

Testimony

June 25, 1998

TS-030 - Seidman's Statement Concerning Financial Modernization Before
the Committee on Banking, Housing and Urban Affairs United States Senate

Office of Thrift Supervision

Remarks, Speeches, & Testimony

Statement on Financial Modernization
by
Ellen Seidman
Director, Office of Thrift Supervision

before the
Committee on Banking, Housing and Urban
Affairs
United States Senate

June 25, 1998

Washington DC

I. Introduction

Mr. Chairman and members of the Committee, I appreciate the opportunity to discuss the Office of Thrift Supervision's views on the ongoing efforts to modernize America's financial services industry.

Last month, the House passed H.R. 10, which represents the most recent proposal to update our financial services system. Even with the tremendous efforts of those in the House who championed this difficult undertaking, it remains unclear whether H.R. 10 truly moves our financial system into the twenty-first century. Several provisions of the bill are particularly contentious, with many of the players in the financial services industry and the public sector still at odds about how best to proceed.

The issues we are confronted with are large and have far-reaching implications. Advancing technology, financial globalization and continuing consolidation have been driving the evolution of our Nation's financial services sector for a generation. The dynamics of the banking industry have changed more dramatically in the last decade than in the five previous decades. Regardless of government's response to these changes, the market will continue to evolve.

In my statement, I will first highlight what we are seeing in this changing world of financial services. Next, I will articulate the principles that we believe must be part of financial modernization, regardless of how legislation is ultimately structured. I will then discuss the issues that we believe are among the most important in this debate. These include ensuring marketplace incentives and regulatory authority to protect the safety and soundness of existing insured institutions, maintaining and promoting the viability of community-based lending institutions, ensuring the continued availability of housing finance, and preserving operational and charter flexibility for insured institutions.

II. The Changing World of Financial Services

What makes the current debate on financial modernization different from those past is that current market dynamics have propelled the discussion to a new level. We no longer have to speculate about the potential implications of legislation; we need only open the business section of the newspaper to read about what is on the line - and to realize that the stakes are already very high.

In contrast to most prior legislative efforts involving restructuring of our financial system, we are not now compelled to act by a crisis. Instead, we are confronted with examining the government's role in a rapidly changing financial world in, what is for now, a relatively stable environment.

Many questions must be answered. Will community-based financial institutions survive, or will these institutions be absorbed by larger regional and national banking concerns? Is a specialized federal charter oriented toward home lending still appropriate? Will there continue to be a significant role in our financial system for federally insured depository institutions? What is the appropriate regulatory and supervisory framework for monitoring modernized financial services activities conducted both inside and outside the insured depository institution? How should the various financial regulators (state and federal) interrelate? These are just some of the questions we must consider.

We are also seeing substantial consolidation and integration among the various sectors of the financial services industry. The idea of offering consumers one-stop financial services shopping has become one of the foremost goals of financial modernization, although the jury is still out on whether consumers truly value this. And it is 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.

Regardless of what new structures government puts in place, the market and new technologies will continue to alter our financial system. Our failure to recognize and respond to this change could result in government rules that impede, rather than advance, the ongoing evolution of our financial markets, and this, in turn, could harm consumers and the communities that rely on these financial institutions. If we intend to keep up in the global marketplace, we must adapt our rules and laws to today's-and tomorrow's-developing marketplace.

This is not an easy task. It requires us to address events that we cannot predict. We must move forward carefully and purposefully to craft legislation that accommodates change and flexibility, yet retains adequate structural and supervisory safeguards to mitigate harm when trouble arises.

III. Principles of Financial Modernization

There are four elements that we believe must be incorporated in developing and implementing legislative reforms affecting the future of our financial services industry.

First, financial modernization legislation should include marketplace incentives and adequate regulatory authority to protect the safety and soundness of existing insured institutions and the federal deposit insurance funds.

Second, financial modernization legislation should foster a structure that facilitates the ability of institutions to continue to provide consumer- and community-based financial services to all Americans, in all our communities.

Third, financial modernization legislation should preserve flexibility for insured depository institutions to compete effectively in today's marketplace.

Fourth, financial modernization legislation should minimize regulatory burdens imposed on existing institutions, consistent with safety and soundness, while ensuring that a full range of financial services are available to all.

The proper balance must be struck between flexibility for institutions - so that marketplace innovations that benefit customers, communities and the financial system are not impeded - and appropriate regulatory safeguards. We believe the thrift charter represents one model of a modern charter with a community and consumer-based focus. It also offers substantial flexibility in that it affords benefits and advantages both to small community-based institutions and larger regional and national providers of financial services.

IV. Key Reform Issues in Financial Modernization

Certain aspects of H.R. 10 remain very controversial, with federal policy makers, interest groups, and industry representatives continuing to wrestle over various provisions. From our perspective, several reform issues stand out from the others.

A. Protecting the Safety and Soundness of Existing Insured Institutions

The debate on financial modernization and H.R. 10 has raised many significant public policy issues, yet many of these discussions appear to have glossed over what should be the key issue and fundamental objective of reform - preserving our financial system by protecting the safety and soundness of our insured depository institutions. Until we clearly set this as the overriding objective of financial modernization, it is difficult sometimes to muddle through and establish priorities with respect to the other outstanding issues in the debate.

As we proceed with this debate in the Senate, we must be vigilant that the reforms proposed and debated do not destroy existing regulatory safety and soundness tools and incentives that protect existing (and future) insured institutions and the federal deposit insurance funds. Equally important, we must avoid perverse market incentives that result from well-meaning, but short-sighted reforms. Market forces should reinforce the regulatory objective of promoting the safety and soundness of insured depository institutions - and the stability of the federal deposit insurance system.

