Remarks
by
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concerning
Financial Modernization
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Introduction:

Powerful market forces are driving events in the financial services industry, including the banking and thrift businesses. They will force the government to adjust accordingly, and the question becomes: will Congress lead the way to financial modernization, with the enhancement of safety and soundness being an integral part, or will it, in effect, allow market forces and the current regulatory system to sort their way through the transformation without further guidance? Obviously, I don t have the answer. But we can look briefly at some of the market dynamics that are changing the landscape.

Market Dynamics Are Changing the Landscape

A by-word in real estate is location, location, location. In financial services today, it is consolidation, consolidation, consolidation.

Both the banking and thrift industries have seen considerable consolidation in recent years. To illustrate the activity in the OTS-regulated thrift industry, between 1993 and the end of 1996, a total of 610 thrifts left the industry. Of that total, 148 were mergers with other federal thrifts and 187 were acquisitions by banks. The remaining departures were conversions to state or commercial bank charters. Although final 1997 figures aren t yet available, through November 25, there were 88 mergers and acquisitions and 105 net departures from OTS jurisdiction. OTS does not attempt to interfere with this market dynamic. We leave it to a thrift s management and directors to decide what is best for their needs. Obviously a good many have opted to join with another entity or to switch charters.

Consolidation is essentially a push by financial institutions to offer their customers one-stop shopping and, thereby, gain a market edge. They want to make it easy and convenient for a customer to make a deposit, take out a loan for personal or business use, invest in stocks and/or mutual funds, obtain a credit or debit card, buy life insurance, and do it all by telephone or personal computer on line at one institution. Whether customers really want such consolidation and concentration may be one of the more important business strategy issues financial institutions face.

Much of the consolidation is possible only because technology is fast changing the financial marketplace. Technology has been a factor in enabling the survivor of a merger or acquisition to broaden its geographic domain and serve more customers cost-effectively, and there is little question that advances in technology are changing the way banks, thrifts and other financial services providers deliver products to their customers.

Technology presents some serious challenges to us as regulators. We need to be aware not only of what s going on today, but also to anticipate where technology is leading us. We have to consider, for instance, how Internet banking operations impact safety and soundness and CRA and how institutions can continue to serve all of their community when they cut back on traditional means of access.

The OTS is on the cutting edge in this regard. Back in May 1995, we approved the nation s first Internet bank, Security First Network Bank. Then we approved two more Internet operations in 1997. Atlanta Internet Bank is operational, and the Principal Group, an insurance company, received approval in November to set up a thrift that will operate, in part, on the Internet.

The OTS is currently finalizing a rule on electronic operations, which we hope to issue before mid-year. It basically permits thrifts to do electronically everything they are authorized to do through more traditional means, consistent with safety and soundness. We would be shortsighted to try to write a rule that covers all bases, given the rapid evolution of technology. Our approach is in line with input we got from the public early in the rule-making process. Our foremost concerns, in addition to operational safety and soundness, are to preserve account integrity, ensure that both the institution and the OTS understand and can evaluate the system, and make certain the institution complies with CRA and consumer protection laws.

Internet operators must have a secure system that denies entry to unauthorized persons. As a condition of approval, the OTS required each Internet applicant to hire an independent security firm to test account security.

CRA compliance by Internet operators and, indeed, by any institution operating primarily by non-traditional means presents some very tricky issues, such as identifying an operator s assessment area. In the case of the three approved institutions, the initial assessment area is limited geographically, which has simplified matters for the time being. We do not have all the answers by any means, and we are taking a hard look at the whole CRA-Internet/e-banking picture on an inter-agency basis.

Over the past few minutes, I have touched on market dynamics and technology. Now I d like to turn to the modernization debate itself. As we all know, the subject is devilishly complex and contentious, and being played out in a fast-changing market. For advocates of modernization in the form of H.R. 10, their hopes for passage by Congress last year were alternately raised and then dashed.

Two House committees Banking and Commerce approved bills with some similarities, but with key differences, and no bill reached a floor vote. On the Senate side, no substantive modernization activity took place. Some Members say the House this year will pick up reform where it left off. Others think Congress will have to go back to square one because the financial services market will already have changed further and altered the debate.

