

Texas Department of Banking Testimony

Testimony of Catherine A. Ghiglieri, Banking Commissioner State Of Texas On Behalf Of The Conference Of State Bank Supervisors Before The House Committee On Banking And Financial Services, U.S. House Of Representatives

Date: April 29, 1998

Good morning, Chairman Leach, Congressman LaFalce, and members of the Banking Committee, I am Catherine A. Ghiglieri, Banking Commissioner for the State of Texas, and Chair of the Legislative Committee of the Conference of State Bank Supervisors (CSBS). I am pleased to be here today to share the views of CSBS on mergers and consolidation in the financial services industry and the need for a strong regulatory foundation to regulate the modern financial services marketplace.

CSBS is the professional association of state officials who charter, regulate and supervise the 6,546 state-chartered banks and more than 400 state-licensed foreign banking offices nationwide.

Industry Mergers and Consolidation

Mr. Chairman, as you wrote in your letter of invitation, "developments in the financial services marketplace, including technological developments, overcapacity in the industry, and other market forces are reshaping America's financial services industry." I think it is important to begin by saying that this is as it should be. Technology and the marketplace should be shaping the industry, not regulation or outmoded legislative structures. CSBS endorses the principle that regulation should follow the marketplace and not dictate it. We commend you Chairman Leach, and members of the Banking Committee, for pursuing legislation that acknowledges this principle.

The Conference of State Bank Supervisors believes that financial institutions should have the flexibility to pursue the structure and affiliations that best suit their business strategy. The only qualifier should be that these affiliations must not seek to impede competition, or pose any safety and soundness risks to our financial system or the deposit insurance fund.

At this stage in time, it is difficult to say how the fast-moving changes in financial services will reshape the industry and the delivery of services to the consumer. I will, however, note that CSBS believes these changes have the potential to provide great benefit to the consumer and our economy.

The most powerful force of change in the industry is technology. Its ability to deliver financial products to the consumer inexpensively will revolutionize the industry. Through the Internet, a small community bank has the ability to reach just as many consumers as the nation's largest bank. That is powerful. The vision of a financial supermarket is already a reality. Many products,

including insurance, annuities, stocks and bond sales, and banking services are already "virtually" available to a consumer through one company at one location. That one company is the consumer's Internet provider, and that one location is their personal computer. Congress should not inhibit these technology-driven developments and the potent ability they have to benefit American consumers and the U.S. economy. Nor should the Congress prevent financial firms from providing the services their customers demand.

CSBS has a long-standing policy in support of 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.

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 -- 71.5% of the industry -- are state-chartered. These banks hold approximately 42% of all assets and deposits in the U.S. banking system.

A key benefit of our dual banking system is that it provides for initiatives at the state level and at 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. Furthermore, most consumer protections have originated at the state level. Because states can act individually to authorize new products and services, banks in other states and the federal banking agencies can 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.

State-chartered banks have conducted many non-banking activities, as authorized by their state legislatures. They have done so within the bounds of safety and soundness, as determined by their state supervisors. These activities have primarily been agency and brokerage: insurance sales, real estate brokerage, sales of uninsured investment products, and travel agency. Thirty-eight states currently authorize discount or full securities brokerage for their state-chartered banks. Twenty-one states allow banks to underwrite municipal revenue bonds; forty-eight allow bank insurance sales, and thirty-two of these allow authority beyond that of a national bank. Thirteen states allow their state-chartered banks to sell real estate.

Future of Community Banking

In your letter of invitation, you ask what smaller banks need to "compete on a level playing field with these newly created financial conglomerates." What they need is a healthy dual banking system that allows the states, and their state-chartered institutions, to continue to respond creatively to the needs of consumers and small business. As you know, community banks are the heart and soul of the state banking system. Any federal financial services legislation must not disadvantage community state-chartered institutions, and should empower states to continue to lead in providing innovative charters and products.

What will allow the large financial services conglomerates to pursue their business vision without harming competition, or threatening the stability of the marketplace, is a healthy and competitive community-banking sector. Federal Reserve Governor Ferguson recently commented that small and medium size financial institutions will thrive in the future as "category-killers," focusing on one range of products or one consumer segment. These "banking and financial services entrepreneurs" will succeed by providing the best service or the best price in their chosen niche. The interest in the state charter – with 134 new state-chartered institutions in 1997 – exemplifies the perceived value of this community bank niche. State and federal bank regulators should work together to ensure that there are not barriers in place that inhibit the creation of the newly chartered institutions that will provide necessary competition in the marketplace.

To empower these "category-killers" we must ensure that federal impediments do not prevent community banks, or the states that charter them, from pursuing their chosen market.

