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Reflections on the Ongoing Effort to Modernize Financial Services Regulation

by John D. Hawke, Jr.*

The subject today is financial modernization, and I will address in particular the proposal that we in the Treasury Department of the Clinton administration put forth last year, in 1997, relating to the modernization of rules governing financial services. I especially wish to share with you the thinking that underlies our legislative proposal. I will not try to get embroiled in the details, because I think the broad principles are, in many ways, more interesting.

The first objective was to try to get rid of the rules that serve—and in fact were intended to serve—to limit competition between different providers of financial services. Such laws as the Glass-Steagall Act of 1933 and the Bank Holding Company Act of 1956, especially as amended in 1970, have served principally to divide markets among politically influential segments of the financial services industry. To the extent that those laws prevent affiliation among firms engaged in the securities, insurance, and depository businesses, while limiting providers of certain of those products from offering a full line of financial products and services in the format that best meets their business needs, we think they should be repealed.

At the same time, we think it is essential that the expansion of the financial activities and affiliations of organizations owning banks not present additional threats to the safety and soundness of federally insured institutions. For several reasons, we are confident that our proposal will not pose such risks.

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* Under Secretary for Domestic Finance, United States Department of the Treasury. This is a transcription of remarks made by Secretary Hawke to law professors at the 1998 Annual Meeting of the Association of American Law Schools held in San Francisco on January 8, 1998.

First, the existing regime for bank capital, which requires the maintenance of high levels of capital, together with prompt corrective action if capital levels should slide, provides a very strong first line of defense. Hypothetically, if one could measure the true market value of bank capital on a real-time basis, one would have very little concern about what activities banks engage in other than the taking of deposits. Obvious problems exist with that hypothesis because a person cannot measure the true value of bank capital on a real-time basis, and bank capital requirements have to be constructed with that reality in mind. Nevertheless, if regulators attempted to measure bank capital on a real market-value basis and move quickly to restore bank capital when it began to fall below various threshold levels, this oversight would provide significant protection for the kinds of federal interests that are involved.

Second, we also have a very strong system of fire walls, particularly those in sections 23A and 23B of the Federal Reserve Act. Under our proposal these safeguards would be made even stronger. We would have provided that in order for a banking organization to take advantage of new expanded powers to engage in other financial activities, either through subsidiaries of the bank or through holding company affiliates, the bank's capital would have to be maintained at the highest level required by law, the so-called well-capitalized level. Moreover, the bank would have to be and stay well managed. If the new financial activity were to be conducted through a subsidiary of the bank, as opposed to a holding company of the bank, the bank's satisfaction of that well-capitalized requirement would have to be measured after deducting the bank's equity investment in the subsidiaries. The bank would have to be in essence *overly* well-capitalized before it could invest equity in a subsidiary to take advantage of expanded financial activity. To put it in other terms, even if the bank's investment in the subsidiary were wiped out by a failure of the subsidiary, the bank's ability to satisfy its capital requirements should not be diminished.

Furthermore, we would also make the 23A and 23B fire walls applicable to dealings with the subsidiaries; they are not so applicable now. We thought that would provide an effective subsidiary framework for expanded financial activity.

I should say that this second main feature of the proposal is not without its detractors. Our position was that there should be full parity between holding company affiliates and bank operating subsidiaries in the scope of permissible financial activities. The Federal Reserve has strongly argued to the contrary that all new financial activities should be permitted only in holding companies subsidiaries and not in bank subsidiaries. Interestingly, the Federal Reserve's position was not based on safety and soundness concerns, because I think the Fed recognized that safety and soundness considerations were probably not affected by that choice of format. The Fed's argument was based instead on the notion that banks enjoy a safety-net subsidy that is somehow more easily spread to subsidiaries than it is to affiliates, and that is a matter of public policy. According to this logic, the format for new activity should be limited to the holding company affiliate in order to dampen the spread of the subsidy.

There is very vigorous debate over whether any subsidy exists, particularly when the costs of bank regulation are taken into account. The Fed's argument, furthermore, fails to recognize that whatever subsidy does exist is no more easily spread downstream to a subsidiary than upstream to a holding company. We thought, particularly in light of the capital haircut that we would provide for investments in subsidiaries, that there was no difference at all in a bank's ability to transmit whatever subsidy value may inhere in its retained earnings either by dividends to its parent or by capital contributions to its subsidiary.

