased competitiveness for insured institutions.

Promoting the Viability of Community-based Lending Institutions: Any plan to modernize our financial services industry should nourish the vitality and strength of America's community-based lending institutions. There are thousands of insured institutions, banks as well as thrifts, whose primary business focus is meeting the lending and credit needs of their local communities. Such institutions, which operate in this manner by choice and at a profit, should not be forced to alter their focus on community lending simply to conform to new rules and regulations.

Any proposal to modernize financial services must ensure that institutions are not discouraged or precluded from continuing to concentrate in mortgage lending. Given their traditional focus on residential mortgage lending, many thrifts over the years have developed strong ties to their local communities.

In our zeal to allow broader affiliations between financial firms, we cannot overlook the invaluable services that local lending institutions provide to their communities. The simple fact is that millions of consumers and businesses prefer to do business with a local institution that they know and that knows them. Any changes to our financial services industry that have the effect of restricting, rather than expanding, the availability of banking services would be a mistake. We must preserve and extend, where possible, the ability of lending institutions to deliver personal, timely lending and other financial services to local communities.

**FINANCIAL MODERNIZATION TESTIMONY
BEFORE HOUSE SUBCOMMITTEE ON FINANCIAL
INSTITUTIONS AND CONSUMER CREDIT
February 13, 1997**

**Nicolas Retsinas, Director
Office of Thrift Supervision**

I. Introduction

I appreciate this opportunity to present OTS's perspective on financial modernization. We are here today, discussing this issue, because of the inevitability of change. Powerful forces such as technology and globalization are driving change in the financial services marketplace. Regardless of what policies we might ultimately adopt to deal with financial modernization, I suspect we can all agree that, no matter what we do, financial modernization will occur in some form. In many areas, technological and operational developments have outpaced the government's response to these changes. The financial services industry has changed radically over the past 10 years -- and in the last several years we have witnessed dramatic and permanent revisions, in particular, to the operations of thrift institutions.

How modernization affects our nation's financial institutions will depend, largely, on how we respond to the forces of change. We can make change our friend or our foe. Clearly, financial modernization has many facets. We must be prepared to move forward, first, to identify the issues we need to address to facilitate meaningful reforms, and, second, to implement the reforms in a constructive manner.

OTS is uniquely positioned to address some of the fundamental issues involved in the financial modernization debate. For decades, thrifts have maintained relationships with commercial firms and operated subsidiaries engaged in a wide variety of businesses. The affiliate transaction protections provided by Congress in the Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIRREA") and the prompt corrective action provisions of the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA") have greatly assisted us in managing the risks involved when an insured institution affiliates with commercial entities.

In many ways, the thrift industry over the years has served as a laboratory for exploring the effects and permutations of affiliations between various sectors of the financial services industry, and between those sectors and other commercial firms. The way that thrifts have managed these various affiliations is by no means the only framework for our financial services system. However, our experience in regulating and observing how insured institutions manage their various business interests, both at the holding company and subsidiary level, is helpful in reaching an understanding of how the system can be structured to accommodate interlocking financial services companies.

In framing the debate about the form our future financial services industry will take, I believe there are four principles that we should follow in order to develop and implement meaningful and long-lasting reforms. These are:

1. Financial modernization legislation should ensure that insured depository institutions, which for generations have protected America's savings and provided a critical source of funding to America's families and businesses, have the flexibility to compete effectively in today's dynamic financial services marketplace.
2. Financial modernization legislation should minimize needless transitional and regulatory burdens imposed on insured institutions, consistent with safety and soundness, to allow institutions the flexibility they need to react in the marketplace.
3. Financial modernization legislation should not substitute the federal government's judgment about the proper role of the financial services industry for that of the marketplace, absent a compelling safety and soundness concern.
4. Financial modernization legislation should maintain a structure that does not hinder or impede the ability of insured institutions to continue to provide community-based financial services.

Applying these principles to whatever financial modernization reforms we consider will help our insured depository institutions to compete effectively in the future. Only after the wisdom of a

reform is accepted should regulatory and supervisory structures be addressed. The reforms we implement will dictate the governmental structures necessary to administer a particular regulatory or supervisory approach. Moreover, focusing on issues of institutional powers and charter flexibility, instead of regulatory structure, will avoid our being sidetracked by issues that are secondary to the job of shaping our financial system for the 21st century.

OTS supports charter modernization legislation and will work with Treasury to assist Congress in moving the debate forward. In my testimony today, I will highlight what I believe are among the most important issues in this debate -- holding company powers; operational and charter flexibility for insured institutions; minimizing transitional and regulatory costs for existing institutions; and maintaining and promoting the viability of community-based lending institutions and ensuring the continued availability of housing finance.

