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TESTIMONY OF
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SUBCOMMITTEE ON
CAPITAL MARKETS, SECURITIES AND
GOVERNMENT SPONSORED ENTERPRISES
of the
COMMITTEE ON BANKING AND FINANCIAL SERVICES
of the
U. S. HOUSE OF REPRESENTATIVES

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

Mr. Chairman and members of the Subcommittee, I welcome this opportunity to offer my views on financial modernization. I commend your efforts to explore this important issue.

When we consider that the framework established with the Glass Steagall Act has endured for over six decades, we must recognize that any action this Congress takes to reshape the landscape of the financial services industry could be similarly durable. Therefore, as we develop a plan for financial modernization, it is important to proceed thoughtfully.

Over the past several decades, Congress has looked at numerous modernization proposals, but has not acted for a variety of reasons. As a consequence, our Nation's banks continue to be constrained by an antiquated legal and regulatory framework. Consumers, communities, and the American economy have a great deal to gain from meaningful reform of that antiquated framework. We will not achieve those gains, however, unless we move beyond debating how to shuffle the boxes into which we attempt to carve up various parts of the financial services industry. After sixty years of laws and regulations that have remained frozen while a dynamic market has been driven by technological change, we need a broad reconsideration of the legal framework to promote a robust competitive marketplace, while maintaining safety and soundness, fair access to financial services, and vital consumer protections.

In creating a new paradigm for the financial services industry, Congress must recognize that, just as financial innovation in our free market economy and interconnected world could not be stopped by the Glass Steagall Act in 1993, it cannot and should not be prevented now. On the contrary, change in the financial markets today is occurring at a much more rapid pace than at almost any other time in our history. If our banks and nonbank providers are to serve the public, compete globally, and be safe and sound in this dynamic environment, they must have the flexibility to serve an evolving economy and changing consumer needs. As advances in communications and computer technology continue to increase competition in international financial services markets, we cannot afford governmentally imposed burdens that impede competition and create inefficiencies but serve no public policy purpose.

In my testimony, I first will describe five principles that should guide financial modernization: maintaining safety and soundness, providing fair access and consumer protection, promoting competition, protecting the role of community banks, and ensuring that financial firms have the flexibility to organize and operate their business as they choose.

An important point emerges in the consideration of those principles: The government should not constrain the activities that financial services firms undertake or the way they structure their businesses without a compelling public policy reason. Every financial services firm is unique, and the communities in which firms operate are different. Business executives know their firms' strengths and weaknesses and their operating environments far better than any lawmaker or regulator. The best business talents

cannot operate most efficiently and effectively without flexibility to adapt to their organizations' characteristics and environment. A one-size-fits-all structure imposed by the government stifles ingenuity and reduces efficiency. Banking companies, in particular, should not be forced to conduct new activities in one particular way. Instead, they should have the option of conducting activities through a bank subsidiary as well as through a holding company affiliate.

Forcing activities into a holding company affiliate will lead banks either to shrink or to take on greater risks to maintain earnings, and the result will be destabilized hollow banks. Markets for banking services will be less competitive, and fewer resources will be available to banks to meet community needs. Bank customers will face higher fees, reduced services, and fewer choices. The many sectors of the economy that depend on community banks will be denied the benefits of modernization. And, in a world in which financial institutions compete globally, and money can move rapidly anywhere, cost disadvantages due to excessive regulation may cause financial activities to move off-shore, weakening U.S. financial services institutions.

In the last part of my testimony, I will address the recent argument that federal deposit insurance, the availability of the discount window, and access to the payment system provide a subsidy to banks that necessitates mandating a holding company structure. I attach an OCC Economics Working Paper on bank organizational form and the risks of expanded activities, which demonstrates that the holding company affiliate structure is not superior to the bank subsidiary approach for maintaining safety and soundness and protecting the deposit insurance fund.

Principles of Financial Modernization

Although it is unquestionably in the public interest to permit banks to compete fully on a level playing field with nonbank financial institutions, it is essential that the efforts to modernize our financial laws be grounded by sound principles. In my view, modernization that does not adhere to the following five principles will do more harm than good.

