STATEMENT OF ELLEN SEIDMAN, DIRECTOR
OF THE
OFFICE OF THRIFT SUPERVISION,
ON
FINANCIAL MODERNIZATION LEGISLATION
BEFORE THE
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
OF THE
UNITED STATES SENATE

FEBRUARY 24, 1999

I. Introduction

Mr. Chairman, Senator Sarbanes, and Members of the Committee, I appreciate
the opportunity to discuss the Office of Thrift Supervision’s views on financial
modernization and the Chairman’s draft for the “Financial Services Modernization Act
of 1999.”

Today, we consider draft legislation that takes a fresh look at how to proceed.
Mr. Chairman, your support of reform of financial services reform is well known, and we
appreciate your support of the thrift industry over the years. We look forward to working
with you and all Members of the Committee on this important legislation. The challenge
is to enact legislation that will enable our financial system to function safely, efficiently,
and profitably in the twenty-first century. Regardless of what happens in the coming
weeks and months on the legislative front, the market will continue to modernize.
Legislation should facilitate this trend, promoting flexibility for existing and future
financial institutions, while maintaining a framework to ensure the system’s continued safe
and sound operation, the provision of fair services to all, and the health and stability of the
national and global economies.
In my statement, I will first articulate four principles we believe should guide financial services modernization legislation. I will then discuss several characteristics of the federal thrift charter we believe should be preserved and used as a model for developing new alternative structures. A discussion of our concerns about proposed changes to the Community Reinvestment Act follows. Finally, I will address several other aspects of the bill principally relating to the deposit insurance funds.

II. The Principles of Financial Modernization

We believe several principles should guide legislative efforts to modernize our financial system. Such legislation must:

- Preserve adequate regulatory authority to protect the safety and soundness of insured institutions and the federal deposit insurance funds, and to protect consumers in their dealings with financial institutions;

- Maintain marketplace incentives to facilitate the ability of institutions to continue to provide consumer- and community-based financial services to all Americans, in all communities;

- Enhance structural and operational flexibility so insured depository institutions can compete effectively with other financial services providers; and

- Minimize regulatory burdens on insured depository institutions, consistent with safety and soundness and the consumer protection and community reinvestment laws.
These criteria balance flexibility for institutions—so that marketplace innovations that benefit customers, communities, and the financial system are not impeded—with appropriate regulatory safeguards. The thrift charter represents one model of a modern charter that is consistent with these principles, and is a model worth studying. The thrift charter is useful for financial institutions that have a community- and consumer-based focus and do not rely heavily on commercial lending activities. In fact, over 70 percent of thrift assets are in residential mortgages or mortgage-backed securities. Specifically, the thrift charter:

- Gives the OTS full authority to supervise the thrift industry in a way that both assures the safety and soundness of the industry and protects the consumer;

- Affords benefits and advantages both to small community-based institutions and larger regional and national providers of financial services, which has enhanced competition as existing thrifts and new entrants have provided more choices, in terms of innovative products and new service delivery systems, at a lower cost, to consumers throughout the country;

- Gives OTS authority to issue regulations under which thrifts enjoy substantial flexibility that permits both single branch and large interstate thrifts to compete with banks and other financial services providers; and

- Minimizes regulatory burdens on thrifts, which are subject to a uniform system governing their operations.
III. Characteristics of a Modern Charter—the Federal Thrift Charter

First let me say that I am pleased the Chairman’s draft recognizes the value of the thrift charter and, in particular, that it retains the existing, but limited, authority permitting a thrift to affiliate with a commercial firm under a unitary thrift holding company structure. There is a vigorous debate over the extent to which financial modernization legislation should permit mixing banking and commerce—such as through a “commercial basket” approach or the new unitary bank holding company concept now under consideration. The thrift charter provides a balance of business flexibility and restrictions to safeguard the deposit insurance funds and consumers. These qualities make the thrift charter different from the bank charter and effectively move it out of the realm of banking and commerce.