B. Preserving the Viability of Community-Based Lending Institutions and Ensuring the Continued Availability of Housing Finance

Financial services in the United States have traditionally been delivered through a decentralized system of smaller, community-oriented financial institutions. Even in this time of mega-bank mergers, over 8,900 insured depository institutions, including 72 percent of the approximately 1,200 OTS-regulated thrifts, have less than \$250 million in assets. And recent charter activity suggests that small institutions continue to thrive. Between 1994 and 1997, over 540 new banks and thrifts were chartered. Of these, over 70 percent of the new banks had \$25 million or less in assets, and over 85 percent of the new thrifts had assets of \$100 million or less. Overall, almost 97 percent of newly chartered depository institutions over the last three years had \$500 million or less in assets.

As articulated in our second principle of financial modernization, any plan to modernize our financial services industry should preserve the vitality and strength of America's community-based lending institutions. Particularly in this age of ever-growing and consolidating mega-regional, national and international banking organizations, many consumers prefer banking at a local community-based institution. There are thousands of insured institutions, banks as well as thrifts, whose primary business focus is meeting the lending and credit needs of their local

communities. Institutions that operate in this manner - by choice and at a profit - should not be forced to alter their focus on community lending simply to conform to new rules and regulations aimed at allowing for larger financial institutions to compete more effectively nationwide and globally.

Moreover, any proposal to modernize financial services must ensure that institutions are not discouraged or precluded from continuing to concentrate in mortgage lending. Public policy in this country has consistently recognized the value of promoting home ownership. Many of the institutions we regulate have found residential lending a profitable line of business, with numerous thrifts far exceeding the levels of residential lending required under the qualified thrift lender ("QTL") test. On the whole, one-to-four family mortgages comprise over half of the industry's assets, with other mortgage-related products representing almost another quarter of thrift industry assets. With home ownership at an all time high of 65.9 percent as of March 31, 1998 - in part due to the considerable efforts of thrifts to serve those previously underserved - it would be a shame to do anything to discourage lenders from continuing to serve this market.

The interagency risk-based capital requirements recognize that residential mortgage loans present a much lower credit risk to institutions than commercial loans. With effective supervision, constant monitoring of interest-rate risk, and maintenance of adequate capital levels, a concentration in residential mortgage lending presents substantially lower risk than some more diversified portfolios. We should not force institutions that focus on housing finance to cut back on or abandon a business that not only is profitable but also fulfills a very important public purpose.

Given their traditional focus on residential mortgage lending, many thrifts over the years have developed strong ties to their local communities. In fact, two years ago Congress modified the QTL test to allow federal thrifts to more adequately and effectively meet the lending needs of their local communities. This reform permitted thrifts to include other consumer lending, such as educational loans and credit card loans, in calculating their QTL compliance. In addition, Congress allowed thrifts to devote up to 20 percent of their portfolio to small business lending, the backbone of any community lending program. These new lending powers enable thrifts to better serve their communities.

Thrifts have an historic commitment to affordable housing and community development and therefore are positioned to meet unique, unmet credit needs. In addition to traditional mortgage lending, many of the smaller, community-oriented thrifts we regulate fill niches not addressed by the conventional mortgage market or larger financial institutions. Let me give you several examples of local thrifts - located in communities that include many low- and moderate-income borrowers - that serve their communities prudently and profitably.

Sunshine State Federal Savings, a \$135 million thrift in Plant City, Florida, operates in an assessment area that has a population that includes approximately 33 percent low- and moderate-income families. During its last review period, Sunshine State originated 45 percent of its mortgage loans to low- and moderate-income borrowers. Sunshine State is well-capitalized and well-managed, posting a return on assets of over 90 basis points and a return on equity of almost 9 percent last year, while receiving an "outstanding" CRA rating in its most recent review by the OTS.

Another community institution, Financial Federal Trust and Savings Bank, is a well capitalized and well managed \$1.24 billion Chicago area thrift. Although somewhat larger in size than the typical community institution, Financial Federal has within its market area Chicago's south and southwestern suburbs, which include some of the most economically disadvantaged communities in Chicago. In addition to providing basic financial services to these communities, Financial Federal builds and rehabilitates affordable housing through several subsidiaries,

Financial Properties and Financial Community Development, a community development corporation. These activities have catalyzed the transformation of blighted neighborhoods into restored and thriving communities. For example, in six neighborhoods in the Dixmoor area of south Chicago, the 52 houses constructed by Financial Properties in 1995 represented the first new housing in that community in 40 years. Recently, Financial Federal has expanded into communities in Detroit, Michigan, and Gary, Indiana, where there is heavy demand for new, affordable housing.

Thrifts were also among the original partners and investors in many locally-oriented community lending organizations that support affordable housing. These include many of the Neighborhood Housing Services organizations across the country, the Neighborhood Housing Services of America ("NHTSA"), and the Savings Associations Mortgage Company, or "SAMCO," a consortium of community-based lending institutions that concentrate their support in multi-family housing projects. Thrifts of all sizes continue to support these important community lending programs. For example, one of the largest thrifts in the country, World Savings, in Oakland, California, is also the largest investor in the NHTSA. Thrifts continue to play an integral role in the affordable housing initiatives of these organizations.

These are a few examples of thrifts serving low- and moderate-income communities and borrowers. Failing to maintain these groups' access to credit and financial services at a fair price would not only be a fundamental failure of the modernization process and detrimental to the American economy, but a betrayal of what we have told underserved communities they should expect of financial institutions.