Maintaining Safety and Soundness

First and foremost, financial modernization must ensure the safety and soundness of the banking system. Historically, the federal government has relied on the banking system to achieve several important policy goals. These goals include maintaining the stability and integrity of the payments system; creating a safe haven for small savers; providing an adequate flow of credit to homeowners, small businesses, and farmers; protecting consumers; and ensuring appropriate investment in local communities. If the banking system does not remain vibrant, safe, and sound, the ability to attain these goals will be threatened.

Effective supervision is the most important tool we have to ensure the safety and soundness of the banking system.(1)
Supervisors need to fully understand the risks and combinations of risks that banks are taking, particularly as banks move into new

or non-traditional lines of business. In 1995, the OCC adopted Supervision by Risk, a forward-looking approach that identifies and focuses our examination resources on those areas that pose the greatest risk to the bank. Under Supervision by Risk, our examiners assess the quantity of risk exposure across the entire spectrum of a bank's activities and bank management's ability to identify, measure, monitor, and control risk. In addition, OCC examiners and economists monitor developments in the industry and assess risk by gathering information from examinations, surveys, reports, and industry comparisons with nonbank competitors. We continually review and update our examination procedures to ensure that our examiners have up-to-date methods for assessing the risks involved with the various bank products and are able to identify and respond to risk.

However, effective supervision, by itself, is not enough to guarantee a safe and sound banking industry. Ensuring that banks have the flexibility to adapt to changes in the marketplace is also

(1) Research on the banking crisis of the late 1980s and early 1990s underscores the importance of bank supervision. See, for example, Joe Peek and Eric Rosengren, "The Use of Capital Ratios to Trigger Intervention in Problem Banks: Too Little, Too Late," New England Economic Review, Sept/Oct. 1996, who find that because prompt corrective action is based on a lagging indicator of a bank's financial health, it is likely to trigger intervention in problem banks only after they have been identified by examiners who rely on far more information than the capital ratio.

critical. Unnecessary restrictions on banks' activities are likely to increase their risk profiles for two reasons. First, as the opportunities for profit in banks' core lines of business decline with changes in the marketplace, banks are pressured to take greater risk within those areas to maintain profitability. Second, banks may become excessively concentrated in those lines of business that are available to them. Losses in commercial real estate and agricultural lending in the 1980s are compelling testimony to the dangers of excessive risk taking and concentrations in particular market segments.

Access to Financial Services and Consumer Protection

The second principle for financial modernization is that reform should promote broader access to financial services for all consumers. Banks play a special and vital role in the development and prosperity of all communities, particularly those encompassing lower- and middle-income Americans. In addition to providing credit and other basic consumer financial services, banks often serve as the primary source of economic development financing and investment in these neighborhoods. One potential outcome of

financial modernization is that the "haves" of our society benefit while the "have nots" are left farther behind. It is incumbent on us, as we pursue the modernization of our financial services industry, to guard against making that possibility a reality. Financial modernization must not reduce incentives for institutions to provide broad consumer access to financial services and credit to all sectors of our society.

Ensuring fair access also means ensuring the protection of consumers who use banking services. New bank activities may offer customers greater convenience and greater choice, but banks must take appropriate steps to inform their customers so they can make intelligent decisions. Proper disclosures are critical because customers must understand what products are FDIC-insured, and what risks they are assuming. In addition, bank employees must follow appropriate and fair sales practices when marketing and selling these products.

Promoting Competition

The third principle is that financial modernization should promote competition and increase efficiency within the financial services industry as a whole -- including banks, securities firms, and insurance companies alike. This increased competition should benefit consumers and businesses through lower costs, increased access, improved services and greater innovation. The increased access to financial services should in turn spur economic development. Indeed, recent experience with interstate branching and banking offers persuasive evidence that removing restrictions that unnecessarily inhibit competition can promote efficiency and lower costs to consumers. (2)

Nonbank providers of financial products and services also are likely to benefit from an expanding market and from the innovation spurred by competition. Years ago, the securities industry raised concerns about bank sales of mutual funds. However, as banks have established a foothold in mutual fund sales, the market for mutual funds has continued to grow. Although the dramatic increase in the mutual fund market is due to a variety of factors, I believe bank involvement in this market has helped the industry reach a broader customer base and thereby has promoted greater access for consumers to the securities markets.