In its narrow context, the debate focuses on breaking down barriers imposed by the Glass-Steagall Act on banks, which, in effect, deny them the ability to sell products and services not considered traditional bank offerings. But, in truth, the debate is much broader. It forces us to consider all aspects of financial services integration, including such difficult issues as the relationship between banking and commerce and the diversity of regulatory systems supervising the various financial services companies.

How the modernization effort will turn out is anybody s guess. Glass-Steagall reform alone, for example, has been discussed in varying degrees of intensity in each Congress over the past 20 years at least. Each time, the debate changes. Just two years ago, the serious arguments were whether affiliations among banks, securities firms and insurance companies were a good idea. In the 105th Congress, the debate started with the premise that they were.

House Proposal Would Eliminate Thrift Charter.

As H.R. 10 now stands, it would eliminate the federal thrift charter and the unitary thrift holding company. Some proponents of elimination regard thrifts as anachronisms. I think this view is partly a legacy of the thrift crisis and the belief that even survivors must share responsibility for a debacle that cost taxpayers $128 billion   out of an estimated total cost of $156 billion   and partly a belief that the residential mortgage specialist has become a dinosaur on the verge of extinction. So, they say, why not get rid of the specialist and avoid the risk of any further damage to the financial environment?

Findings by OTS researchers give us a different perspective. A study last year found that between 1985 and 1996, residential mortgage specialists failed at one-fourth the rate of other thrifts, and when they did fail, the cost of closing them was less than half that for the others. Given the depth of the debacle, a common perception at one time was that most of the thrift industry was under water and its survival doubtful. But bottom line, those thrifts that stayed with residential mortgage lending survived and today form the core of a financially sound and viable industry.

Another 1997 study of 105 highly profitable thrifts in the mid-90s found that they share several key characteristics. One is a concentration in residential mortgages. Originating mortgage loans may not give the thrift as high a return on assets as banks earn with their greater concentration in commercial lending, but the highly profitable ones do well financially. They also hold substantial capital to help protect themselves against interest rate shock.

Thrifts are providing housing finance in their communities. They have gradually increased their concentration in single-family mortgages since 1993 to more than 50 percent of their loan portfolios. OTS researchers have found that equity capital at thrift institutions typically generates three times more in mortgage loans than the same equity capital at commercial banks. Moreover, thrifts match banks in the percentage of lending to low- and moderate-income borrowers.

These studies were done before my arrival at OTS. I can tell you they were straightforward data analyses, undertaken to identify the hallmarks of thrift institutions. They did not call for judgmental conclusions.

So, are thrifts really dinosaurs? Actually dinosaurs are quite popular today. Just ask the young fans of TV s Barney, or the fans of all ages of the Jurassic Park movies. You also could ask executives of several major insurance firms and other commercial companies that have recently applied for a federal thrift charter, but aren t regarded as your typical thrift owner. I think it is safe to say the market has determined that the attributes of the federal thrift charter and the holding company structure are attractive.

Last November, we approved a charter for the Travelers Group, the big insurance firm, and the previously mentioned Principal. More recently, we approved a charter for ReliaStar Group. There are 9 other applications from major insurance companies currently pending, along with another 11 from organizations we consider to be non-traditional owners. Among them are State Farm Insurance; GE Capital Group; Excel, a long distance telephone company; Paine Webber, the brokerage firm; and Hillenbrand Industries, which also happens to be the nation s leading casket maker. An odd collection of potential owners? Perhaps, but that s the nature of the federal thrift and holding company charters.

The integration of businesses has been a characteristic of the thrift holding company charter for many years. However, it is certainly fair to say that the current level of interest in such alliances is quantitatively, and perhaps qualitatively, greater than ever before. So far, our experience with the relationship between a commercial or major financial entity and a subsidiary or affiliated thrift has been good, and devoid of any serious problems. But we recognize that our past experience has been limited in scope in a period of favorable economic growth. The increasing complexity of these alliances demands constant vigilance on our part. It also is essential that new or reconfigured thrifts   just as existing ones   provide real value to the communities they serve, and meet their CRA obligations.

