

For Release Upon Delivery  
May 1, 1997, 10:00 a.m.

TESTIMONY OF  
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Before the  
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND REGULATORY RELIEF  
of the  
BANKING, HOUSING AND URBAN AFFAIRS COMMITTEE  
of the  
UNITED STATES SENATE  
May 1, 1997

Statement required by 12 U.S.C. § 250:

The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

Mr. Chairman and members of the Subcommittee, I appreciate this opportunity to testify, as you requested, on recent regulatory actions by the Office of the Comptroller of the Currency (OCC). You have expressed particular interest in the OCC's recent revisions to Part 5, our regulation that governs corporate applications. I welcome the opportunity to describe our actions, which are designed to maintain a safe and sound National Banking System that serves America's communities and consumers within the context of a continually evolving economy.

Through the years, the banking industry has faced numerous, increasingly rapid, changes, each resulting in new challenges to the long-term health of the industry. Recently, competition within the industry increasingly has been augmented by competition from new participants that are able to target selectively segments of markets traditionally served by banks. Competition is not merely regional or national, but global. Underlying all this, rapid advances in technology are fundamentally changing the nature of how information is created, processed and delivered -- the heart of what banks do. Banks can meet these challenges, remain safe and sound, and profitably serve the needs of consumers and businesses only if lawmakers and regulators take a flexible and adaptable view of both the business and the supervision and regulation of banking.

The basic authority under which the OCC and the National Banking System operate is the National Currency Act of 1863.<sup>1</sup> It was based on the belief that a safe, stable system of national banks was indispensable to our country's economic future. But Congress intended that the particulars of the law, specifying what the national banks could and could not do, would evolve with the demands of experience. The national banking laws also endowed the Comptroller with a large measure of independence and discretion in regulating the system under his care. Four unanimous Supreme Court decisions have recently reaffirmed the OCC's interpretation of the scope and evolutionary nature of the national bank charter.

The laws and regulations governing the National Banking System have changed dramatically over the years, as the drafters of the National Bank Act envisioned. In making these changes, Congress and the OCC have always been guided by the belief that national banks have a critical role to play in fostering the economic health of our Nation. That banks today do not look or act like they did 134 years ago would be a source of satisfaction to those who created the system to endure and adapt to changing times.

As the banking industry evolves to meet the changing needs of the economy, so too must bank supervision evolve, and in my term as Comptroller we have taken many steps to do just that. Just as a failure to change would make banking less relevant to the needs of the economy, a failure to change would make bank supervision less effective in assuring safety and soundness. Banking supervision must therefore be a dynamic process.

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<sup>1</sup>The National Currency Act of 1863 was revised in 1864 and renamed the National Bank Act.

We all remember that the industry was going through difficult times when I took office four years ago. There were numerous bank failures, complaints from small businesses and consumers about a credit crunch, and concerns in the banking industry and Congress about excessive regulatory burden. Community organizations were concerned about fair lending compliance, and both community organizations and banks agreed that the Community Reinvestment Act (CRA) regulations were not as effective as they should be.

We have worked hard to address these issues and to refocus and retool OCC supervision. The results of the changes and innovations we have made to our approach to supervision are evident in the performance of the National Banking System. Today we find a banking system that is not only highly profitable and healthy, but also one that is far better capitalized. Bank failures in 1996 were at a 20-year low. The OCC has also increased its enforcement of fair lending laws. Before my arrival at the OCC, the OCC had referred only one fair lending case to the Department of Justice. Since 1993, we have referred 23 cases. Credit is flowing smoothly -- small business loans, which are reported every June, increased 31 percent over the three years ending June 1996.

We have increased supervisory and regulatory efficiency in numerous ways, for example, by reviewing all of our rules and creating an Ombudsman program. We have revised the CRA regulations, and one result has been that mortgage lending to low-to moderate-income individuals has increased dramatically. Since CRA became law in 1977, we have witnessed over \$140 billion of loan commitments for community development. Remarkably, \$100 billion -- a full 70 percent of the total -- was made in the past three years alone. Also, before I became Comptroller in 1993, banks had invested less than \$1 billion in community development projects; but since then, national banks and their community development partners have made targeted investments of over \$4 billion.

While we are proud of our accomplishments, we are not complacent. Now, while the industry is strong, we must keep a vigilant watch for emerging risks, and we must make productive use of the time to reflect on what banking is, how the industry is changing, and what we as regulators must do to maintain safety and soundness. The mission of the OCC, however, remains constant: to charter, regulate and supervise national banks to ensure a safe, sound and competitive National Banking System that supports the citizens, communities and economy of the United States. To this end, early in my term I outlined four basic principles, or pillars, that have guided the actions we have taken to ensure both the industry and our supervision keep pace with a changing environment:

- Ensure bank safety and soundness to support a strong national economy;

- Foster competition by allowing banks to offer new products and services to their customers as long as banks have the expertise to manage the risks effectively and to provide the necessary consumer protections;
- Improve the efficiency of bank supervision and reduce burden by streamlining supervisory procedures and regulations; and
- Assure fair access to financial services for all Americans by enforcing CRA and fair lending laws, and encouraging national bank involvement in community development activities.

The remainder of my statement will begin by elaborating further about the nature of changes currently affecting the banking industry and why I am concerned about the impact of these trends on the safety and soundness of the industry. Next, I will describe highlights of the regulatory and supervisory actions that the OCC has undertaken over the past four years in accordance with the four principles I just outlined. As you requested in your letter of invitation, I will focus on recent OCC actions, and in a separate section, I will describe the OCC's revised Part 5 regulation. Finally, I will summarize some of the efforts currently underway to prepare the agency for what I believe are the formidable challenges of the future.<sup>2</sup>

### Ensuring Safety and Soundness in a Changing Environment

Competitive Challenges Through History. In prescribing a framework for bank powers and a rigorous program of Federal supervision, the founders of national banking law were reacting to the instability and lack of uniformity in American banking before the Civil War. In their world, public confidence in banking was synonymous with liquidity. Therefore, the law required national banks to hold large reserves against deposits and restricted national banks to loans that could be readily turned into cash. Accordingly, most real estate loans were forbidden by law, and OCC examiners were quick to criticize commercial loans that extended for more than the customary 30 or 60 days. Consistent with the intent of Congress, the OCC moved decisively to curb banking practices which, in the conservative context of the times, it viewed as dangerously venturesome. In 1873, Comptroller John Jay Knox deplored the payment of interest on deposits which, in his view, had "done more than any other to demoralize the practice of banking." By the same token, the OCC would have criticized

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<sup>2</sup>Attachment 1 contains a detailed listing of our actions to improve access to credit and enhance safety and soundness. Attachment 2 contains an analysis of the OCC's legal authority to undertake revisions to Part 5, and Attachment 3 contains a paper analyzing and refuting the recently advanced argument that bank subsidiaries have an inherent advantage over bank holding company affiliates and nonbank competitors by virtue of a safety net subsidy.

national banks for making retail loans for consumer durable goods or home improvements had national banks been making any such loans.

Today, no one would deny that sound mortgage lending, consumer lending, competition for deposits, and many other activities that would once have been frowned upon are necessary and proper activities for commercial banks. Had national banks been unable to respond to the legitimate demands of our people and to the competitive challenges of other financial providers, they would not exist today, and American businesses and consumers would be the worse for banking's demise. But because the laws and regulations have been amenable to change, national banks have been able to continue making important contributions to the growth of our communities and our Nation.

Current Competitive Factors. As I have mentioned, the banking industry of the 21st century is being shaped by an unprecedented combination of pressures. Although we cannot know precisely how the business of banking will change, we can be confident that change will occur and that banks will have to adjust to new competitive challenges. To underscore the importance of providing banks with opportunities to meet new competitive challenges, let me cite four examples that demonstrate that we, as regulators and legislators, must continue to re-think what a bank is in today's environment.