Role of Community Banks

The fourth principle is that financial modernization must not impede community banks from competing in a changing financial services landscape. Community banks are a critical part of the financial services marketplace because they profitably serve the needs of small businesses and farms and the Nation's small, rural

(2)Economists analyzing the effect of removing geographic restrictions on the
banking system have found that banks have become more cost efficient following

entry by out-of-state banks. Adkisson, J. Amanda, and Donald R. Fraser, "The Effect of Geographical Deregulation on Bank Acquisition Premiums," Journal of Financial Services Research 4: 45-155, 1990; Calem, Paul S. and Leonard I. Nakamura, "Branch Banking and the Geography of Bank Pricing," Federal Reserve Board, working paper 95-25, 1995; Laderman, Elizabeth S. and Randall J. Pozdena, "Interstate Banking and Competition: Evidence from the Behavior of Stock Returns," Federal Reserve Bank of San Francisco, Economic Review no.2: 32-47, 1991; Savage, Donald T., "Interstate Banking: A Status Report," Board of Governors, Federal Reserve Bulletin 79: 601-630, 1993; DeYoung, Robert, Iftekhar Hasan, and Bruce Kirchoff, "Out-of-State Entry and the Cost Efficiency of Local Commercial Banks," Draft Working Paper, Office of the Comptroller of the Currency, 1997. Entry by out-of-state banks can also be a catalyst for new banks to enter local markets. Thomas, Christopher R., "The Effect of Interstate Banking on Competition in Local Florida Banking Markets," Working paper, University of South Florida, 1991. Research also indicates that expansion through branch banking leads to lower prices. Laderman and Pozdena, 1991; Marlow, Michael L, "Bank Structure and Mortgage Rates: Implications for Interstate Banking," Journal of Economics and Business, pp. 135-142, 1982; Calem, Paul S. and Leonard I. Nakamura, "Branch Banking and the Geography of Bank Pricing," Federal Reserve Board, Working paper 95-25, 1995.

communities.(3) Even in the globalized economy of the 21st century, our small businesses and farms and small communities will have a continuing need for the services that community banks provide.

Many community bankers are concerned that they will be disadvantaged because financial modernization proposals have been biased in favor of structures and activities that are economical or possible only for larger institutions. We must not impose unnecessary structural requirements that would effectively preclude community banks and the customers they serve from reaping the benefits of modernization.

Flexible Corporate Structure

The fifth principle is that financial modernization must ensure that financial services providers have the flexibility to choose, consistent with safety and soundness, the organizational form that

best suits their business plans. This principle is essential because it is necessary for the full attainment of the other four principles.

Significant benefits flow from allowing this choice. The strength of our economy is built on the individual decisions made by thousands upon thousands of independent entrepreneurs, each with different visions of the future. Permitting choice, in and of itself, adds value. Businesses have different strengths, weaknesses, strategies, and cultures. Those who operate these businesses day-to-day know better than the government how to organize themselves to operate most efficiently and effectively. Absent a convincing public policy reason, it is not government's role to tell financial services firms how to structure their business.

Today, banking companies have two basic options for conducting new banking activities outside the bank -- the holding company affiliate approach and the bank subsidiary approach. Safety and soundness and other public policy goals can be achieved under either option, and firms should be free to choose the approach that they believe will best suit their business objective.

Choice in organizational form clearly supports safety and soundness. Changes in the marketplace are making traditional lending and deposit taking less profitable and increasing the

(3) According to June 1995 Call Report data, small banks (under $1 billion in
assets) provided 62 percent and 66 percent of the number and volume, respectively, of the smallest business loans (under $100,000).

importance of non-traditional, off-balance sheet products and services.(4) Imposing unnecessary constraints that force a bank to offer new products and services only through a holding company affiliate will limit the bank's ability to respond to changes in the marketplace, and impose unnecessary costs that limit the bank's ability to compete. Either the assets and income stream of the bank itself will dwindle away, or the bank will feel pressure to reach ever farther out on the risk curve to attract capital and to remain in business. In either case, what will result is a destabilized hollow bank. This hollow bank will be less safe and sound and will charge higher fees, reduce levels of service, offer fewer choices to customers, and be unable to serve our communities and the broader financial needs of its customers.

