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Testimony

of

Nicolas Retsinas, Director

Office of Thrift Supervision

concerning

Financial Modernization

before the

Subcommittee on Finance and Hazardous Materials
Committee on Commerce

United States House of Representatives

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Office of Thrift Supervision
Department of the Treasury

1700 G Street N.W.
Washington, D.C. 20552
202-906-6288

Summary of Financial Modernization Testimony before the House Subcommittee on Finance and Hazardous Materials by Nicolas Retsinas, Director, Office of Thrift Supervision July 17, 1997

The issues involved in financial modernization have far ranging implications for the future. Advancing technology, financial globalization, industry consolidation and rapidly changing markets have been driving the evolution of our financial services sector for a generation and, regardless of what government does, future change is inevitable. Government should not act in a way that impedes this process.

Merging the federal deposit insurance funds is a highly desirable public policy objective. Attaining this objective, however, by limiting the operating flexibility of existing institutions and curtailing the availability of structural options runs counter to sound public policy. In fact, the thrift model provides useful insights on (i) mixing banking and commerce while retaining adequate supervisory oversight of the risks inherent in such combinations; (ii) conducting nonbanking activities in insured institution subsidiaries while protecting the institution from undue risks and maintaining functional regulation of nonbanking activities; and (iii) consolidating regulatory oversight of an insured institution and its holding company.

Elimination of the federal thrift charter and the future availability of the unitary savings and loan holding company structure reduces options currently available to all providers of financial services. The grandfathering provisions of H.R. 10 that are intended to smooth this process, although generous, would reduce the operating flexibility of both the grandfathered institution and the regulatory body charged with its supervision. In particular, unitary SLHCs currently operating businesses that are profitable and have posed no risks to their insured thrift subsidiary would be restricted (via the risk of loss of grandfathered powers) in their ability to organize their companies in the most efficient structure that satisfies their business objectives.

The thrift powers transfer provisions of H.R. 10 also raise significant regulatory issues regarding the scope of the transfer of powers to national banks and the ability of the future federal regulator to exercise existing OTS authority. Similarly, the grandfathering provisions of H.R. 10 raise significant regulatory issues regarding the scope of the activities that are grandfathered and the ability of the future federal regulator to oversee institutions and holding companies exercising grandfathered powers.

FINANCIAL MODERNIZATION TESTIMONY
BEFORE THE FINANCE AND HAZARDOUS MATERIALS
SUBCOMMITTEE OF THE COMMITTEE ON COMMERCE
UNITED STATES HOUSE OF REPRESENTATIVES

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Nicolas Retsinas, Director
Office of Thrift Supervision

I. Introduction

I appreciate this opportunity to present the Office of Thrift Supervision's (OTS) views on H.R. 10, the Financial Services Competition Act of 1997.

Before getting to the substance of my testimony, I want to acknowledge the tremendous efforts and sacrifices that many have made to bring us to the place we are today, presenting our collective views on the financial modernization proposal set forth in H.R. 10. In particular, I thank Chairman Leach, the members of the House Banking Committee, and their staffs for their tireless work on H.R. 10. So too, it is important to point out that the Treasury Department has dedicated countless hours and substantial resources, for which we are grateful, in grappling with the many issues that arose in connection both with H.R. 10 and their proposal for financial modernization.

Many of the issues raised by H.R. 10 have been vigorously discussed over the past months—and years—in the broader debate on financial modernization. This debate continues to be contentious and remains unsettled. As I stated before the House Banking Committee several months ago, this process has been productive since open debate ultimately makes for good public policy.

The issues we are grappling with have far ranging implications for the future landscape of our financial services marketplace. Advancing technology, financial globalization, industry consolidation and rapidly changing markets have been driving the evolution of our financial services sector for a generation. Those forces have profoundly changed the industry and, regardless of government's response to these changes, future change is inevitable.