First, commercial banking, in essence, is an information business. In the course of servicing depositors and financing borrowers, banks have access to consumer and business information unavailable to would-be competitors. But this competitive edge is dwindling in today's information-driven economy. The information needed to make prudent and profitable loans is now more easily available, and less costly to access, than ever before. Increasingly, competition comes from companies that have not been traditional financial services providers, such as telecommunications companies and software development firms, as technological changes impact the production, packaging and delivery of financial services, and these new competitors are transforming the banking industry in a number of profound ways.

As part of this transformation, banks now outsource a growing portion of the tasks necessary to produce and distribute financial services, and perform fewer of these tasks internally. This stands in direct contrast to the production methods used by commercial banks for decades. Today, banks are:

- purchasing short-term funds in the open market rather than financing loans with core deposits;
- securitizing loans rather than holding loans in portfolio;
- contracting with others to service loans because of scale economies rather than servicing them at the bank; and

- using automated teller machines (ATMs) owned by nonbanks, networks of electronic switches owned by non-banks,<sup>3</sup> the Internet, and home banking software developed and maintained by nonbanks, rather than simply owning ATMs and operating a distribution network of branch facilities.

Technological advancements have allowed banks to move away from vertically integrated production and distribution methods. Some predict that this nexus of ATMs, electronic switches, and home computers will radically transform the financial services industry, with today's commercial banks becoming 'contract banks' that produce very little themselves. These 'virtual banks' would add value by accessing information about suppliers of various financial inputs and delivering this information to end users through electronic interfaces.<sup>4</sup>

Of course, we must be careful not to overstate the extent of change in the short term. Traditional strengths and methods of banking will not change overnight. For example, it is unlikely that the swift pace of technological change and access to information will completely erase the informational advantages fundamental to banking. In addition, banks may soon be able to combine technological advances with their customer relationships to retain the informational and competitive advantage in some lines of business. Moreover, loan securitization has its limits -- some loans are simply so specialized and heterogeneous that securitization is not economical. Nevertheless, it is essential to appreciate that technological change is profoundly changing the financial services industry, and in particular, banking.

Second, even without significant legal or regulatory change, economic globalization has made financial services markets increasingly competitive. A 1994 OCC study of foreign banks operating in the United States reported that foreign banks' share of the U.S. commercial and industrial loan market grew from 16 percent in 1983 to 39 percent in 1993.<sup>5</sup>

Third, the mix of products and services that consumers of financial services want and need has changed and will continue to change in the future. Changing demographics affect the business of banking. For example, today, twelve million American households, many of which are minority families, do not even have deposit accounts with a financial institution. According to some projections, by the year 2010, one-third of the U.S. population will be minority. Success for any retail industry is not simply a question of serving its established

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<sup>3</sup>For example, VISA, MasterCard, EDS, and ADP.

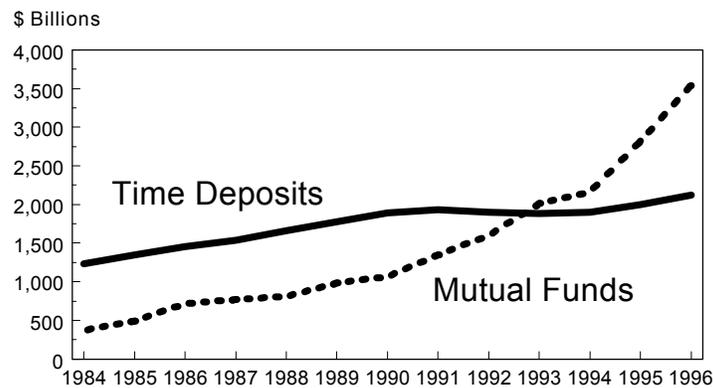
<sup>4</sup>See David Llewellyn, "Banking in the 21st Century: The Transformation of an Industry," presented at the 49th International Banking Summer School, Sorrento, Italy, June 4, 1996.

<sup>5</sup>Nolle, Daniel E. "Are Foreign Banks Out-Competing U.S. Banks in the U.S. Market?" Economics and Policy Analysis Working Paper 94-5, May 1994.

markets but reaching out for new customers and turning them into profitable or more profitable relationships. In order to remain viable and relevant, the country's banking industry must develop relationships now with underserved or unserved customers and the fastest growing segments of our population.

Another important trend is that the population distribution in the U.S. is shifting as the baby-boomer population ages. Consumers demand different products as they enter new phases in their lives. As technological changes have improved the dissemination of information, for example, consumers have learned they have a variety of investment options and opportunities for their retirement savings. Correspondingly, there has been a migration of savings from insured deposits to mutual funds that offer an array of investment and risk/reward profiles. Last year, for the first time in the history of the United States, assets held in mutual funds exceeded assets held in insured deposits, as shown in Figure 1. Furthermore, the percentage of household financial assets invested in bank deposits decreased from 36 percent in 1975 to 18 percent in 1995, as shown in Figure 2. These represent major shifts in the primary source of bank funding.

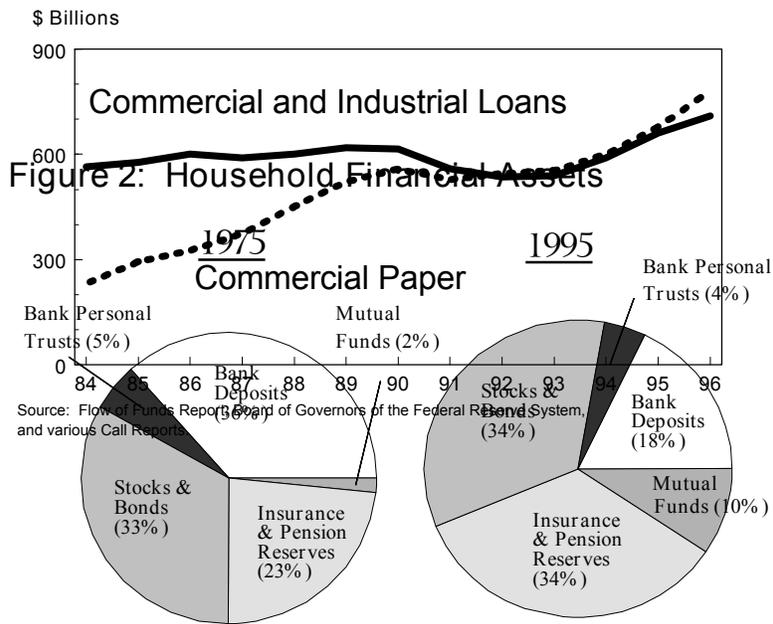
Figure 1: Bank Time Deposits vs. Mutual Fund Assets



Source: Investment Company Institute and various Call Reports

Finally, for the last several decades, more and more of what used to be the core business of commercial banking -- lending money to business -- has declined, as businesses are accessing the capital markets directly (Figure 3). Growth in securitization, brought about by technological advancements, has eroded the comparative advantage once held by banks. The capital markets have appropriated the industry's most creditworthy business, because information is most readily available for this portion of the market. Now, U.S. banks face competition from non-U.S. banks and from domestic and foreign non-bank financial services companies, such as investment banks, securities houses, and insurance companies. As Figure 4 indicates, the share of assets of all financial institutions held by banks continues to decline.

Figure 3: Commercial Paper and Bank C&I Loans

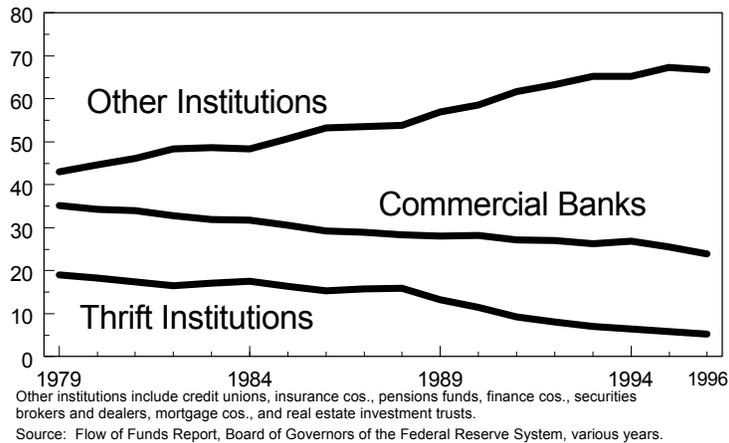


Source: Flow of Funds Report, Board of Governors of the Federal Reserve System, First Quarter, 1996.

