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Statement by

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Chairman

Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing, and Urban Affairs

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It is a pleasure to appear before this Committee to present the views of the Federal Reserve on the need to enact legislation to modernize the U S financial system and to express the Board's strong support for H R 10, which achieves this objective

I. The Need for Financial Reform

U S financial institutions are today among the most innovative and efficient providers of financial services in the world They compete, however, in a marketplace that is undergoing major and fundamental changes driven by a revolution in technology, by dramatic innovations in the capital markets, and by the globalization of the financial markets and the financial services industry

The Federal Reserve believes that it is essential that the nation act promptly to modernize the rules that govern our financial institutions in order to ensure their continued competitiveness and to foster their ability to innovate, to operate efficiently and to provide the best and broadest possible services to consumers as well as to maintain this nation's role as the preeminent world financial center We believe that it is important for Congress to set the rules for this industry, which is so important to our nation's health and prosperity Only Congress has the ability to fashion rules that are comprehensive and equitable to all participants and that guard the public interest

That is why the Federal Reserve strongly supports H R 10 and urges the Senate to consider and pass this legislation as soon as feasible

The market will continue to force change whether or not Congress acts. The strength and viability of our financial institutions, the effectiveness of our regulatory structure, and the role and status of our financial services industry in the international system are in play as a result of the aforementioned market forces as well as regulatory actions. Without Congressional action, changes will occur through exploitation of loopholes and marginal interpretations of the law that courts feel obliged to sanction. This type of response to market forces leads to inefficiencies, expansion of the federal safety net, potentially increased risk exposure to the federal deposit insurance funds, and a system that will undermine the competitiveness and innovative edge of major segments of the financial services industry. Delay in acting on financial modernization legislation would only limit Congress's options as these developments proliferate and complicate, increase the difficulty of enacting protections included in H R 10 to protect safety and soundness and the public interest, and deny to consumers the benefits that immediate changes in our outdated banking laws will surely bring.

Of course, financial modernization involves complicated and sometimes divisive issues because it requires easing rules and opening options for some while increasing competition for others, redrawing lines that create new limits, and applying some pre-existing regulatory structures to new institutions. However, these issues are not new to the Senate.

The Senate Banking Committee has on three previous occasions led the way in developing financial modernization legislation, and the full Senate has twice followed this Committee's recommendation in adopting such legislation (A summary of these financial modernization proposals is provided at Attachment 1). In 1991, the Committee passed S 543, which repealed the Glass-Steagall Act and allowed banks to affiliate with securities firms using the holding company structure to ensure safety and soundness, a level competitive playing field, and protection of the taxpayer. H R 10 uses that same holding company framework from S 543, but expands the range of permissible financial affiliations to include insurance underwriting and merchant banking. Senate action at this time to enact H R 10 would be an historic achievement that would establish a sound and much-needed framework for launching our financial services industry into the 21st century.

There has been much--perhaps too much--arguing over details contained in H R 10 H R 10 is a comprehensive approach to the issues of financial modernization, and it is fundamentally a sound bill No legislation that endeavors to address financial modernization will be considered ideal by all, but time will allow its rough spots to be worked out

What is most important is that for the first time there is an extraordinary amount of agreement on nearly all of the key principles in the bill There is no disagreement--and there has been no disagreement for many years--that the Glass-Steagall Act must be repealed There is now finally no disagreement that insurance companies and banks should be permitted to affiliate, and virtual unanimity that banks should be permitted to sell insurance There is no disagreement that financial holding companies should be permitted to engage in a broad range of other activities that are financial in nature, including merchant banking And, there is no disagreement that new affiliations must be permitted on a level playing field and in a manner that permits a realistic two-way street between banking organizations that seek to affiliate with insurance and securities firms, and between insurance and securities firms that seek to acquire banks Moreover, there is no disagreement that financial modernization must not place insurance and securities firms that choose to remain independent at a

disadvantage in competing against those firms that choose to affiliate with banks

In addition, there is strong agreement that new affiliations must be permitted within a framework that maintains the safety and soundness of our financial system in general and the banking system in particular without imposing unnecessary regulatory burden or intrusion. That means strong functional regulation and reasonable, but not bank-like, umbrella oversight of financial holding companies.

A consensus has also developed that banking and commerce should not be mixed at this time beyond the limited level needed to allow a realistic two-way street for financial firms that are predominantly securities and insurance companies to acquire banks. There is also agreement that the new law must provide regulators with adequate means to protect the consumer and assure that consumers are carefully informed about the differences between products that are backed by federal deposit insurance and those that are not.

These are the fundamental principles embodied in H.R. 10, save one. There are some details surrounding these aforementioned principles that are still under discussion. These surrounding details are important, but not so important that they should be allowed to defeat the consensus that has developed around

these principles themselves. It would be a disservice to the public and the nation if, in the fruitless search for a bill that pleases everyone, the benefits of this vital legislation are lost or delayed.

There is, however, as I indicated, one fundamental principle embodied in H.R. 10 upon which there is disagreement between the Federal Reserve and the current Treasury Department, although there is agreement among the Federal Reserve and many in the affected industries as well as earlier Treasury Departments. That is the considered decision of the House to use the holding company structure, and not the universal bank, as the appropriate structure to allow the new securities and insurance affiliations. That decision, which is fundamental to the way in which the financial services industry will develop, is critical because it provides better protection for our banking and financial system without damaging the national or state bank charters or limiting in any way the benefits of financial modernization. Importantly, that decision also prevents the spread of the safety net and the accompanying moral hazard to the securities and insurance industries and assures a level playing field within the financial services industry and thus full, open and fair competition as we enter the next century. The other route towards universal banking for national banks will, in our view, lead to greater risk for the deposit insurance funds and the

taxpayer It will also inevitably lead to a weakening of the competitive strength of our financial services industry as independent securities, insurance and other financial services providers operate at a disadvantage to those owned by banks It is for these reasons that the Federal Reserve, SEC, many state functional regulators and many in the affected industries support the holding company framework and have opposed the universal bank approach

In virtually every other industry, Congress would not be asked to address issues such as these, which are associated with technological and market developments, the market would force the necessary institutional adjustments Why is it so different for the financial system? I believe the difference reflects the painful experience that has taught us that developments in our financial system--especially, but not solely in our banking system--can have profound effects on the stability of our whole economy, rather than the limited impact we perceive from difficulties in individual nonfinancial industries

Moreover, as a society we have made the choice to create a safety net for depository institutions, not only to protect the public's deposits, but also to minimize the impact of adverse developments in financial markets on our economy Although we have clearly been successful in doing so, the safety net has predictably created a moral hazard the banks determine the level of risk-

taking and receive the gains therefrom, but do not bear the full cost of that risk, the remainder is borne by the government. Since the sovereign credit of the United States ultimately guarantees the stability of the banking system and the claims of insured depositors, bank creditors do not apply the same self-interest monitoring of banks to protect their own position as they would without discount window access and deposit insurance. Instead, this moral hazard requires that the guarantor, the U S government, supervise and regulate entities with access to the safety net to protect its own, that is the taxpayers', interest--the cost of making good on the guarantee.

Put another way, the safety net requires that the government replace with law, regulation, and supervision much of the disciplinary role that the market plays for other businesses. Our experience in the 1980's with insured thrift institutions illustrates the necessity of avoiding expanding risks to the deposit insurance funds and lax supervisory policies and rules. But this necessity has an obvious downside: these same rules limit innovative responses and the ability to take the risks so necessary for economic growth. The last thing we should want, therefore, is to widen or spread this unintended, but nevertheless corrosive dimension of the safety net to other financial and business entities and markets. It is clear that to do so would not only spread a subsidy to new forms

of risk-taking, but ultimately require the expansion of bank-like supervision as well

In our judgment, the holding company approach upon which H R 10 is premised avoids this pitfall, the universal bank approach does not

While financial modernization represents a much needed reform, we should not forget that this modernization will, by itself, introduce dramatic changes in our financial services industry We feel confident that the risks of this type of reform are manageable within the holding company framework set out in H R 10 We believe that the magnitude of the reform to our financial system represented by allowing new and broad affiliations counsels that this is not the time to experiment with these broad new affiliations through operating subsidiaries, an approach that has failed the taxpayer in other contexts and has other serious consequences Instead, we believe the Congress is best advised to retain the existing holding company structure, which achieves the full benefits sought by financial modernization and has a proven track record of protecting safety and soundness, insulating the federal safety net, and providing competitive equality among companies that choose to affiliate with banks and those that choose to remain independent

There are two final points I want to make since they appear to drive Treasury's opposition to H R 10. First, as I will discuss in more detail later, H R 10 would not diminish--but would in fact enhance--the national bank charter.

Second, H R 10 would not diminish the ability of the Executive Branch to continue to play its meaningful role in the development of banking or economic policy. Currently, the Executive Branch influences such policy primarily through its supervision of national banks and federal savings associations. H R 10 would not alter the Executive Branch's supervisory authority for national banks or federal savings associations, nor would it result in any reduction in the predominant and growing share of this nation's banking assets controlled by national banks and federal savings associations.

