The Federal Reserve Board

Remarks by Governor Mark W. Olson

At the conference on the implementation of the Gramm-Leach-Bliley Act, American Law Institute and the American Bar Association, Washington, D.C.
February 6, 2003

The Gramm-Leach-Bliley Act and Corporate Misbehavior--Coincidence or Contributor?

Introduction
Good morning and thank you for inviting me again this year to speak at your conference. The Gramm-Leach-Bliley Act (GLBA) was indeed landmark legislation, and as the financial services industry continues to evolve, this conference on implementing GLBA will remain an important event.

It is quite remarkable the difference a year makes. During 2002, serious accounting improprieties and internal control failures at some of the country's preeminent corporations dealt additional blows to a national economy already suffering from a downturn. Inquiries into aggressive, and in some cases wholly inappropriate, accounting practices revealed losses that propelled investment-grade companies into bankruptcy. Managers and other employees of some of the largest financial institutions were called to account for apparent conflicts of interest between the research functions and investment banking operations. The practices of allocating shares of initial public offering were similarly harshly criticized. And, of course, some financial institutions were roundly criticized for structuring transactions to arbitrage accounting, disclosure, and tax rules-- most notably those structured for Enron.

Appropriately, the questionable practices uncovered in the past year were denounced in congressional hearing rooms and covered extensively in the national press--to the extent that the companies, and even some of the individuals involved, are now household names.

It had occurred to some industry observers that these practices coincided with the final phase-in of the Gramm-Leach-Bliley Act. That timing raises an obvious question: Did passage of the GLBA merely coincide with these corporate governance and conflict of interest problems, or was it a contributing factor? In my presentation today I will address that issue so that both public and private resources are appropriately targeted to correct the problems of the past and properly focused in ways that promote standards of appropriate conduct for the industry as well as the continuing implementation of the GLBA.

To provide some perspective on the relationship between some of the more notable issues involving corporate governance, accounting, and conflicts of interest that surfaced in 2002 and their implications for implementing the GLBA, it is useful to step back and review, in turn, the forces that gave rise to the GLBA; the nature of the recent abuses that have occurred; and some of the issues that confront us as we move forward.

Forces Leading to the GLBA
As I noted in my talk last year, one of the primary objectives accomplished by the GLBA

was to bring the statute more in line with market changes. By 1999, when the GLBA was passed, significant cross-industry affiliations had occurred without the benefit of legislation.

As you know, GLBA modernized a statutory and regulatory framework grounded in the 1930s that was unresponsive to the needs of financial markets and the consumers of financial services in the late twentieth century, much less the twenty-first century. Advances in technology, innovations in financial markets, and globalization over the past few decades rendered anachronistic a statutory and regulatory scheme that viewed banking organizations as only lenders and deposit-takers. Technological and financial innovation in the last twenty years gave rise to new products, new delivery channels, linked international markets, and faster transaction speeds. Consumer demand for innovative financial products and services expanded dramatically, not only for traditional banking products, such as credit cards or traditional stock brokerage services, but for products that combined the characteristics of banking, securities, and insurance products, such as mutual funds and annuities. Because of the limitations imposed by the Glass-Steagall Act and other statutory restrictions, much of this innovation occurred outside the banking industry. For example, Merrill Lynch's Cash Management Account was more than twenty-five years old when the GLBA was enacted.

Corporate and institutional demand for financial services had also evolved dramatically. As the capital markets developed and corporations gained increased access to the commercial paper and bond markets, corporate chief financial officers were offered a broadening array of potential financing vehicles and financial services such as commercial paper. Moreover, innovations in risk management fueled increasing demand for customized over-the-counter derivatives. As a result of these and other influences, the boundaries between commercial and investment banking products and services became less clear. Also, with the declining spreads from traditional bank lending products, as well as the more favorable economics of fee-based services, banking organizations throughout the past decade became increasingly interested in providing a full range of financial products and services. In some cases, providing a broader array of financial services became a competitive necessity given the changes in the capital markets and the inroads made by nonbank financial institutions in the 1990s.