Figure 4: Market Share of Assets

Held by Financial Institutions

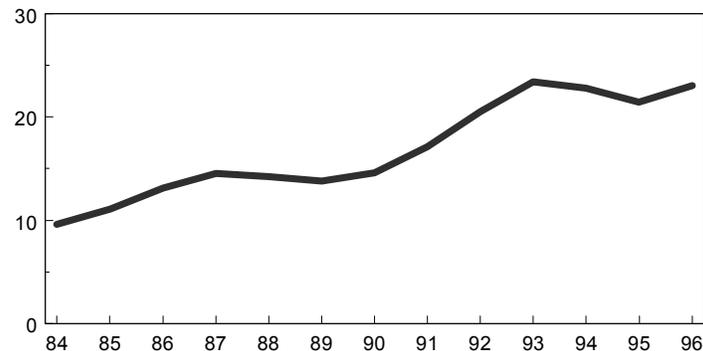
Percentage



Banks have responded to these changes by seeking new sources of income. The banking industry today looks extremely profitable and competitive. What isn't clear from looking simply at the bottom line is the extent to which the composition of bank earnings today is different from the past. As an example, Figure 5 shows that fee income is a much higher percentage of revenue today than in the past.

Figure 5: Noninterest Income to Total Income

Percentage



Note: Total Income is defined as the sum of interest and noninterest income.  
Source: Call Reports.

As the supervisor of the National Banking System, I am vitally interested that banks have the opportunity to respond to these changes and to continue to play their critical role in the Nation's economy. It is troubling, therefore, that a combination of forces impede the opportunities for banks to adapt their business practices prudently. Without those opportunities, banks will continue to face shrinking revenue prospects from their traditional lines of business. A lack of such opportunities creates incentives for banks to reach ever farther out on the risk curve to generate profits and attractive returns on capital and they can disrupt the safety and soundness of the National Banking System.

Because prudent evolution is critical to long-term safety and soundness, every regulator must be concerned about these trends. We must consider the implications for our communities, our businesses, and the economy. The actions taken by the OCC over the past four years, which I will now summarize, were taken in this context, in order to make our supervision meaningful and ensure the banking industry remains relevant.

## OCC Actions

As I noted previously, the OCC has four pillars that provide a framework to guide us in keeping pace with the evolution of the market in supervising the National Banking System. The pillars support and complement each other. For example, banks cannot fulfill their role in assuring access to financial services for all Americans if they act in an unsafe and unsound manner, nor can they be safe and sound if they are unable to compete in this changing environment. It is critical that policy makers not lose sight of these realities when determining the outcome of any financial modernization efforts. In addition, banks should not be unduly burdened by inefficient supervision and regulation, because it can weaken their competitive ability and detracts from their focus on assuring fair access to financial services in a safe and sound manner. Most important, safety and soundness is paramount if banks are to fulfill their fundamental role in the economy.

### Assure Fair Access to Financial Services for All Americans

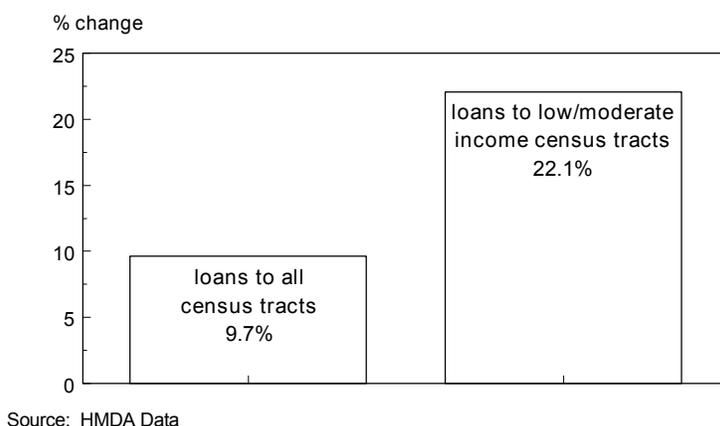
In the four years I have been Comptroller, I have stated repeatedly that one of my goals for the OCC was to help ensure in this changing environment that all Americans receive fair access to financial services. That is the law, but, more fundamentally, it is the right thing to do. Banks perform a vital role in the economy, and, because of that, they remain closely connected to their communities. It is critical to preserve this linkage, especially in light of the changing demographics I mentioned earlier, so that all of our citizens have a safe haven for their savings and are able to participate fully in our economy. Under this pillar, we have revised our Community Reinvestment Act regulations, encouraged national bank involvement in community development activities, stepped up our enforcement of CRA and fair lending laws, and issued various types of guidance to protect the interests of consumers.

CRA. Congress reaffirmed the important responsibility that banks have to serve their local communities when it passed the CRA in 1977. However, as noted earlier, the regulations to implement CRA that were in place when I became Comptroller were not as effective as they could have been. Though well-intentioned, they were in many respects counterproductive, primarily because they focused on process rather than performance. More important, no one was satisfied with how the agencies implemented CRA -- not the banks, not the public, not our examiners. As you know, there were many who preferred that the regulators simply do away with CRA. I strongly believed that CRA could and should work for all of us, and so I led an interagency effort to improve the effectiveness of CRA.

To revise the CRA regulations so they would be effective and accepted, we held town meetings across the country to hear from everyone with a stake in the new CRA, and we put our proposed solution out twice for public comment. In 1993, we held seven public hearings on CRA reform, and we received hundreds of comments from the public. This process

enabled us to move beyond confrontation, and our efforts are being rewarded by the creation of effective partnerships -- partnerships that are, today, growing in strength and helping to rebuild communities. We believe the new regulation will substantially ease the industry's compliance burden and lead to more consistent and more meaningful regulatory assessments of CRA performance. The increased attention given to this area has had concrete results, providing new opportunities for many to participate in the American dream of home ownership: home mortgage loans to low-to moderate- income census tracts increased 22 percent from 1993 to 1995, more than twice the 10 percent increase across all census tracts, as shown below in Figure 6.<sup>6</sup> Also, in the past three years, banks' loan commitments have totaled \$100 billion, representing 70 percent of all reinvestment commitments since enactment of the CRA.

Figure 6: Increased Home Purchase Loans



Community Development. Similarly, in the community development area, we have worked hard to help move banks and community organizations from confrontation to partnership. Last fall, we revised the OCC's Part 24 regulation, which governs national bank investments in community development corporations and community development projects. The revised Part 24 facilitates bank community development investments by eliminating requirements for unnecessary applications in favor of a certification process in many instances and streamlining them in others. The final regulation also relaxed restrictions on the reinvestment of the proceeds of these investments in an effort to attract new capital.

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<sup>6</sup>Source: HMDA data.

Early this year, we published a revised edition of Community Development Finance: Tools and Techniques for National Banks, a reference document on community development first published by the agency in 1989. The booklet includes examples of the basic strategies national banks use to cultivate community development lending and investment opportunities. It also provides new information on safe and sound approaches to meeting community development credit and investment needs in today's marketplace, and a listing of community development resources. As well, we have sponsored various conferences and educational symposia on community development issues, including a conference with over 500 attendees in early 1996.

The National Banking System can take pride in the results of these efforts. National banks of all sizes throughout the country are supporting a variety of community-based partnerships that provide special financing for low- and moderate-income housing, small and minority business development, neighborhood and commercial revitalization, and industrial development. As an example, one consortium of banks and thrifts in Detroit recently committed to lend \$1 billion over the next ten years in the city's empowerment zone. Since I became Comptroller in 1993, national banks and their community development partners have made targeted investments of over \$4 billion in "public welfare" investments alone. In 1996 alone, we approved 187 national bank community development corporations and projects, with investments for the year totaling \$1.4 billion.

