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Testimony by

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before the

Subcommittee on General Oversight and Investigations
Committee on Banking, Finance and Urban Affairs

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I appreciate the opportunity to be here today to present the views of the Federal Reserve Board on the General Accounting Office (GAO) report entitled "Bank Powers: Activities of Securities Subsidiaries of Bank Holding Companies." I should say at the outset that this report provides an excellent discussion of the approach the Board has taken with respect to expanded securities activities for banking organizations, as well as of some of the outstanding issues regarding these activities. The report also includes some initial statistical information on securities activities that should serve as good baseline data for those who seek to track the development of these activities.

The GAO study concurs in the overall initial approach taken by the Board, the principal elements being the reliance on the holding company structure and a careful, incremental expansion of securities activities within that structure to insulate affiliated banks and thrifts, and the resources of the federal safety net, from any potential risk arising from the activity, to minimize harmful conflicts of interest, and to address competitive equity issues.

In my remarks today I will provide a brief summary of the Board's decisions with respect to expanded securities activities for bank holding companies, as well as a discussion of the rationale underlying the structure adopted by the Board. I will then address the issues raised by the GAO report and the committee's invitation letter.

Board's Decisions on Securities Subsidiaries

In April 1987, the Board approved applications by three bank holding companies for separately incorporated and separately capitalized nonbank subsidiaries of the holding companies to underwrite and deal in municipal revenue bonds, mortgage-related securities and commercial paper. These are securities that, under the Glass-Steagall Act, may not be underwritten or dealt in by a member bank directly. The underwriting of these securities is, however, functionally similar to securities activities conducted by banks. The Board's decision, as well as its subsequent decision authorizing the underwriting of consumer-receivable-related securities, was based on section 20 of the Glass-Steagall Act, which allows affiliates of member banks--but not the member banks themselves--to participate in otherwise impermissible securities underwriting and dealing activity so long as the affiliates are not "engaged principally" in this activity. It is from this provision of the Glass-Steagall Act--section 20--that the underwriting subsidiaries authorized by the Board have derived their name--the so-called "section 20 subsidiaries."

Because of the precedent-setting nature of the applications, the Board reached its decision only after considerable deliberations and debate, extending nearly two years. During that time, the statutory language, the legislative history, and the implications of these proposals for banking organizations, the financial markets generally and the federal safety net were carefully analyzed by the Board. As part of this analysis, a hearing was conducted before the Board members to obtain the most thorough public comment possible on these issues.

The ability of bank holding companies to enter the underwriting field depended in large measure on the meaning of the term "engaged principally" in section 20 of the Glass-Steagall Act. The Board devoted a considerable effort to evaluation of the factors that should be used to determine the level of underwriting and dealing activity that would not exceed this "engaged principally" threshold. The Board concluded that a member bank affiliate would not be engaged principally in underwriting or dealing in ineligible securities if those activities were not a substantial part of the affiliate's business. In particular, the Board found that where an affiliate's gross revenue from ineligible securities activities did not exceed a range of between five to ten percent of the total gross revenues of the affiliate, the ineligible securities activities would not be substantial. The Board initially allowed only a five percent threshold, consistent with its view that a conservative, step-by-step approach was most appropriate in addressing the issues raised by these new activities.

In addition, although not required by the Glass-Steagall Act, the Board exercised its authority under the Bank Holding Company Act to establish capital adequacy requirements, as well as a number of prudential limitations or "firewalls," for holding companies engaging in expanded securities activities. These firewalls limit transactions between a section 20 subsidiary and its affiliates in order to address the potential risks, conflicts of interest and competitive issues raised by the activity. The Board's decisions on these section 20 applications were upheld by U.S. courts of appeals.

In January 1989, the Board expanded the range of securities that could be underwritten in a section 20 subsidiary to include any debt or equity security, except shares of mutual funds. Because of the broadened range of activities permitted, the Board felt it prudent to strengthen further the capital requirements for holding companies seeking to enter this field as well as the firewalls between the section 20 subsidiary and its affiliates. Also, the Board required that before the section 20 subsidiaries could commence the expanded securities activities, they must have in place policies and procedures to ensure compliance with the operating conditions of the Board's Order, and demonstrate that they possess the necessary managerial and operational infrastructure to conduct the activity. The Board delayed for one year the commencement of equity activities in order to allow adequate time for the section 20 subsidiaries to establish, and gain experience with, the managerial and operational infrastructure and other policies and procedures necessary to comply with the requirements of the 1989 Order.