Determining the appropriate course of action that we must take is no easy task. The discussions on financial modernization and issues raised by H.R. 10 have crystallized several areas of intense disagreement among various players in the industry and government. The issues evoking the most interest revolve around the impact of rapid changes in the financial services sector, particularly in the delivery of these services; the government's oversight role in the dynamic financial services marketplace; and policy aspects of H.R. 10 involving the combination of banking and commerce, holding company structures, merger of the insurance funds, and regulatory structure. Before delving into these issues, I will review the principles that we believe should guide the debate on financial modernization, and by which the effectiveness of any legislative solution to this debate should be measured. I will then discuss the issues that are raised by financial modernization and the proposed legislative solutions set forth in H.R. 10. I will conclude by examining whether the solutions set forth in H.R. 10 uphold the principles of financial modernization that we have identified.

II. The Changing World of Financial Services

As with changes that prompted prior legislative revisions, America's financial services industry is once again in the midst of rapid change. In contrast to prior legislative responses, however, we are not now compelled to act by a crisis or the need to shore-up government supervision and oversight. Instead, we must now act to reexamine the government's future role in a rapidly changing financial world.

Insured depository institutions, once the most likely repository and still the "safest place" for people's money, are no longer the dominant holder of America's savings. Consumers eager for higher returns are turning to other places to keep their money. Investments in mutual funds are now equal to, and may even exceed, bank and thrift deposits.

Thrifts, once the bastion of home lending operations in the United States, are now subject to increased competition in the residential mortgage markets from numerous competitors, including entities sponsored by the U.S. government. The rapid growth of Fannie Mae and Freddie Mac, along with the increasing availability of bank-like products offered by nonbanks, has imposed significant pressure on depository institutions' bottom lines.

We are also seeing more cross-pollination and integration among the various sectors of the financial services industry. A large money-center bank recently announced its intent to purchase a regional investment banking firm, and news stories continue to speculate about other similar combinations. Various securities firms and insurance companies currently own federal thrifts, and there is significant interest in the federal thrift charter—evidenced in part by numerous recent applications—by others in the securities and insurance industries. It is also becoming increasingly difficult to classify companies as either "financial" or "commercial." The fundamental elements of our financial services marketplace, such as the nature of the competitors and the corporate structures they take, are changing.

As with other sectors of the economy, the banking business has become very competitive. Competition among financial services providers is fierce and global, with the prospects of the slow and inefficient dimming daily. If we wish to maintain a strong financial services industry, we must make sure that banks and thrifts have the powers and tools necessary to continue to compete effectively. At the same time, we must ensure that the doors remain open to others equally able to provide financial services efficiently so that low-cost financial services will be available to all segments of our market economy.

In addition to these factors, perhaps the most powerful force driving change is the explosion in technology and its rapid adoption by worldwide financial markets. This phenomenon has virtually reshaped the landscape for the delivery of financial services in less than a generation. Technological developments have not only enabled institutions to do what they do now faster, they are fundamentally affecting relationships between providers and consumers of financial services. The day may come sooner than we think when borrowers will log onto a modem and access a computerized link matching their needs and assets to particular capital pools. This free, and virtually instantaneous, exchange of information raises central questions about the future role of federally insured depository institutions.

Regardless of what new structures government puts in place for financial institutions, the insistent push of the market and new technologies will continue to alter our financial system. Our failure to account for change could result in government rules that impede, rather than advance, the ongoing evolution of our financial markets. If we intend to keep up in the global marketplace, then we must adapt our rules and laws to today's—and tomorrow's—developing marketplace.

III. Principles of Financial Modernization

While maintaining the safe and sound operation of our insured depository institutions as our fundamental objective, we believe that the debate on financial modernization should be measured against the following four principles:

- First, insured depository institutions, which for generations have protected America's savings and provided a critical source of funding to America's families and businesses, should have the flexibility to compete effectively in today's dynamic financial services marketplace.

- Second, unnecessary transitional and regulatory burdens imposed on insured institutions should be minimized to allow institutions the flexibility they need to react in the marketplace.

- Third, the federal government's judgment about the proper role of the financial services industry should not be substituted for that of the marketplace.

