TESTIMONY OF

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CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

ON

H.R. 1062, "THE FINANCIAL SERVICES COMPETITIVENESS ACT OF 1995" AND RELATED ISSUES

BEFORE THE

SUBCOMMITTEE ON TELECOMMUNICATIONS AND FINANCE
AND THE
SUBCOMMITTEE ON COMMERCE, TRADE AND HAZARDOUS MATERIALS
COMMITTEE ON COMMERCE
U.S. HOUSE OF REPRESENTATIVES

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ROOM 2123 RAYBURN HOUSE OFFICE BUILDING

INTRODUCTION

Chairman Fields, Chairman Oxley and members of the Subcommittees, I appreciate and welcome this opportunity to present the views of the Federal Deposit Insurance Corporation on the Financial Services Competitiveness Act of 1995, and related issues. I commend you for placing a high priority on the need for structural reform of our financial system.

The FDIC supports a repeal of the Glass-Steagall restrictions on the securities activities of commercial banking organizations, provided that this is accompanied by the appropriate protection to the deposit insurance funds. In the financial and regulatory environment of today, the Glass-Steagall restrictions do not serve a useful public purpose. Repeal of the restrictions would strengthen banking organizations by allowing diversification of income sources and better service to customers, and would promote an efficient and competitive evolution of U.S. financial markets.

History demonstrates, however, that expansion of the activities of banking organizations must be accompanied by adequate safeguards. The controls that exist today to protect insured institutions from the risks of related nonbanking entities have generally proven satisfactory in the normal course of business. When banking organizations have experienced severe financial stress, however, interaffiliate transactions have occurred that have resulted in material losses to the deposit insurance funds, although these have not been solely responsible for any bank failures. The FDIC has a special interest in the adequacy of safeguards to protect the deposit insurance funds. My testimony contains several specific comments in this area.

Financial markets have changed dramatically since 1933, when the Glass-Steagall Act first imposed a separation between banking and securities underwriting activities, and since 1956, when the Bank Holding Company Act further limited the activities of bank affiliates. To a greater extent than ever before, nonbanking firms now are offering financial products that were once the exclusive domain of banks. Improvements in information technology and innovations in financial markets make it possible for the best business customers of banks to have access to the capital markets directly, and, in the process, to bypass traditional financial intermediaries.

Large corporations meet their funding needs through the issue of commercial paper, debt securities, equity and through loans. The Glass-Steagall restrictions prevent most banking organizations from providing the full range of funding options to their customers. The shrinking role of banks in lending to business is illustrated by the declining proportion that bank loans represent of the liabilities of nonfinancial corporations. This share declined from about 22 percent in 1974 to 13.7 percent at year-end 1994, the lowest proportion since these data were first collected in the early 1950s. Similarly, it is noteworthy that banks have grown much less rapidly than other financial intermediaries during the past ten years. For example, banking assets grew at an average annual rate of 4.8 percent, compared to growth rates of 26.7 percent and 14.1 percent for mutual funds and securities firms, respectively. Attachment A shows average annual growth rates of the assets of various types of financial institutions for the past ten years.

There is indirect evidence which suggests that as banks have lost their best business customers, they have to some extent turned to riskier ventures such as construction finance and commercial real estate loans. Although the banking industry has experienced record profits recently, the wide swings in past performance indicate increased risks in the industry. In the last ten years, the banking industry achieved both its lowest annual return on assets (approximately 0.09 percent in 1987) and its highest return on assets (1.20 percent in 1993) since the implementation of deposit insurance. As discussed in Attachment B, the volatile swings in the health and performance of the industry may result in part from constraints that limit alternatives for generating profits. Restrictions that resulted in the loss of many of their best corporate loan customers, combined with the need to maintain profit margins and keep market share, led many banks to increase their concentrations in alternative high-yield assets. Some of these investments, such as construction and real estate development loans, loans to developing-country borrowers and loans to finance highly leveraged commercial transactions, carried higher, sometimes unfamiliar, credit risks. Other investments, including longer-term fixed-rate securities and home mortgage loans, as well as securities derivatives, increased the interest-rate risk of banks.

Some might ask whether we are forgetting the lessons of an earlier time -- the 1920s and 1930s. Congress imposed the restrictions of Glass-Steagall in reaction to the abuses of bank securities affiliates and the perception that the abuses contributed substantially to the banking crisis of the 1930s. Attachment C to my testimony describes the historical evidence on this subject. The evidence generally suggests that the concerns that bank securities activities played a major causal role in the banking crisis were overblown, and that remedies other than the Glass-Steagall restrictions would have addressed the abuses more effectively.

When the historical debate is finished, however, we come to this: we have in place today a regulatory structure of comprehensive banking and securities regulation that did not exist in 1933, including restrictions on interaffiliate transactions. Moreover, the marketplace has moved well beyond the Glass-Steagall restrictions. Financial products, regardless of the labels, are converging. The Glass-Steagall Act stands like a dam in the middle of a mighty river that is finding other channels for its inevitable currents. On balance, I believe the risks of eliminating the Glass-Steagall prohibitions can be contained and that the benefits of an evolving marketplace outweigh the costs.

Finally, I would argue that an easing of the broad range of restrictions on activities of banking organizations beyond those that are financial in nature should proceed in a cautious, incremental manner. Banking organizations have expertise in managing financial risks. We should develop a body of experience to evaluate the safety-and-soundness implications of any new financial affiliations, before allowing broader affiliations with firms exposed to a different range of risks. Setting aside real estate development, the limited, but generally successful, experience of the affiliation of savings associations with commercial firms may provide a useful starting point for such an evaluation in the future. However, it does not provide a clear model for intermingling the more comprehensive risk profile of banking with commercial activities.

My testimony will first summarize the special concerns of the FDIC, as deposit insurer, with respect to expanded activities of bank subsidiaries and affiliates. Next, I will discuss the safeguards that are necessary to protect the deposit insurance funds and the financial system. I will then review the advantages and disadvantages of particular organizational structures with respect to the location of new securities activities. The balance of my testimony will focus on specific provisions of the Financial Services Competitiveness Act of 1995.

PERSPECTIVE OF THE DEPOSIT INSURER

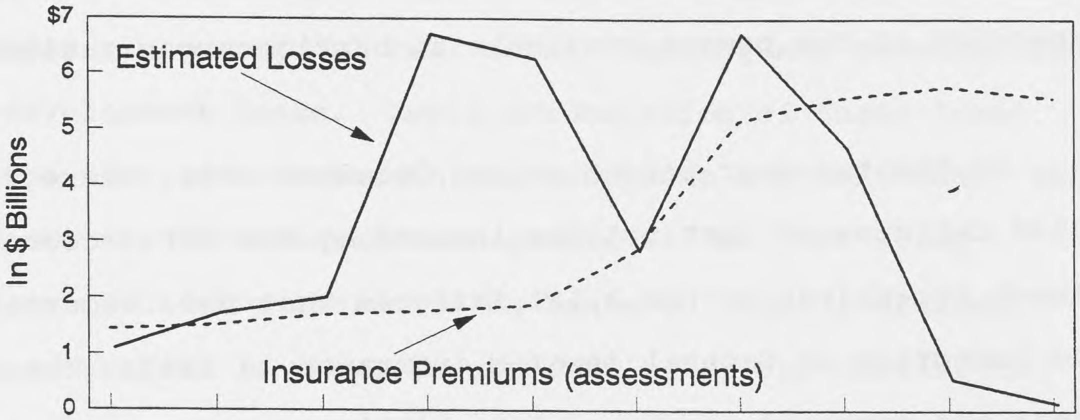
As the deposit insurer, the FDIC has a vital interest in the safety and soundness of insured institutions and the integrity of the deposit insurance funds. Events of the past decade have demonstrated how costly deposit insurance can be. The Bank Insurance Fund (BIF) and the banking industry have spent almost $33 billion to resolve failing banks in the period from 1985 to 1994 (see Figure 1). The thrift crisis, in contrast borne by the taxpayers, has been estimated to cost $150 billion.

We cannot attribute all of the insurance losses to economic events or poor management of depository institutions. A significant share of the responsibility must be assigned to poorly planned efforts to deregulate financial services and ineffective supervision in some areas. Thus, it is imperative

FIGURE 1

Deposit Insurance Cost - Ten Years Ending 1994

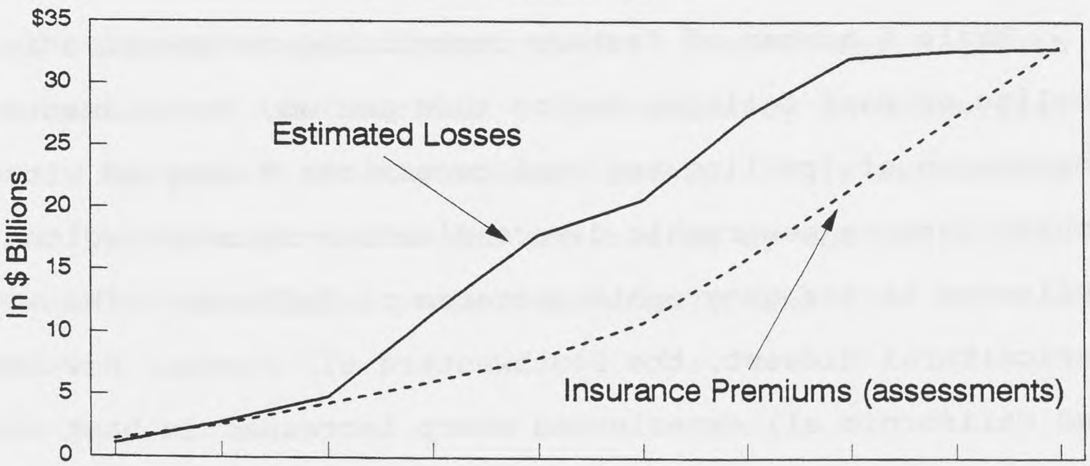
FDIC Bank Insurance Fund



(In $ Millions)	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994 *
Estimated Losses	1,099	1,722	2,007	6,721	6,273	2,856	6,739	4,695	570	139
Insurance Premiums (assessments)	1,433	1,517	1,696	1,773	1,885	2,855	5,161	5,588	5,784	5,591 *

Cumulative Deposit Insurance Cost - Ten Years Ending 1994

FDIC Bank Insurance Fund



(In $ Millions)	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994 *
Estimated Losses	1,099	2,821	4,828	11,549	17,822	20,678	27,417	32,112	32,682	32,821
Insurance Premiums (assessments)	1,433	2,950	4,646	6,419	8,304	11,159	16,320	21,908	27,692	33,283 *

* The 1994 figure reflects rebates to some institutions that appealed their 1993 assessments.

Sources: 1993 FDIC Annual Report and FDIC Failed Bank Cost Analysis, 1986 - 1993.

that we proceed deliberately as we contemplate a substantial expansion of the powers available to banking organizations.

In the ten-year period ending December 1994, there were 1,368 failures of institutions insured by the BIF, accounting for almost two-thirds of the 2,121 failures that have occurred since the inception of federal deposit insurance in 1933. These failed banks had combined assets of $236 billion, and cost an estimated $32.8 billion to resolve. The number of failures reached an annual record level of 221 in 1988, while the losses and combined assets of failed banks peaked in 1991. The 13 bank failures in 1994 were the fewest since ten banks failed in 1981, and speak to the significantly improved financial condition of the banking industry.

While a number of factors contributed to the rise and decline of bank failures during this period, two elements -- the phenomenon of "rolling regional recessions," coupled with constraints on geographic diversification in some regions -- are reflected in the geographic patterns of failures. The agricultural Midwest, the Southwestern oil states, New England, and California all experienced sharp increases in bank failures in the past decade, stemming in large part from regional economic downturns. In general, the largest losses to the FDIC occurred in those states where regional recessions have been most severe.

The most costly failures can be linked to excessive concentrations in commercial real estate lending and construction and land development loans. Rapid accumulation of these loans preceded the rise in failures in the Southwest and Northeast, the regions where the FDIC losses were greatest. An FDIC study published in 1990 found that failing banks in Texas increased their concentrations in these assets long after the decline in local real estate markets had begun. Failed savings banks in New England also had much higher proportions of their balance sheets invested in construction and land development loans, where they had little previous experience.