The 1987 and 1989 Orders were the most important determinations by the Board establishing the structure for allowing bank holding companies to engage in securities underwriting and dealing activities in the United States. The Board has more recently made a number of determinations that have adjusted the provisions of these earlier Orders. For instance, in September 1989, the Board raised from five to ten percent the revenue limit on the amount of total revenues that a section 20 subsidiary could derive from ineligible securities underwriting and dealing activities. Under this higher limit, the ineligible securities activities are still relatively small compared to the bank eligible securities activities of a section 20 company. The Board also permitted, under certain narrow conditions, the underwriting of asset-backed securities issued by affiliates.

In January 1990, the Board approved applications by three foreign banking organizations to establish U.S. section 20 subsidiaries. These decisions required a careful balancing of two somewhat competing concepts: national treatment on the one hand, and limiting the extra-territorial effects that might be caused by full application of the firewalls on the other.

Finally, in February of this year, the Board authorized the Federal Reserve Bank of New York to conduct, as its supervisory resources permit, the infrastructure reviews required by the Board's January 1989 Order before section 20 companies could commence the equity securities underwriting and dealing activities approved in that Order.

Rationale Governing the Board's Decisions

The Board has long been of the view that banking organizations should, in order to maintain their basic competitiveness, be permitted to expand their activities in response to the challenges and opportunities that market forces and recent advances in computer and communications technology are creating in the financial services marketplace, both domestically and abroad. Broadened securities powers, in addition to helping to maintain the domestic and international competitiveness of U.S. banks, may also produce the potential for other substantial public benefits. These include increased competition through *de novo* entry of banking organizations into what can sometimes be moderately concentrated securities markets. Such entry may be expected to reduce concentration levels, lower customer and financing costs, increase the availability of investment banking services, foster product innovation to meet customer financing needs, and enhance liquidity in these markets. Greater customer convenience and gains in efficiency may also be realized through possible economies of scale and scope from coordinated commercial and investment banking business.

The Board recognized at the outset, however, that this expansion of powers must be soundly grounded upon a framework that ensures that new activities are conducted in a manner fully consistent with traditional and essential U.S. concepts of bank safety and soundness, the avoidance of conflicts of interest, partiality in the credit granting process and unfair competition, and the minimization of undue risk to the resources of the federal safety net. After considerable reflection on the complex issues of expanded powers in the light of these fundamental concepts, the Board concluded that an expansion of the securities powers of banking organizations in a manner that is faithful to these essential public policy objectives could be achieved within the current constraints of the law. This decision took into account four principal factors: (1) the separation of the new activity from federally insured affiliates that could be achieved through the bank holding company organizational structure, (2) the need for prudential limitations to manage risks and harmful conflicts of interest, (3) the necessity for strong capital, and (4) the need for careful supervision of the entry by banking organizations into the expanded activities.

1. Bank Holding Company Structure. The applications presented to the Board proposed that the expanded securities activities be conducted in a subsidiary of the holding company. The applicants did not seek to engage in the activity directly through the insured bank or a subsidiary of that bank. This holding company structure was dictated in major part by the constraints of the Glass-Steagall Act, which, as I have noted, generally prohibits a bank from underwriting and dealing in

securities (other than certain government securities) and limits the affiliation of a member bank with a company engaged principally in such activities.

The holding company structure also lends itself to a phased-in and prudent approach to expanded securities activities. The holding company organizational format provides an effective structure to address the potential for risk and harmful conflicts of interest and competitive inequities that might flow through close association of the expanded activities with the resources and support, direct or indirect, of the federal safety net. The effectiveness of the bank holding company format for this purpose derives from the fact that it offers the ability to separate from the bank the ownership and the financial, managerial and operational control of the expanded activity. Thus, the potential for transference of risk and other harmful effects to the bank, and to the federal safety net, is thereby reduced. An important element in this analysis is that in a bank holding company structure, losses in a subsidiary are isolated from the bank and are not reflected in the bank's financial statements and capital accounts.

The structure also takes advantage of the benefits of functional regulation. A section 20 subsidiary--as a nonbank entity separate from its affiliated banks and thrifts--is required under the Securities Exchange Act of 1934 to register with the Securities and Exchange Commission as a broker-dealer.