I have consciously emphasized expansion of the *financial* powers in affiliations of banking organizations, but that leaves aside the question of what *non*financial activities might be open to banks. This is an important question for at least three reasons.

First, many insurance, securities, and diversified financial services firms already engage, to some generally quite modest degree, in nonfinancial activities. American Express, for example, owns a travel business. Fidelity Investments, for one reason or another, owns a limousine company. (I always had a picture of them picking up potential mutual fund investors at Logan Airport and taking them downtown.). For some reason, Goldman Sachs owns bowling alleys. Some of the big insurance companies have interests in healthcare companies. If we want to get these companies in under the tent—that is, to provide a common set of ground rules for different providers of financial services—we cannot expect them to abandon completely an important part of their present franchise.

Another good reason exists to confront the question of the relation between banking and commerce. Companies that own only a single federally insured thrift institution have no limits at all on their ability to engage in nonfinancial activity. And while there are only a relatively few so-called unitary thrift holding companies that have any appreciable degree of nonfinancial activity, the absence of holding company activity restraints on those companies provides a far broader market for thrift stocks than is true respecting banks. If we want to rationalize regulation and provide a common set of ground rules for affiliations with depository institutions, we have to take account of that disparity in some reasonable way. That is not to say that we have to take down all the limits on nonfinancial activities.

The third reason for addressing this issue is that it is increasingly difficult to define in today's marketplace what is financial and what is nonfinancial, given the complex information- and technology-driven economy that we have. Businesses with financial activities should not be required to live under the threat of divestiture or other penalty for making a misjudgement about the nature of their activities. Nor should they be precluded from realizing the benefit of efficiencies that are possible where financial systems and technology can have nonfinancial application.

We had a presentation from Dean Witter as we were considering this legislation that described to us the credit card servicing operation that they put together in connection with the Discover Card, their highly successful credit card. They have large numbers of people who operate their 800 telephone system dealing with complaints and inquiries from credit card customers. They found that by using those same people and phones and with only a little more training they could also do catalog sales for Eddie Bauer and operate Mobil Oil's Auto Club. I thought that was a particularly compelling example of how technology developed for a financial purpose could have a very benign application in the nonfinancial area.

This so-called banking and commerce issue is not really susceptible to easy, rational discourse. Those who believe that banking and commerce should be separated often express a deeply held philosophic feeling on that score, and those who believe that there should be no prohibitions at all on banking and commerce are hard pressed to answer the question, "Who really wants this?" There clearly is not an enormous clamor in the marketplace to eliminate entirely the barriers between banking and nonfinancial activities. Even when a mixing of banking and commerce was fully possible—that is, up until 1970—we never saw much interest in affiliations between banks and purely commercial or industrial firms.

The experience with the unitary thrift holding company bears that out. While a handful of diversified nonfinancial companies own thrifts, there are relatively few—no more than ten of those thrifts—that are over a billion dollars in size. The notion that if we take down these barriers we are going to open the floodgates to a Keiretsu-type economy is not based on experience.

But in light of these realities, the Treasury Department, seeing a linkage between the banking and commerce issue and the disposition of the thrift charter, proposed a choice for Congress. We thought that if Congress was willing to allow banks to engage in a relatively modest basket of nonfinancial activity, together with liberal grandfathering of existing unitary thrift holding companies, a framework for unifying the regulation of banks and thrifts would emerge. That is, if going forward, a person could permit owners of a unified depository institution to have some modest amount of nonfinancial activity (and we did not try to define what that should be), then we could accomplish an elimination of a separate thrift charter and a merger of thrift charters with banks. On the other hand, if Congress was unwilling to allow any such leeway with banking organizations, we believe that Congress should also retain the thrift charter as it is so that it preserves the existing means that diversified financial services companies have to own federally insured depository institutions. Of course, thrifts are virtually indistinguishable from banks to the general public and even as a legal matter they are becoming increasingly indistinguishable.

The choices that we posed (and we do not have any ability to dictate to Congress the choices that they may want to consider) drew the banking and commerce issue in sharp focus, particularly for those who adamantly oppose any mixing of banking and commerce. They generally fear that the consequence of failing to define a specific basket of acceptable nonfinancial activity—or more to the point, the consequence of no legislation at all—would be to preserve the enormously flexible thrift charter and the unlimited range of activities permissible for thrift holding companies. My assumption is that in the absence of some basket that, together with grandfathering, would accommodate a unification of bank and thrift regulation, political support for any stand-alone proposal to curtail the powers of the unitary thrift holding company would evaporate.