1. Permissive Affiliation Authority

The federal thrift charter provides a unique combination of permissible affiliations and restrictive operating conditions. The unitary thrift holding company is a good example. Much has been made of the fact that a thrift may be owned by, or affiliated with, any type of commercial entity. Glossed over in this debate are the restrictions under which the thrift itself must operate, as well as an appreciation for the historical framework for regulation of the unitary structure. Attached to my testimony is a copy of a memorandum, entitled “Historical Framework for Regulation of Activities of Unitary Savings and Loan Holding Companies,” which describes this framework in detail.

Let me describe some of the principal restrictions that apply. Section 11(a) of the Home Owners’ Loan Act (“HOLA”) bars federal thrifts from making any loans or extending credit to affiliates not engaged in activities permissible for a bank holding
company under section 4(c) of the Bank Holding Company Act. This prohibition
serves as an absolute limitation on a thrift’s ability to engage in the types of affiliate
commercial lending that are at the heart of the concern about mixing banking and
commerce. Section 11(a) goes well beyond the affiliate transaction restrictions of sections
23A and 23B of the Federal Reserve Act, to which thrifts are also subject.

In addition, the HOLA constrains federal thrifts in the amount of their overall
commercial lending. A thrift may not hold commercial loans in excess of 10 percent of its
assets, except that it may make small business loans up to an additional 10 percent of
assets. Moreover, the qualified thrift lender (“QTL”) test imposed on thrifts generally
requires 65 percent of thrift assets to be in mortgages, mortgage-related investments,
education, and certain consumer and small business loans. These two provisions
effectively constrain the ability of thrifts to engage in traditional commercial bank lending
activities.

The OTS capital distributions regulation also limits the amount a thrift may
distribute to its parent holding company through payment of a dividend or other
distribution. The amount of a permissible distribution is based on the capitalization level
of the thrift institution. In no event may a thrift make a dividend that would impair its
capital, and OTS must be notified in advance of any dividend paid to a savings and loan
holding company. In addition, thrifts—like banks—are subject to increasingly stringent
activities, dividend, growth, and other restrictions that protect the institution if its
capitalization falls below designated capital levels.

Finally, statutory anti-tying restrictions generally prohibit a thrift from conditioning
extensions of credit, providing credit on more favorable terms, or furnishing services to a
customer on the requirement that the customer obtain certain other services from an affiliate of the thrift. These restrictions address another concern that arises in the banking and commerce debate: the unfair use of market power to coerce banking consumers to purchase non-banking products and services, which would also unfairly disadvantage competitors.

In fact, commercial ownership of thrifts remains very limited. As of the end of 1998, only 24 of the 547 existing thrift holding company structures have commercial activity within them. Another 25 holding companies have some amount of real estate development in their structures.¹ None of the three new thrifts or the six new holding company structures approved since December 31, 1998, involves either commercial activities or real estate development. Relatively low levels of such activities exist despite the fact that for several years there have been serious proposals to prohibit commercial firms from acquiring or chartering thrifts in the future. In fact, most of the few commercial firms that now own a thrift charter do so because the focus of their commercial activity is consumer, rather than business, oriented. These companies view the thrift charter as a way to extend and diversify their consumer business operations.

¹ Pursuant to HOLA § 5(t)(5), enacted as part of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (“FIRREA”), savings associations owning subsidiaries engaged in real estate development activities must separately capitalize their investments in such subsidiaries. This requires the full amount of a thrift’s investment in a real estate development subsidiary to be deducted from the thrift’s capital. As a result, after FIRREA most thrift real estate development subsidiaries were either divested or (for institutions in a holding company structure) the activities were moved to a holding company affiliate of the thrift. Currently, thrift investments in real estate development (and other non-includable) subsidiaries amounted to approximately 0.04 percent of total thrift assets. Because (pursuant to another FIRREA provision discussed above) thrifts are prohibited from making loans to affiliates not engaged in permissible bank holding company activities, a thrift is prohibited from funding the activities of such a real estate development affiliate.
Despite the relatively small percentage of commercial ownership of thrift institutions both today and historically, commercial firms have made significant capital contributions to the industry. For example, we are aware of over $3 billion of capital infused in 79 failed thrifts by commercial firms during the late 1980s.

