

## Testimony of Governor Susan M. Phillips

### *Restrictions on securities underwriting and dealing*

#### **Before the Subcommittee on Financial Institutions and Regulatory Relief of the Committee on Banking, Housing, and Urban Affairs, United States Senate**

**March 20, 1997**

I am pleased to be here today to discuss the Board's section 20 firewalls -- that is, the restrictions the Board has imposed on bank holding companies engaged in underwriting and dealing in securities. As the name suggests, the purpose of firewalls is to insulate a bank and its customers from the potential hazards of combining commercial and investment banking.

Since last year the Board has been engaged in a comprehensive review of the 28 firewalls it erected in the late 1980s, and the Board has recently proposed to eliminate a majority of those restrictions. This oversight hearing provides a constructive opportunity for comment and analysis of the Board's proposal. Furthermore, if financial modernization is to move forward, the issue of firewalls will have to be confronted again. I hope that the Board's review and the public comment process can inform the legislative process as well.

Today, I would like to explain why the Board proposed changes to the firewalls. I will also discuss the final changes the Board made last year to the revenue test that the Board uses to determine compliance with section 20 of the Glass-Steagall Act, and to firewalls regarding cross-marketing between a bank and a securities affiliate, and officer, director and employee interlocks between two such companies.

#### **The Firewalls in Context: Independent Protections for Banks and Consumers**

Before I begin this discussion, I think it is important to place the firewalls in their historical and regulatory context. Although the firewalls have served an important role, they are not the only protection against the hazards of affiliation of commercial and investment banks.

One important protection is the placement of securities activities in a separate subsidiary of the bank holding company, rather than in the bank itself or a subsidiary of the bank. Because non-bank subsidiaries of a bank holding company operating under section 20 of the Glass-Steagall Act are affiliates of a bank, they are not under the bank's control, do not have their profits or losses consolidated with the bank's, and are less liable to have their creditors recover against the bank. A bank therefore has less incentive to risk its own reputation or expose itself or its customers to loss in order to assist a troubled section 20 affiliate or a failed underwriting by that affiliate.

Also, because securities activities are conducted in an affiliate, banks are limited in their ability to fund those activities by sections 23A and 23B of the Federal Reserve Act. These restrictions are vitally important. Section 23A limits the total value of transactions with any one affiliate to 10 percent of the bank's capital and limits transactions with all affiliates to 20 percent of capital. It also requires that substantial collateral be pledged to the bank for any extension of credit. Section 23B requires that inter-affiliate transactions be at arm's length and on market terms, and imposes other restrictions designed to limit conflicts of interest.

Thus, affiliate status prevents the bank from passing along the federal subsidy inherent in the federal safety net to its section 20 affiliate by extending credit. Regulators could conceivably limit a bank's ability to use credit to subsidize a direct securities subsidiary of the bank as well, by applying sections 23A and 23B. But the equity investment in the subsidiary would still be funded from subsidized resources backed by the federal safety net. Even if the investment were deducted from the capital of the bank, the subsidy inherent in the transfer would remain.

A second protection is examination of the bank holding company, including the effect of securities activities on insured depository institution subsidiaries. The Federal Reserve as holding company regulator monitors compliance with sections 23A and 23B and other aspects of the relationship between a bank and its section 20 affiliate. In its supervision of bank holding companies, the Board increasingly pays attention to risk management systems and policies that are centralized at the holding company level and govern both the bank and its section 20 affiliate.

A final series of protections is the regulatory regime that applies to all broker-dealers, including section 20 subsidiaries. The Securities Act of 1933 and the Securities Exchange Act of 1934 impose registration, capital and disclosure requirements, anti-fraud protections, and other investor-protection measures. These laws, and their enforcement by the Securities and Exchange Commission, address many of the safety and soundness and conflict-of-interest concerns about affiliation of commercial and investment banks.

I note that most of these important protections were not in place when the Glass-Steagall Act passed in 1933. Thus, although proponents of high firewalls frequently cite the subtle hazards of affiliation discussed in the legislative history of that Act, the regulatory environment was far different then. I believe that the drafters of the Glass-Steagall Act would have had a very different discussion -- and passed a very different Act -- had today's statutory and regulatory protections been present in 1933.