Furthermore, Congress for sound public policy reasons has purposefully apportioned responsibility for this nation's financial institutions among the elected Executive Branch and independent regulatory agencies. H R 10 retains this balance and the Federal Reserve does not believe it would be appropriate to alter this balance in favor of increased Executive control of financial institution policy. Such action would be contrary to the deliberate steps that Congress has

taken to ensure independence in the regulation of this nation's financial institutions, both banking and nonbanking

II. The Financial Services Act of 1998 (H.R. 10)

Although H R 10 is almost 300 pages in length, its objective is simple and can be stated concisely--H R 10 removes outdated restrictions that currently limit the ability of U S financial service providers, including banks, insurance companies and securities firms, to affiliate with each other and enter each other's markets ¹ This objective--permitting the affiliation of financial service providers and thereby allowing open and free competition in the financial services industry--is supported by the banking, insurance, and securities industries as well as the three federal banking agencies, the Treasury Department, and the Securities and Exchange Commission

For the most part, the remaining provisions of H R 10 are designed to implement and complement this change and to ensure that these new affiliations occur in a manner that is consistent with the safety and soundness of the banking and financial system and the protection of investors and other consumers of financial services H R 10 requires that these new affiliations occur within a holding company structure, which the Federal Reserve believes is

¹ For the Committee's assistance, Attachment 2 to this testimony provides an executive summary of H R 10

sound policy because it best protects the federal deposit insurance funds by limiting the additional risks permitted to insured depository institutions. Arguably of even greater importance, the holding company structure limits the spread of the federal safety net and its related subsidy and moral hazard to entities or activities beyond the insured depository institutions it was intended originally to support. H R 10 builds on the protection afforded by the holding company structure by relying on strong functional regulation of the securities, insurance, and banking components of the holding company. It also provides flexibility to authorize restrictions on transactions between depository institutions and their newly authorized affiliates when necessary to protect the safety and soundness of affiliated depository institutions and the Federal deposit insurance funds. H R 10 grants access to these new affiliations only to those organizations that have and maintain well-capitalized and well-managed subsidiary depository institutions.

H R 10 also includes provisions designed to ensure that these new affiliations occur in a manner that is consistent with the protection of consumers. For example, the bill requires that the federal banking agencies issue consumer protection regulations governing the retail sale of securities and insurance products by depository institutions. And, H R 10 emphasizes the

obligation of depository institutions to help meet the credit needs of their entire community by limiting the new affiliations to only depository institutions that have at least a satisfactory performance record under the Community

Reinvestment Act

1 Umbrella Supervision and Functionally Regulated Entities

H R 10 for the first time would permit broad affiliations among financial service providers that are currently supervised by different agencies. As a result, H R 10 builds on the principle of functional regulation and includes important provisions that encourage and facilitate cooperation among the functional regulators. It also reduces overlap between the various regulators and clearly allocates responsibility and accountability for supervising the different parts of new financial holding companies. At the same time, H R 10 retains a meaningful, albeit streamlined, level of umbrella oversight of the entire organization to assure that some agency has a complete view of, and accountability for, new financial holding companies and can serve a facilitating role in relationships among functional regulators.

The Federal Reserve believes that H R 10 has constructed a good balance that provides the various regulators, including the umbrella supervisor, with the tools needed to supervise financial holding companies adequately. In addition,

H R 10 is helpful in enhancing the ability of the relevant state and federal supervisory agencies to share information on a confidential basis

The focus of H R 10 on functional regulation is perhaps best illustrated through an example Under H R 10, responsibility would be allocated for supervising a new financial holding company comprised of an insurance company, a securities firm, several financial companies such as a mortgage lender and a financial data processing company, and an insured bank H R 10 contemplates that responsibility for supervising and regulating the insurance company, securities firm and insured bank would, as under current law, rest, respectively, with the relevant state insurance authorities, with the Securities and Exchange Commission and the securities self-regulating organizations, and with the appropriate state and federal bank supervisory agencies Each of these agencies would retain the full authority that it currently has to examine firms under its jurisdiction and to interpret and enforce the law applicable to the type of company that the agency is charged with supervising

The Federal Reserve, as umbrella supervisor, would be required to the fullest extent possible to rely on regulatory reports required and examinations conducted by, using our example, the state insurance commissioner, the SEC (and appropriate securities self regulatory agencies) and the appropriate state or

federal banking agency. In a problem bank situation, the Federal Reserve also would be prohibited from requiring that the insurance company or securities firm provide financial resources to the bank if the functional regulator determines that such action would have a materially adverse effect on the financial condition of the insurance company or securities firm. Instead, the Federal Reserve could order divestiture of the bank or affiliate in order to recapitalize the bank.

At the same time, H R 10 preserves the important authority of the umbrella supervisor to apply consolidated capital standards to the financial holding company, to examine the holding company and--under specified circumstances--any subsidiary that poses a material risk to the insured bank, and to enforce compliance by the organization with the Federal banking laws. This assures that, while the functional regulators are supervising various parts of the organization, someone is overseeing the organization as a whole as well as subsidiaries that are not subject to other functional regulation.

2 Enhanced Functional Regulation of Financial Products

Consistent with the bill's emphasis on functional regulation, H R 10 also would repeal the blanket exemptions provided banks from the definitions of "broker" and "dealer" in the Securities Exchange Act of 1934, requiring banks

to register with the SEC if their securities activities fall outside specified categories of transactions. These categories are broad and would permit banks to continue engaging in securities activities in connection with their traditional trust, custody, safekeeping and derivatives operations and in a limited amount of retail securities transactions without registering as a broker or dealer.

The bill also establishes procedures for determining which functional regulator would have primary responsibility for supervising the provision of new or hybrid financial products that may be developed in the future. In the securities area, for example, H R 10 would authorize banks, to the extent consistent with applicable banking law, to offer and sell new or hybrid products that are developed in the future unless the SEC determines, *after a formal rulemaking process and after consultation with the Federal banking agencies*, that the new or hybrid product is a security for purposes of the securities laws. If the SEC makes such a determination, the bill would require that the product be sold by an SEC-registered entity, such as a subsidiary of the bank, subject to functional regulation as a security product.

The bill establishes a similar, although more complex, procedure for determining whether future products that are classified as insurance by a state may be underwritten by a bank within the framework of bank regulation or only

by a functionally regulated insurance underwriting affiliate. This process seeks to ensure that banks will continue to have the ability to provide any product banks are providing today. In addition, it assures that banks may, as principal, provide any new form of a traditional banking product that may in the future be characterized as insurance by state law unless the product is treated as insurance for purposes of the federal Internal Revenue Code. There is also a procedure to resolve disputes between insurance and banking regulators over future products with final decisions by the courts "without unequal deference" to *either* the relevant Federal or State regulators and after reviewing the history of the regulation of the product.

Although any attempt to devise rules for the classification and regulation of future products is bound to encounter difficulties, and improvements could be made in some marginal provisions, the substantive provisions of H R 10 governing the division of regulatory responsibility for future products are carefully balanced in our judgment.

3 Competitive Flexibility

Importantly, H R 10 provides banking organizations--both large and small--substantial flexibility in determining how to respond to the market forces so rapidly changing the industry. Many large banking organizations that meet

applicable criteria may elect to affiliate with full-service insurance and securities underwriting firms and thereby become comprehensive providers or "manufacturers" of financial products. Similarly, small banking organizations would remain free to engage in currently authorized activities or to expand into newly authorized principal activities at the pace most consistent with the organization's competitive strategy. Small banking organizations also would be free to focus their efforts in an area where they have a demonstrable competitive advantage--the sale of any type of financial product as agent.

One of the areas of great interest to banks--and one likely to increase consumer options and benefits greatly--is insurance sales. Importantly, H R 10 would expand the insurance sales opportunities for banks by authorizing subsidiaries of national banks to sell virtually any type of insurance product, whether underwritten by an affiliate or a third party, from any location on a nationwide basis. National banks also would retain their current ability to sell insurance as agent in any place with a population of 5,000 or less. One detail in this area that we do not support is the provision in H R 10 that requires a national bank, for the next 5 years, to expand its insurance activities in additional states only by buying an existing insurance agency.

H R 10 would also provide depository institutions important protections against state laws that might conflict with the ability of these institutions to sell financial products as authorized by Federal law. Some confusion and controversy, however, have arisen in this area, particularly as to whether H R 10 would scale back the Supreme Court's decision in the Barnett case concerning the ability of states to *regulate* the sale by national banks of insurance as agent. It is my understanding that H R 10, in fact, seeks to codify the Barnett decision by incorporating the phraseology used by the Supreme Court and a specific citation to the Supreme Court's opinion in Barnett into a new Federal statute that would preempt any state law that "prevents or significantly interferes" with the ability of any national bank or other depository institution to engage in insurance sales activities authorized by Federal law.