- Fourth, a modernized financial services structure should not hinder or impede the ability of insured institutions to continue to provide community-based financial services.

It is with these principles in mind that I now turn to a discussion of the issues raised by financial modernization and the provisions of H.R. 10.

IV. Issues

A. Overview

Until recently, the financial modernization debate has been premised on the notion that legislation would improve and enhance developments in our financial services system. Now some suggest that maybe legislation is not needed and we should let market forces dictate the pace and tenor of change. This is perhaps due to dissatisfaction with certain of the provisions of H.R. 10 by various industry participants. It doubtless is true that, regardless of what we do, market forces will ultimately determine the outcome of the current debate. That does not mean, however, that we should dismiss legislative actions that will facilitate this process.

Clearly, there is no imminent threat to the banking and thrift industries or the federal deposit insurance funds. Interest rates are low, growth is strong and there is general prosperity in the nation’s economy. These favorable times present us with an excellent opportunity to discuss the public policy issues involved in modernizing our financial services industry. Some of these issues are very familiar to the OTS, and involve areas of great importance to the institutions that we regulate.

B. Merger of the Federal Deposit Insurance Funds

From a public policy perspective, logic dictates that we merge the separate deposit insurance funds, the BIF and SAIF. As a member of the Federal Deposit Insurance Corporation (FDIC) Board, I am acutely aware of the need to eliminate the economic and managerial inefficiencies of a two-fund structure. Operating separate insurance funds for what is the same product is wasteful and potentially costly to the federal government and to the depositors they insure. In addition, given the extent of BIF member ownership of SAIF-insured deposits, it is evident that market forces have already initiated the process of a de facto merger of the insurance funds. Given the current strong health of both the banking and thrift industries, a deposit fund merger should be an integral part of charter reform.

C. Holding Company Structure and the Combination of Banking and Commerce

A more vexing issue in the current modernization debate concerns how the financial services company of the future will structure its various business enterprises. Embedded in this issue is legitimate concern over protecting the insurance funds and the fundamental integrity of our financial system.

Perhaps the most contentious of the issues being discussed is whether to remove the activities restrictions placed on bank holding companies (BHCs) by the Bank Holding Company Act (BHCA). Although this is not an issue that thrifts or savings and loan holding companies (SLHCs) must currently grapple with, it has been one of the most frequently raised issues that we have been asked to address. Because unitary SLHCs are not subject to statutory activities restrictions, the experience of thrifts affiliated with unitary SLHCs engaged in commercial activities—and that of the OTS in regulating these entities—has become a topic of intense interest.

In order to address some of the questions raised by the unitary SLHC structure, I will briefly highlight the current status of unitary SLHCs, OTS regulation of these entities, and our experience, albeit limited, with the combination of banking and commercial activities that has occurred in these structures.

There are currently 102 unitary SLHCs, owning 73 thrifts, that actively engage in nonbanking activities. The 73 thrifts hold approximately $196 billion in assets—representing about 26 percent of the industry total. Of the 102 unitary SLHCs engaged in nonbanking activities, most are engaged in businesses familiar to thrifts, such as real estate development, investment and management activities (51 SLHCs), and insurance sales and underwriting (27 SLHCs). Others have business interests in areas as diverse as automobile sales, country club development and management, fast food and dairy farming.

We are often asked how we regulate unitary SLHCs so as to protect insured thrift subsidiaries from undue safety and soundness risks posed by the diverse range of commercial activities engaged in by some SLHCs and their affiliates. In answering this question, it is important to point out that OTS regulation of SLHCs focuses not so much on the holding company, but on the holding company's interaction with its subsidiary thrift institution. Thrifts owned by SLHCs are subject to OTS supervision and oversight targeted at insulating a thrift from undue safety and soundness risks posed by interaction and affiliations with its parent SLHC and affiliates.

In managing affiliations between thrifts and non-banking holding company affiliates, we have a variety of supervisory tools at our disposal. Although SLHCs are generally not subject to BHC-type activity restrictions or capital requirements, OTS closely monitors the relationship between the holding company and the subsidiary thrift.