I believe we worked out a formula in the Travelers case that permits it to take advantage of the features offered by the federal thrift charter while satisfying, and even exceeding, its CRA obligations. Travelers offered and then agreed to make at least $430 million in home equity loans to low- and moderate-income borrowers over the next three years in areas where it does business   essentially across the nation. Strictly speaking, Travelers CRA assessment area is metropolitan Wilmington-Newark, Delaware. Not surprisingly, Travelers commitment won praises from community action groups. We will, of course, be evaluating Travelers actual performance, but we have every reason to expect it to be consistent with their commitment.

The thrift industry has a heritage of serving the community, mainly through mortgage lending, that dates from 1831 when the first thrift organized in Philadelphia. That role is increasingly important today because of the need to house a growing population and overcome a lack of adequate housing in low- and moderate-income areas.

In an era of expanding regional, national and multinational banks, thrifts have renewed opportunities to serve their communities, and to do so profitably. Congress helped in 1996 by giving federal thrifts greater leeway to make consumer and commercial loans, particularly to small businesses, and by eliminating the deposit insurance premium differential that had put thrifts at a disadvantage to banks. While still a minor portion of thrifts assets, both loan segments have been growing.

As interest in the federal thrift charter has increased, some states that changed their banking laws to attract institutions to state charters may not be too happy about the renewed interest. One critic claimed the agency exceeded its authority in preempting state regulations in certain instances, and that we are approving these applications to preserve the federal charter and save our butts!

It s easy to make such a charge, but the real picture is different. I d like to cite a few relevant facts.

In 1994, realizing that a number of thrifts were interested in converting to other charters, OTS changed its rules to make such conversions easier. Between 1993 and 1997, the same period for which I gave you merger and acquisition numbers earlier, 241 OTS-regulated thrifts converted to either a state charter or a commercial bank charter. The number leaving OTS jurisdiction still surpass those coming under our supervision.

With regard to applications for the federal charter, this agency is bound by law to assess applications on the basis of their merits, not whim and, least of all, self-preservation. The preemption authority is nothing new; it s been around since 1933.

So where do I come out in the modernization debate, as Director of the agency with primary responsibility for regulating the thrift industry? First of all, I will not issue a clarion call for preserving the federal thrift charter, or the OTS for that matter. I am not a cheerleader for the industry. I do believe strongly, however, that regardless of the fate of the federal thrift charter per se, it has important ingredients that should be preserved. I have talked about most of them, but let me quickly recap.

This country needs to allow financial institutions to have a community-focused housing specialty. OTS-regulated thrifts have over half their assets in 1-4 family mortgages, and the ratio has been growing. Such institutions have proved their value by enabling more Americans to own their own homes. It is important that we not make structural changes in financial services that would work against sustaining and increasing the rate of home ownership in America.

The commitment to the community has led more and more thrifts into teaming with other financial service providers, the Federal Home Loan banks, Fannie Mae and Freddie Mac, other businesses and community groups to finance housing for low- and moderate-income families. Increasingly, thrifts are helping finance other aspects of community economic development, including businesses and social services. Their commitment to community reinvestment is essential in meeting a critical need in the nation, and is consistent with a safe and sound financial system. We are actively encouraging further participations of this type by the institutions we regulate.

The flexibility of the holding company charter that permits non-bank entities, particularly other types of financial institutions, to be affiliated with thrifts is another key attribute. The financial services modernization goals of one-stop shopping and increased consumer choice are represented in this structure.

Charter flexibility also permits institutions to engage in activities on a broad geographical basis and to provide myriad services within the parameters of safety and soundness.

I believe we would be extremely shortsighted if, in our efforts to modernize the financial services system in this country, we fail to preserve the best attributes of the federal thrift charter and thrift holding company structure.

That said, I can assure you that we will, of course, abide by whatever decisions ultimately come down on financial modernization. As for our own agency, we expect to participate in shaping our future. We will approach it with reason and honesty, mindful that our principal function is to ensure the safety and soundness of the institutions we regulate. We will be up to the task!