Testimony of Catherine A. Ghiglieri, Banking Commissioner For the State of Texas, on behalf of the Conference of State Bank Supervisors before the Committee on Banking, Housing and Urban Affairs

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Good morning, Chairman Gramm, Senator Sarbanes and members of the Senate Banking Committee. I am Catherine A. Ghiglieri, Banking Commissioner for the State of Texas. I am pleased to be here today to share the views of CSBS on financial modernization.

CSBS is the professional association of state officials who charter, regulate and supervise the 6,633 state-chartered commercial banks, 330 BIF-insured savings banks, and more than 400 state-licensed foreign banking offices nationwide.

Mr. Chairman, CSBS applauds your long-standing support of the dual banking system. Your continuing efforts and those of your colleagues on this committee to defeat state bank exam fees are very much appreciated by the nearly 7,000 state-chartered institutions we regulate.

We also commend you for moving quickly to focus on legislation to modernize our financial system. CSBS supports expanded bank activities that provide a broader range of choices to the consumer, enhance competition, and do not jeopardize safety and soundness. CSBS believes that any changes to our current system must preserve safety, soundness and public confidence. The keys to accomplishing this are: enhancing competition in the financial marketplace; offering opportunities for innovation in products and delivery systems; providing flexibility to regulators and bank management; and allowing the market to promote efficiency by preserving investor choice.

Regulation should not drive new products and services or new delivery systems; rather, the market should drive changes in the industry. As regulators, we must supervise these changes to safeguard consumers, depositors and taxpayers. Regulation in a market-driven environment can promote safe and sound behavior by supplying incentives for well-managed institutions, and by limiting the activities of unhealthy banks.

Your current draft does much to advance these goals.

STATE AUTHORIZATIONS OF EXPANDED BANK ACTIVITIES

Under our dual banking system, states and the federal government independently charter and regulate financial institutions. The vast majority of banks -- 74% of the industry -- are state-chartered. They hold approximately 45% of all assets and deposits in the U.S. banking system.

A bank's charter determines its powers, and states have traditionally authorized a wide range of powers for their state-chartered banks. In fact, Section 20 of the Glass-Steagall Act has never applied to state banks that are not members of the Federal Reserve System. Today, there are 5,651 "nonmember" banks - a vast majority of the industry. However, interpretations of the Bank Holding Company Act have prevented most of these institutions from being able to exercise their authorized powers fully. State-chartered banks that are not currently members of the Federal Reserve System generally have the option of conducting their state-authorized activities within the bank or through subsidiaries. In fact, many states require their banks to engage in certain activities only through subsidiaries.

For years, state banks have conducted many non-banking activities, within the bounds of safety and soundness as determined by their state supervisors. These activities have primarily been in the area of agency and brokerage: insurance sales, real estate brokerage, sales of uninsured investment products, and travel agency. Forty-four states now authorize discount or full securities brokerage for their state-chartered banks. Twenty-five states allow banks to underwrite municipal revenue bonds; 49 allow bank insurance sales, and 32 of these states allow insurance sales powers beyond those allowed for a national bank. Seventeen states allow their state-chartered banks to sell real estate.

As Congress considers financial modernization at the federal level, the states continue their tradition of innovation by granting new powers and creating new charters for financial institutions. In the past two years, states have acted to expand bank insurance powers in Colorado, Connecticut, Georgia, Illinois, Indiana, Louisiana, Maine, Massachusetts, Mississippi, Nevada, Pennsylvania, Utah, and Vermont. In Connecticut, Illinois, Massachusetts and Pennsylvania, these new laws marked the end of years of anti-affiliation laws that prohibited any kind of bank insurance activity. In Indiana, banks that had been able to sell property and casualty insurance since the beginning of the century now have the authority to sell life insurance.

Last year, Utah enacted legislation to allow broad insurance powers for state-chartered banks. Federal law currently prohibits insurance underwriting activities for all banks, but the Utah law envisions a time when this activity might once again be available for healthy, well-managed financial institutions.

In 1997, in an effort to promote economic development and attract new capital to the state, Maine created a new uninsured wholesale financial institution charter. These institutions will not take deposits, but will be funded through equity and borrowings. They have trust powers and have investment and lending powers beyond those of commercial banks.