For example, the OTS limits capital distributions from a thrift to its holding company, based on the capitalization and earnings of the thrift. We also impose stringent affiliate transaction restrictions on a thrift's dealings with its holding company and affiliates. With respect to concerns about thrift lending to commercial affiliates in the unitary SLHC structure, such activity is prohibited by a Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) amendment to the Savings and Loan Holding Company Act (SLHCA) that bars thrift lending to affiliates not engaged exclusively in permissible BHC activities.

In our limited experience, we have found that affiliations between thrifts and commercial firms do not involve inherently greater risk to a thrift than affiliations between a thrift and a more traditional "financial services" company. In fact, since the implementation of FIRREA, it can be argued that the affiliation of thrifts with companies engaged in commercial activities has benefited thrifts more than it has their SLHC parents. In numerous instances, SLHCs with commercial interests have willingly added capital to a troubled thrift subsidiary.

SLHCs that engage in diverse lines of business often have substantially greater financial resources than nondiversified companies. They have enhanced access to capital markets, diverse liquidity sources, and lower borrowing costs. SLHCs can also contribute business and managerial talent and expertise to a subsidiary thrift. This is particularly true for SLHCs that have significant experience in a broad array of financial services activities. Such firms can also promote operating efficiencies through economies of scale.

Customers benefit when they are able to do business with an integrated financial services company. For example, customers have an opportunity to engage in "one-stop" shopping for all their financial services needs. Customers may further gain from the cross-marketing of products and services offered by various entities within the holding company structure.

I must caution, again, that the unitary SLHC experience is limited. Given the restrictions on a thrift's commercial lending activities imposed by both its statutory lending authority and the statutory qualified thrift lender (QTL) test, there is less opportunity for a thrift in a commercial SLHC structure to make selective lending or pricing decisions. The statutory lending authority limits federal thrifts' commercial loans to 20 percent of assets—half of which must be small business loans. The QTL test restricts commercial lending from a different angle—by requiring 65 percent of a thrift's portfolio assets to be in mortgage- and consumer-related assets, subject to certain exceptions. The combination of these two provisions curtails the extent of traditional commercial lending-type operations that thrifts may conduct. Nonetheless, the unitary SLHC model offers valuable insights into the banking and commerce debate, and remains a viable alternative for allowing a partial integration of banking and commerce.

D. Activities of Insured Depository Institution Subsidiaries

Another issue of contention in the financial modernization debate involves the potential exposure of the federal deposit insurance funds to the operations of an insured depository institution's subsidiaries. The question here is whether adequate safeguards can be implemented to protect the system from activities conducted outside an insured institution, but that potentially expose the institution's insured deposits. The suggestions for addressing this issue include the implementation of firewalls and the application of affiliate transaction restrictions between the insured institution and any subsidiaries engaged in riskier types of nontraditional banking activities. Again, the current thrift model offers insights into addressing this issue.

With respect to a thrift's exposure to the activities of its subsidiaries, several points are relevant. First, a federal thrift may engage in activities not otherwise permissible for the thrift itself (but that are "reasonably related" to the activities of a financial institution) only in a service corporation. Second, a federal thrift may invest only 3 percent of its total assets, in the aggregate, in all of its service corporations. Third, thrift investments in service corporations that engage in activities not permissible for a national bank must be deducted dollar for dollar in calculating a thrift's capital.

Our experience has been that with these safeguards in place insured thrift institutions and the federal deposit insurance funds can be protected. These protections, with proper monitoring in place, permit institutions to operate a wide range of subsidiaries and service corporations.

