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**OPTIONS FOR FINANCIAL MODERNIZATION:
FREEING THRIFTS AND BANKS TO MEET
THE CHALLENGES OF RAPID CHANGE**

**REMARKS OF JONATHAN L. FIECHTER
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BEFORE THE EXCHEQUER CLUB**

APRIL 17, 1996

Thank you and good afternoon. It is a pleasure to be here today to give you my perspective on the world of banking -- or at least the corner of that world occupied by thrift institutions.

As we look across the horizon of financial services, there is significant activity. Cyberspace is upon us. A thrift in Pineville, Kentucky, last year became the first Internet bank. Undoubtedly, we will see additional Internet banks. New versions of home banking are being created on a regular basis. Which of these new products and services are ultimately successful will be determined by consumers.

At the same time, the banking system is undergoing structural change through mergers and acquisitions. Consolidation is occurring, and some familiar old banking names have disappeared. Here again, it is the marketplace that is the driving force.

Congress itself is grappling with demands for change on several fronts. Banks want insurance powers that insurance companies are reluctant to share. While banks believe insurance products fit well within their mix of financial products, the insurance companies want to preserve their market turf.

Thrift institutions want parity with banks for deposit insurance premiums. Congress is reconsidering legislation, already passed last year, that would accomplish this objective. My hope is that Congress will act very shortly to fix the premium problem. Once that is accomplished, we need to turn to modernizing the bank and thrift charters.

My remarks this afternoon will focus on these two legislative priorities.

I. THE NEED FOR SAIF/FICO LEGISLATION.

First, let's look briefly at the problems facing the Savings Association Insurance Fund (or SAIF). The SAIF is seriously undercapitalized. The problem is that almost half of all premiums paid by SAIF-insured institutions are being diverted to fund interest payments on bonds issued by the Financing Corporation or FICO. Even under favorable conditions, the SAIF will not capitalize before the year 2001. The SAIF would have capitalized last year, if all premiums paid by SAIF-insured institutions had gone into SAIF.

Because the SAIF is undercapitalized, premiums paid by SAIF-insured institutions are much higher than the premiums charged by the Bank Insurance Fund, or the "BIF." The typical billion dollar SAIF-insured thrift pays an annual insurance premium of \$1.6 million. A comparable bank pays an annual insurance premium of \$2,000.

That's a huge difference. This premium disparity has created a powerful incentive for SAIF-insured institutions to reduce their SAIF-insured deposits. Deposits at SAIF-insured thrifts have dropped from 79% of liabilities in 1991 to below 70% at the end of this year. This is a record low for this industry and could raise safety and soundness concerns if the trend continues.

A declining SAIF assessment base is problematic not only for the SAIF, but also for FICO. If the SAIF-insured deposits of savings associations continue to decline at their current rate, a FICO default could occur by 1998. A faster rate of decline in deposits, prompted by the failure to solve the premium disparity, could cause a default next year.

The Treasury Department, the FDIC, and the OTS have proposed a legislative solution, which Chairman Greenspan and the Federal Reserve Board have endorsed. The joint proposal provides for immediate capitalization of the SAIF and spreads responsibility for interest payments on FICO bonds across all FDIC-insured institutions. Institutions holding SAIF deposits would pay a special assessment of almost \$6 billion to capitalize the SAIF.

Both banks and thrifts have objected to paying for a problem they didn't cause. I understand their concern. The institutions that generated the losses have long since disappeared. No solution will be fair in any absolute sense. But the problem exists, and must be resolved. The joint proposal represents a workable solution. It will benefit all FDIC-insured institutions -- and the American taxpayer -- by preventing another insurance fund crisis.

One thing is clear. The current premium disparity between banks and thrifts is prompting thrifts to aggressively pursue measures to shift deposits out of the SAIF. That process has begun. Delay will only make matters worse.