Before the GLBA, banking organizations responded to these competitive pressures in several ways, including using the bank holding company structure. For example, the provision of securities underwriting and dealing was accomplished through so-called section 20 subsidiaries, which were authorized in 1987. Initially, underwriting and dealing activities were limited to 5 percent of the bank holding company section 20 income, but the limits were progressively expanded by the Board throughout the 1990s. After the limit was increased to 25 percent in 1997, we began to see significant merger activity between securities firms and bank holding companies. As a result of this merger activity as well as an expansion of existing business in the late 1990s, several major banking organizations had dramatically advanced up the securities underwriting league tables or were well positioned to do so. Thus, banking organizations were major factors in the securities industry before passage of the GLBA.

Globalization was also an important force that increased competitive pressures on large U.S. banks. Competition with universal banks in foreign markets necessarily required U.S. banking organizations to build securities business infrastructures overseas. With the increasingly global, 24/7 marketplace for financial services, and expanding cross-border asset holdings, trading, and credit flows, such infrastructures were needed to meet the demands of foreign customers as well as the demand for global financial services by U.S.

customers.

Of course, the economic prosperity and bull markets of the past decade were also significant forces in driving evolution in the financial services market. Given these circumstances, traditional bank deposit products were often unable to meet customer demand. Economic prosperity and trends in the equity markets fueled increased demand by consumers for alternatives to deposit products, such as mutual funds and annuities. The bull market obviously drove demand for securities brokerage services--both discount and full service. In this economic environment, the constraints of a statutory environment designed for a simpler age became all too obvious, and the GLBA stood as an affirmation of economic reality.

Recent Issues in Financial Services Business Lines
This brings us to current times and current issues. We must remember what the GLBA did not do. It did not alter the fundamental business lines and established practices of investment and commercial banking. Upon review, many of the issues of corporate governance and conflict of interest that surfaced in 2002 appear to have been a direct result of inappropriate business practices as well as inadequate internal controls and risk-management practices applied to business lines that were well established before the enactment of the GLBA.

Let's now turn to some of the corporate governance issues and examine their relationship to the GLBA. One example is the well-publicized conflicts of interest between the research and investment banking functions of investment banks. Institutional investors have always been aware of the need to add a grain of salt to sell-side research reports, and *Institutional Investor* magazine has long had separate rankings for buy-side as well as sell-side analysts. For a sophisticated investor, that judgment is as intuitive as taking with a grain of salt a comparative analysis of competing toothpaste brands conducted by a toothpaste manufacturer. But in recent years the long-held distinction between sell-side and buy-side research became less clear. One reason could be that the skepticism of institutional investors may have diminished in light of the record profits to be made in the equity bull market. Added to this was an influx of both new institutional players and individual investors who did not fully understand some of the traditional conflicts within the origination and distribution channels in investment banking--especially given the star status accorded to some sell-side analysts. In hindsight, it becomes clear that the management of some investment banking firms did not fully understand the risks that some established business practices posed to their organization in a changing market. At some securities firms, poor internal controls and management's shortsighted focus on the rewards available from one element of the equity financing business placed other important elements of this business, such as institutional and retail distribution channels, at significant risk. Despite these problems, I am reassured to see that change is occurring. Importantly, changes being made by financial institutions themselves in response to the forces of market discipline and changes imposed through various settlement agreements are making positive progress in correcting those practices embedded in traditional investment banking business lines that are inappropriate for today's markets.

A second group of corporate governance issues, like those involving Enron, involves structured financing. As you know, structured financing transactions have long been conducted by both commercial and investment banks. Before examining the corporate governance issues involving structured financing, we need to identify the components of these transactions. Structured financing is the customization of financial products using various types of financial instruments as "building blocks" to achieve a customer's stated objectives. The basic building block instruments used can include both physical and financial assets and liabilities, various types of derivative instruments, and several types of legal entities structured to isolate legal liability and ownership. All these building blocks are long-standing components of financial transactions and do not carry inherent undue risks. As they became used in structured transactions, the sophistication grew and the inherent risk increased.