H R 10 does provide that a state law will not be preempted under the Barnett standard if the law is no more restrictive than an existing Illinois statute that governs insurance sales by banks. This statute, among other things, requires the licensing of agents and the disclosure that insurance products sold by the bank are not guaranteed or insured by the FDIC. This provision also prohibits the tying of insurance products to credit products, the payment of commissions to unlicensed persons, and the unauthorized disclosure of customer

information. The statute's requirements are not onerous and the Comptroller of the Currency has recognized that the statute's requirements do not on their face conflict with the Barnett decision.

In short, the controversy in this area appears to stem largely from confusion concerning the bill's intent, which can be addressed through clarifying amendments designed to make plain that the bill does not scale back, and is fully consistent with, the Barnett decision.

III. Enhancements to the National Bank Charter

There has been some concern that H R 10 may damage the national bank charter. The Federal Reserve believes that it is important that the national bank charter not be impaired or diminished in view of its significance to the nation's financial system. On the other hand, we do not believe the national bank charter should be fundamentally transformed and enlarged into a universal bank charter by allowing national banks directly or indirectly to engage in underwriting life and property and casualty insurance, underwriting and dealing in securities, merchant banking and direct equity investing, or real estate investment and development. For the reasons laid out in this testimony, we believe such an expansion of the national bank charter would be a mistake for

bank safety and soundness, the deposit insurance funds and safety net, the financial services industry (consumers and businesses alike) and the taxpayer

In the Federal Reserve's view, the concern about H R 10's effect on the national bank charter appears based on a misunderstanding of the bill. Our review of H R 10 indicates that it preserves the existing benefits of the national bank charter and includes significant provisions that actually *enhance* the powers of national banks. First, H R 10 *does not reduce the current* powers of national banks to conduct banking activities or indeed limit the present activities conducted by national banks. In fact, H R 10 contains several provisions that specifically preserve these powers. Moreover, there is nothing in H R 10 that limits the authority of the OCC to authorize new powers for national banks as within the business of banking or incidental to a banking business under the National Bank Act other than those activities prohibited for national banks and future, as yet unauthorized, insurance underwriting activities.

As I mentioned earlier, H R 10 contains, as has every prior version of financial modernization legislation for the past 15 years including the recent Treasury proposal, provisions that encourage all banks to conduct securities activities through an affiliate or, where authorized, a subsidiary of the bank, rather than in the bank. These provisions, however, include significant

exceptions that allow banks to continue to conduct in the bank securities activities that are part of or incidental to traditional banking services or that are conducted in limited numbers. And, as in the Treasury's recent modernization proposal, the provisions of H R 10 apply equally to all national and state banks.

Second, H R 10 *improves* the national bank charter. H R 10 empowers national banks to conduct any financial activity as agent through an operating subsidiary. Under this provision, national banks may, through a subsidiary, sell any type of insurance at any location (including in cities with a population over 5,000). This provision also allows a subsidiary of a national bank to sell *any* financial product as agent, and to engage in *any* financial agency activity that is permitted for a financial holding company. Such activity, as best we can judge, because it is rarely asset intensive and hence requires minimal equity, transfers little subsidy to the bank subsidiary.

H R 10 also authorizes national banks for the first time to underwrite any type of municipal security, including municipal revenue bonds, directly or through a subsidiary. At the same time, H R 10 removes the current advantage that state banks have over national banks in the securities area. H R 10 *prohibits state banks* from engaging in underwriting or dealing in securities,

either directly or through an operating subsidiary, to the same extent that a national bank is prohibited from underwriting and dealing in securities

H R 10 would clarify that national banks should not in the future underwrite life or property and casualty insurance beyond that currently permissible for national banks. State banks are already prohibited by the Federal Deposit Insurance Corporation Improvement Act of 1991 from commencing insurance underwriting activities or making equity investments. Thus, under H R 10, the only financial activity of which we are aware that state banks in *some* states could conduct, either directly or in an operating subsidiary, that national banks cannot is real estate investment and development. Treasury's recent bill, however, would wisely, in our view, also have prohibited that activity to national banks and their subsidiaries.

As I explained earlier, H R 10 also includes provisions that guarantee national banks the right to affiliate--through holding companies--with securities firms, insurance companies and other financial services providers, and to sell and market the products of those affiliates notwithstanding any state law. In addition, H R 10 preserves the rule of law established in Barnett

Together, these provisions allow national banks to remain strong and vibrant competitors. H R 10 also does nothing to encourage national banks to

convert to state charters. Nor does H R 10 tarnish in any way the appeal that many see in the national bank charter, particularly as a vehicle for conducting interstate branching. Indeed, nearly 90 percent of all interstate branches are operated by national banks, which operate under one set of rules and with one regulator at all their locations--the OCC.

The heart of the concern about H R 10's applicability to national banks does not appear to be that it fails to enhance the national bank charter, but that it fails to enhance the national bank charter *enough* for some. However, the record does not demonstrate that the national bank charter is in decline. In fact, the opposite is true. In the postwar years, national banks have controlled more than 50 percent of total bank assets. In fact, the share of assets controlled by national banks rose sharply last year and early in 1998, reflecting the increased attractiveness of the national charter as interstate branching has been authorized, and assets held by national banks are at the highest level this decade and near the postwar high relative to state banks. Attachment 3 provides additional data on the relative strength of the national bank charter.

In any event, the issue that is facing Congress is not whether we need to provide an edge to a particular type of bank charter. The record is replete with evidence that what is really needed is reform of the laws that prevent the

affiliation of banks of all types with securities firms, insurance companies and other financial services providers, and thereby allow the financial services industry to adjust to a rapidly changing market. That is the deficiency that H R 10 is designed to address and does address very well. If the future finds, contrary to the past and present, that further adjustments are needed to the national bank charter to allow it to remain competitive and viable, those concerns can and should be addressed more clearly once an actual deficiency is shown.

IV. Operating Subsidiaries vs. Holding Companies

One area where some have argued that H R 10 does not go far enough is in authorizing national banks to own so-called operating subsidiaries, which are subsidiaries of the bank that engage in activities that national banks are forbidden by Federal law to conduct directly. This is not a detail or a technical issue, but one that we believe is critical to determining the shape, soundness and competitive fairness of our financial system as it develops into the 21st century, and will have profound ramifications for our Federal safety net.

There are two reasons why the Board believes that it is not wise or necessary to expand the ability of banks to engage in new principal activities through operating subsidiaries that are prohibited to the bank. These are

(1) extension of the safety net subsidy to activities beyond what Congress originally intended and resultant harm to the vibrancy of competition in our financial services industry, and (2) the safety and soundness implications for banks and risk exposure of the deposit insurance funds

Extension of the Safety Net In my introductory remarks, I noted that a major reason the Congress is called upon to involve itself in a legislative response to technical innovation in financial markets is the safety net. Institutions covered by it receive a subsidy because insured depositors correctly perceive their risk exposure as virtually zero. These depositors--and other creditors who benefit from the stability brought to the banking system by the safety net--are willing therefore to provide funds to banks at much lower rates than are available to competing institutions. Moreover, the insured creditors--and many of the uninsured ones as well--do not feel the necessity to monitor their credit exposure because of the government guarantee and the other implications of the safety net. As a result, the government is required to monitor the risk-taking--to put itself in the shoes of the creditors--in order to protect the taxpayers and maintain financial market stability.

The existence of this subsidy is clear in debt ratings--which are virtually always higher at banks than at their parent holding company. It is clear in the

higher capital ratios required of nonbanking financial firms, even those that receive the same debt rating as banks. It is clear in the tendency for banking organizations, when geographic restrictions were eased, to shift back to the bank and its subsidiaries those activities that, while authorized for banks, had been conducted in holding companies. Bank holding companies, the owners of most banks, have no doubt also gained by the higher debt ratings and lower cost of capital that comes from having as their major asset an entity--the bank--with access to the safety net. But holding companies also own nonsubsidized entities that have no direct access to the safety net. Accordingly, both bank holding companies and their non-bank subsidiaries have a higher cost of capital than banks that cannot be credibly explained by the holding companies' responsibilities to their insured depository institutions. Moreover, any benefit that holding companies might currently be experiencing from ownership of an insured bank can be expected to decline as the holding company's ability to expand its affiliations causes the insured bank to become a smaller part of the total organization.

Virtually all nonbank subsidiaries of bank holding companies, with the exception of Section 20 securities affiliates, were historically put in the holding company, not because the holding company could conduct broader activities

than the bank, but for other reasons, such as geographic restrictions on the bank. As these restrictions have been eased over the last decade, the share of consolidated assets of bank holding companies associated with nonbank activities--other than Section 20s, whose purpose is to conduct a business that is not permissible for the bank itself--has declined by about 50 percent. Bank holding companies tell us that the primary reason for shifting back to banks those operations that can be shifted is to obtain cheaper funding and avoid limitations on funding transactions contained in sections 23A and B of the Federal Reserve Act. Activities that have stayed in holding company subsidiaries, we are told, remain there for tax reasons, inertia, and established names separate from the bank. In time, inertia will fade.