Indeed, while most observers thought early in the game that the obstacles to achieving financial modernization would come from the various components of the insurance industry and from small community banks, it now appears that opposition from the thrift industry is likely to create the most formidable obstacle to achieving legislation on the model that appears to be acceptable to both the House Banking and Commerce Committees. Such a mutually acceptable model might involve elimination of a separately regulated thrift industry while providing some grandfathering for unitary thrifts and some defined basket of permissible nonfinancial activities for at least some bank holding companies going forward.

The thrifts believe that the thrift charter has highly desirable flexibility, and I think that is hard to contest. Despite the thrift debacle of the 1980s, no history of problems can be attributed to the unitary holding company format. Moreover, the nationwide branching and preemption advantages that federal thrifts enjoy are extremely attractive. They believe that anything less than the full highest common denominator approach to financial modernization (that is, an approach that would unify the bank and thrift charters and regulation in a way that would preserve all the benefits of the thrift charter) would be a step backwards. In fact, the thrifts would still be unhappy if Congress was willing to take a highest common denominator approach, because they assume that all future regulation of bank holding companies, whatever the range of their powers, would be given to the Federal Reserve. Thrifts, as well as the diversified financial services companies that own or want to own thrifts, do not view the Fed, with its rather cumbersome application proceedings and holding company capital requirements, as fondly as they view the Office of Thrift Supervision. They have not gotten to know my friend and fellow panelist Tom Hoenig as well as I have.

It has also become increasingly clear that if there is no legislation in the current Congress, thrifts and the diversified financial services firms that own or want to acquire thrifts will be the big winners, and banks will be the losers. Banking organizations will be denied the broad new authority to expand their financial activity that seems to be taken for granted in the legislative process so far. Both the House Banking and Commerce Committees have approved formulations that would significantly expand the financial powers of banking organizations. If there is no legislation, banking organizations will have to make due with the limited ability they have to sell insurance and securities under present law and with whatever might emanate from the Comptroller of the Currency's so-called Part Five Initiative. The full potential of Part Five will not be known for a number of years until the inevitable litigation is all resolved. In the meantime, the thrift charter will increasingly be turned to by insurance and securities firms that will recognize its utility as a point of entry into the business of depository institutions. The more invested in the thrift charter the diversified companies become, the more difficult it will be in succeeding Congresses to achieve the kind of legislation we proposed, because by then interest will have shifted. Paradoxically, the biggest losers are likely to be those who have been most hostile to financial modernization legislation—the independent bankers, the banking hard-liners, and to some extent the Federal Reserve itself—who will find that the financial services industry has passed it by in favor of entering the banking industry through the means of the thrift charter.

Question for Secretary Hawke from Professor David Oedel: Your remarks invite consideration of the recent Korean experience with universal banks—that is, banks that are involved with both commerce and the traditional banking business. At least in the Korean experience, such institutions appear to be rather susceptible to serious and quick problems. Could that be a concern in the United States if there were to be some kind of a marriage of commerce and banking?

Response from Secretary Hawke: I think you have to recognize that the culture and history in Korea and Japan is quite different in structure from what we have here. In Japan, for example, the lead banks in the Keiretsu or diversified organizations have an accepted obligation that the government puts moral suasion behind to support their related company. We have never had anything like that. We have never had any movement toward a real mixing of commercial and industrial interest with banking interest. Up until 1970, when the Bank Holding Company Act of 1956 was amended, anybody could own one bank, or before 1956, any number of banks. Yet we never saw any movement at all toward a mixing of nonfinancial and banking interests. What we saw, and what caused more legislative action than anything else, was financial conglomeration. It was the other financial activities of insurance companies that fell under the same umbrella as banks that really motivated restrictive legislation. Much of that legislation was spurred by competitors that did not want to see banks get into their business rather than philosophical reasons or safety and soundness. Certainly one cannot deny that if you take down all of the barriers, the Korean or Japanese models could theoretically exist, but I think that is really nothing more than theory given the history of our structure.

Question for Secretary Hawke from Professor David Oedel: I have a second question related to the reasons behind the failure over many years to enact financial services modernization legislation. Why has that been? Is it a political stalemate problem? Is it that industry groups have veto power? Is it a lack of consumer interest? What are the prospects in the future?

