Hon. Henry M. Paulson  
Department of the Treasury  
1500 Pennsylvania Avenue, NW  
Washington, D.C. 20220

Dear Secretary Paulson:

The American Financial Services Association (“AFSA”) commends the Secretary for reviewing the current regulatory structure for financial institutions. AFSA is the national trade association for the consumer credit industry, protecting access to credit and consumer choice. The Association encourages and maintains ethical business practices and supports financial education for consumers of all ages. AFSA has provided services to its members for over ninety years. The Association's officers, board, and staff are dedicated to continuing this legacy of commitment through the addition of new members and programs, and increasing the quality of existing services.

1.1 WHAT ARE THE KEY ISSUES THAT NEED TO BE ADDRESSED IN A REVIEW OF THE CURRENT REGULATORY STRUCTURE FOR FINANCIAL INSTITUTIONS?

The current regulatory structure in the U.S. has developed piecemeal over many decades and will benefit from periodic reviews. We believe the key issues in the current regulatory structure can be summarized as follows:

- Is the regulatory system too fragmented? Should the multitude of separate regulators be consolidated into one or a smaller number with broader oversight over individual institutions, groups with many financial services providers, and the financial markets generally?
- Is the current regulatory system burdensome? Do any regulators over regulate their constituents? Is there a more efficient model for regulation?
- Are any financial institutions at a competitive disadvantage domestically or internationally as a result of the current regulatory system?
- Is the current regulatory structure prompting institutions or industries to consider moving their main office to another location such as London?

1.2 WHAT SIGNIFICANT DEVELOPMENTS HAVE OCCURRED IN THE MARKETS AND HOW HAVE THESE AFFECTED REGULATION OF FINANCIAL INSTITUTIONS?

During the past thirty years the financial services markets have changed in two fundamental ways mostly as a result of the development of electronic commerce.
First, today most financial services flow through interstate commerce. Until about thirty years ago the opposite was the case—almost all financial services were provided and regulated locally. Products and services flowing through interstate commerce cannot be provided efficiently or conveniently if subject to regulation by multiple states imposing inconsistent laws and regulations. State regulation must adapt to this change.

Second, the number and diversity of financial services providers has expanded dramatically. Prior to electronic commerce, financial services providers were generally segmented and segregated from commerce generally and each other. Banks provided most credit, securities companies underwrote and sold most securities, insurers provided most insurance, and everyone else sold or manufactured goods and services. The market has greatly diversified since then. These lines are increasingly blurred as a result of growing market demand for multiple services that can be provided more conveniently by companies the customer already knows and trusts. At the same time, other providers have become highly specialized serving specific customer groups throughout the nation. These market driven developments should be facilitated as much as possible without sacrificing the goals of safety, soundness, honesty and fairness.

1.2.1 Does functional regulation still work efficiently? We believe functional regulation remains preferable to omnibus regulation. The key consideration is how well regulation meshes with the regulated industry. The diversity of financial services providers would not be regulated best by a “one size fits all" model. Our members do not report a trend to merge functional lines into single operating entities. For example, there is no demand or business logic for having a bank also underwrite insurance and sell building materials within the same entity that holds deposits. What the market increasingly supports instead is affiliations between functional providers. Many securities companies and large banks have found increasing demand for access to both securities underwriting and debt financing through one provider. But that is best accomplished by having separate bank and broker-dealer subsidiaries in the same corporate group. We have received no reports from members that functional regulation of separate bank and broker-dealer subsidiaries affiliated in a corporate group results in conflicts or inefficiencies for either the regulated entities or the group. Similarly, many commercial companies report growing demand for financial services by their customers. Those may be provided most efficiently through a bank but in those instances the bank should be a separate subsidiary that only engages in activities that are appropriate for a bank while the commercial parent acts as a source of capital and marketing.

The emerging question is how the affiliates should be regulated along with the bank, broker-dealer or insurer. We believe the most efficient and effective model for the current market is functional regulation of the primary financial services provider combined with regulatory authority over the transactions and relationships involving affiliates. For banks, this model is called “bank centric".
This model is the best adapted to regulate diversified groups and the growing diversity of stand alone financial services providers in the market. Many traditional community banks will continue to prefer regulation by a state regulator while larger multistate banks might elect to be chartered by a federal regulator instead. State charters continue to provide a multifaceted laboratory to innovate new kinds of products and services in a controlled environment and manageable scale. Broker-dealers do not want to be supervised by bank regulators because the bank regulators do not understand the securities business as well as the Securities and Exchange Commission ("SEC") and state securities regulators. The regulatory conflicts reported by our members relate to cross industry regulation and the imposition of regulatory standards adapted to one kind of business on a different business.

