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TESTIMONY OF JOHN D. HAWKE, JR.

COMPTROLLER OF THE CURRENCY

Before the

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

of the

UNITED STATES SENATE

February 24, 1999

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

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

Introduction

Mr. Chairman and members of the Committee, thank you for the opportunity to appear before you today to comment on the discussion draft titled the "Financial Services Modernization Act of 1999." Virtually everyone agrees that the laws that prohibit affiliations among banks and other financial services providers and limit the ability of banking organizations to diversify their financial activities are archaic. Changing these laws in ways that promote increased competition, greater efficiency, and more effective delivery of financial products to consumers will strengthen U.S. financial services firms and benefit their customers.

Financial modernization is both a political process and a process of innovation in a competitive marketplace. Every day, financial services firms evolve and adapt to serve the changing needs of their customers. Technological advances and the development of new financial products and services have blurred the lines that once separated the offerings of banks, securities firms, and insurance companies. As a result, consumers of financial services now have a greater choice of financial services and products, at more competitive prices.

An important goal of financial modernization legislation should be to ensure that the government does not impede the process taking place in the marketplace. Of course, some constraints are necessary to ensure that important governmental interests are safeguarded, and that the interests of consumers are properly protected. But legislation that is crafted to discriminate against any segment of the industry, or to limit the choices financial firms have for organizing their businesses for no compelling or clearly demonstrable public policy purpose needlessly retards the real and dynamic financial modernization occurring in the marketplace. Even more significantly, legislation that will diminish the safety and soundness of our insured financial institutions should not be enacted, particularly under the guise of "financial modernization." I am concerned that key provisions of this discussion draft may have that effect.

In my testimony today, I will discuss why I believe that financial modernization legislation should be pursued in a form that will not interfere with the free operation of financial markets, except to the degree necessary to protect fundamental and clearly demonstrable government interests such as promoting the safety and soundness of our financial system and safeguarding the interests of consumers. I will then broadly address the provisions of the discussion draft that relate to bank organizational structure and consumer protection issues. I am attaching to my testimony a supplemental analysis of certain key provisions of the discussion draft and the Office of the Comptroller of the Currency's (OCC) views on the issues they present. My testimony will highlight some areas we support and those that concern us.

Modernization Has Been Occurring in Financial Markets

Federal laws restricting bank geographic and product diversification date back nearly 70 years. Many of these restrictions have been removed, allowing banks to become more efficient and competitive, but significant constraints still exist. Geographic restrictions on bank location were dramatically reduced when the Riegle-Neal Interstate Banking and Branching Efficiency Act was passed in 1994. However, other laws restricting the activities of banking organizations remain, most notably, the Glass-Steagall Act of 1933, which was intended to separate commercial banking from investment banking, and provisions of the Bank Holding Company Act that confine the ability of corporations owning banks to diversify into other financial activities.

It has become clear in recent years that these constraints segregating various sectors of the financial marketplace have outlived their usefulness. The financial services marketplace has undergone enormous changes. Banks, securities firms, and insurance companies compete directly through an array of similar products and services. Regulatory and judicial rulings continue to erode many of the barriers separating the different segments of the financial services industry. In short, technological and financial innovation, together with market pressures to offer consumers a wider array of services, are breaking down the traditional segmentation of the financial services marketplace.

Many financial services providers have been able to respond to these competitive forces without legislation. Clearly, the time has come for Congress to dismantle antiquated constraints that exist in current law and bring the statutory framework that governs the financial services industry into line with the realities and needs of the marketplace. Mr. Chairman, this discussion draft goes a long way toward providing a blueprint for financial modernization, and I want to commend you for bringing forth an innovative proposal early in this session of Congress that contains many positive elements. However, I respectfully regret to say that one key provision of the discussion draft will impose a needless constraint on the ability of banks to take advantage of the broadened powers that the draft proposes to make available, and will not, therefore, permit them to compete in the most efficient manner. This provision could have a significant adverse effect on the long-term safety and soundness of our banking system. Also, as discussed later in my testimony, I am concerned that this proposal will, in practice, make the process for evaluating bank compliance with the Community Reinvestment Act more burdensome for banks.