Fair Lending. Over the past four years, the OCC also undertook a number of measures to improve our enforcement of fair lending laws. We issued new procedures to detect lending discrimination, and the OCC has conducted over 3,000 fair lending examinations using the new procedures. Along with new examination procedures, we have used mystery shoppers to test for the presence of discriminatory lending behavior, and we have encouraged banks to self-test. Also, as I noted earlier, since April 1993 the OCC has made 23 referrals to the Department of Justice, or notified the Department of Housing and Urban Development, of national banks in violation of fair lending laws.

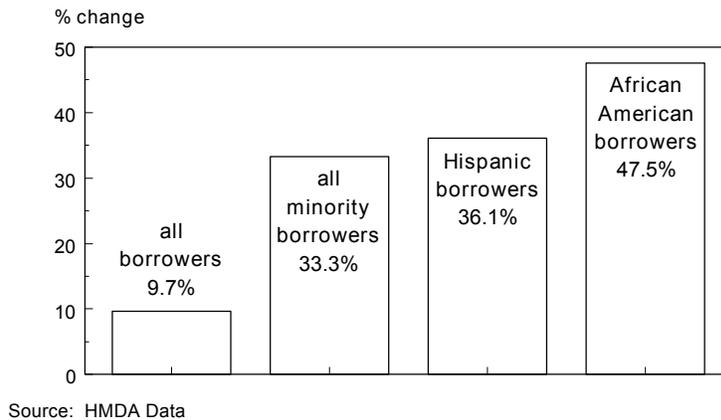
Furthermore, OCC economists have begun to participate in fair lending examinations, employing statistical models to supplement judgmental evaluations in checking for the presence of discriminatory behavior. These models increase the efficiency of our examination effort, both by pre-screening banks to find possible discriminatory behavior and then to guide us in completing our actual examinations in a highly efficient, objective manner.

Along with the Secretary of the Department of Housing and Urban Development (HUD) and the Attorney General, in 1993 I initiated an Interagency Task Force on Fair

Lending to deter lending discrimination.<sup>7</sup> This Task Force has undertaken a comprehensive review of fair lending enforcement and issued a joint policy statement on lending discrimination. In addition, starting this past January, a separate interagency group of economists and statisticians has commenced meeting to exchange ideas regarding the approaches and statistical techniques they employ in their fair lending exams.<sup>8</sup> Most important, these task forces have provided the agencies that are responsible for fair lending enforcement with a means to exchange information and enhance their ability to work together toward a common goal.

As a result of the OCC's efforts to improve access to financial services, we have seen an increase in lending to minorities. Mortgage loans to all minorities increased 33 percent from 1993 to 1995, three times the increase in overall mortgage lending, as shown in Figure 7.<sup>9</sup>

Figure 7: Increased Home Purchase Loans



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<sup>7</sup>In addition to the OCC, this group includes the Federal Reserve Board, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, the National Credit Union Association, the Office of Federal Housing Enterprise Oversight, the Federal Housing Finance Board, the Departments of Justice and HUD, and the Federal Trade Commission.

<sup>8</sup>This interagency group includes representatives of the OCC, the Federal Reserve Board, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the Federal Trade Commission.

<sup>9</sup>Source: HMDA data.

Consumer Protection. To protect the interests of consumers, we issued new compliance examination procedures in August 1993 and have issued a series of guidance to our examiners, consumers and the industry. In the fall of 1993, we issued guidance for consumers about the differences between mutual funds and insured accounts. We followed up on that effort by issuing an interagency statement offering uniform guidance on the sales of mutual funds. In 1994, the OCC undertook a review of bank mutual fund advertisements and marketing materials, to ensure conformity with the earlier guidance issued. Over 700 national banks engaged in the retail sale of mutual funds voluntarily submitted materials for this effort. I initiated meetings based on the results of our findings with bank trade associations to address our concerns and establish disclosure standards, and spearheaded efforts to require bank retail securities sales personnel to take the National Association of Securities Dealers Series 6 and Series 7 examinations. We also reached an agreement among the bank regulatory agencies and the National Association of Securities Dealers in 1995 concerning mutual fund broker-dealer compliance examinations.

We also issued revised credit life insurance regulations in 1996, specifically requiring that credit life insurance sales be based on customer needs, not profit to the seller. Also last year we issued an advisory on national banks' insurance and annuity sales activities.

Organizational Commitment. To solidify the OCC's commitment to fair access, we made certain organizational changes. We created the Community and Consumer Law Division in 1994 to provide a focal point for legal advice and interpretations with regard to consumer and community development laws and regulations and associated policy issues. We also created the Community Relations Division in 1995, which is responsible for the OCC's relations with consumer and community organizations, particularly national public interest organizations. The division provides analysis and advice to the Comptroller and senior policy makers on consumer and community organization interests and activities that affect or could affect the OCC, the National Banking System or the relationship of national banks to their communities. In 1996 we named community reinvestment and development specialists in each of our districts to help foster national bank involvement in community development.

Recognizing the need to develop an understanding of and eliminate impediments that limit access to banking services in certain pockets of the economy, recently we created the OCC's National Access Committee. Its purpose is to establish an institutional structure at the OCC to assist national bank exploration of new business opportunities, especially to small businesses and low-income individuals. The National Access Committee meets quarterly, and includes 12 members drawn from throughout the OCC, including safety and soundness examiners, compliance examiners, economists, attorneys, district community reinvestment/development specialists, and the Director of Community Relations. In addition, we continue to help banks identify effective community development strategies through the efforts of our Community Development Best Practices Group. In February, the group visited

a number of banks, community development intermediaries, and government agencies. The findings of these visits are being analyzed, and will be released shortly as a guide for effective community development practices.

### Improve Supervisory Efficiency

A key to ensuring safety and soundness and good government in an evolving industry is to use resources wisely, particularly in this day and age when timing can be critical. While regulation is necessary to ensure safety and soundness, excess burden is counterproductive. If supervisors or bankers spend time on wasteful activities, safety and soundness may suffer. With this in mind, we tackled extensive regulatory and supervisory review projects, and then, to ensure that our regulations are less burdensome going forward, we established standards for developing regulations. Early in my term, we also established a meaningful dialog with bankers, community groups, and consumers to help us determine where we could improve.

**Regulatory Review Program.** After soliciting industry, community, and consumer feedback, the OCC launched several major initiatives in 1993 to streamline supervisory procedures and regulations. The OCC Regulatory Review Program involved reviewing all of the OCC's rules and eliminating provisions that did not contribute significantly to maintaining the safety and soundness of national banks, facilitate equitable access to banking services for all consumers, or accomplish the OCC's other statutory responsibilities.

The program is part of the OCC's overall effort to promote an environment where risk is prudently managed by banks and appropriately monitored by the OCC, without imposing unnecessary regulatory burdens that undermine the ability of banks to operate efficiently, compete vigorously, and provide credit and other financial products and services to the public. The Regulatory Review effort -- the first of its kind in OCC history -- also included clarifying regulations to convey more effectively the standards the OCC seeks to apply. We designed the program to ensure that the rules we employ are better tailored to the goals we seek to achieve. We completed this significant endeavor in December 1996, with publication of our revised Part 9 regulations governing fiduciary activities of national banks.

Early this year, the OCC issued a set of Standards for Developing Regulations that apply to all the new rules that the agency issues. These standards are based on the guiding principles the OCC used in its comprehensive Regulatory Review Program. The new standards include the following key principles:

- Effectively target the areas of bank activity that present the greatest risk to safety and soundness, the payments system, or the long-term vitality of the National Banking System, or are required by statute;

- Eliminate unnecessary regulatory burden and minimize the burden resulting from requirements that are necessary for the effective supervision of national banks;
- Promote national banks' competitiveness and allow industry innovation;
- Adopt regulations that can be understood by a reasonably knowledgeable person;
- Maximize the opportunity for national bank and public participation in its rulemaking, including timing the effective dates of its regulations to facilitate national banks' planning processes; and,
- Encourage continual re-evaluation of the OCC's rules.