C. Operational and Charter Flexibility for Insured Institutions

Providing sufficient operational flexibility for insured institutions to compete more effectively is another key element in the financial modernization debate. As I previously stated, this is one of the principles of financial modernization to which we believe any legislative reform must adhere.

1. Depository Institution Holding Company Activities

There has been considerable discussion throughout the consideration of H.R. 10 about the so-called "unitary" savings and loan holding company ("SLHC") structure. Many have suggested that it is a "loophole" through which banking and commerce may be mixed. A review of the legislative history of the Savings and Loan Holding Company Act and examination of existing restrictions on the thrift charter, however, appear to refute the "loophole" notion. In fact, what emerges is a deliberate distinction in the treatment of banks and thrifts and their holding companies based on the fact that thrifts cannot engage in the traditional type of banking activity - unlimited commercial lending - that raises concerns about the mixing of banking and commerce.

a) Overview of Unitary Savings and Loan Holding Company Structure

The evolution of the unitary SLHC as a structure with different regulatory treatment than a bank holding company ("BHC") structure reflects a number of public policy decisions made by Congress over the last forty years.

Modern federal regulation of BHCs began in 1956 when Congress identified two areas of concern: (1) the geographic concentration of commonly controlled commercial banking facilities in a particular geographic area, and (2) the combination of banking and nonbanking enterprises under a common ownership structure. Initially, Congress directed the Federal Reserve Board ("FRB"), pursuant to the Bank Holding Company Act of 1956 ("BHCA"), to impose acquisition standards and activities limitations only on multiple BHCs (i.e., BHCs owning two or more banks). At the time, the prevailing view was that one-bank BHCs were generally small and presented no serious supervisory concerns. By 1970, however, this perception had changed - with the six largest banks in the country owned by unitary BHCs - and Congress extended the BHCA acquisition and activities restrictions to one-bank BHCs.

While Congress extended the so-called "banking and commerce" restrictions to multiple BHCs in 1956, concerns related to the growing number of SLHC acquisitions of thrifts in the late 1950s were addressed in a very different manner. In 1959, pursuant to the Spence Act, Congress prohibited existing SLHCs from acquiring any additional thrift institutions; and limited prospective holding company acquirors to the acquisition of one thrift. In addition, Congress directed the thrift regulator, the Federal Home Loan Bank Board ("FHLBB"), to submit recommendations to Congress regarding the overall regulation of SLHCs. Although the FHLBB proposed restricting SLHC activities as early as May 1960, Congress did not act on the SLHC issue until 1967.

Congress chose to disregard the FHLBB's restrictive recommendations. Rather, pursuant to the Savings and Loan Holding Company Act of 1967 (SLHCA), Congress provided a framework for the registration and supervision of all SLHCs and imposed activities restrictions on multiple SLHCs, but did not restrict the ownership and operation of nonthrift-related businesses by unitary SLHCs. Given the FHLBB's recommendations to the contrary, this appears to have been a deliberate decision.

Subsequent legislation, that was not aimed at curbing the unrelated business activities of unitary SLHCs but rather at reinforcing the historical mortgage and consumer lending focus of thrifts, implicitly recognized the trade-off struck in the unitary SLHC structure. Congress' authorization in the SLHCA for unitary SLHCs to engage in any legitimate business enterprise that does not pose a safety and soundness risk to their thrift subsidiaries was subsequently folded into the Home Owners' Loan Act (HOLA) pursuant to the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA).

The legislative history of the SLHCA demonstrates that Congress intentionally sought a different route than it took with BHCs to address the mixing of banking and commerce in the unitary SLHC structure. Whereas Congress chose to restrict BHC activities and thereby enforce a separation between banking and commerce in the BHC structure, the focus in the SLHC context was not to limit the holding company's activities, but rather to place limits on the activities of its subsidiary savings association. Thus, in exchange for permitting a unitary SLHC to engage in any legitimate business activity, the commercial lending activities of its subsidiary thrift are limited and the institution must maintain a focus on mortgage and other consumer lending activities, as set forth in the QTL test.

Although the unitary SLHC model has received a lot of recent attention and has been around for a long time, very few SLHCs, in fact, engage in commercial businesses. Currently, of a total of 554 SLHC structures regulated by the OTS, only 71 SLHC structures (owning 73 thrifts) were engaged in non-banking activities. In fact, of the 71, only 21 SLHC structures (owning 21 thrifts) are engaged in truly commercial activities. Of the remaining 71, 26 (owning 25 thrifts) are engaged in only financial activities such as insurance sales and underwriting, investments, mutual fund management and investor services, and broker-dealer operations. The other 24 SLHC structures (owning 27 thrifts) do business in areas that, while non-financial in nature, are closely related to the thrift business, predominantly real estate and related services.

From an operational standpoint, based on a recent OTS survey of existing unitary SLHCs, it appears that the thrift in a SLHC usually contributes either a minimal amount to holding company revenue (less than 10 percent of revenue in 41 percent of the cases) or a very significant amount (over 80 percent of revenue in 46 percent of the companies surveyed) of a holding company's consolidated income.

Although unitary SLHCs may engage freely in a variety of commercial and financial activities, a SLHC cannot operate a subsidiary savings association for the purpose of financing the activities within the holding company structure. Both Congress and the OTS have imposed a

variety of requirements on unitary (and multiple) SLHCs that are designed to protect the safety and soundness of the subsidiary thrift and enable the thrift to perform its core functions, and to significantly restrict interactions between the thrift and its parent holding company and affiliates.

