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Gramm-Leach-Bliley and the Changing Nature of Financial Service Supervision

PLEASE NOTE: Due to inclement weather and flight cancellations, the following remarks prepared for Michael H. Moskow, President and CEO of the Federal Reserve Bank of Chicago, for the Iowa Bankers Roundtable, Drake University, were delivered by Jack Wixted, Senior Vice President, Supervision and Regulation, Federal Reserve Bank of Chicago.

Good afternoon. It's a pleasure to be here to discuss the Gramm-Leach-Bliley Act and the changing nature of financial service supervision. This is an Act appropriate to its time. In the year 2000, it seems almost everything is new or beginning again. The millennium is new. The \$5 and \$10 greenbacks are newly redesigned. The new golden dollars are being praised by the public as a breath of fresh air. And it's not just the face of money that's changing. The newest face of money has no face at all. Interest in virtual currencies is increasing as Internet shopping becomes the latest national past-time.

Some have even claimed the entire economy is new as well. And while I wouldn't go so far as to say we have a "New Economy," it is true that the way we do business, and the way we bank, is rapidly changing. Where once banking was focused on investments in homes and manufacturing, today banking is more about processing information. Banking used to be a meat and potatoes industry. Now it's nouvelle cuisine. Our old staples of banking are as unrecognizable as carrots julienne are to a rabbit.

From the perspective of the Federal Reserve, the passing of the Gramm-Leach-Bliley Act was a much-anticipated step toward modernizing the legal structure surrounding banking. It is the writing down of an exact recipe for a dish many have been cooking for some time, despite some disagreement on the exact ingredients. And it was a truly ambitious undertaking. To paraphrase Federal Reserve Governor Lawrence Meyer, the Act is a massive and complicated effort to make the legal structure consistent with the new reality of the financial services industry.

For all its scope and potential impact, the four basics of the Act are straightforward and clear. First, the statutory limitations on banking organizations' financial activities have been reduced for qualified financial holding companies. However, there are still a few restrictions on the location of the new or expanded nonbank financial activities within a banking organization. Firewalls will be less abundant than they were in the past, but far more critical. In particular, I am referring to section 23A&B — the regulation of in-company transfers. And the new law still limits the mixing of banking and commerce. Second, the law blends functional supervision of the component entities of financial holding companies with umbrella supervision of the consolidated organization. Third, the law enhances privacy protections on disseminating information about customer accounts to third parties.

And finally, the Act contains several provisions affecting the implementation of the Community Reinvestment Act. Gramm-Leach-Bliley recognizes that for small banks, frequent exams are highly burdensome. The Act responds to that concern by reducing the number of CRA exams required for banks with at least a satisfactory rating. This should not be taken in any way to imply a reduction in any bank's CRA responsibilities. And in fact, the Act has tried to reinforce CRA in a non-burdensome way by including a satisfactory CRA rating as a requirement for becoming a financial holding company. The act also requires public disclosure of all CRA agreements, the so-called "Sunshine Provisions."

In essence, what all this means is that bank holding companies that are well-capitalized, well-managed and have satisfactory CRA ratings can now become financial holding companies. And once they've achieved this status, they can engage in activities new to bank financial subsidiaries and bank holding companies. These new activities include underwriting insurance, issuing annuities and merchant banking, among others.

Banks have now gained what they've been desiring for decades: the opportunity to serve their customers better by offering a broader range of services. But they will also now face greater competition from those in other industries choosing to expand their businesses into areas that were traditionally the preserve of banks.

I know many of you here today are from community banks. Certainly some of you may have already applied to become financial holding companies. Some of you may feel that your bank needs the designation to better compete with larger banking organizations from other states. Others may be pursuing financial holding company status because you have been heavily involved in selling insurance in the past and now want to underwrite policies as well. Still others may wish to offer equity as well as debt financing to commercial firms.

What does Gramm-Leach-Bliley mean to the future of the small banks? Certainly the Act does not mean the impending extinction of small banks. In fact, at the Federal Reserve Bank of Chicago, we think — with apologies to Mark Twain — that the reported demise of smaller banks is greatly exaggerated. Community banks do have some key advantages. For example, small banks can offer individual attention. Community banks often have knowledge of their customers that cannot be gleaned from loan applications or credit reports. And this can make decision-making faster at the local level. There are also many consumers who associate larger banks with bureaucracy and stringent policies. Furthermore, those concerned enough about privacy may be turned off by the mere thought of one-stop shopping at a larger bank. In some ways, the playing field is more level. Through technology, community banks have a greater ability to provide diverse financial services than in the past. However, in their rush to embrace technology, community banks must be particularly aware of the importance of the "personal touch" to their customer base. After all, even in this age of fast food, Mom-and-Pop corner bakeries still attract loyal followings.