If, on the other hand, banks have the ability to choose to conduct newly authorized financial activities in bank subsidiaries, the result will be stronger and more stable institutions. U.S. banks have, for many years, successfully engaged in a variety of financial services abroad in their overseas branches and in bank subsidiaries. Under longstanding authority of the Federal Reserve Act and other banking laws and regulations, these institutions can engage in equity underwriting, as well as dealing and investing in corporate debt securities. Overseas subsidiaries outperformed the domestic operations of their companies in each year from 1990 through 1995.

In addition, banks in most G-10 countries,(5) with the notable exceptions of the United States and Japan, have been engaging in a broad range of financial services activities, including

(4) Businesses are increasingly bypassing banks and accessing the capital markets directly. As an illustration, banks' share of nonfinancial corporate debt declined from 28 percent in 1975 to 21 percent in 1995. Banks are facing competition not only from nonbank financial services companies, such as GE Capital, Merrill Lynch and General Motors Acceptance Corporation to name a few, but also from firms that traditionally have not offered financial services, such as telecommunications and computer companies. Banks also face greater competition for retail funding, as consumers have a growing array of alternatives for their savings. Mutual funds have become the preferred savings option for millions of households. Last year for the first time, total mutual fund assets surpassed total deposits of the commercial banking system. As of the third quarter of 1996, net assets of mutual funds were $3.4 trillion compared with $3.1 trillion in deposits in FDIC-insured commercial banks.

(5) The G-10, or Group of Ten, includes the governments of nine countries and the central banks of two others for a total of 11 members. The members are the governments of Belgium, Canada, France, Italy, Japan, the Netherlands, Switzerland, the United Kingdom, the United States, and the central banks of Germany and Sweden.

underwriting and brokering securities, and insurance, directly in the bank or in direct subsidiaries of the bank. (6) This broader range of activities has not impaired bank safety and soundness. On the contrary, foreign bank supervisors have told me that income from non-traditional activities has been a key support for the safety and soundness of certain banks during periods of financial stress.

The bank subsidiary approach may have the added advantage of reducing risk to the government in its role to preserve the stability of the banking system and to insure deposits. Earnings from new activities in a bank subsidiary lowers the probability of bank failure. The lower probability of failure results from the fact that the bank subsidiary's earnings are available to support the bank in times of distress, but not vice versa. The bank's ability to support its subsidiary in times of distress is limited to its investment in the subsidiary. Furthermore, the diversification benefits associated with the conduct of new

activities in a subsidiary can result in a reduction in the volatility of consolidated bank earnings.(7) There is a reduced probability of bank failure which improves the stability of the banking system, and reduces the potential need to draw upon the deposit insurance fund to resolve failed institutions.

Failure to provide the organizational flexibility to conduct new activities in a bank subsidiary will deprive community banks, and hence the consumers, small businesses and farms that depend on those banks, of an essential alternative in an increasingly competitive marketplace. Requiring smaller banks to operate under a cumbersome holding company structure to conduct critical activities may impose costs and create inefficiencies that make these activities unprofitable. These same costs and inefficiencies may not prevent larger banks from engaging in new activities, but they will reduce the benefits that consumers would receive from a less constrained, more efficient marketplace.

(6)Because of the organizational flexibility that other countries give their financial services companies, forcing U.S. banks into a holding company structure is particularly problematic as the financial services marketplace is increasingly globalized. A number of U.S. banks have expressed concern that the holding company approach may disadvantage U.S. banks as they compete with universal banks, which enjoy the cost advantages of being able to structure their activities in whatever manner they find most efficient.

(7) See, for example, Peter S. Rose, "Diversification of the Banking Firm," The Financial Review, vol. 24 (May 1989), pp. 251-280.

Recent experience with intrastate and interstate branching demonstrates the efficiency gains and consumer benefits of organizational flexibility. Research on intracompany mergers finds that choice of organizational form is an important determinant of the efficiency of a company's operations. These mergers enable banking organizations to streamline their operations and better serve their customers.(8)

Finally, organizational flexibility is critical to ensuring fair access to financial services. Just as forcing new activities outside the bank and its subsidiaries impairs safety and soundness, forcing activities into holding company affiliates has adverse implications for community reinvestment. As more activities are forced out of the bank, fewer resources are available to support the bank's Community Reinvestment Act (CRA) activities. By contrast, earnings from a bank subsidiary flow up to the bank and remain available for CRA activities. In addition, regulators consider the assets of a bank subsidiary when they assess the capacity of the bank to serve its community.