1.2.2 Does functional regulation adequately address overall risk to the financial system? There is no simple answer to this question. Functional regulators do not regulate more than the industry they oversee and affiliated entities, but ensuring their safe and sound operation contributes significantly to the overall health of the financial system and the economy generally. Regulation of holding companies and affiliates is clearly appropriate to the extent that is needed to ensure the safety and soundness of the regulated entity.

We are aware of no evidence that traditional bank holding company regulation is needed or contributes significantly to the stability of the financial system. Activities restrictions on traditional bank holding companies tend to promote weaker parents. Some bank holding companies manage the bank’s stock and provide little or no capital or marketing support to the bank. The fact that the holding company model utilizes separate regulators for the bank and the holding company who do not act in a coordinated fashion or apply consistent standards also raises possible concerns. This model is less of a problem for banks that elect to operate as stand alone providers of credit and we do not advocate eliminating this option for banks that choose it, but it should not be imposed on other credit providers because of these deficiencies.

It is also a misconception that the Federal Reserve Board ("FRB") regulates the “financial system” through its oversight of bank holding companies. The FRB’s role in the financial system has changed. In the past, the FRB cleared most checks and provided liquidity to the banking system. The economy then used checks and cash exclusively. Now, though, most payments flow through card systems. The FRB still does have an important role here as the administrator of Regulations B, E and Z. The products and services that constitute the financial system are provided by the banks, which are regulated separately, and by a growing number of commercial and other kinds of financial companies operating beyond the FRB’s or any other regulator’s jurisdiction. However, the FRB is still responsible for the management of the nation’s money supply and interest rates.
Regulation of the “financial system” is perhaps too big an issue to address comprehensively in this comment. It involves all the credit provided by businesses of every kind and privately controlled card systems that have grown into international operations. This is beyond what any functional regulator can feasibly supervise directly and comprehensively. Thus far the card systems that have become the backbone of electronic commerce have developed outside any overall regulatory system without any apparent problems. Should those be regulated? Could they be comprehensively regulated? That would seem to be the key systemic issue in today’s economy.

1.2.3 Would a unified regulator be better? We believe a diverse group of regulators has served the nation well and should be continued. The U.S. banking system has many important and unique features. Unlike most other nations, banks in the U.S. are entrepreneurial and highly diversified. Other nations tend to have a few large banks that function more like public utilities. It wouldn’t make sense to have state bank regulators if there were only a few large federally chartered banks in the nation, but that is not the case. Community banks play a vital role in our economy and communities and they should be able to choose a state regulator if that is the regulatory system that fits best with their plans.

Financial institutions that operate nationally or in multiple states should also have access to a federal charter that enables them to operate under one set of laws and regulations, and they have that option now with the Office of the Comptroller of the Currency (“OCC”), the Office of Thrift Supervision (“OTS”) and the National Credit Union Administration (“NCUA”).

We take no position on whether the OTS and the OCC should be merged. A comprehensive survey of the continuing advantages of a separate (Federal Savings Bank (“FSB”) charter would appear to be worthwhile with an opportunity for FSBS to provide input on their choice.

The current system with multiple regulators utilizing Federal Financial Institutions Examination Council (“FFIEC”) to set uniform federal standards appears to have worked well. Our members report that multiple regulators provide many benefits in the overall system. Innovation is one. Many products and services were developed within various regulatory structures in the past. In addition, our members report that multiple regulators provide a critical option if one regulator becomes overzealous or unreasonable to a degree that threatens the business itself, which occasionally happens.

The risk often cited in this regard is the tendency of multiple regulators to compete in laxity to attract constituents. We think this risk is exaggerated. Regulators know how quickly they can be subjected to public criticism and removal if the institutions they regulate fail or engage in abusive or unfair practices. Banks, insurance companies and securities companies want credible regulation. It is critically important to maintaining the public trust that is central to all financial services industries. Those companies don’t want weak regulators,
they want competent and fair regulators. Successful regulators are supported by both the companies they regulate and the public that counts on their protection. Competition among regulators has helped maintain that proper balance, not driven regulators to shirk their duties.

