Chapter 4

The Gramm–Leach–Bliley Act

In recent decades, financial markets here and abroad had advanced well beyond the structures assumed by U.S. banking laws. The growing divergence between markets and laws created new challenges for U.S. financial institutions in their efforts to serve customers and compete in world markets, forcing them to devise costly and inefficient ways to meet market demands. The Gramm–Leach–Bliley Act of 1999 (Public Law 106-102) provides long-needed reform of the U.S. financial regulatory system: It recognizes market pressures that have been building for many years, creates the necessary legal and supervisory framework for accommodating further evolution, and minimizes the need for U.S. institutions to adapt their efforts to outmoded law.

Legislative Overview

The Gramm–Leach–Bliley Act is wide ranging, creating ways for traditional bank holding companies and foreign banks to expand into a host of new insurance and securities activities and for insurance and securities firms to enter commercial banking. Moreover, it does so in a relatively expeditious way, avoiding many of the regulatory procedures that would have been required in the past.

For a bank holding company to become a financial holding company (FHC) and be eligible to engage in new activities, the act requires that all U.S. depository institutions controlled by the holding company be well capitalized and well managed and have satisfactory ratings issued under the Community Reinvestment Act. Foreign banks that operate U.S. branches or agencies or that own or control U.S. commercial lending companies and wish to become FHCs must meet capital and management standards that, in the judgment of the Federal Reserve, are ‘‘comparable’’ to those imposed on U.S. banks.

The legislation also provides institutions flexibility in structuring their activities by allowing them a choice of conducting certain financial activities within subsidiaries of commercial banks or through direct nonbank subsidiaries of the holding company. Subsidiaries of banks may engage in all financial activities permissible to FHCs, including securities underwriting and dealing, except those that involve insurance underwriting, merchant banking, or real estate investment or development. The act makes even merchant banking more broadly permissible in FHCs, and merchant banking might become permissible for subsidiaries of banks in five years if both the Federal Reserve and the Treasury agree with that approach.[1]

In permitting expanded powers for financial institutions, the Congress saw the need for adequate supervisory oversight and also for potentially greater overlap in regulatory jurisdictions. Accordingly, it assigned to the Federal Reserve the role of ‘‘umbrella supervisor,’’ that is, supervisor for all U.S. financial holding companies, and gave it authority to establish minimum capital

1. Merchant banking is an activity in which a financial institution invests in a corporation, taking up to full ownership and usually a seat on the board of directors, but does not engage in its day-to-day management.

requirements for these firms. The act preserved for U.S. functional regulators the responsibility for the entities they oversee. The Securities and Exchange Commission, for example, will continue to set prudential and operating rules for its registered brokers and dealers, and the self-regulatory organizations such as the New York Stock Exchange and the National Association of Securities Dealers will continue to supervise and examine the activities of their respective members. Likewise, state insurance commissions will continue to set rules for insurance companies chartered in their states and monitor and enforce compliance with the standards.

Federal Reserve supervisors will not interfere with, or unnecessarily duplicate, the efforts of the functional regulators and will rely as much as possible on their reports and on public information. The role of other U.S. bank regulators remains unchanged, and the Federal Reserve will continue to coordinate with them its oversight of holding companies.

The Federal Reserve's objective as umbrella supervisor will be to understand the holding company's group-wide, or consolidated, financial condition, to insure that companies have adequate information systems and internal controls in place, and to identify emerging threats to banks arising from their nonbank affiliates.

Issues and Implementation

The Gramm–Leach–Bliley Act, along with the implementing regulations and supervisory policies, may materially transform the U.S. financial system. By validating affiliations between banks and diversified financial services firms, the legislation sets the stage for improving the competitiveness and efficiency of financial markets and providing a broader array of financial products to consumers. With the flexibility introduced by the new legislation—together with the workings of time, technology, and innovation—one can expect world financial markets and institutions a decade from now to look much different from the way they do today. Whether the new landscape will be fruitful for institutions and consumers depends a great deal on how well government and industry develop regulations and define new strategies for competing effectively in the years ahead.

Market discipline declines as protection against risk is perceived to rise; hence, market discipline cannot prevail while noninsured creditors believe that their funds are not at risk in banks and their affiliates. Preventing the extension of such a distortion by preventing the extension of the federal safety net to more institutions remains an important consideration for the Federal Reserve as it constructs supervisory and regulatory policies under financial reform. The federal safety net gives banks the special benefits of access to federal deposit insurance and to the Federal Reserve's clearing process and discount window. Extending that access could distort market incentives and practices through the enlargement of the risks of moral hazard and thereby expose U.S. taxpayers to the kind of dangers realized a decade or more ago during the thrift institutions crisis.