The Safety Net

On the other side of these powerful arguments in favor of allowing financial services providers the flexibility to choose their organizational form, stands a newly minted argument that government must restrict product innovation to holding company affiliates because banks are uniquely subsidized. As I understand this unfolding argument, the subsidy takes the form of a lower weighted average cost of funds due to bank access to the federal safety net.(9) The proponents of this view assert that this supposed subsidy may be down-streamed to bank subsidiaries, but is unlikely to be up-streamed to holding company affiliates. As a result, they declare that the bank holding company structure is superior to the bank subsidiary approach for containing the transfer of the alleged

(8) Robert DeYoung and Gary Whalen, "Is a Consolidated Banking Industry a More Efficient Banking Industry", OCC Quarterly Journal, September, 1994.

(9) The safety net was created as a public policy effort to provide citizens of the United States with a stable banking system. Other public policy decisions have resulted in Federal benefits to other industries, just as other industries face significant regulatory costs like the banking industry. For example, insurance companies have several significant tax benefits, including the fact that owners of whole life insurance policies can defer taxes on the accumulation of value without paying an annual tax. In addition, when the insured individual dies, generally there is no income tax paid on the insurance benefits.

subsidy, which must be contained to avoid giving banks a competitive advantage over other financial services firms. This argument is simply wrong and would provide a flawed basis for designing public policy.

The subsidy argument against organizational choice is incorrect for two reasons. First, the best evidence is that banks do not benefit from any net subsidy because they pay substantial costs in exchange for their access to the safety net, costs which all available evidence suggests outweigh any safety net benefit. Second, the argument rests on the unsupported assertion that the holding company structure can contain the alleged subsidy better than the operating subsidiary approach.

The safety net has three components: access to the Federal Reserve discount window, final settlement of payments transferred on Fedwire, and federal deposit insurance. In recent years, a number of measures have had the effect of reducing any gross subsidy arising from discount window access and participation in the payments system. For example, the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) tightened the terms

under which a bank can access the discount window. FDICIA also expanded access to the discount window to securities firms under limited situations. In 1988, the Federal Reserve began imposing net debit caps on banks' daily Fedwire overdrafts. Furthermore, the Federal Reserve started charging fees for daylight overdrafts in April 1994.(10)

Regarding deposit insurance,(11) preliminary OCC research has found that the gross subsidy stemming from federal deposit insurance is roughly 4 basis points (4 cents for every $100). That amount,

(10) The Federal Reserve could further adjust its charges for daylight overdrafts to better reflect the market value of the Fedwire settlement guarantee it provides. Moreover, in time, as technological improvements impact
the payments system, real-time settlement and other advances will decrease the
subsidy received from daylight overdrafts.

(11) Changes have also reduced any subsidy from mis-priced deposit insurance.
In particular, FDICIA mandated risk-related deposit insurance premiums to
require such premiums to be based on the financial institution's perceived level
of risk to the insurance fund. In this way, deposit insurance pricing has begun
to emulate practices employed by the market. As a result, the benefit from
underpriced deposit insurance, which is higher for less healthy institutions,
is reduced. FDICIA also required the FDIC to resolve failed banks at the least
cost to the deposit insurance funds. Finally, the regulatory agencies have
adopted minimum capital standards and tied capital requirements to risk.

however, is more than offset by the corresponding costs that banks bear, estimates of which range on the order of 22 to 30 basis points.(12)

Some of these costs are more easily measured than others, but they are all very real. They include assessments for examination by Federal and state regulators, forgone interest on sterile reserves, interest on FICO bonds, deposit insurance premiums, and the myriad costs of regulation.(13) Indeed, Congressional concern over whether regulatory costs are excessive has been the focus of several hearings and much Congressional testimony in the last five years.(14)

Even more persuasive than estimates of the costs and benefits is the fact that banks do not behave as though there is a subsidy. If banks benefited from a subsidy, one would expect them to conduct

their business in a way to exploit fully that subsidy. We do not see such skewed behavior.

