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Testimony by

Alan Greenspan

Chairman, Board of Governors of the Federal Reserve System

before the

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Regulation & Insurance

Committee on Banking, Finance & Urban Affairs

United States House of Representatives

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Mr. Chairman, members of the Committee, it is my pleasure today to present the Federal Reserve Board's views on modernizing our financial system to adapt it to the important changes in technology and competition that have already transformed financial markets here and abroad. You have set an agenda for a searching inquiry into the proper organization and functions of depository institutions, and it is important that this work be completed promptly so that the process of evolutionary development of our financial system may go forward in an orderly way. The foundation now being laid in this Committee and in the Senate Banking Committee provides an historic opportunity to take a crucial first step that can set our course for the future.

The Board has for some years taken the position that our laws regarding financial structure need substantial revision. Developments have significantly eroded the ability of the present structure to sustain competition and safe and sound financial institutions in a fair and equitable way. It is essential that the Congress put in place a new, more flexible framework.

Recently, a great deal of attention has been focused, properly we think, on revising the laws that govern our financial structure. The aim of these proposals is to permit

the affiliation of a broader variety of financial and commercial organizations with banks, while attempting to assure that affiliated banks are not adversely affected by this relationship. Much of this thinking has now centered on a specific proposal by Senate Banking Committee Chairman Proxmire to permit the affiliation of banking organizations with securities firms that is now prohibited by the Glass-Steagall Act.

Our own analysis of the broader proposals leads us to the conclusion that they have many positive elements that deserve continuing attention, but that it would be appropriate at this time to concentrate attention on the specific suggestion to repeal the Glass-Steagall Act. It is our view that this action would respond effectively to the marked changes that have taken place in the financial marketplace here and abroad, and would permit banks to operate in areas where they already have considerable experience and expertise. Moreover, repeal of Glass-Steagall would provide significant public benefits consistent with a manageable increase in risk. Accordingly, we would suggest that the attention of the Committee should focus on the Glass-Steagall Act and we recommend that this law should be repealed insofar as it prevents bank holding companies from being affiliated with firms engaged in securities underwriting and dealing activities. We prefer this comprehensive approach to the

piecemeal removal of restrictions on underwriting and dealing in specific types of securities such as revenue bonds or commercial paper. This limited approach would artificially distort capital markets and prevent financial institutions from assuring benefits to customers by maximizing their competitive advantage in particular markets.

A very persuasive case has been made for adoption of the repeal proposal. It would allow lower costs and expanded services for consumers of financial services through enhanced competition in an area where additional competition would be highly desirable. It would strengthen banking institutions, permitting them to compete more effectively at home and abroad in their natural markets for credit that have been transformed by revolutionary developments in computer and communications technology. It could be expected to result in attracting more equity capital to the banking industry where more capital is needed. In sum, the securities activities of banking organizations can provide important public benefits without impairing the safety and soundness of banks if they are conducted by experienced managers, in adequately capitalized companies, and in a framework that insulates the bank from its securities affiliates.

In reaching these conclusions we are guided by the principles set down in the Bank Holding Company Act of 1970 which requires the Board to consider, in determining the

appropriateness of new activities for bank holding companies, whether they will produce benefits to the public such as greater convenience, increased competition, or gains in efficiency. It also asks us to evaluate whether these gains may be outweighed by possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices.

These are the principles that Congress has set down to guide the evolution of the banking system. They made good sense then and they make good sense today. Over the years we have interpreted these principles to be consistent with our efforts to promote competitive and efficient capital markets and to protect impartiality in the granting of credit, to avoid the risk of systemic failure of the insured depository system, and to prevent the extension of the federal safety net to nonbanking activities. In our view achieving these goals is fully consistent with permitting bank holding companies to engage in securities activities. In short, in my testimony today I will explain why we believe that changes in the Glass-Steagall Act will have major public benefits. I will also explain why we believe that with the right structure and careful implementation, the changes in the law that we support can be accomplished without adverse effects.