Under this regulatory system, the section 20 subsidiary is subject to the net capital rules and other regulations of the Commission, and will be supervised by that agency and self-regulatory bodies operating under its purview.

2. Prudential Limitations. Building on the advantages of corporate separateness achieved through the holding company structure, the Board developed certain prudential limitations on transactions between the subsidiary engaging in the expanded securities activities and its insured bank affiliates. These firewalls are designed to ensure that the potential for risk and conflicts of interest and other adverse effects of the activity do not spill over to the insured affiliate through lending or other inter-corporate financial transactions, and that the benefits derived by the bank from the federal safety net are not inappropriately extended to the section 20 subsidiary.

As I have noted, an important element in the Board's decision was the belief that synergies could be achieved and banking competitiveness maintained, with the potential for substantial public benefits, through the combination of investment and commercial banking. The Board recognized, however, that certain of the prudential limitations implemented to curtail risk could lessen somewhat the anticipated synergies, as well as increase the cost of doing business for a bank-affiliated securities company. Nevertheless, the Board believed it important to proceed cautiously in these areas, and that until sufficient experience was gained, the effect of the prudential limitations on the attainment of the expected synergies was to be balanced against potential risks to the federal safety net.

The Board's decision was not, however, intended to be static. The Board recognized the need to reformulate the limitations on the basis of experience. Thus, the Board's Orders state that when experience shows that adjustments to the firewalls are warranted, by way of tightening, loosening or other modification, the Board retains the flexibility to do so, consistent with the underlying goals of the Board's Order. In this vein, the Board has already made several adjustments to the firewalls where it determined that certain transactions between the section 20 subsidiary and its affiliated banks or thrifts could be permitted without increasing the risks to these institutions.

The GAO has recognized the importance of this process, and endorsed this approach in its report. The report states that "[w]hen bank holding companies can demonstrate adequate capital, effective internal controls, and ability to manage new powers in a responsible manner, consideration can be given to reducing regulatory burden by relaxing some of the firewalls in light of the other regulatory controls that are in place and provided that sufficient regulatory resources are available."

3. Capital Adequacy. It has long been Board policy that strong capital is indispensable to any banking expansion

proposal. A sound capital base is fundamental in ensuring the safety and soundness of individual institutions, and thereby providing real protection for its customers and the resources of the federal safety net. Equally important in the Board's mind, the requirement for a strong capital base promotes sound and responsible operation, and controls the moral hazards, such as undue risk-taking, that tend to arise when an institution operates in reliance on the resources of the federal safety net rather than with its own funds at stake.

Thus, it is not surprising that the Board adopted as a prerequisite to expanded debt and equity securities activities the requirement that there be no impairment of the capital strength of the banking organization. To ensure that essential banking capital is not diverted to support the new activity, a holding company is required to deduct from its consolidated primary capital any investment it makes in the underwriting subsidiary. This requirement serves to ensure that even if there should be losses resulting from the new activity, the losses do not detract from the capital needed to support the organization's banking operations.

In addition, in authorizing the debt and equity underwriting powers in 1989, the Board required a bank holding company to deduct from its capital any credit it extends to an underwriting subsidiary, unless such lending is fully secured. The Board also took the additional step of requiring a bank holding company seeking to avail itself of these powers either to demonstrate that it is strongly capitalized and will remain so after the required capital deductions or to raise additional capital to support the expanded activity. In most cases the applicants were required to raise additional capital to offset the investment in the section 20 subsidiary.

4. Supervision. The final element in the Board's decision on expanded securities powers has been a phased-in approach based on the section 20 subsidiary's experience, including a demonstrated managerial and operational infrastructure, and the development by the Federal Reserve of appropriate procedures for supervising these new activities. This gradual approach allows review of the growth and operations of the section 20 subsidiaries and provides opportunities for adjustments and modifications to the conditions placed on the activities, as circumstances warrant.

The Board believes its approach to be appropriate where the alternative--the large scale introduction of new activities--could have a potentially deleterious effect on the institutions and the resources of the federal safety net. In this regard, the Board has also required annual inspections of section 20 subsidiaries in order to ensure compliance with the prudential limitations. Moreover, examiners are required to monitor the risk profile and financial condition of a bank holding company's section 20 subsidiary to evaluate its impact on the consolidated banking organization.