For example, if bank-issued debt were subsidized, one would expect to see banking organizations issue debt exclusively at the bank level. Instead, one finds a mix of bank and holding company debt

(12) According to OCC calculations, the median gross subsidy stemming solely from deposit insurance was roughly 4 basis points for the top 50 banking companies in the U.S. as of June 30, 1996. This value is derived using a standard option pricing model. Using the lower bound of the estimate of the regulatory cost burden on banks contained in the 1992 FFIEC study (six percent of noninterest expenses), the median value of the implied net deposit insurance subsidy for these banks is in the range of a negative 18 to 26 basis points. In other words, rather than a subsidy, there is a net cost to banks of 18 to 26 basis points. It is important to note that these are conservative estimates that do not include costs associated with maintaining required reserves or interest payments on FICO bonds, which were issued in 1989 to cover costs associated with failures in the thrift industry.

(13) Banks are subject to a number of regulations, including operational limitations for safety and soundness reasons, as well as for consumer protection. There are entry and exit requirements, and regulations on geographic and product expansion. Banks are examined on a regular basis for safety and soundness, compliance, fiduciary activities, and information systems.

(14) Since 1991, when Congress directed the FFIEC to identify unnecessary regulatory burdens imposed on depository institutions, Congress has held approximately a dozen hearings on this topic.

issuances.(15) Also, if the deposit insurance subsidy were important, we would expect to see nearly uniform reliance by banks on insured deposits. In fact, less than sixty percent of commercial bank assets are supported by domestic deposits, and we observe significant differences in how banks fund themselves. For the ten largest commercial banks, as of September 1996, domestic deposits range from 5 percent of liabilities to 90 percent. Foreign deposits at those banks, which are not insured, compose up to 61 percent of liabilities.(16)

Likewise, if banks benefited from a subsidy not available to the holding company, one would expect to see activities located in bank subsidiaries rather than in bank holding company affiliates, when such a choice is permissible. Again, real world evidence provides no indication that a subsidy exists. For example, banks can locate their mortgage banking operations in a bank, a bank subsidiary, or in an affiliate of a holding company. Of the top twenty bank holding companies, six conduct mortgage banking operations in a holding company affiliate, nine conduct mortgage banking activities in the bank or bank subsidiaries, and five conduct mortgage lending through a combination of the bank and holding company. Similarly, the table below demonstrates that other activities -- such as consumer finance, leasing and data processing -- are found in both holding company affiliates and bank subsidiaries.

(15) Some have argued that the small bond rating differential between bank debt and holding company debt, which under current market conditions results in bank borrowing costs that are 4 to 7 basis points lower than bank holding company borrowing costs, is evidence of a subsidy. That view is incorrect. The two primary rating agencies, Standard and Poor's and Moody's, explain that the rating difference is due to the ability of the federal banking agencies to limit payment to the bank from the holding company. They also note that there is little reason to believe that the safety net plays a substantive role in the ratings differential between banks and holding companies. There are other reasons bank debt may be rated more highly than its parent's, such as that a bank holding company is dependent on its subsidiaries' earnings power.

(16) Call Report data as of September 1996.

Most Common Nonbank Affiliates of Bank Holding Companies and Subsidiaries of Banks : 1996 (17)

Type of Nonbank Subsidiary	Number of Subsidiaries, Bank Holding Companies	Number of Subsidiaries, Banks

Consumer finance	318	124
Leasing personal or real property	191	365
Mortgage banking	129	201
Data processing	123	96
Insurance agency or brokerage services(18)	72	74
Commercial finance	46	39

Other evidence also argues against the existence of any meaningful subsidy for banks. In offering many of the activities shown in the table above, banks compete side-by-side with nonbank providers. If banks had a competitive advantage they should dominate over other providers. However, in many fields nonbank providers have a bigger market share than banks.(19) In addition, if banks had a competitive advantage, one would expect to see abnormal profits and growth in market share or other evidence of an unlevel playing field.(20) In fact, bank profits, while strong in recent years, are not disproportionately higher than other competitors in the financial services industry.(21)

(17) Data as of September 30, 1996. Includes all direct subsidiaries of the bank or holding company. All banks in this analysis were members of holding companies. Source: Federal Reserve Board National Information Center.

(18) Insurance agency or brokerage services related to credit insurance.

(19) As of December 1996, two out of the top five largest mortgage servicing companies are nonbanks. Source: Inside Mortgage Finance.

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

(21) According to data presented in the Property/Casualty Fact Book published by the Insurance Information Institute, banks, on average, had a lower annual rate of return than diversified financial services firms for the period 1984 through 1993, the last year for which comparable data are available.