E. Functional Regulation and Consolidated Oversight

On the issues of functional regulation and consolidated regulatory oversight, or what some call "umbrella supervision," the existing thrift model provides one example of how these regulatory approaches may fit together. The OTS is the consolidated regulator for all insured savings associations, their subsidiaries, and their holding companies. In this regard, the thrift model is unique—it is the only segment of the banking industry that enjoys a single federal regulator for both its insured institutions and their holding companies. In our experience, this arrangement has worked well. The agency has access to information on all aspects of an institution's operations—including at the holding company level—and the regulated entities are afforded "one-stop" regulatory oversight. Consolidated regulatory oversight that minimizes regulatory red-tape and government intrusion into the operations of profitable and well-run holding company structures enhances synergies from this form of operation.

With respect to functional regulation, unlike national banks, thrift institutions may only conduct insurance and securities activities through a subsidiary service corporation (and may also be conducted by a thrift's affiliate in a SLHC structure). Insurance and securities sales activities conducted directly by a national bank are not subject either to state insurance licensing requirements or Securities and Exchange Commission (SEC) broker-dealer registration (although a majority of national banks choose to conduct their securities sales activities through an SEC-registered subsidiary). By contrast, thrift subsidiaries (or affiliates) engaged in securities activities must register with the SEC, and insurance subsidiaries (and affiliates) must be licensed and regulated by the appropriate state insurance regulator. Although we maintain oversight of all thrifts' subsidiary (and affiliate) activities, which in some respects may result in tandem regulation, primary oversight of insurance and securities activities remains with the functional regulator.

F. Powers and Grandfathering Issues

In addressing the provisions of H.R. 10 that would eliminate the federal thrift charter by converting existing federal thrifts to national banks (except for federal thrifts that opt to switch to a state thrift charter), I note that any approach to grandfathering the activities and powers of existing thrifts and SLHCs must be considered very carefully. Grandfathering, no matter how well intended, will reduce the operating flexibility of both the grandfathered institution and the regulatory body charged with its supervision.

Many unitary SLHCs operate businesses that are profitable and have posed no safety and soundness risk to their thrift subsidiary. Although the SLHC grandfathering provisions of H.R. 10 appear on their face to be generous, the bottom line is that going forward these holding company structures would be restricted (via the risk of loss of grandfathered powers) in their ability to organize their companies in the most efficient structure that satisfies their business objectives.

In addition to the overall impact that grandfathering may have on the franchise value of existing thrifts and SLHCs, there are particular issues of concern raised by the grandfathering provisions of H.R. 10. These arise both from ambiguities in the proposed statutory language and from potentially unwieldy results that may hamper sound regulation of these companies. Briefly, the issues raised by H.R. 10 are:

- **Transfer of Federal Thrift Powers to National Banks.** The bill is unclear on whether national banks could exercise only federal thrift powers specifically authorized by statute and OTS regulations or also those powers the OTS has authorized for a particular federal thrift (i.e., by application, order, or interpretive opinion). The provision is also unclear whether in addition to specifically authorized "powers," it transfers other "privileges" authorized by the OTS in areas such as federal preemption of state laws and activities authorized for federal thrift subsidiary service corporations.

Perhaps more troublesome is the fact that the future federal regulator might be limited in its authority to supervise the transferred powers. For example, if a change in the financial climate makes a previously authorized power unduly risky, it is unclear whether the future federal regulator could bar the exercise of the power.

- **Federal Savings Association Activities.** A federal thrift would generally be permitted to engage in any activity (and hold any asset) it was lawfully engaged in (or held) immediately before converting to a national bank. As described with the transfer of federal thrift powers to national banks, it is not evident that the future federal regulator would have the authority to curtail a grandfathered activity if a safety and soundness issue subsequently arose due to the activity. Finally, it is unclear what would happen to grandfathered activities where a thrift undergoes a change of control, including a mutual-to-stock conversion.

- **Savings and Loan Holding Company Activities.** Perhaps the most significant feature of the grandfathering provisions is the authority for a SLHC to engage in any activity or enter into any affiliation it was authorized to engage in immediately prior to its subsidiary thrift converting to a bank. Retention of this grandfathered status, however, carries a heavy price—limited ability to acquire another bank and broad restrictions on the SLHC undergoing a change of control or being merged with another entity.