Ability to Diversify Products and Services is Essential to Banks' Safety and Soundness

Preservation of the safety and soundness of the banking system is a fundamental government interest and a pivotal consideration in any financial modernization legislation. For this reason, we have supported the inclusion of strong safety and soundness provisions, in tandem with any authorization for expanded activities. But protecting the safety and soundness of banking institutions involves more than simply writing safeguards against loss into the law. Providing banks -- large and small -- the opportunity to maintain strong and diversified earnings through a range of prudently conducted financial activities is an equally critical component of safety and soundness.

Historically, banks have been heavily dependent on net interest margins -- generated through traditional lending -- as a source of earnings. This makes banks particularly vulnerable to changes in economic conditions. During the 1990s, the net interest income of commercial banks has declined, both as a percentage of assets and as a percentage of net operating revenue; the growth in the volume of lending activity due to the strong economy has been offset by significant compression in bank net interest margins. At the same time, however, banks have been able to preserve or enhance their profitability through growth in noninterest income. In the last 10 years alone, noninterest income has increased from approximately 30 percent of net operating revenue to 39 percent. Noninterest income consists primarily of fees, service charges, commissions, and the performance of data processing services for others, and is equally critical to large and small institutions trying to enhance and vary their income streams. Thus, the ability of banks to continue to pursue market opportunities that diversify their sources of income is critical to their long-term health.

Banks can seek additional earnings sources by providing new products and services or moving into new geographic markets; or they can improve earnings by reducing their operating costs or increasing their risk profile in their lines of business. The OCC and other financial institution regulators have increasingly expressed concern about banks taking on additional credit risk to achieve high earnings targets, particularly given the slowdown in global economic activity and the likelihood of stresses in regional economies. Evidence over the past year showing deterioration in the quality of loan underwriting standards for commercial and industrial loans has been a particular source of worry.

Product, geographic, and income diversification all contribute importantly to bank safety and soundness. Many different factors have been responsible for the waves of bank failures that have characterized various periods of our financial history. Yet, one consistent factor has been excessive *concentrations* -- geographic concentrations or concentrations in one or another type of *lending*. The high rate of bank failures in the 1920s was largely confined to small agricultural banks that lacked diversification with respect to either geography or lines of business. In the early 1980s, banks that had excessive concentrations of loans in the oil business failed in large numbers. Many of the banks that failed in the years 1984-1986, when agricultural land prices fell more than 40 percent from their 1981 peak, also appear to have suffered from an inability to diversify. And, finally, in the late 1980s and early 1990s, bank failures throughout the world were associated with excessive real estate lending.

Ideally, of course, bank regulators could anticipate what geographic areas and product lines would be associated with future loan losses and would use their powers of persuasion to prevent banks from developing heavy exposures in lending to those areas. Given the impossibility of perfectly foreseeing the future regarding the nature and location of lending problems, however, the prudential strategy of diversification reduces the vulnerability of banks to unexpected losses from lending, wherever they may occur.

A wealth of empirical research demonstrates that diversification is critically important to maintaining a strong banking system. Firms with diversified assets and revenue streams can better withstand economic shocks during the business cycle, whereas firms limited by geographic or product restrictions can be affected more seriously by downturns. Diversification can enable banks to increase their average rate of return for any given volatility of return, or to reduce the volatility of earnings for any average level of return, in either case reducing their probability of failure.[1]

[1] For a review of the literature, see Mote, Larry, R., "The Separation of Banking and Commerce," *Emerging Challenges for the International Services Industry,* JAI Press, 1992, pp. 211-17, and Whalen, Gary, *Bank Organizational Form and the Risks of Expanded Activities,* Economics Working Paper 97-1, January 1997, pp.5-12.

Risk management is central to the business of banking, and banks have demonstrated they can effectively manage a variety of risks. Banks already manage complex risks, such as those associated with derivatives and other off-balance sheet activities -- risks that are similar to those presented by new financial activities. The effect of the discussion draft -- which allows some additional diversification for small banks, but forces larger banks and smaller banks owned by holding companies to remain primarily intermediaries of credit risk -- is to make those larger banks and holding company-owned community banks inherently more exposed to risk than banks that are permitted to diversify their sources of income. When bank financial activities are restricted, risk exposures are correspondingly concentrated, and banks that are less diversified become more vulnerable to economic shocks.

