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Statement by

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before the

Subcommittee on Telecommunications, Consumer Protection, and Finance

of the Committee on Energy and Commerce

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I appreciate the opportunity to appear before this Subcommittee today to review some of the concerns of the Federal Reserve Board with respect to evolving changes in the financial structure that serve to link depository institutions and other financial entities. To the extent that previously separate financial services come to be merged with those traditionally provided by depositories, it seems to me eminently reasonable to ask whether safeguards can be put in place to constrain or eliminate the potential for abuse, without at the same time unduly limiting the benefits of the merged activities. In my remarks, I will focus on both the potential benefits and costs of these relationships and illustrate some of the problems that may be involved by indicating how we at the Federal Reserve have addressed similar issues and conflicts in the recent past.

The basic framework within which the Board approaches the issues arising from expanded relationships between depository institutions and other financial entities can be summarized as follows:

- -- We want to encourage fair competition in the provision of banking services in order to preserve impartial access to credit;
- -- We want to promote efficiency and reduced costs so customers may benefit in terms of lower prices for existing services and gain from possible new and innovative services;
- -- We want to protect against undue concentrations of economic resources that would result in unfair discrimination among customers, conflicts of interest, and other potential abuses; and
- -- We want a strong and stable banking system, with continued close attention to safety and soundness of banks and other depository institutions, both as an objective in and of itself and because of the

crucial importance of banking stability to the smooth operation of the economy.

These goals will, in some circumstances, be in conflict so that each of the various avenues toward financial consolidation requires an examination of the particular issues raised and a careful balancing of the likely costs and benefits involved. In approaching that balance, the normal perception for most industries--that one may simply look to the marketplace to promote competition and efficiency--must be tempered by a recognition of the need to maintain confidence in banking institutions and continuity in the provision of money and payments services. In addition, any market perception that diversification into new and riskier activities significantly increases overall banking risk may lead to higher funding costs and hence the cost to the public of bank credit.

Long-standing policy in the United States has been to prevent banking organizations from engaging directly in commercial enterprise. Concern over the commingling of banking and commerce was an important motivation for the Bank Holding Company Act of 1956 and the 1970 Amendments to that Act. Potential abuses that were of concern to the Congress may be divided into four categories: (1) potential conflicts of interest, (2) decreased or unfair competition, (3) undue concentration of resources, and (4) increased risk to banks that might result from affiliation with risky nonbank enterprises. With respect to potential conflicts of interest and decreased or unfair competition, particular concern has centered on avoiding such anticompetitive practices as (1) tying arrangements involving banking services and nonbank activities, (2) preferential treatment of nonbank affiliates, and (3) unequal access to credit for independent firms competing with the bank's affiliates.

The Board has consistently supported the concept of maintaining the separation of banking and commerce. In this regard, the recent proliferation of "nonbank banks" is a particularly disturbing development. Such institutions are allowed to exist along with conventionally defined banks but, by virtue of a narrow definition of what constitutes a "bank" in the Bank Holding Company Act, may not be subject to that Act and to the rules governing holding company relationships. This is the case whenever the nonbank bank is owned by a commercial, industrial or nonbank financial parent. Since by definition these owners do not thereby become bank holding companies, the anti-tie-in provisions of the Act do not apply, nor are they subject to the inspection and enforcement powers of the Federal Reserve. Yet nonbank banks can take different forms of deposits, including transaction accounts, and make consumer loans, as well as a wide variety of other types of credit extensions. By offering insured deposits, nonbank banks could serve to increase the risks faced by the deposit insurance funds since their parents may not be subject to the safeguards embodied in the Bank Holding Company Act.

Concern over conflicts of interest is not limited to issues of separating banking and commerce. It also relates to potential conflicts of interest that may arise from combinations of financial firms and from the diversity of activities allowed within the bank itself. The usual means of addressing these issues in banking are through a system of prohibitions, limitations, and insulation.