The major public benefit of Glass-Steagall modification would be lower customer costs and increased

availability of investment banking services, both resulting from increased competition and the realization of possible economies of scale and scope from coordinated provision of commercial and investment banking services. We believe that the entry of bank holding companies into securities underwriting would, in fact, reduce underwriting spreads and, in the process, lower financing costs to businesses large and small, as well as to state and local governments. In addition, bank holding company subsidiary participation in dealing in currently ineligible securities is likely to enhance secondary market liquidity to the benefit of both issuers and investors. These, we believe, are important public benefits that will assist in making our economy more efficient and competitive.

Studies of the market structure of investment banking suggest that at least portions of this industry are concentrated. The most recent evidence in this regard is provided in the September Report of the House Committee on Government Operations, which presented data supporting its conclusion that corporate securities underwriting is highly concentrated. The five largest underwriters of commercial paper account for over 90 percent of the market; the five largest underwriters of all domestic corporate debt account for almost 70 percent of the market; and the five largest underwriters of public stock issues account for almost half of the market.

I would emphasize that concentration per se need not lead to higher consumer costs, because the possibility that new firms will enter a market may be sufficient to achieve competitive prices. However, it is just in this regard that the Glass-Steagall Act is particularly constraining, because bank holding companies with their existing expertise in many securities activities and their broad financial skills and industry network more generally, would be the most likely potential competitors of investment banks if not constrained by law.

It is also important to emphasize that the changes in the Glass-Steagall Act that we support would be likely to yield cost savings in local and regional corporate underwriting and dealing markets. At a minimum, local and regional firms would acquire access to capital markets that is similar not only to the access now available to large corporations, but also to that currently available to municipalities whose general obligations bonds are underwritten by local banks.

Another area of substantial expected public benefit is the encouragement of the free flow of investment capital. Both we at the Board and the Congress have stressed the importance of improving the capital ratios of banking organizations and it can reasonably be assumed that expansion of banking organizations into securities markets would make them more attractive investments. Equally important, banks and

securities firms would be free to deploy their capital over a wider range of activities designed to serve the public better.

There is another important reason why the Glass-Steagall Act should be changed. Developments in computer and communications technology have reduced the economic role of commercial banks and enhanced the function of investment banking. These permanent and fundamental changes in the environment for conducting financial business cannot be halted by statutory prohibitions, and the longer the law refuses to recognize that fundamental and permanent changes have occurred the less relevant it will be as a force for stability and competitive fairness in our financial markets. Attempts to hold the present structure in place will be defeated through the inevitable loopholes that innovation forced by competitive necessity will develop, although there will be heavy costs in terms of competitive fairness and respect for law which is so critical to a safe and sound financial system.

The significance of technological developments to which I have referred is that the key role of banks as financial intermediaries has been undermined. The heart of financial intermediation is the ability to obtain and use information. The high cost of gathering and using facts in the past meant that banks and other intermediaries could profit from their cumulative store of knowledge about borrowers by making significantly more informed credit decisions than most

other market participants. These other market participants were thus obliged to permit depository intermediaries to make credit decisions in financial markets and therefore allow bank credit to substitute for what would otherwise be their own direct acquisition of credit market instruments.

Computer and telecommunications technology have altered this process dramatically. The real cost of recording, transmitting, and processing information has fallen sharply in recent years, lowering the cost of information processing and communication for banks. But it has also made it possible for borrowers and lenders to deal with each other more directly in an informed way. On-line data bases, coupled with powerful computers and wide-ranging telecommunication facilities, can now provide potential investors with virtually the same timely credit and market information that was once available only to the intermediaries.

These developments mean that investors are increasingly able to make their own evaluations of credit risk, to deal directly with borrowers and, especially with the increasing institutionalization of individuals' savings, creditors are in a position to develop their own portfolios and strategies to balance and hedge risk. Thus, the franchise of bank intermediation, the core element of a bank's comparative advantage, and its main contribution to the economic process -- credit evaluation and the diversification of risk -- has been

made less valuable by this information revolution. Examples of new financial products that have resulted from this technological innovation and that challenge traditional bank loans abound -- the explosion in the use of commercial paper, the rapid growth of mortgage-backed securities and the recent development of consumer loan-backed securities or consumer receivable-related (CRR) securities. There are many others. Our concern is that these real changes in the way that providers of credit utilize financial intermediaries has reduced the basic competitiveness of banks and that the trend toward direct investor-borrower linkages will continue.