Perhaps the most significant statutory protection for a subsidiary thrift is set forth at § 11(a)(1)(A) of the HOLA, which establishes an absolute prohibition on loans and extensions of credit by a thrift to affiliates that are not engaged in activities permissible for a BHC. This provision, part of the broader thrift affiliate transaction provisions of FIRREA (described below), bars a thrift from lending to a commercial affiliate. Thus, although a thrift may affiliate with a commercial entity in a SLHC structure, the institution may not engage in any financing of the commercial activities of an affiliate - which limits the thrift's exposure to commercial activities.

The commercial lending limits imposed on thrifts and the QTL test, both statutory requirements, also limit the ability of 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-and any amount in excess of 10 percent of assets must be in small business loans. The QTL test restricts commercial lending by requiring that 65% of a thrift's portfolio assets be in mortgage- and consumer-related assets. These two provisions sharply limit a thrift's ability to do commercial lending.

In addition to the bar on thrift loans to an affiliate not engaged solely in permissible BHC activities, transactions between a thrift and its other affiliates are subject to the restrictions of §§ 23A and 23B of the Federal Reserve Act. These require, among other things, that a thrift's transactions with any one affiliate may not exceed 10% of the thrift's capital stock and surplus, and transactions with all affiliates may not exceed 20% of capital stock and surplus. These provisions also impose an independent dealing requirement to prevent preferential pricing and other preferential terms by an institution in transactions with its affiliates.

Sections 5(q) and 10(n) of the HOLA impose anti-tying restrictions on thrifts that prohibit them from conditioning extensions of credit or the furnishing of services to a customer by requiring the customer to obtain certain other services from an affiliate of the thrift, including a commercial holding company. These anti-tying restrictions help prevent the unfair use of market power to coerce banking consumers to purchase non-banking products and services, which not only protects consumers but mitigates concern about the unfair use of the SLHC structure to disadvantage competitors. OTS regulations also prohibit the sale of holding company securities on the premises of the subsidiary thrift.

Finally, § 10 of the HOLA prohibits a holding company from undertaking an activity for the purpose of evading the restraints on the activities of the subsidiary thrift. This section also provides the OTS the authority to impose certain restrictions on a SLHC or any of its subsidiaries if there is reasonable cause to believe that an activity by a thrift affiliate constitutes a serious risk to the financial safety, soundness, or stability of the subsidiary thrift institution.

From the perspective of financial risk to a subsidiary thrift, several statutory and regulatory provisions prevent a SLHC from undermining the capital position of the thrift, whether through dividend payments, tax-sharing arrangements or other means by which income or capital could be upstreamed from a thrift to its holding company. First, the thrift itself is subject to capital requirements that the OTS has developed (in conjunction with the other federal banking agencies) under the so-called "prompt corrective action" provisions of the Federal Deposit Insurance Act. Generally, a subsidiary thrift must maintain a total risk-based capital ratio of 8 percent and Tier 1 risk-based capital and leverage ratios of 4 percent to remain

adequately capitalized. On an industry-wide basis, as of March 31, 1998, thrifts currently maintain ratios of 14.6 percent and 7.6 percent, respectively.

Thrift capital levels are carefully monitored through annual on-site examinations and off-site monitoring by the OTS. If capital drops below statutorily designated levels, then the holding company must guarantee the thrift's compliance with a capital restoration plan and provide adequate assurances of performance by the thrift. If the holding company fails to provide adequate guarantees and assurances of performance, the OTS may, among other things, require the holding company to divest itself of the thrift.

Further protection is provided by OTS's capital distribution rule, which predates the prompt corrective provisions of FDICIA. That rule requires OTS approval of any dividend that would cause a thrift to fall below any of its capital requirements. Dividends that would not cause a capital failure are also subject to limitations based on the thrift's net income. Further, tax sharing agreements between a thrift and its holding companies must conform with several OTS guidelines designed to ensure that the thrift bears only its proportional tax liability, not that of the holding company or affiliates.

When we review any holding company application to acquire a thrift institution, we routinely impose conditions on applicants intending to establish non-traditional branch network thrift operations in order to protect the safety and soundness of the thrift, as well as to protect consumers. An overview of our application process and a description of the types of conditions that we have imposed on unitary SLHC applicants is set forth in our letter to the Conference of State Banking Supervisors, dated April 27, 1998, which responds to questions raised about these issues. ([The letter is attached to this statement.](#)) And, of course, we monitor approved applications to ensure compliance with imposed conditions as well as to determine that adequate supervisory controls are in place.

Since enactment of the FIRREA affiliate transaction restrictions in 1989, unitary SLHCs have not as a class presented special supervisory problems. Although this experience is limited, it does offer valuable insights on how our system may accommodate, from both a capital standpoint and an operational perspective, a limited intermingling of commerce and depository institutions.

OTS has commenced an internal review of our existing procedures with respect to holding company oversight to look at how we supervise thrift holding companies. The primary focus of this review is to determine the sufficiency of our existing procedures for non-traditional structures, what we can do to improve our current oversight activities, and whether there are specific adjustments to our examination and supervisory approach that should be implemented.