Dialog Established. I did not believe I could succeed in carrying out my primary responsibility of ensuring the long-term safety and soundness of the banking industry without hearing directly from the banks we regulate and the diverse constituencies they serve. Therefore, the OCC solicited banking industry and community and consumer feedback to aid us in this endeavor by increasing our outreach to the banking community. I initiated annual meetings between myself and the 25 largest national banks shortly after I became Comptroller to promote better communication between the agency and the largest banks. I revived nationwide "Meet the Comptroller" sessions throughout the country, and we have held 17 such meetings over the past 4 years. These meetings are widely attended by community bankers. I encouraged OCC senior management to increase their meetings with bankers and bank customer groups. In addition, I meet regularly with community leaders all across the United States. For example, I have met once a month at lunch with community and consumer leaders, and meet with community leaders as part of my visits to cities in which we hold "Meet the Comptroller" sessions.

To improve communications further, and give banks an opportunity to present concerns about their examination findings and other supervisory matters, I created the office of the Ombudsman in 1993. The Ombudsman and his staff are responsible for ensuring that the OCC appeals process provides a fair and speedy review of disagreements on agency findings or decisions. He has the discretion to supersede any agency decision or action during the resolution of an appealable matter. Since 1993, the office has resolved 110 formal appeals from national banks, and facilitated resolutions in 359 additional cases. The Ombudsman has also recently assumed responsibility for the OCC's consumer complaint operations.

Measures of Success. Our regulatory and supervisory streamlining has been successful, and we are able to pass along the benefits of the OCC's increased efficiency to banks in the form of decreased assessments. At year-end 1995, the OCC cut assessments by 3 percent and eliminated the adjustment for inflation. At year-end 1996, we reduced assessments on 600 affiliated national banks, and again waived the 1997 increase for inflation. These reductions

are concrete evidence that the benefits of our efforts can be passed along to reduce further regulatory burden without jeopardizing safety and soundness.

This year, we are also developing and implementing effectiveness measures to improve our measurement of our progress and ultimate success in meeting our goals, including tracking the results of key projects such as our regulatory review. This effort is one of the OCC's priority objectives for 1997. Just as businesses monitor key performance measures on a regular basis to assess their progress and success, these measures will give us the ability to keep track of our progress and monitor areas that need improvement.

### Promote Competitive Opportunities

As I noted in the introduction, the banking industry has changed dramatically since the creation of the OCC. The National Bank Act designed the system to allow enough flexibility for the industry to evolve over time and continue to support the economy and the needs of American consumers. Failure to evolve would have had dire consequences for the safety and soundness of the industry. Thus, a third pillar underlying the OCC's mission is to promote competition by fostering the ability of the national banking industry to change.

Particularly in the American free market, industries exist in a constant state of evolution. Over time, more established product lines may mature or a product may become obsolete. As a result, profit margins may decrease and companies may lose money. Faced with maturing or obsolete product lines, businesses must evolve into new product lines or markets where greater profit opportunities exist or face extinction. In order to maintain their profitability and viability, businesses seek growing products or markets where they believe their comparative advantage can best be used to achieve these greater profits.

Similarly, banks must evolve. Over the past four years, the OCC has considered, case-by-case, bank applications to engage in new activities that are related or incidental to the business of banking. We allow banks to offer new products and services that are incidental to or part of the business of banking provided they have the expertise to manage the risks effectively and to provide appropriate consumer protections, and we have the capacity to supervise them. The OCC acts responsibly to monitor, and where appropriate, to limit the risks of new banking activities, so as not to jeopardize achievement of our primary goal, ensuring bank safety and soundness. In many of these cases, banks sought new ways to deliver their products. For example, we have allowed banks to develop financial management software, and provide data processing services, again, recognizing the change in customer product demand. In my introduction I noted that the National Bank Act intended that banking -- and related supervision -- evolve over time. Our interpretations of the National Bank Act and the ability of the national bank charter to evolve to meet new customer needs and changing

marketplace demands have been sustained by the Supreme Court in four unanimous decisions in the last four years.

### Ensure Bank Safety and Soundness

Banks are -- and have always been -- in the business of risk management. The sheer pace and scope of changes that banks now face make effective risk management more important than ever before. These same factors have led to advances in risk management theory and in technology that together allow banks to measure risk more quickly and accurately.

These changes required the OCC to find more effective ways to carry out our primary mandate: ensuring the safety and soundness of the Nation's banking system. I strongly believe the key to meeting this challenge is for bank supervisors to focus on the risk management systems of banks. At the OCC, we are doing this through a program we call supervision by risk. We have also issued guidance or advisories on a number of current issues and established specialized committees to monitor risks, and communicate relevant findings to the industry.

**Supervision by Risk.** In January 1994, we began with the Bank Supervision Review Project to focus our supervisory efforts on those banking activities and those banks that pose the most likely threats to the safety and soundness of the banking system. That study underscored the need to tailor our oversight to the key characteristics of a bank -- including size, products offered, markets in which it competes, and management's tolerance for risk. As a result of our review, we developed new procedures for examinations of noncomplex community banks. We also issued new procedures for consumer compliance examinations.

In completing our supervisory review, our goal was to enhance safety and soundness supervision by both focussing on the highest risk areas and getting the most from our historic strength: hands-on, in-the-bank examination and supervision. For example, we now have a dedicated examiner staff assigned to each of the 30 largest national banks. Most of these examiners are on-site full time, giving their undivided attention to the affairs of the bank to which they are assigned. This program allows the assigned examiner to be more vigilant and to develop a more thorough knowledge of the bank, its activities, and risks than is possible under traditional periodic examinations. Under this program, our examiners are better able to identify increases in risk or deterioration in risk management so that we can act quickly to ensure that risk management weaknesses are corrected. In both large and small banks, we still complete on-site examinations that include reviews of loan files and testing of transactions as important parts of our evaluation of risk, even in areas of low risk. Also, because we believe that on-site work is essential for effective and timely bank supervision, we have resisted attempts to increase the examination cycle for community banks to 24 months.

Under supervision by risk, the first step in our supervision of an individual bank or in evaluating a new product or activity is to identify the key associated risks. The risks may include credit, liquidity, interest rate, price, foreign exchange, transaction, compliance, strategic, and reputation risks. Having identified the risks for individual banks, we measure and evaluate the quantity of risk and the quality of risk management to form a conclusion about the bank. In developing supervisory policies, we assess the potential for risk, and the types of risk management systems banks need to properly identify, measure, monitor, and control those risks. Because market conditions and company structures vary, there is no single risk management system that works best for all banks. However, we do expect each bank to have a system, whether formal or informal, that is commensurate with the risks it assumes and that addresses each of the four aspects of effective risk management.

We have increasingly emphasized the importance of banks' having strong internal controls and information systems. As banking activities become increasingly complex, senior management in banks must have timely, comprehensive information about their institution's risk position and strong controls in place to manage that exposure. In our risk-based supervision, we focus on banks' internal control systems and test individual transactions to make sure those controls are fully operational.

Our supervision by risk program allows us to apply a common and consistent supervisory approach across an increasingly diverse group of banks that engage in an increasingly diverse set of activities. Because the design of this approach focuses not on specific products or activities, but rather on underlying risk characteristics and elements, it allows us to tailor our supervision to new and changing products, and to direct OCC resources to the banks or activities exhibiting the greatest risk. I strongly believe that supervision by risk is the most effective way to supervise banks in this rapidly changing environment. Since the OCC adopted the process, other U.S. regulators have embraced the approach, and the Bank of England and other international regulators are developing similar systems.

Guidance and Advisories Issued. Our supervision by risk philosophy for individual bank examinations is reinforced and supplemented by our policy guidance and advice to the industry, which we try to issue in-step with emerging risks. In monitoring emerging risks, I and members of OCC's senior management have been vigilant in sending warning signals to the banking community through public statements and formally issued guidance and advisories. The relationships we have developed with bankers in our outreach programs allow us to disseminate warnings in a timely manner. To increase our knowledge and to foster dialog among the regulators, banks, and academic experts, we also sponsored conferences on bank lending to small businesses and on systemic risk.