There are two lessons to be drawn from these experiences. First, inadequate diversification of income sources is dangerous for banking organizations. This is an argument in favor of the repeal of the Glass-Steagall restrictions. Second, rapid growth in lending by insured institutions -- particularly in unfamiliar activities -- can result in significant losses. This emphasizes the need for strong supervision and monitoring by the regulators using adequate safeguards to protect insured financial institutions.

The Demise of the FSLIC

The experience of the thrift industry in the 1980s serves as an even stronger reminder of the importance of maintaining safety-and-soundness standards. The highlights of the experience bear repeating as we consider the expansion of activities of banking organizations. In the early 1980s, most of the thrift industry was economically insolvent due to interest-rate-induced losses from lending longer term at lower interest rates and borrowing short-term at higher interest rates. Rather than address the problems directly, the political and regulatory response was to relax capital and accounting standards, forbear from closing insolvent institutions, and expand the powers available to thrifts.

Federal legislation in the early 1980s significantly liberalized the permissible assets of thrifts. By 1982, thrifts could make commercial mortgage loans of up to 40 percent of assets, consumer loans up to 30 percent of assets and commercial loans and leases each up to 10 percent of assets. By midyear 1983, the Federal Home Loan Bank Board (FHLBB) allowed federally chartered savings and loan associations to invest up to 11 percent of their assets in high-risk bonds. Direct equity investments in real estate, equity securities and in subsidiary service corporations were permitted up to 3 percent of assets. Several states permitted state-chartered institutions significantly greater scope for direct investments. The attempt by many troubled institutions to use the new powers to "grow themselves out of their problems" added substantially to the cost of the thrift crisis.

Some might argue that the experience of thrifts in the 1980s is irrelevant today. I would disagree. Wherever there is a government guarantee, there will be some who attempt to exploit it inappropriately. Mechanisms must be in place to contain these risks. In addition, the supervisory staff that has been trained to detect losses from traditional activities will need to become familiar with the risks and potential losses associated with the new activities.

We also must keep in mind the extent to which a strong deposit insurance system depends on a sound regulatory structure as we eliminate the Glass-Steagall barriers. Securities activities of banking organizations should be subject to the regulation of the Securities and Exchange Commission (SEC). As securities activity increases in the banking industry, so will the role of functional regulation and the need to coordinate the distinct regulatory approaches. Supervision has been the keystone of the regulation of commercial banking, while disclosure and market discipline have been the key elements of securities regulation. The challenge will be to combine these approaches in a seamless fashion that permits no gaps that might threaten the insurance funds, and yet avoids burdening banks with regulatory overlap.

Finally, as banking organizations enter new activities, care should be taken to confine deposit insurance protection appropriately. Securities markets in the United States are dynamic and innovative; they have expanded the growth potential of the economy and have become the envy of the world. Our securities markets do not need the backing of the deposit insurance guarantee, nor do they need the added requirements of bank regulation that come with it. To promote the continued efficiency of securities markets, as well as to protect the insurance funds from undue risk, it is critical to separate the insured entity from the securities units of the banking firm. This will be addressed more extensively in the following discussion of necessary safeguards to the insurance funds and the appropriate structure for the conduct of new activities by banking organizations.

PROTECTION FOR THE INSURANCE FUNDS

My testimony has emphasized that in expanding the securities activities of banking organizations, we must not lose sight of the need to maintain the safety and soundness of insured institutions. This requires protection against inappropriate transactions between insured institutions and their securities subsidiaries and affiliates.

In general terms, there are two areas of concern from an insurance standpoint with respect to transactions between an insured institution and a related securities firm. The first involves the inappropriate use of an insured institution to benefit a related securities firm in the course of business. A second arises when an insured institution is in danger of failure. In the latter situation, there is an incentive for the owners and creditors of the related entities to extract value from the insured entity prior to its failure in order to maximize the share of losses borne by the FDIC and minimize their own losses. The FDIC's experience suggests useful lessons regarding necessary protections for the insurance funds in both areas.

There are numerous ways an insured institution could benefit a related securities firm in the course of business. These include: direct equity injections to a securities subsidiary; upstreaming of dividends to a parent that are used to inject equity to a securities affiliate; purchasing of assets from, or extensions of credit to, the related firm; issuing a guarantee, acceptance or letter of credit for the benefit of the related firm; extending credit to finance the purchase of securities underwritten by the related firm; and extending credit to the issuers of securities underwritten by the related firm for purposes of allowing the issuers to make payments of principal, interest or dividends on the securities.

There are three main dangers in such transactions from the standpoint of the deposit insurer. First is the danger that the consolidated entity will attempt to use the resources of the insured institution to promote and support the securities firm in a way that compromises the safety and soundness of the insured institution. An equally important concern is that the business relationship between the insured entity and the securities firm will create a misperception that the investment products of the securities firm are federally insured. Finally, there is the danger that the business and operating relationship will cause the courts to "pierce the corporate veil" -- that is, to hold the insured entity responsible for the debts of the securities firm in the event the securities firm fails.

Current law provides a number of safeguards against these dangers. Attachment D provides a summary of some of the major provisions. We must be concerned with how well these safeguards will work after Glass-Steagall restrictions are lifted. The experience with the involvement of banks with securities activities has to this point been limited, but generally favorable. Since 1987, the Federal Reserve has allowed limited securities activities in so-called "Section 20 subsidiaries" of bank holding companies. The Federal Reserve indicates that there have been no instances in which a Section 20 subsidiary adversely affected an affiliated bank. There are currently 36 bank holding companies that have Section 20 subsidiaries; these subsidiaries range in size from a few million dollars in assets to tens of billions of dollars in assets. There has been one failure of an insured institution affiliated with a Section 20 subsidiary. The Section 20 subsidiary played no role in causing the failure.

U.S. banks also are permitted to engage in securities activities overseas within various limitations. Typically these activities are conducted by subsidiaries of Edge Corporations, which, in turn, are generally subsidiaries of U.S. banks. Federal Reserve staff indicate that these activities have not posed any significant safety-and-soundness problems for U.S. banks.

The FDIC permits institutions it supervises to engage in securities activities through "bona fide subsidiaries" -- that is, subsidiaries that meet certain criteria designed to ensure corporate separateness from the insured banks. A detailed description of the bona fide subsidiary structure and the FDIC's regulatory safeguards in place to insulate the insured institution is included in Attachment D. More limited activities are permissible to subsidiaries that do not meet the "bona fide" subsidiary test.

The experience of banking organizations conducting securities activities through such subsidiaries has been limited. Currently, only one FDIC-supervised institution owns a subsidiary actively engaged in the full range of securities activities permitted by the FDIC. There are, however, over 400 insured nonmember banks that have subsidiaries engaged in more limited securities-related activities. These include management of the bank's securities portfolio, investment advisory activities, and acting as a broker/dealer. With one exception, none of these activities has given cause for a significant safety-and-soundness concern.

There has been one failure of an insured institution supervised by the FDIC that conducted securities activities through a subsidiary. While not the sole cause of the failure, the business relationship with the securities subsidiary added to the cost of the failure. The bank made a substantial unsecured loan that was used to benefit the securities subsidiary. This transaction was in compliance with the restrictions on affiliate transactions of Section 23A of the Federal Reserve Act because Section 23A does not specifically apply to transactions between a bank and its subsidiary. Given the Federal Reserve's residual rulemaking authority with respect to Sections 23A and 23B, we will work with the Federal Reserve to determine whether the provisions of Sections 23A and 23B should be extended to apply to these subsidiaries. We would also support an amendment to the legislation to assure coverage of these kinds of transactions.

The experience with bank-sponsored mutual funds has also been free of substantial safety-and-soundness concerns. Nevertheless, this experience demonstrates that the mixing of banking with securities activities is not without risk. Within the last year, 12 banking organizations have elected to provide financial assistance to their proprietary money-market mutual funds. The assistance has ranged from $1 million to about $83 million. The decisions to provide assistance presumably reflected business judgments that weighed the cost of the assistance against the loss of reputational capital that these organizations would have sustained if investors in their mutual funds had suffered losses.

None of these episodes posed any serious safety-and-soundness concerns to the insured entities. In all but two cases, the assistance was provided by the holding company rather than the bank, and in no case did the assistance exceed approximately one percent of the consolidated capital of the holding company. Nevertheless, the instances serve as a reminder that banking organizations can have an incentive to manage their businesses as a unit, and the result may involve the transfer of resources among affiliates that can adversely affect the insured entity.

The affiliation of banking and securities activities as it currently exists in both bank subsidiaries and bank affiliates has, in general, not presented significant safety-and-soundness concerns. This experience suggests that current safeguards are for the most part adequate and that any reform of Glass-Steagall should include similar safeguards against dealings between the insured bank and a securities affiliate.

Although the experience thus far has been generally positive, it has been limited. As mentioned above, we have not seen the combination of a failed or severely distressed bank that was associated with significant securities activity. This is important from the perspective of the deposit insurer because the past decade provided examples where distressed banks breached statutory or regulatory protection of the insured bank to the detriment of the FDIC.

While none of the interaffiliate transactions were solely responsible for the failure of any insured institutions, there were a number of instances where "deathbed transactions" were proposed or consummated that served to advantage the holding company or an affiliate at the expense of the insured bank. The transactions often involved sums in the tens of millions of dollars. Not all of these transactions required regulatory approval. The regulators often, but not always, denied those that did.

Unpaid tax refunds arose as an issue in more than one case. Bank holding companies generally receive tax payments from and downstream tax refunds to their banking subsidiaries, acting as agent between the bank and the Internal Revenue Service. The FDIC has observed that in some cases unpaid tax refunds accumulated on the books of failing bank subsidiaries, leaving the cash with the holding company. This practice occurred without regulatory approval.

Consolidation of nonbank activities at the parent level is another way to transfer value away from insured bank subsidiaries. One notable case involved the consolidation of trust operations at the subsidiary banks into a single parent-owned company that was later sold at a profit. When service company affiliates carry out data processing or other activities for banks, the issue of intercompany pricing also is raised. In one case the FDIC observed a large and retroactive increase in charges by an asset management company to troubled bank affiliates. In other cases, service company affiliates failed to provide promised overhead reimbursement for the use of bank premises.

Linked deals involving the sale of purchased mortgage servicing rights have in some cases been used either to subsidize the sale of a holding company asset or to allow the bank subsidiary to book an accounting gain. The effect of a linked deal may be to either transfer value to the parent or delay the closing of a subsidiary without the benefit of needed fresh capital.

Finally, there have been instances of "poison pills" created by interaffiliate transactions. In one case, key bank staff were transferred to the holding company payroll, apparently to reduce the attractiveness of bringing in an outside acquirer. Interaffiliate data processing contracts also have been structured so as to limit the availability of information to the FDIC or an acquirer after the bank was closed, thereby making regulatory intervention more costly.

To summarize, factors other than interaffiliate transactions typically have caused the failure of FDIC-insured subsidiaries of bank holding companies. However, such transactions were used in several cases to extract value from the insured bank just prior to its failure at the expense of the deposit insurance fund. This generally did not come about through excessive dividends or the transfer of blatantly misvalued assets. They more often occurred through the pricing of services traded between affiliates, early retirement of subordinated debt and linked deals involving third parties. These transactions probably added tens of millions of dollars to the losses realized in resolving these large banking organizations.

Some of the most spectacular examples of inappropriate intercompany transactions come from the thrift industry in the 1980s. Thrifts have traditionally spawned a variety of subsidiary service corporations to perform tasks such as mortgage servicing, brokerage, title insurance and other types of insurance. With the liberalization of federal and state restrictions on direct real estate investment in the early 1980s, the real estate development subsidiary became a common vehicle for these activities. However, while federally chartered institutions in the early- to mid-1980s were limited to investing 3 percent of assets in these activities, state-chartered institutions in California and Texas could make virtually unlimited direct investments.

