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**FREEING THRIFTS AND BANKS TO MEET
THE NEEDS OF AMERICA'S COMMUNITIES**

OPTIONS FOR FINANCIAL MODERNIZATION

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The overriding reason for the declining market share of depository institutions is that the existing bank and thrift charters do not offer sufficient powers and flexibility, relative to other financial services providers, to permit banks and thrifts to compete effectively in today's marketplace. For example, commercial banks are generally not permitted to affiliate with securities and insurance companies. Thrifts face a different set of problems; they are sharply restricted in the amount of commercial and consumer loans they can originate. Moreover, both thrifts and banks are subject to a level of federal regulation that far exceeds what other financial institutions face.

On the Hill, various financial modernization bills have been proposed. One bill would authorize commercial banks to affiliate with securities and insurance companies, subject to certain firewalls. However, this bill is bogged down in disputes over the extent to which commercial banks should be allowed to sell insurance at the depository institution level. Moreover, even if the bill were enacted, commercial banks would still be at a disadvantage compared to thrifts, which can affiliate with companies engaged in any line of business that does not threaten safety and soundness.

Another so-called "financial modernization" bill advocated by some, including segments of the banking community, would force all federal thrifts to convert to commercial banks. Ironically, this bill would expand the commercial and consumer lending authority of federal thrifts, thereby making it easier for thrifts to compete with banks in the same line of business. In exchange, however, thrifts would be stripped of other important powers, such as the power to affiliate with companies engaged in diverse financial and commercial enterprises and the power to sell insurance through service corporations. Most thrifts oppose the trade-off of broad affiliation powers for expanded commercial and consumer lending authority. They find it hard to understand why they must give up profitable and safe businesses in order to make more loans.

Clearly, if financial modernization is to be achieved, new approaches are needed.

An ideal solution for financial modernization would be to combine the best features of both the commercial bank and thrift charters. But this approach also faces difficulties. Restrictions on the ability of banks to affiliate with diverse commercial companies have historically been based on policy concerns about too much concentration of economic power. If large banking networks were permitted to affiliate with commercial enterprises, some worry that banks would give priority to the operations of their affiliates, thereby making it more difficult for nonaffiliated companies to obtain credit and other banking services or to compete with bank affiliates. For these reasons, some have long opposed commingling commercial banking and commerce. Given these policy concerns, a comprehensive merger of the bank and thrift charters is probably unattainable at this time.

But this should not stop us from pushing for modernization in ways that do not raise these policy concerns. The objections to mixing banking and commerce arise in the context of large-scale commercial lending; the fear is that large commercial or industrial companies will combine with huge banks and that the commercial credit these companies can obtain from their affiliated banks will provide an unfair advantage over their commercial or industrial competitors. But the vast majority of depository institutions today are community banks and thrifts that do not engage in large-scale commercial lending. For example, nearly 2/3 of all banks and thrifts have assets of less than \$100 million, and over 90% have assets of less than \$500 million. These institutions, which are nearly always locally owned and managed, provide vital credit and financial services to their local communities. They are frequently located in the small towns and less populated areas that are often passed over by the megabanks. They understand their communities' economic needs and know their customers as individuals. Moreover, because these institutions closely identify with, and have strong ties to, their communities, they are often in the forefront in their support of civic programs and activities that enrich the quality of community life. They sponsor

the local softball team, buy advertising in the high school play program, and contribute to the volunteer fire department. This community spirit is illustrated by a story I recently heard of a small thrift that led the way in constructing a new economic development facility for its local community.

Mutual thrifts, in particular, exemplify the locally-based nature of these institutions, because their depositors, in essence, own the institution and direct its operations. There are still nearly 600 mutual thrifts in this country whose unique community ownership is a positive attribute. We hear complaints from these mutuals that they are being pressed by professional depositors to force their conversion to stock institutions in order to be sold to the highest bidder, many times to an out-of-state financial institution. This may serve to boost the net worth of professional depositors, but it may do so at the expense of the local community's control over its financial institutions.

Many policy makers are concerned that community-based depository institutions are an especially endangered species, given the trend toward consolidation -- a trend that is driven in part by the need to increase economies of scale to compete with less regulated financial services providers.

Yet I have to believe that it must be possible to find ways to enable community-based institutions to compete more effectively in our modern economy, while still preserving the line between banking and commerce. Let me take a few minutes to flesh out what a modern community bank charter might look like.

II. A NEW COMMUNITY BANK CHARTER

A. Powers of the Community Bank

Let's begin by considering what products and services a community bank should be authorized to provide, either directly or through affiliated entities. The

objective would be to deliver financial services needed by the individual consumers and small businesses that are now provided by small local banks and thrifts. The goal could be met by combining the best of the current bank and thrift charters. This suggests the following array of powers:

- First, a community bank should be able to offer the full range of credit products needed by the typical American household, including home mortgages, home equity loans, consumer loans, education loans, and credit cards. (Currently banks can offer these products without restriction, whereas thrifts are limited in the amount of consumer and education loans they can hold.)
- Second, a community bank should be able to engage in retail sales of insurance products. Most families view insurance as an essential component of their financial planning. It simply doesn't make sense to impede consumer access to insurance. (Currently banks can sell most types of insurance from offices located in towns of less than 5,000, whereas thrift insurance sales are not limited to towns of less than 5,000.)
- Third, a community bank should be able to engage in retail sales of investment products, including securities brokerage and investment advisory services. As I noted at the outset, many consumers view uninsured products as an essential part of their financial planning and are increasingly relying on them. (Both banks and thrifts can already do this.)
- Fourth, a community bank should be able to make unlimited small business loans, but be subject to certain limits on other commercial loans in order to draw the line between commerce and banking. I will elaborate on this point in a moment. (Currently banks can offer commercial loans without restriction, whereas thrifts are sharply limited.)