Operating Subsidiaries Will Strengthen Banks and Enhance Safety and Soundness

Financial modernization legislation should not artificially restrict the ability of financial services providers to choose, consistent with safety and soundness, the most efficient way to conduct their business. There is no a priori governmental interest in restricting organizational choice, and with appropriate safeguards, expanded activities may be conducted safely and soundly in either a bank subsidiary or a bank affiliate.

The discussion draft under consideration today mandates that larger banks -- those with over $1 billion in assets and any community bank owned by a holding company -- wishing to diversify into new activities as principal do so only through bank holding company affiliates. This approach needlessly denies firms the choice of undertaking new financial activities through a bank subsidiary structure. Imposing this restriction on larger institutions, in particular, would disserve safety and soundness principles because these are the institutions whose instability could have the greatest systemic effect and whose failure could be most expensive for the federal deposit insurance fund.

In short, prohibiting banks from electing the option to use operating subsidiaries will undermine, rather than enhance, safety and soundness. It will inevitably force resources out of banks, lessen the opportunities for large banks to diversify their earnings, and diminish the protections for the federal deposit insurance fund. The Federal Deposit Insurance Corporation (FDIC) has repeatedly testified that, in the event that a bank should itself suffer financial difficulties, earnings from bank subsidiaries can compensate for a downturn in bank profits, and, in the event of bank failure, the existence of such subsidiaries can significantly reduce the losses of the federal deposit insurance fund. In 1997, former Chairman Helfer noted in her testimony that "[w]ith appropriate safeguards, having earnings from new activities in bank subsidiaries lowers the probability of failure and thus provides greater protection for the insurance fund than having the earnings from new activities in bank holding company affiliates."[2]

Consider the business decision facing a banking organization that may want to take advantage of the newly legislated opportunity to expand into insurance or securities activities on a principal basis. If the only organizational choice available is the holding company

[2]See testimony of Ricki Helfer, Chairman, FDIC, on financial modernization before the Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises, Committee on Banking and Financial Services, U.S. House of Representatives, March 5, 1997.

affiliate, it is highly likely that resources of the bank will be drawn down to capitalize and fund the new activity. The bank will upstream dividends to its parent either to inject capital into the new affiliate, or to support new holding company debt or equity issued for that purpose. The bank itself will reap no direct financial benefit from the new activity. In fact, since many of the business opportunities of the new affiliate may be generated by the day-to-day business of the bank, the bank will be deprived of profit opportunities that would rightfully belong to and be captured by it if the operating subsidiary format had been permitted.

By contrast, if the new activity could be positioned in a subsidiary of the bank, any capital or funding provided by the bank would remain as part of the bank's consolidated resources. In addition, banks would be able to capture directly the benefits of new business opportunities that may be closely related to, or generated by, their normal day-to-day banking activities. Income flows resulting from such new activities would flow directly to the bank, would not be diverted to the holding company, and would provide the bank with a diversified source of earnings.

The FDIC also recognizes the benefits of diversification for the safety and soundness of the banking industry. FDIC Chairman Donna Tanoue and former FDIC chairs have consistently pointed out that the subsidiary format strengthens the bank. Last September, in a joint article in the *American Banker*, former Chairmen Helfer, Isaac, and Seidman stated their position clearly: "Requiring that bank-related activities be conducted in holding company affiliates will place insured banks in the worst possible position. They will be exposed to the risk of the affiliates' failure without reaping the benefits of the affiliates' successes."[3] In her testimony before the House Banking Committee just last week, Chairman Tanoue stated that "the subsidiary structure can provide superior safety and soundness protection."[4]

Moreover, longstanding policy and practice of the Federal Reserve Board demonstrates that banking organizations can safely and successfully engage in expanded financial activities through bank subsidiaries. For example, the Board has long permitted U.S. banking organizations to engage in securities activities overseas through foreign subsidiaries. At year-end 1997, U.S. banking organizations operated 100 direct and indirect bank securities subsidiaries, a high proportion (88 percent) of which were profitable, with aggregate net income of $732.3 million.[5]

This comparison also highlights the discriminatory nature of the structural restraints the discussion draft would impose on U.S. banks as compared to foreign banks. Under the discussion draft, U.S. banks could have subsidiaries -- operating abroad -- that conduct an expanded range of financial activities. But a *U.S.* bank's domestic subsidiary could not engage in the activities that are permissible for that bank's foreign subsidiary. Also, a *foreign* bank may engage in nonbanking activities in the U.S., including securities underwriting, through a

[3] "Ex-FDIC Chiefs Unanimously Favor the Op-Sub Structure," *American Banker*, September 2, 1998.

