NORTH CAROLINA BANKING INSTITUTE

Volume 3 | Issue 1 Article 4

1999

The Future of Nonbank Depository Financial Institutions

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ARTICLES

THE FUTURE OF NONBANK DEPOSITORY FINANCIAL INSTITUTIONS

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I. INTRODUCTION

Imagine, if you will, 1959. Elvis Presley is performing with Frank Sinatra on *The Ed Sullivan Show*. Eisenhower is in the White House. Financial services are neatly divided by charter. Banks offer personal and business loans; thrifts offer home loans; credit unions are tied to their single employer and offer unsecured personal loans; securities are bought and sold by brokers for the wealthy; and insurance is sold by the friendly neighborhood insurance agent who lives down the street. Deposits are insured to $10,000; interest on savings deposits are fixed. The certificate of deposit has yet to be invented. Credit cards are an idea in the imagination of a few. There is a bank or savings association on most corners of Main Street, USA. There are no drive-up windows, ATMs, or Saturday hours.

Quite a contrast to 1999. Over 50% of all U.S. households own a personal computer.[1] The Internet reaches over 50 million households.[2] Stocks are bought and sold by individual investors over the Internet via E-Trade and other online brokerages. Commerce over the Internet reached $8.6 billion over Christmas 1998.[3] Books, music, flowers, travel, toys, clothes are all available 24 hours a day via the Internet and a credit card. PC banking attracts both the young and the

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† General Counsel, America's Community Bankers. Please note that while much of the following is consistent with ACB's legislative position and draws on testimony presented in congressional hearings, it has not been officially reviewed and is solely the opinion of the author.

1. *See* KPMG PointCast, *Half of All U.S. Homes Now Have a PC – Survey* (Feb. 9, 1999) (visited Feb. 9, 1999) <http://pioneer.pointcast.com>.

2. *See* Brett Chase, *Bank One CEO Bets $500M On Internet's Sales Potential*, AM. BANKER, Feb. 22, 1999, at 5.

3. *See id.*

old due to its 24-hour availability. Home loans, car loans, unsecured credit are all available via a telephone call, mail solicitation, or Internet inquiry. Insurance is an adjunct to the loan application process. Consumer ease and convenience drive the offering of financial services.

The difference between revolution and evolution is that you know when you are in a revolution. Yet given the pace of change, the case can be made for declaring the current financial services marketplace both a revolution and an evolution. It is the result of an evolving consumer revolution of financial services. Credit unions offer business loans, personal loans, car loans, credit cards, and home loans. Banking is no longer a checking account. Banks offer financial planning services including investments and insurance. Need trust services? Call your local savings and loan or your insurance company. Delivery channels and consumer convenience, not charter, drive the offering of financial services.

II. CHARTER IRRELEVANCY AND THE LEGISLATIVE PROCESS

Yet against this backdrop of charter irrelevancy toils the legislative process. Financial reform, whether reorganizing the federal regulation of savings associations, eliminating Glass-Steagall, trying to eliminate regulatory overlap of banking and its tug of war between agencies has been studied since at least 1969.[4] Yet after three decades of study, hearings, market change, and major crises in financial services, the United States has yet to repeal Glass-Steagall or reform the regulation of financial services beyond the heady "preventative" legislation that was FIRREA.[5]

Why? It's as if all the parties involved were gathered in a circle shooting water pistols at each other. No one gets hurt, but everyone gets wet. Treasury and the Federal Reserve shoot at each other over affiliate versus subsidiary issues and who regulates the business of banking. Securities firms shoot at banks because banks have more flexibility to affiliate with other, but closely related to,

4. *See, e.g.*, IRWIN FRIEND, STUDY OF SAVINGS & LOAN INDUSTRY (1969).

5. *See* Financial Institutions Reform, Recovery & Enforcement Act of 1989, Pub. L. No. 101-73, 103 Stat. 183-553 (codified in scattered sections of 12 U.S.C.).

banking entities and securities firms cannot buy banks.[6] Insurance companies juggle their tentative truce with insurance agents and target banks because the Supreme Court said that banks can offer insurance from places of less than 5,000. Banks target savings institutions because the unitary charter is more flexible in its alliances than the banking holding company structure. Everyone targets credit unions unless they think they can sell them a service. And Congress sits in the middle.[7]

III. THE FUTURE OF NONBANK DEPOSITORIES

So what is the future of nonbanking depositories? First, the difference in nomenclature will disappear. A bank is an insurance agency is a savings institution is a brokerage is a trust department is a credit union. They are all pieces of the financial services industry. Consumers will think of all of them as banks. Savings banks and savings institutions have quietly incorporated the word "bank" in their names over the last ten years. Even credit unions use the word bank in their advertising. And why not? The consumer does not care whether the entity is a bank or a savings institution or a credit union. Are the deposits insured? What products and services are available and when? These are the more important questions, not the charter type.

