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TESTIMONY OF

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COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

of the

UNITED STATES SENATE

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Statement required by 12 U.S.C. § 250:

The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

Introduction

Mr. Chairman and members of the Committee, I appreciate the opportunity to appear before you today to discuss H.R. 10 -- the Financial Services Act of 1998. This legislation is comprehensive in scope and far-reaching in its effect on financial services providers, consumers, communities, and the American economy. I commend you for holding these hearings and ensuring that all involved parties have an opportunity to evaluate carefully all aspects of H.R. 10 and come to understand its many implications for the future of our financial services markets.

In light of the changes in the financial services industry over the past twenty years, the need for some form of financial modernization, soon, is evident. Our nation will benefit from an updated legislative framework that affirmatively supports the sound evolution of the financial services marketplace. But it is imperative that we proceed with care. The issues we are addressing are extraordinarily complex, and the consequences of the choices made by the Congress in this area will be far-reaching and long-lasting. As Secretary Rubin stated last week, financial modernization legislation will be "the constitution for the financial services system of the next century."[1] The industry and the communities and customers it serves could suffer if we rush into change without taking the time to get it *right*. The U.S. financial services industry is currently as competitive as ever in recent memory and the steps we take must enhance, rather than jeopardize, that success.

H.R. 10 contains some important and promising steps toward financial modernization, but unfortunately, it also contains such flaws that, on balance, it would be more damaging than progressive. In my statement today, I will detail where H.R. 10 needs major reconfiguration in order to be worthy to serve as the type of financial services framework that our financial firms, consumers, and communities deserve for the next century.

Discussion of H.R. 10

Financial modernization legislation should be guided by principles that clearly embody our public policy goals. The five principles set forth by Secretary Rubin in his testimony to this Committee last week provide reference points for a sound approach to those goals. These are: protecting the safety and soundness of our financial system; providing adequate consumer protection; reducing costs and improving access for consumers, businesses, and communities; promoting innovation and enhancing the competitiveness of the financial services industry; and permitting financial services firms to choose the corporate structure that makes the most business sense.

I. Protecting the Safety and Soundness of Our Financial System

A cornerstone of bank regulation and supervision is protection of the safety and soundness of the financial system, both short- and long-term. Providing banks the opportunity to maintain

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[1]Testimony of Robert E. Rubin, Secretary, Department of the Treasury, Before the Committee on Banking, Housing and Urban Affairs, U.S. Senate, June 17, 1998, at 2.

strong earnings through prudently conducted financial activities is the essence of safety and soundness. Unfortunately, the complexities, convoluted structural requirements, and inefficient business restrictions contained in H.R. 10 undermine the favorable effects of product diversification and enhanced profitability that the bill seeks to promote.

Allowing new financial activities in subsidiaries of banks, subject to appropriate safeguards, enhances safety and soundness and does not put deposit insurance funds at risk.

H.R. 10 would require that financial organizations wishing to diversify into new financial and financially related activities as principal -- such as new securities activities and the provision of insurance and annuities -- do so only through bank holding company affiliates rather than having the choice of doing so through a bank subsidiary structure.

Supporters of H.R. 10 have put forth two considerations that they claim require this result. The first is that allowing subsidiaries of banks to conduct the same range of financial and financially related activities as would be permitted for bank holding companies would raise safety and soundness concerns and present risks to the deposit insurance funds. The second contention is that banks receive a "safety net subsidy" and that this benefit could be more easily transferred to bank subsidiaries than to holding company affiliates, providing those subsidiaries with an unfair advantage in competition with providers not owned by banks.[2] I address the first concern here and the latter in Section V. below.

With respect to safety and soundness, the restrictive approach of H.R. 10 *undermines* rather than enhances long term safety and soundness. Bank subsidiaries provide a means for prudent diversification of bank activities and income. Fees and other income from the subsidiaries enable banks to offset the effects of cyclical downturns in other economic sectors, diminishing the volatility of bank earnings and making the banking system as a whole less risky.