The origin of structured transactions can be traced back to the Chicago futures and options exchanges, the development of the interest rate swap in the early 1980s and the subsequent development of the over-the-counter derivative markets, and the securitization of residential mortgages and various other types of consumer debt. As financial markets have grown and evolved over the past few decades, innovations in financial instruments have facilitated the structuring of cash flows and the allocation of risks among borrowers and a range of investors in more efficient ways. In this respect, the abuses that have received recent attention have obscured their risk-mitigation value. Aggressive interpretations of accounting rules and misuse of structured transactions have cast a shadow over a wide array of financial instruments that have dramatically enhanced the efficiency of financial markets and the availability of funds to all sectors of the economy. Financial derivatives, asset-backed securities, and a myriad of other "structured" products have, in the vast majority of cases, served the legitimate business purposes of borrowers and investors alike. Both commercial banks and securities firms have played important roles in structuring, arranging or participating in these transactions to the economy's great benefit.

To be sure, as these products evolved and became more complex, they placed increasing pressure on the interpretation of accounting rules that were established in simpler times. Despite attempts to keep pace with financial innovation, traditional accounting rules were severely challenged to appropriately reflect the economic substance of some transactions. This strain progressively increased as some corporations, with professional and legal advice, exploited the ambiguities in the accounting rules. These efforts not only pushed the envelope of acceptable accounting practices but, in some cases, intentionally hid the true economic substance of a transaction while staying in technical "compliance" with Generally Accepted Accounting Principles, or GAAP. The new initiatives by the Financial Accounting Standards Board to revise the accounting treatment of some special purpose entities (now termed variable interest entities) are attempts to address abuses that may result from these practices--as are the measures being implemented through the Sarbanes-Oxley Act. Regardless of the specific measures under way, however, both corporations and financial institutions must recognize that the analysis of whether an accounting treatment for a particular transaction is appropriate should not be based on technically meeting GAAP requirements. Rather, such analysis must look beyond technical compliance to determine whether the accounting treatment actually reflects the economic substance of the transaction.

What Are the Lessons?

Once again, review of the underlying causes of the abuses uncovered involving structured financing can be traced to several factors, starting with internal control lapses within this specific business line at commercial and investment banks alike. Other contributing factors include the continual reach to maximize earnings, which encouraged aggressive accounting treatments, and extraordinary financial rewards accorded financial professionals who created and executed these transactions.

In ascertaining the relevant facts and circumstances surrounding these lapses and in identifying appropriate responses, Federal Reserve supervisors have discovered some initial lessons to be used by both supervisors and financial institutions in guiding future efforts. These lessons are relatively straightforward, reaffirm basic risk-management principles, and can easily be seen in hindsight. Perhaps the most fundamental lesson is the need to fully assess the character of a borrower, counterparty, or customer and to incorporate that assessment into the entire relationship between the institution and the customer. Traditional suitability standards, which evaluated only whether a customer understood the risks of a given transaction, are no longer sufficient for adequate risk management. Financial institutions must recognize that, although they are not directly accountable for the actions of their customers, to the extent that their name or product is implicitly associated with their customer's misconduct, they may be significantly exposed to additional legal and reputational risks.

Financial institutions appear to have learned some of these lessons and are establishing policies and procedures that require management to understand the totality of the business relationships. Several institutions have adopted internal policies regarding their willingness to do business with a customer based on the customer's disclosure of the transactions. Some have also revised their approval processes for new products to better incorporate considerations of legal and regulatory risk. Many of these changes are being made in response to market demand. Thus far, market discipline has played a critical role in effecting needed change.

The Federal Reserve will continue to review complex structured transactions to identify further lessons for supervisory guidance. An important element in our supervisory process has always been the periodic identification of best practices compiled from our supervisory reviews. And we will be looking for these best practices over the coming year--as institutions implement their improved risk-management structures--with the expectation of communicating any pertinent findings to the industry at large. We are revising our supervisory guidance to emphasize the need for more-comprehensive approaches to the legal and reputational risks entailed in customer relationships.

Challenges Moving Forward

Earlier I noted questions about the relationship between the abuses uncovered over the past year and the implementation of the GLBA. In fact, some have even blamed the abuses on the GLBA, questioned its merits, and called for its substantive review. As I have pointed out, the abuses recently brought to light are the result of corporate governance issues, such as lax internal controls, that had not kept pace with the changing financial markets. They are not related to the GLBA. Breakdowns in internal controls and relaxation of basic risk-management fundamentals do not indict the objectives, principles, or the statutory structure for implementing the GLBA. The merits of the GLBA remain as valid today as when the law was enacted in 1999, despite the recent problems of internal control and risk management in some individual business lines.