Two factors made this liberalization of powers particularly conducive to creating losses for the Federal Savings and Loan Insurance Corporation (FSLIC) and later the Resolution Trust Corporation (RTC). First, under regulatory accounting practices, direct investments in subsidiaries were carried on the books of the parent thrift at historical cost, instead of their market value, which was often considerably lower. Second, thrift regulators as a rule neglected to conduct detailed examinations of subsidiary operations. Under these conditions, thrift managers were free to invest in residential and commercial real estate development activities with which they had little experience, and when these projects became problematic they could use a variety of transactions to hide the losses. The thrift could make unsound loans to help sell new properties built by the subsidiary. In some cases the thrift would sell the note to the subsidiary, removing it from the balance sheet for a period.

Our review of the examples described above suggests that, for the most part, the problem has not been that the existing protections were inadequate. Instead, it appears that the regulatory community has been reluctant at times to enforce these protections. This reluctance is understandable to some extent, given the considerable uncertainties that surround banks in distress and the desire to mitigate market pressures that may unnecessarily aggravate the plight of those banking organizations that have a chance to survive.

What steps can be taken to encourage more vigilant enforcement of protections? First, the enforcement of safeguards against transactions between an insured bank and its securities affiliates should allow for few exceptions. Congress should consider whether the perspective of the FDIC as insurer would be useful in identifying, through guidelines or other means, those limited areas where exceptions to the safeguards may be beneficial without creating the potential for losses to the insurance funds. In addition or in the alternative, it may be useful to develop an interagency codification of the standards for enforcing Sections 23A and 23B of the Federal Reserve Act, so that insured financial institutions and all regulatory agencies will have clear notice and fuller understanding of the nuances of these safeguards. Second, while sound business judgment should dictate when healthy, well-capitalized banks provide support to related entities, such support should come through the transfer of excess bank capital -- beyond the capital required for a well-capitalized bank -- not through the relaxation of safeguards such as those discussed earlier. For bank holding companies, this means the well-capitalized bank could provide dividends that allow the parent to provide support to nonbank subsidiaries. For banks conducting activities in subsidiaries, the bank could make additional equity investments in the subsidiary and those investments should be deducted from bank capital before determining whether the insured bank meets the standard of being well-capitalized.

In addition, bank regulators may want to consider whether to require prompt reporting of intercompany transactions under certain conditions, as the SEC does in some contexts. These requirements may be tied to the capital level of the bank, the size of the transaction, or other relevant factors.

As the deposit insurer, it is the FDIC's responsibility not only to protect depositors when a bank fails, but also to learn from the failure of that bank. The FDIC is prepared to provide information and analysis to fellow regulators where there is evidence that intercompany transactions have contributed to the failure of, or increased the cost of resolving, an insured institution. Such reports would contribute to an increased understanding and awareness of these issues, and we believe ultimately would promote improved enforcement of the safeguards.

STRUCTURAL ISSUES

An important consideration in the deliberations concerning the possible combination of traditional commercial banking and securities activities is the organizational structure under which such combinations would be permitted. The perspective of the deposit insurer focuses on two issues: the ability to insulate the insured bank from the risks of the securities underwriting activities and the burdens and inefficiencies associated with a particular regulatory structure. The following analysis addresses these issues.

There are two organizational structures with which we have experience in the United States that can be used to combine commercial and securities underwriting activities. These are: (1) the conduct of each activity in separate organizations owned and controlled by a common "parent" organization (the "bank holding company" model); and (2) the conduct of each activity in a separate organization, one of which owns and controls the other entity (the "bona fide subsidiary" model). A third model -- the conduct of both activities within the same entity (the "universal banking" model) -- has been used in some other developed countries. For reasons discussed in Appendix B, I believe that universal banking is not a model that would best fit the dynamic financial marketplace in the United States or provide sufficient protection for the deposit insurance funds against the effects of potential conflicts of interest between banking and nonbanking functions in an insured entity.

The Bank Holding Company Model

Since the adoption of the Bank Holding Company Act of 1956, one of the primary methods of expanding permissible activities beyond those associated with traditional commercial banking has been through formation of affiliated entities within the bank holding company umbrella. Within this framework, banking organizations have been permitted to engage in an increasing array of financial services. Most recently, some bank holding companies have been permitted by the Federal Reserve to engage in corporate securities underwriting activities through so-called "Section 20" subsidiaries. Attachment E describes in detail the prohibitions and restrictions on securities activities that are imposed by Section 20 of the Glass-Steagall Act and by the Bank Holding Company Act.

In terms of the criteria for safeguards set forth earlier, the bank holding company model has considerable merit. The advantages include:

- Provision of a good framework for monitoring transactions between insured and non-insured affiliates and for detecting transfers of value that could threaten the insured institution; and

- Maintenance of a meaningful corporate separation between insured and non-insured organizations to assure that nonbank affiliates have no competitive advantages from the insured status of the bank.

The disadvantages of the bank holding company model include:

- In distressed situations, the parent will have the incentive to transfer or divert value away from the insured bank, leaving greater losses for the FDIC if the bank ultimately fails; and

- The holding company model requires bank owners to establish and maintain an additional corporation. This may add costs, inefficiencies, complexity and, in some cases, an additional regulator.

Bona Fide Subsidiary Model

From a practical perspective, there has been less experience with the "bona fide" subsidiary form of organization than with the bank holding company form. However, the experience discussed earlier in this testimony supports the view that direct ownership of a securities firm by an insured bank need not be significantly different from the bank holding company model in terms of affording protections to the deposit insurance funds, and may have some additional advantages.

Analytically, there are several factors that make this approach different from the bank holding company model. The advantages of the bona fide subsidiary approach include:

- The residual value of the subsidiary accrues to the bank, not the holding company; and

- The bank, rather than the parent, controls the allocation of excess capital of the organization. This may mean that in making corporate investment decisions, greater weight will be given to the needs of the insured bank. Financial investments will be structured to diversify the risks of the bank's portfolio, while investment in systems and physical capital will benefit the operations of the bank.

However, on the negative side:

- While corporate separateness theoretically can be maintained regardless of organizational structure, in practice, a bank holding company structure may be a more effective vehicle for this purpose;

- Inappropriate wealth transfers may be more easily executed if made directly to a subsidiary, rather than indirectly to the parent and then to an affiliate; and

- Consolidated earnings of a bank that includes a fully consolidated securities firm may exhibit more volatility than the bank alone. This may be negatively perceived by the market, and might inhibit the ability of banks to raise capital or attract funds at market rates.

Based on these observations, it is clear that there are advantages and disadvantages to both models. Furthermore, the safeguards that are necessary to protect the insured bank and ultimately the insurance funds can be similar for either structure. If these safeguards are in place and enforced, either approach will work. If safeguards are inadequate or there is not a strong commitment to enforcing them, the deposit insurance funds, the financial system and the public will suffer, regardless of which model is used.

In the final analysis, I favor allowing financial institutions to choose the model that best suits their business needs, as long as strong safeguards are in place to protect the insurance funds. Legislation based on a progressive vision of the evolution of financial services need not mandate a particular structure. A combination of flexibility and sound regulation has contributed to the successful development of the U.S. financial system, and these key elements should be present in any proposal for reform.

COMMENTS ON THE FINANCIAL SERVICES COMPETITIVENESS ACT OF 1995

I want to commend the Subcommittee Chairmen again for holding this hearing to serve as a focus for debate on how best to achieve financial services reform. The Financial Services Competitiveness Act of 1995, as reported from the Committee on Banking and Financial Services ("the bill"), is designed to enhance competition in the financial services industry by providing a prudential framework for the affiliation of banks and securities firms. It accomplishes this by eliminating current statutory restrictions on these affiliations and establishing a comprehensive framework for affiliations within a holding company structure overseen by the Federal Reserve with functional regulation of securities activities by the SEC.

As discussed earlier in my testimony, the protections against inappropriate intercompany transactions provided in the bill are sound. I would expect that any exceptions to these restrictions that could be made pursuant to the legislation would be structured to protect the deposit insurance funds from potential losses. Moreover, provided the appropriate protections are in place, I would support an approach that allows a commercial bank the flexibility to conduct securities activities in an affiliate of its holding company where the bank has a holding company or wishes to organize one, or in a subsidiary of the bank where that approach more effectively conforms to the business plan of the organization. I recognize, however, that the bill would permit additional securities activities to be conducted only under the holding company structure. While I do not believe the advantages of the bank holding company structure are so pronounced as to justify imposing additional costs on the banking system by mandating a particular structure, I support the bill as a reasonable balancing of the competing considerations of safety and soundness and additional flexibility for banking organizations.

Criteria for Approval

Turning to a more detailed discussion of the bill, any expanded authority may be exercised only through a financial services holding company structure and only when the Federal Reserve has concluded that certain procedural safeguards have been met. The criteria outlined in the bill are sensible and appropriate.

Only financial services holding companies that are adequately capitalized are eligible to acquire a securities affiliate. For purposes of determining whether a financial services holding company is adequately capitalized, the holding company's capital and total assets are reduced by the holding company's equity investment in any securities affiliate, and further reduced by certain extensions of credit to any securities affiliate.

The lead bank within the holding company must be well-capitalized before the holding company is eligible to acquire a securities affiliate. Moreover, 80 percent of the aggregate total risk-weighted assets of the holding company's depository institutions must be controlled by well-capitalized institutions, excluding certain recently acquired depository institutions. All subsidiary depository institutions controlled by the holding company must be well-capitalized or adequately capitalized.

Well-capitalized financial services holding companies may elect alternative capital treatment, however. A financial services holding company and its depository institution subsidiaries will be deemed to have satisfied the capital requirements prescribed by the bill if the holding company files a notice of its election for alternative capital treatment with the Federal Reserve; all of the holding company's depository institutions are at least adequately capitalized; and the holding company is well-capitalized and would continue to be well-capitalized immediately after the acquisition of the securities affiliate. Any holding company that elects such alternative capital treatment will be liable for any loss incurred by the FDIC in connection with the default of any insured depository institution controlled by the holding company.

We support these provisions. I believe these provisions help to preserve a strong capital cushion for the bank and the financial services holding company as a possible source of strength for its banking subsidiaries. It is appropriate to impose losses incurred by the FDIC on holding companies that elect the alternative capital treatment described above.

The bill properly provides an incentive to financial services holding companies and their depository institutions to maintain adequate capital levels after they have been allowed to affiliate with a securities company. In the event the lead depository institution drops below the well-capitalized category, or if well-capitalized institutions cease to control 80 percent of the aggregate total risk-weighted assets of the depository institutions within the holding company, the holding company must execute an agreement with the Federal Reserve to meet the prescribed capital requirements within a reasonable period of time or to divest control of the depository institution within 180 days (or such additional period of time as the Federal Reserve may determine is reasonable). If the holding company fails to execute such an agreement or fails to comply with such an agreement, the securities affiliate cannot agree to underwrite or deal in any securities starting 180 days after the capital deterioration, with limited exceptions. While there are certainly instances where, as provided for in the bill, the securities affiliate should be barred from agreeing to underwrite or deal in any securities, such a blanket prohibition may not be prudent in all cases. For example, a profitable securities affiliate may serve as a source of strength to a holding company and its bank subsidiary.

At the same time, however, we note that the bill gives the Federal Reserve the authority to waive the capital safeguards for up to two years if the financial services holding company submits a recapitalization plan for the banks. We have an interest in assuring that a waiver will be granted only in situations where greater safety and soundness can be expected to result and losses to the insurance fund are not likely to be increased. For that reason, we want to work with the Federal Reserve on an interagency basis to develop guidelines on when waivers of these safeguards would be appropriate.

In addition to capital conditions, the bill imposes a broad array of managerial safeguards and internal controls. The holding company and all of its depository institutions must be well-managed. The financial services holding company must have the "managerial resources" necessary to conduct the securities activities safely and soundly. The holding company must have adequate policies and procedures in place to manage any potential financial or operational risks. In addition, the holding company must have established adequate policies and procedures to provide reasonable assurance of maintenance of corporate separateness within the financial services holding company. Finally, the acquisition must not adversely affect the safety and soundness of the financial services holding company or any depository institution subsidiary of the holding company. These operational safeguards, particularly the emphasis on maintaining corporate separateness, are well-designed to insulate federally insured banks from the risks of securities activities.