Not only were these protections largely absent in 1933, some were not even present in 1987 when the Board first erected its firewalls. Section 23B of the Federal Reserve Act had not been adopted at the time of the Board's first section 20 order in 1987. As a result, many of the firewalls overlap the restrictions of section 23B, which as I noted requires inter-affiliate transactions to be at arm's length and on market terms, but also prohibits a section 20 affiliate from representing that an affiliated bank is responsible for its obligations, and prohibits a bank from purchasing certain products from a section 20 affiliate. Similarly, risk-based capital standards did not exist in 1987, and those standards now require a bank to hold capital against many of the on- and off-balance-sheet exposures it maintains in conjunction with a section 20 affiliate. Finally, the Interagency Statement on Retail Sales of Nondeposit Investment Products was not adopted until 1994. The Interagency Statement includes disclosure and other requirements that are now the primary means by which the federal banking agencies seek to ensure that retail customers are not misled about the nature of non-deposit products they are purchasing on bank premises.

### **The Board's Review**

Thus, when the Board last year decided to reexamine the firewalls, we felt it important to do so with a fresh eye, benefitting from our ten years of experience supervising the section 20 affiliates, acknowledging regulatory and legal developments since 1987, and focusing on the relevance of the firewalls in today's financial markets. As we began to look at the concerns the firewalls were designed to address, we asked two questions. Does the affiliation of a

commercial and an investment bank cause safety and soundness or other concerns not present with any other commercial bank affiliation -- concerns not addressed by general bank holding company regulation? Does operation of a broker-dealer within a bank holding company cause concerns that independent operation does not -- concerns not addressed by broker-dealer regulation? In some areas -- most notably, consumer protection -- we believed that the answer was "yes." In most other areas, however, the Board believed, at least pending public comment, that the answer was "no."

The answers to these questions are important because the firewalls are far from costless. They impose operational inefficiencies on bank holding companies that increase their costs and reduce their competitiveness, and they limit a bank holding company's ability to market its products in a way that is both most profitable and desired by its customers. As such, the firewalls have served as a significant barrier to entry for small and mid-size bank holding companies because those companies cannot realize sufficient synergies or achieve adequate operating revenues to justify establishing a section 20 subsidiary. The loss is not just to these companies but also to their customers and market competition.

Let me now discuss the most important of the firewalls to which the Board has proposed changes. The comment period closed on this proposal last week, and the comments were overwhelmingly favorable. I will not discuss all 28 firewalls but have attached a summary list and their proposed disposition.

### **Restrictions on Funding**

The Board proposed to eliminate a series of firewalls that constitute a blanket prohibition on a bank's funding its section 20 affiliate, and to rely instead on the protections of sections 23A and 23B of the Federal Reserve Act. The firewalls in question prohibit a bank from extending credit to a section 20 affiliate, purchasing corporate and other non-governmental securities being underwritten by the section 20 affiliate, or purchasing from the section 20 affiliate such securities in which the affiliate makes a market. These firewalls were intended to prevent a bank from assisting a troubled affiliate by lending to it on preferential terms or by bailing out a failed underwriting by purchasing securities that cannot otherwise be sold.

Except for the prohibition on purchasing securities during the underwriting period, none of these funding firewalls was applied under the Board's original 1987 order, but were added in 1989 when the range of permissible securities activities was expanded. Bank subsidiaries of the fourteen companies operating under the 1987 order have therefore been free to, and have in fact, funded their section 20 affiliates subject to sections 23A and 23B. The Board has not encountered problems arising from such funding.

If the Board were to eliminate the funding restrictions for the remaining section 20 subsidiaries, sections 23A and 23B would continue to impose quantitative and qualitative restrictions on inter-affiliate transactions. In addition to requiring that the transaction be on market terms, section 23B specifically prohibits a bank from purchasing any security for which a section 20 affiliate is a principal underwriter during the existence of the underwriting or selling syndicate, unless such a purchase has been approved by a majority of the bank's board of directors who are not officers of any bank or any affiliate. If the purchase is as fiduciary, the purchase must be permitted by the instrument creating the fiduciary relationship, court order, or state law. We believe these are substantial protections, and have proposed to rely on them in place of a firewall.

### **Prohibitions on a Bank Extending or Enhancing Credit in Support of Underwriting or Dealing by a Section 20 Affiliate**

Three of the Board's firewalls restrict the ability of a bank to assist a section 20 affiliate *indirectly*, by enhancing the marketability of its products or lending to its customers. These firewalls prohibit a bank from extending credit or offering credit enhancements in support of corporate and other non-governmental securities being underwritten by its section 20 affiliate or in which the section 20 affiliate makes a market; extending credit to issuers of securities to repay principal or interest on securities previously underwritten by a section 20 affiliate; or extending credit to customers to purchase securities currently being underwritten by a section 20 affiliate. The firewalls share a common purpose: to prevent a bank from imprudently exposing itself to loss in order to benefit the underwriting or dealing activities of its affiliate.