We now have a window of opportunity to fix the SAIF and FICO while thrifts and banks are strong and without using taxpayer resources. It is in everyone's interest that we enact SAIF/FICO legislation promptly.

II. THE NEED FOR CHARTER REFORM.

While the need to solve the problems of SAIF and FICO is urgent, we also need to update the bank and thrift charters. Many of the statutes governing these charters were passed decades ago. Just as corporations update their strategic operating plans on a regular basis, so we need to update and amend our federal statutes.

Changing demographics, new technology, and the introduction of new products are transforming our financial system. This year, baby boomers started turning 50. The financial products and services demanded by this group are very different from those demanded by their parents. When my brothers and I were born in the late 1940's, my father opened a passbook savings account for each of us at his local bank. By contrast, when my daughter was born, I opened an indexed mutual fund for her.

Last weekend, I saw my first smart card. It looks exactly like a credit card, but has a microchip embedded in it. That chip has a memory equivalent to the early personal computers. The federal government plans to use these cards nationwide to dispense various federal benefits. Smart cards will be offered at the Olympic Games in Atlanta this summer. If smart cards become popular in this country, they may render the present generation of cash dispensing machines obsolete. Travelers' checks could become museum artifacts.

Clearly, core aspects of the business of banking, such as information processing and telecommunications, are undergoing incredible change. This is changing the competitive environment. Any company with access to the right technology can now provide almost any financial service it wishes. The statutory framework governing our insured depository institutions has not kept pace with this change.

Although the banking and thrift industries are earning record profits, they cannot sustain those profit levels unless we give them the freedom to respond to market changes. The fact that bank profits are being used primarily to fund industry mergers and stock repurchases, rather than to expand services, is a good indication of the declining competitiveness of depository institutions.

Given this state of affairs, where do we go from here? Unfortunately, it's easier to make the case for charter reform than to figure out how to accomplish it.

Three options related to the bank and thrift charters have been suggested. Before reviewing these charter options, however, let's review the differences between the bank and thrift charters.

A. The Current Bank and Thrift Charters.

The first page of the handout you received this afternoon provides a thumbnail sketch of the major financial differences between banks and thrifts.

As you can see from line 18, both banks and thrifts have about the same level of equity capital. Beyond this, however, there are significant differences. Line 6 shows that 70% of all thrift assets are invested in mortgage products, compared to only 23% for banks. By contrast, as shown on line 8, less than 1% of thrift assets are invested in commercial and industrial loans, compared to 15% for banks. Banks also hold more consumer loans -- 12% for banks compared to 4% for thrifts (line 9).

The differences in bank and thrift asset composition is a direct consequence of the difference in charters. If you turn to the second page of the handout, the key differences in the powers of banks and thrifts are highlighted. As you can see, commercial banks may engage in commercial and consumer lending on an unlimited basis. By contrast, thrift institutions must keep a portion of their funds in mortgage assets and have limited commercial and consumer lending authority.

The federal thrift charter, nonetheless, has features that promote operating flexibility. For instance, thrifts may operate subsidiaries called service corporations that engage in any activities deemed by OTS to be reasonably related to the thrift business. Examples of such approved activities include real estate development and management and retail insurance sales without regard to the size of the town from which they make those sales.

In addition, thrift holding companies are not subject to the same activities restrictions as bank holding companies. A thrift, through its holding company, can affiliate with any company whose business does not threaten the thrift's safety and soundness. Thrift institutions are presently affiliated with companies that engage in insurance sales and underwriting; securities brokerage and underwriting; real estate brokerage, management and development; retail sales; telecommunications; health care; transportation; and manufacturing.

Thrift institutions also have more flexible branching rules than banks, even after the recent enactment of interstate banking legislation. Federal thrifts can create *de novo* branches regardless of state law, and can acquire existing branches through merger, a power national banks will not enjoy before June 1, 1997.

In fact, but for the restrictions imposed on their commercial and consumer lending, thrifts arguably already have the "universal bank charter" that many analysts believe represents the future of commercial banking. With this as background, what charter options are presently being considered?

