Testimony

April 29, 1998

TS-028 - Seidman's Testimony Before the Committee on Banking and Financial Services Concerning the Recent Proposed Mergers of Large Financial Institutions

Office of Thrift Supervision

Remarks, Speeches, & Testimony

Testimony on Recent Proposed Mergers of Large Financial Institutions
by
Ellen Seidman
Director, Office of Thrift Supervision

April 29, 1998

before the
Committee on Banking and Financial Services
U.S. House of Representatives

Washington DC

I. Introduction

Good morning, Mr. Chairman and members of the Committee. On behalf of the Office of Thrift Supervision ("OTS"), I appreciate the opportunity to appear before the Committee to discuss the timely issue of the recent proposed mergers of several large financial institutions. Although consolidation in the financial services industry is not a new or startling development, the sheer size of the recent proposals has attracted much attention.

In just the last several weeks, we have learned of proposals to create the world's largest consolidated financial services company and America's first truly nationwide bank. These proposed transactions are in many ways the culmination of a generation of increasing competition in the financial services market and the consequent drive for increased productivity and efficiency. In order to survive, many large institutions see no other way to achieve the economies of scale necessary to conduct large interstate operations than to acquire or merge with other large institutions.

At the same time, the recent mergers and acquisitions raise significant policy questions about the operations of the new companies. Your invitation letter for today's hearing, Mr. Chairman, asks us to address some of those issues. What implications do the size of these new institutions have for regulators, including the OTS? How will the mergers affect consumers and small businesses? What impact will the transactions have on communities in which branches of acquired institutions are closed? What effect will the continuing evolution of the financial services industry have on Congress's efforts to enact financial modernization legislation that is responsive to the needs of the marketplace?

Although several of the merging institutions own thrifts (for example, both Citicorp and Travelers own and operate federal thrifts), most attention in the thrift industry involves the proposed merger between Washington Mutual ("WAMU") and Home Savings. If approved, that transaction will produce the largest thrift, by far, in the country. It will have roughly three times the assets of its nearest competitor, and be about the same size as the largest commercial banks in California.

These recent transactions, aimed at creating fully-integrated financial services companies, demonstrate some of the advantages-and the limitations-of the federal thrift charter. Through the thrift charter, thrifts, both directly and through subsidiaries and affiliates, can already offer their customers a full range of consumer-oriented financial services, while maintaining their focus on their local communities. On the other hand, the thrift charter is not a commercial bank charter. The kind of commercial lending business that, for example, Citibank engages in belongs in a bank, not a thrift.

Nevertheless, given their community focus, thrifts are well positioned to fill the niches and gaps, particularly for individuals and small businesses, that will inevitably arise as larger institutions focus less on individual communities. With the improvements in lending powers Congress granted them in 1996, thrifts can now meet most of the financial services needs of their local consumers and local businesses. Large-scale commercial lending and equity investments are, of course, still the province of other parts of the financial services system.

The thrift charter also offers the organizational flexibility that many institutions are seeking. Thrifts can offer various financial services either directly or through their subsidiaries. Alternatively, the holding company structure, with a single federal financial services regulator, is also available. Institutions can choose to organize their business as it best suits them and their customers' needs.

II. Discussion

A. The Policy and Regulatory Implications of Large Financial Institutions

To paraphrase F. Scott Fitzgerald, big banks really are different. In the United States, the concentration of financial resources, particularly in the fields of retail and commercial banking, securities and insurance, has a long history of arousing suspicion. Concerns about inordinate power and the ability to influence financial markets and services have delayed the consolidation of the financial services industry for well over a half a century.

Nevertheless, the market marches forward. Although banking is a highly regulated field, it is subject to the same competitive pressures and economic realities as any corporate endeavor in a capitalistic, free-market economy. In light of the intense competition and shrinking markets over the last generation in the banking industry, the wave of consolidation among the larger players is not only unsurprising, it is probably inevitable.

