STATEMENT OF ELLEN SEIDMAN, DIRECTOR
OFFICE OF THRIFT SUPERVISION
ON
FINANCIAL MODERNIZATION AND H.R. 10
BEFORE THE
COMMITTEE ON BANKING AND FINANCIAL SERVICES
OF THE
UNITED STATES HOUSE OF REPRESENTATIVES

February 12, 1999

I. Introduction

Mr. Chairman and members of the Committee, I appreciate the opportunity to discuss the Office of Thrift Supervision's views on financial modernization and your bill, H.R. 10, the "Financial Services Act of 1999."

Last year, Congress made tremendous strides in its efforts to modernize America's financial services industry. Today, we have been asked to consider legislation that builds on the work of the 105th Congress. Many of the same issues remain—and we must work together to resolve these differences—but ultimately the question we must ask is whether proposed legislation will facilitate the ongoing movement of our financial system into the twenty-first century. Because regardless of what happens in the coming weeks and months on the legislative front, the market will continue to modernize. Legislation should facilitate this trend, promoting flexibility for existing, and future, financial institutions, including insured depositories, while maintaining a framework to ensure the system's continued safe and sound operation, fair service to all, and the health and stability of the national and global economies.

In my statement, I will first articulate four principles we believe should guide financial services modernization legislation. I will then discuss several characteristics of the federal thrift charter we believe should be preserved and, potentially, modeled in developing new alternative structures, including several issues that are particularly important to us in this debate. I will then comment on your articulated goals, Chairman Leach, for financial services modernization legislation and reflect on these in light of our experience with the federal thrift charter. Finally, I will address several aspects of H.R. 10, introduced by Chairman Leach, and H.R. 665, introduced by Congressman LaFalce earlier this week.

II. The Principles of Financial Modernization

We believe several principles are paramount as Congress moves forward in developing and enacting legislative reforms affecting the future of the financial services industry. Such legislation must:

- Preserve adequate regulatory authority to protect the safety and soundness of insured institutions and the federal deposit insurance funds, and to protect consumers in their dealings with financial institutions;
- Maintain marketplace incentives to facilitate the ability of institutions to continue to provide consumer- and community-based financial services to all Americans, in all communities;
- Enhance structural and operational flexibility so insured depository institutions can compete effectively with other financial services providers; and
- Minimize regulatory burdens on insured depository institutions, consistent with safety and soundness and the consumer protection and community reinvestment laws.

These criteria balance flexibility for institutions—so that marketplace innovations that benefit customers, communities and the financial system are not impeded—with appropriate regulatory safeguards. The thrift charter represents one model of a modern charter with a community- and consumer-based focus. It also offers substantial flexibility in that it affords benefits and advantages both to small community-based institutions and larger regional and national providers of financial services.

III. Characteristics of a Modern Charter—the Federal Thrift Charter

1. Permissive Affiliation Authority

While the federal thrift charter is certainly not the only way to structure a modern charter, it is a model worth studying. The federal thrift charter provides a unique combination of permissible affiliations and restrictive operating conditions. The unitary thrift holding company is a good example. Much has been made of the fact that a thrift may be owned by or affiliated with any type of commercial entity. Glossed over in this debate are the restrictions under which the thrift itself must operate, as well as an appreciation for the historical framework for regulation of the unitary structure (which is described in the appendix to this statement).

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

In addition, federal thrifts are constrained in the amount of their overall commercial lending. By statute, a thrift may not hold commercial loans in excess of 10 percent of its assets, except that it may make small business loans up to an additional 10 percent of assets. This provision, coupled with the qualified thrift lender restriction imposed on thrifts—which requires 65 percent of thrift assets to be in mortgages, mortgage-related investments, education and certain consumer and small business loans—effectively constrains the ability of thrifts to engage in traditional commercial bank lending activities.

OTS's capital distributions regulation also limits the amount a thrift may dividend or otherwise distribute to its parent holding company. The amount of a dividend or similar distribution is based on the capitalization level of the thrift institution. In no event may a thrift make a dividend that would impair its capital. In addition, thrifts—like banks—are subject to increasingly stringent activities, dividend, growth and other restrictions that protect the institution if its capitalization falls below designated capital levels.