1.3 WHAT SHOULD BE THE KEY OBJECTIVES OF REGULATION?

We believe fundamental principles and goals of financial services regulation should include the following:

- It is important to always bear in mind that regulation serves the market. It strives to promote the stability of the market by ensuring that financial services providers operate in a safe and sound manner and promotes public trust by ensuring that the markets and financial services providers operate honestly and fairly. To fulfill these goals, regulation must be well coordinated with the market and the providers and consumers of financial services.

- Equal access to financial services is fundamental to economic development and economic justice.

- Innovation is key to the development of financial services that serve the largest number of people and businesses. Financial services providers must have the maximum freedom to innovate consistent with safe and sound operation.

- Access to capital is critical to diversify, innovate, expand and strengthen the financial services industry. Investment from capital-rich corporate America through commercial ownership of banks should not be excluded as a source of funding to achieve these desirable outcomes. However, such ownership must incorporate the principles of safety and soundness and avoid conflicts of interest.

- The U.S. financial markets currently lead the world because financial services providers are diverse, entrepreneurial and generally well regulated. These factors must be maintained.

1.3.1 How should financial institutions with government guarantees be regulated differently than those without such guarantees? Public trust is crucial to the proper functioning of all financial services companies. Government guarantees are one means to promote public trust in some instances but the need to maintain trust in all instances remains crucial to the success of the nation’s financial markets.

Federally insured banks must obviously be regulated to ensure to the greatest extent possible that they don’t fail. Failure not only causes losses for the Federal Deposit Insurance Corporation (“FDIC”) and NCUA insurance funds (and in extreme cases the taxpayer), it also erodes public confidence in the banks and credit unions themselves.
Loss of confidence in banks, credit unions, insurance companies, and securities brokers could cripple the economy. It is important for all of these industries to be regulated for solvency and honesty, not just the federally insured depositories. The tradeoff for such intensive regulation is the need to ensure that the regulators are competent and exercise good judgment, which is best accomplished by functional regulation with multiple regulatory choices. We believe the current system is adequate in this regard.

Regulation of other financial services providers is also generally adequate, with possibly some minor exceptions. Regulation of anticompetitive and unfair trade practices is clearly needed to maintain the integrity of the financial services market. Other federal agencies and the states play key roles in this regard. We believe federal laws and regulations such as those regulating loan disclosures, credit reporting, debt collection, equal access to credit, electronic commerce and community reinvestment have all been balanced and effective measures to facilitate the fair development of financial services nationwide.

The challenge will always be to find the right balance and maintain it in the face of changing market conditions. The current turmoil over subprime mortgages is a good example. Many proposals will undoubtedly be offered to increase regulation of mortgage brokers and mortgage loans and some of those will have merit, but there is a great danger of restricting mortgage lending to a degree that will be counterproductive. It could deny home ownership to many people and cause a major constriction in the economy.

1.3.2 Is there a need for additional regulation of financial services companies that do not have explicit government guarantees? See answer to foregoing question.

1.3.3 Does holding company regulation promote market stability? See answer to 1.2.2 above.

1.3.4 Would “principle-based regulation” be better? This is another very complicated question. The ideal is a balance. Rules can become unavoidably abusive and arbitrary if not guided by principles and good judgment.

But the system can become equally arbitrary without rules. Rules play an important role in planning by management. Without minimum capital standards, managers would not know what amount of capital they will need to maintain to satisfy the examiner.

Ideally, regulation is a collaborative process in which the regulators and interested parties agree on basic goals and the best rules to achieve them. The key is not to emphasize the principles or the rules but the collaboration and process to develop and revise the principles and rules that govern the system.

1.3.5 Would uniform basic principles be desirable? An ongoing review of basic principles would be good. Some principles would apply to the whole market and financial services companies. Other principles would work better for a bank than for a broker-dealer. We think the uniform standards developed for
specific industries by organizations such as FFIEC for banks, the SEC and the stock exchanges for broker-dealers, and the state insurance commissioners for insurers have worked well. These industry level regulatory bodies, both public and private, provide both the expertise and the collaborative opportunities needed to fashion good principles and rules.

1.4 **DOES THE CURRENT SYSTEM ADEQUATELY PROTECT CONSUMERS AND INVESTORS?**

Generally, yes. Of course, this is one subject about which opinions will differ greatly and the role of the legislatures and regulators is critical to striking a proper balance.