- **Savings and Loan Holding Company Regulation.** Another provision would permanently prohibit the appropriate federal banking agency (i.e., the FRB) from ever applying holding company capital rules to such SLHCs, notwithstanding that all other (FRB) holding company regulations would apply three years after the conversion of a SLHC's subsidiary thrift to a bank. Thus, even though most existing SLHCs generally engage only in financial-related activities that would become permissible for all BHCs, a BHC that elects to engage in the same mix of financial activities as an existing SLHC would continue to be subject to (FRB) capital requirements while the SLHC would never become subject to such rules.

- **Branching Rights.** Although the bill permits a federal thrift to continue to operate any branch or agency office in existence or in the process of being established, it does not grandfather existing branching "rights." It is also unclear what is necessary for an existing thrift to be "in the process of establishing" a branch for a prospective branch or agency office to be grandfathered. At the least, this may invite a spate of last minute maneuverings by existing thrifts to garner as many grandfathered branches and agency offices as possible. Finally, federal thrifts that opt to convert to a state (bank or thrift) charter may actually find themselves in a position where they have to divest of existing branch and agency offices.

G. Preserving Community-Based Financial Services

In adopting banking reforms, we must remember that the ultimate indicator of success is if the change is to the betterment of America's communities, including its homebuyers, small businesses, and local bank customers. Fundamental to this is protecting the safety and soundness of our insured depository institutions so that they may continue to serve their communities.

Also important to many of our community-based lending institutions is their ability to access needed short-term funding from the Federal Home Loan Bank (FHLB) System so they may maintain the continuity of their lending activities. This permits institutions to base their lending decisions solely on merit, not according to a system that requires the allocation of scarce loan resources.

This is why, in adopting needed changes to our financial services system and its regulatory oversight, we should keep in mind those features of our existing system that have served us well. Historically, we have relied on a decentralized system for the delivery of credit and depository services through smaller, community-oriented financial institutions. Despite many changes in the financial services industry over the past two decades, over 70 percent of savings associations and 87 percent of commercial banks have assets under $250 million. Locally based institutions provide healthy competition in the delivery of financial services to their communities. We should not take this contribution for granted.

As we go forward, we must remain vigilant to assure the continued flow of capital and financial services to all communities, large and small, and to all segments of those communities. While macro-issues—such as the combination of banking and commerce—monopolize the financial modernization debate, we should be mindful that low- and moderate-income and minority individuals sometimes have difficulty accessing financial services. If there are creditworthy borrowers or areas of the country that cannot access credit and financial services at a fair and reasonable price, then we will have failed to meet one of our critical financial modernization objectives.

V. Analysis of Pending Legislation

As I mentioned earlier, this is a good time to debate the issues involved in financial modernization. These discussions have been balanced in soliciting the viewpoints of the many different interests affected by financial modernization, and have produced positive results in framing the outstanding issues. H.R. 10 provides us with a good start but, on balance, I do not believe the legislation in its current form satisfies all of the necessary objectives that we set out to achieve.

Having explored the issues raised by H.R. 10, let us examine how the proposed legislation measures up to the principles of financial modernization that we previously articulated. Recalling these principles, for ease of reference I will identify the objectives as (i) preserving competitive flexibility; (ii) minimizing regulatory burdens; (iii) fostering market-based decision making; and (iv) maintaining community-based financial services.

Most would agree that a merger of the federal deposit insurance funds, the BIF and SAIF, whether as part of comprehensive financial modernization reforms or as stand-alone legislation, furthers competitive flexibility, minimizes artificial regulatory burdens, and tangentially promotes community-based financial services by promoting a more efficient federal deposit insurance structure.

Although the approach in H.R. 10 of a limited basket for combining banking and commerce and a so-called "reverse basket" for limited ownership of banks by commercial entities appears prudent, this compromise appears to falter under the principles of financial modernization. It is unclear whether the legislation provides all institutions with sufficient flexibility to compete effectively in today's dynamic financial services marketplace. As currently drafted, this compromise imposes arbitrary regulatory burdens on some institutions' existing operating flexibility.