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

In fact, commercial ownership of thrifts remains limited. Currently, only 24 of the 547 existing thrift holding company structures have commercial activity within them. Another 25 holding companies have some amount of real estate development in their structure.[1] This despite the fact that for several years there have been serious efforts to prohibit commercial firms from acquiring or chartering thrifts in the future. In fact, most of the small number of commercial firms that now own a thrift charter do so because the focus of their commercial activity is consumer, rather than business, oriented. These companies view the thrift charter as a way to extend and diversify their consumer business operations.

Despite the relatively small percentage of commercial ownership of thrift institutions both today and historically, commercial firms have made significant capital contributions to the industry. For example, we are aware of over $3 billion of capital infused in 79 failed thrifts by commercial firms during the late 1980s.

With respect to reports regarding an increase in new thrift charter applications, the vast majority of recent charter applications come from groups of individuals and insurance and securities companies, not commercial firms. Insurance and securities companies could, of course, own a commercial bank were H.R. 10 enacted in its current form. Insurance and securities applicants are seeking to use the operating and marketing synergies available between their existing business and product lines and those available with ownership or affiliation with a thrift.

Predictably, there have been some tricky policy and supervisory issues raised by some of the new applications, particularly with the proposals that have involved unique business plans and strategies. Some of these applications have required difficult regulatory analysis and novel responses. We thoroughly consider all relevant safety and soundness, compliance, consumer protection and related issues prior to our action on each individual application. OTS conditions of approval typically require applicants to implement adequate internal controls, training programs and reporting mechanisms that ensure effective oversight, and protect the safety and soundness of the institution and the federal deposit insurance funds. I have heard that some applicants have become so perplexed about the care we exercise in reviewing unique business strategies that they question whether we have a self-imposed moratorium on new charters. I can assure you, we do not.

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[1] Pursuant to HOLA § 5(t)(5), enacted as part of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA"), savings associations owning subsidiaries engaged in real estate development activities must separately capitalize their investments in such subsidiaries. This requires the full amount of a thrift's investment in a real estate development subsidiary to be deducted from the thrift's capital. As a result, after FIRREA most thrift real estate development subsidiaries were either divested or (for institutions in a holding company structure) the activities were moved to a holding company affiliate of the thrift. Currently, thrift investments in real estate development (and other non-includable) subsidiaries amounted to approximately 0.04 percent of total thrift assets. Because (pursuant to another FIRREA provision discussed above) thrifts are prohibited from making loans to affiliates not engaged in permissible bank holding company activities, a thrift is prohibited from funding the activities of such a real estate development affiliate.

2. Uniform Standards of Operation

Another example of the balance in the federal thrift charter is the inherent tie between its consumer lending focus and the ability to operate under uniform federal standards. Unlike commercial banks, federal thrifts are statutorily required to direct the predominant portion of their lending activities to consumers—via home lending, consumer loans, education loans, and credit card lending. One of the trade-offs for this consumer lending focus is that federal law affords thrifts the opportunity to engage in these activities on a nationwide basis. Congress has recognized the value of permitting these institutions to conduct their lending and deposit-taking activities subject to a uniform, federal system of oversight, requiring in HOLA that in regulating federal thrifts, we give "primary consideration of the best practices of thrift institutions in the United States." Practically, this means that these institutions need comply with one set of federal laws governing their lending and deposit-taking activities, instead of the laws of each of the states where they may conduct their operations.

This authority to establish uniform federal standards is, however, limited. OTS regulations—adopted after public notice and full opportunity for comment—specifically delineate areas where we generally determine that federal law does not preempt state laws because of the states' legitimate interest in enacting contract and commercial laws, real property laws, criminal laws, tort laws, and any other laws that further a vital state interest and have an incidental impact on thrift operations. For example, several years ago we were asked to preempt a Georgia law requiring lenders to perform the ministerial function of collecting a "per loan fee" from borrowers and transmitting it to the State. The Georgia law involved a relatively minor burden, which applied to all mortgage lenders in the State, and the collection requirement was incidental to the safe and sound operation of Georgia thrifts and did not interfere with the efficient production of mortgage loan originations. Thus, we concluded that the State provision was not preempted by federal law.