Even so, as your invitation letter indicated, Mr. Chairman, the size and magnitude of the recent proposed mergers raise important questions about regulatory oversight and consumer choice.

1. Regulating Large Financial Institutions

For many, the basic issue from a regulatory perspective is simply whether the existing regulatory framework can effectively oversee and control large institutions. This seemingly simple question is made more difficult when the institutions in question control a very large portion of the industry's assets, raising concerns that the failure of, or large losses in, one institution could stress the insurance funds or have a ripple effect in the financial industry.

These are understandable concerns. In the thrift industry, if it is approved, the combination of WAMU and Home Savings will result in a group of institutions under common control with over 15% of all thrift industry assets. For commercial banks, the NationsBank/Bank of America merger (if approved) will result in a group of commonly controlled institutions that will control over 10% of that industry's assets. In fact, if the NationsBank/Bank of America merger is approved, the two largest commercial banking organizations will control nearly 18% of that industry's assets (as compared to slightly more than 22% for the two largest thrifts). Moreover, after the proposed mergers, the ten largest commercial banks would control 44% of that industry's assets, and the ten largest thrifts would control 36% of thrift industry assets.

From the perspective of managing the insurance funds, this concentration creates important incentives to ensure that those institutions are run safely and soundly. It also demonstrates the need for merging the federal deposit insurance funds, the Bank Insurance Fund ("BIF") and the Savings Association Insurance Fund ("SAIF"). If the funds were merged, on a *pro forma* basis, the WAMU/Home combination would represent just over 2% of combined industry assets insured by the Federal Deposit Insurance Corporation ("FDIC"), and the NationsBank/Bank of America merger would constitute slightly less than 9% of FDIC-insured assets. Clearly, a merger of the federal deposit insurance funds is sound public policy.

Given the increase in the stakes that would result from these proposed mergers, some question whether the regulators will be willing, or able from a practical perspective, to crack down on (or close) one of these institutions if troubles surface. The OTS is squarely faced with these issues in the proposed WAMU/Home merger.

Regulators confront different pressures when examining and supervising large institutions. In our view, these concerns are not unduly troubling in the context of the proposed WAMU/Home merger. Although the new institution would control a very large share of the industry's assets concentrated on the West Coast, it would operate in the manner of a traditional thrift, albeit on a larger scale. Both WAMU and Home have a history of solid management, traditional, well-run lending programs, strong Community Reinvestment Act ("CRA") records, and relatively straightforward portfolios. In terms of their operations, the proposed institution will not be breaking new ground.

OTS' supervisory oversight of WAMU, conducted out of our West Regional office, involves a multi-pronged approach that includes annual full scope safety and soundness examinations, quarterly on-site visits, periodic Year 2000, information systems, compliance and CRA examinations, extensive off-site monitoring (including the review of periodic filings, formal case reviews, stock analysis, and coordinated intra-agency oversight activities), and regular meetings with management. The individuals with primary supervisory responsibility for WAMU are highly experienced, come from all over our Western Region, and include individuals with substantial experience in the California market. In addition, our supervisory efforts are coordinated with the FDIC and the State of Washington which oversee a state chartered savings bank in the WAMU structure. We also coordinate our oversight with other regulatory authorities, such as the National Association of Securities Dealers ("NASD"), that have an interest in aspects of the WAMU organization.

By virtue of their sheer size, bigger institutions such as WAMU present unique regulatory challenges. I can assure you, however, that we will continue to meet our responsibilities to ensure the safe and sound operation of every thrift, large or small, and the industry as a whole, even as we meet the challenges associated with regulating larger financial institutions.

2. **Impact of Mergers on Smaller Institutions**

Another aspect of the largeness issue is the impact of mergers on smaller institutions that compete in the same markets as the large, consolidated institutions that result from these mergers. Acknowledging this, the Chairman's invitation letter asks whether legislation is needed to provide smaller institutions the ability to compete on a level playing field with larger, more consolidated institutions. In our view, the Home Owners' Loan Act, which provides for the chartering of federal savings associations, already meets this standard.