This is in fact the foreign experience. Foreign experience with financial activities conducted by U.S. bank subsidiaries shows that expanded financial activities can be conducted in bank subsidiaries on a safe and sound basis. For example, evidence indicates that permitting U.S. banking organizations to engage in securities activities overseas through banking subsidiaries has benefited the safety and soundness of the bank. This analysis, as well as a more detailed examination of the performance of individual holding companies, indicates that banking companies *lowered* their overall risk by engaging in overseas securities activities through bank subsidiaries.[3]

Conducting authorized financial activities is no less risky for a subsidiary of a bank than

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[2]Testimony of Alan Greenspan, Chairman, Federal Reserve Board, Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, June 17, 1998, at pp.25-26.

[3]Whalen, Gary, “The Securities Activities of the Foreign Subsidiaries of U.S. Banks: Evidence on Risks and Returns,” Office of the Comptroller of the Currency, E&PA Working Paper 98-2, February 1998.

for a holding company affiliate when subject to the same prudential safeguards. For example, the House Banking Committee version of H.R. 10 provides that the parent bank must deduct from its own capital any equity investment made in its financial subsidiary, and must continuously qualify as well-capitalized after making that deduction. This means that even if the subsidiary fails and the bank experiences a total loss, the bank will still be well-capitalized for purposes of regulatory capital adequacy determinations. Further, because the bank's investment in the subsidiary is deducted from its regulatory capital, the bank's regulatory capital is not affected by fluctuations in the earnings of the subsidiary. Moreover, the bank could not make an equity investment in the subsidiary that exceeds the amount the bank could otherwise pay in dividends to its shareholders, including a bank holding company, without regulatory approval.

Additional safeguards would include the application of the equivalent prudential restrictions of sections 23A and 23B of the Federal Reserve Act to any loans or other extensions of credit between the parent bank and its financial subsidiary. This means that, just like loans or other extensions of credit to a bank holding company affiliate, transactions between the parent bank and its financial subsidiary will be subject to quantitative limits (10 percent of capital for each subsidiary and 20 percent of capital in the aggregate for all affiliates), must be at least 100 percent collateralized with high quality collateral, and must be conducted on an arm's length basis under the same terms that would apply to an unaffiliated third party. Moreover, a bank would be subject to the same very strict limitations on purchases of low quality assets from its financial subsidiary under section 23A that would apply to purchases by the bank from a bank holding company affiliate.

In sum, with these types of safeguards in place, new financial activities can be conducted as safely and soundly in a subsidiary as in an affiliate.

Indeed, the prudent diversification of activities through the subsidiary structure enhances bank safety and soundness by increasing banks' earnings and diminishing their volatility and thereby also strengthens the deposit insurance funds. In fact, current and former Federal Deposit Insurance Corporation (FDIC) Chairmen have agreed that allowing banks to conduct new activities in subsidiaries is at least as safe and sound -- probably more so -- than conducting these activities in a holding company affiliate. FDIC Chairman Ricki Helfer noted that: "with appropriate safeguards, having earnings from new activities in bank subsidiaries lowers the probability of failure and thus provides greater protection for the insurance fund than having earnings from new activities in holding company affiliates."[4] Also, in the event of a bank failure, the value of the bank's investment in the subsidiary is fully available to the FDIC to cover the costs of failure resolution.

By contrast, the prompt corrective action provisions of the Federal Deposit Insurance Act

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[4]Testimony of Ricki Helfer, Chairman, Federal Deposit Insurance Corporation, Before the Subcommittee on Capital Markets, Securities, and Government-Sponsored Enterprises of the Committee on Banking and Financial Services, U.S. House of Representatives, March 5, 1997, at p. 22.

of 1991 (FDICIA) specifically limit the ability of a Federal agency to require a parent bank holding company to contribute funds to an undercapitalized bank through a capital restoration plan to the *lesser* of 5 percent of the bank's assets or the amount necessary to bring the institution up to the adequately capitalized standard.[5] While the assets and earnings of a bank subsidiary are always available to support a troubled parent bank, the ability of a Federal agency to require a holding company to support a troubled subsidiary bank is uncertain. The Federal Reserve Board's so-called "source of strength" doctrine has never been fully litigated, and bank holding companies have occasionally successfully balked at meeting regulators' demands to downstream funds into a troubled bank. In fact, the FDIC has been sued twice to recover funds that were injected by a holding company into a bank subsidiary.

Finally, Congressional and regulatory actions over the past decade have significantly strengthened the safety and soundness tools available for bank regulators.[6] These new supervisory tools enable regulators to address promptly supervisory concerns that may arise in connection with activities engaged in by banks or their subsidiaries.