For now, we note that most of the recently approved applications have involved either *de novo* thrifts that plan a slow "roll-out" of their operations or the conversion to a thrift charter of existing institutions with good track records. We will continue to use the case-by-case approach to address specific issues of concern that arise in connection with pending applications. We expect the type and scope of conditions imposed on applicants to continue to evolve, as well as our overall supervisory approach and strategy in tackling difficult issues.

b) Concerns With H.R. 10

H.R. 10 as it is currently drafted eliminates the ability of an existing company engaged in otherwise legitimate business activities to acquire or charter a savings association. As I have already described, there are numerous statutory and regulatory restrictions already in place that guard against the concerns that appear to form the basis for eliminating this existing structural option. Moreover, there is little evidence to suggest that, in the more than 30 years

that the unitary SLHC has been in existence, it has created systemic problems or undue concentrations of economic power that could threaten the stability of our financial system. In addition, as I have already stated, with respect to concerns expressed about the recent increase in unitary SLHC applications, a substantial majority of the applicants are engaged in activities that are financial in nature - entities that could acquire a bank if H.R. 10 were enacted.

2. Consolidated Regulatory Oversight and Functional Regulation

In recent years, we have seen a gradual lowering of the traditional barriers among the various sectors of the financial services industry. During this time, we have gained a better understanding of the risks involved in these activities, and have become more comfortable with the ability of institutions to address the specific risks posed by these activities. As a result of our experience, we have continued to refine our regulatory approach to monitoring these risks and evaluating the appropriateness of various activities of insured institutions and their affiliates. Risk-focused supervisory approaches, including the adoption of risk-based capital requirements and risk-focused examinations, enable us to adapt our supervision to focus on safety and soundness risks to a thrift arising from the activities of the thrift or its affiliates.

Unique in the financial institutions industry, the OTS is the consolidated federal regulator for all insured savings associations, their subsidiaries and their holding companies, unless the holding company also includes a bank. This approach has worked well. We have access to information on all aspects of the institution's operations and provide the institutions with "one-stop" regulatory oversight.

Thrifts also have experience with functional regulation. Thrifts may only conduct insurance and securities activities through a subsidiary service corporation (although SLHCs may also provide these services through a holding company subsidiary). Thrift and SLHC subsidiaries engaged in insurance activities must be licensed and regulated by the appropriate state insurance regulator, and thrift subsidiaries engaged in securities activities must register with the SEC. Primary oversight of insurance and securities activities remains with the functional regulator (i.e., state insurance commissioners and the Securities and Exchange Commission, respectively).

Financial modernization should be structured to preserve these unique attributes of the thrift regulatory system - combining the best aspects of consolidated regulatory oversight and functional regulation. This approach not only benefits OTS-regulated thrifts by reducing excessive regulatory overlap, it embraces a common-sense regulatory division of labor while maintaining the ability of the OTS to monitor all aspects of a structure to protect the safety and soundness of the thrift.

D. Merger of the Federal Deposit Insurance Funds

As I have stated before, we believe that, from a public policy perspective, the insurance funds should be merged. We need to eliminate the economic and managerial inefficiencies of a two-fund structure for what is essentially one product - insured deposits.

Indeed, market forces have already begun this process. It is becoming increasingly anachronistic to refer to a "bank fund" and a "thrift fund." The overlap between the two funds has been an open secret for some time. As of March 31, 1998, almost 33 percent of total SAIF-insured deposits (\$227 billion) were held by commercial banks and 28 percent of savings institution insured deposits (\$183 billion) were insured by the BIF.

Now is the ideal time to do what sound public policy clearly tells us must be done. Both industries are sound and healthy, and both funds are well-capitalized.

E. Elimination of the SAIF Special Reserve

Although the issue of the SAIF special reserve does not pertain directly to the subject of financial modernization, it highlights the need for public policy makers to be attentive to outdated and burdensome laws that no longer serve a valid public purpose.

The SAIF Secondary Reserve was established pursuant to the 1996 SAIF recapitalization legislation as a budget-scoring mechanism. The recapitalization legislation required any excess SAIF reserves (i.e., above the 1.25 percent required reserve ratio) on January 1, 1999 (or at the time of a BIF-SAIF fund merger before January 1, 1999), to be transferred to the Secondary Reserve.

Because the legislation did not provide the FDIC with rebate authority for SAIF excess reserves (and since economic projections indicated low SAIF losses), a buildup in the SAIF was deemed to be a budget certainty and, thus, was accorded favorable budget-scoring to offset other, unrelated programs. These projections have proven accurate and, based on the current buildup in the SAIF, relatively conservative. Currently, the FDIC staff estimates that SAIF reserves on January 1, 1999, may approach 1.45 percent, which could result in the funding of the SAIF Secondary Reserve in an amount equal to \$1.35 billion.

Other than budgetary considerations, there was no public policy reason for creation of the SAIF Secondary Reserve. As structured, the legislation provided that the Secondary Reserve would be available to the SAIF (or the combined BIF-SAIF, in the event of a merger) in the event that the SAIF (or the combined BIF-SAIF) reserve ratio falls below 50 percent of the statutorily required 1.25 percent SAIF (or the combined BIF-SAIF) reserve ratio, and is expected to remain below that level for the following four quarters.

Given that the FDIC is required to maintain the SAIF (or the combined BIF-SAIF) at a 1.25 percent reserve ratio and must raise deposit premiums (up to 23 basis points annually) to do so, it is highly unlikely that the Secondary Reserve will ever be utilized. In addition, funding of the Secondary Reserve would have two very troublesome outcomes. First, absent a fund merger, the transfer of the SAIF excess reserve would result in the SAIF reserve ratio being pared to 1.25 percent. This would eliminate the capital cushion now available to the SAIF to absorb even incremental insurance losses. Existing SAIF institutions would be placed in a position, after already substantially overcapitalizing the SAIF, of being exposed to increased premiums and, once again, a BIF-SAIF premium differential.