Our policy guidance focuses on the risks posed by activities and the critical elements for prudent risk management. For example, our issuance and examination procedures on

derivative activities stress the need for board and senior management oversight, timely and accurate market and credit risk measurement systems, and effective operational and risk controls. We issued guidance on stored value card systems that described emerging electronic cash systems and the associated risks to banks investing or participating in those payment systems. Our guidance outlined the various functions and roles banks can play in stored value card systems and analyzed the risk exposures that can arise from those roles. We revised *The Director's Book: The Role of National Bank Directors*. The revised book provides guidance to bank directors on how to meet their responsibilities in the increasingly complex financial services industry. Furthermore, we revised a number of sections of the *Comptroller's Handbook*, including sections on mortgage banking, credit card lending, and, most recently, on risk management in derivatives.

Our March 1997 advisory letter on credit underwriting and credit portfolio risk management stressed the need for bank management to assess the credit culture of their institutions, set portfolio objectives and risk tolerances, have quality management information systems, conduct and set portfolio segmentation, stress tests, and risk diversification objectives, and maintain independent and effective control functions. We are constantly on the alert for areas that may become problems. At the same time we issued this advisory letter, I urged banks to focus on three potential problem areas: cuts in banks' internal controls to boost earnings, consumer credit quality, including credit card losses, and managing the overall credit risk in bank loan portfolios. In a speech last week before the National Association of Affordable Housing Lenders, I warned lenders that we have recently noticed some decline in asset quality and increased delinquency patterns in some national banks' affordable housing mortgage portfolios. We plan to issue an advisory letter shortly on affordable mortgage portfolios describing what we found in our review, the elements of effective techniques, and some strategies banks may want to consider to enhance their affordable mortgage portfolio efforts.

Now, while the economy remains strong and banks remain healthy, it is particularly important for regulators to focus on safety and soundness and for the industry to ready itself for future shocks. Hence, we will expand the supervision by risk approach to include several new specialty areas in 1997 -- bank information systems and fiduciary. We are preparing an advisory/bulletin on risks in credit scoring. We are also developing guidance for banks and examination procedures on risks associated with new electronic banking technologies. We are planning examinations that will assess the preparedness at all national banks on the year 2000 problem by mid-1998.

Interagency policies and guidance. The bank regulatory agencies continue to work together toward a common approach in maintaining safety and soundness. In 1996, we issued a uniform interest rate risk policy. In the fall of 1996, we issued our final market risk rule. Last December, we revised our bank rating system, putting additional emphasis on the quality of

risk management practices and adding a new component on sensitivity to market risk. This new component rating reflects a combined assessment of a bank's level of market risk and the ability of the bank to manage that risk. Just last week, the banking regulators jointly issued guidance on sales of 100 percent loan participations.

International Cooperation. In this era of increased globalization, it is imperative that U.S. banking regulators cooperate with their counterparties abroad. The OCC's primary focal point in these efforts is the Basle Committee on Banking Supervision, which carries out its goal to improve supervisory cooperation and the quality of supervision by exchanging information and expertise, developing and sharing improved supervisory approaches, guidance and technology, and setting minimum standards where needed. Recently, the Basle Committee has furthered the development of international capital adequacy standards, completing standards for market risk. In adopting "sound practices" guidelines for the supervision of derivatives, the Basle Committee also adopted in large part the derivatives guidance issued by the OCC. We are extending our international coordination efforts to securities and insurance supervisors. Currently, in addition to participating in all subgroups and task forces, the OCC chairs the Basle Committee's Information Subgroup, whose purpose is to focus on the information needed by supervisors to supervise effectively, and by market participants to improve market transparency and promote market discipline.

Organizational Changes. Since I became Comptroller, we have undertaken organizational changes to improve our ability to monitor and effectively supervise emerging risks. In 1995, I formed the National Credit Committee because of growing concerns about erosion in credit underwriting standards. The Committee surveyed loan standards at the 40 largest national banks, identified areas that needed improvement, and communicated its findings to bank management. We conducted a similar exercise in 1996. The Committee continues to help the OCC identify and respond to changes in credit risk that could affect the safety and soundness of the National Banking System.

Last year, I created a new position, the Deputy Comptroller for Risk Evaluation, to serve as our national risk expert and as my principal advisor on risks facing the National Banking System. The new Deputy Comptroller helps the OCC identify risks, assists in developing timely supervisory responses, and monitors those responses to ensure that they are effective. He also chairs the OCC's National Risk Committee, which is charged with identifying potentially serious risks to the banking system.

In our Economics Department we have created the Risk Analysis Division, which is devoted to the delivery of expertise in quantitative modeling of financial risks. Economists from that division assist our examiners in evaluating banks' use of quantitative models to measure, monitor, and control market risk, interest-rate risk, and credit risk. The economists

offer assessments of whether the risk models are logically and empirically well-founded and whether they are applied appropriately by the bank.

Currently, the OCC is undergoing a realignment of its operational and policy units. On the operations side, we are restructuring our supervision units to recognize the differing risks and supervisory challenges posed by large, mid-size, and small banks. We believe these changes will create a more flexible and efficient organizational structure that will allow the OCC to respond better to an industry that has and will continue to change dramatically. On the policy side, we have created risk speciality units for asset management, banking technology, capital markets, and community and consumer policy. These units are charged with ensuring that we keep abreast of emerging risks, and have appropriate policies and examination expertise in these key areas.

For instance, early this year, we established a Bank Technology Unit to focus on the impact of changing technology on national bank activities. This group is responsible for determining how the use of technology can be best supervised, and providing OCC examiners who specialize in bank use of technology training and support to make sure national banks are managing this risk appropriately.

## Part 5

All of the efforts I have just described, particularly those related to our safety and soundness supervision, are measured responses to the dramatic changes facing the banking industry that I discussed at the beginning of my statement. A dwindling core business, increased competition, changing consumer needs, and -- most significantly -- a dynamic environment in terms of technological change and globalization means that banking cannot stand still. If we deny banks the opportunity to evolve and pursue opportunities in new financially related activities they can undertake safely, banks will be pressed to squeeze more profit out of their dwindling traditional activities, either by moving further out on the risk limb or by shortchanging basic risk management systems and internal control mechanisms as they seek to cut costs without losing revenue. Indeed, it is this dynamic, the lack of opportunity to evolve and resulting increase in risk, that led to bank losses in lending to lesser-developed countries, and highly leveraged transactions within the past decade.

By contrast, creating a process through which banks can prudently respond to new marketplace demands for products and services will enable them to achieve balance and offset downturns in their traditional lines of business. The OCC's revised Part 5 regulation details a process by which banks can apply to engage in activities that are part of or incidental to the business of banking through operating subsidiaries, which, structurally, have been permitted for many years. It does not authorize any new activity; rather, it provides a framework within

which the OCC will consider applications case-by-case, and provides explicit safeguards to maintain the highest safety and soundness standards and protect the interests of America's consumers and communities. It does not breach any division between banking and commerce. And, it protects the interests of America's taxpayers by providing the framework upon which to build a stronger banking system that is well-positioned to meet the challenges of the next century.

In these respects, the rule provides many benefits. Bank earnings diversification from operating subsidiary activities would help reduce bank failures, and any subsequent need to tap the Bank Insurance Fund. Stronger institutions with increased profits and asset growth will be better positioned to meet the credit needs in their communities and in the economy as a whole. FDIC Chairman Helfer stated recently that allowing a bank to put new activities in a bank subsidiary "lowers the probability of failure and provides greater protection to the insurance funds."<sup>10</sup>

The process of revising our regulation has been slow and thoughtful. When we initiated our revisions to the Part 5 rule by first proposing changes in November 1994, we began a careful and deliberative process, reviewing the many helpful comments that we received on the proposal, that culminated in issuance of the revised final rule in November 1996. We carefully considered our alternatives within the confines of current law. The result of that analysis is the legal memorandum from the OCC's Chief Counsel (see Attachment 2). With this background, let me turn to a discussion of our revised Part 5 regulation.

**Review of Corporate Applications.** Part 5 as a whole represents a fundamental rethinking of our corporate application procedures. Building upon our risk-based approach to supervising today's banks, the regulation employs different application procedures depending upon the level of risk of the proposed activity as well as the financial strength and operational capabilities of the institution. National banks that qualify as "eligible banks" may receive expedited processing of many different types of applications. To be "eligible," a bank must be well capitalized, be CAMELS rated 1 or 2, have at least a "satisfactory" CRA rating, and not be subject to specified enforcement orders.