An example of this approach is the "Chinese Wall" separation of bank trust departments from the rest of the bank. In addition to securities laws against insider trading and laws specifying the fiduciary responsibilities of trustees, the Board issued a policy statement in 1978 that augmented further these prohibitions and limitations for banks. The Board advised that trust

personnel should be denied access to commercial credit files; government, agency, and municipal securities underwriting files; and other pertinent records. Greater insulation was also recommended through the physical separation of trust and commercial bank lending and investing personnel. Such prohibitions and limitations on activities between trust and other departments appear to have been successful in preventing abuses of the potential conflicts of interest inherent in a combination of trust and commercial bank activities.

In accordance with this general approach, the Board has supported some expansion of bank holding company powers into other financial activities under appropriate regulatory safeguards. Such activities include the ability to sponsor, control, and distribute the securities of mutual funds; to underwrite and deal in municipal revenue bonds, 1-4 family residential mortgage-backed securities, and commercial paper; and to engage in a limited way in a variety of real estate brokerage, some types of insurance underwriting, and travel products. Certain other activities appear to raise serious risk and conflict of interest concerns, and thus the Board has been much less willing to support bank involvement. For example, we recently denied the application of a bank holding company to acquire a national bond rating service because of the pervasive conflicts of interest that would be present in the combination. The Board has similar concerns with respect to proposals to permit banks to underwrite corporate securities.

A related issue is whether a new activity should take place "inside" the bank, as with trust activities, or should be lodged in a separate affiliate of the bank holding company in order to address better the insulation and conflict of interest concerns. The Board believes that in many cases the latter strategy is the most appropriate. Conduct of a nonbanking activity in a separate subsidiary would permit equivalent ground rules across institutional lines and

would also provide a structural basis for at least partial insulation of one activity from another.

An area where the insulation issue has emerged recently is that of direct equity involvement in real estate activities by banks. Such investments have been suggested as one area where depository institutions might play a greater role in the future. Proponents argue that permitting depository institutions to make direct equity investments in real estate will permit these institutions to diversify their portfolios, improve service to their real estate customers, and enable them to share in the profits of real estate development more directly than through the provision of real estate loans. On the other hand, real estate development has historically been a risky and highly cyclical activity. And, as often is the case regarding these new activities, diversification benefits could be swamped by increased risks of loss if they are permitted to exceed relatively low levels of concentration. In order to better insulate the bank, we believe that such activities should be placed in separate affiliates of a bank holding company rather than undertaken within the bank itself.

Lastly, considering the various ways in which depository institutions in the past have sometimes been weakened by activities of their holding company affiliates, a number of common elements emerge. These serve to illustrate possible limitations which could be considered in order to improve the insulation concept. It may be desirable, for example, to require each subsidiary to maintain capital that is fully adequate to meet its own commitments. Similarly, stricter rules designed to prevent extensive or regular support in the form of loan guarantees on behalf of, preferential financing to, or cross collateralization clauses in financing for affiliates, may be desirable. Adherence to all of the formalities of separate incorporation may also be desirable

so that the public is not led to believe that holding company affiliates together constitute a single entity, and therefore that losses at one affiliate could spread throughout the organization.

In sum, there are obvious problems in insuring that activities of nonbanking affiliates (and parents) do not unduly affect banks and other depository institutions. Where risk is substantial and could threaten the banking entity, we would seek to insulate the bank in order to protect depositors and the payments system. Quantitative limitations on such investments, perhaps based on the capital of the holding company, might also be usefully employed. Insulation and other efforts to avoid conflicts of interest cannot always be fully successful, and thus some risk will remain. Nevertheless, the marketplace is clearly evolving toward ever-broadening combinations of financial services, and there may well be economies, as well as the convenience and other benefits of increased competition, to be gained. In each instance of broader corporate powers, whether in banking, insurance, securities or real estate development, we would urge that these potential benefits be compared with the probable costs, taking into account whether and what workable safeguards against injurious potential conflicts need to be imposed.