B. Charter Reform Options.

The first option is to eliminate the thrift charter and require existing thrift institutions to become commercial banks. Legislation, in fact, has been introduced that would force all federal thrifts to convert to a commercial bank or state thrift charter. While this legislation would preserve a state thrift charter option, such thrifts would in effect be treated as commercial banks under the federal statutes, remaining thrifts in name only.

The second option is to do nothing other than to remove the barriers under current law that limit the ability of institutions to change charters. Specifically, this

option requires removing the tax penalty that is triggered when a thrift converts to a commercial bank.

The third option is to modernize both the thrift and bank charters by blending the advantages of both charters. Under this option, many if not all of the restrictions that differentiate the bank and thrift charters would be removed.

Commercial banks could affiliate with both financial and nonfinancial companies and offer a wider range of products through separately capitalized service corporations. Thrift institutions would gain full commercial and consumer lending powers and would no longer be required to hold the bulk of their assets in residential mortgages.

C. Guiding Principles.

In evaluating these three options, we should be guided by three principles.

First, the option chosen should be consistent with safe and sound banking.

Second, the option should be consistent with maintenance of a strong and responsive financial system. Insured depository institutions must be granted the flexibility to adapt their operations and services to changes in technology and customer preferences efficiently and at a competitive cost.

Third, the option must be consistent with competitive equity. Competitive equity can be achieved by "leveling the regulatory playing field" -- by requiring all financial institutions to operate under identical rules.

Competitive equity, however, can also be achieved by eliminating artificial barriers to entities choosing among charter options. We could allow market considerations to determine whether an entity chooses to become a thrift, a bank, or some variant of the two.

We should resist the temptation of trying to achieve competitive equity through reducing the operating flexibility of institutions to the lowest common denominator. I support the principle of competitive parity, but it should be achieved in a way that provides more competition and options for the consumer, not less.

Let's now apply each of these principles to the three charter reform options.

1. Require Thrift Institutions to Convert to Commercial Banks.

The first charter option is to require all federal thrifts to become commercial banks. This option does not violate our safety and soundness principle. While the history of the 1980s suggests that there may be some risk to shifting the focus of thrifts from residential mortgage lending to commercial lending, the current health of the industry and the improved supervisory process limit that risk. Allowing thrifts to better diversify their asset portfolios should be a net plus.

On the downside, elimination of the federal thrift charter would force thrifts to terminate holding company and service corporation affiliations that have been safe and profitable for years. Removing the authority of thrifts to affiliate with diverse companies would also eliminate a source of external capital that has been extremely important in the past.

Although the mandatory conversion of thrifts to banks would probably not present safety and soundness concerns, it is hard to see how this option would advance our second principle, that of strengthening the overall competitiveness of depository institutions.

In terms of the third principle, competitive parity, eliminating the thrift charter would place banks and thrifts on a level playing field with each other. But is parity in this case worth it? Simply eliminating the thrift charter sweeps existing options off the table and reduces the operating flexibility of depository institutions to the lowest common denominator. And it leaves both banks and thrifts at a significant disadvantage to unregulated competitors.

Some thrifts, especially those located in difficult mortgage markets, may well benefit from becoming banks. Many others, however, are convinced that, for them, the best business strategy is to remain mortgage lending specialists. Although such institutions could presumably remain mortgage lending specialists as banks, is there any reason to strip them of the greater operating flexibility currently available through the thrift charter?

I believe that forcing thrifts to convert to banks flunks two of the three principles. It doesn't enhance operating flexibility and it takes a lowest-common-denominator approach to competitive parity.

2. Remove Charter Conversion Barriers.

The second chartering option is to maintain the current bank and thrift charters, but eliminate the barriers to thrift-to-bank conversions. Under this option, institutions would be free to choose between the different sets of benefits and constraints offered by the current thrift and bank charters.