With respect to reports regarding an increase in new thrift charter applications, the vast majority of recent charter applications comes from groups of individuals and from insurance and securities companies, not commercial firms. Insurance and securities applicants are seeking to use the operating and marketing synergies available between their existing business and product lines and ownership or affiliation with a thrift—the same synergies that have been driving financial modernization efforts for several years. All recent financial modernization bills authorize affiliations between insurance and securities firms and a commercial bank under a holding company structure with insurance and securities activities considered to be financial in nature.

Predictably, some of the new applications have raised challenging policy and supervisory issues, particularly the proposals that have involved unique business plans and strategies. Some applications have required difficult regulatory analysis and novel responses. We thoroughly consider all relevant safety and soundness, compliance, consumer protection and related issues prior to our action on each individual application. OTS conditions of approval typically require applicants to implement adequate internal controls, training programs, and reporting mechanisms that ensure effective oversight, and protect the safety and soundness of the institution and the federal deposit insurance funds.

I have heard that some applicants have chafed so much at the care we exercise in reviewing unique business strategies that they question whether we have a self-imposed
moratorium on new charters. To set the record straight, OTS does not have a moratorium on approving new charters.

2. Consolidated Regulatory Oversight and Functional Regulation

Another important characteristic of the federal thrift charter is its ability to provide a combination of consolidated regulatory oversight and functional regulation. If a holding company provides financial services only through savings associations, OTS is the consolidated federal regulator for the savings associations, their subsidiaries, and their holding companies. This approach is unique for federally chartered institutions and has worked well. We have access to information on all aspects of the institution’s operations and provide the institutions with “one-stop” regulatory oversight that focuses primarily on the safe, sound, and compliant operations of the thrift.

If the holding company’s structure includes insurance or securities firms, its components are functionally regulated. Thrifts also operate under functional regulation, with insurance and securities activities performed almost exclusively only in subsidiary service corporations or affiliated holding company parents or subsidiaries. Service corporations and holding company affiliates engaged in insurance activities must be licensed and regulated by the appropriate state insurance regulator, and those engaged in securities activities must register with the Securities and Exchange Commission (“SEC”) and their appropriate self regulatory organization (“SRO”), such as the National Association of Securities Dealers (“NASD”). Primary oversight of insurance and securities activities remains with the functional regulator (i.e., state insurance and securities commissioners and the SEC and NASD or other SRO). OTS works closely with these organizations when an issue affecting the thrift or its charter arises.
Not only does this unique approach benefit OTS-regulated thrifts by avoiding regulatory overlap, it embraces a common-sense regulatory division of labor. In practice, we exercise our authority to monitor all aspects of a structure in order to protect the safety and soundness of the thrift and to monitor activities that could adversely affect the thrift’s customers. The existing combination of consolidated regulatory oversight and functional regulation is worth preserving, and worth seriously considering as a broader model for consumer-oriented financial institutions.

In this regard, we believe it is neither necessary nor wise to restrict our ability to examine investment company affiliates of thrifts, as proposed in section 114 of the Chairman’s draft. This is especially important in light of a few recent applications from large investment companies to establish thrift institutions. If OTS ever needs to examine an investment company, it will do so for different purposes and examine different aspects of the firm’s operations than its primary regulator. To be faithful to our statutory responsibility, it may become necessary to examine a relationship from both sides of the transaction: the thrift’s and the affiliate’s. For example, if a case arises where there is reason to believe that assets held by a thrift in trust are being used primarily to benefit a related mutual fund—such as by increasing the asset level of a new fund or maintaining it in a fund that is experiencing liquidity problems—rather than for the benefit of the beneficiaries, OTS should be able to examine the mutual fund to determine whether this is in fact the case. We believe that any OTS investigation will provide complementary, not duplicative, oversight. We will take steps to assure that our examination of an investment company to protect a thrift or its customers will not result in redundant examination of an investment company. We know that this approach must not be intrusive or burdensome.
OTS already works closely with the primary securities regulator to coordinate our examination efforts. We have all learned during the 1980s that it is not wise to reduce supervisory tools simultaneously with an expansion of permissible activities.