Also, banks' market share, measured by income-based data, has remained flat.(22) There simply is no evidence of a subsidy.(23)

The second flaw in the argument regarding the safety net subsidy is that there is no evidence that the bank holding company structure is more effective than the bank subsidiary approach for restricting the transference of the alleged subsidy. Proponents of the holding company affiliate approach note that bank profits have not been channeled up through the holding company and back down to affiliates in the past. No one can know if this is actually true. Since money is fungible, no one can determine definitively the source of the affiliates' funds. Furthermore, if broader activities are permitted to affiliates through financial modernization legislation, past behavior may well prove irrelevant. As the range of activities that bank holding companies could conduct increases, there will be greater incentive to use bank profits to fund activities of nonbank affiliates.

Containment of any theoretical subsidy will depend not on where we place new activities in the financial organization chart but on the restrictions imposed on transfers between a bank and its subsidiaries or affiliates and on supervision. Restrictions can be fashioned to limit transfer of any subsidy to a bank subsidiary as effectively as a holding company affiliate.

In fact, under current rules, the bank subsidiary structure may provide better protection against extending the supposed subsidy beyond the bank. The OCC's Part 5 regulation imposes on transactions between a bank and a bank subsidiary engaged, as

(22) George Kaufman and Larry Mote, "Is Banking a Declining Industry? A Historical Perspective," Economic Perspectives, Federal Reserve Bank of Chicago (May/June 1994), pp 2-21.

(23) Although proponents of the holding company affiliate structure point to the fact that banking companies have lower equity ratios than finance companies as evidence of a subsidy, the difference in equity ratios does not support that conclusion. First, banks do not uniformly have lower equity-to-asset ratios than their nonbank competitors. Large finance companies and some large insurance companies, on average, have higher equity-to-asset ratios than large bank holding companies. In contrast, most large brokerage firms are more leveraged than large bank holding companies. In any event, to make meaningful comparisons of equity-to-asset ratios, one needs information about the risk profiles of the institutions being compared. For example, two institutions

could be engaged in very different lines of business, resulting in distinct risk profiles. One institution would have a higher equity to asset ratio, because it holds much riskier assets in its portfolio than the other institution. Merely comparing the institutions' equity ratios is insufficient.

principal, in an activity not permitted for the bank the same limitations as those applied by sections 23A and 23B of the Federal Reserve Act to transactions between a bank and its holding company affiliates. These limitations apply to investments by a bank in an operating subsidiary and therefore limit investments to 10 percent of the bank's capital.

Furthermore, the OCC's regulation permits only well capitalized banks to make such investments. On the other hand, neither sections 23A and 23B nor any comparable restrictions apply to payment of dividends by a bank to its holding company, and banks need only be adequately capitalized to pay dividends without restrictions. Thus, as long there are adequate earnings, there is no limit on the amount of funds an adequately capitalized bank can upstream to the holding company to capitalize a holding company affiliate, but there is a limit on the amount of funds a bank can downstream to a subsidiary.

Indeed, proponents of the holding company approach themselves suggest that there would be no way to prevent at least some benefit associated with the subsidy they assert that banks enjoy from leaking to its holding company and affiliates. Thus, if one accepts the argument that banks benefit from a subsidy, and that this advantage should not be used in the marketplace, the logical conclusion is to reject financial modernization altogether and to limit banks and all of their affiliated companies to a narrow range of activities.

Fortunately, in light of the evidence, this counterproductive approach is not necessary. In fact, there is no sound public policy reason to limit a banking company from engaging in a wide range of financial activities or to constrain its choice of corporate structures for conducting those activities.

Conclusion

Financial modernization is long overdue, and it is too important to be sacrificed to an unsupported hypothesis that banks benefit from a unique subsidy. Instead, financial services reform must be guided by sound principles: maintaining safety and soundness, furthering fair access and consumer protection, promoting competition, protecting the role of community banks, and ensuring that financial services firms have the flexibility to organize in a way that makes business sense. Any reform enacted by this Congress is likely to be with us for many decades to come. In an increasingly competitive and global financial system, American consumers, their communities, and our economy cannot afford another half century of unnecessary burdens on the financial services industry. I urge you to build a new legal framework that gives the

financial services industry the flexibility it needs to evolve with a changing economy and changing consumer needs.