The new community bank charter in Connecticut also seeks to encourage lending to local businesses and consumers, by making it easier for financial institutions to enter the market. This community bank charter requires slightly less capital than a traditional commercial bank charter.

The most dramatic development on the charter front, however, was another charter from Maine. Maine identified the most attractive qualities of all its state charters - the commercial bank, savings bank, savings and loan - and combined them into one premier charter.

Anticipating future changes in federal law, the Maine law eliminates restrictions on ownership of these new institutions, and allows for a broad choice of ownership structures - stock, mutual, limited liability partnerships, limited liability corporations, and limited partnerships.

Until 1991, states were also able to authorize their banks to conduct a wide range of expanded activities as principal. The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) restricted such state bank activities to those permitted to national banks, unless the FDIC determines on a case by case basis that the activity poses no significant risk to the deposit insurance fund. Under this standard, the FDIC has approved most applications for additional activities by state-chartered banks. The FDIC has recently streamlined this application process, and reduced the requirement for certain expanded activities from an application to a notice for qualifying institutions.

STRUCTURES FOR BANK SECURITIES ACTIVITIES

One concern we have with your draft is its rollback of state-chartered banks' securities underwriting activities. State-chartered banks should continue to have the option of conducting securities activities in bank subsidiaries, as law in many states currently allows, or through holding company affiliates. This may jeopardize the balance of our dual banking system by reducing state banks' ability to offer their customers expanded products and services in the most cost-effective way.

The bill rolls back existing authority in 16 states for securities underwriting in a subsidiary, grandfathering only existing activity. This would preempt state authority. Under our current structure, we are not aware that the activities of any state bank's securities subsidiaries have threatened the deposit insurance fund. Given this experience, we should not dismantle this structure.

The new affiliate structure proposed by the bill would offer important new opportunities to member banks and bank holding companies. However, we feel strongly that this should not be the only option available to state-chartered banks that want to engage in these activities.

BENEFITS OF STATE INNOVATIONS

A key benefit of our dual banking system is that it provides for innovations at both the state and the federal level. In fact, state initiatives have spurred most advances in U.S. bank products and services. Everything from checking accounts to adjustable-rate mortgages, from electronic funds transfers to interstate branching, originated at the state level. A state bank was the first to offer a NOW account, and state banks developed the automatic teller machine. Texas passed legislation in 1993 authorizing "pass through" taxation of small banks, an idea that eventually resulted in changes in federal law allowing banks to elect Subchapter S status.

Because states can act individually to authorize new products and services, banks in other states and the federal banking agencies have an opportunity to learn from these state-chartered banks' experience. When new activities emerge one state at a time, systemic risk is minimized. If an activity proves too risky, unprofitable, or harmful to consumers, it is much easier for a single state to change its law than for the federal government to reverse itself.

When changing federal law, we must preserve the states' ability to experiment independently with new products and services, new structures and new delivery methods. State-authorized powers are the bridge that brought us to this point. Now that we are here, we must not burn that bridge. Federal law should not become the only avenue for innovation in the banking system. Otherwise we will close the book on the dual banking system that has served our country, and our economy, so well for so long.

PRESERVATION OF REGULATORY FLEXIBILITY

Regulation and supervision of banking in the United States, like banking itself, evolved over time, largely in reaction to historical events with no grand structure or design. As a result, the United States today has a multiplicity of supervisory agencies at both the state and federal levels.

Critics of this system of multiple regulators have called it redundant and inefficient. On the contrary, CSBS believes that, with coordination and cooperation, a diversity of regulators actually strengthens the U.S. banking system by providing an environment that nurtures innovation and flexibility in both regulation and banking products and services. In protecting the safety and soundness of the nation's banking system, we believe that two sets of eyes are better than one. The comparatively lower failure rate for state banks versus national banks during the late 1980s and early 1990s, we believe, demonstrates the particular value that is brought to the examination process by the cooperation of the states, the FDIC, and the Federal Reserve.

The lack of a monopolistic regulatory environment has also created a healthy dynamic tension among regulators, resulting in a wider range of products and services available to consumers, lower regulatory costs, and more effective, more responsive supervision.