Banks, of course, have not stood still while these vast changes were taking place around them. Indeed, they have responded to the technological revolution by participating in it. Loan guarantees and other off-balance sheet arrangements, private placement of corporate debt, commercial paper placement, loan participations and sales, and interest rate and currency swaps are examples. Similarly, the foreign offices of U.S. banks and their foreign subsidiaries and affiliates have been actively engaging abroad in a wide variety of securities activities. These include securities that are ineligible in the United States for banks to underwrite and deal, such as corporate debt and equity. In the corporate debt market, for example, U.S. banks' foreign subsidiaries served lead roles in underwritings approaching \$17 billion in 1986, or about

10 percent of the volume of such debt managed by the 50 firms most active in the Eurosecurities market last year. These and other essentially investment banking activities have permitted banks to continue to service those customers seeking to rely increasingly on securities markets. Nevertheless, in their home market banks are sharply limited by the Glass-Steagall Act in competing for the business of acting as intermediaries in the process of providing credit, in the new financial environment, a process that has been transformed by technological change and which is a natural extension of the banking business.

In short, Congress should modify the financial structure to conform to these changes. If the Congress does not act, but rather maintains the existing barriers of the Glass-Steagall Act, banking organizations will continue to seek ways to service customers who have increasingly direct access to capital markets. But banking organizations are nearing the limits of their ability to act within existing law; and spending real resources to interpret outmoded law creatively is hardly wise. Without the repeal of Glass-Steagall, banks' share of credit markets is likely to decline -- as it already has in our measures of short- and intermediate-term businesses credit. A soundly structured change in the law will allow financial markets to serve us better by lowering costs to users while strengthening financial institutions within a framework that will protect the financial integrity of banks.

The basic principles that I outlined at the outset require us to take into account not only public benefits but also possible adverse effects including unsound banking practices, which clearly includes the concept of excessive risk, conflicts of interest, impairment of competition and undue concentration of resources. These concerns have been heightened by the unprecedented stock market decline that occurred on October 19, 1987 and the subsequent market volatility.

We had reached our decision to endorse repeal of the Glass-Steagall Act before these events occurred. When we made our decision we had very much in mind that there are risks involved in underwriting and dealing in securities and we decided that we would recommend the necessary changes only because we believe that a framework can be put in place that can assure that the potential risks from securities activities can be effectively managed. The events since October 19 have not altered our view that it is both necessary to proceed to modernize our financial system and that it is possible to do so in a way that will maintain the safety and soundness of depository institutions.

Congress adopted the Glass-Steagall Act over 50 years ago because it believed that banks had suffered serious losses as a result of their participation in investment banking. Congress also thought that bank involvement in the promotional

aspects of the investment banking business would produce a variety of "subtle hazards" to the banking system such as conflicts of interest and loss of public confidence. In answer to these concerns we believe that experience has shown that the risks of investment banking to depository institutions are containable, that the regulatory framework established in the securities laws minimizes the impact of conflicts of interest, that the federal safety net implemented through deposit insurance and access to Federal Reserve credit will avoid the potential for panic withdrawals from banks if affiliated securities firms experience losses, and that banks can be effectively insulated from their securities affiliates through an appropriate structural framework.

Bank holding company examinations indicate that U.S. banking organizations have generally shown an ability to manage the inherent risks of both their domestic and foreign securities activities in a prudent and responsible manner. Of all the domestic bank failures in the 1980s, to our knowledge none has been attributed to underwriting losses. Indeed, we are unaware of any significant losses in recent years owing to underwriting of domestically eligible securities. For that matter, research over the past 50 years concludes, contrary to Congress' view at the time, that bank securities activities were not a cause of the Great Depression and that banks with securities affiliates did not fail in proportionately greater numbers than banks more generally.