Second, as noted above, it is highly unlikely that the Secondary Reserve would ever be utilized. Yet, once it is funded, any legislative efforts to transfer the money back into the SAIF, or the combined BIF-SAIF, would likely have a negative budget scoring impact since such funds would be used in lieu of increasing SAIF premiums to fund any SAIF shortfall.

The only way to resolve this problem without a negative budget scoring consequence is to eliminate the SAIF Secondary Reserve before it is funded. This would preserve the capital cushion currently available to the SAIF (or that would be available to a combined fund in the event of a merger) and would avoid the possibility of increased SAIF assessments where a substantial reserve has already been built up with existing SAIF premiums. We support legislation that achieves this result.

V. Conclusion

The financial modernization debate over the last several months has resulted in serious, thoughtful discussion about many issues that are fundamental to the strength and stability of America's financial markets, the most expansive, durable, and creative in the world. It has also had the result (perhaps unintended) of directing attention to certain aspects of the thrift

charter and the SLHC structure that have been discussed without the benefit of a full understanding of the trade-offs inherent in the charter.

In many respects, the thrift charter offers the organizational flexibility and broad affiliation powers now being sought by some financial institutions from different branches of the financial sector. It is not a panacea, however, for those seeking unrestricted affiliations of banking and commerce. In fact, traditional commercial banking authority is severely restricted. Institutions seeking the affiliation authority permissible in a unitary SLHC structure must accept significant restrictions on their commercial lending authority and structure their portfolio to satisfy the QTL test. In addition to being subject to various other provisions intended to protect the safety and soundness of the thrift, in no event may a thrift be used to finance the activities or operations of a commercial affiliate.

The current attributes of the thrift charter make it an excellent vehicle through which to offer a full range of locally-focused, consumer-oriented financial services. For institutions that wish to focus their business operations in this manner, the thrift charter provides one model of the modern charter. At the very least, financial modernization should preserve the freedom of institutions to choose whether the attributes and limitations of the thrift charter suit their particular business goals and needs.

Although we are not in a crisis mode, we should not overlook the opportunity to strengthen and modernize our financial system. The competitive pressures and technological advances I discussed earlier make change inexorable. Our depository institutions must have the flexibility and the tools to continue to compete and to thrive; and our regulators must have both the responsibility and the authority to make certain the system continues to operate in a safe and sound manner to serve all Americans and all communities.

[\[View related press release\]](#) [\[View letter to the Conference of State Banking Supervisors\]](#)

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The Office of Thrift Supervision (OTS), a bureau of the U.S. Treasury, regulates and supervises the nation's thrift industry. OTS' mission is to ensure the safety and soundness of thrift institutions and to support their role as home mortgage lenders and providers of other community credit and financial services. For copies of news releases or other documents call PubliFax at 202/906-5660, or visit the OTS web page at www.ots.treas.gov.

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April 27, 1998

Mr. Neil Milner
President and CEO

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1015 18th Street, N.W.
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Dear Mr. Milner:

This is in response to your February 25, 1998, letter requesting our views on questions you raised in four principal areas. For each of the issues you raise, I have summarized the questions you posed, and then provided our response.

Before addressing these issues, I again want to thank you for the opportunity to speak before the Conference of State Bank Supervisors on March 9. In addition, as we discussed, we are treating your correspondence as a comment to the State Farm Mutual Automobile Insurance Company ("State Farm") application to establish a *de novo* federal savings association.

Regulatory Framework

The first set of questions you ask us to address involves the regulatory oversight and supervisory framework that the OTS contemplates for thrift charter applicants that propose to operate outside a traditional branch network. Several points are relevant in addressing this question.

First, all transactions between a savings institution and its affiliates are subject to the quantitative and qualitative restrictions of sections 23A and 23B of the Federal Reserve Act ("FRA"). These provisions limit to 10 percent of capital stock and surplus the amount of certain permissible transactions, including purchases from and loans to, any one affiliate and impose an aggregate 20 percent of capital stock and surplus limitation on all affiliate transactions by an institution. In addition, these provisions impose an "arms' length" requirement on an institution in its dealings with its affiliates.

Perhaps most significant, section 11(a)(1)(A) of the Home Owners' Loan Act ("HOLA"), establishes an absolute prohibition on loans and extensions of credit by a thrift to affiliates not engaged in activities permissible for a bank holding company under section 4(c) of the Bank Holding Company Act ("BHCA"). This bar serves as an absolute limitation on a thrift's ability to engage in the types of affiliate commercial lending that are at the heart of the concern with the mixing of banking and commerce.

The statutory anti-tying restrictions set forth in sections 5(q) and 10(n) of the HOLA also prohibit a thrift from conditioning extensions of credit or the furnishing of services to a customer by requiring the customer to obtain certain other services from an affiliate of the thrift. These restrictions address another concern that arises in the banking and commerce debate -- the unfair use of market power to coerce banking consumers to purchase non-banking products and services, which also, in turn, unfairly disadvantages competitors.

