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ORAL STATEMENT

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Mr. Chairman and members of the Subcommittee, I welcome this opportunity to offer my views on financial modernization. I commend you and your colleagues for exploring this important issue. I have a prepared statement that I would like to submit for the record. I would like to summarize the key points in that statement.

Over the past several decades, Congress has considered numerous proposals to modernize the laws that govern financial services in this country. For various reasons, all these efforts have been unsuccessful, and as a result, our nation's banks continue to operate under an antiquated legal and regulatory framework.

This year we have a real opportunity to correct that problem. Consumers, communities, and the American economy stand to gain a great deal from meaningful reform. To achieve that reform, however, we must move beyond debating how to shuffle the boxes into which we have tried to cram banks, insurance companies, securities firms and other financial service providers.

Rather, we need to take a fresh look at the entire legal framework governing financial services. Our goal should be to promote a vigorously competitive financial marketplace, while safeguarding the safety and soundness of our financial institutions, fair access to financial services, and vital consumer protections.

In an age of rapidly changing communications and computer technology, banks and other financial competitors must have the flexibility to serve an evolving economy and changing consumer needs.

This is not just an academic argument. Government restrictions on financial institutions that are not clearly justified by safety and soundness or other public policy concerns hurt the long-term health of our financial institutions. Equally important, these restrictions hurt small banks in particular and the ability of all financial institutions to meet the needs of consumers, poor people, and small businesses.

Simply stated, absent clearly demonstrable public policy concerns, it is not government's business to tell financial services providers how to structure their business.

Obviously, one relevant policy concern is the safety and soundness of our nation's financial institutions. Over the past 15 years, we have learned through hard experience that effective supervision is our most important tool to ensure bank safety and soundness. In fact, many -- including myself -- believe that banking problems in the past 15 years resulted from outdated legal restrictions on bank activities, which pressured banks to take increasingly greater risks or become excessively concentrated in those lines of business that were available to them.

With that experience in mind, a consensus has developed that banks must be permitted to broaden their activities. But old habits and old ways of thinking die hard. There is no consensus on how banks should be permitted to structure those activities.

Some argue that banks must be forced to use holding company affiliates rather than subsidiaries to avoid giving banks an unfair competitive advantage. They contend that banks benefit from a kind of subsidy through federal deposit insurance and participation in the payments system and discount window, whereas bank holding companies are less likely to benefit to the same extent. This argument simply doesn't stand up to analysis.

First, the best evidence is that no net subsidy exists. While banks gain some benefit from deposit insurance and participation in the payments system and discount window, they are also subject to significant regulatory burdens, including compliance costs, examination fees, deposit insurance premiums, FICO bond payments, and the obligation to hold a portion of their deposits in sterile reserves.

The FFIEC estimates the cost of regulatory burden for the banking industry to be at least $9 billion per year -- even without considering the cost of deposit insurance, foregone interest on sterile reserves, and interest payments on FICO bonds. This $9 billion translates into about 30 basis points -- 30 cents for every $100. These costs more than offset any net benefit from the safety net that banks might enjoy -- which, in the case of deposit insurance, our economists estimate to be about 4 basis points.

Bank behavior is consistent with the economic analyses that show there is no net subsidy. If a subsidy existed, we would expect banks to take full advantage of it in the way they structure their operations today. But that's not the case. Where banks have a clear choice of how to structure their non-banking operations, there is no clear pattern. Banks currently conduct activities such as mortgage banking and data processing sometimes through a holding company affiliate, sometimes directly in the bank, and sometimes in a bank subsidiary.

Nor do banks fund themselves as if a subsidy exists. If bank-issued debt is subsidized, we would expect banks to issue all their debt at the bank level. Yet many companies issue debt at the holding company level, and sometimes then downstream the funds to the bank.

If insured deposits give banks a significant funding advantage, one would expect to see uniform reliance on them to raise funds. In fact, less than 60 percent of commercial bank assets are backed by domestic deposits, and foreign deposits range from zero to 61 percent of liabilities at the ten largest banks.

Further, if a funding subsidy existed, we would expect banks to dominate markets where they are competitors. In fact, exactly the opposite is true. Over the past half century, banks have lost market share in core banking services, and they certainly do not dominate new markets for non-traditional bank activities.

Proponents of the funding subsidy argument argue that requiring banks to provide new services through holding company affiliates limits the benefits of the subsidy and promotes a more level playing field. I disagree. Even if there were a subsidy, a bank could pass it up to the holding company to fund an affiliate just as easily as it could pass it down to fund a subsidiary.

Containment of any theoretical subsidy depends not on where we place new activities in the financial organization chart, but on the restrictions we impose on transfers between a bank and its subsidiaries or affiliates and on vigilant supervision. We could restrict transfer of any subsidy to a bank subsidiary just as effectively as to a holding company affiliate.

Those who advance the subsidy argument point to the small bond rating differential between bank debt and holding company debt as evidence of the alleged funding advantage. But Standard and Poor's and Moody's, the rating agencies responsible for this difference, don't agree. They say the rating difference reflects the ability of the federal banking agencies to limit payments from the bank to the holding company in times of distress rather than a bank safety net benefit.

Taken to its logical conclusion, the subsidy argument is not just an argument against giving financial firms the freedom to determine their own corporate structure. It is an argument against financial modernization itself. Those who make this argument themselves suggest that there would be no way to prevent at least some benefit associated with the purported subsidy from leaking to the holding company and its affiliates. Thus, in order to truly prevent banking companies from enjoying an unfair advantage, it would be necessary to confine banks and all their affiliates to a narrow range of activities.

But we should not let an unsupported hypothesis that banks enjoy a subsidy dissuade us from pursuing financial modernization. And we should not let an unsupported hypothesis dissuade us from adhering to a fundamental principle that should underlie modernization: Financial institutions need the freedom to manage their activities and structure their operations in a way that best suits their needs and the needs of their customers. Allowing these institutions to engage in new activities on the one hand but imposing an artificial structure on the other will impede rather than promote safety and soundness. It will not limit any more effectively their use of the alleged subsidy, even if the subsidy actually existed. And it will impose substantial costs and inefficiencies on the financial services industry that limit the industry's ability to prosper, to serve America's consumers and communities, and to compete in the global marketplace.

Forcing all financial institutions into a single structure, such as the bank holding company, would certainly increase costs for small banks -- in some cases so much that the activities would not be profitable. It would deprive all banks of potential sources of earnings that could help them weather economic downturns. And it would shrink the assets and earnings available to the bank to meet its obligation under the Community Reinvestment Act to serve the needs of all its customers, including low- and moderate-income customers and small businesses.

In the absence of compelling public policy concerns, there is no justification for government depriving individual institutions of the freedom to choose how to provide financial services. There is every reason for government to leave these decisions to the discretion of private sector financial institutions. The result will be strong, healthy, well-diversified financial institutions that can weather economic downturns and continue to provide financial support to the nation's economy and financial services to the nation's businesses, communities and citizens.

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