The investment banking experience of U.S. banking organizations in foreign markets has been favorable and their operations have been generally profitable in the last decade or so. This is not to say there have been no problems. In the mid-1970s some large U.S. banks encountered problems with their London merchant bank subsidiaries in connection with venture capital investments and the development of the Eurobond market. More recently, in the post Big Bang era, U.S. banks' securities affiliates and subsidiaries have shared in the transitional difficulties that arose in the London securities market. All of these problems appear to have been in the nature of "start-up" difficulties rather than long-term safety and soundness concerns. In these situations, and even in the perspective of the unprecedented stock market decline, risks have been contained and losses have been small relative to the capital of the bank or the holding company parent.

Finally, I would note that empirical studies invariably find that underwriting and dealing are riskier than the total portfolio of other banking functions in the sense that the variability of returns to securities activities exceeds that of the returns to the combination of other banking functions. It is also important to note, however, that the average return to securities activities is also usually found to exceed the average return to the combination of other

banking functions. In addition, there is evidence of some potential for limited diversification gains, or overall bank risk reduction, for banks being allowed increased securities powers.

The preliminary evidence on the limited effects of recent stock market events on securities firms reinforces several conclusions drawn previously. First, while securities activities are clearly risky, the risks can be managed prudently. Second, securities activities of bank holding companies should be monitored and supervised in such a way as to control the risk to an affiliated bank. Third, the events of recent weeks highlight the need to have capital adequate to absorb unexpected shocks and to maintain an institutional and legal structure which minimizes the degree to which securities underwriting and dealing risk could be passed to affiliated banks. As I have stressed, such a system can be established. I would now like to turn to what we see as the major elements of such a system.

Fundamental to our recommendation on Glass-Steagall is the view that the safe and sound operation of banks requires that securities activities involving significant risk be conducted behind walls designed to separate, in so far as possible, the bank from the risks associated with the securities activities. Let me note at this point, that some have argued that insulating walls cannot completely protect a

bank from the risks of its affiliates. Management has a natural incentive in periods of stress to assist endangered components of what it sees as one entity, and depositors are free to withdraw their funds from the bank if they perceive -- correctly or incorrectly -- a threat to the bank's safety from losses at affiliates. The task before you is to reduce the risk, taking into account public benefits relative to the risk, to acceptable levels. This effort will require clear rules and a firm expression of public policy that corporate conduct which passes on the risks of securities activities to insured depository institutions is unacceptable.

We see two major elements to an approach to developing a practical insulating structure:

- the holding company structure should be used to institutionalize separation between a bank and a securities affiliate, and
- the resulting institutional firewalls should be strengthened by limiting transactions, particularly credit transactions, between the bank and a securities affiliate.

First, we would take maximum advantage of the legal doctrine of corporate separateness. Under this rule a separately incorporated company normally is not held liable for the actions of other companies even if they are commonly owned or there is a parent-subsidiary relationship. If effective separation can be achieved a bank would not be liable for the

actions of its securities affiliate and the benefits of the federal safety net would not be conferred on the securities affiliate.

We believe that this goal is most effectively achieved if securities activities take place in a direct subsidiary of a holding company rather than in a bank or a subsidiary of a bank. The Board has long supported the holding company framework as the most effective method of accomplishing separation, and it was with these goals in mind that, in 1984, the Board joined the Department of the Treasury in supporting legislation to use the holding company framework to broaden the securities and other powers of affiliates of banks.

The Board believes that the holding company approach, reinforced by the measures I will outline below, has several important advantages over other methods of expanding the powers of banking organizations. First, any losses that may be incurred by the securities affiliate would not be reflected in the balance sheets or income statements of the bank, as they would under normal accounting rules if the bank conducted the securities activities directly or through a subsidiary of the bank. A bank affiliated with a securities firm through a holding company structure thereby obtains the advantages of the holding company's diversification into securities activities without the disadvantages that necessarily flow from the bank conducting the securities activities directly or through a subsidiary of the bank.