In addition, the OTS uses a case-by-case approach to tailor its regulatory oversight and supervision of non-traditional branch network thrift operations. The types of conditions that we have imposed on applicants include:

- all cross-marketing activities, including contracts or agreements for cross-marketing, between a thrift and its holding company affiliates are subject to prior OTS approval and must comply with the interagency regulatory statement on disclosure regarding retail sales of non-deposit investment products (which requires products offered to institution customers to be clearly labeled to avoid confusion about whether or not the product carries with it federal deposit insurance);

- requiring applicants seeking to conduct Internet thrift operations to certify that adequate security measures are in place to protect account holders, including a security review by an independent computer security specialist;
- requiring applicants seeking to implement retail on-line personal computer banking operations to comply with OTS guidance issued in June 1997 for evaluating potential risks and establishing prudent controls arising from this activity, as well as requiring planning, testing and monitoring of systems both before and after a program is implemented;
- prior OTS approval of any fee payment arrangements for agents marketing the thrift's products;
- requiring that contracts with electronic data processing vendors hired by an applicant authorize the OTS to examine the operations of the vendor, with respect to services provided to the applicant; and
- where appropriate, requiring an applicant to hire persons with expertise in particular areas of emphasis in the applicant's business plan.

In addition, we have advised applicants of our authority to conduct examiner testing of the appropriateness of disclosures by a thrift or its affiliates in the marketing of insured and uninsured products. This includes the use of so-called "mystery shoppers" to check on whether an applicant's cross-marketing activities are in compliance with required insured/uninsured deposit product disclosures. Consideration is also currently being given to requiring applicants to bear the cost of this oversight by contracting with an independent entity, subject to OTS approval, to do mystery shopping.

The State Farm Application

Another issue raised in your letter involves how the OTS intends to supervise thrift activities conducted by a pending applicant, State Farm. Specifically, you inquire about our oversight of activities conducted by State Farm's agents; how State Farm's proposed structure will comply with laws governing branching and deposit taking; and how the OTS will ensure that State Farm agents adequately disclose whether a product is federally insured.

Due to the fact that the State Farm application is currently pending before the agency, we are not in a position to comment on any aspect of the pending application. However, any applicant for a federal thrift charter must operate under all applicable rules setting forth standards for permissible deposit-taking activities. As discussed above, OTS has in the past required an applicant seeking to sell both insured and uninsured financial products to comply with the interagency regulatory statement on marketing disclosures pertaining to retail sales of non-deposit investment products. However, federal thrifts are not subject to interstate branching restrictions, and state laws that have the effect of regulating the core lending or deposit-taking activities of a federal thrift are generally preempted by federal law.

Insurance Company Issues

You have also raised several general questions regarding OTS' authority and ability to monitor and oversee the activities of an insurance company applicant seeking to acquire or charter *de novo* a federal thrift.

First, you ask whether OTS has the legal authority to examine an insurance company's agency network. The OTS has authority to examine all aspects of a thrift's affiliate structure, including the holding company and other holding company affiliates. As a practical matter, this authority is generally exercised where it is necessary either to make determinations related to the safety and soundness of the insured savings institution, or to monitor activities affecting the institution's customers.

Notwithstanding the broad reach of our regulatory and oversight authority of a thrift holding company and its affiliates, it is important to note that OTS is not in the business of regulating

or overseeing the insurance activities of insurance companies. That is the regulatory jurisdiction of state insurance commissioners. This structure of preserving supervisory oversight to protect the safety and soundness of insured institutions while maintaining separate substantive oversight by the appropriate functional regulator is a unique aspect of the thrift holding company model. We are currently developing, and will maintain, effective information sharing arrangements with state insurance commissioners that are mutually beneficial and that may be relied on if and when issues arise.

With respect to concerns that you expressed about OTS' supervisory authority to examine independent agents utilized by an insurance company to market its products and services, our examination authority gives OTS access to anyone acting as an agent of the thrift and to all relevant documents. In this regard, it is the thrift's responsibility to make sure that any marketing materials used by such agents are not misleading. OTS has authority to direct a thrift to cease using any agent in marketing the thrift's products where the actions of the agent either pose a risk to the thrift or run afoul of the interagency guidance on the marketing of insured and uninsured financial products. In addition, we would contact the state insurance commissioner where it appears that an insurance agent is engaged in marketing activities that may run afoul of the requirements of law and existing prudential safeguards.

Finally, you inquire about how the OTS would be able to determine whether an insurance company that is offering deposit and loan products through a network of agents is observing applicable anti-tying restrictions. OTS can rely on various supervisory tools, including examinations, consumer complaints, and cross-marketing conditions imposed on an applicant to ensure compliance with the anti-tying rules. In addition, our examiners would be required to review the internal policies and procedures established by an institution to train sales representatives, monitor their sales practices, and follow up on potential sales abuses.

You also raised questions about OTS' ability to ensure that insurance agents and other representatives of non-banking affiliates within a thrift holding company structure make appropriate disclosures on uninsured products and comply with the Truth in Savings Act and other consumer disclosure requirements with regard to the banking products and services they offer.

As noted above, the interagency statement on retail sales of non-deposit investment products applies to the marketing of uninsured non-deposit insurance and securities products by an affiliate or agent of a thrift, as well as to insured products offered by the thrift itself. We have required applicants to apply this guidance to sales outside a thrift's office as well as on-site. In addition, insurance and securities companies and their agents are subject to applicable state and federal law requirements relating to suitability standards and fairness in disclosures provided to their customers. We would use the same supervisory techniques described above (i.e., examinations, consumer complaints, and cross-marketing conditions) to ensure compliance with the interagency statement.

The Unitary Thrift Holding Company

The second topic of your letter addresses questions related to the so-called "unitary thrift holding company" structure. In particular, you ask whether OTS plans 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 thrift charters.

As I indicated at our February 3, 1998, meeting, OTS has commenced an internal review to look at what we are doing to supervise thrift holding companies. The primary focus of this review is to determine the sufficiency of our existing procedures, what we can do to improve

our current oversight activities, and whether there are specific adjustments to our examination and supervisory approach that should be implemented.