This option fares well from a safety and soundness perspective. Thrifts constrained by restrictions on commercial and consumer lending would be permitted to convert to a commercial bank charter. Thrifts choosing to remain residential mortgage lenders could continue to take advantage of the additional affiliation and activity flexibility of the thrift charter.

From the perspective of competitive equity, bank and thrift institutions would be permitted to exchange charters based on the mix of charter features most suitable for their markets. While the charters would not be identical, the owners of institutions could freely choose the best charter for their institution.

Maintaining the status quo, however, would not expand the operating flexibility or affiliation powers of the current thrift or bank charter. Because it would not expand the range of products and services offered by depository institutions, it would not enhance the competitiveness of the bank and thrift charters. The result could well be a continuing loss of market share by banks and thrifts to unregulated competitors.

Thus, while the second option is clearly preferable to the first, I think we can do better.

3. Modernize Both the Thrift and Bank Charters.

The third option is to relax the restrictions that distinguish the bank and thrift charters. For banks, this might mean relaxing the affiliation rules to permit banks to affiliate with insurance companies and securities firms. For thrifts, this might mean an expansion in their authority to engage in commercial and consumer lending.

This option is consistent with all three of our principles. Broadening the sources of income for insured institutions makes them less vulnerable to economic downturns. Providing broader affiliation powers, particularly with financial services companies, would strengthen competition and provide another source of capital to the banking

industry. The result would be enhanced safety and soundness; a stronger, more flexible system of depository institutions; and greater competitive parity.

Criticisms of this third option tend to be of a pragmatic nature, which brings me to my final point -- what can we realistically expect to achieve?

D. Recommended Strategy for Modernization.

The ideal solution would be to create a new charter that combines the best of the current bank and thrift charters. But that approach would run headlong into longstanding policy concerns about mixing commerce and banking.

If large banks could affiliate with commercial enterprises, some worry that these banks would give priority to the operations of their affiliates. If IBM owned J.P. Morgan, would that give IBM an unfair funding advantage over Microsoft? Would it be more difficult for other computer companies to obtain credit and banking services from Morgan? Would such a combination result in too much concentration of economic power?

Any solution that does not take account of these concerns is probably doomed. Thus, we have to explore whether there are ways to modernize charters while addressing fears about mixing banking and commerce. I believe we can. I suggest that we move forward on two tracks.

First, all barriers to thrift-to-bank and bank-to-thrift conversions should be eliminated promptly. At a minimum, this means that the tax barrier to thrift-to-bank conversions, which arises from mandatory bad debt recapture, should be removed. I support removing the tax barrier to thrift-to-bank conversions in conjunction with the SAIF/FICO legislation.

Second, we should explore creative ways to provide greater operating flexibility to a greater number of depository institutions without unduly raising banking and commerce concerns. No significant banking and commerce concerns would be raised, for example, if we combined the subsidiary, holding company, and branching flexibility of thrifts with the unrestricted consumer and small business lending authority that banks currently enjoy. Concerns about mixing commerce and banking could be addressed by imposing a limit on large-scale commercial lending.

For example, institutions taking advantage of that charter could be limited in their commercial lending other than to small businesses. This type of modernization could be achieved by moving towards a new "community bank charter" that is freely available to any institution that finds it attractive.

That is just one idea. There are many potential variations. The main point is that banks and thrifts should be working together to find creative legislative solutions that provide greater flexibility to both. This is a time to be expanding, not restricting, flexibility. Absent safety and soundness concerns and other overriding public policy issues, market forces, not government fiat, should determine how institutions structure their operations.

No one can accurately predict how financial services will be delivered even five years from now. Significant change is certain. There will be a continuing blurring of the differences between banks and nonbanks. In such times, the last thing the federal government should do is restrict choice and limit flexibility. Eliminating the unique features of the thrift charter from the current mix of options available to depository institutions would be a step backwards.