More recently, we were asked to preempt a New York law setting forth lighting requirements for ATM machines, a provision intended to ensure the security of customers using ATM facilities within the State. Recognizing the State's overriding interest in protecting the security of its citizens, we concluded that the New York provision was not preempted by federal law—a result clearly consistent with the criteria set forth in our regulations

3. Consolidated Regulatory Oversight and Functional Regulation

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

If the holding company's structure includes insurance or securities firms, then its components are functionally regulated. Functional regulation also applies where thrifts engage in insurance and securities activities through subsidiary service corporations or affiliated holding company subsidiaries. Service corporations and holding company affiliates engaged in insurance activities must be licensed and regulated by the appropriate state insurance regulator, and those engaged in securities activities must register with the Securities and Exchange Commission ("SEC") and their appropriate self regulatory organization ("SRO"), such as the National Association of Securities Dealers ("NASD"). Primary oversight of insurance and securities activities remains with the functional regulator (i.e., state insurance and securities commissioners and the SEC and NASD or other SRO), with whom the OTS works closely when an issue affecting the thrift or its charter arises.

Not only does this unique approach benefit OTS-regulated thrifts by avoiding regulatory overlap, it embraces a common-sense regulatory division of labor while maintaining the ability of the OTS to monitor all aspects of a structure to protect the safety and soundness of the thrift. This combination of consolidated regulatory oversight and functional regulation is certainly worth preserving, and seriously worth considering as a broader model for consumer-oriented financial institutions.

IV. Goals of Financial Modernization

When you and your colleagues introduced H.R. 10 this year, Mr. Chairman, you indicated that financial services modernization legislation should pursue several goals:

- Leveling the competitive playing field within the financial services industry;

- Increasing competition so that the costs of financial services are lowered for consumers;

- Boosting the international competitive position of American firms; and

- Providing consumers and smaller businesses in more rural areas with access to a wider variety of financial products by enabling local institutions to offer a full range of products and services.

We agree with these stated objectives, provided that in pursuing legislative efforts to attain these goals we do not sacrifice the stable underpinnings of our existing financial services system. That is, the stated goals of financial modernization should be pursued in a manner consistent with the principles of financial modernization I previously articulated.

With these goals of financial modernization in mind, and with a watchful eye on maintaining existing checks and balances in our financial system, I briefly want to evaluate how the thrift charter measures up. As to the level playing field objective, it is quite clear that the thrift charter has enabled insurance and securities firms to own depository institutions—if the institutions concentrate on consumer lending and operate within statutory commercial lending limitations. This absence of competitive barriers to entry seems to be at the heart of creating a level playing field.

Next, with respect to increased competition and reduction in the costs of financial services to consumers, although the absolute number of thrifts continues to decline, competition has been enhanced as existing thrifts and new entrants have provided more choices for consumers through innovative products and new service delivery systems. This influx of new financial products and increase in delivery systems clearly is increasing competition—and will reduce costs to users of financial services. The innovation and expansion of delivery systems can also expand access to services of depository institutions in communities that have limited access to these products.

As for international competitiveness, the thrift charter has had very limited exposure to international operations. The charter is virtually an exclusively domestic charter.

With respect to providing consumers and small businesses in more rural areas with greater access to financial services, the thrift charter has been empowering local, community-based institutions for years to offer a full range of financial products and services. The charter is well-suited to this in both underserved rural and urban areas, with thrifts offering a full range of consumer deposit and loan products.

Through service corporation subsidiaries, thrifts also provide securities and insurance brokerage services, and a statutorily limited amount of real estate development activities. Thrifts also have the flexibility to offer products and services that could be conducted in the thrift itself, such as mortgage banking, through an operating subsidiary. Finally, thrifts may be part of a corporate structure that conducts additional, non-banking lines of business. On this final point, because of the commercial lending, anti-tying, and other limitations imposed on the thrift charter, this is accomplished without triggering the traditional concerns raised with mixing banking and commerce.

V. Comments on H.R. 10

For these reasons, I believe the federal thrift charter is a good model for a modern federal depository institution charter. We therefore oppose provisions of H.R. 10 that would restrict existing and future, lawful unitary thrift holding company activities and that would amend existing authority for federal thrifts to operate under uniform standards nationally. We believe the safeguards currently in place are effective and the charter should not be altered as proposed in H.R. 10.

We continue to support a merger of the federal deposit insurance funds. The insurance funds should be merged, whether as part of broad financial modernization legislation or via some other legislative vehicle. We need to eliminate the economic and managerial inefficiencies of a two-fund structure for what is essentially one product—insured deposits.

Market forces have already begun this process. It is becoming increasingly anachronistic to refer to a "bank fund" and a "thrift fund." The overlap between the two funds has been an open secret for some time. As of September 30, 1998, over 35 percent of total SAIF-insured deposits ($246 billion) were held by commercial banks and almost 29 percent of savings institution insured deposits ($185 billion) were insured by the BIF.