[4] See testimony of Donna Tanoue, Chairman, FDIC, on H.R. 10, the Financial Services Act of 1999, before the Committee on Banking and Financial Services, U.S. House of Representatives, February 12, 1999.

[5] At year-end 1997, these 100 direct and indirect bank securities subsidiaries had aggregate total assets of $249.5 billion. They represented 90.9 percent of the total number of overseas securities subsidiaries and accounted for more than 98 percent of the total assets in all foreign securities subsidiaries. The average aggregate rate of return on assets for bank securities subsidiaries over the 1987-1997 period was around 60 basis points, roughly three times higher than the comparable figure for holding company securities subsidiaries. See Whalen, Gary, *The Securities Activities of the Foreign Subsidiaries of U.S. Banks: Evidence on Risks and Returns*, Economics Working Paper 98-2, February 1998.

direct subsidiary of the bank. But a *U.S.* bank could not have a *U.S.* subsidiary that engages in the same range of activities permitted for a *foreign* bank's *U.S.* subsidiary. Thus, U.S. law would allow a foreign bank to use the structure it determines most efficient for the delivery of products and services in the United States, while U.S. banks would be restricted to a single format in this country. This result cannot be rationalized.

In addition, the discussion draft uniquely discriminates against large national banks relative to *state* banks by retaining or imposing burdensome statutory requirements that are not imposed on state banks. For example, national bank subsidiaries are not authorized to engage as principal in expanded financial activities; state banks are subject to no such comprehensive bar. Further, although the discussion draft requires that all of a national bank's depository institution affiliates be well capitalized and well managed in order for the national bank's subsidiary to conduct new *agency* activities, no similar requirements are imposed on either state banks or thrifts engaged in the same activities through subsidiaries. And national bank subsidiaries are further limited to conducting those expanded agency activities *only* through a *wholly-owned* subsidiary. Thus, national banks, but not state banks, are deprived of the ability to use joint ventures or consortiums of banks to engage in new agency activities.

One could argue that, to protect the interests of the deposit insurance fund and ensure prudent bank supervision, the *only* format that should be used for expanded activities is the operating subsidiary. But individual banking organizations may have particular reasons, based on their business, why the use of a holding company affiliate is better for them, and a prescriptive approach would be inconsistent with the basic principle I discussed earlier -- that restrictions on organizational format should not be imposed except where unavoidably needed to protect clearly defined, compelling public interests.

That is not the case here. There is no clearly defined, compelling public interest that requires that larger banks (those over $1 billion in assets), and *any* size bank with a holding company, should be barred from engaging in expanded financial activities in a subsidiary of the bank. In fact, common sense and safety and soundness considerations argue strongly for allowing those banks the same opportunity to diversify through bank subsidiaries as is provided for small non-holding company banks.

Arguments about the existence of a "subsidy" are ephemeral and do not negate these basic safety and soundness considerations. Moreover, even if it were assumed for the sake of argument that some type of subsidy were enjoyed by banks, the existence of a subsidy at any place in the bank holding company organizational structure benefits the consolidated organization, and the organization can allocate the benefit of that subsidy in a variety of ways to whatever element of the organization it chooses. If one seeks to limit the transference of a subsidy by blocking the flow of funds, the prudential constraints on lending and investment that the OCC supports would contain with equal efficiency the spread of a subsidy to a bank subsidiary or a holding company affiliate,[6] and would also ensure that the size of a bank