However, as financial intermediation has evolved, corporate customers frequently seek to obtain a variety of funding mechanisms from one source. By prohibiting banks from providing routine credit or credit enhancements in tandem with a section 20 affiliate, these firewalls hamper the ability of bank holding companies to serve as full-service financial services providers. The firewall thereby reduces options for their customers. For example, existing corporate customers of a bank may wish to issue commercial paper or issue debt in some other form. Although the bank may refer the customer to its section 20 affiliate, the bank is prohibited from providing credit enhancements even though it is the institution best suited to perform a credit analysis -- and, with smaller customers, perhaps the only institution willing to do so. As another example, the restriction on lending for repayment of securities causes a bank compliance problems when renewing a company's revolving line of credit if a section 20 affiliate has underwritten an offering by that company since the credit was first extended. The bank must either recruit other lenders to participate in the renewal or amend the line of credit in order to specify that its purpose does not include repayment of interest or principal on the newly underwritten securities.

Notably, even if these firewalls were lifted, a bank would still be required to hold capital against all credit enhancements and credit extended to customers of its section 20 affiliate. Section 23B of the Federal Reserve Act would require that such credit and credit enhancements be on an arm's-length basis. Similarly, the federal anti-tying statute would prohibit a bank from offering discounted credit enhancements on the condition that an issuer obtain investment banking services from a section 20 affiliate. Thus, for example, a bank could not offer such credit enhancements below market prices, or to customers who were poor credit risks, in order to generate underwriting business for a section 20 affiliate.

The firewall prohibiting lending to retail customers for securities purchases during the underwriting period addresses one of the most important potential conflicts of interests arising from the affiliation of commercial and investment banking: the possibility that a bank would extend credit at below-market rates in order to induce consumers to purchase securities underwritten by its section 20 affiliate. The concern here is not only safety and soundness but customer protection.

The Securities Exchange Act of 1934 already prohibits a broker-dealer (including a section 20 affiliate) from extending or arranging for credit to its customers during the underwriting period. Still, we recognize the Act would not apply in the absence of arranging and, unlike the firewall, would not cover loans to purchase a security in which a section 20 affiliate makes a market. Section 23B of the Federal Reserve Act, and to some extent section 23A, would address some of these remaining concerns, but perhaps not all. The Board will be reviewing the comments on this firewall carefully.

## **Capital Requirements**

The next group of firewalls I will discuss imposes capital requirements on a bank holding company and its section 20 subsidiary. These firewalls require a bank holding company to deduct from its capital any investment in a section 20 subsidiary and most unsecured extensions of credit to a section 20 subsidiary engaged in debt and equity underwriting; they also require the section 20 subsidiary to maintain its own capital in keeping with industry norms. These requirements apply only to section 20 subsidiaries and not to any other nonbank subsidiary of a bank holding company.

The Board proposed to eliminate the capital deductions for investments in, or credit extended to, a section 20 subsidiary. The original purpose of the deduction was to ensure that the holding company maintained sufficient resources to support its federally insured depository institutions. In practice, however, the deductions have created regulatory burden without strengthening the capital levels of the insured institutions.

The deduction is inconsistent with Generally Accepted Accounting Practices, which require consolidation of subsidiaries for accounting purposes. The deduction therefore has created confusion and imposed costs by requiring bank holding companies to prepare statements on two bases. The deduction does not strengthen the capital of either the bank or its section 20 affiliate, and elimination of the deduction would not create or expose any incentive for a bank holding company to divert necessary capital from a depository institution to a section 20 subsidiary. One of the purposes of the system of prompt corrective action adopted in 1992 is to ensure that a bank holding company maintains the capital of its subsidiary banks.

The Board also sought comment on whether it should continue to impose a special capital requirement on section 20 subsidiaries in addition to the SEC's net capital rules. The purpose of this requirement was to prevent a section 20 subsidiary from being able to leverage itself more than, and gain a competitive advantage over, its independent competitors by trading on the reputation of its affiliated bank. Although the SEC imposes capital requirements on all broker-dealers, these are minimum levels that are far below the industry norm.

This capital firewall has proven confusing and controversial, as "industry norms" are difficult to determine. Federal Reserve examiners have expected section 20 subsidiaries to maintain capital to cover risk exposure in an amount approximately twice what the SEC requires, but some section 20 subsidiaries have complained that this is more than their competitors maintain. They also argue that whereas SEC capital requirements allow all capital to be concentrated in the broker-dealer and dedicated to meeting capital requirements, a bank holding company must meet capital requirements at the bank and holding company levels as well.

Indeed, bank holding company capital is measured on a consolidated basis, and thus includes the capital and assets of the section 20 subsidiary. Therefore, the Board believes it may be unnecessary to impose a separate capital requirement on the bank holding company's section 20 subsidiary.

