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SENATE BANKING COMMITTEE

Mr. Chairman, Senator Sarbanes, Members of the Committee, I welcome this opportunity to discuss financial modernization and its effects on our nation's economy and our citizens.

This Administration has been a consistent proponent of financial modernization. From the beginning, our overall objective has been to do what best serves the interests of consumers, businesses and communities. However, we oppose the bill that very narrowly passed the House, HR 10, because it does not meet that standard. Before I describe our concerns, let me make a couple of larger points regarding our financial system and financial modernization.

The nation's financial system is at the very heart of our economy. It accounts for 7.5 percent of our GDP and employs 5 percent of our workforce. It performs a critical function as an intermediary between savers and borrowers, between buyers and sellers of securities, and among insurance policyholders.

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I should also note that the U.S. financial services industry is now as competitive as ever in recent memory. Abroad, the United States is dominant in investment banking and strongly competitive in other segments of financial services.

While our financial services industry is adapting and competing, with good financial modernization legislation that evolution could occur in a more coherent and orderly way. But without legislation, our financial services industry will continue to adapt and U.S. firms will remain competitive abroad. It is worth noting that they can already engage abroad in the activities at issue in financial modernization legislation here at home. Thus, we have an important issue, but we are currently competitive and the crucial thing is to get the solution right. Because financial services are so important to our economy, legislation in this area should be adopted with broad-based support and address the full range of concerns surrounding financial modernization as fully as possible.

Two recent developments need to be taken into account as legislation is crafted to meet all of the various concerns surrounding financial modernization. First, despite agreement on some issues, H.R. 10 has given rise to enormous controversy. It has pitted one industry against another. It is opposed by every major organization of banking institutions, and consumer and community groups have significant concerns, which I will return to in a few moments. While we must recognize that we will never achieve unanimity, we must build broad-based support for fundamental changes to a sector that is so central to the U.S. economy.

The second development is the announcement over the last several months of major mergers in the financial services industry. Each of these mergers should be judged by the appropriate regulators, but crafting the best possible legislation requires Congress to consider the impact of what may be a trend toward consolidation on the various concerns surrounding financial modernization.

In writing financial modernization legislation, you are, in effect, writing the constitution for the financial system of the next century. With that in mind, we believe any financial modernization proposal must meet five principles: it must protect the safety and soundness of our financial system; provide adequate consumer protection; reduce costs and improve access for consumers, businesses and communities; promote innovation and enhance the competitiveness of the financial services industry; and, finally, permit financial services firms to choose the corporate structure that makes the most business sense.

Mr. Chairman, in the context of these principles let me turn first to specific concerns the Administration has regarding HR 10. Then I will say a word about the more general concerns of others about financial modernization which I believe need to be addressed as fully as possible to improve the legislation and build broad-based support for legislation.

First, the bill discriminates against banks and in favor of insurance companies. For example, the bill would deprive the Office of Comptroller of the Currency of the judicial deference accorded to all other federal agencies whenever the OCC was considering an insurance

question. Such discrimination would impede competition and innovation and would fail to serve the interests of consumers. That's one reason why all major bank organizations are on record in opposing this bill.

Second, the bill expands the Federal Home Loan Bank system without resolving that system's fundamental problems. We are in favor of a FHLB that helps communities, but this bill would not curtail the System's use of subsidized capital to earn arbitrage profits, and could expand the System's funding with subsidized capital of activities that have nothing to do with fostering home ownership or helping small and distressed communities.

Third, it would prompt the shifting of assets out of national banks and into holding company affiliates. This would reduce resources covered by the Community Reinvestment Act, a key tool in the effort to expand access to capital in economically distressed areas. H.R. 10 would undermine the remarkable progress that has been made in the areas of urban economic revitalization and financing for affordable housing and small businesses -- nonprofit community groups estimate that since 1992 the private sector has pledged over \$397 billion in loans for community development. As we work to modernize the financial system, we need to make sure it works for all communities.

Fourth and most significantly, the bill would force organizations that include banks to conduct new financial activities in bank holding company affiliates, and prohibit using subsidiaries of banks. We believe financial service firms here ought to be able to organize themselves in the way that makes the most business sense, just as businesses do across the

economy, and not in a government dictated, one-size-fits-all structure. By restricting business choice, HR 10 would limit the ability of market participants to make their own judgments about how best to lower costs, improve services and provide benefits to consumers.

