FRBSF WEEKLY LETTER

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Legislation to Expand Bank Powers

Several bills have been submitted to both Houses of the Congress that would expand the powers of banking organizations or otherwise reform the financial regulatory framework. In the Senate there are three major bills: Proxmire-Garn (S1886), supported by the Administration and the heads of the bank regulatory agencies; Wirth-Graham (S1891), which is essentially the proposal that was recently put forth by Gerald Corrigan, the president of the Federal Reserve Bank of New York; and Cranston-D'Amato (S1905), which is much more sweeping in scope than the other bills. On the House side, similar bills have been introduced. However, Congressman St Germain, Chairman of the Banking Committee, is drafting a bill as well, which may partly determine the direction the House will follow.

This *Letter* discusses the similarities and differences among the major Senate bills as of February 15. The analysis focuses on the way each bill addresses several important policy issues. The first issue is the proper scope of a *bank holding company*'s activities, and which of those activities are proper for the *bank* itself. The second is whether a federally-insured bank can be "insulated" from the risky activities of its affiliates. And the third is how to regulate and supervise banking organizations that have greatly expanded powers.

Proper scope of activities

The major bills differ greatly on the types of new activities that would be allowed. The Proxmire-Garn bill is the most restrictive. It would expand the securities powers of bank holding companies by repealing the relevant sections of the Glass-Steagall Act in several steps. However, the Proxmire-Garn bill does not explicitly authorize any other new types of activities such as real estate or insurance.

Under the bill, securities firms could own banks, and would not be subject to Federal Reserve capital regulation and monitoring of the consolidated organization as long as 80 percent of the organization's consolidated earnings and assets were derived from *securities* activities and each bank subsidiary were adequately capitalized. Currently, many of the largest securities houses are affiliated with insurance, real estate and even commercial firms. Thus, the present version of the bill would not allow these firms to own banks without major divestitures.

The Wirth-Graham bill is less restrictive. It would allow nonbank subsidiaries of bank holding companies to engage in any activities deemed financial in nature by a newly created regulatory oversight committee, although it would prevent banks from affiliating with commercial firms. It also would create a new type of "financial holding company," which would not own banks or be affiliated with commercial firms, but which could have access to the large-dollar electronic payments system through a newly created National Electronic Payments Corporation.

Since the Wirth-Graham bill would define banks as any institution with federally insured deposits, companies that owned "nonbank banks" no longer could avoid bank holding company regulation. In addition, the bill would create "commercial" holding companies in which financial and commercial firms could be affiliated. However, commercial firms that now own institutions with insured deposits such as thrifts and nonbank banks would have to divest them.

The Cranston-D'Amato bill is the most liberal of the major bills. In addition to allowing banking organizations to conduct all types of financial activities, this bill would allow commercial firms to own banks and vice versa.

These bills represent a range of opinion on how broadly the powers of banking organizations would be expanded — from essentially securities powers only under Proxmire-Garn versus all financial and even commercial powers under Cranston-D'Amato. The key concern in this debate is the likely effects of an expansion of powers on the riskiness of the banking and financial systems.

It is now well recognized that a fixed rate deposit insurance system can provide strong incentives for insured institutions to undertake

excessive risks. Currently, such opportunistic behavior is limited by bank and bank holding company regulation. The concern, then, is whether the risks associated with the new activities can be contained to prevent them from spilling over to the insured bank and ultimately, to the federal deposit insurance system.

Insulation

Each of the bills tries to insulate the insured bank by placing new activities in legally separate nonbank subsidiaries of bank holding companies and by placing rather severe restrictions on transactions between bank and nonbank affiliates. The idea is to try to limit the opportunities for the bank to bail out the holding company or sister affiliates with loans or asset purchases funded with insured deposits.

