The Federal Reserve Board

Remarks by Governor Mark W. Olson

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Implementing the Gramm-Leach-Bliley Act: Two Years Later

First of all, my thanks to Ron Glancz, Bill Sweet, Pat Doyle, and Marty Lybecker for inviting me to speak on the very important subject of Gramm-Leach-Bliley Act (GLB) implementation.

In reviewing the first day of the program, I see that you have covered some major topics including financial holding company (FHC) mergers, acquisitions and regulation, and new bank activities. At the risk of repeating some of what has already been discussed, I will focus today on GLB implementation from the vantage point of the Federal Reserve Board. Since your other presenters are quite specifically focusing on implementation issues, my comments will be more at a policy level. To do so, I first need to put the GLB Act in perspective. This act is arguably the most significant banking legislation in the last quarter of the twentieth century, but it pales in significance to the dynamic changes in the marketplace during that period.

In passing this bill, the Congress accomplished three important and occasionally controversial objectives. First, the act significantly realigned the statute to comport with changes that had already occurred--laboriously and at great expense--in the marketplace.

Second, by expanding permissible activities to include those that are "financial" or "complementary" to financial activities, the act granted the Fed and the Treasury the authority to allow modifications that allow FHCs to compete in the financial marketplace.

Third, and very importantly, GLB addressed an important public policy concern of the Congress, which was to provide a clear separation between entities that received the benefit of deposit insurance and those engaged in the new permissible activities.

As I look around this room I see many people who have been involved for years in attempting to update our banking laws to expand product opportunity. During the twenty years that I have been an active participant in this process, I have heard many arguments for and against this expansion. However, one constant over that period has been the clear recognition that the Congress would not permit expanded product opportunity if it would bring additional risk exposure to the deposit insurance funds. Thus, vehicles needed to be created that would allow new opportunities or new affiliations while insulating the safety net of deposit insurance and direct access to the discount window and payment system from them. The vehicles identified for this purpose were the financial holding company and, to a limited but important extent, the financial subsidiaries of banks.

That, in brief summary, is the GLB. It expanded banking organizations' activities, allowed cross-industry affiliations in the financial services business, gave regulators the ability to modify permissible activities without new legislation, and put in place a prudential framework using the FHC and separating the safety net from new risk-taking. The Congress has freed financial institutions to follow their markets and has provided the regulators with the ability to let them do so, while still requiring prudential supervision focused primarily on ensuring the safety and soundness of insured depository institutions.

The Prologue

I am sure that everyone who has been involved in the financial services industry during the past two decades recognizes that it is the markets--not the Congress and not the regulators--that are the force for dynamic change. As a reminder, let me briefly review some of the significant changes.

If ever a set of institutions was insulated from competitive pressures, it was U.S. banks after World War II. Entry was limited. The Depression and World War II had left the banks with excess portfolio liquidity and no need to compete for deposits or other funding. Regulations essentially set deposit rates and state usury laws, and custom limited inter-institutional loan price competition. Capital and money markets provided very poor substitutes for bank credit.

Markets and technology would eventually destroy this insulation. Money market funds contributed early to blurring the lines between the banking and securities industries as saving deposits, which had historically been the exclusive purview of depository institutions, proved no match for an account that could provide market rates, liquidity, and third-party access. With money market funds, banks discovered that bank deposits, including checking accounts, had substitutes. Larger corporate borrowers found substitutes for bank loans when they began to borrow increasingly through the commercial paper market.

The more-sophisticated banks found ways to meet changing competition. Besides purchasing funds in the money market through negotiable certificates of deposit when domestic deposit-rate ceilings were binding, they learned to use the eurodollar market to fund domestic operations. Both of these developments revolutionized the way banks thought of the liability side of their balance sheets. Securitization quickly followed on the asset side. Securitizations, of course, reflected a new use of the market by banks--a shift of assets from the bank balance sheet to the securities market whenever liquidity needs or margin pressures made such a move advantageous. Also, higher-quality borrowers shifted to the commercial paper market, and a broader spectrum of borrowers shifted to the capital markets, pressing banks even further.

The banking industry's early response to these pressures took two forms: bank facilities that offered very short-term, market-rate, low-margin credit on the bank balance sheet (renting the banks' balance sheet) and letters of credit to permit some borrowers to tap the markets with the banks' help (renting the banks' credit rating). Bound by the limits of Glass-Steagall, however, even the most sophisticated banks had only these avenues as their range of options.

The shift of customers from bank credit to the capital markets was a particularly profound challenge because, as I noted, since the early 1930s the Glass-Steagall Act had prohibited banks from affiliating with companies that engaged principally in underwriting securities, except for government securities. The contrast here is worth repeating. Securities firms had the latitude to evolve as the markets and technology changed, but banks were very tightly restricted.