The Federal Reserve has sought to address the risks associated with any extension of the safety net by separating the conduct of new activities as much as reasonably possible from insured depositories and by providing a framework for adequate supervision of financial holding companies. Such efforts will contribute to the market discipline necessary to make supervision most effective.

Determining the right mix of active government oversight and market discipline has become more difficult as financial markets and institutions have grown larger and more complex. In fulfilling its role of umbrella supervisor, the Federal Reserve must look across the entire financial holding company to adequately assess its risk management process and financial condition. Fortunately, the diversification that comes with the greater size and range of activities of today's large financial institutions has improved the ability of these firms to withstand shocks and has probably reduced the likelihood that one or more of them will fail. On the other hand, the increased size of these institutions has likewise increased the potential damage to the whole financial system that might come from the failure of just one of them.

Supervisory Coordination

The supervision of FHCs requires the Federal Reserve to coordinate its policies and actions with functional and other financial regulators in this country and abroad. In the past year or so, the countries represented on the Basel Committee of Banking Supervision agreed to structure their financial oversight programs around three so-called pillars: sound capital standards, effective supervision, and market discipline fueled by adequate public disclosures.[2]

Capital Standards

Regarding capital standards and foreign banks, the Gramm–Leach–Bliley Act requires the Federal Reserve to apply standards ''comparable'' to those applied to U.S. firms and requires institutions to meet *more* than the minimum standards of financial strength. While the Board is sensitive to concerns about extending U.S. standards extraterritorially, it must also provide a ''level playing field'' for competition in this country, recognizing material differences in the structure and composition of foreign bank balance sheets and in the effective capital requirements of home country supervisors.

The approach that the Federal Reserve has taken for foreign banks reflects the wide variety of factors that should be considered in assessing capital adequacy, such as the composition of various debt and equity accounts, accounting standards, long-term debt ratings, and whether home country supervisors practice consolidated, comprehensive supervision. This potentially case-by-case approach for foreign banks should provide the flexibility necessary to address different banking and operating structures in a manner equitable to all.

Effective Supervision and Risk Management

While all banks must adhere to minimum regulatory capital standards, a more fundamental and growing need is for them to better understand the scope of their economic risks. The astute management of risk is most important among large, complex banking organizations, whose activities and innovative practices have evolved beyond those envisioned in the current regulatory capital standard, the 1988 Basel Capital Accord. For these institutions, in particular, the accord—even with its subsequent amendments—may not provide a sufficient measure of capital adequacy.

Only through the continued progress of the banking industry in managing underlying economic risks can the Federal Reserve and other regulators of

2. The member countries are the Group of Ten: Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom, and the United States.

internationally active banks make corresponding progress in developing regulatory capital standards that are more sensitive to such risks. As with most major initiatives, the banking and regulatory community must work together toward a solution.

The Federal Reserve conducts much of its regulatory work in this area through the Basel Committee on Banking Supervision. In 1999 the committee issued for comment a proposed amendment to the 1988 Basel accord that would make greater use of external credit ratings and provide more consistent treatment of collateral, guarantees, and other protective measures by which banks mitigate risk. It also agreed to pursue an alternative approach for capital standards that would build upon banks' internal credit ratings of borrowers and counterparties and other aspects of their internal credit risk models. In an effort to spur this process and otherwise strengthen risk management techniques, the Federal Reserve has told large U.S. bank holding companies and state member banks that their internal assessments of economic risks and capital adequacy will be closely evaluated during supervisory reviews.

Market Discipline and Disclosure

Market discipline, conveyed through credit ratings, funding costs, stock performance, and other factors, can help greatly in controlling risk in large, complex institutions. By making use of market judgments as potential early warning signals—particularly in the case of large, publicly traded institutions—supervisors may be able to strengthen their performance while intruding less into the activities of banks and bank holding companies.

Generating market discipline, however, requires the disclosure of relevant information. Although regulatory agencies can help, the banking and investing community should require institutions to provide continually improving measures of risk and substantive discussions of their risk management processes. Heavy reliance on the supervisory process and regulatory standards, alone, cannot suffice.

Conclusion

Implementing the new Gramm–Leach–Bliley Act, developing and maintaining better capital standards, and providing prudential oversight to a growing and increasingly diverse U.S. financial system present many challenges for the years ahead. Financial institutions and their regulators must remain flexible and innovative in dealing with rapidly changing markets and financial products. Large banking organizations and financial holding companies, in particular, must be willing to meet high standards of soundness and disclosure and improve their ability to assess risk in step with the burgeoning complexity of the marketplace. The potential benefits from financial reform should be substantial, but they will be so only if both government and industry work together to keep the system sound. ▪