II. Key Charter Reform Issues

A. Holding Company Powers

Perhaps the most controversial aspect of the financial modernization debate is the extent to which the powers of existing bank holding companies ("BHCs") would be expanded. Historically, this issue is highly charged and is the major reason why financial modernization legislation has repeatedly failed in recent years. Notwithstanding the concern expressed by many that banking and commerce should not mix, insured savings associations have for years affiliated with, and been owned by, a myriad of commercial entities. Indeed, our experience has been that affiliations with commercial firms do not involve inherently greater risk to a thrift than affiliations between a thrift and more traditional "financial services" companies.

Since the 1950s, unitary savings and loan holding companies ("SLHCs") have been engaged in securities and insurance activities and a wide range of other commercial and industrial enterprises. Clearly, the functional distinctions between "financial services" companies and other "commercial" enterprises have become more and more blurred over the last generation. In our experience, there has been little, if any, evidence that ownership by a "commercial" enterprise entails a greater risk to a thrift than ownership by an insurance or securities firm.

In fact, evidence suggests that instead of being a drain on insured institution resources, unitary SLHCs have often provided a valuable source of stability and strength to their subsidiary thrifts. Although some commercial entities have chosen to pull out of the thrift industry, since enactment of the affiliate transaction restrictions in FIRREA and the prompt corrective action provisions in FDICIA, we have seen no instances where a commercial affiliation has operated to the detriment of an insured thrift institution.

Currently, there are over 700 unitary thrift holding companies. The majority of these companies are predominantly financial services companies, but some are engaged in enterprises as diverse as paper and wood products, integrated food services and even state carpenters union pension funds. They generally have proven to be solid parents and have presented no safety and soundness problems to their insured subsidiaries. Although not all unitary SLHCs have remained in the financial services industry, the institutions that they left behind remain viable and profitable depositories. For example, although both Ford Motor Company and Sears, Roebuck and Company ultimately divested their thrift subsidiaries, their investments in the thrifts saved taxpayers several hundred million dollars.

Although not all of these relationships have been productive, our experience suggests that affiliations between thrifts and companies engaged in financial, commercial and industrial activities have raised neither systemic safety and soundness nor public policy concerns. Indeed, these affiliations have numerous potential benefits. First, as I highlighted above, SLHCs that engage in diverse lines of business often have substantially greater financial resources than nondiversified companies. Diversified companies have infused several billion dollars in equity capital into thrifts, often well after the initial acquisition, to expand customer services and maintain capital. In many instances, these capital infusions have decreased taxpayer exposure to potential federal deposit insurance losses.

In addition, although less quantifiable, diversified companies can contribute business and managerial talent and expertise to their subsidiary savings associations, particularly if the holding company has significant experience in financial services activities. This, of course, can cut both ways, and what may be gained with the general business experience of the holding company may be lost because the holding company lacks familiarity with the operations of insured depository institutions.

Finally, savings associations that affiliate with diversified, commercial holding companies may recognize increased business opportunities and provide consumers with benefits that arise from the cross-marketing of products and services offered by various entities within the holding company structure. Again, this is an area that may present benefits as well as produce potential detriments. Regulatory oversight that enforces applicable anti-tying restrictions will preserve the consumer benefits that arise from these arrangements and guard against predatory or anti-competitive marketing practices.

The thrift holding company model is useful because it demonstrates how the system can accommodate, from both a capital standpoint and an operational perspective, the intermingling of banking and commerce. Although SLHCs are not generally subject to activity restrictions, nor capital requirements, the interaction and relationships between the subsidiary thrift institution, the SLHC and its affiliates are monitored closely. In this manner, we attempt to ensure that a holding company (and its affiliates) will not adversely impact a subsidiary thrift.

This is accomplished in a number of ways. First, based on the capitalization and earnings of a savings association, we impose restrictions on the extent to which the association may make capital distributions (e.g., via dividends and other capital payments) to its holding company. Second, we impose stringent affiliate transaction restrictions on a thrift's dealings with its holding company and affiliates. In addition, if a SLHC (or affiliate) is engaged in non-permissible BHC activities, the restrictions on an affiliate savings association are even more stringent -- it may not make *any* loans or extensions of credit to the SLHC (or affiliate). Besides these specific restrictions on the relationship between a thrift and its affiliates within a particular holding company structure, we have taken an umbrella supervisory approach to the SLHC as a whole. This approach allows us to accurately assess how risks to an insured institution may be affected by risks in the other components of the holding company structure.

The SLHC also is subject to examination and intervention in the event that its (or an affiliate's) operations appear to threaten a thrift's safety and soundness. Otherwise, the SLHC generally is free of government intrusion into its operations.