Second, the industry will divide into diversified financial services companies and niche players. It does not matter to consumers whether it is a thrift, a bank, or a credit union that they use to get a mortgage, credit card or car loan so long as the service and terms offered are competitive. The services offered by the separate charters will become, and already are, indistinguishable.

Third, competition will continue to cause consolidation in the number of financial services firms. In 1985, there were over 5,000 federal savings associations regulated by the Federal Home Loan Bank Board. In 1999, there are approximately 1,300 regulated by the

6. *See* Letter from Arthur Levitt, Chairman of the Securities and Exchange Committee, to Senator Phil Gramm, Chairman of the Committee on Banking, Housing, and Urban Affairs (Feb. 4, 1999) (on file with the *University of North Carolina School of Law Banking Institute*).

7. *See* Daniel Parks, *Fuzzy Battle Lines Complicate Effort To Overhaul Financial Services*, CONG. Q. WKLY., Feb. 27, 1999, at 491, 491-93.

Office of Thrift Supervision.[8] While the upheaval of the 1980s caused the demise of many, consolidation has been and continues to be a reality of the marketplace, although there is a current slowing in the rate of consolidation that may be attributable to Y2K concerns.

Fourth, electronic delivery of financial services will accelerate the market's shift into a new competitive paradigm of which we are only beginning to see the outline. Investments into brick and mortar may be replaced by investments in cyberspace and smartcard technology that may advance the business of banking to a new plateau. There will still be the brick and mortar institutions, but they will play a niche role in the competitive landscape.

Fifth, the financial services legislation pending before Congress is completely irrelevant to the final outcome of the evolving revolution of financial services. The market and consumers have already moved on.

While Congress can't change the eventual result, it can and does affect the rate and cost of change.

IV. FINANCIAL REFORM

A. Financial Services

With this in mind, what can Congress do to ensure that banking has a substantial role in the future of financial services? It can do the following:

1. Merge the insurance funds. Merging the funds makes logical, actuarial, and financial sense. The FDIC supports it, the other federal banking agencies support it and the market place supports it. Many individual banks own both SAIF- and BIF-insured funds. Delay only perpetuates administrative duplications and stretches out the inevitable. Merger makes sense.
2. Eliminate the SAIF Special Reserve. Any diversion

8. *See* Office of Thrift Supervision, *Holding Companies in the Thrift Industry* 2 (April 1997) (visited Feb. 24, 1999) <http://www.ots.treas.gov/docs/48031.html> [hereinafter *Holding Companies*].

of monies from the insurance funds makes no sense. This provision was pure punitive revenge for FICO sharing. Public policy dictates elimination of this fund.
3. Clarify and expand national bank powers on affiliations and product offerings. Banks should have confidence that they can offer insurance products without protracted litigation exposure or unnecessary limitations. Provide banks with the flexibility to choose whichever corporate structure works best in their communities for the offering of a diversified array of financial products and services. No one structure, subsidiary, or affiliate should be arbitrarily mandated.
4. Adopt a modern structure for the Federal Home Loan Bank System that provides voluntary membership for all members and provides permanent capital for the System. Expand both the membership and the type of collateral that qualifies as security for advances. Financial institutions should have access to the liquidity of the System on an equal and voluntary basis.
5. Leave thrifts and their holding company structures alone. The goal of financial modernization legislation should be to improve existing charters and holding company structures without reducing any competitive options and consumer choices. Just as there are more flavors of ice cream than vanilla, strawberry, and chocolate, there is no reason to require all financial services to be delivered from one or two charter types. Indeed, such an effort contradicts consumer choice and inhibits competition.[9]

B. *Charter Choice and Operating Trade-Offs*

Because the charter, particularly the unitary charter, has

9. *Hearings on the Financial Services Act of 1999 Before the House Comm. on Banking and Financial Services*, 106th Cong. (1999) [hereinafter *Beard Testimony*] (testimony of E. Lee Beard, Chair of America's Community Bankers and President and CEO of First Federal Bank of Hazelton, PA) (on file with the *University of North Carolina School of Law Banking Institute*).