## **Remaining Restrictions**

Before leaving the Board's proposal, I should also note which restrictions the Board proposed to *retain*. The Board proposed to reserve its authority to reimpose the funding, credit extension, and credit enhancement firewalls in the event that an affiliated bank or thrift becomes less than well capitalized and the bank holding company does not promptly restore it to the well-capitalized level. The Board considered proposing to reimpose the

firewalls on less than well capitalized banks automatically -- as some recent bills introduced in the Congress would -- but decided against it because a decline in a bank's capital ratios may be wholly unrelated to the bank's dealings with its section 20 affiliate. Thus, for example, forcing a bank suffering serious losses on real estate lending to desist from credit enhancements may be unproductive or -- if the business is profitable -- counterproductive.

The Board also proposed to retain existing firewalls requiring adequate internal controls and documentation, including a requirement that a bank exercise independent and thorough credit judgment in any transaction involving an affiliate. Although we expect banking organizations to have such internal controls and look for them during examinations, we believe that they are sufficiently important to warrant reinforcement through the operating standards. They are especially important in the section 20 context because of the likelihood that a bank and its section 20 affiliate may be selling similar products to the same customer.

Because of the potential for customer confusion as to which products are federally insured, the Board proposed to require a section 20 affiliate to make disclosures to customers similar to those that the Interagency Statement requires of a bank selling nondeposit products on bank premises. The proposal would also continue to prohibit an affiliated bank from knowingly advising a customer to purchase securities underwritten or dealt in by a section 20 affiliate unless it notifies the customer of its affiliate's role. The proposal also continues to prohibit a bank and its section 20 affiliate from sharing any nonpublic customer information without the customer's consent.

#### **Earlier Board Action on Other Firewalls and the Revenue Limit**

In addition to describing the Board's recent proposal, you also asked me to discuss other changes the Board finalized last year: increasing the section 20 revenue limit from 10 percent to 25 percent; allowing cross-marketing between a bank and a section 20 affiliate; permitting employee interlocks between a bank and a section 20 affiliate; and scaling back a restriction on officer and director interlocks.

The review that led to changes to the cross-marketing and interlocks firewalls was akin to what the Board recently went through for all the firewalls. The Board acted on these firewalls before the rest because it had previously sought comment on them some years ago and because they were identified by commenters as among the most unduly burdensome of all the firewalls. After reviewing its experience administering these firewalls, the Board decided that they caused inefficiencies that could not be justified by any benefit to safety and soundness, and commenters agreed overwhelmingly. Repeal of the interlocks and cross marketing restrictions allows increased synergies in the operation of a section 20 subsidiary and its bank affiliates. Persons may be employed by both companies, and the trend toward coordinated management of like business functions can accelerate, with reporting lines running between companies. Companies need not fund dual back offices or trading floors, for example. To the extent that senior bank managers may now oversee related operations at a section 20 affiliate, risk management and safety and soundness may be improved.

Moreover, existing disclosure requirements adequately address concerns about customer confusion arising from increased cross-marketing and employee interlocks. Most notably, the Interagency Statement on Retail Sales of Nondeposit Products states that, prior to the initial sale of a non-deposit product by a bank employee or on bank premises, the customer must receive and acknowledge a written statement that the product being sold is not federally insured, is not a deposit or other obligation of the bank, is not guaranteed by the bank, and is subject to investment risks including loss of principal.

Finally, with regard to the revenue limit, section 20 of the Glass-Steagall Act prohibits a bank from being affiliated with any company "engaged principally" in underwriting and dealing, and the Board was obliged to make a narrow, legal determination of the level of revenue at which a company becomes "engaged principally." The Board interpreted the statute to allow 25 percent of total revenue to be derived from underwriting and dealing in bank-ineligible securities. In reviewing the revenue limit, the Board was not deciding what level of underwriting and dealing was consistent with safety and soundness or public policy. If it were, the Board may well have raised the limit to 100 percent, which would have been consistent with the Board's support of repeal of section 20.

I am pleased to report that early indications of the effects of these changes have been favorable. The Board currently has pending three applications to establish a section 20 subsidiary. As we had anticipated, two of these are small to mid-size bank holding companies which may previously have either found it too expensive to fund the dual staffing required by the interlocks restrictions or too difficult to generate sufficient eligible revenue to maintain compliance with a ten percent revenue limit. Furthermore, existing section 20 subsidiaries have indicated that they have been able to rationalize their organization and expand their activities given the added flexibility with respect to both staffing and revenue.

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**Last update: March 20, 1997 10:00 AM**