In sum, the OTS experience with SLHCs is useful in better understanding how banking and commerce may be mixed without exposing insured depository institutions, and the federal deposit insurance funds, to undue risks. Although our experience with banking and commerce is somewhat tempered by the fact that the commercial lending activities of thrifts are limited by the qualified thrift lender, or "QTL," test, we nonetheless believe that the SLHC model offers valuable insights into the banking and commerce debate.

B. Operational and Charter Flexibility for Insured Institutions

Providing sufficient operational flexibility for insured institutions to compete more effectively -- now and in the future -- in our rapidly evolving marketplace is another key element in the financial modernization debate. Enhancing operational flexibility also raises sensitive issues, particularly when it involves insured depository institutions directly or indirectly engaging in securities and insurance activities.

In recent years, we have seen a gradual lowering of the traditional barriers between the various sectors of the financial services industry. During this time, we have gained a better understanding of the risks involved in these activities, and have become more comfortable with the ability of institutions to address the specific risks posed by these activities. As a result

of our experiences, we have continued to refine our regulatory approach in monitoring these risks and evaluating the appropriateness of various activities of insured institutions and their affiliates. We have developed risk-focused supervisory approaches, including the adoption of risk-based capital requirements and risk-focused examinations, to adapt our supervision of a particular institution's activities to the risk they pose to the institution.

Regardless of where the current debate takes us, market forces have clearly opened numerous inroads by insured institutions into the marketing and sale of securities and insurance products. At this point, we should not try to hold back those market forces, but rather work to ensure that adequate and effective safeguards continue to be implemented by insured institutions that are commensurate with the riskiness of the activities in which they engage.

For instance, there is concern that allowing parent insured institutions to operate a variety of nonbanking businesses through operating subsidiaries and service corporations could adversely affect the health of the parent. Our experience suggests that, with the proper safeguards in place, an insured institution can operate these subsidiaries without threatening the health of the parent insured depository parent. That experience also suggests that insured institutions and their subsidiaries can safely provide consumers a wide array of fee-generating services, such as investment advice and insurance sales, without raising significant supervisory concerns.

A thrift's exposure to activities engaged in by its service corporations is limited in a number of ways. First, a thrift can invest only 3% of its total assets in service corporations. Second, a thrift's equity investment in a service corporation that engages in activities not permissible for a national bank is deducted dollar for dollar in calculating the thrift's capital. This separate capitalization requirement means that a thrift must maintain additional capital if it wants to pursue non-traditional banking activities in its service corporations.

We also know that for many years, state-chartered banks have been operating a variety of subsidiaries engaged in nonbanking activities. Today, state banks, whose deposits are also federally insured, successfully operate subsidiaries that engage in businesses as diverse as print shops, automobile rental agencies and travel agencies, as well as the more traditional real estate development, insurance sales, and correspondent banking services. These state banks also operate under restrictions tied to their capital levels and are subject to FDIC review of their subsidiaries' activities. While the insured institution can never be completely and continually insulated from the operations of its operating subsidiaries and service corporations, our experience again suggests that with the proper safeguards in place, insured institutions can operate these subsidiaries in a way that does not unduly threaten the institutions, or the federal insurance funds.

In addition to expanding the operational flexibility of insured institutions to engage in securities, insurance and other financial activities, subject to reasonable safeguards, we must be vigilant to ensure that our nation's financial institutions adapt to the wave of technology rolling over the financial services marketplace. Although opinions vary as to how quickly and completely bank customers will embrace technology, we must encourage and allow insured institutions sufficient flexibility to implement changes, while retaining sufficient regulatory oversight to ensure that the overall impact of these changes is positive for institutions and consumers.

Institutions should be permitted to engage in any activities related to their financial intermediary functions that do not otherwise pose an undue safety and soundness risk to the federal deposit insurance funds. Enhancing the business opportunities and, therefore, the market competitiveness of insured institutions, while providing the best service possible to consumers, is the fundamental objective of financial modernization. Thus, we must grant insured institutions the greatest degree of latitude and flexibility to pursue business strategies that optimize their health and profitability and safeguard the federal deposit insurance funds. Options provide opportunities, and failing to include business flexibility in a modernized charter would not only miss an opportunity to enhance financial competitiveness, but also could prove to be a fundamental flaw in our reform efforts.

C. Minimizing Transitional and Regulatory Costs for Existing Institutions

Another key principle that I noted at the outset deals with transitional and regulatory costs. Regardless of the ultimate form that any financial modernization legislation takes, we cannot compromise on minimizing these costs for existing institutions.

Although a certain amount of disruption is inevitable when attempting to implement changes of the magnitude we are now discussing, we must be vigilant to do all within our power to minimize governmental interference with the business operations of existing insured institutions. Financial modernization should not undermine the very objective it is intended to achieve -- making insured institutions more competitive. We must resist imposing unnecessary procedural requirements that drive up compliance costs; statutory provisions that disproportionately impact one group of institutions to the advantage of others; and inflexible reforms that interfere with the business operations of institutions, their holding companies and affiliates. These burdens translate into higher costs and, thus, decreased competitiveness for insured institutions.