In many respects, the federal thrift charter offers the organizational flexibility and broad affiliation powers now being sought by large financial institutions from different branches of the financial services sector. For decades, thrifts have been affiliated with companies engaged in a wide variety of businesses, including insurance companies and securities brokerage firms. Moreover, thrifts have the flexibility to engage in various financial activities through operating subsidiaries or service corporations, subject to prudent safeguards, including separate capitalization requirements, where appropriate. This flexibility and freedom are particularly important for smaller institutions.

Indeed, it is particularly critical for small institutions that any financial services modernization legislation enhance, not limit, business choice. Whether an institution wishes to operate as a thrift or a bank, and whether its activities are done in a holding company structure or with separately capitalized subsidiaries operating under the same rules as those governing affiliate transactions, can and should be a matter of business choice. As former FDIC Chairman Ricki Helfer observed, "direct ownership of a nonbank firm by an insured [institution] need not be significantly different from [ownership of the firm by a holding company] in terms of affording protections to the deposit insurance funds."

Choice is particularly important for small institutions, both those now in existence and the new institutions we expect to see-and have seen-emerging as a result of mergers. Choice keeps costs, and artificial barriers to entry, low. It enables small institutions to offer a wide range of products and services to their customers at a price that is competitive, especially taking their generally higher level of personal service into account. And the choice to operate without a holding company structure, whether as a thrift or a bank, also increases the reach of the CRA.

3. **Doing Business with Large Financial Institutions**

Another concern about the proposed mega-mergers is how they may affect consumers and small businesses. There is apprehension that larger institutions will be less responsive to smaller borrowers and communities, and less willing to extend basic, often less profitable, banking services to those individuals and businesses of lesser means.

Although the proposed mergers will no doubt affect consumers, not all of those effects are necessarily negative. For instance, the advent of a truly nationwide banking franchise like the combined NationsBank and Bank of America will make it more convenient for a customer who travels throughout the country to access basic banking services. In theory, larger institutions will also have larger economies of scale, thereby improving efficiencies, eliminating overlap and, ultimately, lowering prices.

Nevertheless, if the past is any guide, some smaller communities will be left behind. This is perhaps the most regrettable result of bank consolidation: branch closings that result in the severing of ties between local communities and their financial institutions; withdrawal of local control of branches and the attendant loss of civic leadership and community service often provided by smaller, home-town banks; the reduction of available sources of small business loans; and the elimination of basic banking services to low- and moderate-income customers.

Banking is just the latest industry to undergo this shift. Coal, timber and steel are examples of industries that have been buffeted by changing economics over the years. These changes are the inevitable result of an evolving and changing economy. Dynamism and growth are the hallmarks of a free market economy. While their effects are sometimes disheartening, our history has shown that new leadership and new businesses often emerge to replace those that disappear.

This could happen in the banking industry as well. As larger institutions leave markets and customers, they open up opportunities for smaller, community-focused institutions. With their strong local ties and community-oriented charter and lending authority, thrifts are in an excellent position to move into the niches and gaps that the big players leave behind. In fact, many mergers over the past several years have brought into our regional offices former executives of the merged companies who want to start "plain vanilla" *de novo* thrifts. Although startup companies provide more supervisory challenges than established institutions with similar portfolios, OTS is up to these challenges.

Thrifts now have the authority to make unlimited credit card and educational loans. Although their overall commercial lending authority is still limited, thrifts now can devote up to 20% of their assets to small business lending. This authority could be crucial to a small entrepreneur whose current bank will no longer consider his loan request because it falls below a certain dollar amount.

Fortunately, we are not alone in seeing opportunity in the current marketplace. Over 540 new banks and thrifts were chartered between 1994 and 1997. Over 70% of the new banks had $25 million or less in assets. Over 65% of the new thrifts had $100 million or less assets. Overall, more than 95% of these new institutions have $500 million or less in assets.