Choice in the regulatory environment can have many of the same benefits that it has in the business environment. Knowing that banks have a choice, regulators work smarter and more effectively. Dedication to the safety and soundness of the financial institutions we regulate is our goal, and it is essential that we have the necessary resources to ensure safety and soundness. Without an alternative, however, an expensive, inefficient and arrogant regulatory regime could easily develop that would burden and restrict financial institutions - disadvantaging them in the marketplace - resulting in a less healthy banking system.

SUPERVISION OF NONBANKING ACTIVITIES - RISK-BASED SUPERVISION

As we learned all too well during the savings and loan crisis of the 1980s, the key to expanding powers is effective supervision. Therefore, we believe that the state and federal banking agencies must supervise any banking organization that engages in additional activities from the top down, and from the bottom up. CSBS is pleased that your draft recognizes this regulatory principle.

The structure in your draft is appropriate because it does provide for comprehensive supervision at the top. This concept is familiar to this committee, as you codified it in the "Foreign Bank Supervision Enhancement Act of 1991," in response to the failure of BCCI.

CSBS believes that the Federal Reserve, with its joint responsibilities of protecting the safety and soundness of the banking system and promoting stability and growth for the economy, is well suited to serve in this umbrella regulatory role for the new qualified bank holding companies.

Virtually all of the large holding companies now operate and are managed as integrated units, especially in their management of risk. As it is managed on a comprehensive basis, this global holding company risk must be supervised on a comprehensive basis as well.

Effective comprehensive supervision of the entire organization - using the concept of risk-based supervision - allows regulators to protect safety and soundness while minimizing regulatory burden. Experience shows that enacting rigid requirements into statutory language almost inevitably creates loopholes that may be exploited, while limiting the regulators' flexibility to address these loopholes. Regulatory guidelines, which regulators could adapt for institutions on a case-by-case basis, are a better approach than rigid statutory requirements. The types of restrictions appropriate for large institutions may not be suitable for small ones, and vice versa.

A consolidated model of supervision, with a risk-based approach to examination and regulation, allows for an expansive view toward powers while protecting supervisory authority to guard safety and soundness. The risk-based model, developed and accepted by the Federal Reserve Board, the FDIC, and the state banking supervisors, allows a tailored approach to supervision that focuses examination resources on a bank's greatest risks. This approach - using computer aided analysis -- allows examiners to look beyond the traditional "snapshot" view of a bank's condition to how an institution with a variety of business activities will respond to changing market conditions.

As a state bank supervisor, I have observed that this risk-based model has allowed the state system to simultaneously bolster regulation for safety and soundness, expand powers, and - by forcing us to focus and coordinate our resources -- reduce regulatory burden. These efficiencies in regulation have developed because of our system of multiple regulators.

COORDINATED SUPERVISION

We are not comfortable with a "functional regulation" model that disregards the bank regulators' responsibility for the overall safety and soundness of the entire organization. As we have seen throughout this debate, interested parties do not agree on exactly what "functional regulation" is, or on how it would work in practice. We would like to reiterate our conviction that comprehensive supervision at the top of an organization is absolutely necessary to protect insured deposits, consumer interests, and - for very large organizations -- the stability of our financial system as a whole. To accomplish this, coordination and cooperation is necessary among all regulators involved with an institution.

To further this necessary cooperation and coordination, we have formed joint task forces with the National Association of Insurance Commissioners (NAIC) and the North American Securities Administrators Association (NASAA). The purpose of these task forces is to share information and coordinate our supervision of financial institutions toward our mutual goal: a wide range of safe, responsible, accessible financial services for our states' citizens. Sixteen states, including Texas, have independently developed plans for the coordinated supervision of bank insurance sales by state banking and insurance departments.

Forty-nine states currently allow bank insurance sales, and 32 allow insurance sales powers beyond those permitted for national banks. The issues now under discussion are how to regulate these banks, and the appropriate extent of consumer protection provisions. We believe the system of "coordinated regulation" now developing at the state level -- which recognizes the role of both the bank and insurance regulator -- could serve as a model for all banks selling insurance.

ACTIVITIES OF FOREIGN BANKING OFFICES

A significant portion of the assets that state bank supervisors oversee are held by foreign banks. These international banks operating in the United States have different structures; most are wholesale, uninsured operations that are prohibited from taking insured deposits.