[6] The OCC favors applying the following investment constraints, or safeguards: 1) requiring that the bank be well capitalized before making the investment in a financial subsidiary that is engaged as principal in the new types of authorized activities; 2) requiring that the bank deduct from its assets and equity, for purposes of regulatory capital calculation, the amount of the bank's equity investments in a subsidiary (and, correspondingly, the assets and liabilities of the subsidiary are not consolidated with those of the bank for regulatory capital calculation purposes); 3) requiring that the bank remain well capitalized after making this capital deduction; 4) requiring that the bank not make an equity investment in a subsidiary that would exceed the amount that it could pay to its holding company as a dividend, without prior regulatory approval; and 5) requiring that the qualitative and quantitative limitations of sections 23A and 23B apply to extensions of credit to the subsidiary.

subsidiary engaged in new types of financial activities remained modest in comparison to its parent bank. In short, given these constraints, the organizational format for conducting nonbanking activities in either a subsidiary or an affiliate is irrelevant to the subsidy issue, and the subsidy issue is no reason to deny larger banks and non-holding company smaller banks the option to use subsidiaries to conduct expanded types of financial activities.

Ensuring Adequate Consumer Protection is an Essential Component of Financial Modernization

Financial modernization legislation must ensure that the interests of consumers are appropriately protected through adequate disclosure mechanisms and the deterrence of deceptive sales practices. This discussion draft would require the federal banking agencies to issue joint customer protection regulations governing the retail sale of insurance products. We favor this provision as the federal banking agencies have worked together to advise depository institutions to conduct retail sales in a safe and sound manner that protects the interests of consumers. It is not only appropriate but essential for the government to foster an environment in which consumers can evaluate the relative riskiness of their financial choices based on a fair understanding of the products and services available to them.[7] However, we urge that the provisions concerning coordination with state law be simplified so that banks would have more

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[7] The OCC's "Guidance to National Banks on Insurance and Annuity Sales Activities," issued on October 8, 1996 ("Advisory") instructs banks to follow proper procedures to ensure customers are able to distinguish between insurance and deposit products. These procedures include making adequate disclosures that an insurance product is not FDIC insured, is not a deposit or an obligation of the bank, and is not guaranteed by the bank. Moreover, the OCC's Advisory emphasizes that banks need to ensure that only qualified people are selling insurance, and that insurance is sold in areas that are separate from traditional banking functions, *e.g.*, deposit taking, to the extent practicable.

certainty and uniformity in the customer protection provisions that apply to their insurance sales in different states.

Finally, the OCC does not support the discussion draft's "safe harbor" provision regarding the CRA examination process. While this provision reflects an understandable concern about the burdens of CRA compliance, it is likely to increase, rather than decrease those burdens. Faced with the prospect that a bank's "satisfactory" CRA examination rating might foreclose meaningful consideration of CRA issues in an application proceeding, community groups would inevitably focus their attention and efforts on the examination and rating process. Since only a small percentage of applications are protested, while every bank is rated for CRA performance, such a shift in focus would mean that a great many more confrontations between banks and community groups would be likely to occur, and that the examination process would take on aspects of adversary proceedings, thus prolonging the duration and expanding the scope of examinations[8].

Moreover, if a Satisfactory rating were to have the effect of preempting consideration of CRA issues in a subsequent application, it is likely that CRA exams would become more extensive and less efficient, and therefore more burdensome. At present, many CRA exams, particularly those of large banks, combine full scope exams of certain markets with more limited scope reviews of data from other markets. In an application proceeding, however, it is not uncommon for the agency to scrutinize markets beyond those included in the full scope

[8] In the past three years, less than one percent of the applications subject to CRA that were filed with the OCC were protested. Specifically, we received protests on 11 out of 3,390 applications in 1996, 14 out of 2,631 applications in 1997, and 6 out of 2,229 applications in 1998. In those years, the OCC assigned CRA ratings to 998, 784, and 490 institutions, respectively.

portion of the exam. Because the "safe harbor" provision in the discussion draft would preclude consideration of CRA issues in an application proceeding if the parties had Satisfactory ratings, the agencies would be under enormous pressure to make a broader and more searching inquiry into the parties' CRA performance at the examination stage, raising a significant question whether the efficiencies involved in combining full scope with more limited data reviews could be maintained.