become a lightning rod for criticism in the current legislative debate, it is important to delve behind the rhetoric and sound bites and understand the benefits of the different charters. Members of the savings institution industry represent a wide selection of charter types including federal and state, mutual and stock, converts from credit unions, and new corporate entrants from the world of insurance and securities along with commercial firms. This level of diversity allows the savings industry to speak from experience on the value of choice and flexibility in charter and charter powers. Participants choose their corporate form based on business decisions as to what will best serve their customers and communities - not on Washington-based dictates that are not related to the local market.

Parts of the financial industry - thrifts and mutual funds, for example - are already structured to take advantage of the evolving modernized financial services marketplace. Commercial banks and bank holding companies (BHCs) have been left behind in some respects. They face significant limitations on their ability to offer financial services beyond what has traditionally been called banking. The Glass-Steagall Act hampers affiliations between the banking and securities industries. Although the Federal Reserve has loosened Glass-Steagall substantially, the law remains an anti-competitive anachronism. Bank holding companies may only acquire securities firms that fit within arbitrary size limits, while major securities firms are unable to acquire banks.

Similarly, the Bank Holding Company (BHC) Act does not permit banks to affiliate with insurance underwriting companies. Beyond that, the BHC Act limits banks to affiliations with firms "closely related" to banking. Banks that wish to sell insurance products face a patchwork of state and federal statutes, as well as court and agency interpretations that sometimes permit and sometimes prohibit insurance activities.

The current legislative proposals both increase and reduce the competitive flexibility of banks and BHCs in various ways. The 1999 version of H.R. 10 as introduced goes in just one direction for thrifts and their holding companies - backwards. It would limit new unitary thrift holding companies to strictly financial activities and prevent existing unitaries with commercial activities from changing ownership.

Over 875 unitary charters would be frozen in time and flexibility.[10]

This is most certainly *not* an issue that concerns just a handful of big companies trying to "get into banking" through the thrift charter. Even Alan Greenspan, Chairman of the Federal Reserve Board, noted in his February 1999 testimony that the recent applicants do not represent "as yet any major breach into the commercial area" because most of the firms seeking the unitary charter are financial companies.[11] In addition to insurance firms, trust interests and securities firms, bank holding companies may also operate saving associations. For example, Citigroup does much of its "banking" outside of New York through a thrift. Similarly, a commercial bank in Iowa converted to a thrift and is now opening branches in its parent holding company's grocery stores.[12]

In exercising these choices, there are logical tradeoffs involved. For the unlimited commercial lending authority provided by the banking charter, an institution cannot affiliate with commercial firms. For the affiliation rights provided by the thrift charter, an institution must strictly limit its commercial lending, among other limitations of the Qualified Thrift Lender Test.[13] The decision is the institution's to make. Consumers, businesses, and communities all benefit from the diversity of services that results from these individual decisions.

Home buyers are another beneficiary of charter choice. Thrifts maintain a high percentage of their assets in mortgage loans and related securities - 73.7% for thrifts owned by non-banking companies, 70.6% for thrifts as a whole. By contrast, banks have only 32.6% of their assets in mortgage loans and related securities.[14] The National Association of Home Builders and the National Association of Realtors have pointed out that, "thrifts have

10. *See Holding Companies*, *supra* note 8.

11. KPMG Banking Insider, *Greenspan Q & A - Banking System, Regulation* (Feb. 23, 1999) (visited Feb. 23, 1999) <http://www.us.kpmg.com/fs/insider> (question and answer session after the first leg of Federal Reserve Chairman Alan Greenspan's semiannual Humphrey-Hawkins testimony before the Senate Banking Committee).

12. The bank was the Principal Bank in Des Moines, Iowa.

13. *See* 12 U.S.C. § 1467a(m) (1994). *See also* Office of Thrift Supervision, *Historical Framework for Regulation of Activities of Unitary Savings and Loan Holding Companies* 7-8 (visited Feb. 24, 1999) <http://www.ots.treas.gov/docs/48035.html> [hereinafter *Historical Framework*].