The bill provides that a holding company's acquisition of a securities affiliate must not result in an undue concentration of resources in the financial services business. The bill also provides that the lead depository institution subsidiary as well as the depository institutions controlling at least 80 percent of the aggregate total risk-weighted assets of all depository institutions controlled by the holding company must have achieved a satisfactory record of meeting community credit needs during the most recent examination. We support these provisions.

The bill also places several interaffiliate safeguards on the relationship between a securities firm and its affiliated bank or parent holding company. For example, a depository institution affiliated with a securities affiliate is prohibited from extending credit to the securities affiliate, issuing a guarantee, acceptance, or letter of credit for the benefit of the securities affiliate or, with certain exceptions, purchasing assets of the securities affiliate for its own account. I support these safeguards. In moving from a framework based on prohibition to one based on regulation, prudential safeguards such as those set forth in the bill will avert the hazards Glass-Steagall was intended to prevent.

In addition, the bill provides for some exceptions to the safeguards for well-capitalized banks. For example, a well-capitalized institution may extend credit for the purpose of enhancing the marketability of a securities issue underwritten by its securities affiliate but only if the depository institution has adopted limits on its exposure to any single customer whose securities are underwritten by the affiliate and the transaction is on an arm's-length basis. This appears to be a reasonable exception to the safeguards. The FDIC would like to work with the Federal Reserve to assure that in practice, any additional exceptions to the safeguards will not present substantial risks to the deposit insurance funds.

Some may argue that the safeguards provided for in this bill would hamper the ability of a financial services holding company to compete against non-regulated entities and would impede its ability to realize business synergies. The potential for risks associated with the conduct of such activities by an entity affiliated with insured depository institutions, however, carries with it the need for some protections for the insured institution. The bill draws an appropriate balance between these competing considerations.

I also support the additional safeguards for director and senior executive officer interlocks. Finally, I support the various public disclosures included in the bill. In particular, I strongly support the requirement that customers be informed that the securities offered or sold by securities affiliates of insured banks are not federally insured deposits. This is an important protection for these customers and for the deposit insurance funds.

Existing Bank Securities Activities

The bill provides that, subject to discretionary determinations by the SEC or the Federal Reserve, banks could continue to conduct some existing securities activities within the bank. Some of these activities must be moved to a Separately Identifiable Department (SID) and some activities must be moved to an affiliate -- both of which would be functionally regulated by the SEC.

While there is no separate capital requirement for SIDs, the risk associated with the activities conducted through the SID is included currently in the assessment of the bank's overall capital adequacy. In addition, bank regulators are in the process of developing a proposed amendment to more formally incorporate market risks associated with underwriting and dealing activities into their capital adequacy requirements.

Concerns have been raised about the provisions of the bill that provide for discretionary determinations of the SEC and the Federal Reserve with respect to what is a security or a bank product and where such activities can be conducted. Such determinations could result in limitations or unnecessary regulatory burdens on activities that have been conducted within the bank for many years without posing significant safety-and-soundness problems. We believe that there may be some room for further refinement of these provisions in order to avoid unnecessary organizational or regulatory burdens.

Functional Regulation

With respect to regulation, the bill calls upon the banking agencies and the SEC to work together to ensure compliance with the securities laws. As I mentioned earlier in my statement, functional and supervisory regulation must be seamless to be effective. By calling for the banking agencies and the SEC to share information, the bill promotes this goal by facilitating coordination among the regulatory agencies. Further refinement may need to be made to the provisions of the bill with respect to SEC and Federal Reserve discretion in order to avoid the possibility of duplicative supervisory and reporting burdens.

Securities Firms

The bill creates the possibility for securities firms to become affiliated with banks by acquiring an insured bank and becoming a financial services holding company. In circumstances where more than 50 percent of a company's business involves securities activities, the bill allows the company five years, with the possibility of an additional five-year extension, to divest its nonfinancial activities. In addition, such a company could be permitted to continue holding any subsidiaries engaged in financial activities that the Federal Reserve has not authorized if the company acquired the subsidiaries more than two years prior to its becoming a financial services holding company and the aggregate investment by the company in these subsidiaries does not exceed 10 percent of the total consolidated capital and surplus of the company. The company would not be permitted to engage in any new activities not otherwise authorized by the bill once it becomes a financial services holding company. This means that some securities companies that become financial services holding companies could be permitted to engage in activities not otherwise permitted generally to financial services holding companies.

I support in general the approach of the bill with respect to the affiliation of a securities firm with an insured institution. If it is understood that prudential restrictions may be imposed by the Federal Reserve where necessary to protect the safety or soundness of an insured institution with respect to a grandfathered affiliate's activities, I see no reason to go further and require divestiture. Further, it should be clear that each of the banking agencies should be able to apply the full panoply of enforcement powers, ranging from cease-and-desist actions to deposit insurance termination, in order to protect an insured bank and the deposit insurance funds.

Wholesale Financial Institutions

The bill provides the additional option of an "investment bank holding company" (IBHC) that would be allowed to engage in a broader range of financial activities and could conduct banking activities through a "wholesale financial institution" (WFI). WFIs would be uninsured state member banks that could, with certain exceptions, only take initial deposits over $100,000. This provision allows for a wholesale banking operation to conduct a broader range of financial services activities without exposing the deposit insurance funds to the risks of these activities.

The IBHC concept may prove attractive to some financial firms and may even cause some FDIC-insured banks to consider terminating their deposit insurance. The proposed IBHC appears to the FDIC to be sound as long as there is clear disclosure to the public of the uninsured nature of commercial bank operations and the exceptions for initial deposits of $100,000 or less are appropriately limited and clearly defined for public disclosure purposes.

Holding Company Supervision

The bill provides a different supervisory structure for holding companies engaged primarily in nonbanking activities. Certain financial services holding companies and investment bank holding companies, that have relatively smaller percentages of consolidated risk-weighted assets in depository institution assets, would be under limited reporting and examination requirements and minimal approval requirements for new activities. As insurer, the FDIC finds this approach reasonable, and adequate, to provide for the identification of risks associated with nonbanking activities. Capital requirements and guarantee provisions protect the insured depository institutions and maintain a degree of supervision that while appropriate, does not unduly disadvantage financial services holding companies or investment bank holding companies with respect to unregulated entities.

Voluntary Termination of Insured Status

In order to facilitate transition by existing insured depository institutions to WFI status, the bill adds a new section governing voluntary termination of deposit insurance and repeals certain provisions of the FDI Act with respect to such termination. The bill would permit an "insured State bank" or a national bank to voluntarily terminate its status as an insured depository institution upon six months' written notice to the FDIC, the Federal Reserve, and the institution's depositors. Before a bank may terminate its insurance under this provision, the deposit insurance fund must equal or exceed the fund's designated reserve ratio (DRR) of 1.25. In addition, the FDIC must confirm that the insurance fund will continue to equal or exceed the fund's DRR for the two semiannual assessment periods following notification of the institution's intent to terminate insurance. If the insurance fund does not meet its DRR, the bank must pay an exit fee and obtain the approval of the FDIC and the Federal Reserve. The FDIC is required to prescribe procedures for assessing any such exit fee by regulation.

The FDIC currently has in place procedures governing the termination of insurance. The legislative provisions described above appear to be intended to prevent the dilution of the fund for which coverage would be terminated. However, because a termination of insurance has the effect of increasing, not decreasing, the reserve ratio of the affected fund, Congress may wish to reconsider this provision. Moreover, the requirement that the FDIC confirm that the insurance fund would not fall below the DRR for one year following notification of the intent to terminate insurance would be very difficult to satisfy. Thus, the provision could have the unintended effect of precluding the transition of insured institutions to WFI status and of preventing voluntary terminations of insured coverage where no disadvantage to the deposit insurance fund would necessarily result.

Savings associations as well as insured depository institutions excepted from the Bank Holding Company Act definition of "bank" would no longer be eligible voluntarily to terminate insured status. We believe these institutions, which are presently authorized under the law to leave the federal deposit insurance system, should continue to have that option.

The primary purpose of this provision of the bill is presumably to protect depositors when insured institutions convert to non-insured status. We agree that depositor protection must be paramount when any insured institution voluntarily relinquishes its insured status.

Under current law, an insured depository institution must obtain prior written consent of the FDIC before it may convert to non-insured status. The FDIC weighs several factors prescribed by statute in deciding whether to grant or withhold such consent. The bill does not amend or repeal these provisions; the FDIC's power to disapprove any institution's conversion from insured to non-insured status would continue without change. The voluntary termination procedures specified in the bill, however, differ somewhat from these consent requirements found elsewhere in the FDI Act. Consequently, it would be appropriate to clarify the bill to assure consistency of the various termination provisions. The bill could in part be clarified by including a provision that the bill does not override the provisions of Section 18(i) of the FDI Act.

The bill provides that a depository institution that voluntarily elects to terminate its insured status shall no longer receive insurance of any of its deposits after the specified transition period. It also should be made clear that this provision is not intended to bar a formerly insured institution from reapplying for federal deposit insurance.

Under the bill, any institution that voluntarily terminates its status as an insured depository institution is prohibited from accepting deposits unless the institution becomes a WFI. If the institution becomes a WFI, it may not accept any initial deposit that is $100,000 or less other than on an incidental and occasional basis. These prohibitions limit the flexibility non-insured institutions now have under federal law. It is not clear why the law should compel institutions that have voluntarily terminated insurance to obtain WFI status so that they can accept deposits where state law permits other kinds of uninsured entities. The flexibility non-insured institutions enjoy under current federal and state laws should not be diminished without good cause. The bill can be improved by clarifying the termination provisions along the lines I have outlined. The FDIC will be pleased to work with members of Congress in making reasonable modifications to these provisions to avoid unintended consequences.

In conclusion, on balance the bill represents a thoughtful approach to easing the restrictions between commercial and investment banking. It provides for prudential safeguards and appropriate restrictions designed to insulate insured institutions from the risks inherent in investment banking activities. It is an important foundation for considering the most effective and efficient approach by which appropriate financial services reform can be achieved.

CONCLUSIONS

The restrictions of the Glass-Steagall Act do not serve a useful purpose. Their repeal would strengthen banking organizations by helping them to diversify their income sources, and would promote the efficient, competitive evolution of financial markets in the United States. History demonstrates, however, that a significant expansion of the powers available to insured institutions must be accompanied by appropriate safeguards for the insurance funds. Chairman Leach and other members of the House Committee on Banking and Financial Services have recognized the need for such safeguards in the bill.

Existing experience with the combination of banks and securities firms suggests that, in general, current safeguards have been adequate to prevent significant safety-and-soundness concerns in the normal course of business. This experience has been limited, however; in particular, we have not seen a severely distressed banking organization that had significant securities activities.