II. Providing Adequate Consumer Protection

The second key principle underlying fair and effective financial modernization legislation is ensuring that consumers are adequately protected in the complex, sometimes confusing new environment for the provision of financial services. New activities and newly permissible affiliations may offer consumers greater convenience and greater choices, but may also give rise to enhanced responsibilities of financial firms to their customers.

H.R. 10 has important implications for consumers' privacy.

H.R. 10 would authorize the creation of diversified, potentially very large, financial conglomerates that will be able to amass vast amounts of information about the insurance, credit, and other transactions of their customers. In light of this, an issue that stands out is how the new conglomerates will use customer information to market and deliver their services to consumers and communities.

In this regard, I would note that in 1996, Congress amended the Fair Credit Reporting Act (FCRA) to allow persons related by "common ownership or affiliated by corporate control" to share and use any customer information they possess (in addition to experience information,

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[5]12 U.S.C. § 1831o(e)(2)(E).

[6]These measures include the Basle Accord of 1988, in which the regulatory agencies tied regulatory capital requirements to risk and adopted minimum risk-based capital standards, and several provisions of FDICIA. The provisions of FDICIA include the prompt corrective action provisions that require regulators to close a troubled institution before the book value of its equity reaches zero, reducing the loss to the deposit insurance fund. They also include the least cost test that requires the FDIC to resolve failed banks at the least cost to the deposit insurance funds, increasing the likelihood that creditors would suffer losses in the resolution of a failed bank.

which can be freely shared). These amendments balanced this valuable grant of authority with provisions designed to protect consumer privacy. Thus, the FCRA allows a company to share information within the corporate family only if it clearly and conspicuously discloses to the consumer that such sharing of customer information may occur. In addition, the consumer also must be provided the opportunity to direct that the information not be shared -- that is, consumers have the right to protect their privacy by "opting-out."

However, the same amendments to FCRA also restricted the ability of the federal financial regulatory agencies to conduct examinations to ensure compliance with FCRA, including the information sharing disclosures and opt-out provisions. A banking agency can only conduct an examination for FCRA compliance if the agency has information, following an investigation of a complaint or otherwise, indicating that an institution has violated FCRA. In other words, we do not have the ability, absent those circumstances, to examine for compliance with the FCRA affiliate information sharing disclosure and opt-out requirements.

III. Reducing Costs and Improving Access for Consumers, Businesses and Communities

Financial modernization also should facilitate broader access to financial services for consumers, businesses, and communities. It should neither erect new barriers to, or erode current protections for, fair access to financial services for all sectors of our society, nor undermine the ability of financial services providers to contribute to consumer welfare by artificially limiting the competitive incentives and opportunities for those providers to improve the content and delivery of their products and services. Unfortunately, again, certain provisions of H.R. 10 are inconsistent with this goal.

In particular, H.R. 10 will likely diminish the benefits of the Community Reinvestment Act (CRA), impair the future competitiveness of community banks, and deprive consumers of the benefits of additional competition and potentially greater convenience in the availability of insurance products.

H.R. 10 would undermine the current scope and success of CRA.

H.R. 10 would sap the effectiveness of CRA, because it would effectively force new growth businesses out of banks and their subsidiaries and into holding company affiliates. If financial modernization limits the new businesses that may be conducted in operating subsidiaries, and encourages new types of financial activities only in affiliates, we must recognize that a bank's capacity to engage in community reinvestment activities will be diminished.

Significant assets and income at a bank subsidiary increase a bank's financial capacity and ability to lend or invest in its community. The joint agency CRA regulations provide that the "performance context" that governs the evaluation of a bank's CRA performance includes the "institutional capacity and constraints" of the institution "including the size and financial condition of the bank ... and any other factors that significantly affect the bank's ability to provide lending, investments, or services in its assessment areas." The Office of the Comptroller of the Currency's (OCC) examination policy recognizes this link between the financial strength of national banks with operating subsidiaries and opportunities for enhancing CRA performance by the bank.

Stronger banks, which have greater potential for growth through operating subsidiaries, are in the best position to help meet the credit needs of local communities. If the bank's resources are limited by legal restrictions that permit new financial activities to be conducted only through holding company affiliates, resources will not be available to allow the bank to expand the products and services it offers in its communities.