However, this statement does not mean that financial institutions and their supervisors do not face significant challenges as they implement the GLBA or as they refine existing business lines. The financial services sector continues to evolve in directions that could not have been predicted even at this time last year. As institutions confront today's market conditions and trends, significant rationalization and focusing of business strategies and tactics are under way. The GLBA provides opportunities for financial entities to combine in a single financial holding company to respond better to marketplace changes.

The GLBA is still relatively young, and institutions are continually in the process of identifying the right mix of products and services to meet the changing demands of their customers. Clearly, this challenge of finding the appropriate product mix has increased substantially in the current market environment. In the 1990s, leading up to the passage of the GLBA and directly thereafter, many financial institutions positioned themselves to offer a myriad of products to both retail and corporate customers. As in the financial supermarket trend of the 1980s, some institutions readied themselves to offer all things to all customers and to take advantage of all possible business lines. Now, in today's business circumstances, financial institutions are more willing, and in some cases are compelled, to better focus business strategies on core competencies--to be all things to only certain people or one thing to many. Institutions are increasingly rationalizing and focusing their product offerings--shedding some businesses while expanding others. A particularly pertinent example of the way the changing market environment has affected businesses and business strategies is merchant banking, a business that was a centerpiece of the GLBA deliberations four or so years ago. Market trends have dramatically taken the bloom off the merchant banking rose, with some institutions trying aggressively to downsize or, and in some cases, drop their merchant banking businesses.

And for their part, bank supervisors in implementing the GLBA continue to face the challenge of reconciling the need for markets to function efficiently while protecting the deposit insurance fund and the safety net. This challenge can manifest itself in the applications process, when the Board must consider approving new activities as financial or as complementary or incidental to a financial activity. To date, the Board has not considered many of these applications; however, as the marketplace evolves, we expect financial institutions to propose new activities that may fit the definitions of financial, complementary, or incidental.

Another challenge is continuing to balance functional regulation and umbrella supervision. Functional regulation is a recognition of the importance of decentralized authority and checks and balances--principles on which this country was founded. It is also a recognition that the supervisory approach best suited to one line of business may not be well suited to another in the same consolidated organization. While, as many in this audience can attest, the presence of several different regulators in a complex financial institution is sometimes cumbersome, it is intrinsic to a decentralized regulatory scheme. Our challenge as umbrella supervisor is to work with our fellow regulators to improve the efficiency of the regulatory process by enhancing cooperation and communication.

In fact, we have improved interagency cooperation and communication in the post-GLBA environment. In one well-publicized case, the Federal Reserve took coordinated action with the Office of the Comptroller of the Currency and the Securities and Exchange Commission to address inappropriate accounting practices at a large banking organization. We need to continue to share information and discuss issues with our fellow regulators if we are going to minimize risks to an ever more-complex banking system.

Another challenge inherent in the Federal Reserve's role as umbrella supervisor is finding the proper balance between the objectives of protecting the depository institution subsidiaries of increasingly complex organizations and not imposing an unduly duplicative or onerous regulatory burden on the nonbank entities that are part of the consolidated organization. Though our focus is on consolidated risk management and capital adequacy, we must also consider how the activities conducted in various legal entities and business lines affect the overall risk profile of the consolidated organization and the safety and soundness of affiliated depository institutions. Our ability to share information with the functional regulators of nonbank entities in the holding company structure will enhance our ability to minimize regulatory burden while protecting depository institutions and the insurance fund.

Conclusion

While 2002 undoubtedly was a difficult year that focused a number of supervisory issues for the Federal Reserve and its fellow regulators, our analysis to date suggests that these issues were neither caused nor exacerbated by the GLBA. Rather, they were largely the result of corporate governance and internal control weaknesses in individual business lines. I believe that the progress already made by banking organizations and other participants in the financial markets in addressing some of these problems should give us optimism for the future. This effort toward self-correction will go a long way to reduce the need for additional legislation and regulation to correct what are essentially internal weaknesses of corporate governance and control. The legal community has an essential role to play in facilitating the self-correcting tendencies of the market, a role I encourage all of you to embrace.

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