For instance, we should avoid statutory changes that require institutions and their holding companies to divest existing, profitable business activities. Thrift holding companies with healthy businesses that have been profitable for years and have not adversely affected the insured institution's safety and soundness should not have to divest those subsidiaries.

Similarly, we should avoid charter application or notice requirements that are not necessary to complete the process of charter modernization. For example, we should not require institutions to undergo a re-chartering process in order to adopt any modernized charter. This can be accomplished simply by automatically converting institutions to the new charter and giving them the option of "opting out" to a state charter. The joint efforts of the OTS and the other federal banking agencies over the past five years to implement streamlined and unified regulatory requirements, as directed by Congress in various statutory provisions, gives solid support for an automatic rechartering process.

Finally, we should avoid reforms that require institutions, their holding companies and their affiliates to restructure programs and policies merely in order to streamline government oversight functions, without any tangible benefit for the institutions. For example, legislation aimed at more closely monitoring the business activities of insured institution holding companies and affiliates should not be substituted for effectively monitoring and regulating the health of the insured institution. Focused supervision and oversight on the insured institution is the most effective and efficient method of ensuring a sound and viable depository system.

D. Promoting the Viability of Community-based Lending Institutions and Ensuring the Continued Availability of Housing Finance

Any plan to modernize our financial services industry should nourish the vitality and strength of America's community-based lending institutions. Even in this age of ever-growing and consolidating mega-regional, national and international banking organizations, many consumers prefer banking at a local community-based institution. There are thousands of insured institutions, banks as well as thrifts, whose primary business focus is meeting the lending and credit needs of their local communities. Such institutions, which operate in this manner by choice and at a profit, should not be forced to alter their focus on community lending simply to conform to new rules and regulations aimed at allowing financial institutions to compete more effectively nationwide and globally.

Moreover, any proposal to modernize financial services must ensure that institutions are not discouraged or precluded from continuing to concentrate in mortgage lending. Public policy in this country has always recognized the value of promoting home ownership. Many of the institutions we regulate have found residential lending a profitable line of business, with numerous thrifts exceeding the levels of residential lending required under the QTL test.

The interagency risk-based capital requirements recognize that residential mortgage loans present a much lower credit risk to institutions than commercial loans. With effective supervision, constant monitoring of interest-rate risk, and maintenance of adequate capital levels, a concentration in residential mortgage lending presents substantially lower risk than some more diversified portfolios. We should not force institutions that focus on housing finance to abandon a business that not only is profitable but also fulfills a very important public purpose.

Given their traditional focus on residential mortgage lending, many thrifts over the years have developed strong ties to their local communities. In fact, just last year, Congress modified the QTL test to allow federal thrifts to more adequately and effectively meet the lending needs of their local communities. As a result, thrifts can now include educational loans and credit card loans in calculating their QTL compliance. Thrifts may also now devote up to 20% of their portfolio to small business lending, the backbone of any community lending program. With these new lending powers, thrifts are able to expand their community lending activities.

In our zeal to allow broader affiliations between large financial firms, we cannot overlook the invaluable services that small, local lending institutions provide to their communities. The simple fact is that millions of consumers and businesses prefer to do business with a local institution that they know and that knows them. Any changes to our financial services industry that have the effect of restricting, rather than expanding, the availability of banking services would be a mistake. We must preserve and extend, where possible, the ability of lending institutions to deliver personal, timely lending and other financial services to local communities.

III. Conclusion

Last year, there was concern that any solution to the BIF/SAIF premium disparity should also include a legislated merger of the insurance funds. As you are aware, the compromise that was struck did not bar a fund merger but, instead, imposed a condition that no insured depository institution could be a savings association for a fund merger to occur. The crux of this provision was to maintain the momentum for charter modernization by preventing a fund merger until charter modernization occurs. The fact that pressures built into last year's legislation to advance financial modernization reforms may no longer be compelling should not, however, dissuade us from pursuing the laudable objective of modernizing our financial services industry.

Financial modernization remains as important today as before. We have been unable to move forward, however, because of the dilemma our political process continually poses -- at what cost, reform? Our nation's financial institutions, though comfortable in their current activities and eager for reforms that will ultimately make them more competitive, are sometimes wary of having their brethren across the street gain the same opportunities.

Clearly, we are not in an immediate crisis situation. However, the longer we do nothing, the more ground we concede to non-depository competitors. The time is right for financial modernization and we should move forward to achieve this objective. Some may ultimately pay a price much greater than they were willing to offer, but such a price may be necessary to ensure the long-term competitiveness and viability of our nation's financial services industry.