The Proxmire bill would prohibit virtually all credit transactions between a bank and its securities affiliate, including indirect transactions such as bank-issued standby letters of credit backing securities underwritten by a securities affiliate. The Cranston bill also would prohibit direct and indirect credit transactions between a bank and its securities affiliates. However, the latter bill would allow transactions between a bank and other types of affiliates up to the limits of Rules 23A and 23B in current banking law. (Rule 23A of the Federal Reserve Act limits a bank's extensions of credit to a single affiliate to ten percent of the bank's capital and limits the credit to all affiliates combined to 20 percent of capital. Rule 23B requires that permissible interaffiliate transactions be on terms and conditions that are substantially the same as arm's-length transactions with nonaffiliated firms.) The Wirth bill, in contrast, would apply these limitations to transactions between banks and *all* of their affiliates.

Although the three bills differ regarding the stringency of the restrictions they would place on interaffiliate transactions, the approach itself has several limitations. First, it is doubtful whether the restrictions contained in any of these bills could be enforced in times of financial stress. The gains from using the bank to bail out failing nonbank affiliates increase as the organization approaches bankruptcy. Thus, far more stringent restrictions than those contained in these bills may be necessary to insulate banks fully.

Second, even if it were possible to insulate the bank, perhaps by restricting *all* interaffiliate transactions, doing so would preclude the organization from realizing important synergies among separate subsidiaries. For example, banks and securities companies may benefit from sharing information, but unless the two can work out a way to share the costs of acquiring that information, they will have little incentive to do so, even if they are subsidiaries of the same parent organization.

Finally, restrictions on interaffiliate financial flows also limit the extent to which the bank can benefit from the diversification and reduced risk of bankruptcy that might result from an expanded range of activities. Moreover, apart from bank capital regulation, there is no mechanism for forcing a bank holding company to provide support for a failing bank subsidiary.

Regulatory oversight

The major bills also differ significantly in their provisions regarding supervision of the consolidated firms, although all of the bills provide for functional regulation of the various subsidiaries of the holding company. The Proxmire bill would leave intact the regulatory framework established by the Bank Holding Company Act, with the Federal Reserve as the primary regulator of the holding company. The bill would give the Fed explicit authority to regulate the holding company's capital unless the company meets the 80 percent test mentioned above.

The Wirth bill also would leave the Federal Reserve as the regulator of bank holding companies, but in addition would give substantial powers to a fifteen-member "super-agency" composed of the various functional regulators. This agency would oversee the functional regulation of the subsidiaries of bank, financial and commercial holding companies, would have the authority to set capital standards for financial holding companies and could promulgate regulations defining permissible activities for bank and financial holding companies.

In contrast, although the Cranston bill would create a "super agency" called the National Financial Services Committee, that agency's role appears to be limited to an advisory one. Moreover, this bill would reduce the Fed's authority to regulate the activities of nonbank affiliates of insured banks.

Risk containment

Clearly, there are substantial differences among these three bills regarding the permissible scope of banking powers and the extent of regulation and oversight of the consolidated firm. These differences reflect divergent views on the benefits of expanded powers and the costs associated with the potential for increased risk taking.

The Cranston-D'Amato bill allows the broadest range of powers apparently on the assumption that reliance on the holding company structure and restrictions on interaffiliate transactions is an inexpensive and effective way of insulating the bank. It also apparently assumes that apart from regulation and supervision of *banks,* little else is needed to contain risk taking. For example, it expressly prohibits capital regulation of consolidated financial holding companies. However, it permits bank regulators to require higher capital in *banks* that are affiliated with nonbank firms and gives bank regulators the power to require holding companies to divest inadequately capitalized banks.

The Wirth-Graham bill takes a more middle-of-the-road approach. It apparently assumes that insulation cannot be made completely fireproof, and instead, assigns a greater role to regulation of the consolidated organization. Thus, it limits the scope of powers and requires Federal Reserve regulation of the capital adequacy of the consolidated bank holding company.

Finally, the Proxmire-Garn bill seems the least sanguine about insulating insured banks from the risks associated with a broad range of new activities and therefore takes the most cautious approach. It requires the Federal Reserve to monitor and ensure that the capital position of the consolidated bank holding company is adequate. Moreover, it allows expansion only into securities activities, presumably because, unlike many other activities, the benefits from such an expansion are more obvious and the costs of monitoring the market values and volatility of securities activities are relatively low.