It is critical that the subsidy implicit in the federal safety net be limited to those activities that a bank can conduct directly. The Federal Reserve is concerned that operating subsidiaries would be a funnel for transferring the sovereign credit subsidy directly from the bank to finance any new principal activities authorized by either the Congress or by OCC regulatory action--imparting a competitive advantage to such entities. We approve of new principal activities, but we believe they should be financed competitively in the marketplace. Moreover, we do not believe that it is possible to bring to bear

the separation of an operating subsidiary from its parent bank that one can introduce between a bank and its sister affiliates

Rules can be devised to limit the aggregate equity investment made by banks in their subsidiaries. But one cannot eliminate the fact that the equity invested in subsidiaries is funded by the sum of insured deposits and other bank borrowings that directly benefit from the subsidy of the safety net. Thus, inevitably, a bank subsidiary must have lower costs of capital than an independent entity and even a subsidiary of the bank's parent. Indeed, one would expect that a rational banking organization would, as much as possible, shift its nonbank activity from the bank holding company structure to the bank subsidiary structure. Such a shift from affiliates to bank subsidiaries would increase the subsidy and the competitive advantage of the entire banking organization relative to its nonbank competitors.

I am aware that these are often viewed as only highly technical issues, and hence ones that are in the end, of lesser significance. I do not think so. The issue of the use of the sovereign credit is central to how our financial system will allocate credit, and hence real resources, the kinds of risk it takes, and the degree of supervision it requires. If the use of the sovereign credit is to be extended, that decision ought to be made by Congress in full recognition of

the consequences of the subsidy on the financial system. But, it should not, in the name of some technical change, or in search of some minor efficiency, inadvertently expand significantly the use of the sovereign credit.

This issue would not be so important were we not in the process of addressing what must surely be a watershed in the revamping of our financial structure. But we are at such a watershed, and the Federal Reserve believes that we must avoid inadvertently extending the safety net and its associated subsidy without a thorough understanding of the implications of such an extension on the competitive balance and systemic risks of our financial system.

The safety net subsidy is difficult to measure and several observers have doubted its existence net of regulatory costs. Subsidy values--net or gross--vary from bank to bank, riskier banks clearly get a larger subsidy from the safety net than safer banks. In addition, the value of the subsidy varies over time. In good times, such as now, markets demand a low risk premium and it is difficult to discern the safety net subsidy. But, when markets turn weak, financial asset holders demand to be compensated by higher yields for holding claims on riskier entities. It is at this time that subsidy values are the most noticeable, as spreads open up between bank and nonbank claims. What was it worth in the late 1980s and early 1990s for a bank with a troubled loan portfolio to have

deposit liabilities guaranteed by the FDIC, to be assured that it could turn illiquid to liquid assets at once through the Federal Reserve discount window, and to tell its customers that payment transfers would be settled on a riskless Federal Reserve Bank? For many, it was worth not basis points but percentage points. For some, it meant the difference between survival and failure.

The Federal Reserve has no doubt that the costs of regulation are large, too large in our judgment and we wish to reduce the degree of regulatory burden. But no bank has turned in its charter in order to operate without the cost of banking regulation, which would require that it operate also without deposit insurance or access to the discount window or payments system. To do so would require both higher deposit and other funding costs and higher capital. It is also instructive that there are no private deposit insurers competing with the FDIC. For the same product offered by the FDIC, private insurers would have to charge premiums far higher than those of government insurance, and still not be able to match the certainty of unlimited payments in the event of default, the hallmark of a government insurer backed by the sovereign credit of the United States.

The Federal Reserve has a similar status with respect to the availability of the discount window and riskless final settlement during a period of national

economic stress. Providing such services is out of the reach of all private institutions. The markets place substantial values on these safety net subsidies, clearly in excess of the cost of regulation. To repeat, were it otherwise, some banks would be dropping their charters.

Safety and Soundness. Even if there were no subsidy issue, engaging in principal activities in an operating subsidiary exposes the bank--and hence the safety net--to greater risks. I am not arguing that the new financial activities that financial modernization would permit to banking organizations are unusually risky. But they do present additional risk as principal and any losses associated with these activities would have to be absorbed. If such losses were suffered by a bank holding company subsidiary, the loss would be consolidated into the holding company parent--an entity without direct access to the safety net. In contrast, if the loss occurred at a subsidiary of a bank, the loss would fall directly on the bank parent, increasing the risk exposure of the deposit insurance funds and the safety net. This difference is neither small nor technical. It lies at the heart of the matter.

The Treasury, as you know, has proposed and supported new principal activities in the operating subsidiary. It argues that potential losses in the operating subsidiary could be capped in such a way as to eliminate the exposure

of the safety net Under the Treasury plan, investment by a bank in its operating sub must be deducted from the regulatory capital of the bank, after which the bank's regulatory capital position must still be deemed "well-capitalized " Moreover, the bank would be prohibited from making good any of the debts of the failed subsidiary

I should note that it is necessary that all of these prohibitions be statutory, since generally accepted accounting principles--GAAP--require that the subsidiaries' operations be consolidated with its parent and that courts determine if a parent is responsible for the claims on its failed subsidiaries I should further note that what may be viewed as a regulatory matter as excess capital--the maximum amount that is to be invested in the subsidiary under this proposal--may or may not be excess in an economic or real sense Regulatory accounting principles--RAP--are not often designed to reflect economic realities, as we saw last in the S&L crisis of the 1980s Moreover, as I understand it, the RAP capital deduction for purposes of computing the level of a bank's investment in its operating subsidiaries would not be mirrored by a capital deduction for other regulatory purposes--like loans-to-one-borrower or dividend limit purposes

And, I can assure you it will not be deducted for the GAAP bank statements that uninsured creditors and large loan customers will insist on reviewing before they conduct business with the bank. Thus, a capital deduction may matter for the regulators for some purposes, but it is not the way the market will view the organization.

In addition to being inconsistent with sound accounting standards (GAAP), the proposed deduction treatment also runs counter to the way that banks manage their subsidiaries, the way regulators have supervised subsidiaries and the way financial markets are likely to perceive the bank as a whole. Historically, both bank management and supervisors have considered subsidiaries of the bank to be an integral part of the bank (in fact they have been treated as departments of the bank) whose operations, if material, could have a significant impact on the bank's risk profile. Bank managers have invariably sought to support their subsidiaries in the past, and supervisors have carefully examined the operations of material subsidiaries in view of the difficulty in insulating the parent bank from problems in its subsidiaries.

Even if statutory barriers are erected that attempt to limit the impact of subsidiary losses on the parent bank, substantial losses in a subsidiary will likely erode the market's confidence in the management and health of the bank. This

would be a critical development in the case of a bank whose stability--and whose level of risk to the federal deposit insurance funds--depends in large measure on its reputation and standing in the financial markets. A law may endeavor to mandate accounting and regulatory treatment, but it is not so easy to alter perceptions of counter-parties or the reality of financial markets.

It is worth noting that a dividend payment by a bank to its holding company results in a real decline in bank capital. This is a genuine constraint on the subsidy transfer from banks to their holding company affiliates and helps explain the reality that bank dividends historically have not chronically exceeded the dividends paid out by holding company parents plus debt service. The use of bank dividends to fund holding company expansion would, of course, incorporate a modest safety net subsidy since bank earnings are higher than they otherwise would be because of the safety net. But the capital constraint--plus the supervisor's natural tendency to guard against significant capital reductions--has limited such transfers. It is unlikely that a capital adjustment for regulatory purposes that is in conflict with GAAP would be as effective a constraint on the investments that a bank may make in its subsidiary.

Moreover, losses in, for example, securities dealing or fire and casualty insurance underwriting conducted in an operating subsidiary could occur so

rapidly that they could overwhelm the bank parent before actions could be taken by the regulator. Put differently, losses in an operating subsidiary can easily far exceed a bank's original equity investment long before the supervisor has any such knowledge. The resulting bank safety and soundness concerns are only deepened by the extent to which past retained earnings of the operating subsidiary would have strengthened the capital of the parent bank--an ostensible reason for operating subsidiaries. Such a buildup in capital could be used to support other bank activities, and then eliminated by subsequent losses in the operating subsidiary, leaving the bank in an undercapitalized position.

The argument that operating subsidiaries are desirable because of the organizational flexibility they provide to bank management seems less than compelling. Having two options is better than one. But there is no real choice here. From the purview of banking organization profitability, the operating subsidiary is far superior to a holding company affiliate because of the funding advantage gained from access to the safety net. Hence, if profitability is the gauge, there is no increase in managerial flexibility. Rational management will always select the operating subsidiary.