**New Approach to Operating Subsidiaries.** Part 5 applies a risk-based approach to the activities permitted for subsidiaries of national banks. It allows well-run banks to establish subsidiaries to conduct certain specified non-complex activities, (which the OCC has previously approved, pursuant to an application process), with a simple, after-the-fact notice. These non-complex activities include financial advice and consulting for the bank and its

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<sup>10</sup>See testimony of Ricki Helfer, Chairman, FDIC, on financial modernization before the Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises, Committee on Banking and Financial Services, U.S. House of Representatives, March 5, 1997.

affiliates, certain types of data processing, and selling money orders, savings bonds and travelers' checks. Another category of activities, also previously permitted by the OCC, is eligible for an expedited application process (but not after-the-fact notice). These activities include establishing or acquiring an operating subsidiary that will engage in securities brokerage, investment advice, underwriting and dealing in securities permissible for banks under the National Bank Act, acting as investment adviser, and acting as a futures commission merchant.

Further, under section 5.34(f) of the new regulation, certain well-managed and well-capitalized banks can apply for a subsidiary to engage in activities that are part of the business of banking or incidental to banking -- but different from what is permitted for the parent bank. As I noted above, the types of new activities that may be permitted do not constitute engaging in commerce -- they must be part of or incidental to banking. Also, expedited procedures are not available for these applications.

If the OCC has not previously approved the activity, the proposal will be published in the Federal Register, and we will invite public comments. We will carefully consider the impact of the activity on the bank's safety and soundness. And we will take a very cautious and judicious approach to reviewing and deciding any requests made through this new process.

Safeguards. Part 5 contains important, explicit corporate and supervisory safeguards to ensure that any new activities are conducted safely and soundly. The safeguards in the rule will apply regardless of the particular activity undertaken by the special operating subsidiary. Also, in many cases, activities will be regulated on a functional basis by another regulator. Furthermore, the OCC will impose additional safeguards application-by-application as warranted by the particular activities the subsidiary proposes to conduct. In other words, the safeguards in the regulation are a starting point; the OCC will add whatever precautions are necessary. These constraints have been carefully thought out in order to protect the bank, the safety and soundness of the National Banking System, consumers, and the taxpayer.

Specific safety and soundness safeguards that apply to all operating subsidiaries engaging in activities not permissible for the bank include:

- The subsidiary must be adequately capitalized and have separate accounting and corporate records.
- The subsidiary must be separate from the bank, with physical facilities distinct from the bank, employees compensated by the subsidiary, and a corporate name that is not the same as the bank's.
- It must conduct its operations under independent policies and procedures, intended to inform customers that the subsidiary is separate from the bank.

- It must ensure that any contracts with the bank are on terms and conditions comparable to contracts with independent entities.
- One third of the subsidiary's directors must not be directors of the bank and must have relevant expertise that makes them capable of overseeing the subsidiary's activities.
- Both the bank and the subsidiary must have internal controls appropriate to manage the financial and operational risks associated with the subsidiary.

Additional safety and soundness restrictions are applied if the subsidiary conducts activities as principal:

- The bank's equity investment in the subsidiary must be deducted from the bank's capital and assets, and the assets and liabilities of the subsidiary may not be consolidated with those of the bank.
- The regulation applies the safeguards of sections 23A and 23B of the Federal Reserve Act to transactions between the parent bank and such an operating subsidiary. Generally, these sections limit the bank's investments in and loans to operating subsidiaries to 10 percent of bank capital, require extensions of credit to the operating subsidiary to be fully collateralized, and require that transactions between the bank and the subsidiary be conducted at arm's length.

The rule protects taxpayers. The rule protects the interests of taxpayers by providing the framework upon which to strengthen the National Banking System. Bank subsidiaries as a structural option are not new; they have been used in the United States and abroad for decades. As shown in Table 1 below, U.S. banks have, for many years, successfully engaged in a variety of financial services abroad in their overseas branches and in bank subsidiaries. Under longstanding authority of the Federal Reserve Act and other banking laws and regulations, these institutions can engage in equity underwriting, leasing, insurance activities, dealing and investing in corporate debt securities, and making certain limited investments in other types of enterprises. Less than a year ago, Congress increased the amount that U.S. banks were permitted to invest in foreign subsidiaries that conduct these activities.<sup>11</sup> Notably, overseas subsidiaries outperformed the domestic operations of their companies in each year from 1990 through 1995.

Furthermore, state banks have been authorized to engage in activities through operating subsidiaries, including securities brokerage, municipal securities underwriting, real estate brokerage, real estate equity participation, real estate development, and insurance brokerage. As noted in recent FDIC testimony, the FDIC's experience with the activities of bona fide securities subsidiaries of insured nonmember banks has not raised safety and soundness concerns.<sup>12</sup>

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<sup>11</sup>Section 2307 of the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (enacted on September 30, 1996) increased from 10 to 20 percent of capital the amount that a national bank can invest in an Edge Act or Agreement Corporation, provided the Federal Reserve determines that the additional investment would not be unsafe or unsound. This provision is codified at 12 U.S.C. 618.

<sup>12</sup>See testimony of Ricki Helfer, Chairman, FDIC, on financial modernization before the Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises, Committee on Banking and Financial Services, U.S. House of Representatives, March 5, 1997.



Table 1  
Subsidiaries of U.S. Banks Operating Abroad

<u>Primary Activity</u>	<u># of Subsidiaries</u>	<u>Total Assets (\$ million)</u>	<u>Net Income (\$ million)</u>
Insurance Agency & Brokerage	7	1,341	70
Insurance Underwriting	11	2,728	92
Securities Underwriting & Brokerage	75	94,222	353
Investment & Merchant Banking	55	76,176	362
ALL ACTIVITIES	1,236	405,408	5,588

(Data as of December 31, 1995 for subsidiaries with total assets above \$1 million)

Insurance activities include:

- Selling all forms of insurance as agent
- Underwriting life, annuity and pension-fund related insurance

Securities activities include:

- Underwriting and dealing in debt securities
- Underwriting and dealing in equity securities (subject to volume limits)
- Underwriting foreign government securities (subject to capital limits)
- Sponsoring mutual funds

Profits and Assets

- These subsidiaries earned a profit in every year between 1990 and 1995, and, on average, had higher returns than the U.S. banks themselves.
- In 1995 total assets in these activities accounted for 17 percent of the consolidated assets of the respective holding companies.

In addition, as shown in Table 2 below, banks in most G-10 countries,<sup>13</sup> with the notable exceptions of the United States and Japan, have long engaged in a broad range of financial services activities, including underwriting and brokering securities and insurance, directly in the bank or in direct subsidiaries of the bank.<sup>14</sup> This broader range of activities has not impaired bank safety and soundness. On the contrary, foreign bank supervisors have told me that income from non-traditional activities has been a key support for the safety and soundness of certain banks during periods of financial stress.

**Table 2**  
**International Comparison:**  
**Corporate Form in Which Bank Activities are Most Often Conducted**

<u>Country</u>	<u>Securities Activities</u>	<u>Insurance Activities</u>	<u>Real Estate Activities</u>
SOMEWHAT RESTRICTED BANK POWERS			
Italy	Bank	Bank sub <sup>1</sup>	Bank sub
Sweden	Bank	Bank sub	Prohibited
Canada sub	Bank sub	Bank sub	Bank
Greece	Bank sub	Bank sub	Bank sub

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<sup>13</sup>The G-10, or Group of Ten, includes the governments of nine countries and the central banks of two others for a total of 11 members. The members are the governments of Belgium, Canada, France, Italy, Japan, the Netherlands, Switzerland, the United Kingdom, the United States, and the central banks of Germany and Sweden.

<sup>14</sup>Because of the organizational flexibility that other countries give their financial services companies, forcing U.S. banks into a holding company structure is particularly problematic as the financial services marketplace is increasingly globalized. A number of U.S. banks have expressed concern that the holding company approach may disadvantage U.S. banks as they compete with many foreign banks, which enjoy the cost advantages of being able to structure their activities in whatever manner they find most efficient.