And what about the impact of the proposed mergers on the application of the CRA? Many institutions now realize that there is money to be made serving the customers and markets that the CRA was enacted to promote. In the two decades since its passage, the CRA has helped strengthen and improve communities. It has proven that if communities have access to capital and are part of the financial mainstream, economic development follows, as do jobs and profits. As I have stated before, the CRA is good public policy that is also good business.

As we all know, a good CRA record does not depend on the size of an institution. Plenty of larger institutions have very good CRA records, and some smaller institutions have less impressive records. In our view the WAMU/Home merger creates a larger institution with a larger community to serve. Both these institutions have outstanding CRA records. We expect the management of the combined institution to keep up this record in their larger community.

B. Supervisory Issues: Merger Approvals and the Unitary Savings and Loan Holding Company

Having outlined some of the policy issues involved in the proposed mergers of large institutions, I would now like to discuss the practical considerations involved in our review of a merger application. I will then briefly discuss another aspect of the OTS's supervisory activities attracting attention these days-the supervision of unitary thrift holding companies.

1. **The Evaluation of Merger (and *De Novo*) Applications**

    Besides the recent merger applications involving federal thrifts, we at the OTS have also been reviewing several applications to acquire and/or establish new thrifts. Although applications for mergers and for the acquisition or establishment of *de novo* institutions involve the review of some different elements, many of the factors that we must consider in reviewing those applications are similar. Moreover, regardless of the type of application involved, the OTS approval process is serious. As a result, it is frequently time-consuming and can be expensive.

    Regardless of the type of application involved, we require institutions to create serious, credible and realistic business plans, and to demonstrate that they have the managerial and financial capacity to support those plans. The process actually begins long before we receive a written application to acquire, establish, or merge with a federal thrift. Before an application is actually filed, we encourage parties interested in a thrift charter to come to us to discuss the matter fully. In those discussions we learn about the intended business operation of the thrift. We also clearly explain the information we will need and the types of issues applicants must address in their application.

    With regard to merger applications, there are a number of specific factors that we must consider. Under applicable statutes and regulations, we must take into account the capital level of the resulting thrift, the financial and managerial resources of the constituent institutions, the future prospects of the constituent institutions, the convenience and needs of the communities to be served, and the conformity of the transaction to applicable law, regulation and supervisory policy.

    We also must consider certain factors related to fairness and disclosure. Our regulations require that the transaction be fair and equitable to all concerned, including account holders, borrowers, creditors and stockholders. We pay special attention to transactions that appear not to be the result of arms' length bargaining or, in the case of a stock thrift, where controlling stockholders are receiving different consideration from other stockholders. Finders fees or similar fees are not allowed. An application must disclose fully all written or oral agreements or understandings that result in any person or company receiving any money, property, service, release of pledges made, or any other thing of value, in connection with the transaction.

    Our regulations also require us to consider the proposed compensation to officers, directors and controlling persons of the disappearing institution to ensure that such compensation is reasonable and commensurate with the person's duties and responsibilities. Any increase in compensation over that paid before the proposed merger will draw particular scrutiny, and increases over a certain amount will be presumed unreasonable. We also consider the tax and accounting treatment of the transaction, and the fees paid and the professional services rendered in connection with the transaction.

    We are also required to consider the competitive effects of the proposed merger. Specifically, we look at whether, for any particular section of the country, the transaction would be an attempt to monopolize the business, substantially lessen competition, or amount to a restraint of trade. Even if we find that such an effect is likely, however, the anti-competitive effects of the proposed merger can be outweighed by the probability that the transaction will help meet the convenience and needs of the communities to be served.

Although it is less of an issue in the merger of two established companies than in our review of a proposed new institution, we also closely scrutinize the business plan for the proposed institution. In our view, a solid, long-range business plan is critical. Applicants must convince us that their business plans are realistic and well thought-out. We must know what the new institution plans to do. If those plans change, we must be advised of the change immediately, and we will often ask for a new or updated business plan if we notice changes in the thrift's operations.