Other efforts by banks to expand their customer service menu had been constrained by law as well. Spurred by the attempted affiliation of Transamerica, one of the largest insurance underwriters of the time, with Bank of America, one of the largest banks of the time, the Congress enacted the Bank Holding Company Act of 1956. The act prohibited such affiliations, as well as those between banks and nonfinancial firms, in multi-bank holding companies. The affiliation some forty-plus years later of Travelers and Citibank occurred just before GLB repealed the ban on insurance-bank affiliation.

Bank regulators recognized the quandary that banks faced as competitive pressures and technology eroded the post-Depression legal framework in banking, even though staying within both the letter and, arguably, the spirit of the law permitted some additional regulatory flexibility for banking organizations to follow their customers. Of particular note were the Federal Reserve decisions authorizing the section 20 affiliates that permitted banking organizations with sufficient U.S. government securities operations to engage in corporate securities underwriting and the Comptroller of the Currency's rulings that allowed insurance to be sold by national banks anywhere from towns of fewer than 5,000 residents. As a result of these actions, bank holding companies had achieved expanded securities authority and national banks had achieved broader insurance brokerage authority, and both kinds of institutions had done so without the benefit of legislation. The authority instead took the form of a sequence of regulatory rulings, usually vigorously challenged in court, that allowed new products to be offered but often with constraints that were both inefficient and occasionally irrelevant. However circuitous the route the actions by the Federal Reserve and the Comptroller of the Currency helped reduce the final restrictions, other than the ones on insurance underwriting, that had been in the way of full financial-service integration. Thus, by the time the Gramm-Leach-Bliley Act passed through the Congress, in the summer and fall of 1999, it was long overdue.

After Gramm-Leach-Bliley
Now let's look at post-GLB developments: In particular, the level of participation by banks and nonbanks, the new or expanded activities conducted in the FHCs, and the differences in the regulation of FHCs and BHCs.

There has not been a land rush of large inter-industry mergers since GLB was enacted. Though some see this lack as evidence of weakness in the law, one should remember that many major bank and securities firm mergers predated GLB. What's more, the market has not perceived bank and insurance underwriter mergers to have the same attractiveness as bank and securities firm mergers. Still, several interesting combinations have occurred:

- Charles Schwab has merged with U.S. Trust.
- Two large foreign banks have purchased large U.S. securities firms.
- One large domestic insurance company (Metlife) and two securities firms have acquired small banks.
- And, of course, Travelers, Solomon and Citicorp have affiliated.

The traditional banking industry has also been active. Twenty-four of the largest twenty-five bank holding companies have chosen financial holding company status. In total, about 570 domestic and 24 foreign bank organizations have applied for such status and, at least initially, have met the statutory standards. Of that total, 460 of the FHCs have $1 billion or less in assets with a substantial segment holding less than $150 million.

At this point, only seventy-one of the FHCs report activities that require the GLB Act. But the minimal notification process has allowed these new entities the authority to make financial acquisitions on a post-notification basis. Indeed, those FHCs that have not yet used their new authorities apparently want the flexibility that FHC status provides to act promptly without application. Virtually all of the previous section 20 companies have converted to regular securities underwriting and dealing subsidiaries. Twenty of the authorized FHCs either lost or dropped their FHC certification because of supervisory downgrades or changes in strategic direction.

What are the FHCs doing that they could not have done as bank holding companies? Probably the most important benefit to date has been the removal of the previous restrictions on the securities business of banking organizations. Removing them has improved the efficiency and competitiveness of bank-affiliated broker-dealers by eliminating the cumbersome restrictions applicable to section 20 companies. Some of these benefits are obvious, such as the elimination of the eligibility revenue limits, although others are more subtle. For example, post-GLB, several FHCs have established multiple broker-dealers to enhance internal controls and management incentives. The previous section 20 rules acted to force institutions to have only one full-service securities subsidiary.

Not surprisingly, another significant result is that the largest institutions have used the merchant banking powers to enhance their existing private equity business. A common example is using the merchant banking authority to establish and manage private equity funds for venture capital investment, an activity that was generally not feasible under previous authorities used by BHCs to conduct their venture capital business. The smaller FHCs have most commonly used the new authority to acquire insurance brokerage entities without the artificial constraint of locating that brokerage in a town of less than 5,000 residents.

From a regulatory perspective (and even from a lawyer's perspective) the application process is as interesting as the new authorities. The requirement for approval or even prior notice of a nondepository acquisition has been eliminated. Instead, all the non-depository acquisitions by FHCs are completed and then the Federal Reserve is notified.

How has the regulation and supervision of FHCs differed from the regulation of BHCs? First, the need for and, consequently, the number of applications have dwindled, and FHCs can rapidly complete nonbank acquisitions. This change removes some previous oversight that the Fed had for ensuring safety and soundness, but to date the elimination of this authority has not had adverse effects. Moreover, though not required, some dialog between the Fed and FHCs generally occurs with large proposed acquisitions.