The subsidiary option is important for community banks.

The subsidiary option is important for the future of the community bank franchise. If legislation allows banking organizations to engage in a wider range of activities, banks of all sizes should have the ability to choose a subsidiary or bank holding company structure. When faced with the prospect of competing against the type of financial conglomerates that H.R. 10 would authorize plus other types of financial institutions, banks should be allowed to choose the form that is most effective and efficient to allow them to compete. Inefficiencies that lead to increased costs would have a disparate impact on the ability of community banks to compete. Thus, H.R. 10 tilts the competitive playing field in favor of large financial conglomerates.

This is not merely a theoretical problem. For community banks in particular, the subsidiary structure may be the most efficient and perhaps only feasible option for conducting new activities. And the activities at issue can be very beneficial to community banks and their customers. For example, in Massachusetts, nearly 60 community savings banks joined together to provide savings bank life insurance through a jointly owned subsidiary. This joint venture has proven to be enormously successful in providing low cost insurance to consumers in a safe and sound manner. H.R. 10 unnecessarily constrains options such as these and thereby undermines the competitive vitality of community banks.

Customers would be deprived of the benefits of more competition and increased convenience in connection with the provision of insurance.

H.R. 10 also would deprive customers of the benefits of increased competition by reducing the current insurance authority of both national and state banks. In some cases, the ability of banks to provide insurance or annuity products to their customers is eliminated; in other cases, H.R. 10 significantly restricts how banks may go about selling the insurance products they are currently authorized to provide. These limits on competitive incentives to provide and improve insurance product content and delivery simply penalize insurance customers. This concern is discussed in greater detail below.

IV. Promoting Innovation and Enhancing the Competitiveness of the Financial Services

Industry

Financial modernization legislation also should promote innovation and enhance the competitiveness of the financial services industry. Developments within the financial services landscape -- in particular, the increase in competition -- have led to product innovation, increased geographic diversification, and other changes in banks' balance sheets. These developments have generally been beneficial to consumers -- through greater choice in financial products and delivery mechanisms, and lower costs.[7] But H.R. 10 would restrict entry into certain markets, thereby denying consumers the possible benefits of increased competition.

H.R. 10 would cut back banks' current insurance authorities.

It is clear that financial services firms have, over time, developed products that have characteristics of both bank products and insurance products. The dynamic evolution of the marketplace has resulted in clear benefits for the consumers of bank and insurance products. It is therefore troubling that H.R. 10 would substantially limit such innovation by the banking industry in the future.

H.R. 10 prohibits banks and subsidiaries from providing new insurance products as principal. The bill grandfathers insurance products that the OCC had authorized national banks to offer as of *January 1, 1997*, and products that national banks were actually offering as of that date. However, the prohibition will bar banks from lines of business that are *today*, under current law, permissible for banks to offer. It will also prevent banks from offering products in the future that the OCC might find to be permissible. Because provisions in the Federal Deposit Insurance Act limit the ability of state-chartered banks to underwrite insurance with reference to what national banks can do, this section of H.R. 10 will also cut off insurance opportunities for state-chartered banks.

H.R. 10 also reduces the current authority of national banks to sell insurance as agent. First, the bill contains an anticompetitive requirement for banks to buy an existing insurance agency that is at least two years old if the national bank wants to sell insurance in a state in which it was not selling insurance as of the date of enactment.

With respect to title insurance, H.R. 10 provides that national banks may only sell title insurance if they are doing so as of the date of enactment of H.R. 10, and *no subsidiary* or affiliate provides *any kind* of insurance as principal. If state-chartered banks were authorized to sell title insurance as of January 1, 1997, national banks may also sell title insurance, but if a state-chartered bank is authorized to sell this insurance after January 1, 1997, national banks are not given parity.

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[7]Product innovations such as the variable rate mortgage, securitization, and credit cards have expanded consumers' credit choices.