As always, good management is key. The successful banks of the future will be the well-managed ones, whether they be small or large. I'm sure I'm not alone in hoping that community banks proceed cautiously when considering venturing into areas such as merchant banking that require specialized knowledge and experience. Different activities require different talents and hold different risks.

So how will Gramm-Leach-Bliley change the structure of the industry? I don't have a crystal ball, but I think it's fair to say that the removal of product restrictions in the Act will continue the trend of banking consolidation. With the removal of geographic restrictions we have seen many banking organizations opt to consolidate their separate banks into one charter. Gramm-Leach-Bliley eliminates some of the regulatory incentives for maintaining separate charters, such as the ability to sell insurance in small towns. Banking organizations can now choose the structure that is most appropriate for their operations based on their strategic plans rather than regulatory incentives. This should benefit large and small banks alike.

Community banks, as well as large banks, want to be able to offer a full complement of financial services to their customers. Larger banks have already been able to offer some of the products now permitted under Gramm-Leach-Bliley. Community banks can now compete in these areas.

There are other features of the Act that benefit community banks. One trend in banking is the decline in deposits. Larger banks can replace deposits by accessing the capital markets, but this is more difficult and costly for smaller organizations. Gramm-Leach-Bliley addresses this issue with several provisions that increase the availability of funds from Federal Home Loan Banks for community banks with total assets of less than \$500 million. These banks no longer have to meet the qualified thrift lender test and can use loans to small businesses and small farms, as well as housing loans, as collateral for loans from the Federal Home Loan Bank.

Finally, and of particular importance to community banks, the Act closes the unitary thrift loophole. This reduces the possibility that a commercial firm like Wal-Mart could compete with banks by offering financial services.

Now let's move on to how Gramm-Leach-Bliley will help the banking industry as a whole. One consequence of the Act will be its impact on bank risk. Bank risk profiles have changed. In fact, everything about risk has changed — from the way banks manage it, to the way the Fed monitors it. Increased diversification under the Act should result in healthier banks, as risk is spread across different investments, lowering the organization's consolidated risk profile. On the other hand, there will be new risks as well. New activities present new risks that require specialized expertise and internal controls.

More pressing for larger banks are the risks associated with increased size. This issue is now front and center in the financial services industry. This year we have seen merger difficulties humble the largest banking organizations. And these organizations were merging companies engaged in similar lines of business. When mergers commence between organizations engaged in different product lines, such as banking and insurance, the risks will multiply. Financial holding companies will face the challenge of combining the vastly different cultures of organizations centered on different business lines. Management teams that can successfully negotiate these issues and deliver financial results in the time frame demanded by the markets will be among the winners in coming years.

Gramm-Leach-Bliley obviously has dramatic implications for the Fed as a supervisor. The changing nature of risk has caused the Fed to revise its approach to bank supervision in recent years.

The Federal Reserve supervises nearly 1,000 state member banks and over 5,000 bank holding companies nationwide. Currently, 155 bank holding companies have elected to become financial holding companies. Some

of you in the audience who are bankers realize that you can leave your office one day and return to what is, in terms of risk, an essentially different bank the next.

If I had to highlight what our bank supervisors do differently today, as compared to how we supervised financial institutions in the past, I'd say we are far more proactive. In the past the Fed has been a cop-on-the-beat of the banking industry. Now we're more like risk analysts. Our goal isn't to come in after the fact and clean up problems. Rather, we want to foresee problems well before they materialize in order to help banking institutions better manage risk in an increasingly complex economic age. Fed supervisors today need to know the competitive forces facing your bank, as well as how to enforce banking laws. And there is good reason for this. Prioritizing risk management at the individual bank level is the best way to limit problems that could contribute to macroeconomic instability.

This change in focus has also altered how our supervisors go about doing their jobs. Once a supervisor would show up unexpectedly at a bank, badge on display, like Kevin Costner in "The Untouchables." Now you're more likely to find supervisors on the phone, keeping in regular communication with bank managers.

Just as banks strive for efficiency, so do supervisors. We've come a long way from the days when we asked for everything in triplicate. In fact, we're becoming more efficient bank supervisors in many ways. For example, because our supervisors visit many institutions and see many different approaches to similar problems, we can keep bank managers advised of the best practices we've seen, as well as provide alternative solutions. Last year, a Chicago Fed supervision and regulation employee was singled out in the Fed system for outstanding achievement, not for his work examining a particular bank, but for his ability to spread the word about best practices.