From a supervisory perspective, among the most dramatic changes has been the elimination of the section 20 examinations for broker-dealer subsidiaries of FHCs. Many of you have been involved in either premerger reviews or on-site examinations. These examinations focused in great detail on firewalls, internal controls, interlock restrictions, reporting requirements, and funding limitations. The special firewalls created to separate the insured depository from risks undertaken by subsidiaries are no longer required, and the Fed now relies almost totally on section 23A and 23B of the Federal Reserve Act to protect the insured depository institution subsidiary. These provisions, which statutorily apply to all insured depository institutions, place quantitative limits and collateral requirements on credit flows from an insured depository institution to its nondepository affiliates and require that virtually all such transactions be made on market terms. Since GLB, these provisions also apply to transactions between the bank and its own financial subsidiaries, just as it applies to nondepository affiliates.

The Fed now collects hard data each quarter to ensure that the quantitative requirements of these provisions are being met. In addition, it has invited public comment on a regulation that would put in one place all the limitations and Board interpretations dealing with 23A and 23B. Moreover, the Board has adopted a temporary rule addressing how these provisions would apply to derivatives and intraday credit, as required by GLB.

This leads to another major change in Fed regulatory involvement, an approach to supervision and regulation, which acquired the name "Fed lite." Implicit in the umbrella supervisory role of the Fed endorsed by GLB is the recognition that the focus of supervisory attention would be on risks that could adversely affect the insured depository institution. An FHC must maintain a well-managed/well-capitalized designation for all its subsidiary depository institutions. Such FHCs, in turn, are subject to only limited Fed regulatory oversight. Fed holding company supervision centers on the FHC level, not on nondepository subsidiaries, and is focused only on those risks that could affect depository subsidiaries. Within this framework, the umbrella supervisor is to rely on the supervisor of other regulated subsidiaries (the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, and the state insurance supervisors) as much as possible and to examine functionally regulated nonbank affiliates only if it believes that their activities are creating risk for the bank affiliate. That is, the umbrella supervisor is charged with evaluating both on- and off-balance sheet risks in the consolidated organization that could affect the insured depository affiliates. GLB has not impaired the Federal Reserve's ability to monitor management and direct it to correct risk exposures that could impair the health of the FHC and its depository subsidiaries.

On this same issue, a concern often expressed is that though GLB may provide expanded opportunities for FHCs, the advertised Fed-lite regulatory oversight effectively blocks the so-called two-way street. Undoubtedly, organizations that would have to divest significant business lines falling outside parameters of allowable FHC activities, such as nonfinancial commercial activities, might find becoming a financial holding company is not in their strategic best interest. But marketplace activity suggests that umbrella supervision has not discouraged some of the largest securities firms and at least one large insurance company from affiliating with banks in an FHC structure.

What do we expect to happen? The Fed does not attempt to predict market changes, but I hope the process put in place by the Congress will allow financial institutions to adjust to market changes within certain notable bounds. For example, we expect insured financial institutions to propose new activities which may fit the definition of "financial" and "complementary" as changes in technology or new market opportunities suggest new strategies. At present the Fed is considering requests to rule on real estate brokerage as a permissible activity.

We also expect nondepository financial institutions to examine the trade-offs in accepting the regulatory oversight accompanying bank ownership in exchange for the benefits of affiliation with banks in the FHC format. Though some nonbank financial institutions have deemed the regulatory oversight to be excessive, we find reassuring the ongoing affiliation of banks and securities firms, which involves many of the nation's largest banks and securities firms.

To carry out its responsibilities as umbrella supervisor, the Fed has had to work closely with other agencies. We have established formal procedures for sharing information with a number of regulators and have informal arrangements for sharing with many others. We meet periodically with a broad spectrum of agencies to discuss general issues and to coordinate supervision. We continue to work on pilot programs for creating the practical processes of meeting joint responsibilities, especially with the OCC and the SEC. Practically, we need to continue to cooperate if we are going to minimize the risks to our banking system that could accompany the new financial structure.

Summing Up

The Glass-Steagall and the McFadden-Douglas Acts sought to impede the natural development of markets. The Gramm-Leach-Bliley Act does the opposite. Indeed, GLB allows both banks and supervisors to respond to the marketplace, while still safeguarding a banking system with access to the safety net.

Over time, we believe that the success of GLB will be evaluated by its effect on the marketplace. Specifically, it will be judged by the quantity, quality, and price of the services that are delivered to households and businesses. GLB has created a flexible system that permits financial organizations to adopt, within the constraints previously described, the structure that best fits their skills. It relieves them from the pre-GLB necessity of adopting inefficient structures to better serve their customers.

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