In addition, we believe the legislation goes too far in substituting the government's judgment for that of the marketplace in defining the proper mix of banking and commerce for the financial services industry. Currently, there is a balance struck between limiting the commercial lending activities of thrift institutions, which are generally permitted to affiliate with commercial enterprises (subject to federal oversight), and permitting unlimited commercial lending by banks, which may not have commercial affiliations. The proposed legislation eliminates the ability of market forces to allocate financial services resources according to this formula and, instead, makes a judgment call that a limited amount of commercial affiliations is sufficient for all financial services to compete effectively in today's marketplace.

Finally, on preserving community-based financial services, I note that the "reverse basket" provision of the bill actually singles out smaller community-based institutions (i.e., with assets of less than $500 million) for acquisition by larger commercial entities. While this provides these institutions with access to more capital sources, it jeopardizes their local focus.

As with the banking and commerce compromise, the proposed treatment of depository institution subsidiaries in H.R. 10 reduces institutions' competitive flexibility and incorporates duplicative regulatory requirements by requiring certain subsidiaries to be both separately capitalized and subject to affiliate transactions rules. Either of these requirements should suffice in safeguarding an insured institution from subsidiary activities that raise policy concerns. As we have seen with the thrift model, imposing a separate capitalization requirement on thrift subsidiaries engaged in activities not permissible for a national bank appears adequate to insulate the insured thrift to risks of loss if the subsidiary fails. In addition, the duplicative requirements for subsidiaries in H.R. 10 tend to diminish structural options available to community-based lending institutions.

In examining whether the functional regulation approach in H.R. 10 satisfies the principles of financial modernization, the functional regulation provisions carry an uncertain cost. It is difficult to assess how these provisions fare under the principles of financial modernization. One observation worth noting, however, is that regulation of SLHC structures would move from a single regulator to dual federal oversight, with the institution and holding company subject to oversight by different federal regulators.

Even with the generous grandfathering approach adopted in the legislation, the bill falls short. The need for grandfathering arises only because the bill cuts back on existing powers and activities. An approach that restricts existing powers and activities for some institutions and impedes future regulatory flexibility is inconsistent with the financial modernization objectives of preserving competitive flexibility, minimizing regulatory burdens, and fostering market-based decision making by financial services providers. In the interests of federal uniformity and furthering a competitive and level playing field, this forced amalgamation of bank and thrift powers reduces competitive options currently available to many financial services providers.

The H.R. 10 grandfathering provisions also adversely impact the options available to providers of community-based lending services. Competitive flexibility would be reduced and regulatory burdens increased for many community-based financial institutions because of provisions such as this that reduce structural options and the “reverse basket” proposal which targets smaller institutions for acquisition.

On the other hand, the FHLB System provisions of H.R. 10 that provide for voluntary membership for all FHLB members, that stabilize the Resolution Funding Corporation financing mechanism, and that liberalize access to FHLB advances by small community-based lending institutions are positive aspects of the bill. I remain concerned, however, about the need to clearly articulate a mission that retains and strengthens the FHLB System’s accountability to community-based lending needs.

VI. Conclusion

As I stated at the outset, the march of change in the financial services industry will continue regardless of what actions government eventually takes. The need to remain competitive in today’s fast-moving, global economy has driven many institutions to embrace new technologies—and the access to markets and new delivery systems that those new technologies offer. Fundamental changes in the relationships between consumers and providers, and the various sectors of the financial services industry, are occurring almost daily. We should expect and encourage institutions to do what is necessary to stay flexible and competitive in today's financial services marketplace.

Although we are not in a crisis mode, we should not overlook the opportunity to strengthen and modernize our financial system. Our depository institutions must be provided the flexibility and the tools required to compete in our modern economy. Absent a compelling public policy concern, we should defer to market forces to dictate the pace and magnitude of competitive changes. Impediments to enhancing competitiveness and flexibility should be removed. Settling for anything less could have significant implications for the future of our financial institutions and the American economy.