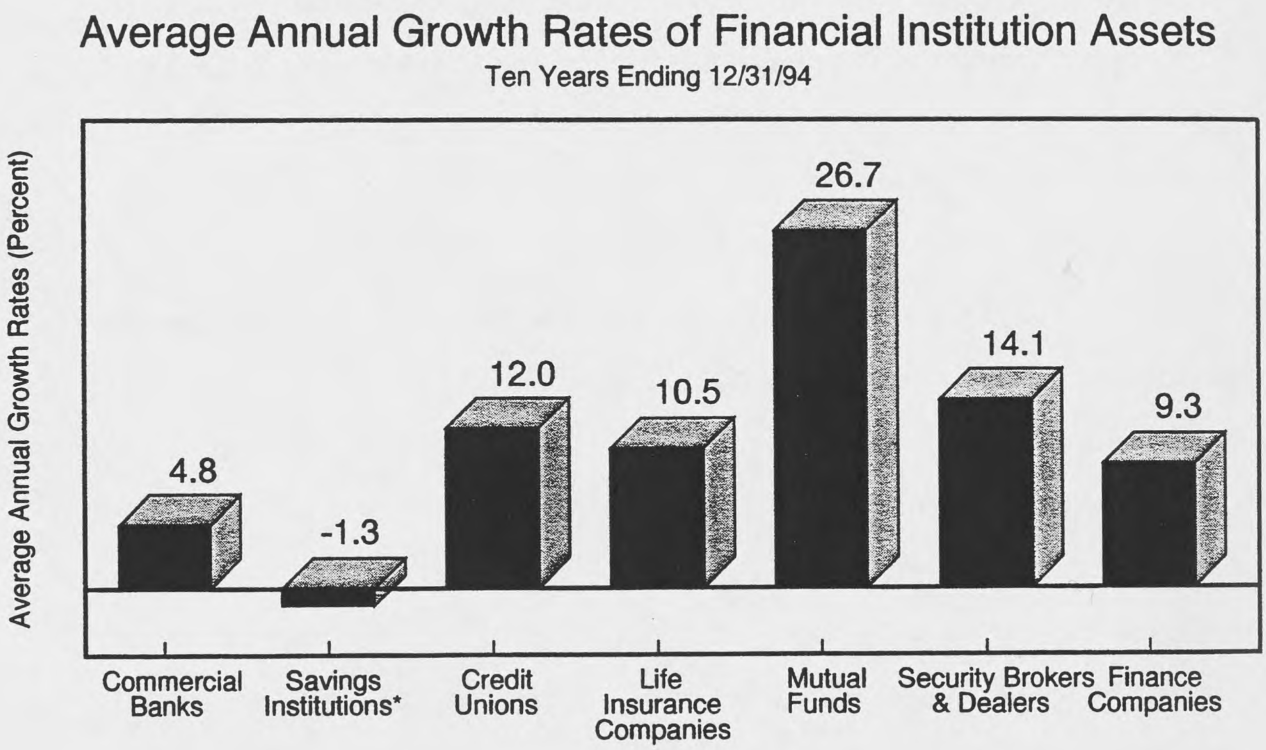
The experience of the FDIC has been that in times of financial stress, banking organizations may attempt to engage in transactions that transfer resources from the insured entity to the owners and creditors of the parent company or nonbanking affiliates. In some cases the FDIC has suffered material loss as a result of such transactions. We seek to assure that reform of Glass-Steagall is not the vehicle for more such episodes.

My general comments on the safeguards against inappropriate intercompany transactions in the proposed bill are as follows. First, exceptions to the safeguards should be allowed only after taking account of potential losses to the insurance funds. While there should be room for supervisory discretion and the exercise of good business judgment in determining whether a healthy bank may support an affiliate, such support should be provided through transfers of excess capital -- beyond that required for a well-capitalized bank -- not through relaxations of restrictions on intercompany transactions. Second, it could be useful to develop an interagency codification of the standards for enforcing Sections 23A and 23B of the Federal Reserve Act. To promote improved enforcement of the safeguards, the FDIC is prepared to provide information and analysis to fellow regulators on instances where intercompany transactions contributed to the failure of, or increased the cost of resolving, an insured institution.

There are two United States models for conducting the new securities activities within banking organizations -- the holding company model and the bona fide subsidiary model. There are advantages and disadvantages both to housing the securities activities in bank subsidiaries, and to housing the activities in holding company affiliates. On balance, I do not believe the case for either approach is strong enough to warrant dictating to banks which approach they must choose.

In general, I believe that banks should be able to chose the corporate structure that is most efficient for them, provided adequate safeguards are in place to protect insured financial institutions and the insurance funds. H.R. 1062 is a sound and constructive approach to evaluating how best to reform our financial system. The FDIC stands ready to assist the Subcommittees with this important effort.

Attachment A



* FDIC-Insured Savings Institutions, includes savings banks, savings associations and S&Ls.

Source: Flow of Funds, Federal Reserve System; FDIC Research Information System; National Credit Union Administration.

Asset growth rates are expressed as annual average for the 10-year period 12/31/84 to 12/31/94, adjusted for compounding.

ATTACHMENT B

THE CHANGING FINANCIAL MARKETPLACE

Banking was a simpler business in the early decades of the Federal Deposit Insurance Corporation. Interest rates were regulated and stable. Competition from nonbanking companies was limited. Banks were the primary source of borrowed funds for even the strongest, best-established businesses. In more recent years, the financial services industry, technology and capital markets have evolved, creating new risks and new opportunities. Bankers have had to manage the risks, but the Glass-Steagall Act and other legislation limit the ability of bankers to mitigate risk by diversifying their sources of income.

Credit-risk exposure has increased dramatically since enactment of the Glass-Steagall Act. In 1935, approximately one-third of the industry's balance sheet was concentrated in assets that bear significant credit risk. Now, over 60 percent of banking assets are exposed to credit risk.

Beginning in the mid-1960s and lasting through the mid-1980s, the industry experienced rapid asset growth, typically exceeding ten percent per year. In that 20-year span, the assets of the industry increased nearly tenfold, from $345 billion to almost $3 trillion. This growth was achieved by increasing credit risk and decreasing the proportion of lower risk investments. During this period, commercial banks built up large portfolios of loans with concentrated credit risk including loans with large balances at risk to a single borrower.[1]

In 1935, about one-quarter of the balance sheet was invested in loans with "credit-risk concentrations." That level increased to almost 45 percent in 1984 (prior to the wave of recent bank failures), and has declined to 34 percent as of December 1994. Until the early 1980s, asset growth was fueled by commercial and industrial ("C&I") loans. C&I loan concentrations reached their highest level in 1982, peaking at nearly 25 percent of the industry's balance sheet. There were some notable lending excesses during these boom years, including real estate investment trusts, less-developed-country loans, and energy credits.

In the early 1980s, the largest commercial borrowers learned to bypass banks and replace loans from banks with lower-cost commercial paper. Burgeoning loan demand from energy-related businesses supported continued C&I loan growth for a time, but by

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[1]Credit-risk-concentrated loans include commercial and industrial loans, commercial real estate and construction loans, and loans secured by multifamily residential properties.

December 1994, C&I loans had declined to 15.4 percent of the industry's total assets.

When C&I loans began to decline, many banks turned to commercial real estate loans and construction loans for new -- but high risk -- profit opportunities. In the mid- to late-1980s, growing concentrations in commercial real estate loans and construction loans offset shrinkage in C&I loans. In 1976, commercial real estate loans and construction loans together comprised about five percent of the balance sheet. In ten years, the concentration increased to nearly nine percent of assets. It reached its highest level -- 11 percent -- in 1990. Banks were not the only providers of these loans. Savings and loan associations and other nonbank lenders also financed the speculative real estate development. Consequently, real estate markets in many regions became overbuilt, credit losses soared and commercial real estate loan demand diminished.

Loan growth since 1990 has been concentrated in loans where credit risk is more diversified. Credit card, consumer and home mortgage loans extend relatively small and often collateralized balances to a relatively large number of borrowers. Failure of a single borrower to repay does not have a significant impact on a bank's earnings or capital. Most of the growth in "credit-risk-diversified" loans has come from home mortgages. Concentrations in home mortgage loans have nearly doubled since 1984, increasing from 7.7 percent of the industry's balance sheet to nearly 15 percent as of year-end 1994. Credit card loans constitute 4.9 percent of assets and other "consumer" loans constitute 7.8 percent.

Beginning in 1990, the industry's risk profile began to change direction. Banks were able to take advantage of a widening difference between shorter- and longer-term interest rates to improve earnings while reducing credit risk. They shortened the average maturity of their liabilities and increased their concentrations of fixed-rate securities and residential mortgages. In effect, the industry replaced some of its credit risk with higher levels of interest-rate risk. The industry's asset composition has changed since the deregulation of deposit interest rates. In the early 1990s, the growth of investment securities held by banks -- primarily mortgage-backed instruments and U.S. Treasury securities -- accelerated. Market conditions also favored the growth of home mortgages, which have more than doubled since 1986, increasing from $223 billion at year-end 1986 to $568.9 billion as of December 31, 1994. While about 46 percent of these loans in the portfolios of banks carry adjustable rates, there is still interest-rate exposure, due to repricing lags, as well as caps that limit the amount by which the interest rates on the loans can increase.

In recent years, increased market volatility has made it more important for banks to manage risks other than credit risk, such as interest-rate risk, prepayment risk, and foreign-exchange risk. Banks have responded to this challenge by devoting considerable resources to asset-liability management and other risk management systems.

The tools for managing these risks have expanded considerably over the past decade, particularly with the increasing use of off-balance-sheet instruments such as swaps, options, and forward contracts. While smaller banks for the most part still use on-balance-sheet instruments to manage risk, these off-balance-sheet instruments have become an integral part of risk management for most large banks.

Banks are not only end users of these swaps, options, and forwards. Several large banks are major dealers of over-the-counter instruments. This activity has provided an important source of revenue and allowed these banks to respond to the needs of their customers. Nevertheless, a series of recent losses has raised concerns about the potential risks of these investments.

Record bank failures in the 1980s and early 1990s were quickly replaced with record earnings as the economy improved in a very favorable interest-rate environment. In the last ten years, the industry achieved both its lowest annual return on assets (about 0.09 percent in 1987) and its highest return on assets (1.20 percent in 1993) since the implementation of deposit insurance in 1933. Declining loan losses account for the wide swing in earnings. Declining loan-loss provisions have added roughly 25 basis points (pre-tax) to the industry's return on assets in 1992 and 1993, and 18 basis points in 1994. Interest margins have improved steadily since 1934, but these improvements have had relatively little impact compared with the reduced burden of loan-loss provisions. Ten-year growth in noninterest income has outstripped noninterest expense growth by a narrow margin, providing a relatively small boost to the industry's bottom line.

Bankers were not able to obtain expanded powers when the industry was in trouble, as in the late 1980s, owing to concerns about adding new potential risks to an industry struggling with existing risks. Now, opponents may argue that expanded powers are not needed, given the record profits the industry has reported for the last three years. Volatile swings in the health and performance of the industry may result in part from constraints that limit alternatives for generating profits. The data show that credit risk, interest-rate risk and competition have all increased since the enactment of Glass-Steagall. While the earnings trend recently has been positive, the wide swings in past performance indicate heightened uncertainty and increased risks in the industry.

International Developments

Global competitive pressures also present a compelling need to reconsider the Glass-Steagall prohibitions between investment and commercial banking. Domestic financial deregulation in major industrialized nations, the development of new financial instruments, and advances in communication and computer technologies have contributed to the rapid integration of international financial markets during the past two decades. These changes in the financial marketplace, both domestic and international, have led several major industrialized nations to change their laws governing financial institutions, with the goal of creating a more level competitive playing field. In particular, there has been a growing worldwide trend toward easing traditional distinctions among the three major segments of the financial services industry -- commercial banks, investment firms, and insurance companies.

It should be noted that commercial and investment banking have long been combined in countries with universal banking systems, such as Germany and most of western Europe. Universal banks have the authority to offer the full range of banking and financial services -- including securities underwriting and brokering of both government and corporate debt and equity -- within a single legal entity, the bank. Although some financial services are provided through subsidiaries, the bank or financial services holding company structure is virtually unknown in other countries.

In contrast to the universal banking structure allowed in Continental European countries, Canada, Japan and the United Kingdom traditionally maintained barriers and restrictions against combining commercial and investment banking activities. These restrictions have been largely removed by legislation in each of these countries. For example, British banks were permitted to join the stock exchange in 1986 and to acquire or develop investment banking subsidiaries. These affiliations are important to the ability of British banks to compete within the European Union's single market.

Canada amended its laws governing financial institutions in 1987 and 1992, removing many of the statutory barriers separating banks, trust companies, insurance companies and securities firms, to allow greater latitude in bank ownership of institutions in the other financial sectors. As a result, most of the major Canadian securities firms are now owned by banks. Additionally, banks were permitted to offer more services "in-house," and to set up networking arrangements through which their branches sell the products of institutions in other sectors of the financial industry.

In 1992, Japan approved the "Financial System Reform Act," amending Japan's Securities and Exchange Law, and effectively removing the barriers between investment and commercial banking. By law since 1993, banks and securities companies have been allowed to enter each other's businesses through subsidiaries, although the establishment of securities subsidiaries by Japan's City Banks was delayed until July 1994. Additionally, the Ministry of Finance has elected to restrict the range of powers permissible for new subsidiaries of banks and securities firms. Thus, new trust banking subsidiaries are not permitted to manage pension funds and new securities subsidiaries of banks are only permitted to underwrite corporate bonds. In any event, Japan has had a moratorium on new equity offerings, with the exception of initial public offerings, since 1990.