So how does the Gramm-Leach-Bliley Act tie into the changing nature of banking supervision? First, the Act institutionalizes some of the changes that have already been occurring in the supervision of risk. In particular, it has made concrete what has become the Fed's dual role in financial services supervision. One of these roles for the Fed has become known as "umbrella" supervision. The Fed will assess the health of the financial holding company as a whole and ensure that the organization is managing the comprehensive risk of the total company. The Fed is responsible for monitoring not only risks to the health of the company, but given the size of some financial holding companies, the potential risks to the health of the financial system as well. Some would argue that these new companies can be potentially more of a risk than the sum of their individually assessed parts would lead us to believe.

The Act deals with these concerns by making the Federal Reserve an umbrella supervisor. By carefully monitoring the organization to make sure firewalls between insured and uninsured activities are not being breached; by making sure the organization is measuring, monitoring and mitigating its consolidated risk; and by ascertaining that no unregulated activities pose undue risk to the banking organization, the umbrella supervisor can help improve the safety and soundness of individual banking organizations, as well as limit systemic risk to the entire financial services sector.

The second half of the Fed's dual-role supervisory responsibility is its role as a "functional" regulator for state member banks. This role has not changed under Gramm-Leach-Bliley. What has changed is that non-banking activities in financial holding companies will be regulated by the supervisor that is primarily responsible for that activity. For example, state insurance commissioners will now regulate all insurance activities.

The good news is that the banking regulators have a history of working well together and sharing information. We all understand that in the complex, contemporary world of banking, we need all the help we can get. We must use our scarce resources wisely by focusing on areas where there is the most risk.

In sum, functional supervisors will monitor risks associated with the various parts of financial holding companies, and the Fed, as umbrella supervisor, will monitor the financial holding companies as wholes and in the context of the broader industry.

I mentioned earlier that small banks could capitalize on current concerns over privacy. But in fact, all banks must prioritize this issue. Given consumer sensitivity, banks will lose customers if they disregard public concern over who has access to sensitive personal information. This is true regardless of how many custom-tailored financial products an institution offers.

Gramm-Leach-Bliley contains the first attempt of Congress to address the critical issue of privacy. It reflects this public concern by requiring all financial service providers to disclose their privacy policies, by preventing banks from disclosing account numbers to third-party marketers, and by giving customers the ability to “opt-out” of any information sharing agreement between a financial service provider and a third party. It also makes it a crime for anyone to misrepresent themselves to a financial organization in order to obtain personal customer information. These provisions apply to any entity that the Federal Trade Commission determines provides financial services to customers. Clearly one concern of the banking industry is the cost and time required to implement these provisions. Proposed regulations to implement the Act’s privacy requirements were released for public comment earlier this year, and more than 8,600 comment letters were received. The banking regulators will be evaluating the comments, with final regulations scheduled to be released in May.

What is most notable about Gramm-Leach-Bliley? It is not a new beginning for our industry. But it does provide the framework for a constant reappraisal of the financial services industry and room for bankers to regularly reassess how they are meeting the needs of their industry customers. This is not just an opportunity, it is an obligation. And this holds for the regulators as much as for the industry professionals.

Certainly the greatest challenges are still to come. I know that many community bankers are concerned about moral hazard issues surrounding large banks. At the Chicago Fed we strongly endorse efforts to better use regulation to promote market discipline, rather than suppress it. In fact, since the 1980s the Chicago Fed has recommended requiring larger banks to take on subordinated debt, which we argue would make them more sensitive to market forces. We are encouraged to see that the Act recommends a study into the potential of subordinated debt to reduce moral hazard.

Alan Greenspan has said of our efforts to implement Gramm-Leach-Bliley that regulators are trying to “develop a program that is the least intrusive, most market based, and most consistent with current and future sound risk-management practices possible, given our responsibilities for financial market stability.”

Of these challenges, the greatest for the Fed and other regulators is how to ensure minimal intrusiveness. Our ongoing challenge is to further increase cooperation in order to reduce the regulatory burden on banks while balancing the necessity to supervise new risks.

I said earlier that Gramm-Leach-Bliley is as much a reflection of change that has already taken place as it is a creator of change. But there is now a greater opportunity for bankers to respond to the changes that have taken place. Some in the industry feel this allows bankers greater freedom to think outside the box. This is exactly what the industry needs right now.