IV. Community Reinvestment Act Concerns

The involvement of the private sector, in general, and the thrift industry, in particular, in community development and economic revitalization initiatives has dramatically increased during this decade. Even as public money and subsidies once available for community development projects have been reduced, the private sector has stepped in, partnering with non-profit and for-profit community organizations and developers, leveraging scarce public resources, and creating innovative financing methods to revitalize distressed communities. These partnerships have resulted in extraordinary increases in the availability of housing for low- and moderate-income individuals. For example, from 1993 through 1997, the number of home mortgage loans increased by 58 percent for African-Americans, 62 percent for Hispanics, and 38 percent for all low- and moderate-income borrowers, figures all well above the overall market increase.

The Community Reinvestment Act (CRA) deserves at least part of the credit for these positive efforts. We believe the CRA stimulates insured depository institutions to pursue creative and profitable financing endeavors they might not have otherwise explored. Both time series data and anecdotal information demonstrate it has been the catalyst for much of the innovation we have seen in recent years.

We also know that there are aspects of the CRA regulation, the examination process, and the applications process that have raised concerns for some participants. As I
have stated publicly, the revised CRA regulation is not perfect; depository institutions, community organizations and advocates, and even our examiners have raised some practical, legitimate regulatory issues that we need to address to add clarity and ease implementation.

We believe, however, the flexibility inherent in both the CRA statute and the revised regulation makes it possible to address these and other issues without statutory change and without a wholesale revision of the regulation.

1. **CRA Examinations**

Section 303 of the draft would deem any insured depository institution with at least a satisfactory CRA rating in its most recent CRA examination and in each examination during the preceding 36 months to be “in compliance” with the CRA until the completion of its next regularly scheduled examination, with one exception. The institution would no longer be “in compliance” if a person files “substantial verifiable” information contrary to the satisfactory or better rating with an appropriate federal banking agency. The person filing the information would have the burden of proving to the federal banking agency that the information is both substantial and verifiable.

This provision has been characterized as a “safe harbor” by those who believe that a satisfactory rating should be all a financial regulator needs in order to assess an institution’s record in connection with a merger or other application. However, this does not take into account factors such as the time between CRA examinations, changes in an institution’s business strategy or geographic reach subsequent to an examination (including changes that would result from approval of the application at issue), and the
inability of regulators to fully cover all aspects of a far-flung institution’s business during an examination that does not overburden either the institution or the regulators.

Although we place great weight on an applicant’s current CRA rating (where one is available) and performance record in reaching a decision on an application, we generally find that the information received from those few who do comment on applications is relevant, constructive, and thoughtful, and frequently raises issues that need to be considered. In order for us to reach a supportable disposition on an application, and satisfy our statutory responsibilities, we need to have public input. We take seriously issues that bear on an applicant’s ability to serve the convenience and needs of its community. In the case of mergers that involve combinations of geographically distant businesses, comments help us evaluate how well the surviving institution will respond to banking needs in areas where it did not have a market presence in the past.

In addition to our concerns about the safe harbor aspects of section 303, we also believe it is likely to increase burden on everyone—community groups, regulators, and financial institutions. Alone, or especially if the criminal penalty provisions under consideration are adopted, section 303 could have the unintended result that only the worst about an institution is brought to our and the public’s attention, doing a severe disservice to those many institutions that are serving their communities well. This is likely to make the applications process more cumbersome and adversarial by reducing incentives for community organizations to work constructively with local institutions.

Finally, this provision can be read to prohibit a regulator from conducting a CRA examination on a shorter than normal cycle, or reconsidering the CRA rating of an institution even where circumstances suggest that an off-cycle review is appropriate.
for example, new issues arise that bear on an institution’s CRA rating from a regular safety and soundness examination, subsequent releases of HMDA data, newspaper articles about local lending patterns, or an allegation of discriminatory conduct received from another federal or a state agency, the regulator must have the flexibility to accelerate its normal examination cycle.

2. **CRA Antiextortion and Antibribery Amendment**

Included as one of the undecided issues you are considering for inclusion in the bill is a legislative proposal under the heading “CRA Antiextortion and Antibribery Provisions.” This proposal would make it unlawful for an insured depository institution (including its affiliates) subject to the CRA “to intentionally attempt to motivate, encourage, or influence the testimony” of any interested party before one of the banking agencies concerning compliance by the institution with the CRA by taking certain actions. The provision would prohibit (1) making payments or otherwise providing monetary benefits to an interested party, and (2) establishing a quota or set-aside for business activities for the benefit of, or on behalf of, an interested party. Anyone who violated these prohibitions or who knowingly solicited or received prohibited benefits would be subject to a fine of up to $1 million and/or imprisonment for up to one year. The bill would also require a beneficiary of prohibited benefits to disgorge them to the United States Treasury.