Some observers have argued that operating subsidiaries should be allowed to conduct broad activities as principal in the U.S. because Edge Corporations,

which are Congressionally authorized corporations chartered to conduct a banking business outside the U S and are largely owned by banks, have conducted a broader range of activities as principal outside the U S without damage to banks. As an initial matter, it is important to realize that there are only a handful of banks that engage to any significant extent through Edge Corporations in activities not permissible to their parent bank, and these engage primarily in various securities activities. Importantly, Congress authorized the Edge Corporation as a means to allow our banks to be competitive abroad. In order to do so, Edge Corporations had to be able to conduct outside the U S activities that are somewhat broader than those permitted domestically, provided the activities are usual in connection with the conduct of banking in the country in which the Edge Corporation operated. The Edge Corporation, therefore, conducts broader activities not because Congress believed that it was, as a general matter, prudent to permit subsidiaries of banks to conduct broad powers. Instead, Edge Corporations may conduct broader activities because they must be allowed to be as competitive as possible in the arena in which they compete-- which is in foreign markets where the rules governing the activities of banks and other financial service providers differ from the rules in the U S.

This same principle--allowing competitive equity--argues against authorizing operating subsidiaries to conduct broad activities *within* the U S . As discussed above, the universal bank approach would allow banks and their subsidiaries a competitive advantage over U S securities and insurance firms that remain independent of banks--thereby inevitably impairing their competitive strength . Thus, given the structure of the financial services industry inside the U S , the principle of competitive equity that gave rise to the Edge Corporation as a vehicle for conducting a banking business outside the U S argues against a similar vehicle within the U S .

Others have concluded that the Federal Reserve's objection to operating subsidiaries is solely jurisdictional--solely turf . If by such comments, these critics believe that our concern is simply to maintain our status or prerogatives, they are mistaken . This has certainly not been our approach to bank powers . The Board was an early and strong supporter of interstate banking, knowing that it would induce shifts from state to national bank charters, reducing the Federal Reserve's supervisory role . Interstate banking was right for the economy, and we supported it . Operating subsidiaries are not, and that is why we oppose them .

V. H.R. 10 and the Community Reinvestment Act

It has also been argued that H R 10 damages the Community Reinvestment Act. The Board believes that this argument is incorrect. In fact, enactment of H R 10 would strengthen the CRA in very material ways.

The Board believes that the CRA has played an important role in encouraging banks to identify lending markets that may be underserved and to develop credit products and services in response to identified needs of their communities. H R 10 provides a compelling incentive for financial holding companies to continue these efforts by requiring as a prerequisite to the expanded powers and affiliations authorized by the bill that all of the subsidiary depository institutions have at least a "satisfactory" CRA rating.

Moreover, H R 10 adds teeth to the CRA. Currently, the CRA is enforced through the application process. But there is no current requirement that a depository institution divest a bank once a merger is approved if the bank fails to maintain adequate CRA performance levels after the merger. H R 10, however, requires that satisfactory CRA ratings be maintained as a condition for continued affiliation with companies authorized under the bill. Thus, a financial holding company has a strong incentive to assure that its depository institution subsidiaries continue to meet their CRA obligations. H R 10 also would

expand the CRA to wholesale financial institutions, a new form of depository institution authorized by the bill

There exists some confusion, however, as to whether the CRA would be further benefitted if banks were permitted to engage, either directly or through a subsidiary, in securities and insurance activities as principal. The CRA by its terms requires that the Federal banking agencies assess the record of depository institutions in meeting the credit needs of their entire community, including low- and moderate-income communities. While the CRA relates to the lending activities of depository institutions, it does not apply to securities or insurance underwriting activities--whether conducted by a bank, a subsidiary of a bank, or an affiliate of a bank. Accordingly, authorizing a bank to directly or indirectly conduct the securities and insurance underwriting activities authorized by H R 10 for financial holding companies would not increase a bank's obligations under the CRA, although it would expose the bank and its CRA-related lending activities to the earnings fluctuations and possible losses associated with such principal activities.

Under H R 10, banks would remain free to develop and offer the type of innovative or targeted lending products, either directly or through a subsidiary, that are designed to meet the identified credit needs of their communities and

that are relevant to the bank's CRA assessment. Moreover, if a banking organization elected to engage in CRA-related activities through a holding company subsidiary, the organization would remain free under the CRA regulations issued by all of the Federal banking agencies to have the activities of the holding company subsidiary count towards the CRA performance of an affiliated bank.

VI. Commerce and Banking

Last year, the Board, in testimony before the House Banking and Commerce Committees, recommended caution about authorizing banking and commerce affiliations. We noted that technology was already in the process of eroding any bright line between commerce and banking. Nonetheless, we concluded that the free and open legal association of banking and commerce would be a profound and surely irreversible structural change that should best wait while we absorbed the significant changes called for by financial modernization.

Recent events have, if anything, strengthened our view on the desirability for caution in this area. The Asia crisis has highlighted some of the risks that can arise if relationships between banks and commercial firms are too close. It is not so much that U.S. entities would face structures like those in Indonesia,

Thailand, or Korea. Rather it is the experience that interactions of complex structures can make it extremely difficult to monitor, analyze, and manage financial exposures. In short, the Board would prefer more experience with financial change as a prelude to considering further and more profound structural changes. We thus support the H.R. 10 provisions on commerce and banking.

H.R. 10, as passed by the House, prohibits the affiliation of banking and commerce, with three exceptions. Companies, such as securities and insurance firms, that engage predominantly in financial activities and that acquire an insured depository institution may continue to own commercial firms but must divest them within ten years (with the possibility of a further five year extension). Financial holding companies that own only uninsured wholesale financial institutions also are permitted to retain limited grandfathered investments made as of the date of enactment of the bill, but are not required to divest them at the end of a specified period.

Unitary thrift holding companies--holding companies with only one thrift subsidiary--now may be affiliated with commercial entities. Only a few are, but H.R. 10 would grandfather the ability of all unitary thrift holding companies to establish commercial affiliations. For securities firms and insurance companies

that acquire banks, however, H R 10 would not permit new commercial affiliations

In light of the dangers of mixing banking and commerce, the Board supports elimination of the unitary thrift loophole, which currently allows any type of commercial firm to control a federally insured depository institution. Failure to close this loophole now would allow the conflicts inherent in banking and commerce combinations to further develop in our economy and complicate efforts to create a fair and level playing field for all financial service providers.

Accordingly, the Federal Reserve strongly supports the provisions of H R 10 that would prohibit new unitary thrift holding companies from having nonfinancial affiliations on a prospective basis. However, H R 10 would also permit *existing* unitary thrift holding companies to retain their current commercial affiliations, to expand those commercial affiliations, and to sell those rights to do so. Equity and fairness do not justify providing these grandfathered organizations such unique economic benefits. The Board, therefore, strongly supports an amendment to H R 10 that would at least prohibit or significantly restrict the ability of grandfathered unitary thrift holding companies to transfer their legislatively created grandfather rights to another commercial organization through mergers or acquisitions.

VII. Conclusion

The markets are demanding that we change outdated statutory limitations that stand in the way of more efficiently and effectively delivering financial services to the public. Many of these changes will occur even if Congress does not act, but only Congress can establish the ground rules designed to assure the maximum net public benefits and a fair and level playing field for all participants and to assure the continued primacy of U S financial markets.

The Senate has an historic opportunity to modernize our financial system by passing a bill that creates an unusually desirable framework. The Federal Reserve urges the Committee to establish a wider scope for the delivery of financial services through the holding company vehicle. This is the best way to minimize the spread of the safety net subsidy and its resulting competitive inequities, to minimize risks for depository entities and their insurance funds, and to facilitate a safe and sound banking and financial system that is able to serve the American public and maintain the leadership role of the American financial system in the global economy.

ATTACHMENTS

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| ATTACHMENT 1 | Summaries of Prior Financial Modernization
Legislation Considered and Passed by the Senate
Banking Committee Since 1984 |
| ATTACHMENT 2 | Executive Summary of H R 10 |
| ATTACHMENT 3 | National Bank Market Shares |

ATTACHMENT 1

**Summaries of Prior Financial Modernization Legislation Considered
and Passed by the Senate Banking Committee Since 1984**

I S 2851, 98th Congress, 2d Session (1984)

After lengthy hearings in the 97th and 98th Congresses, on June 27, 1984, the Senate Banking Committee marked-up and reported legislation designed to revise significantly the statutory framework under which financial institutions compete. The bill, numbered S 2851 and entitled the "Financial Services Competitive Equity Act," passed the full Senate three months later, on September 13, 1984, by an 89 to 5 margin. No action was taken on the bill by the House of Representatives, however.