GAO Report

While the GAO has not endorsed the Board's entire system of prudential limitations as an essential part of expanded securities activities for bank holding companies, the GAO found the overall approach of the Board to be consistent with that suggested by the GAO in a 1988 report on repeal of the Glass-Steagall Act. The GAO suggests, however, several areas in which the Board might consider the need for further changes in the operations of section 20 subsidiaries. I will discuss the major areas cited by the GAO.

Organizational structure. The GAO report supports, at least in the near term, using bank holding company subsidiaries--as opposed to subsidiaries of banks--to expand the securities powers of banking organizations. While not endorsing any particular organizational structure in the long run, the GAO would advocate (1) retaining a separate corporate identity for the firm engaging in the ineligible securities activities; (2) regulation of the banking and securities affiliates by a federal bank regulator and the SEC, respectively; and (3) regulation by the Federal Reserve of the financial holding company that owns the bank and securities affiliates. As discussed, these are all positions with which the Board agrees.

The GAO states that there is currently some legal question regarding the extent to which a bank holding company may be required to use nonbanking assets to support bank subsidiaries, and therefore funds upstreamed to the parent bank holding company may not be available to support a bank subsidiary if the parent decides not to so invest them. The GAO states that "[c]larification of the operational basis of this source of strength policy would help in providing a clearer perspective on how the firewalls and source of strength policy work together in strengthening banks affiliated with a Section 20 firm."

The Federal Reserve Board agrees with the GAO that clarification in this area is desirable, and would support efforts to ensure that bank holding companies and their subsidiaries continue to serve as a source of strength to troubled subsidiary banks.

Purposes, regulatory burden and effectiveness of firewalls and other limitations. The GAO report states that it is important that each of the firewalls and that the purpose served by each of the limitations on the powers of section 20 companies be as clear as possible. In its lengthy Orders, the Board has tried to set forth in detail its rationale for each such limitation. In addition, the Board has been, and will be, reviewing the firewalls periodically, on the basis of holding company experience in the activity, in order to ensure that they serve the intended purpose without unnecessarily hampering the operations of the section 20 subsidiary. In this regard, the Board has modified or interpreted several of the firewalls to allow certain transactions that would not be deemed to cause any financial risk to affiliated banks and, in its January 1990 Order, the Board stated that it would review the firewalls regarding management interlocks and marketing as well as the condition requiring prior approval for additional holding company financial support of a section 20 company.

With respect to the amount of securities activities allowed, the GAO noted that the Office of the Comptroller of the Currency and the Association of Bank Holding Companies, in comments on the GAO report, suggested that either a higher limit could be set, or alternative measures could be explored, for defining "engaged principally." The GAO stated, however, that it agreed with the Board's policy of using the revenue limit to phase-in bank-ineligible securities activities. The GAO did not have a position on the percentage of revenue that ultimately should be allowed.

The Board devoted considerable effort to evaluation of the factors that should be used to determine the level of ineligible underwriting and dealing activity that would not exceed the substantiality threshold incorporated in the "engaged principally" language in section 20 of the Glass-Steagall Act. The Board determined that the five to ten percent limit was an appropriate quantitative level of ineligible activity under that statute. This measure has been reviewed by several courts of appeals and found to be consistent with the statutory provision.

Except for the "engaged principally" language in the Glass-Steagall Act, the Board would not have chosen to have a revenue limit on the level of ineligible securities activity of a section 20 subsidiary. While this limit has a prudential effect, it was placed on the section 20 subsidiaries for legal, not prudential, reasons. Although one might disagree with the precise level of ineligible activity that may be allowed and still be within the "engaged principally" test in section 20 of the Glass-Steagall Act, only Congress, by amending or repealing that provision, can remove the requirement entirely.

<u>International Perspective</u>. The GAO report points out that U.S. banking organizations engage in securities activities overseas in a different structural framework than has been required in the United States. What the report does not state is that one of the basic reasons for these differences is that the Glass-Steagall Act does not apply overseas, and there are virtually no statutory restrictions on the activities in which U.S. banking organizations may engage abroad. Moreover, the Edge Act directs the Board to create a regulatory climate in which Edge corporations may compete effectively with foreign banks. Because direct competitors of U.S. banks in foreign markets offer not only commercial banking but also capital market services, the Board has permitted U.S. banking organizations to engage in

securities activities abroad in order to be in a position to compete with local banks. This authority may be exercised through indirect subsidiaries of a member bank as well as through bank holding company subsidiaries.