Federal Impediments for Community Banks

Until 1991, states were able to authorize their banks to engage as principal in a wide range of expanded activities. The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) restricted 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.

While CSBS commends the FDIC for its current effort to make this requirement (known as Section 24) less burdensome, we believe more needs to be done in this area.

CSBS suggests that the Congress consider allowing well-capitalized community banks to engage in activities allowed by their charter without the bureaucratic Section 24 process. CSBS recommends that a financial institution be allowed to engage in authorized activities, limited by Section 24, to a de minimis level before the Section 24 process is triggered. Should an institution want to grow these new activities, it would then apply to the FDIC for approval. A bank's controlled experience with a new activity would give the FDIC a concrete demonstration of the institution's ability to conduct the activity without posing any threat to the safety and soundness of the institution.

It is this type of experimentation that has shaped the successful history of the state banking system, and which will allow state-chartered institutions to innovate in ways that enable them to compete with the financial conglomerates. Allowing states to authorize their institutions to

experiment in new niche-markets will provide the sort of competition envisioned by Governor Ferguson, to prevent anti-competitive concentration in the marketplace.

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.

The Second Circuit Court, in *Citicorp v. the Board of Governors*, 936 F.2d 66 (2d Cir. 1991) has ruled that the Federal Reserve Board has no authority, under the Bank Holding Company Act, to prohibit bank holding companies from conducting state authorized activities through the subsidiaries of their holding company-owned state banks.

CSBS suggests that Congress consider clarifying the authority for an insured state bank that is controlled by a bank holding company to engage in state authorized activities through a subsidiary, provided such activities are permissible under Section 24 of the Federal Deposit Insurance Act.

Supervision of Nonbanking Activities – Need for Financial Modernization Legislation
As we learned all too well during the savings and loan crisis of the 1980's, the key to expanding powers is effective supervision. Therefore, 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 H.R. 10 as passed by both the House Banking and Commerce Committees recognizes this regulatory principle.

We are not comfortable with a "functional regulation" model that disregards the banking 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 reiterate our conviction that comprehensive supervision at the top of an organization, whether it is a bank or financial services company, is absolutely necessary to protect insured deposits, consumer interests, and – for very large organizations -- the stability of our financial system as a whole. 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 perfectly 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.

Comprehensive supervision will require coordination and cooperation among all regulators involved with an institution. To advance this necessary cooperation and coordination, CSBS has formed joint task forces with both the National Association of Insurance Commissioners, and with the North American Association of Securities Administrators. 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. A system of functional regulation could address consumer protection issues, since it will tend to be specific to individual products and services.

States have worked very well with both the FDIC and the Federal Reserve in supervising a wide range of financial institutions engaged in many types of activities. We believe comprehensive supervision is necessary and that the Federal Reserve is well qualified to serve in this function for qualifying bank holding companies.

Risk Based Supervision

Recent merger announcements, as well as flurry of applications for unitary thrift charters, should lead all of us to think about supervision. Achieving adequate control systems to monitor the far-reaching scope of these organizations provides challenges to both bank management and their supervisors.

Over the last several years, the Federal Reserve, working closely with the states, has been developing and implementing risk-focused frameworks for supervision and examination. The "pilot" project has been the Foreign Bank Organization (FBO) program, used to manage the supervision of foreign banks operating in the United States.

At the same time that we have been encouraging banks to adopt a risk-based approach to their business activities, we have also applied these principles to supervision. We are now using a risk-focused approach to examining and supervising an organization's business activities, in which we tailor supervisory activities to the bank's risk profile. We believe that this program will sharpen supervisors' focus on areas that pose the greatest risk to the safety and soundness of banking organizations, and on management's ability to identify, measure, monitor and control risks.

Concerns About Modernization Without Legislation

CSBS does have some concerns about the course financial modernization will take without the input of the Congress. We are particularly concerned about the ability of the Office of Thrift Supervision to oversee the burgeoning unitary thrift holding companies.

The growing number of unitary thrift holding company applications from non-banks raises questions in four principal areas.

First, what regulatory oversight and supervisory framework does the Office of Thrift Supervision (OTS) contemplate for such 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, 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.

Expansion of unitary thrifts, without an adequate regulatory structure to ensure safety and soundness, echoes the origins of the savings and loan crisis, when thrift powers were expanded without appropriate supervision.

Conclusion

The health of the predominantly state-chartered community banking industry is essential to ensure that financial conglomerates do not control the delivery of financial services. Financial legislation that liberates state banking regulators to allow their institutions to deliver innovative financial services, while strictly maintaining safety and soundness, will help ensure a competitive and thriving financial sector.

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