Conclusion

In conclusion, let me again emphasize the importance of limiting intervention in financial markets to that which is necessary to protect clearly defined, demonstrable governmental interests, such as maintaining the safety and soundness of the banking system and ensuring that consumers are adequately protected. Our concerns over the current version of the Financial Services Modernization Act of 1999 arise from the inclusion of certain key provisions that work contrary to the interests of safety and soundness and may undermine much good work that the CRA has achieved.

THE OCC’S PRIMARY CONCERNS ABOUT “THE FINANCIAL SERVICES MODERNIZATION ACT OF 1999" Staff Discussion Draft (February 16, 1999)

February 24, 1999

1. EXPANDED ACTIVITIES ALLOWED FOR BANK HOLDING COMPANIES

Section 102 of the draft “Financial Services Modernization Act of 1999" (the Draft) would amend the Bank Holding Company Act (BHCA) to permit bank holding companies (BHCs) that satisfy certain requirements to engage in a broad range of activities that are defined as financial in nature or incidental thereto without the prior approval of the Federal Reserve Board (FRB). These new financial activities include *principal and agency* securities and insurance activities, as well as merchant banking. The FRB, in coordination with the Secretary of Treasury, could by regulation or order add to the list of approved financial activities after taking into account certain factors. Currently BHCs may conduct only activities that are closely related to banking or permitted under another exception in the BHCA. 12 U.S.C. § 1843.

A BHC would be authorized to engage in the new financial activities only if all insured depository institution subsidiaries were well capitalized and well managed. If a depository institution failed to satisfy these requirements, the FRB could impose limitations on the *conduct or activities* of the BHC or any affiliate, including a depository institution, and require divestiture if it failed to correct the problems within six months.

Thus, in essence, if a banking organization wanted to use any of the new powers authorized for holding company affiliates (and the larger banks and any holding company-owned banks would be forced to conduct most new financial activities through a holding company affiliate), the banks in the organization would essentially be opting-in to a new system of Prompt Corrective Action, administered by the FRB, triggered if the bank merely becomes *adequately* capitalized. Banks would be subject to a new set of standards, administered by the FRB, that would involve the FRB ordering and imposing corrective actions if the bank slipped below the well capitalized or well managed standard. Ordinarily, the bank's *primary regulator* imposes remedial requirements if the bank ceases to be adequately capitalized. In addition, banks would be subject to additional costs to conduct these new financial activities through holding company affiliates that might not be present if the activities were conducted in a bank subsidiary.

2. ACTIVITIES PERMITTED FOR SUBSIDIARIES OF NATIONAL BANKS

Section 122 of the Draft would amend the National Bank Act to allow small national banks that have total assets of $1 billion or less and that are not affiliated with a BHC to conduct *principal and agency* activities through wholly owned subsidiaries if the activities were financial in nature or incidental to financial activities (except real estate development). Larger national banks that had total assets of over $1 billion and community national banks that are owned by a holding company could engage in new financial activities through a wholly owned subsidiary only on an *agency* basis. The financial activities could be conducted in a subsidiary provided that the national bank and all insured depository institution affiliates were well capitalized and well managed and the bank receives the approval of the Comptroller.

If the subsidiary were engaging in financial activities as principal (and only smaller national banks that are <u>not</u> part of BHCs would be permitted to conduct new financial activities as principal under the Draft), other safeguards would apply. The bank's equity investment in the subsidiary would have to be deducted from the bank's assets and tangible equity and the subsidiary's assets and liabilities could not be consolidated with the those of the bank. Thus, the bank would have to be well capitalized before and after its investment in the subsidiary. In addition, the operational requirements in section 23B of the Federal Reserve Act (FRA) would apply. Finally, Section 122 would prohibit a subsidiary of a national or state bank, or a thrift, from engaging in new securities underwriting of bank impermissible securities after September 15, 1997. Foreign banks would be specifically exempted from this prohibition.

The proposal would have the perverse result of denying the larger national banks and all holding company-owned community banks in the National Banking System the safety and soundness benefits of using a subsidiary to conduct expanded new financial activities. These are the institutions that control the overwhelming majority of assets held in the National Banking System.