Opportunities vs. incentives

Limitations on the scope of activities as well as restrictions on interaffiliate transactions can be seen as attempts to limit *opportunities* for increased risk taking with insured deposits. However, the sponsors of these bills apparently also recognize that limitations on opportunities to undertake risk do not necessarily alter the *incentives* to do so. Thus, these bills also attempt, in various ways, to constrain the incentives for a banking organization to shift risk to its insured banks.

The Proxmire-Garn and the Cranston-D'Amato bills contain capital "bear-down" provisions that would allow regulators to force a holding company to divest its inadequately-capitalized bank subsidiaries. Such a provision, if enforced on a market value basis regardless of the size of the bank holding company, could be a very powerful tool to limit risk taking.

As we have argued in previous *Letters,* banks with stronger capital positions should be much less inclined to use insured deposits to bail out nonbank subsidiaries. And, even if they did, as long as the bank had sufficient capital, the insurance fund would not be at risk. Therefore, if bank capital regulation could be strengthened, there is considerably less risk in expanding banking organizations' powers.

On the other hand, without enforcement of such a provision, the incentives to find ways around the holding company structure will remain and could become particularly troublesome in times of financial stress. Thus, without a market value closure or divestiture rule, an approach that calls for a more modest range of new powers and more active oversight of the consolidated organization as proposed in Proxmire-Garn or Wirth-Graham may be appropriate.

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MONETARY POLICY OBJECTIVES FOR 1988

Federal Reserve Chairman Alan Greenspan presented a report to the Congress on the Federal Reserve's monetary policy objectives for 1988 on February 23. The report includes a summary of the Federal Reserve's monetary policy plans along with a review of economic and financial developments in 1987 and the economic outlook in 1988. Single or multiple copies of the report can be obtained upon request from the Public Information Department, Federal Reserve Bank of San Francisco, P.O. Box 7702, San Francisco, CA 94120; phone (415) 974-2246.

Editorial comments may be addressed to the editor (Barbara Bennett) or to the author. . . . Free copies of Federal Reserve publications can be obtained from the Public Information Department, Federal Reserve Bank of San Francisco, P.O. Box 7702, San Francisco 94120. Phone (415) 974-2246.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 2/24/88	Change from 2/17/88	Change from 2/25/87 Dollar	Percent[7]
Loans, Leases and Investments[1] [2]	203,558	− 57	− 1,001	− 0.4
Loans and Leases[1] [6]	180,200	− 284	− 4,181	− 2.2
Commercial and Industrial	51,040	− 176	− 1,455	− 2.7
Real estate	70,752	− 67	4,329	6.5
Loans to Individuals	36,218	149	− 4,224	− 10.4
Leases	5,781	5	396	7.3
U.S. Treasury and Agency Securities[2]	16,295	217	2,994	22.5
Other Securities[2]	7,063	9	187	2.7
Total Deposits	200,309	− 3,721	− 668	− 0.3
Demand Deposits	47,209	− 3,670	− 1,999	− 4.0
Demand Deposits Adjusted[3]	43,253	12,105	9,864	29.5
Other Transaction Balances[4]	19,906	− 231	1,130	6.0
Total Non-Transaction Balances[6]	133,194	181	200	0.1
Money Market Deposit Accounts—Total	43,201	− 326	− 2,345	− 5.1
Time Deposits in Amounts of $100,000 or more	30,614	547	− 1,115	− 3.5
Other Liabilities for Borrowed Money[5]	22,003	− 2,182	− 6,196	− 21.9

Two Week Averages of Daily Figures	Period ended 2/22/88	Period ended 2/8/88
Reserve Position, All Reporting Banks		
Excess Reserves (+)/Deficiency (−)	28	98
Borrowings	6	9
Net free reserves (+)/Net borrowed(−)	22	90

1 Includes loss reserves, unearned income, excludes interbank loans
2 Excludes trading account securities
3 Excludes U.S. government and depository institution deposits and cash items
4 ATS, NOW, Super NOW and savings accounts with telephone transfers
5 Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources
6 Includes items not shown separately
7 Annualized percent change