We believe this proposed criminal statute would—

- reduce public participation in the application process and the amount of information regulators have on which to base their decisions, and make the
process more adversarial as those who might have commented positively are
discouraged from doing so;

- inhibit the ongoing development of the effective partnerships that are at the
  heart of the spectacular increases in homeownership among lower income and
  minority households; and

- make suspect completely appropriate corporate philanthropy toward, and
  purchase of services from, individuals and groups active in a depository
  institution’s community, putting depository institutions at a competitive
  disadvantage in serving their communities.

As the Secretary of the Treasury notes in his testimony, the Department of Justice
has provided a preliminary assessment of its concerns with this provision, pending a full
analysis. As an initial matter, the Justice Department has noted that criminal activities
amounting to bribery or extortion appear to be covered under existing criminal law.\textsuperscript{2} It
further notes that existing laws covering bribery and witness tampering incorporate a
requirement that a defendant act “corruptly” in attempting to influence testimony or being
influenced in providing testimony. This bill does not include such a requirement, and the
Department is concerned that it could be read broadly to criminalize legitimate, arms-
length transactions between banks and community groups. Given the questions that the
legislation raises, we urge the Committee to provide the Department of Justice with an
opportunity to study the language further and provide its formal views to the Committee.

\textsuperscript{2} For example: the federal witness tampering statute (18 U.S.C. 1512(b)); the witness bribery provisions of
the federal bribery statute (18 U.S.C. 201(b)(3) and (4)); the false entries statutes (18 U.S.C. 1005 and
1006); and the misapplications of funds statute (18 U.S.C. 656 and 657).
V. Depository Insurance Fund and Other Issues

1. Elimination of the SAIF Special Reserve

I am especially pleased to join with FDIC Chairman Tanoue in strongly supporting the elimination of the SAIF Special Reserve, as proposed in your draft, Mr. Chairman. This proposal would remove a serious threat to the future stability of the deposit insurance funds. Transferring $1.1 billion from the SAIF to the SAIF Special Reserve (by reducing the SAIF reserve ratio from an estimated 1.40 percent to 1.25 percent) has removed a vital cushion that would otherwise protect SAIF members from potential insurance premium increases to cover unexpected future SAIF losses and a subsequent premium disparity between the funds. By the end of 1998, both the SAIF and the BIF had generated substantial, comparable “cushions” above their statutory designated reserve ratios. Funding of the SAIF Special Reserve has recreated the risk of premium disparities and costly, destabilizing deposit shifting between the two funds. One reason Congress enacted the Deposit Insurance Funds Act of 1996 was to prevent such a result. The FDIC now estimates that the SAIF will increase by a maximum of $200 million due to premium collections and earnings during the first six months of this calendar year. While no one anticipates significant claims, this relatively small new cushion exposes SAIF institutions to the risk of increased premiums and, once again, to a troublesome BIF-SAIF premium differential.

2. Merger of the Insurance Funds

I also join Chairman Tanoue in urging the merger of the two FDIC insurance funds. Merger makes sense for several reasons. First, and most important, the federal government and the federal taxpayer have an interest in eliminating the economic and
managerial inefficiencies of a two-fund structure for what is essentially one product—insured deposits. It would be unfortunate if merger of the funds were delayed as a result of other political considerations. Although the bank and the thrift charters are very different structures, insured deposits offered by these two types of entities are identical products. Having two funds makes no sense since the funds are, in effect, already well on the way toward converging. It is becoming increasingly anachronistic to refer to a “bank fund” and a “thrift fund.” Today, commercial banks account for an estimated 35 percent of all SAIF-insured deposits, and almost 30 percent of thrift deposits are insured by the BIF.