- Requiring larger banks and all holding company-owned community banks to use an organizational structure for conducting expanded financial activities would weaken them by forcing them to use their resources to capitalize and fund holding company affiliates rather than husbanding those resources in the bank. This would increase the exposure of the bank to credit risk and credit concentrations in their traditional lines of business. This provision would be particularly damaging in the case of larger banks, which are the very

  institutions whose instability could have the most unsettling systemic effects, and whose failure could be the most costly to the Federal Deposit Insurance Corporation (FDIC).

- Limiting larger national banks and holding company-owned community banks to conducting expanded activities in subsidiaries only in an *agency* capacity would limit sources of revenue that flow to the bank. These banks would be deprived of opportunities to diversify their revenue flows and instead those business opportunities -- and revenue -- would be diverted away from the bank to holding company affiliates. State banks would not be subject to comparable restrictions.
- Requiring all national banks that conduct expanded financial activities to use a *wholly* owned bank subsidiary would prevent national banks from using joint ventures or joining consortia to engage in the expanded activities. This restriction could particularly impact community national banks that want to engage in the new financial activities but do not have the resources or the customer base to support a *wholly* owned subsidiary. For example, community national banks could not join together to jointly own an insurance agency subsidiary that was based outside a "place of 5,000." No similar requirement would apply to state banks.
- Permitting foreign bank competitors to use subsidiaries to conduct expanded financial activities in the U.S. while barring the same option for our largest national banks and a substantial portion of our community banks would create an unlevel playing field. U.S. banks would be hobbled by provisions that unnecessarily restrict their options, flexibility, and efficiency. Foreign banks would not.

Moreover, the risks to the bank from activities conducted in a subsidiary are no greater than if the activities were conducted in an affiliate if the equivalent safeguards are imposed. In addition, with the equivalent safeguards in place, the leakage of any net subsidy (if one exists) will be contained to the same extent as if the activities were conducted in a BHC affiliate. The equivalent safeguards that we recommend include: (1) restricting the bank's equity investment in the subsidiary to the amount a bank could dividend to its parent bank holding company (unless the regulator permits a greater investment), (2) further limiting the size of the subsidiary by deducting the bank's investment in the subsidiary from the bank's capital and requiring the bank to remain "well capitalized" after the deduction, and (3) imposing the same limitations that are in sections 23A and 23B of the FRA to loans and other extensions of credit between the parent bank and the subsidiary that apply to transactions between the bank and its holding company affiliates.

3. SUPERVISION AND REGULATION OF HOLDING COMPANIES

Section 114 of the Draft would prohibit the appropriate Federal banking agencies (AFBAs) from examining or inspecting any registered investment company that is not a bank holding company or a savings and loan holding company; only the FDIC could do so if necessary to determine the condition of an insured depository institution for insurance purposes. The Securities and Exchange Commission (SEC) would provide the AFBAs with the results of an examination of registered funds upon request. This prohibition would apply to common and collective funds that are *part* of the bank and that also may be registered investment companies. Thus, this provision would prevent the AFBAs from performing the examinations required under existing law and would undermine our authority to assess the safety and soundness of funds maintained for fiduciary purposes by depository institutions that have been registered as investment companies. With respect to these types of funds, the SEC and the AFBA for the bank both have responsibilities and neither should be displaced.

4. PREEMPTION

Section 104 of the Draft would provide that state law may not prevent or restrict the affiliations authorized under this legislation. In addition, state law could not prevent or restrict an insured depository institution, or a subsidiary or affiliate thereof, from conducting activities authorized by the Draft if the practical effect of the state action were to discriminate against the institution, or its subsidiaries or affiliates based on their affiliation with the institution. These rules would not affect the jurisdiction of the State securities commission to investigate and bring enforcement actions consistent with the Federal securities laws. These rules also would not affect state actions of "general applicability relating to the governance of corporations" or the "applicability of the antitrust laws of any State or any State law similar to the antitrust laws."

Thus, state laws relating to corporate governance and state laws labeled as antitrust laws would be permitted to "prevent or restrict" authorized affiliations and activities. This is true even if these laws had a disparate impact on banks, their subsidiaries, or affiliates. A state law could be "generally applicable" but still have a disparate impact on a bank as compared with its effect on companies that are not banks or affiliated with banks. Unfortunately, national banks' experience with some state laws characterized as "antitrust" laws or some laws related to "unfair methods of competition" is that these laws in many cases are intended to prevent or impede the ability of banks to sell insurance.