That is not to say that we do not consider applicants with nontraditional business plans, particularly in our review of applications to establish *de novo* thrifts. We certainly do. But they too must be comprehensive and well considered. Moreover, if the proposed plan outlines activities that we consider more risky than traditional lines of business for thrifts, we often will require that the new institution hold additional capital until we are comfortable that those activities are conducted safely and soundly.

And we pay a good deal of attention to CRA issues. The CRA specifically applies to merger applications, and we must take into account an institution's CRA record when considering such an application. As part of that review we carefully consider the comments filed by individuals or organizations who have a particular interest in community development. We are particularly sensitive to ensuring that the new institution has a realistic, satisfactory plan to meet its CRA obligations.

We now also put a strong emphasis on how an applicant (whether for a merger or the acquisition or establishment of a *de novo* thrift) is preparing for the Year 2000. Potential Year 2000 computer problems are a serious issue, and we are looking closely at all applicants' operations to ensure that their systems will be prepared by the time of the rollover to the new millennium. That scrutiny, of course, applies to every thrift under our regulatory jurisdiction, not just those seeking to merge with other institutions.

In fact, the Year 2000 computer compliance problem is one of our major regulatory concerns right now. As this Committee knows, we recently obtained the same authority as the other federal banking regulators to examine thrift vendors and service providers for Year 2000 compliance. In our view, that authority is crucial to ensure that thrifts themselves are prepared for the year 2000. Year 2000 compliance requirements are now part of virtually every approval we issue.

2. **Special Issues Concerning the Unitary Thrift Holding Company**

Although the recent flurry of merger activity has garnered a lot of attention, we at the OTS have spent a substantial amount of our time over the last few months evaluating a number of applications, from a variety of companies, to become unitary thrift holding companies. This recent activity has resulted in a heightened appreciation for the unique qualities of-and regulatory challenges presented by-unitary savings and loan holding companies.

Before Travelers proposed to join with Citicorp, it had made the news by converting its existing CEBA bank to a thrift, using the unitary thrift holding company structure. Although insurance companies have owned thrifts for over twenty years-thirteen owned thrifts before 1997-Travelers, as well as some other recent applicants, has focused our attention on how we regulate these entities.

Traditionally, the OTS has focused its supervisory resources on the thrift in a holding company structure. In the past, that approach has worked well because most thrifts (although certainly not all) in that structure have been traditional residential mortgage lenders and have either been the overwhelming contributor to the holding company's profits, or a very small part of a much larger organization.

In that situation, our examiners' approach has been to concentrate on the interaction between the thrift and its parent. The goal is to ensure that the activities of the parent do not adversely affect the subsidiary thrift. Toward that end, we look at such things as whether the parent is relying unduly on the thrift for upstreaming dividends, whether fees charged by the parent for services to the subsidiary thrift are reasonable, whether tax-sharing agreements between the parent and the subsidiary thrift are fair to the thrift, and whether the parent is usurping the subsidiary thrift's corporate opportunities or ability to offer new products and services.

However, the new thrift applicants, some with new business strategies, have caused us to reflect on whether this approach is always the best way to meet our responsibility to ensure the safety and soundness of the subsidiary thrift-and the federal deposit insurance funds. As a result, we are looking at whether and how our regulatory approach to supervising thrift holding companies should evolve.

We will not become duplicative regulators of insurance companies, securities firms or other types of thrift holding companies. But we need to consider such issues as the extent to which systems and risk management are integrated, and the impact of such integration on the thrift. And we need to build good relationships with our fellow regulators, and do it while all of the related institutions are healthy.

III. Conclusion

The recent group of proposed mergers between large financial institutions, including banks, thrifts, investment banks and insurance companies, has resulted in a serious discussion among regulators, business people and policy makers about how those mergers will impact the marketplace. Although consolidation in the financial services industry is not new, the size of the recent proposed mergers raises fundamental questions about how to regulate these new banking giants, and how their creation will affect consumers and businesses. These are serious questions, and now is the time to consider them carefully A rush to judgment is neither appropriate nor required.

###