For now, we note that most of the recently approved applications have involved either *de novo* thrifts that plan a slow "roll-out" of their operations or the conversion to a thrift charter of existing institutions with good track records. We will continue to use the case-by-case approach to address specific issues of concern that arise in connection with pending applications. We expect the type and scope of conditions imposed on applicants to continue to evolve, as well as our overall supervisory approach and strategy in tackling difficult issues.

Potential Risks to the Savings Association Insurance Fund ("SAIF")

The third set of questions you raise involves the number of non-bank commercial firms that you see expanding into banking under the federal thrift charter. Specifically, you ask what supervisory policies and procedures OTS will follow to minimize potential risks to the SAIF, including risks created by the activities of commercial affiliates. You also inquire whether, given the significant growth in commercial companies seeking federal thrifts, express statutory firewalls are needed to shield the SAIF from new risks from commercial affiliates.

Before addressing the substantive issues you raise, it is important to note that relatively few thrift holding companies currently engage in commercial activities. As of June 30, 1997, 558 thrifts were owned by savings and loan holding companies ("SLHCs"). Of the total 558 thrifts, 64 (11%) were owned by SLHCs engaged in non-banking activities. Forty-four of these 64 thrifts (69%) were owned by SLHCs engaged only in financial-type activities (e.g., insurance and securities activities).

Thus, out of the 558 thrifts owned by SLHCs, 20 thrifts (4%) are currently owned by SLHCs engaged in some type of commercial activity no matter how insignificant. These activities are wide ranging -- including wood products, travel agencies, dairy farming, laundry and grocery store operations -- and the relative proportion of the commercial and banking activities in the structures also varies greatly.

It is important to note that the number of existing SLHCs changes frequently and, sometimes, varies significantly. For example, over the first six months of 1997, 66 new SLHCs were created and 71 existing SLHCs were terminated. Although many of these changes occurred in connection with mutual-to-stock thrift conversions, the number of thrifts owned by SLHC's engaging in non-banking activities also declined during the period -- from 73 at the end of 1996 to 64 as of June 30, 1997.

Currently, there are 43 pending applications for federal thrift charters. Of those, 23 are from companies engaged in non-banking activities -- with 15 of these from insurance companies and three of the applications from manufacturing firms.

Notwithstanding the relatively small number of thrift holding companies that have commercial activities in their structure, we are currently examining our regulatory and oversight role and the adequacy of our supervisory mechanisms in monitoring these and all other SLHCs. As previously described, numerous statutory firewalls operate to shield the federal deposit insurance funds from undue risks (e.g., the affiliate transaction rules under FRA §§ 23A and 23B and HOLA § 11, the prompt corrective action provisions of the Federal Deposit Insurance Act, and the commercial, QTL and other investment limitations under the HOLA). OTS' dividend restrictions are also effective in minimizing a thrift's exposure to its holding company and other affiliates.

Finally, various case-by-case conditions that we have imposed and will continue to impose (as described above) enable us the flexibility to tailor our supervision to particular risks posed by particular applicants.

You also inquire how the OTS would insulate insured deposits in the event that an insurance company or commercial firm that owns a federal thrift becomes insolvent. In addition to the above-referenced statutory, regulatory and supervisory provisions that are intended to protect insured depository institutions and insured deposits, we rely on oversight mechanisms that allow us to monitor affiliate activities with an insured institution. In addition, we recently initiated discussions with state insurance commissioners to attempt to establish a dialogue and a working relationship for information sharing and to address potential supervisory issues as they arise.

Community Reinvestment Act Compliance

The final set of questions that you ask relates to how the OTS intends to apply the Community Reinvestment Act ("CRA") to insurance and other non-bank commercial entities. In particular, you ask how OTS plans to apply the CRA to a thrift institution that undertakes a marketing program through non-banking affiliates, particularly on an interstate basis.

OTS has routinely required all thrift holding company applicants to have a complete CRA plan that describes their business strategy for serving the credit needs of their identified community. As a condition of approval in numerous applications (including Principal, Travelers, Reliastar and BankExcel), OTS required applicants to comply with any future changes to the CRA regulations and OTS must approve any changes to an existing CRA plan made within three years of OTS' approval of the application.

A significant issue is what constitutes the CRA lending area for an entity operating on a national basis. This problem has been addressed on several occasions, but most notably in the recent Travelers approval where the applicant agreed to make at least \$430 million in home equity loans to low- and moderate-income borrowers over the next three years. In addition, OTS required Travelers to engage in certain educational programs to ensure that their employees and agents did not administer this program in a manner that could harm those it is targeted to benefit.

Because each application presents a unique and different set of CRA issues that must be addressed for that applicant, it is not possible to provide a general answer to how OTS proposes to apply the CRA in each case. This must be done on a case-by-case basis taking into account the particular facts and circumstances of both the applicant and its identifiable CRA lending community.

Clearly, the issues you raise in your letter deserve our focus and attention and I want to thank you for giving us the opportunity to respond to your questions. These are very important issues for our financial system. It is my intention to make certain that OTS remains committed to ensuring that all existing thrift holding companies and applicants for a thrift charter fulfill the responsibilities that come with ownership of a federally insured depository institution. Moreover, I hope that we can continue this dialogue to address concerns and issues that you see developing as we proceed in our supervisory and oversight efforts.

Thank you, again, for meeting with me on February 3, the opportunity to speak before the Conference of State Bank Supervisors on March 9, and for your continued interest in issues involving thrifts. If you have any additional questions, please do not hesitate to contact me.

Sincerely,

Ellen Seidman

Director