5. BANK SECURITIES AND INSURANCE ACTIVITIES

Section 121 of the Draft would authorize well-capitalized national banks and their subsidiaries to underwrite and deal in municipal revenue bonds.

The OCC supports the change in Section 121. However, there is nothing in the bill that would repeal the antiquated restrictions on national banks engaging in insurance agency activities. National banks' permissible insurance agency activities are limited in 12 U.S.C. § 92 to banks that are located and doing business in a place that does not exceed 5,000 in population. This restriction dates from <u>1916</u>. Many states permit their banks to sell insurance free from any comparable restraints. Agency activities are substantially riskless and there are no offsetting safety and soundness concerns that warrant restricting national banks to this outdated restriction on their insurance activities.

6. <u>CONSUMER PROTECTIONS</u>

Section 201 would require the Federal banking agencies to prescribe joint consumer protection regulations that apply to retail sales and advertising of any insurance product by an insured depository institution, its subsidiaries, or employees/agents thereof. This section would also prohibit an "inconsistent" or "contrary" state provision from being preempted by the Federal regulations <u>unless</u> the Federal banking agencies jointly made certain determinations and appropriately considered the comments of the state authorities. If the Federal agencies made this determination, notice would have to be given to the states and the preemption would become effective unless the state enacted a law in three years overriding the preemption.

This provision is quite convoluted and presents the troubling prospect that in each state, banks selling insurance would be subject to a different combination of provisions of the Federal rules, state provisions that co-exist with the Federal rules, state provisions that supersede the Federal rules, and state provisions that are superseded by the Federal rules. The mix of these provisions could be different in each state in which a bank sells insurance and there is nothing in the provision that would require the state law to be in compliance with Section 104. The provision is further complicated by the provision that would give states three years to opt-out of a determination by the Federal banking agencies that a state provision is superseded because the Federal rule provides greater protection. In any case, the potential combination of state and Federal provisions in any given state could be quite burdensome to decipher and to apply. Customer protection would be enhanced with a simplified approach.

7. COMMUNITY REINVESTMENT ACT

Section 303 of the Draft would provide that, if an insured depository institution has received a "satisfactory" rating at its most recent examination under the Community Reinvestment Act (CRA), and it has been found to be in compliance with the requirements of CRA in examinations during the preceding three years, it would be deemed to be in compliance with CRA until the completion of the next regularly scheduled examination unless certain information to the contrary were filed with the AFBA. The information filed with the AFBA would have to be "substantial verifiable information" that arose since the time of the institution's most recent examination under CRA. The person filing the information would have the burden of proving to the AFBA that the information is substantial and verifiable. The AFBA would determine if the information provided sufficient proof that the institution was no longer in compliance with CRA.

The OCC does not support the Draft's "safe harbor" provision regarding the CRA examination process. This provision would be likely to increase, rather than decrease, the burdens of CRA compliance. Today only a small percentage of applications are protested but every bank is required to be rated for CRA performance. If community groups believed that they could not raise meaningful issues during the application process, their only opportunity to raise their concerns would be during the CRA examination and rating process. An increased emphasis on the examination and rating process could mean that this process takes on aspects of an adversarial proceeding thereby prolonging the duration and expanding the scope of examinations, and making the examination process more burdensome.

In addition, if a "Satisfactory" rating would have the effect of foreclosing the AFBA's consideration of a bank's CRA performance in a subsequent application, the AFBA could be under increased pressure to use more extensive procedures to determine a bank's CRA performance at the time of the examination. Today many CRA examinations, particularly those of larger banks, combine full scope examinations of certain markets with more limited reviews of data from other markets. In the application process, however, it is not uncommon for issues to arise concerning markets beyond those included in the full scope examination. The "safe harbor," thus, could raise significant questions whether the efficiencies involved in the current examination process could be maintained.

We also note that there is nothing in the legislation that would require depository institutions that are part of BHCs, or banks seeking to engage in expanded activities through subsidiaries, to have and maintain at least a "satisfactory" CRA rating. The OCC supports the approach taken in the House-passed version of H.R. 10, which would apply a satisfactory CRA requirement on an on going basis as a condition to engaging in the new financial activities.