Among other things, the Financial Services Competitive Equity Act revised the Glass-Steagall and Bank Holding Company Acts to authorize banking holding companies to underwrite and deal in certain securities. Specifically, S 2851 permitted a bank holding company, or a depository institution securities affiliate ("DISA") of a holding company, to engage in certain securities underwriting and dealing activities in which a national bank is prohibited from engaging, including underwriting and dealing in revenue bonds, commercial paper, and mortgage-backed securities. S 2851 did not, however, authorize new insurance activities. The bill also did not authorize any mixture of banking and commerce.

The Senate bill specified that the newly authorized securities activities could only be conducted within the holding company framework. The DISA had to be a subsidiary of a bank holding company and not a subsidiary of a bank. To this end, the Banking Committee's Report emphasized that "the bill would amend the Glass-Steagall Act to permit the DISA to be affiliated with (but not to be owned by) a depository institution." S Rep No 560, 98th Cong, 2d Sess 19 (1984) (emphasis added). The Committee Report noted that the requirement of separate incorporation and holding company affiliation would help to prevent the DISA from drawing on the depository institution's

favorable funding and possible tax advantages and would avoid potential conflicts of interests See id

Under S 2851, the Board remained umbrella supervisor for bank holding companies, and a bank holding company could engage in the newly permitted securities activities only after giving prior notice to the Board. Any DISA also was required to register as a broker-dealer with the Securities and Exchange Commission ("SEC") and was made subject to regulation and supervision by the SEC.

II S 1886, 100th Congress, 2d Session (1988)

After 14 days of hearings on financial modernization, on March 2, 1988, the Senate Banking Committee for the 100th Congress marked up another bill to modernize regulation of financial services. S 1886, entitled the "Proxmire Financial Modernization Act of 1988," authorized more extensive securities activities for banking organizations than had been permitted by S 2851 in the 98th Congress. S 1886 was reported to the Senate and within the same month, on March 30, 1988, the bill passed the full Senate by a resounding 94-2 margin. The House Banking Committee also approved revision of Glass-Steagall restrictions, but the full House took no action.

S 1886 repealed sections 20 and 32 of the Glass-Steagall Act and authorized affiliations between banks and securities companies, which were permitted to underwrite, distribute, and deal in most types of securities, including shares of mutual funds and corporate debt securities. Permission for securities affiliates of banks to underwrite, distribute and deal in corporate equity securities was made contingent on a separate Congressional action, to be taken no later than April 1991. S 1886 did not authorize the mixing of banking and commerce.

S 1886, like S 2851 in the 98th Congress, built on the framework of the Bank Holding Company Act. Securities underwriting and dealing activities were required to be conducted through a separately incorporated nonbank subsidiary of a bank holding company that was "carefully insulated" from the bank. S Rep No 305, 100th Cong, 2d Sess 15-16 (1988). The Senate specifically prohibited any affiliations between FDIC-insured banks and securities companies other than through the holding company structure because,

as noted in the Banking Committee Report, conducting such activities through holding company affiliates "is a much sounder alternative" than engaging in the activities through subsidiaries of a bank. In addition, the Report noted that the Secretary of Treasury, as well as several academic observers, emphatically supported the use of the holding company framework as "the only acceptable means of expanding nonbanking activities." Id. at 15-16, 21 (emphasis added)

The bill retained the Board's role as umbrella supervisor of bank holding companies, and it mandated that bank holding companies obtain Board approval under section 4 of the Bank Holding Company Act prior to acquiring or forming a securities affiliate. S. 1886 also made the securities affiliate subject to functional regulation by the SEC.

The Proxmire Financial Modernization Act generally retained the prohibition on bank holding companies engaging in insurance activities, and it limited national banks to acting as principal, agent, or broker for credit life insurance. Finally, S. 1886 allowed state bank subsidiaries of bank holding companies, and subsidiaries of such state banks, that are located in the same "home" state as the parent holding company to underwrite and broker insurance products if (1) such activity is authorized by state law, and (2) the insurance products are provided only to natural persons within the "home" state.

III S. 543, 102d Congress, 1st Session (1991)

Like the Proxmire Financial Modernization Act, S. 543 in the 102d Congress repealed sections 20 and 32 of the Glass-Steagall Act and allowed banking organizations to affiliate with securities firms. S. 543 was reported out of the Senate Banking Committee on August 2, 1991, after a series of 22 hearings on financial modernization issues. This bill, entitled the "Comprehensive Deposit Insurance Reform and Taxpayer Protection Act of 1991," was eventually enacted as the Federal Deposit Insurance Corporation Improvement Act of 1991 (commonly known as "FDICIA"), a law that considerably strengthened the supervisory and enforcement authority of the federal banking agencies but did not restructure the financial services industry as the Senate Banking Committee had originally envisioned.

As reported out of the Senate Banking Committee, S. 543 permitted banks and securities firms to affiliate through holding companies in a manner

that was substantially similar to that which was permitted in S 1886 in the 100th Congress and S 2851 in the 98th Congress. Citing the same concerns as had been noted in the 98th and 100th Congress, the Committee required securities underwriting and dealing activities to be conducted in a subsidiary of a bank holding company and not in an insured depository institution or a subsidiary of an insured depository institution. The Committee noted, for example, the substantial dangers of allowing a bank to engage in a full range of securities activities. "The temptation for the bank to support an ailing subsidiary would be very strong given that the bank's consolidated balance sheet would directly reflect the securities activity." S. Rep. No. 167, 102d Cong., 1st Sess. 157 (1991).

The Banking Committee's version of S 543 authorized a bank holding company's securities affiliate to engage in any securities activity that is permissible for SEC-registered broker-dealers, including underwriting and dealing in securities of any type. The Board remained the holding company supervisor, and the SEC supervised the securities affiliate.

S 543 did not permit the mixing of banking and commerce. The Senate Banking Committee examined the issue carefully and, as noted in the Committee Report, found no convincing arguments to support the combination of banking and nonfinancial activities. Rather, the Committee Report noted at length the potential undesirable concentration of resources, conflicts of interest, unfair competition, and unsafe and unsound practices that could arise from the affiliation of banks and industrial companies. See id. at 151-57.

S 543 made several amendments to provisions of current law governing insurance activities of banking organizations. Expressing concerns about the risk to the deposit insurance funds arising out of insurance underwriting, the Senate Banking Committee generally prohibited state banks, and subsidiaries of state banks, from engaging in insurance underwriting activities (to the same extent as national banks are generally prohibited from engaging in insurance underwriting activities). S 543 also gave parallel treatment to state and national banks with respect to insurance agency activities. The bill granted national banks the same powers to sell insurance as agent as are provided under state law to

state banks operating in the same state. The bill also narrowed the authority of banks to sell insurance from towns of 5,000 or fewer. Finally, the bill generally prohibited any bank holding company from allowing a subsidiary bank, or subsidiary of such bank, to sell insurance beyond the borders of the state in which the bank is chartered.

ATTACHMENT 2

Executive Summary H.R. 10

On May 13, 1998, the House of Representatives passed H R 10, the Financial Services Act of 1998. This attachment presents an executive summary of H R 10.

I. Expanded Powers for Qualifying Bank Holding Companies

- Repeal of Current Restrictions on Affiliations (Sections 101 and 102) H R 10 would repeal those provisions of the Glass-Steagall Act and the Bank Holding Company ("BHC") Act that restrict the ability of bank holding companies to affiliate with securities firms and insurance companies
 - Financial Holding Companies (Section 103) Bank holding companies that qualify as a "financial holding company" could engage in a broad array of financially-related activities including--
 - * Securities underwriting and dealing,
 - * Insurance agency and insurance underwriting activities,
 - * Merchant banking activities,
 - * Any activity in the United States that the Board has found to be usual in connection with banking overseas, and
 - * Any other activity that the Board determines to be financial in nature or incidental to financial activities
- * Criteria to be an FHC To qualify as a financial holding company, each depository institution subsidiary of the bank holding company must (i) be well capitalized and well managed, (ii) maintain at least a satisfactory CRA rating, and (iii) have a demonstrable record of providing low-cost basic banking services
- * Failure to Continue to Meet Criteria An FHC that fails to continue to meet any of the qualifying criteria must divest or terminate its newly authorized financial activities (e.g. merchant banking or insurance or securities underwriting activities) unless the FHC returns to qualified status within certain time periods, typically 180 days

- Banking and Commerce (Section 103) H R 10 would not permit an FHC to mix banking and commerce (i.e. there would be no commercial "basket") The bill would permit a company that becomes an FHC through the acquisition of a bank to retain those commercial activities it held as of September 30, 1997, for 10 years after enactment provided that the company at all times derives at least 85 percent of its revenue from financial activities The Board may extend this 10-year divestiture period for up to an additional 5 years on a case-by-case basis
- Elimination of Application Requirements FHCs may engage *de novo*, or acquire a company engaged, in any permissible financial activity without the Board's prior approval The company must provide the Board notice within 30 days after commencing a permissible nonbanking activity or acquiring a permissible nonbanking company
- Engaging in Innovative Activities Without Prior Board Review FHCs may engage in, and acquire companies engaged in, activities that the company reasonably believes are financial in nature (even if the Board has not yet reviewed the activity) so long as the Board has not determined that the activities are not financial FHCs could not derive more than 5 percent of their revenue from activities conducted under this authority, or have more than 5 percent of their assets or capital devoted to such activities This authority is designed to allow FHCs to respond quickly to changes in the financial services marketplace and to engage in developing activities without a prior approval process
- Prudential Safeguards (Section 114) H R 10 authorizes the Board to adopt rules governing relationships between depository institutions and their holding company affiliates if the Board finds that such rules are consistent with the public interest and Federal law The Board must regularly review any safeguards adopted and modify or eliminate outdated or unnecessary safeguards