Table 2 (cont.)  
International Comparison:  
Corporate Form in Which Bank Activities are Most Often Conducted

<u>Country</u>	<u>Securities Activities</u>	<u>Insurance Activities</u>	<u>Real Estate Activities</u>
WIDE BANK POWERS			
Finland	Bank	Bank sub	Bank sub
Germany	Bank	Bank sub	Bank sub
Luxembourg	Bank	Bank sub	Bank sub
Portugal	Bank/Bank sub	Bank/Bank sub	Bank sub
Spain	Bank/Bank sub	Bank sub	Bank sub
VERY WIDE BANK POWERS			
Austria	Bank	BHC sub	Bank
Switzerland	Bank	Bank sub	Bank sub
United Kingdom sub	Bank/Bank sub	Bank sub <sup>2</sup>	Bank/Bank
	/BHC sub		/BHC sub
Netherlands	Bank	BHC sub	Bank sub /BHC sub

SOURCE: OCC using information provided by bank supervisory authorities in the respective countries.

ACTIVITIES: Securities includes underwriting, dealing and brokering all kinds of securities and all aspects of the mutual fund business. Insurance includes underwriting and selling insurance products/services as principal and as agent. Real estate includes investment, development and management.

NOTES: (1) Insurance activities must be conducted by insurance companies. Banks usually act as an agent of insurance companies.  
(2) With the exception of selling insurance as an agent, which is commonly conducted directly in the bank.

This is not a matter of theory, but experience. Non-traditional activities have been and today are conducted safely and soundly by bank operating subsidiaries. As former FDIC Chairman L. William Seidman testified nearly a decade ago, “[I]f banks are adequately insulated...then from a safety and soundness viewpoint it is irrelevant whether nonbanking activities are conducted through affiliates or subsidiaries of banks.”<sup>15</sup>

Some have also expressed concern that banks benefit from a safety net subsidy that can be transmitted to an operating subsidiary and is best contained by the bank holding company structure. The attached paper addresses these concerns in detail. To summarize, there simply is no evidence of a net subsidy. Any benefit to banks from access to the safety net has declined in value over the past decade. The value of any benefit is offset by regulatory costs. Even when being conservative with respect to cost estimates the net subsidy received by banks is negative. Evidence cited as proof of a subsidy is readily attributed to other factors. Most important, banks do not behave as if they enjoy a subsidy.

Even if there were a subsidy, the appropriate response to contain it would be with carefully constructed regulations -- similar to those safeguards we have developed for operating subsidiaries -- rather than to impose organizational constraints on banking companies. If a subsidy existed, the transfer could be contained by rules restricting transactions between organizational components. Indeed, where any activity is placed on the organizational chart will not affect the transfer of any alleged subsidy. Under current rules, the bank holding company structure is not superior to the bank subsidiary structure in containing any alleged subsidy; the bank subsidiary structure is actually the superior structure for containing any alleged subsidy. If the safeguards of sections 23A and 23B are applied to transactions between a bank and its subsidiary and a bank and its affiliates, the subsidy is equally contained from all angles. But a bank can also pay dividends to its holding company -- a transfer of funds which is not subject to sections 23A and 23B. Those funds may then, in turn, be downstreamed to a holding company affiliate.

Moreover, in addition to protecting the interests of taxpayers, the subsidiary structure offers important benefits from a safety and soundness and public policy perspective, as discussed below.

**Benefits of Part 5 Revisions.** The revised Part 5 regulation provides a broad range of benefits. First, the streamlined application procedures promote safety and soundness because they provide a powerful incentive for banks to ensure that they are well managed and well capitalized so they can take advantage of expedited processing. They enhance competitiveness and efficiency by reducing the paperwork that must be filed in connection with many applications and simplifying the process for charter conversions, consolidations, mergers, and corporate reorganizations.

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<sup>15</sup>Hearings before the Senate Committee on Banking, Housing and Urban Affairs, December 3, 1987.

The revised operating subsidiary framework set forth in Part 5 has long-term safety and soundness benefits. Use of bank operating subsidiaries, for example, allows banking organizations to focus their capital and earnings strength on their banks, or a lead bank, rather than removing capital and channeling earnings away from the bank. Use of operating subsidiaries also allows the benefits of activities diversification to flow to the bank and strengthen it.

Moreover, forcing new lines of business that are responding to the newest customer needs to be conducted in holding company affiliates has troubling long-term ramifications for the health of banks generally. Either the assets and income stream of the bank itself will dwindle away, or the bank will reach farther out on the risk curve. In either case, what will result is a destabilized hollow bank. This hollow bank will be less safe and sound.

Also, the kind of structure allowed for new bank activities also has profound implications for the application and scope of the Community Reinvestment Act. As Allen Fishbein, General Counsel of the Center for Community Change, recently noted, "...it is also important to understand that the OCC's new rule provides a potentially important means for increasing the resource base for CRA-related activities."<sup>16</sup> If growth and new lines of business in banking organizations are forced to occur in holding company affiliates and not allowed in bank operating subsidiaries, that growing base of activities and earnings is not available to support a bank's CRA efforts. The source of support for CRA will shrink, and, in the worst case, the CRA may become functionally obsolete.

The subsidiary option should also help banks of all sizes compete more effectively. For large and mid-size banks, competition is increasingly global. Most of the foreign banks with which U.S. banks compete are able to engage in broad securities, insurance and other activities, which they provide efficiently and conveniently through operating subsidiaries, (or in some cases directly through the bank itself). This structure is particularly notable in the European Community, where many formidable financial conglomerates are taking shape. For U.S. banks that must compete against these firms, the subsidiary option gives them an organizational mode that puts them on more equal competitive footing.

For community banks, use of operating subsidiaries can be a simpler, less costly structure for providing new products and services. Community banks today face multi-faceted competition -- ranging from non-bank competitors that have lower regulatory costs, to credit unions with significant tax advantages. Community banks need to be able to choose the organizational form that enables them to compete most effectively to meet these challenges. Diversification through operating subsidiaries may be their best means of survival in an increasingly competitive marketplace.

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<sup>16</sup>See written testimony, hearing before the Subcommittee on Financial Institutions and Consumer Credit, Committee on Banking and Financial Services, U.S. House of Representatives, February 25, 1997.

## Conclusions

In March 1993, when I stood before the Senate Committee on Banking, Housing and Urban Affairs at my confirmation hearing, I stated that I wanted to focus particular attention on the structure and function of the banking system from a long-term perspective. I also stated that developing this vision of the future direction of the banking industry specifically, and the financial services sector in general, was a critical basis for a truly safe and sound banking system. My actions taken to date as Comptroller, including promulgation of the revised Part 5, demonstrate my commitment to those statements I made four years ago.

The OCC has changed significantly over the past four years and implemented many improvements in order to maintain safety and soundness in the banking industry. We continue to look for potential sources of problems in the industry and to make changes as needed. I am proud of our efforts and of the OCC's employees for their hard work and dedication in effecting these changes. They are a strong group of highly skilled professionals who are committed to ensuring the safety and soundness of the National Banking System.

The revisions to Part 5 are only one example of the OCC's actions over the past four years, but they epitomize what the OCC is about: chartering, regulating and supervising national banks to ensure a safe, sound and competitive National Banking System that supports the citizens, communities and economy of the United States. Certainly, the new Part 5 does not provide answers to all the difficult issues that banks face. Like so many changes, the new Part 5 is a small, but logical, step forward. But it does hold the promise of significant progress, and it can be a powerful tool for business opportunities, greater efficiencies, enhanced safety and soundness, and a broader and less expensive array of financial services for America's communities and consumers -- goals that should be shared by all supporters of financial modernization.

My goal for the remainder of my term is to assure that the National Banking System remains healthy, stable and able to serve the diverse needs of American consumers and communities. We will continue to build on the actions of the four-pillar approach I established to guide OCC supervision of the National Banking System. At the same time, I am committed to making certain that our supervision and our policies meet any new challenges that the future will bring. That is the essence of safety and soundness.