Second, assuming restoration of the SAIF Special Reserve funds, merger would not result in dilution of either fund. Both are at nearly equal reserve ratios, assuming the elimination of the SAIF Special Reserve, and all federally insured banks and thrifts would thus equally benefit from a larger, single insurance fund providing federal deposit insurance to both industries.

Third, merging the funds would result in better diversification which will promote stability should there be a future major insurance claim. In sum, using two funds to provide the same federal insurance product is both inefficient and more risky, since it creates opportunities for costly and destabilizing deposit shifts between the two funds.

3. **Uniform FICO Assessments**

   Consolidating the two FDIC deposit insurance funds would not only strengthen the deposit insurance system and provide greater protection to federal taxpayers, banks, and thrifts, it would also reaffirm the wisdom of the current law that will equalize the FICO bond interest burden among all FDIC-insured institutions starting in 2000. Even if you
decide this is not the year to merge the funds, we believe the equalization of the FICO assessment should still take effect at the beginning of next year, as planned. If all insured institutions pay the same FICO rate—expected to be approximately 2.2 basis points—none would be excessively burdened.

The large percentage of thrift deposits insured by the BIF and bank deposits insured by the SAIF demonstrates the inappropriateness of extending the large disparity in the FICO bond interest burden between BIF- and SAIF-insured institutions. (The rate for SAIF-insured institutions is 6.10 basis points, which is five times the 1.22 basis points rate paid by BIF-insured institutions.) Today’s SAIF-insured institutions are no more responsible for the financial crisis of the 1980s than today’s BIF-insured institutions, but both groups benefit equally from the public’s confidence in a strong federal deposit insurance system.

Members of both the BIF and the SAIF have expected the FICO rate differential to end at the end of this year. Extending it could revive the incentive to shift deposits from the SAIF to the BIF. Deposit shifting represents a waste of resources and could unnecessarily leave the SAIF less able to diversify risk. Although current law authorizes regulators to prevent institutions from shifting deposits for the purpose of evading assessments, enforcing this provision is very difficult.

4. Miscellaneous Comments

Section 201 of the draft would add a new section 45, Consumer Protection Regulations, to the Federal Deposit Insurance Act. Under section 45, the federal banking agencies, including OTS, must publish consumer protection regulations related to insurance products. Subsection (e)(2) provides that if the Federal Reserve Board, the
OCC, and the FDIC determine jointly that the federal regulations provide greater consumer protections than State law, the State law is preempted. It does not mention OTS. There is no reason not to include the OTS in the determination since we are one of the agencies responsible for the regulations. We recommend that OTS be added to this subsection.

One of the matters under consideration for inclusion in the bill is reform of the Federal Home Loan Bank System. We continue to strongly support making membership by federal savings associations voluntary and permitting them to withdraw from membership if they choose.

VI. Conclusion

Mr. Chairman, I am pleased to provide you with OTS’ views on financial modernization. Despite our concerns about some of the provisions in the draft, I want to emphasize that we support efforts to modernize the federal laws governing the provision of financial services in the United States. We believe modernization must provide the tools necessary to assure the safety and soundness of the national banking system and protect the American public in its dealings with these institutions, result in consumer- and community-based financial services for all Americans, provide structural and operational flexibility for insured institutions, and minimize regulatory burdens.

Consistent with these goals, OTS urges the Committee to retain the existing thrift charter as one model of a modern charter. In our experience, the modern thrift charter provides business flexibility and choice coupled with sound regulatory oversight. It permits affiliations of insured depository institutions with insurance, securities, and other firms, but
with built-in safeguards to avoid undue risks to the taxpayer and to meet the needs of consumers and communities. Based on our experience, there is no evidence that shows that affiliations permitted in the unitary thrift holding company structure are inherently risky and should be constrained. In fact, there are numerous reasons to retain the structure in its current form.

I want to emphasize the importance we place on the repeal of the SAIF Special Reserve and merger of the funds, and urge you to support enactment of these initiatives at the earliest opportunity. Inclusion of such amendments in both the financial modernization and the regulatory burden relief bills would help accomplish this objective. Similarly, it is important to stay the course with respect to FICO equalization.

I look forward to working with you during the 106th Congress toward the enactment of financial modernization legislation that achieves these goals. Thank you.