II. Permissible Bank and Operating Subsidiary Activities

- Holding Company Model H R 10 requires that newly authorized principal activities (e.g. insurance and securities underwriting and

merchant banking) be conducted through a nonbank subsidiary of a holding company and not through a subsidiary of an insured bank

- Municipal Securities Activities (Section 181) H R 10 would allow national banks directly to underwrite and deal in all types of municipal securities
- Financial Agency Activities (Section 121) H R 10 would authorize subsidiaries of national banks to engage in any financial agency activity, including those listed in H R 10 as well as any financial agency activity permitted for FHCs, if the national bank and its depository institution affiliates are well capitalized, well managed and have at least a satisfactory CRA rating Under this authority, a subsidiary of a national bank could engage in general insurance agency activities nationwide
- Other Subsidiaries Prohibited (Section 121) H R 10 prohibits subsidiaries of national banks from engaging as principal in any activity that a national bank cannot conduct directly (e g insurance underwriting, securities underwriting and dealing, merchant banking, and real estate investment and development) This prohibition would not apply to subsidiaries that a national bank is expressly authorized to control by Federal law, such as Edge Act corporations, small business investment corporations and community development corporations
 - Parity of Treatment for State Banks (Section 121) H R 10 would prohibit subsidiaries of state banks from underwriting bank-ineligible securities (Subsidiaries of state banks already are prohibited from engaging in insurance underwriting and merchant banking activities)

III. Umbrella Supervision

- Board Authority (Section 111) H R 10 provides that the Board would be the umbrella supervisor of bank holding companies, including FHCs and WFI holding companies Under the so-called "Fed-lite" provisions of the bill, the Board would have the authority to require reports from and examine bank holding companies or their subsidiaries, subject to certain limitations

A-10

* H R 10 limits the Board's ability to obtain reports from, examine, or take enforcement action against a functionally regulated subsidiary of a bank holding company, such as a securities broker-dealer or insurance company subsidiary

* The Board also is required to defer to the SEC with respect to the interpretation and enforcement of the Federal securities laws, and to state insurance authorities with respect to the interpretation and enforcement of state insurance laws

* The Board may not require that an insurance company or broker-dealer subsidiary of a bank holding company provide funds or assets to an affiliated depository institution if the appropriate state insurance authority or the SEC, respectively, determines that the transfer would have a material adverse effect on the financial condition of the insurance company or broker-dealer (Section 113)

- Holding Company Capital The Board would retain the authority to establish consolidated capital adequacy guidelines for all bank holding companies, including FHCs. The Board may not impose capital adequacy requirements on a broker-dealer or insurance company subsidiary of a bank holding company that is in compliance with the capital requirements of its appropriate functional regulator

IV. Wholesale Financial Institutions

- New Type of Financial Institution (Section 136) H R 10 would authorize the establishment of wholesale financial institutions. WFIs would be prohibited from accepting retail or FDIC-insured deposits, but would have access to the discount window and the payments system

* The Board would have supervisory authority for WFIs as would the OCC for nationally chartered WFIs and the state banking authorities for state-chartered WFIs. All WFIs would be subject to the CRA

- WFI Holding Companies (Section 131) The Board would serve as the umbrella supervisor of WFI holding companies, and would have similar

supervisory authority (reporting and examination) over WFI holding companies as for FHCs. WFI holding companies could not own an insured bank or savings association, other than certain limited-purpose institutions (e.g. a credit card bank)

* A company that becomes a WFI holding company could retain indefinitely any commercial holdings that the company held as of the date of enactment. Otherwise, WFI holding companies would generally be subject to the same activity and affiliation restrictions applicable to FHCs (i.e. they could engage in, or acquire companies engaged in, only financial activities)

* The Board may adopt only risk-based capital requirements for WFI holding companies (i.e. no leverage ratio), and must focus any capital requirements on the use by WFI holding companies of debt and other liabilities to fund capital investments in subsidiaries ("double leverage")

V. Insurance Activities of National Banks

- Agency Activities (Section 121) National banks could continue to engage directly in insurance agency activities in any location with a population of 5,000 or less. National banks also could engage in general insurance agency activities through a subsidiary in any location

* For a period of 5 years after the date of enactment, a national bank could commence insurance agency activities in a new state (either directly or through a subsidiary) only by purchasing an existing insurance agency in the state that has been licensed for at least 2 years (Section 305)

- Existing Principal Activities (Section 304) National banks also could continue to provide as principal any insurance product that they were authorized to provide as principal as of January 1, 1997 (National banks would be prohibited from providing annuities as principal)
- Title Insurance (Section 306) H.R. 10 permits any national bank that is currently engaged in the sale or underwriting of title insurance to

continue that activity H R 10 also authorizes any national bank to sell title insurance as agent if state banks located in the same state were authorized to sell title insurance as agent as of January 1, 1997

* If a national bank has an affiliate or subsidiary that engages in insurance underwriting, however, the national bank may not engage directly in underwriting or selling title insurance (the activity must be conducted in the affiliate), except the bank may sell title insurance as agent to the extent permitted as of January 1, 1997, for state banks located in the same state

- Future Products (Section 304) H R 10 establishes a complex procedure for determining whether financial products developed in the future are banking products that may be underwritten by a national bank, or are insurance products that may not be provided by a national bank as principal In general, national banks would be prohibited from underwriting a product that is classified as insurance by state law unless the product qualifies as a "traditional banking product" and the product does not qualify for special tax treatment as insurance under the IRS Code

* Federal courts would be directed to resolve disputes concerning future products without giving "unequal deference" to the positions of the OCC or state insurance authorities

- Interplay of Federal and State Law (Section 104) H R 10 would preempt any state law that "prevents or significantly interferes" with the ability of an insured depository institution to (1) affiliate with another institution, where the affiliation is permitted by Federal law, or (2) engage in any activity, either directly or in conjunction with an affiliate, that is permissible under Federal law

* Bank Insurance Sales and Solicitation Activities H R 10 specifically adopts the Barnett decision, by name, governing the applicability of state law to the insurance sales or solicitation activities of insured depository institutions The bill also provides that a state law governing insurance sales and solicitations will not be deemed to "prevent or significantly interfere" with the insurance

sales and solicitation activities of an insured depository institution if the law is no more restrictive than a specified, existing Illinois statute (See Appendix A to the attached memorandum for a summary of this Illinois statute)

- Consumer Protection Regulations (Section 308) H R 10 directs the Federal banking agencies to jointly publish, to the extent appropriate, consumer protection regulations governing the retail sale of insurance products by, or on the premises of, insured depository institutions and WFIs

VI. Bank Securities Activities

- Broker-Dealer Registration (Sections 201 and 202) H R 10 would repeal the blanket exemption provided banks from the definitions of "broker" and "dealer" in the securities laws Banks could avoid registering as a broker or dealer only if they limited their securities activities to those permitted under the bill
 - Exempted Transactions As a general matter, the bill would allow banks to continue to engage, without registering as a broker or dealer, in securities transactions in connection with their traditional banking activities, including transactions effected in connection with their trust, custody and safekeeping operations H R 10 would also allow banks to engage in up to 500 retail brokerage transactions per year without registering as a broker or dealer
 - Future Products (Section 206) Banks also could offer and sell, without registering as a broker or dealer, new financial products that are developed in the future unless the SEC determines after a formal rulemaking process that the product is a security
- Consumer Protections and Complaint Mechanism (Section 204) H R 10 requires that the Federal banking agencies jointly promulgate, after consultation with the SEC, regulations governing the retail sale of securities by insured depository institutions and their affiliates (other than an SEC-registered broker-dealer) The regulations must impose

sales practice requirements that are substantially similar to the Rules of Fair Practice of the NASD. The Federal banking agencies also must jointly establish, after consultation with the SEC, procedures for receiving and investigating consumer complaints arising from securities transactions with banks, including a procedure for referring fraud-related complaints to the SEC.