As a result of these legislative changes in other countries, the United States stands alone among the 25 nations comprising the Organization for Economic Cooperation and Development (OECD) in continuing to impose domestic legal restrictions on affiliations between commercial banks and securities firms. Efforts to quantify the effect of these restrictions on the international competitiveness of U.S. banks are hampered by cross-border differences in accounting practices, tax laws, and other regulations governing financial institutions. Moreover, the data may be misleading due to currency fluctuations. Therefore, while we hesitate to provide any statistics regarding international competitiveness, some anecdotal evidence may be instructive.

Among the advantages of universal banking often cited are the cost savings derived from the ability to cross-sell a wider range of products and to offer highly-competitive products at a lower cost by subsidizing them with higher margins on less-competitive products. Universal banks may have a significant competitive advantage in customer loyalty through their ability to provide customers with all their financial services needs. Finally, universal banks have greater opportunities to spread risk and to smooth out income fluctuations in different areas of their business.

Not surprisingly, universal banks tend to be large and profitable institutions. The degree to which they dominate domestic market share varies according to the number, powers, and other structural characteristics of countries with universal banks. In Germany, for example, the four largest universal banks controlled less than 10 percent of total domestic bank assets in 1991; during the same year, the four largest Swiss banks controlled nearly 50 percent of domestic bank assets. These differences may be attributed to differences in their respective domestic markets: German banks directly compete with approximately 200 regional banks, over 700 government-owned savings banks, and nearly 3,000 cooperative banks, many of which are also universal banks; in Switzerland, which has only about 600 institutions, most of the regional banks are small savings banks that specialize in mortgage lending.

There are several disadvantages inherent to universal banking as well. The one most often cited is the obvious potential for conflicts of interest among different areas of business. Another disadvantage is that capital markets are not as developed in countries with universal banking. It should be noted here that universal banks typically are permitted to own fairly sizeable equity positions in nonfinancial firms.

Banking and commerce links also exist in Japan, where banks are permitted to own equity investments in up to five percent in any one company. Studies comparing the German-style universal banking system and Japan's "keiretsu" form of industrial organization with the segmented U.S. banking system have concluded that the former may provide several important economic benefits. While these banking and commerce links no doubt have contributed to the industrial growth in these countries in the postwar era, they do raise serious concerns over concentration of power.

In Japan, these concerns are addressed through limitations on equity investments and the absence of bank personnel in the day-to-day management of nonfinancial firms. In contrast to Japan, where banks typically interfere only in cases of corporate distress, Germany not only permits banks to own shares, but also to serve on the supervisory boards of corporations and to exercise proxy rights over large blocks of shares through bank-managed portfolios. Other countries with universal banking have tended to curb bank control over industrial firms in recent years. Proposals to do so in Germany recently have been introduced as a result of the near-failure of several of Germany's nonfinancial firms.

These highly publicized cases were more of an embarrassment to Germany's major banks than a threat to their safety and soundness. These banks have been able to withstand losses due to their sheer size and strength, and to the very conservative accounting practices that allow equities to be carried at historical cost and allow banks to transfer portions of income to hidden reserves.

In fact, there are no cases in recent memory of a major bank failing in another country due to its securities activities or affiliations with commercial firms. The majority of banking problems in industrialized countries have been the result of traditional banking activities. For example, losses from foreign-exchange trading have caused isolated cases of bank failures, while real estate lending in "boom" years led to system-wide banking crises in the United Kingdom, most of the

Scandinavian countries and Japan, in addition to the well-known problems encountered by U.S. banks and savings and loan institutions.

If other problems have occurred, and no doubt there have been some, they have been dealt with quietly and effectively, without recourse to deposit insurance funds. This is largely due to the differences in the supervisory structure of countries that permit such affiliations, and to differences in failure-resolution methods and the role of deposit insurance. For example, while deposit insurance coverage is roughly comparable between the United States and Japan, the private sector plays a larger role in the operation of deposit insurance in many other countries. Consequently, the direct link to the government's "full faith and credit" is less explicit than in the United States. Major banks in other countries also are called upon more often to help in "bailouts" of other banks, voluntarily or otherwise, due to a traditionally close relationship with the central bank and more highly concentrated banking systems.

Given the greater potential for conflicts of interest between insured and uninsured functions, the governmental nature of deposit insurance in the United States, and the more dynamic and diverse financial marketplace in the United States, the universal banking model does not seem to be as suited to the current U.S. environment as other Models with which the United States has experience.

ATTACHMENT C

HISTORICAL BACKGROUND

Information concerning the principal abuses that arose during the 1920s and early 1930s in connection with the investment banking activities of commercial bank affiliates is largely limited to the extensive Senate investigation into stock exchange practices, which included the highly publicized Pecora hearings. A substantial portion of these hearings, which were held in 1933 and 1934, dealt with the activities of the securities affiliates of the country's two largest commercial banks, National City Bank and Chase National Bank.

The Glass-Steagall Act, which to a certain extent was the result of these hearings, was enacted primarily for three reasons. First, Congress believed the Act would help to protect and maintain the financial stability of the commercial banking system, and would strengthen public confidence in commercial banks. Second, Congress wanted to eliminate the potential for conflicts of interest that could result from the performance of both commercial and investment banking operations. The final Congressional concern was a belief that the securities operations of banks tended to exaggerate financial and business fluctuations and undermine the economic stability of the country by channeling bank deposits into "speculative" securities activities.

The actual and potential abuses that were revealed during the Senate investigation can be categorized as follows: first, abuses that were common to the entire investment banking industry; second, abuses that may be attributed to the use of affiliates for the personal profit of bank officers and directors; and third, abuses related to conflicts of interest that resulted from the mixing of commercial and investment banking functions. The primary types of abuses relevant to each of these categories are discussed below. Analyses of the appropriate remedies for these abuses are presented, together with comments directed toward examining the degree to which the Glass-Steagall Act was an effective or desirable solution.

<u>Abuses Common to the Investment Banking Business</u>

The principal types of abuses common to the investment banking business during the 1920s and early 1930s included:

- underwriting and distributing unsound and speculative securities
- conveying untruthful or misleading information in the prospectuses accompanying new issues
- manipulating the market for certain stocks and bonds while they were being issued.

Examples of the first two types of abuses can be found by examining National City Company's involvement in the financial operations of the Republic of Peru. Throughout the 1920s National City Company received reports that Peru was politically unstable, had a bad debt record, suffered from a depleted Treasury and was, in short, an extremely poor credit risk. In 1927 and 1928, National City Company participated, nevertheless, in the underwriting of bond issues by the government of Peru. The prospectuses that were distributed made no mention of Peru's political and economic difficulties. As a result, the public purchased $90 million of the bonds, which went into default in 1931 and sold for less than five percent of their face value in 1933.

While the National City case may be one of the more flagrant examples of these types of abuses, it was generally acknowledged that the extremely competitive banking environment of the 1920s led bankers to encourage overborrowing, particularly by governments and political subdivisions in Europe and South America. Questionable practices were employed to induce the public to purchase the security issues that resulted from the promotional efforts of bank affiliates. In addition to falsifying or withholding pertinent information, National City Company and Chase Securities Corporation attempted, on occasion, to prop up the price of securities while the securities were being sold.

A large portion of the abuses uncovered during the Pecora hearings were common to the entire investment banking industry. Because these problems were not directly related to the relationship between banks and their affiliates, the Glass-Steagall Act was not the proper remedy for these kinds of abuses. There are several reasons why the problems just described are of less concern today. First, the Securities Act of 1933 and the Securities Exchange Act of 1934 hold individuals involved in the issuance of securities responsible for any misstatement of facts or failure to reveal pertinent information concerning the financial condition of governments and corporations issuing securities. Second, it is now the duty of the SEC to prevent any manipulation of the market while a security is being issued. Additionally, these safeguards may help deter banks from underwriting unsound and speculative securities.

<u>Self-Dealing by Bank Officers and Directors</u>

Bank affiliates not only attempted to manipulate the stock and bond prices of other business and governmental entities, they also attempted to manipulate the stock prices of their parent banks. The procedure generally employed was for the affiliate to organize investment pools that traded in the stock of the parent bank. While the pools were financed primarily by the affiliates, they were generally open to selected individuals, including bank officers and directors. Bank officials claimed that the purposes of such trading accounts were to steady the market in order to maintain public confidence in the bank and to encourage increased distribution of the bank's stock. However, there were other motivations for such activity.

First, it is likely that many of the participants expected to benefit from their inside information and gain large profits from their trading activity. In practice, however, these expectations were not always realized. Chase's affiliates earned only $159,000 in profit on trades in Chase National Bank stock totaling $900 million. National City Company sustained $10 million in losses from dealing in the stock of its parent bank.

A second reason may have been that by advancing the stock's price it became more attractive to the stockholders of other banks that were acquired on an exchange-of-stock basis. Chase National and National City Bank each acquired several other banks during the period when their affiliates were trading in their stock.

In addition to the profits obtained by trading in their own bank's stock, bank officers and directors often received compensation from affiliates far in excess of that paid to them by their banks. For example, instead of permitting the stock of affiliates to be owned by bank stockholders, the stock was often wholly owned by officers and directors of the bank. This "ownership" may have been illegal and was clearly improper. Because the profit opportunities of the affiliates were a direct result of their association with their parent banks, any profits they derived rightfully belonged to the bank's stockholders.

The types of abuses just described sparked public outrage against commercial banks and their investment banking affiliates. However, the Glass-Steagall Act was not the proper remedy for such self-dealing and insider abuse. Trading accounts in the stock of parent banks by affiliates and the participation in such trading by bank officials could have been prevented by making it illegal for affiliates to deal in or own the stock of parent banks. The establishment of management funds is a problem mainly of concern to stockholders. With adequate disclosure of the salaries and bonuses distributed through such funds, stockholders can determine whether they are excessive. Affiliates owned entirely by bank officers and directors instead of by bank stockholders also could have been prohibited.

<u>Abuses Arising From the Mixture of Commercial and Investment Banking</u>

There were a number of abuses that occurred from the mixing of commercial and investment banking functions. Most of these relate to conflict-of-interest concerns, and while they have implications for bank safety and soundness, there is no evidence that a large number of bank failures were due to interactions between banks and their affiliates. The types of abuses revealed during Senate testimony in 1933-34 included:

- Using the affiliate as a dumping ground for bad bank loans. In an example highlighted during the Pecora hearings, National City Bank transferred to National City Company $25 million worth of loans to Cuban sugar producers after the price of sugar collapsed and the borrowers were unable to repay the loans.

- Using the bank or its trust department as a receptacle for securities the affiliate could not sell. While examples where Chase National Bank bailed out its affiliates were revealed during the Senate investigation, it appears that trust departments generally were not used for such a purpose.

- Lending to finance the purchase of securities underwritten by the affiliate. This could have been another means whereby the affiliate's problems were transferred to the bank. That is, if the affiliate found it difficult to sell a particular issue, the bank may have chosen to offer loans to prospective purchasers under conditions disadvantageous to bank stockholders.

- Excessive lending to affiliates to finance underwritings. This practice may have led to an inadequate level of bank asset diversification, the significance of which would have depended upon the quality of the underwritings.

- There was a tendency for banks to invest too much in long-term securities. This practice caused liquidity problems that contributed to a number of bank failures during the late 1920s.

- Lowering the quality of bank assets by purchasing part of a poorly performing security after it had been issued. The reason for such action would have been that the bank was concerned with its image if a security its affiliate had underwritten or distributed began to lose value.

- Lending to a corporation that would otherwise have defaulted on an issue underwritten by the bank's securities affiliate. Again, this would have occurred if a bank was concerned that its image would be severely tarnished in the event a corporation defaulted on an issue the bank's affiliate had underwritten or distributed.