H.R. 10 does allow national bank subsidiaries to sell other types of insurance -- in an agency capacity -- from any location. However, when a national bank's subsidiary's insurance agency is located in a place with a population of over 5,000, the subsidiary will be treated as an "affiliate" under section 23B of the Federal Reserve Act. This means that virtually all types of transactions between the bank and its own subsidiary (including the payment of any money or furnishing of services to the subsidiary) can only be made if they are on terms that are comparable to the terms that the bank would use for the same type of transaction with an unrelated third party. A bank would need to maintain sufficient records to reflect its compliance with this standard. Thus, an agency located in a place with a population of 5,001 would bear these new burdens, while an agency located in a place with a population of 4,999 would not. This treatment of banks' insurance *agency* activities is simply discriminatory and anticompetitive and has no basis in safety and soundness or other public policy goals.

Proponents of H.R. 10 have asserted that section 104 of the bill, which provides that state laws may not "prevent or significantly interfere" with a bank engaging in insurance (and other) activities authorized under *Federal* law, simply reflects the decision of the Supreme Court in the *Barnett* case. That assertion, however, is incorrect. H.R. 10 does not codify *Barnett*. The *Barnett* decision itself used several different phrases, and also specifically referenced other cases that use terms such as "hamper," and "impede." (In other words, the standard could be that state law should be preempted if it *hampers* the ability of a national bank to exercise a power authorized under Federal law.) What section 104 does, in fact, is put into place a new standard that offers banks less protection from discriminatory and restrictive state regulation than is the case today under the standards spelled out by the Supreme Court in its *Barnett* decision -- and virtually guarantees new rounds of litigation under the new standard.

Section 104 also refers to the recently adopted Illinois law regarding bank sales of insurance and provides that state laws that are no more restrictive than that law would not be deemed to "prevent or significantly interfere" with the ability of a bank to sell insurance. Using the Illinois law as a benchmark like this is particularly risky because the result will depend on how that law is *interpreted*. If the law is interpreted in certain ways, it should not be preempted under current standards for preemption, but if it is interpreted differently, it could significantly interfere with national bank insurance activities.

Removing OCC deference could discourage future innovation.

Given the ambiguities that the bill creates about when a product is "insurance," when an "insurance" product can be provided by a bank, and when state law that restricts a bank's ability to sell insurance would be preempted, the process by which these questions are resolved becomes crucial. H.R. 10 contains an unprecedented provision that *directs a court not to give any deference to the OCC*, even when the OCC is interpreting the National Bank Act, or even when the OCC is opining on whether a state law or rule interferes with the ability of a national bank to sell insurance. This result singles out national bank insurance activities and uniquely excludes OCC decisions in this area from the long-standing doctrine of judicial deference to Federal administrative agency decisions that the Supreme Court pronounced in the *Chevron* case. This provision will effectively limit competition in insurance markets by preventing or discouraging banks from engaging in new activities that could be deemed to be "insurance" by a state insurance regulator, since the banking institution will not be able to rely on agency decisions that have not been tested in the courts. It will have the practical effect of elevating the unelected judiciary to the policy-making role of determining permissible banking activities.

In addition, Section 104 limits the ability of an insurance affiliate of a bank to engage in insurance activities. While section 104 provides that a state law may not prevent or significantly interfere with the authority of a bank to affiliate with another entity under Federal law, a state may freely regulate the insurance activities conducted by the affiliate or in other ways restrict its operations (other than cross-marketing) as long as the same regulation is applied to affiliates and nonaffiliates alike. There is no protection against state regulation that appears neutral on its face but would have a disparate impact on the ability of a bank's insurance affiliate to do business.

V. Permitting Financial Services Firms to Choose the Corporate Structure that Makes the Most Business Sense[8]

The fifth and last modernization principle is that banks should have the freedom to choose the corporate structure that is best for their business, consistent with safety and soundness. Our position on this issue is that banks of all sizes should be permitted to engage in an expanded range of financial activities, thus receiving the proven and tangible benefits of financial diversification, and should have the freedom to use either a holding company affiliate or a bank subsidiary structure to do so. Without such appropriate organizational flexibility, banks will be less safe and sound, offer fewer choices to customers, may be under pressure to charge higher fees on the products and services they are allowed to offer, and be less able to serve the financial needs of their communities and their customers.

Operating subsidiaries and bank holding company affiliates offer the same opportunities for safety net subsidy insulation.

The form under which a bank chooses to operate should be a matter of choice absent compelling public policy considerations. As alluded to earlier, one of the most commonly asserted public policy reasons for denying this form of organizational choice is that banks receive a "safety net subsidy" and that that benefit could be more easily transferred to subsidiaries than holding company affiliates, providing those subsidiaries with an unfair advantage in competition with providers not owned by banks.