VII. Other Significant Aspects of the Legislation

- Unitary Thrift Holding Companies (Section 401) H R 10 would close the unitary thrift holding company loophole as of March 31, 1998. Companies that apply to acquire a thrift after that date could engage only in financial activities. Existing unitary thrift holding companies would be grandfathered and could continue to engage in any type of financial or commercial activity.
- Federal Home Loan Bank System H R 10 would significantly expand the ability of the FHLB System to make advances to commercial banks by (i) eliminating restrictions that require FHL Banks to focus their lending on institutions that meet the Qualified Thrift Lender Test, and (ii) relaxing the membership requirements for insured depository institutions. H R 10 would also revise the governing structure of the FHLB System.
- Redomestication of Mutual Insurers H R 10 would allow mutual insurance companies to change their state of incorporation for the purpose of reorganizing into a stock insurer with a mutual holding company. H R 10 would also preempt any state law that impedes the redomestication of a mutual insurer or that discriminates against a mutual insurer that has changed its state of incorporation.
- National Association of Registered Agents and Brokers H R 10 would create a new National Association of Registered Agents and Brokers ("NARAB") to establish uniform criteria for the qualification, training, and continuing education of insurance agents and brokers. Insurance agents and brokers that meet the requirements established by NARAB could sell insurance in any state.

- CRA Study H R 10 requires the Secretary of the Treasury to conduct a study concerning the impact of the bill on the CRA and to report the study's findings and recommendations to the Congress within 2 years of enactment. The Treasury must consult with the Federal banking agencies and the SEC in conducting the study and preparing the report to Congress.
- GAO Studies and Reports H R 10 requires that the General Accounting Office (1) submit an annual report to Congress on market concentration in the financial services industry and the impact of such concentration on consumers, (2) submit a report to Congress within 6 months of enactment on the projected impact of the bill on banks and other financial institutions that have less than \$100 million in total assets, and (3) study the benefits of establishing a uniform limit on the fees that may be imposed in connection with the acquisition of financial products

ATTACHMENT 3

National Bank Market Shares

Chart A3-1 shows the significant increase in market share for national banks in 1997 and early 1998, when the logic of interstate branching induced conversions mainly from state nonmember to national bank charters, as well as absorption by national banks of state banks through merger. Table A3-1 provides more detail on such shifts.

The memo panel of Table A3-2 also clearly indicates that interstate branching is dominated by national banks. The upper two panels of the table show the dominance of the national bank charter among the larger banks.

Chart
Percent of Commercial Bank Assets held by National Banks

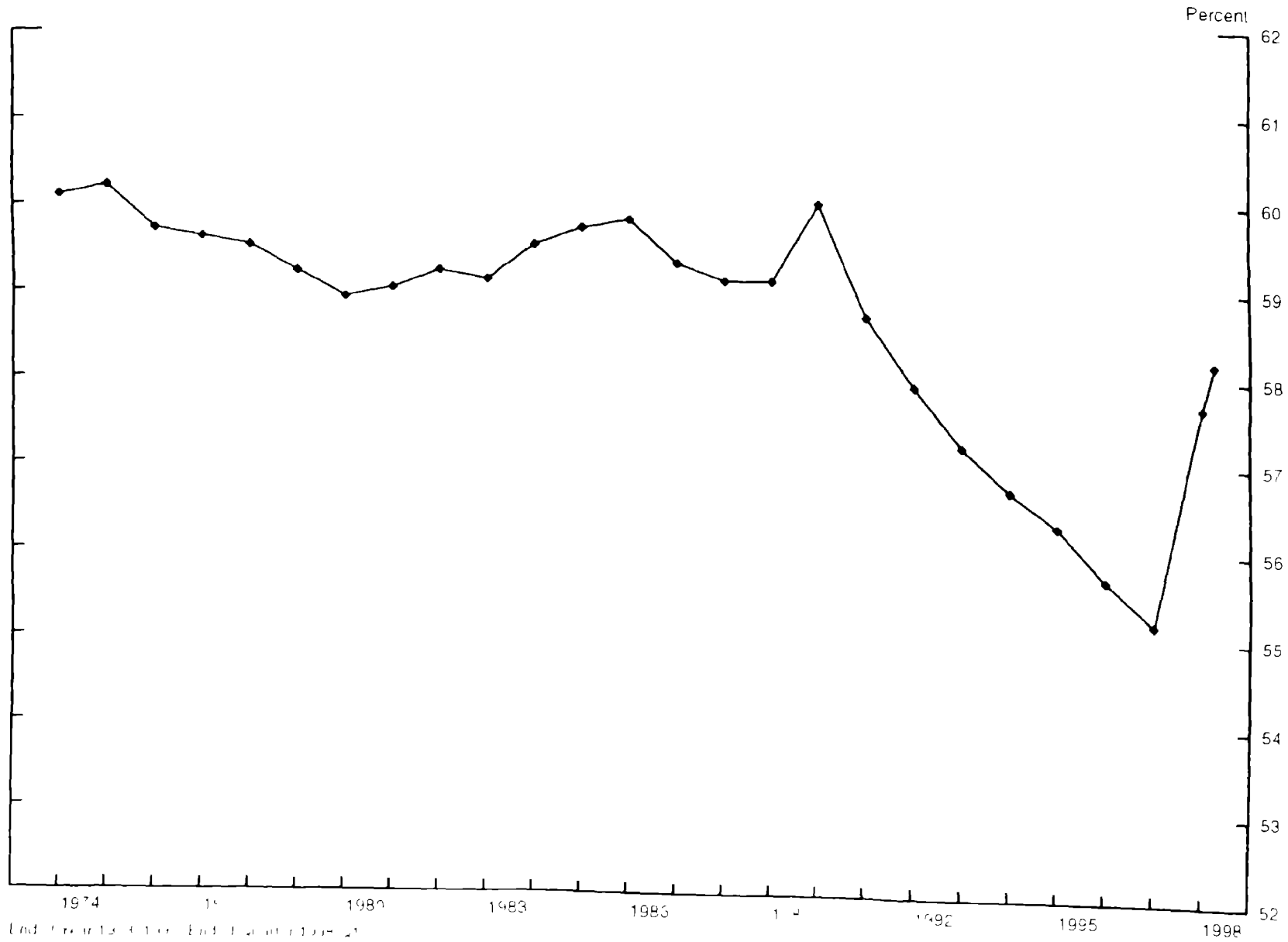


Table A3-1

Net Change in Commercial Bank Assets from De Novos, Mergers, and Charter Conversions
Assets (\$ Billions)
1995-1998

National Banks					
	1995	1996	1997	First 5 Mos 1998	12/31/94- 6/9/98
Additions From					
De Novo Banks	4.0	6.5	7.6	0.8	18.9
Mergers with Other Charter Types	22.0	86.4	113.9	17.4	239.7
Charter Conversions	21.1	52.8	60.3	2.6	136.8
Total Additions	47.1	145.7	181.8	20.8	395.4
Deletions From					
Failures	0.0	0.1	0.0	0.0	0.1
Mergers with Other Charter Types	16.2	136.5	7.6	2.8	163.1
Charter Conversions	49.7	6.0	0.9	2.8	59.4
Total Deletions	65.9	142.6	8.5	5.6	222.6
Net Increase In National Bank Assets from De Novos, Mergers, and Charter Conversions	-18.8	3.1	173.3	15.2	172.8
State Banks					
	1995	1996	1997	First 5 Mos 1998	12/31/94- 6/9/98
Additions From					
De Novo Banks	8.0	2.6	2.4	1.0	14.0
Mergers with National Banks	16.2	136.5	7.6	2.8	163.1
Charter Conversions	51.0	9.1	18.2	2.8	81.1
Total Additions	75.2	148.2	28.2	6.6	258.2
Deletions From					
Failures	0.7	0.0	0.0	0.0	0.7
Mergers with National Banks	22.0	86.4	113.9	17.4	239.7
Charter Conversions	18.9	52.4	45.7	2.2	119.2
Total Deletions	41.6	138.8	159.6	19.6	359.6
Net Increase In State Bank Assets from De Novos, Mergers, and Charter Conversions	33.6	9.4	131.4	13.0	-101.4

Note: Assets for June 9, 1998 are as of March 31, 1998, the latest quarter for which financial data is available, and are adjusted for mergers.

Table A3-2
Percent Distribution
Various Indicators of Relative Size
By Charter Class of Commercial Bank
As of March 31, 1998

Indicator	Charter Class		
	National	State Member	State Nonmember
	(OCC)	(FR)	(FDIC)

Top 25 By Size

Consolidated Assets	70.6	29.4	0.0
Domestic Deposits	82.2	17.8	0.0
Offices in U S	92.2	7.8	0.0

Top 50 By Size

Consolidated Assets	68.0	30.5	1.5
Domestic Deposits	75.9	21.8	2.3
Offices in U S	83.3	13.5	3.2

All

Consolidated Assets	58.1	24.4	17.5
Domestic Deposits	58.4	18.6	23.0
Offices in U S	58.1	15.8	26.1

Number of Banks Operating Full-service Facilities in:

2 states	37	8	23
3 states	13	6	2
4 states	3	2	0
5 states	2	0	1
More than 5 states	10	0	0