The first five problems outlined above could have been controlled with fairly simple legislative remedies. For example, to prevent the use of a bank or its affiliate as the dumping ground for the other's bad assets, federal authorities could have been given, and now have, authority to conduct simultaneous examinations on a periodic basis. Lending to finance the purchase of securities underwritten by a bank's affiliate could have been prohibited. The concern that banks may lend excessive amounts to their affiliates could be handled by prohibiting such lending, by requiring that it be collateralized, or by simply placing a limit, perhaps as a percentage of bank capital, on the amount a bank may invest in any one and in all of its affiliates. However, the underlying concern in this case is that banks, by investing heavily in their affiliates, would not have a sufficiently diversified asset base. This concern can also be directly addressed by limiting overall investments in related markets or product lines. Similarly, the tendency for banks to invest too much in long-term securities could be controlled by prohibiting or limiting the number or amount of securities a bank could purchase from operating securities affiliates.

The potential for "tie-ins" also should be of concern. While it appears that investment banks can, and on occasion do, threaten to withhold certain services unless an entire "package" is purchased, the power of such a threat takes on a somewhat greater significance when it is a line of credit that might be withdrawn if an issuer does not choose a particular bank or bank affiliate as its underwriter. As with the previous two concerns it does not appear that examples of abuse were uncovered during the Pecora hearings.

The types of potential tie-ins that should be of concern to public policymakers are due either to self-dealing or to inadequate levels of competition. In neither case is a continued separation of commercial and investment banking an appropriate way to address effectively the problem. An example of the former is if a bank official tried to induce potential customers into purchasing a service (presumably, but not necessarily, at a relatively high price), in which the official had a personal interest, by tying-in and underpricing at the expense of the bank's or its affiliate's stockholders a second service in which the official's personal stake was less direct. Self-dealing of this kind can largely be prevented by other means.

In the absence of self-dealing at the expense of the benefactors of the proceeds of one of the tied-in services, the only way the tie-in threat can be effective is if the customer has no viable alternative. In competitive markets, customers would simply purchase the services elsewhere at more reasonable rates. This type of tie-in, to the extent it can occur, represents only one facet of a broader antitrust concern which is most appropriately dealt with through policies designed to foster greater competition. Since most banking markets are reasonably competitive, it is highly unlikely that investment bankers, as a group, will be at an unfair competitive advantage due to such tie-ins. Moreover, since nondepository institutions are becoming more involved in the extension of credit, it is difficult to argue that commercial banks should not be permitted to underwrite corporate securities on the grounds that such tie-ins are possible.

Conclusion

By the 1930s, the general view in Congress was that the mixing of commercial and investment banking posed a threat to the safety and soundness of the banking system, created numerous conflict-of-interest situations and led to economic instability due to the channeling of bank deposits into "speculative" securities activities. To alleviate those concerns, the Glass-Steagall Act was enacted.

From the evidence gathered during the Senate investigation into stock exchange practices it appears that, to the extent the concerns of Congress were valid, they could have been handled through less disruptive legislative means. There is little evidence that the investment banking activities of commercial bank affiliates were a major factor in causing bank failures. Where investments in securities underwritten by affiliates contributed to an institution's failure, it was generally because the bank was illiquid due to an overinvestment in long-term assets. Affiliate losses were generally due to speculative activities unrelated to investment banking.

Most of the abuses that arose during the 1920s in connection with the operation of security affiliates by commercial banks appear to have been conflict of interest concerns rather than factors threatening the safety and soundness of commercial banks. However, it appears that most of these problems could have been remedied without having to resort to a forced separation of commercial and investment banking. Certain abuses which arise from mixing commercial and investment banking cannot entirely be controlled; but, they do not appear to have been so significant as to have warranted legislation separating commercial and investment banking. Finally, the provision of the 1934 Securities Exchange Act that authorized the Federal Reserve Board to regulate the extension of credit for the purchase of securities effectively achieved the third objective of the Glass-Steagall Act, which was to control the speculative uses of bank assets in the securities markets.

In conclusion, bank affiliates were not regulated, examined, or in any way restricted in the activities they could participate in until the 1930s. As a result, abuses occurred. A certain degree of supervision and regulation and some restrictions on bank affiliate powers would have gone a long way towards eliminating the types of abuses that occurred during this period.

ATTACHMENT D

CURRENT SAFEGUARDS

Section 23A of the Federal Reserve Act restricts transactions between member banks and their affiliates, and the Federal Deposit Insurance Act extends the coverage of 23A to nonmember insured banks. Section 23A attempts to prevent the misuse of insured institutions by placing quantitative limitations on "covered transactions" between a bank and its affiliate, establishing collateral requirements for certain transactions, requiring that all transactions be on terms and conditions that are consistent with safe and sound banking, and prohibiting a bank from purchasing low-quality assets of an affiliate. "Covered transactions" include loans to an affiliate, purchases of securities issued by an affiliate, acceptance of securities issued by an affiliate as collateral, and the issuance of a guarantee, acceptance or letter of credit on behalf of an affiliate.

Section 23B of the Federal Reserve Act places additional limitations on federally insured banks and their affiliates, by providing that a bank may engage in certain transactions with its affiliates only on an "arm's length" basis. In addition to the "covered transactions" of Section 23A, Section 23B applies to the sale of securities or other assets to an affiliate, to service contracts between the bank and its affiliate, and to transactions with a third party where the affiliate has a financial interest in the third party.

The Federal Reserve Board has established prudential limitations on the activities of the "Section 20 companies" of bank holding companies (BHCs) that underwrite and deal in debt and equity securities to a limited extent. Among other things, in determining capital compliance, BHCs must deduct from consolidated primary capital any investment in an underwriting subsidiary, or any extension of credit that does not meet certain collateral requirements. BHCs and their subsidiaries are prohibited from: entering into any financial arrangement that might be viewed as enhancing the marketability of a bank-ineligible security issued by the underwriting subsidiary; extending credit to a customer to purchase a bank-ineligible security issued by the securities affiliate during or shortly after the underwriting period; or purchasing ineligible securities from a securities affiliate during or shortly after the underwriting period. Officer, director or employee interlocks between a BHC's underwriting subsidiary and any bank or thrift subsidiary are prohibited. An underwriting subsidiary must provide adequate disclosures that its products are not federally insured. There are limitations on the ability of affiliated banks or thrifts to provide investment advice regarding the purchase of securities underwritten or dealt in by the securities affiliate. Bank or thrift subsidiaries are prohibited from extending credit to a securities affiliate except in certain limited instances, or from purchasing or selling certain financial assets to or from a securities affiliate.

On December 28, 1984, the FDIC implemented its regulation on securities activities of subsidiaries of insured nonmember banks and bank transactions with affiliated securities companies (12 CFR § 337.4). At that time, the FDIC determined that it is not unlawful under the Glass-Steagall Act for an insured nonmember bank to establish or acquire a bona fide subsidiary that engages in securities activities nor for an insured nonmember bank to become affiliated with a company engaged in securities activities if authorized under state law. At the same time, the FDIC found that some risk may be associated with those activities. In order to address that risk, the FDIC regulation (1) defines bona fide subsidiary, (2) requires notice of intent to acquire or establish a securities subsidiary, (3) limits the permissible securities activities of insured nonmember bank subsidiaries, and (4) places certain other restrictions on loans, extensions of credit and other transactions between insured nonmember banks and their subsidiaries or affiliates that engage in securities activities.

In our regulation, the term "bona fide" subsidiary means a subsidiary of an insured nonmember bank that at a minimum: (1) is adequately capitalized, (2) is physically separate and distinct in its operations from the operations of the bank, (3) maintains separate accounting and other corporate records, (4) observes separate corporate formalities such as separate board of directors meetings, (5) maintains separate employees who are compensated by the subsidiary, (6) shares no common officers with the bank, (7) a majority of the board of directors is composed of persons who are neither directors nor officers of the bank, and (8) conducts business pursuant to independent policies and procedures designed to inform customers and prospective customers of the subsidiary that the subsidiary is a separate organization from the bank and that investments recommended, offered or sold by the subsidiary are not bank deposits, are not insured by the FDIC, and are not guaranteed by the bank nor are otherwise obligations of the bank.

This definition is imposed to ensure the separateness of the subsidiary and the bank. This separation is necessary as the bank would be prohibited by the Glass-Steagall Act from engaging in many activities the subsidiary might undertake. Also, the separation safeguards the soundness of the parent bank.

The regulation provides that the insured nonmember bank must give the FDIC written notice of intent to establish or acquire a subsidiary that engages in any securities activity at least 60 days prior to consummating the acquisition or commencement of the operation of the subsidiary. These notices serve as a supervisory mechanism to apprise the FDIC of which insured nonmember banks are conducting securities activities through their subsidiaries that pose potential risks to which the bank otherwise would not be exposed.

Activities of the subsidiary are limited in that it may not engage in the underwriting of securities that would otherwise be prohibited to the bank itself under the Glass-Steagall Act unless the subsidiary meets the bona fide definition and the activities are limited to underwriting of investment quality securities.

A subsidiary may engage in underwriting other than that listed above if it meets the definition of bona fide and the following conditions are met:

(a) The subsidiary is a member in good standing of the National Association of Securities Dealers (NASD);

(b) The subsidiary has been in continuous operation for a five-year period preceding the notice to the FDIC;

(c) No director, officer, general partner, employee or 10 percent shareholder has been convicted within five years of any felony or misdemeanor in connection with the purchase or sale of any security;

(d) Neither the subsidiary nor any of its directors, officers, general partners, employees, or 10 percent shareholders is subject to any state or federal administrative order or court order, judgment or decree arising out of the conduct of the securities business;

(e) None of the subsidiary's directors, officers, general partners, employees or 10 percent shareholders are subject to an order entered within five years issued by the Securities and Exchange Commission pursuant to certain provisions of the Securities Exchange Act of 1934 or the Investment Advisors Act of 1940; and

(f) All officers of the subsidiary who have supervisory responsibility for underwriting activities have at least five years experience in similar activities at NASD member securities firms.

A bona fide subsidiary must be adequately capitalized, and therefore, they must meet the capital standards of the NASD and SEC. As a protection to the insurance fund, a bank's investment in these subsidiaries engaged in securities activities that would be prohibited to the bank under the Glass-Steagall Act is not counted toward the bank's capital, that is, the investment in the subsidiary is deducted before compliance with capital requirements is measured.

An insured nonmember bank which has a subsidiary or affiliate that engages in the sale, distribution, or underwriting of stocks, bonds, debentures or notes, or other securities, or acts as an investment advisor to any investment company may not engage in any of the following transactions:

(1) Purchase in its discretion as fiduciary any security currently distributed, underwritten or issued by the subsidiary unless the purchase is authorized by a trust instrument or is permissible under applicable law;

(2) Transact business through the trust department with the securities firm unless the transactions are at least comparable to transactions with an unaffiliated company;

(3) Extend credit or make any loan directly or indirectly to any company whose obligations are underwritten or distributed by the securities firm unless the securities are of investment quality;

(4) Extend credit or make any loan directly or indirectly to any investment company whose shares are underwritten or distributed by the securities company;

(5) Extend credit or make any loan where the purpose of the loan is to acquire securities underwritten or distributed by the securities company;

(6) Make any loans or extensions of credit to a subsidiary or affiliate of the bank that distributes or underwrites securities or advises an investment company in excess of the limits and restrictions set by section 23A of the Federal Reserve Act;

(7) Make any loan or extension of credit to any investment company for which the securities company acts as an investment advisor in excess of the limits and restrictions set by section 23A of the Federal Reserve Act; and,

(8) Directly or indirectly condition any loan or extension of credit to any company on the requirement that the company contract with the banks securities company to underwrite or distribute the company's securities or condition a loan to a person on the requirement that the person purchase any security underwritten or distributed by the bank's securities company.

An insured nonmember bank is prohibited by regulation from becoming affiliated with any company that directly engages in the sale, distribution, or underwriting of stocks, bonds, debentures, notes or other securities unless: (1) The securities business of the affiliate is physically separate and distinct from the operation of the bank; (2) the bank and the affiliate share no common officers; (3) a majority of the board of directors of the bank is composed of persons who are neither directors or officers of the affiliate; (4) any employee of the affiliate who is also an employee of the bank does not conduct any securities activities of the affiliate on the premises of the bank that involve customer contact; and (5) the affiliate conducts business pursuant to independent policies and procedures designed to inform customers and prospective customers of the affiliate that the affiliate is a separate organization from the bank and that investments recommended, offered or sold by the affiliate are not bank deposits, are not insured by the FDIC, and are not guaranteed by the bank nor are otherwise obligations of the bank. The FDIC has chosen not to require notices relative to affiliates because we would normally find out about the affiliation in a deposit insurance application or a change of bank control notice.