Response from Secretary Hawke: Ever since the Glass-Steagall Act of 1933 we have had a set of laws that divided markets. If you are the beneficiary of market division, it is generally something you want to preserve. What has happened in more recent times is that regulators—banking regulators in particular—have enabled banks to escape some of the rigors of that market division. The Fed, through its rulings under Section 20 of Glass-Steagall, has allowed banking organizations to get into a fairly significant amount of securities activity. The Comptroller of the Currency has found ways to expand the insurance activities of banks. And insurance and securities firms now see that is something of a one way street. One of the reasons they are changing is that securities firms now see that it is in their interest to rationalize these rules so that they have equal opportunity to get into the banking business.

And that brings me to the second reason to be optimistic about the prospects for legal reform: what is happening in the marketplace. Consumers of financial services are no longer drawing distinctions between various types of investment products. They do not see huge differences between variable annuities, mutual funds, certificates of deposits, and other kinds of financial products. These are all different points on the spectrum of financial products, and they do not want to have to go to a whole variety of different financial services to get what they need. I think this is becoming increasingly true as people have more and more control over their own retirement investments, for example. In short, legal reform is possible today because the market is helping to drive this and competitive realities are changing attitudes.

Question for Secretary Hawke from Professor David Oedel: So you are not pessimistic. Do you think there is a chance for legislation this year?

Response from Secretary Hawke: The irony is that the banks are the biggest laggards in the legislative process. It is really being driven by the securities and insurance firms who want to find a way to get into the banking business or at least have equivalent opportunities. And the paradox in my view is that if there is no legislation, the banks are going to end up being the big losers because there is going to be a big switch to the thrift charter and the securities and insurance firms are going to exploit the thrift charter as a way of getting into the business of depository institutions. The landscape will have changed so much by the next Congress that banks will be struggling along with these regulatory exceptions that they have now, but they will not be the beneficiary of a broad expansion of their ability to engage in financial activity.

Question for Secretary Hawke from Professor David Oedel: Are you suggesting that we may be on the brink of creating a new banking crisis, but this time with the banks rather than the thrifts?

Response from Secretary Hawke: Not at all. No, I do not see any banking crisis at all. The banking and thrift industries both are in the strongest condition they have ever been in. What I am saying is that from a competitive point of view there is a certain smugness in the banking industry, as if the banks were saying, "Why do we need legislation after all? We can do some securities activities, we can sell some insurance." I think that is very short sighted, because the insurance and securities firms can get into the depository institutions business by acquiring thrifts.

The federal thrift charter is fabulous. It can branch any place in the country. It has better preemption rights with respect to state laws and even national banks for reasons that are attributable to court decisions. And for anybody doing a nationwide retail consumer finance type business, a federally chartered thrift is ideal. A big movement will emerge, and we are already beginning to see it, toward ownership of thrifts. The public cannot tell the difference between a thrift and a bank. Legally their powers are almost indistinguishable; in the absence of rational legislation, the thrift charter will become the charter of choice. Banks will be left struggling with what they have.

Question for Secretary Hawke from Professor Heidi Schooner: To what extent was your proposal based on functional regulation? What would the likely effect on functional regulation be if distinctions between functions were increasingly blurred?

Response from Secretary Hawke: That's a good question. We do have separate regulation of depository institutions and securities firms at the federal level, and we have got state regulation of insurance. While the lines may be blurring, we have not proposed to change radically that system of regulation. We have taken the view that comparable activity ought to be comparably regulated, and that if banks engage in securities activities or insurance activities those activities ought to be regulated in the same way as their competitors in the insurance and securities fields.

The difficulty comes in dealing essentially with historic anomalies. Banks have been able to engage in certain securities activities within the bank, and the real question is how vigorous do we want to be in forcing a change in existing patterns of activity? Is that necessary to achieve true functional regulation? That is one of the points of conflict in the process. With insurance, it is not so much a question of regulation, it is a question of how you define the activity. It is very difficult, in some cases, to distinguish certain banking products from insurance. The insurance interests are concerned that banks are able to do what is essentially insurance underwriting in the bank in the name of some kind of deposit taking and that they will have a significant competitive advantage. I think our proposal, which would allow banks to engage in expanded insurance and securities activities through wholly owned subsidiaries, is really an answer to that, because it takes away a lot of the incentive to fight about whether an activity is insurance or not. If you can do it in a subsidiary, it is probably going to be cheaper and more efficient to do it there than to argue about whether or not it is insurance. But those are the points of conflict.