Some participants in this debate suggest that the bank holding company model is better than bank subsidiaries in containing the net subsidy, *i.e.*, funding advantage, accruing to banks

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[8] The attached white paper contains a detailed analysis of issues raised by proposals to preclude choice in corporate structure.

from the benefits of the federal safety net. The OCC and many other independent analysts believe this assertion is fundamentally flawed for two significant reasons. First, government and private sector studies strongly suggest that -- to the extent any subsidy actually exists -- there is no meaningful *net* subsidy after factoring in the costs of bank regulation and the payments made by banks for the services contained within the federal safety net.[9] Second, even if the existence of a net subsidy could be proven, there is no evidence that a bank holding company structure is uniquely effective in limiting the transmission of that subsidy to organizations owned or affiliated with the bank.

There is no credible evidence that banks are subsidized in a manner that provides them with a special competitive advantage. The existence of a subsidy would imply that banks receive benefits without paying for them. Banks bear significant costs in return for access to the safety net. They are subject to a number of regulations, which impose operational limitations to protect their safety and soundness and to protect consumers. Laws and regulations also govern exit and entry to the banking system, geographic and product expansion, fiduciary activities, the quality of internal and external information systems, and equal access to credit and other financial services.

Recent studies also tend to confirm that only a small minority of the banks -- those in the weakest financial condition -- enjoy even a gross subsidy, that is, the majority of banks pay more for components of the safety net than they are worth, even before factoring in the costs of bank regulation. Additionally, one can credibly argue that recent legislative and regulatory measures have reduced any gross benefits from the federal safety net even further. Such measures have decreased the amount of benefit accruing to troubled institutions and increased the cost of safety net features. These measures include, among others, risk-based capital requirements, prompt corrective action provisions, and risk-related deposit insurance premiums.

Finally, the real test of this theory takes place in the real world. There is no indication that bankers behave as if a net subsidy exists. If it existed, banks would conduct their business to fully exploit that subsidy and dominate the markets they seek to serve. This type of behavior is nonexistent, neither in the way banks fund themselves or structure themselves, nor do banks dominate the businesses in which they are engaged.

For example, if banks enjoyed a lower cost of funds because of benefits accruing from the safety net, we would expect to see banking organizations issue debt exclusively at the bank level. Instead, we see debt issuances by banks, bank holding company parents, and nonbank affiliates. Furthermore, if there were a subsidy, banks could take best advantage of it by selling their debt directly to the public. Instead, most bank debt is issued to the parent holding company, which in

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[9] With respect to efforts to measure the value of the safety net, research by OCC staff, published as OCC Economics Working Paper 97-9, Whalen, Gary, "The Competitive Implications of Safety Net-Related Subsidies" focuses on measuring the value of federal deposit insurance. The safety net comprises two additional components: access to the Federal Reserve's discount window and coverage of daylight overdrafts through Fedwire. To the extent that those two components of the safety net convey any subsidies, their magnitude reflects decisions by the Federal Reserve to charge below market interest rates on those extensions of credit.

turn funds this purchase by issuing commercial paper. If the deposit insurance subsidy were important, banks would rely almost exclusively on insured deposits as their source of funds. In fact, less than 60 percent of commercial bank assets are supported by domestic deposits, and some banks hardly use them. As of March 1998, domestic deposits at the ten largest commercial banks ranged from four percent of liabilities to 91 percent of liabilities. Among the top ten banks, foreign deposits, which are not insured, currently compose as much as 59 percent of liabilities.[10]

In their consumer finance and mortgage banking activities, among others, banks compete side by side with nonbank providers. If banks had a competitive advantage, they would dominate over other providers. However, in many fields, nonbank providers have a bigger market share than banks. As of June 1997, two out of the top five largest servicers of residential mortgages were nonbanks, and two of the top five originators of mortgages were nonbanks.[11] The Federal Reserve, in fact, has stated persuasively that banks engaging in permissible securities activities do not dominate their respective markets.[12]

Some have noted the movement of assets from holding companies to banks as an indication that the subsidy exists. In particular, they point to a reported drop over the last decade in the share of bank holding company assets held by non-bank subsidiaries, after removing the Section 20 affiliates (firms engaged in Federal Reserve-approved securities activities). The argument seems to be that such a shift is motivated by a desire to exploit a subsidy available to banks and their subsidiaries but unavailable to affiliates of bank holding companies. However, evidence does not support that this shift -- if one has in fact occurred -- is due to a subsidy.