- Fifth, a community bank should be able to engage in reasonable amounts of real estate development and management to aid in the rebuilding of their communities. (Currently thrifts can do this to a significantly greater degree than banks.)
- Finally, community banks should be permitted to affiliate with holding companies engaged in a broad array of business enterprises, as is currently the case for thrift holding companies. Because community banks, like thrifts, do not present banking and commerce concerns, there is no policy reason for interfering with the market's judgment as to what affiliations make good business sense and offer profitable synergies.

It is important to emphasize that none of these proposed powers are new for depository institutions. A community bank charter would simply combine the best features of the current bank and thrift charters. The goal is to enable community banks to be efficient providers of financial services to consumers and small businesses, and to use their knowledge of their locality to serve the funding needs of their communities.

B. Limitations on the Community Bank

Of course, we must deal with the question of what limitations might be imposed on community banks to avoid policy concerns about commingling banking and commerce and to ensure that they remain focused on their communities. One approach would be to limit the size of the institutions that can adopt and retain a community bank charter. Any such limitation, however, is apt to be perceived as arbitrary, especially given the varying sizes of communities. What would be an appropriate size limitation for Woodstown or Mays Landing, would be unduly restrictive if applied to an institution in Cherry Hill or Philadelphia. It could also be unfair to institutions that grow because of excellence in the services they provide and their operating efficiency, and over time the size limitation would become outdated.

A better approach could be to limit the commercial lending authority of community banks. Under this scenario, the community bank charter would be restricted primarily to residential, consumer and small business lending, with authority for other types of commercial lending being restricted.

At present, federal thrifts can only invest 10% of their assets in commercial loans. Although this limit is probably too low, some type of hard cap on commercial lending might be appropriate. However, this cap should not apply to small business loans. In other words, community banks should be able to make an unlimited amount of small business loans, but not be permitted to invest more than a relatively small percentage of their assets in large-scale commercial loans. This would ensure that banking and commerce would not combine and result in an undue concentration of economic power and that community banks would remain focused on residential, consumer and small business lending. Any bank or thrift willing to operate under this commercial lending restriction would be able to elect to operate as a community bank.

III. CONCLUSION

The enhanced flexibility of this type of community bank charter would enable depositories to compete more effectively with other financial services providers and would likely translate into stronger profits and capital, thereby reducing risk to the federal deposit insurance funds. Moreover, it would also permit each institution to determine the specific products and services it wishes to offer, in order to better serve its current and future customers. One of the themes I hear from thrift executives is the need to develop a market niche -- each institution has a unique set of circumstances and competitive pressures. This concept allows an institution that wishes to focus primarily on mortgage lending to continue to do so, another to concentrate on auto loans, while those that wish to diversify could do so. In this way, the future of depository institutions can be determined by the market, rather than by legislative decree. A market driven approach to banking activities should be one of the linchpins of charter reform. With a rapidly changing market place and constant

of charter reform. With a rapidly changing market place and constant improvements in technology, a charter needs to be flexible if institutions are to compete effectively.

I acknowledge that bank modernization of any type faces difficult political hurdles. But if we can at least begin to move toward agreement on policy objectives, perhaps the politics can be worked out.

The main point is that banks and thrifts ought to start working together to find creative legislative solutions to the common problems that threaten the long-term survival of both, rather than expending their energies fighting each other. They should seek to combine the best features of both charters, rather than to eliminate each other's perceived advantages. The real challenge for the future is to compete more effectively with non-depositories.

We should use the opportunity presented by the current discussion of financial modernization to flesh out the various facets of banking that need to be updated. *Giving banks and thrifts the flexibility to handle their communities' financial business* is an area that bears further discussion and one where you, as local bankers, should make your views known. I would be interested in your reaction to this concept.

I. THE CURRENT DILEMMA

I would like to thank Congressman Lobiondo for the invitation to speak to you this morning. I have been asked to comment on the future of the thrift charter. But I would like to broaden the focus of my remarks to address the future of both the thrift and commercial bank charters. I believe the most fundamental challenge facing both banks and thrifts over the next decade is not how well they can compete with each other, but how effectively they compete against other, less-regulated financial services providers.

Those of you who studied classical history will remember that, about 2500 years ago, Greek civilization reached its height, producing some of our most valued intellectual, artistic and literary heritage. However, you may not remember that the decline of Greek civilization occurred primarily because its two most powerful city-states, Athens and Sparta, for decades engaged in useless and destructive warfare. Meanwhile, neighboring Macedonia grew more powerful and steadily expanded its territorial reach. Ultimately, the Greeks were overrun by the Macedonians. In truth, however, the Greeks defeated themselves.

What does this have to do with banking? I see a similar situation occurring among depository institutions. While banks and thrifts continue to battle one another on the legislative front, their combined share of the financial services market is steadily declining. This is occurring because other less regulated financial institutions (including mutual funds, securities and insurance companies and mortgage bankers) can offer a wider array of products and services at less cost. For example, in 1980 1/3 of the financial assets of individuals were held in bank and thrift deposits; by 1995 that portion declined by nearly half, to 18%. Meanwhile, during this same period the proportion of financial assets of individuals held in mutual funds nearly quadrupled, from 2.3% to 8.8%.

If banks and thrifts wish to avoid the fate of Athens and Sparta, they must join together to seek the legislative reforms vital to their survival.