It should be noted, however, that the equity underwriting and dealing activities of U.S. banking organizations have been constrained overseas, with dealing positions for a U.S. banking organization being limited to $15 million in the securities of any one issuer, and underwriting limits not covered by binding commitments by subunderwriters also being limited to that amount. Proposals regarding these limitations are to be presented to the Board in the near future, and a question that is logically raised by any expansion of this authority is the extent to which a section 20 approach should be required overseas. This issue and its ramifications for U.S. bank competitiveness will be considered when the Board requests comments on amendments to the current rules.

The GAO report also notes that in its January 1990 Order allowing three foreign banks to establish securities subsidiaries in the United States, the Board did not apply the firewalls exactly the same way that it had applied them to U.S. bank holding companies one year earlier. Those applications raised substantial issues of national treatment, primarily because most foreign banks do not have a holding company parent but rather hold their U.S. investments through the foreign bank itself. Because the foreign bank also acts as a bank holding company, the Board had to decide whether the bank holding company firewalls or the bank firewalls were more appropriate. This is further complicated by the fact that the rationale for some of the firewalls, such as protecting the federal safety net, does not apply when the holding company in question is a foreign bank.

The Board examined carefully how the firewalls should be applied to foreign bank applicants, making sure to the greatest extent possible that pertinent safety and soundness and competitive equity considerations were fully taken into account, while at the same time trying to limit the extent to which application of the firewalls would interfere with the responsibilities of the home country supervisor and the non-U.S. operations of the foreign banks. Admittedly, this task cannot be accomplished perfectly, and one might argue that under the Board's Order it is easier for foreign organizations, than for U.S. bank holding companies, to fund their U.S. securities operations, although the foreign banks would argue otherwise. The Board, however, stated in its January 1990 Order that it would review for both domestic and foreign banking organizations the prior approval requirements for all funding of securities subsidiaries and the capital deduction for unsecured lending by a bank holding company to a securities subsidiary.

Reciprocal treatment of securities firms. The GAO notes that an issue that needs to be studied is whether there are comparable opportunities for domestic securities firms to expand into domestic banking. The GAO recommends that any structure that is adopted needs to include appropriate controls over the entire holding company comparable to the Federal Reserve's current control over bank holding company operations.

As recognized by the GAO, the ability of investment banks to affiliate with commercial banks--while possible under the current state of the law--is best accomplished by legislation. The repeal of the Glass-Steagall Act would open the opportunity for Congress to determine how these relationships should be structured.

In addition to asking for comments on the GAO report, the committee's letter also asked for our views on whose responsibility it should be to enforce the firewalls and how they should be enforced. In the bank holding company context, the Federal Reserve Board is the appropriate agency to enforce the firewalls separating a section 20 company from its affiliated banks and nonbanks. As the agency responsible for supervising and regulating the holding company on a consolidated basis, the Board is also the appropriate agency to review the operational and managerial infrastructure of the section 20 company to ensure that the firewalls are in place and being observed. This does not mean, however, that the Board would be examining those companies to ensure that they are in compliance with the securities laws and regulations. As I discussed earlier, the

Board's Orders rely on functional regulation; as a broker-dealer, the section 20 company is and should be subject to SEC regulation. Indeed, the Board's supervisory procedures are designed, to the extent feasible, to avoid duplicating the efforts of a section 20 subsidiary's designated self-regulatory organization. This dual regulation by function is a concept endorsed by the GAO report.

With respect to how these firewalls should be enforced, the Board believes it has adequate authority under the Bank Holding Company Act and other enforcement laws, especially in light of the increased penalty provisions contained in the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, to ensure that bank holding companies adhere to the requirements of Board Orders.

Conclusion

In the absence of legislation establishing a comprehensive framework for the conduct of securities underwriting activities by banking organizations, the Board is required, as provided in existing law, to act on applications within mandated time periods. In acting on applications by bank holding companies to engage in expanded securities activities, the Board is proceeding cautiously and with due regard to the potential for risk to federally insured institutions and the federal safety net. The Board believes this is appropriate when banking organizations are expanding their powers into nontraditional activities. This process is a continuing one, and the Board will be reviewing periodically the operations of the section 20 subsidiaries and the effect that the prudential limitations have on their operations.