First, it is simply unclear that such an asset shift has actually occurred. There are no current systematic data available to document that a shift occurred. The existing data are problematic for several reasons: between 1994 and 1995, the Federal Reserve changed the instructions governing the filing of the asset data used in the calculation of the reported shift to reduce, if not eliminate, apparently widespread, year-by-year, reporting errors. The presence of these reporting errors and the changes in reporting instructions mean that we cannot make accurate year-to-year comparisons. Indeed, the absence of comparability could fully account for the reported drop in the bank holding company affiliate share of bank holding company assets.

Second, various explanations account for banking organizations moving activities from holding company affiliates to banks and bank subsidiaries. Importantly, over the past decade, the relaxation of geographical and other barriers to interstate banking has permitted banking

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[10] Call report data as of March 1998.

[11] "Ranking the Banks: Statistical Review 1997," American Banker.

[12] In its 1987 ruling, "Order Approving Activities of Citicorp, J.P. Morgan, and Bankers Trust to Engage in Limited Underwriting and Dealing in Certain Securities, Legal Developments," the Federal Reserve Board stated, "the Board notes that banks do not dominate the markets for bank-eligible securities, *suggesting that the alleged funding advantages for banks are not a significant competitive factor*" (emphasis added).

companies to engage in the interstate conduct of lines of business in banks that they could previously conduct only through bank holding company subsidiaries. That flexibility could lead banking organizations to shift assets from long-established bank holding company subsidiaries in those states to newly permissible banks or bank subsidiaries.[13] Moreover, firms consolidate their operations for many reasons, including the desire for increased efficiency. Recent experience with intrastate and interstate branching demonstrates the efficiency gains of organizational flexibility. Research on intracompany mergers finds that choice of organizational form is an important determinant of the efficiency of a company's operations. These mergers enable banking organizations to streamline their operations and better serve their customers.[14] After many states eased restrictions on intrastate branching, most banking companies responded by consolidating all of their existing subsidiaries into branch banks, although this was not the universal response.[15]

Despite the weight of this evidence, let us assume, for the sake of argument, that a net subsidy exists. Is the holding company organizational form inherently more efficient in containing that subsidy than the bank subsidiary model? Again, the evidence is persuasive that the answer is no. The key point in this debate is how the alleged subsidy might flow to bank affiliates or subsidiaries and how to contain that flow. The legal restrictions that today apply -- and apparently sufficiently prevent the transmission of any potential subsidy from a bank to its holding company affiliates (sections 23A and 23B of the Federal Reserve Act) -- can be applied to transactions between a bank and its subsidiaries.

In fact, one can argue that, under current law, it is actually easier for the subsidy to reach holding company affiliates than it would be for the subsidy to reach a bank subsidiary, provided Sections 23A and 23B are applied to transactions between the bank and the subsidiary. Under the bank holding company model, transmission of the potential subsidy involves a two-step process. First, the subsidy would need to be transmitted from the bank to the bank holding company in the form of a dividend payment; second, there must be a transfer of value from the holding company to the nonbank affiliate -- either in the form of an equity investment or other transaction, such as below-market extension of credit by the bank holding company to the nonbank affiliate. There are no legal restrictions to contain transmission of the subsidy in this scenario, except for the

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[13]In fact, a 1994 Federal Reserve Bank of Dallas report indicates that "[t]he reduction in nonbank activity outside the securities areas is consistent with the view that the recent movement toward nationwide banking has reduced the attractiveness of nonbank subsidiaries, although additional factors may be at work. Before the mid-1980s, when many states began to relax interstate banking restrictions, nonbank subsidiaries were a useful vehicle for interstate expansion. However, the continued erosion of interstate banking restrictions may have reduced nonbank subsidiaries' usefulness in this regard, since bank holding companies can now establish, subject to some remaining restrictions, an interstate network of banks." From *"Financial Liberalization Changes Focus of Nonbank Subsidiaries, Financial Industry Issues,"* Federal Reserve Bank of Dallas, Third Quarter, 1994.