Second, it is difficult, if not impossible from a practical standpoint, for a bank to avoid assuming responsibility and liability for the obligations of its direct subsidiaries. Experience has shown that the direct ownership link between a bank and its subsidiaries creates a powerful public perception that the condition of the bank is tied to the condition and financial success of its subsidiaries.

Third, because of the direct ownership link between the bank and its subsidiary, any breach of insulating walls that may be constructed between the bank and its subsidiary would be more likely to result in the loss of protection from the legal doctrine of corporate separateness than would the same breach in the wall between a bank holding company and a securities affiliate. This is simply a function of the fact that there is no direct ownership link between the bank and the securities affiliate.

Fourth, separation of a bank and an affiliated securities firm through a holding company helps promote competitive equity. Securities activities that are conducted directly within a depository institution or in a subsidiary of a depository institution are much more likely to benefit from association with the federal safety net through increased public confidence in securities offerings made by the insured banks and their subsidiaries than would be the case if these activities were conducted in a holding company affiliate.

Similarly, the holding company technique would be more effective in minimizing any competitive advantage banks would have in raising funds because of their association with the federal safety net and their ability to collect deposits.

The second major element of the separateness structure is to assure that corporate separateness firewalls are not impaired and that the risks of securities activities are not passed on to an affiliated bank. We suggest a number of measures to accomplish this goal.

- bank lending to, and purchase of assets from, a securities affiliate should be prohibited;
- banks should not be able to enhance the creditworthiness of securities underwritten by a securities affiliate through guarantees or other techniques,
- banks should not lend to issuers of securities underwritten by a securities affiliate for the purpose of paying interest or principal on such securities;
- banks should not be able to lend to customers for the purpose of purchasing securities underwritten by a securities affiliate;
- appropriate rules should limit interlocks between the officers and directors of banks and those of affiliated securities firms;
- a securities affiliate should be required to prominently disclose that its obligations or the securities that it underwrites are not the obligations of any bank and are not insured by a federal agency; and
- a securities affiliate should be adequately capitalized.

Under this approach, rules should be put in place that will prevent use of the credit facilities of the bank for the benefit of the securities affiliate and to this end, in constructing these walls, a premium should be placed on arrangements that are simple, clear, and easy to apply, and that will not be subject to erosion by interpretation.

It is with these principles in mind that we approach one of the most important issues in separating banks from their securities affiliates -- the question of whether a bank should be able to lend to or purchase assets from its securities affiliates. We considered that lending may be appropriate as a way of taking maximum advantage of the synergies that can be achieved between a bank and securities affiliates to the benefit of customers and that, as we have described here today, securities activities are the natural extension of the credit facilities provided by banks. We also considered that rules now exist limiting the amount of credit that a bank can provide to an affiliate and require that this lending be at arms-length and adequately collateralized.

Nevertheless, our experience indicates that these limitations, embodied in sections 23A and 23B of the Federal Reserve Act, do not work as effectively as we would like and, because of their complexity, are subject to avoidance by creative interpretation, particularly in times of stress. On the other hand, a prohibition on an affiliated bank's loans to

and purchases of assets from its securities affiliate would sharply limit the transfer of the risk of securities activities to the federal safety net and would eliminate one of the key factors viewed by the courts as justifying "piercing the corporate veil" between the bank and its nonbank affiliates -- that operations of the securities affiliate are financed and supported by the resources of the affiliated bank. For these reasons, and because of the desirability of having a clear rule that is not subject to avoidance, we decided to recommend to you that we have a simple rule that banks should not be permitted to lend to, or purchase assets from, their securities affiliates. A securities affiliate would, however, be free under our proposal, to borrow from its holding company parent -- an entity that is not protected by the safety net.

A similar limitation was proposed in the recent study by the House Government Operations Committee. We would support only one very limited exception to this rule. We propose allowing fully collateralized intraday borrowing by a securities underwriter and dealer from an affiliated bank to support United States government and agency securities clearing operations.