Both industries are sound and healthy, and both funds are well-capitalized. Now is the ideal time to do what sound public policy clearly tells us must be done: merge the two funds. Thus, we urge that H.R. 10 include merger of the federal deposit insurance funds.

Finally, I want to applaud the Chairman for including in H.R. 10 elimination of the SAIF special reserve. Because the FDIC is required to maintain the SAIF (or the combined BIF-SAIF) at a 1.25 percent reserve ratio and must raise deposit premiums (up to 23 basis points annually) to do so, it is highly unlikely that the reserve will ever be utilized. In essence, the establishment of the SAIF special reserve transferred to a special fund over $1 billion of the $4.5 billion that institutions with SAIF-insured deposits contributed to the SAIF in 1997 to fully capitalize the fund.

A greater concern is that funding of the reserve pares the SAIF reserve ratio from an estimated 1.39-1.41 percent—which is equivalent to the BIF ratio—to 1.25 percent. The FDIC established the reserve on January 1, 1999, using September 30, 1998 data, and will adjust the amount (approximately $1 billion) to reflect year-end figures when they become available this spring. Funding the reserve eliminates the capital cushion of the SAIF to absorb insurance losses above those covered by fund earnings and incremental premiums. The FDIC is now estimating that the SAIF will grow a maximum of $200 million during the first six months of this calendar year. While no one anticipates significant claims, this new $200 million cushion is relatively small, and it exposes SAIF institutions to increased premiums and, once again, a BIF-SAIF premium differential. It would not be surprising if this triggered another wave of that singularly most pointless of financial transactions: deposit-shifting.

The only way to resolve this problem is to eliminate the special reserve and return the funds to the SAIF. This will restore the capital cushion of the SAIF (or a combined fund in the event of a merger) and avoid the possibility of future, increased SAIF assessments where a substantial reserve already exists but cannot be used. We support legislation that achieves this result.

VI. Other Legislative Proposals

Earlier this week, Ranking Minority Member LaFalce introduced H.R. 665, the "Financial Services Modernization Act of 1999," which is co-sponsored by other members of the Committee. H.R. 665 takes a simpler approach to financial services modernization legislation and has many attractive features. It focuses only on the key elements necessary for financial modernization, and thereby avoids some of the pitfalls of other approaches. Among the key elements included in the bill are repeal of the Glass-Steagall bank/securities firm anti-affiliation rules; authority for bank holding companies to engage in financial activities specified by law plus others determined by the Federal Reserve Board; streamlining of bank holding company supervision while enhancing functional regulation; and strong protections for consumers who purchase insurance products from financial institutions.

OTS is pleased that H.R. 665 retains the existing federal thrift structure, including leaving the unitary thrift holding company in place. This recognizes the advantages of retaining the unitary structure as a vehicle to offer a full range of locally focused, consumer-oriented financial services. The bill would give institutions the freedom to choose whether the unitary structure suits their particular business goals and needs.

If H.R. 665 becomes the model for financial modernization legislation, we would urge the addition of amendments to merge the federal deposit insurance funds and eliminate the SAIF special reserve.

VII. Conclusion

Mr. Chairman, I am pleased to provide you with OTS' views on financial modernization. Despite our serious concerns regarding some of the provisions in H.R. 10, I want to emphasize that we support efforts to modernize the federal laws governing the provision of financial services in the United States. We believe modernization must provide the tools necessary to assure the safety and soundness of the national banking system and protect the American public in its dealings with these institutions, result in consumer- and community-based financial services for all Americans, provide structural and operational flexibility for insured institutions, and minimize regulatory burdens.

Consistent with these goals, OTS urges the Committee to retain the existing thrift charter as one model of a modern charter. It permits affiliations of insured depository institutions with insurance, securities and other firms, but with built-in safeguards to avoid undue risks to the taxpayer and to meet the needs of consumers and communities. Based on our experience, there is no reason to believe that affiliations permitted in the unitary thrift holding company structure are inherently risky and should be constrained. In fact, there are numerous reasons to retain the structure in its current form. Similarly, we support retaining existing federal law that facilitates implementation of federal thrifts' mandate to operate under uniform national standards based on the "best practices" found throughout the country. Finally, we urge the Committee to take the opportunity presented in H.R. 10 to merge the two federal deposit insurance funds and eliminate the SAIF special reserve.

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