We believe that "national treatment" means parity of treatment, not identical treatment. Your draft, in most cases, attempts to provide national treatment to foreign banking organizations operating in the United States. This is the right thing to do. While some foreign banking organizations operate under different structures from their domestic competitors, parity of treatment is important. These international banks, through their operations in the United States, add important sources of liquidity to our markets and provide many opportunities for US companies to export their products to overseas markets.

STATE SAVINGS BANK PROVISIONS

We would encourage you to incorporate a repeal of Section 3(f) of the Bank Holding Company Act, as this Committee did last year in H.R. 10.

Congress approved Section 3(f) of the BHCA in 1987 to allow savings banks to engage in activities allowed under state law. This provision also grandfathered savings banks that were providing savings bank life insurance.

However, subsequent court rulings and Federal Reserve Board interpretations have made these savings bank-specific provisions unnecessary. Section 3(f) was intended to be a special grant of authority for savings banks, not a restriction. Repeal of these provisions would bring the regulation of savings banks in line with the regulations governing all other financial institutions in a bank holding company structure.

CONSULTATION AND JOINT REGULATION

Title II of your draft requires that the Federal banking agencies publish customer protection regulations for the sale of insurance. Since these regulations will apply to state-chartered banks as well, we believe that the state banking regulators should be a part of this joint rule making process.

CONCERNS ABOUT MODERNIZATION WITHOUT LEGISLATION

CSBS does have some concerns about the course financial modernization will take without the input of the Congress. Congress has an obligation to create an appropriate regulatory structure for the new financial organizations already emerging in the marketplace.

The growing number of unitary thrift holding company applications by entities outside of banking raise questions in four principal areas.

First, what requirements does the Office of Thrift Supervision (OTS) contemplate for entities that plan to operate outside a traditional branch network? Second, does the OTS plan to evaluate its overall supervisory approach to unitary thrift holding companies, given the significant increase in applications and the size and scope of the non-bank firms applying for unitary thrifts? Third, given the rapidly growing number of non-bank commercial firms that are expanding into banking under the federal thrift charter, what supervisory policies and procedures will the OTS follow to minimize potential risks to the Savings Association Insurance Fund (SAIF), including risks created by the activities of commercial affiliates? Finally, how does the OTS intend to apply the federal Community Reinvestment Act (CRA) to these entities?

These four issues have important implications for the chartering and regulation of thrift institutions, the safety and soundness of the SAIF, and the application of CRA to insured depository institutions.

We have posed these questions to OTS Director Seidman, and appreciate her thoughtful response. We particularly commend the OTS for acknowledging the need to review its supervision of unitary thrift holding companies. We also appreciate that the OTS acknowledged some of these concerns in the approval of the State Farm application for a unitary holding company charter.

Current federal policy allows for the expansion of thrift powers by non-banking commercial firms while leaving the state equivalent to the federal thrift charter at a competitive disadvantage.

CSBS, however, believes that any legislative proposals addressing concerns about the unitary thrift charter should be forward looking, and enable competitive opportunities for all financial institutions.

Additionally, we would ask you to include a provision in your bill calling for publication in the Federal Register of preemption of state law by the Office of Thrift Supervision. We believe this provision - which does not in any way affect the agency's authority -- is clearly consistent with the Congress's continuing pursuit of a "government in sunshine." There is no arguable defense for preemption to be shrouded in mystery.

In fact, we believe that this publication notice requirement will help states recognize which of their laws and regulations might need modernizing.

CONCLUSION

State bank supervisors are an integral part of this nation's bank regulation system. State regulation and supervision is professional, cost effective and efficient. State banks are well capitalized, profitable, and serving their customers. Restriction of state powers, state bank structures, and state regulation weakens the system as a whole. Preserving the authority of each state to decide the bank structure, products and services that best suit their citizens' needs, strengthens the system.

We believe that your proposal is a strong beginning to modernizing our federal banking system. It recognizes that the lines between traditional banking and other financial services are disappearing. It provides for a system of comprehensive oversight. We look forward to working with you, Mr. Chairman, and with the other members of the Committee, in adapting our dual banking system for the 21st century.

I would be happy to answer any questions the Committee may have.