Perhaps the most heated debate at the moment is the role of the states in protecting consumers. The states claim they are closer to their constituents and do a better job of protecting them. State legislators and regulators undoubtedly feel pressure from their constituents in that regard. But regulating a national market with fifty non uniform laws and standards is unworkable. Some federal preemption is necessary and federal laws such as Truth in Lending, Credit Reporting, Fair Debt Collection, and the securities laws have worked well to avoid that problem.

When does state regulation become too burdensome? Should a state attorney general be allowed to sue a lender based in another state if the lender is violating the law and its regulators fail to act? What if the attorney general and the lender’s regulators disagree about whether regulatory action is warranted? While not a perfect solution, we believe the principle of comity should govern. If a financial services company is based in and regulated by another state, that state and federal regulators should have the primary authority to regulate it. There will undoubtedly be times when local officials disagree with another regulator but operating to the most restrictive standard that might be imposed by any state too often becomes overly burdensome and undermines the ability of the market to efficiently deliver financial services nationally. Comity does not apply if a financial services provider is not otherwise regulated, only if it is a conflict between two different U.S. based regulators.

1.5 **WHAT IS THE PROPER ROLE OF THE STATES?**

Current federal law allows states significant latitude to regulate businesses located in their jurisdictions. States should continue to offer chartering options for banks, insurers and securities dealers. We see no reason why state authority should be limited except to the extent necessary to avoid undue burdens on interstate commerce. To do that, the best principle is to recognize that transactions take place at the business providing the product or service. The modern financial services markets are largely premised on the concept that the situs of a loan is where the lender approves the loan and disburses the funds. That situs should determine the applicable law.

1.6 **GLOBAL REGULATION**
Many of the same issues relating to interstate commerce apply to international commerce as well. We have all benefited by the ability to access the same financial services from a foreign nation that we enjoy at home. Travel and commerce have been greatly facilitated through the development of financial systems that operate seamlessly across borders.

Like interstate commerce regulation should facilitate the development of the markets as much as possible without compromising safety and protection of U.S. interests. Particular attention should be paid to measures necessary to help U.S. financial services providers maintain their leading role in the world economy.

2.1 DEPOSITORY INSTITUTIONS

2.1.1 Multiple charters. See comments above. We believe the option to choose between different charters is healthy and promotes innovation and diversity within our financial services industries.

2.1.2 What are the strengths and weaknesses of the dual banking system? The dual banking system has played an integral role in the development of the nation’s banking system and economy and we expect it will continue to make significant contributions to the health and diversity of the banking system in the future.

2.1.3 What is optimal role for the FDIC and National Credit Union Share Insurance Fund (“NCUSIF”)? We see no reason to change the current system in which the FDIC is the primary federal regulator of state non member banks and plays backup to the member banks, national banks and federal savings banks, and the same for the NCUSIF in connection with credit unions. On one level this appears somewhat inconsistent but the system has worked reasonably well especially when uniform banking standards are set by FFIEC and the FDIC has an equal voice in that process. We do not think the FDIC should be relegated to the role of pricing deposit insurance. It has played an important role in setting standards for safety and soundness for all banks and should not be put in a position where it insures all the risk while having limited authority to set and enforce risk standards.

2.1.4 What is the optimal role for the central bank? We believe that the optimal role for the central bank is to set monetary policy by taking the lead on interest rates. Although banks are not required to use the interest rate set by the FRB, many use them as a benchmark for their prime rates. This is in everyone’s best interest. It is the best way to manage inflationary pressures and maintain balance. However, if the FRB, or another regulator, was given the legal authority to dictate interest rates for banks, most lenders would probably be driven out of the banking system so they could better control their rate risks. Additionally, the FRB has consistently played an important role in the area of consumer protection.

The Bank Holding Company model is not the most efficient model currently utilized in the banking industry. Eliminating the choice to operate under
a different model will not enhance the safety and soundness of the banking industry or system as a whole, but will primarily inhibit the development of efficient financial services providers by the growing number of other financial services companies.

It is not necessary for the FRB to play a larger role in banking supervision. Its ability to control monetary policy faces some challenges due its diminished role in the payments system and in controlling anything as complex as the U.S. economy has become. As mentioned above, in the past almost every transaction that took place in the U.S. involved the FRB in some way since payment was made with cash issued by the FRB or with checks cleared through the FRB. The cost of cash at the discount window and the cost of overnight loans to settle checks became the basic mechanism to set interest rates and control the supply of credit for the whole economy. Today, the payments system has been largely privatized and the discount window is hardly used. Transactions using debit cards already exceed the total of all payments made with cash and checks. Credit card transactions are larger as well.