14. *See generally Beard Testimony*, *supra* note 9.

demonstrated a pattern of . . . serving low- and moderate-income borrowers. In many markets, thrifts are the leading source of residential construction and development loans."[15]

Unfortunately, there are those who would severely limit unitary thrift holding company affiliation rights for companies that had not applied for a charter by October 7, 1998.[16] Some of those firms might be satisfied with the improvements in the bank holding company structure provided by the legislative proposals. Others might not, and some of the applicants would not qualify for a bank charter. There is no reason to cut off this successful, market-tested business option as of October 7, 1998, or any other arbitrary date.

C. *The Overworked Concern with the Commingling of Banking and Commerce*

In addition, the current version of H.R. 10 would prohibit existing thrift holding companies with non-financial affiliates from being acquired by other firms. The only exception to this proposed statutory ban would allow acquisitions by the limited number of grandfathered thrift holding companies. All other firms - financial firms and non-grandfathered commercial firms - would be barred by law from acquiring a grandfathered unitary thrift with non-financial affiliates.[17]

These artificial constraints on mergers, acquisitions, and divestitures would decrease the franchise value of existing holding companies and reduce economic efficiency without any substantive public policy justification. Prospective thrift holding companies would also lose business options because of newly imposed limitations.

These proposed limitations have been justified by the ballyhooed cry concerning the mixing of banking and commerce. The facts paint another story. Unitary thrift holding companies *do not* mix banking and commerce in any meaningful manner. Thrifts *may not* lend to commercial affiliates *under any circumstances*. And, thrifts' permissible commercial lending is strictly limited to 20% of assets,

15. Joint Letter from the National Association of Home Builders and the National Association of Realtors to Congress (June 12, 1997) (on file with author).

16. *See* H.R. 10, 106th Cong. § 401 (1999).

17. *See id.*

half of which must be small business loans.[18]

The Office of Thrift Supervision (OTS) and the Federal Deposit Insurance Corporation impose the same tough capital and examination standards on thrifts as those imposed on commercial banks. Protection of thrifts and banks operating in holding company structures is equally as vigorous. In some cases, thrift regulation imposes special requirements; for example, thrifts may not make any loan to an affiliate engaged in activities prohibited for bank holding companies.

While undergoing vigorous supervision, combinations of thrifts and commercial firms have added demonstrably to the stability of the thrifts involved. These thrifts have compiled an exemplary safety and soundness record. The OTS reported that only 0.3% of enforcement actions against thrifts and thrift holding companies from January 1, 1993, through June 30, 1997, were against holding companies engaged in non-banking activities.[19] In short, the industry's experience with well-segregated commercial affiliates has been the opposite of what the critics contend.

V. CONCLUSION

Given the differences between the asset powers of banks and thrifts, Congress should reaffirm these competitive options.[20] Banks must be free to choose the structure that best allows them to serve their communities and consumers. If they wish to maintain the authorities permitted for unitary holding companies, the Qualified Thrift Lender test requires a commitment to housing and consumer lending. Commercial lending authority is limited. On the other hand, if a bank's commercial lending authority is critical to the institution's business plan, then a bank holding company is the structure of choice. It is a trade-off between two desirable business options, rather than forcing a one-size-fits-all government requirement.

Consumer convenience will drive the future of financial

18. *See Historical Framework*, *supra* note 13, at 7-8.

19. *See Holding Companies*, *supra* note 8, at 5; Letter from Robert R. Davis, Director of Government Relations at America's Community Bankers, to Senator Phil Gramm, Chairman of the Committee on Banking, Housing and Urban Affairs 1 (Feb. 8, 1999) (on file with author).

20. *See generally Beard Testimony*, *supra* note 9.

services. It is a future that can have banking as its centerpiece if charter flexibility and choice are encouraged and incorporated into the statutory framework. The reality of the marketplace is that wherever change or innovation is constricted, like a balloon, it will "pop out" somewhere else. The future of financial services is banking's to lose if it falls prey to protectionism and parochial interests. Constrict innovation in banking and it will "pop out" in securities, insurance, or trust.

True financial modernization legislation would strengthen private sector mechanisms that provide credit and other critical financial services. It would expand—not reduce—choices for financial firms by improving the bank charter, while maintaining the thrift charter and holding company structure as an option for firms that choose to pursue a housing and consumer focus. Unfortunately, some of the legislative proposals have been too focused on dividing turf among competing financial industry segments, rather than permitting firms to use all the tools available to best serve their customers and communities. Congress can do better. Consumers and their communities deserve better. The future demands it.