For very similar reasons, and as I have already outlined, we would recommend that a bank should not be able to guarantee or extend its letter of credit, or otherwise support securities issued by a securities affiliate. Allowing such

practices would not only raise the question of competitive fairness, but also would permit a transferring of the risks of securities activities to the federal safety net. For the same reasons, loans to customers for the purpose of buying securities underwritten by a securities affiliate or to a company whose securities have been underwritten by a securities affiliate for the purpose of repaying interest or principal due on such securities, should not be permitted. Prohibiting these transactions will establish a sound firewall.

Another major purpose of firewalls is to prevent conflicts of interest that are competitively unfair and which can impair confidence in banking institutions. As I mentioned, this problem is effectively dealt with by the disclosure requirements and other provisions of the securities laws. The already built-in protection of these laws should be strengthened by other provisions. We would recommend that a securities affiliate must disclose its relationship to an affiliated bank and plainly state that the securities it sells are not deposits and are not insured by a federal agency. In addition, we should reinforce the requirements of existing law by providing that a securities affiliate cannot sell securities to an affiliated bank or its trust accounts during an underwriting period or 30 days thereafter or otherwise sell securities to the bank or its trust accounts unless the sale is at established market prices.

We would also recommend that neither banks nor their securities affiliates be able to share confidential customer information without the customer's consent and that a bank cannot express an opinion on securities being sold by its securities affiliate without disclosing that its affiliate is selling that security. As another step to prevent conflicts of interest, we would suggest that a securities affiliate could not sell securities backed by loans originated by its affiliate bank unless the securities are rated by an independent rating organization.

We believe that the firewalls that are proposed will substantially augment the existing insulation of banks from affiliates that is now provided by the Bank Holding Company Act. In addition to these measures, perhaps the best insulator is adequate capital for both banks and securities affiliates. Adequate authority should be provided to assure that holding companies involving banks and securities activities should be adequately capitalized. In particular, investments by bank holding companies in securities firms should not be permitted if the investment would cause the holding company to fall below minimum capital requirements.

With these safeguards in place we do not believe it is necessary to prevent a bank and a securities affiliate from jointly marketing banking and securities products or from using a similar corporate name. Here we believe that an analysis of

the tradeoff between corporate separateness on the one hand, and taking advantage of the efficiency and convenience to customers that can be achieved through coordinated marketing on the other, indicates that the gains to separateness would be small and the losses to efficiency would be high. The requirement of separate names would be artificial particularly because securities law disclosure would, in any event, require an affiliate to inform the users of its services of its association with a banking enterprise. Similarly, as I pointed out at the outset, the market for securities is only an extension of the market for other banking products and to deny a banking organization the ability to sell both products would lose much of the gains for the economy that we seek to achieve through the association between the two. Moreover, there would be no competitive unfairness in this arrangement since the broad relaxation of the Glass-Steagall requirements that we propose would enable securities firms to own banks as well as bank holding companies to own securities affiliates.

The important point is whether these measures would cause the risks of securities activities to be passed on to banking institutions and to the federal safety net. As I indicated, the Board believes that the corporate separateness measures that we recommend should be put in place effectively deal with these problems.

The guidelines Congress has established for expansion of banking activities require a concern for whether expansion of securities powers will lead to a concentration of resources in the securities or banking industries. We believe that repeal of Glass-Steagall should have the opposite effect. As I have stressed today it will increase the number of viable competitors in both the banking and securities industries, enhancing competition in both. As a result, we doubt that the Congress need go beyond the requirements of the antitrust laws to anticipate a problem with concentration of resources in the emerging financial services industry. However, because we see as one of the major advantages to repeal to be an expected increase in competition, and because we could understand anxieties that this goal might be impaired by a combination of the largest banking and securities firms, the Board would not oppose a limited provision aimed at preventing the largest banking and securities organizations from consolidating.

We commend this Committee for its active role in considering one of the most important issues that now faces our financial markets. We strongly recommend that you adopt legislation to repeal the Glass-Steagall Act and to put in its place a new framework allowing the affiliation of banking organizations and securities firms. We urge you to allow the moratorium on banking activities contained in Title II of CEBA

to expire on March 1, 1988 as the law now provides. We believe that these measures will ensure a more responsive, competitive and safe financial system.