There are good business reasons why one firm may prefer operating through a subsidiary instead of an affiliate. Holding companies can be expensive to form, particularly for small banks, and restrictions on the activities of subsidiaries could therefore discriminate against such banks. In addition, bank management may wish to retain the earnings flows from a new venture generated by an existing line of the bank's business, or use the new venture to diversify earnings. Moreover, for reasons of corporate culture, management may wish to organize new financial services activities in subsidiaries.

If a bank should choose the subsidiary structure, that choice could have benefits for safety and soundness and the taxpayer. First, a bank wishing to commence a new activity would not have to deplete its resources by paying out its retained earnings in dividends for the holding company to use in capitalizing a new affiliate. Second, if the bank were to fail, the FDIC would have a claim on the bank's interest in the subsidiary -- something that is not true of an affiliate.

In short, to best serve the interests of consumers, businesses and communities, it is important that we avoid needlessly -- for no purpose -- restricting the choices businesses can make about how they structure their activities. Allowing business choice would not confer a competitive advantage or impair safety and soundness. There are safeguards that would ensure that a subsidiary structure and an affiliate structure are absolutely equivalent with regard to

safety and soundness and use of the bank's funding subsidy, if such a subsidy exists. The bill reported out by the House Banking Committee included a number of such safeguards, including the following:

First, requiring the bank to be well capitalized and well managed, and to face sanctions if it fails to do so.

Second, requiring one hundred percent of the bank's equity investment in the subsidiary to be deducted from the bank's capital -- and requiring the bank to remain well capitalized even after the deduction.

Third, prohibiting the bank from making an equity investment in a subsidiary that would exceed the amount that the bank could pay as a dividend.

Finally, requiring that any loans by the bank to a subsidiary be subject to exactly the same limits as loans by the bank to an affiliate. Such loans would also have to be on market terms and fully secured by high-quality collateral.

With these safeguards in place, there is zero difference between conducting an activity in a subsidiary and in an affiliate with respect to safety and soundness or competitive advantage from any bank funding subsidy that may exist. That is why the FDIC has consistently concluded that the subsidiary structure poses no threat to safety and soundness. In fact, as to safety and soundness, under the Edge Act, many U.S. banks have long engaged overseas in investment and

merchant banking through subsidiaries -- some of them very large -- and Edge Act subsidiaries are chartered and regulated by the Federal Reserve Board. Furthermore, for the reasons already discussed, the subsidiary is actually stronger than an affiliate from a safety and soundness perspective.

Our final objection to the bill is that the elected Administration is accountable for economic policy -- and bank policy is a key component of economic policy. Under H.R. 10, banks would gravitate away from the national banking system, and the elected Administration would lose its nexus with the banking system, thereby losing its capacity to affect bank policy.

Let me be clear: *supervision* of banks is -- and should be -- apolitical. Indeed, capital standards, reporting requirements, and examination procedures are already uniform regardless of which federal agency regulates the bank. But banking *policy* is a different matter. It is essential that any elected Administration have a voice in this important area of economic policy, and that they be held accountable to the public.

Mr. Chairman, let me turn now to the concerns that others have raised about this bill and financial modernization legislation in general. I believe that these concerns should be addressed as fully as possible to build broad-based support for this effort. Also, in addressing these concerns, I believe that Congress should take into account the possible impact of recent merger activity on the financial services industry. Many smaller, community-based banks are concerned about the growth of financial conglomerates, and the threat they pose to community banking. These concerns are exacerbated by the costs imposed by requiring community banks to form a

holding company in order to conduct new non-banking financial activities. Community groups have raised concerns that concentration of the financial services industry could have an adverse impact on access to capital for lower-income communities. These groups have also expressed concerns regarding the impact on CRA, which I discussed earlier. Consumer groups are concerned about the adequacy of consumer protection against misuse of personal information and against overly aggressive marketing that would take advantage of consumers. Let me add that some have also expressed concern that the recent merger activity may raise new questions about the implications of concentration of economic and political power, which Congress may wish to consider in putting together financial modernization legislation.

Before concluding, let me say a word about the differences between Treasury and the Federal Reserve Board on the subsidiary issue. It is important to emphasize that Treasury and the Fed enjoy a remarkably positive working relationship on a broad array of issues, and that has been of enormous benefit to the nation. We have agreed to put this issue aside and not allow it to interfere with the very good cooperation between the Treasury and the Fed on other issues.

Mr. Chairman, we are committed to working with Congress and all of the relevant parties to thoughtfully and fully address the many serious issues that need to be resolved in order to have good legislation with broad-based support. Thank you very much.