2.1.5 Should the current regulation of bank holding companies be changed? The restrictive nature of the traditional bank holding company structure has led many companies in the financial services arena to choose other models. However, it does not cause significant conflicts when applied to holding companies that only own healthy banks. It also ensures that the holding company does not cause problems for its bank subsidiary.

Over the past thirty years the development of electronic commerce and the financial services markets generally have increased demand for access to a bank charter for financial services providers that engage in activities not permitted for a bank holding company. One of the key characteristics of the information age is the development of financial services throughout the economy. In contrast to the past when banks were the primary providers of credit to the economy, commercial companies and other financial services companies have become major suppliers of credit and may provide more credit than banks. The U.S. economy has become the most innovative and prolific producer of credit and other financial services ever known. Those developments are in direct conflict with what remains of the Bank Holding Company Act after its original restrictions on affiliation with insurance and securities companies and multistate operations were repealed in the 1990s.

Unlike the FDIC that called for the repeal of the Bank Holding Company Act (“BHCA”) in 1987, we recommend continuing the status quo. Allow those banks that want to operate under the BHCA model the choice to do so. But also preserve the choice to operate under a bank centric model for those that would be better served by that structure. There is no economic or public policy reason to eliminate the choice of diversified holding companies to own banks. Diversified holding companies have demonstrated that they can safely own and
operate bank subsidiaries. Indeed, existing bank subsidiaries of diversified holding companies are generally stronger and more profitable than traditional stand alone banks. Bank subsidiaries of larger diversified parent companies generally have access to abundant capital and receive extensive marketing support. These banks are currently the strongest and safest group of banks in the nation and we believe there is no reason why their development should be constrained with any amendments to current federal law. If any amendments are considered, they should be to expand the availability of this type of charter choice across the nation.

2.1.6 Consumer protection and depository institutions. We believe current protections are adequate. Depository institutions are extensively regulated to avoid offering products or services that could be characterized as abusive or dishonest. That is often called “reputation risk”. Actions that could damage a bank’s reputation undermine public trust and confidence. Maintaining public trust and confidence involves ensuring that the products and services offered by banks are fair and fully disclosed, and perceived as such by the public. Abusive products and services are also more likely to result in defaults and losses and so present safety and soundness issues as well.

2.2 INSURANCE

2.2.1 What are the costs and benefits of state regulation of insurance? Like banking, the choice to organize under state supervision is helpful to many insurance companies. If there is a downside, it is the lack of an optional federal charter. Many insurance companies and agencies serve the whole nation. Regulation by fifty independent regulators, in addition to multi-state licensing requirements, is burdensome and inefficient. Because of the importance of insurance to people and businesses, insurance underwriters and providers should be closely regulated for solvency and integrity but chartering options should be as well matched to the market and diverse as those available to banks. As such, the creation of an optional federal charter is supported.

Among the costs for state regulation of insurance is the licensing of agents who sell, solicit or negotiate insurance products. Specifically, if an insurance agency operates in a multi-state environment, then the agency is required to have each agent that it employs to go through mandatory training and licensing for each state in which the agent will be selling, soliciting or negotiating an insurance product. For an insurance agency operating in a multi-state environment with multiple agents, the licensing of agents becomes very costly.

2.2.2 What are the key federal interests in regulating insurance? Simply put, the more efficient flow of interstate commerce will benefit consumers through lower prices.

2.2.3 Should the states continue to have a role in insurance regulation? Yes. There is no reason to terminate the state systems in favor of a single federal regulator. There is only a reason to create a federal regulatory option for companies operating in multiple states.
2.2.4 Should special risks insurance programs mandated by the states continue? We see no reason for the federal government to intercede in those issues with the states. If the programs are working why terminate them? If they are not working, why preempt the state’s decisions about ending or changing the program? The federal government only needs to provide a comparable federal option.

CONCLUSION

AFSA again commends the Treasury Department for taking this opportunity to examine the regulatory structure of our nations’ financial services system. We believe that the Department and the regulatory agencies at the federal and state levels must be guided by the notion that regulation should facilitate market development without sacrificing the goals of safety, soundness, honesty and fairness.

Sincerely,

Bill Himpler
Executive Vice President
Federal Government Affairs