The FDIC has created an atmosphere in which bank affiliation with entities engaged in securities activities is very controlled. Although we have examination authority over bank subsidiaries and under Section 10(b) of the Federal Deposit Insurance Act we have the authority to conduct examinations of affiliates to determine the effect of that relationship on the insured institution, we have in practice allowed these entities to be functionally regulated, that is FDIC examination of the insured bank and SEC and NASD oversight of the securities subsidiary or affiliate.

The FDIC feels that its established separations for banks and securities firms has created an environment in which the FDIC's responsibility to protect the insurance fund has been met without creating duplicative regulation for the securities firms. However, our experience indicates that these separations may not be perfect. Insider maneuvering may be able to evade the intent of the firewalls, securities firms affiliated with nonbank bank holding companies may fall outside the regulatory coverage of Part 337.4, and if systemic problems were to develop in the securities industry, the difficulties may overwhelm the protection in place.

Therefore, the FDIC believes that functional regulation should not be designed in a fashion that would preclude the FDIC from examining securities subsidiaries and affiliates for matters which are unsafe and unsound. This would include reviewing insider involvement in the securities firms, monitoring financial transactions between the insured institution and the securities firm, reviewing securities firms records to assure that the restrictions contained in Part 337.4 are being adhered to, and regularly reviewing financial statements of the securities firms.

The FDIC is also maintaining an open dialogue with the NASD and the SEC concerning matters of mutual interest. To that end, we have entered into an agreement in principle with the NASD concerning examination of securities companies affiliated with insured institutions and have begun a dialogue with the SEC concerning the exchange of information which may be pertinent to the mission of the FDIC.

The number of banks which have subsidiaries engaged in activities that could not be conducted in the bank itself is very small. The activities these subsidiaries are engaged in are underwriting of debt and equity securities and distribution and management of mutual funds. We have received notices from 444 banks that have subsidiaries which are engaged in activities that do not require the subsidiary to meet the definition of bona fide such as investment advisory activities, sale of securities and management of the bank's securities portfolio.

Since implementation of the FDIC's regulation, the relationships between banks and securities firms have not been a matter of supervisory concern. We believe in great part that this can be attributed to the protections we have in place. However, we are aware that in a time of financial turmoil that these protections may not be adequate and a program of direct examination may be necessary to protect the insurance fund and continuation of our examination authority in that area is important.

ATTACHMENT E

PROHIBITIONS AND RESTRICTIONS ON SECURITIES ACTIVITIES IMPOSED BY SECTION 20 OF THE GLASS-STEAGALL ACT AND BY THE BANK HOLDING COMPANY ACT

Section 20 of the Glass-Steagall Act ("Section 20") (12 U.S.C. §377) prohibits banks that are members of the Federal Reserve System ("member banks") from affiliating with organizations that are "engaged principally" in underwriting, distributing or selling securities. Section 20 states, in relevant part, that: "no member bank shall be affiliated in any manner . . . with any corporation, association, business trust, or other similar organization engaged principally in the issue, flotation, underwriting, public sale . . . of stocks, bonds, debentures, notes, or other securities . . . ." 12 U.S.C. §377. The statute defines an "affiliate" to include any corporation, business trust, association or other similar organization --

> (1) Of which a member bank, directly or indirectly, owns or controls either a majority of the voting shares or more than 50 percent of the number of shares voted for the election of directors, trustees, or other persons exercising similar functions . . .
>
> (2) Of which control is held, directly or indirectly, through stock ownership . . . by the shareholders of the member bank who own or control either a majority of the shares of such bank or more than 50 percent of the number of shares voted for the election of directors of such bank . . .
>
> (3) Of which a majority of directors, trustees, or other persons exercising similar functions are directors of any one member bank; or
>
> (4) Which owns or controls, directly or indirectly, either a majority of the shares of capital stock of a member bank or more that 50 percent of the number of shares voted for the election of directors of a member bank . . . . 12 U.S.C. §221a.

In contrast to Section 16 of the Glass-Steagall Act, which imposes an absolute ban on bank securities underwriting activities, Section 20 prohibits affiliations between banks and entities that are "engaged principally" in securities underwriting activities. Therefore, affiliations are permitted as long as the nonbank institution is not engaged "principally" in the securities activities restricted by Section 20. Section 20 itself, however, does not define the term "principally engaged." The legislative history of Section 20 also fails to define or explain the precise meaning of the term.[1] To date, the United States Supreme Court has not ruled on the question and very few lower federal courts have addressed it.[2] Thus, the meaning of the term "engaged principally" is not firmly resolved. Based on court decisions on other related provisions of the Glass-Steagall Act, and absent further clarification by the United States Supreme Court, the term "engaged principally" is not confined to the majority of a firm's business. Instead, any bank affiliate engaged in securities underwriting as a "substantial activity" would be in violation of Section 20.[3] A determination of what level of activity is "substantial," however, is still required.

The Federal Reserve has approved numerous applications allowing so-called "Section 20 subsidiaries" to underwrite and deal in securities (that are not exempt from the Glass-Steagall restrictions (i.e.,"ineligible securities")) on the grounds that the subsidiaries are not "engaged principally" in such activities, and thus their affiliation with member banks is not proscribed by Section 20.[4] In a precedential order issued in 1987 ("1987 Order") the Board of Governors of the Federal Reserve System imposed a "five-to-ten-percent" standard to differentiate permissible from impermissible levels of securities underwriting activities. The Board explained its rationale, in part, as follows:

> [T]he Board believes it is bound by the statutory language of section 20 [of the Glass-Steagall Act] to conclude that a member bank affiliate may underwrite and deal in the ineligible securities proposed in the application, provided that this line of business does not constitute a principal or substantial activity for the affiliate. The

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[1] See Banking Law, Vol. 5, § 96.02[3] (Matthew Bender, 1994).

[2] In Board of Governors v. Agnew, 329 U.S. 441 (1947), the United States Supreme court defined the term "primarily" to mean "substantial." This was in the context of section 32 of the Glass-Steagall Act, however, and not Section 20. (Section 32 restricts officer, director and employee overlap between member banks and entities "primarily engaged" in securities underwriting.)

[3] Cf. Board of Governors v. Agnew, supra

[4] The Federal Reserve has approved the establishment of over thirty "Section 20 subsidiaries." 59 Fed. Reg. 35,517 (1994).

Board reaffirms its conclusion . . . that Congress intended that the 'engaged principally' standard permit a level of otherwise impermissible underwriting activity in an affiliate that would not be quantitatively so substantial as to present a danger to affiliated banks . . . .

With respect to the appropriate quantitative level of ineligible activity permitted under section 20, the Board concludes that a member bank affiliate would not be substantially engaged in underwriting or dealing in ineligible securities if its gross revenue from that activity does not exceed a range of between five to ten percent of its total gross revenues . . . . " Citicorp, J.P. Morgan & Co., Inc., and Bankers Trust New York Corp., 73 Fed. Res. Bull. 473, 475 (1987).[5]

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[5] The Federal Reserve Board's standard was sustained by the Second Circuit Court of Appeals in Sec. Ind. Ass'n v. Board of Governors, 839 F.2d 47, 68 (2d Cir. 1988), cert. denied, 486 U.S. 1059 (1988).

In July 1994, the Federal Reserve requested comments on proposed alternatives to the current "gross revenue" and "indexed gross revenue" tests. 59 Fed Reg. 35,516 (1994).

With specified exceptions, the Bank Holding Company Act[6] ("BHC Act) prohibits a Bank Holding Company ("BHC") from acquiring direct or indirect ownership or control of any voting shares of any company that is not a bank (12 U.S.C. §1843(a)). Under Section 4(c)(8) of the BHC Act (Id. at 1843(c)(8)) that prohibition does not apply to a BHC's acquisition of "shares of any company the activities of which the [Federal Reserve] Board . . . has determined (by order or regulation) to be so closely related to banking or managing or controlling banks as to be a proper incident thereto . . . ."[7] In the 1987 Order the Federal Reserve concluded that underwriting and dealing in "ineligible securities" is "closely related" and a "proper incident" to banking under the BHC Act.[8]

Specifically, the Board of Governors stated that "underwriting and dealing in commercial paper, municipal revenue bonds and 1-4 family mortgage-related securities, under the limitations discussed in [the 1987] Order, are closely related to banking, because banks provide services that are so operationally and functionally similar to the proposed services that banking organizations are particularly well equipped to provide such services . . . [T]he proposed activities are natural extensions

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[6] The BHC Act requires approval by the Federal Reserve for the formation of a BHC. 12 U.S.C. §1841 et seq. A BHC is any "company" that has "control" over any "bank" or over any company that is or becomes a BHC. The BHC Act defines a "company," in part, as a corporation, partnership, business trust, association, or similar organization. Id. at 1841(b). A "bank" includes an "insured bank" under the Federal Deposit Insurance Act that: (1) accepts demand deposits or deposits that the depositor may withdraw by check or similar means for payment to third parties, and (2) is engaged in the business of making commercial loans. Id. at 1841(c).

Under the BHC Act a company "controls" a bank if: (1) the company directly or indirectly owns, controls, or has the power to vote at least 25 percent of any class of the bank's voting securities; (2) the company controls the election of a majority of the bank's board of directors or trustees; or (3) the Federal Reserve determines after the opportunity for hearing that the company exercises a controlling influence over the bank's management or policies. Id. at 1841(a).

[7] This exception is implemented by the Federal Reserve in Regulation Y of the Federal Reserve's regulations. 12 C.F.R. §225.

[8] 1987 Order, p. 477.

of activities currently conducted by banks . . . ."[9] The Board of Governors also concluded that the "proposed underwriting and dealing activities" were a "proper incident to banking [because they] may reasonably be expected to result in substantial public benefits that outweigh possible adverse effects."[10]

In the orders that the Federal Reserve has issued in connection with the permissible securities underwriting activities of member bank affiliates, the Federal Reserve has expressed concerns about the potential for adverse effects that might result from the proposed activities, such as unsound banking practices, conflicts of interest, unfair competition, undue concentration of resources and loss of public confidence. Because of these concerns, the Federal Reserve has included limitations and conditions in its "Section 20" orders. There were separate protections in the Federal Reserve's original order of which the following are the most significant:

- In determining compliance with capital adequacy requirements, the applicant is required to deduct from its consolidated capital any investment in the underwriting subsidiary that is treated as capital in the underwriting subsidiary.

- The underwriting subsidiary shall maintain at all times capital adequate to support its activity and cover reasonably expected expenses and losses in accordance with industry norms.

- No applicant or subsidiary shall extend credit, issue or enter into a stand-by letter of credit, asset purchase agreement, indemnity, insurance or other facility that might be viewed as enhancing the creditworthiness or marketability of an ineligible securities issue underwritten by an affiliated underwriting subsidiary.

- There will be no officer, director or employee interlocks between an underwriting subsidiary and any of the BHC's bank or thrift subsidiaries.

- An underwriting subsidiary will provide each of its customers with a special disclosure statement

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[9] 1987 Order, p. 487.

[10] 1987 Order, p.489.

describing the difference between the underwriting subsidiary and its banking affiliates.

- An affiliated bank may not express an opinion with respect to the advisability of the purchase of the ineligible securities underwritten or dealt in by an underwriting subsidiary unless the bank affiliate notifies the customer that its affiliated underwriting subsidiary is underwriting or making a market in the security.

- No applicant or any of its subsidiaries, other than the underwriting subsidiary, shall purchase, as principal, ineligible securities that are underwritten by the underwriting subsidiary during the period of the underwriting and for 60 days after the close of the underwriting period.

- No lending affiliates of an underwriting subsidiary may disclose to the underwriting subsidiary any non-public customer information consisting of an evaluation of the creditworthiness of an issuer or other customer of the underwriting subsidiary (other than as required by securities laws and with the issuer's consent) and no officers or employees of the underwriting subsidiary may disclose such information to its affiliates.[11]

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[11] 1987 Order, pp. 503-504.