[14]Robert DeYoung and Gary Whalen, "Is a Consolidated Banking Industry a More Efficient Banking Industry?", *OCC Quarterly Journal*, September 1994.

[15]Robert DeYoung and Gary Whalen, "Banking Industry Consolidation: Efficiency Issues", Working Paper No. 100, The Jerome Levy Economics Institute, April 1994.

requirement that the dividend be permissible for the bank.

Moreover, as discussed earlier, the OCC supports safeguards, such as those included in the House Banking Committee version of H.R. 10 and supported by the Department of Treasury, that ensure that there is no economic difference between conducting an activity in a subsidiary or conducting the activity in an affiliate. These restrictions include applying the quantitative and qualitative limits in sections 23A and 23B to a loan made by a bank to its subsidiary engaged in the new financial activities in the same manner that these statutes apply to loans made by a bank to its bank holding company or other nonbank affiliates. Equity investments in the subsidiary would have to be deducted from a bank's regulatory capital, and assets and liabilities of the subsidiary could not be consolidated with the assets and liabilities of the parent bank. A bank would be prohibited from making a downstream investment in its subsidiary in excess of what it can legally pay out as a dividend to its bank holding company without specific regulatory approval. These safeguards will stop the spread of subsidized dollars, if there are any, to the subsidiary to the same extent that the restrictions impede the flow of subsidized dollars to the bank holding company and its nonbank affiliates.

Furthermore, it is simply incorrect to assert that the holding company structure better insulates the bank from the risks of an affiliate because courts are more likely to impose liability on a bank for activities of a bank subsidiary than for activities of a bank affiliate. In fact, statistics indicate that it is somewhat less likely that the corporate veil between a parent and its subsidiary will be pierced than between that parent company and a sister company (e.g., a bank holding company affiliate).[16] Whether a bank's corporate veil is pierced by a court depends on how the entity's operations were conducted, not on the entity's location in a corporate organizational chart.

Similarly, others have asserted that accounting conventions make a holding company affiliate a better choice than a subsidiary because Generally Accepted Accounting Principles (GAAP) require consolidation of a bank and its subsidiary's financial statements, and that therefore national banks would have strong incentives to rescue troubled subsidiaries. It is also argued that subsidiary losses, reflected in the consolidated financial statements, would cause depositors and investors to lose confidence in the bank. These arguments, too, upon close review, are not sustainable.

First, accounting standards do not determine corporate liability; rather they provide an external yardstick of an institution's financial condition. When financial reports are consolidated, companies are simply <u>reporting</u> their assets and liabilities on a combined basis, but *they do not become legally responsible for each other's liabilities*. Those statements simply reflect a reporting convention. Second, holding company financial statements also reflect the consolidation of the financial statements of its subsidiary entities. Thus, the same incentives exist for a holding company and its subsidiary bank to bail out their affiliates. Bank holding company statements

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[16] Thompson, Robert, "Piercing the Corporate Veil: An Empirical Study." *Cornell Law Review* 76 (July 1991), 1036-1074.

reflecting financial difficulties could cause equal or greater concern to investors and depositors. In fact, for virtually all large banks, the only equity securities available to investors are those of the holding company, so any market reaction will be driven by those investors' views of the holding company. Third, accounting rules require the deconsolidation of subsidiary financial statements when a bank no longer controls a subsidiary, when it is ordered to sell or liquidate the company, or when a subsidiary goes bankrupt. At that point, a bank's financial statements would reflect the true economic loss to a bank, which would never be greater than its actual investment in the subsidiary (already deducted from capital) and any limited credit exposure under section 23A limits.

Once all of the forgoing factors have been considered, the public policy direction becomes clear. As long as appropriate prudential safeguards are in place to maintain safety and soundness and prevent transmission of any so-called safety net subsidy outside the bank, banks should have the choice of being able to engage in an array of financial and financially related activities through either affiliates or through their subsidiaries.

Conclusion

Financial modernization involves complex, far-reaching issues. Legislative changes will have long-term implications for the structure and vitality of our nation's financial institutions and their ability to serve their customers and support their communities. The bill before you contains some promising elements but requires a major reconfiguration before it will be worthy to serve as the framework for our nation's financial system in the next century.