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Testimony by

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Chairman, Board of Governors of the Federal Reserve System

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Mr. Chairman, members of the Committee, I welcome this opportunity 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. Earlier this year, during its consideration of CEBA, this Committee came to the conclusion that the laws governing financial activities are in need of major repairs and that there is an urgent need for Congressional action to this end. As I read the record, this Committee, and then the Congress as a whole, accepted the task of reconciling the present outdated financial structure with the realities of a changed marketplace for financial services and pledged to move ahead promptly to develop the necessary legislation.

The majority and minority leadership of this Committee have now taken a major step toward fulfillment of this promise by putting before you, with their full endorsement, a bill which addresses what is perhaps the single most important anomaly that now plagues our financial system -- the artificial separation of commercial and investment banking. That bill, S. 1886 - the Financial Modernization Act of 1987 -- is also precedent setting because it establishes a framework that can be tested and, if it proves adequate as we expect it will, should serve as a foundation on which to build more generally for the future.

I want to express the appreciation of the Board to Chairman Proxmire and Senator Garn for providing this Committee with an excellent framework on which to launch the necessary reforms. In our view, we now have an historic opportunity to put the financial system on a sounder footing -- perhaps a unique opportunity to make it more responsive to consumer needs, more efficient, more competitive in the world economy, and equally important, more stable. At the same time, I would also like to thank Senators Wirth and Graham for their most useful contribution to the legislative effort now going forward in this Committee.

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.

Recently, a great deal of attention has been focused, in this Committee and elsewhere, on proposals 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. Our own analysis of these useful contributions 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 on the specific proposal contained in the Financial Modernization Act to repeal the Glass-Steagall Act.

It is our view that enactment of this legislation 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 be repealed insofar as it prevents bank holding companies from being affiliated with firms engaged in securities underwriting and dealing activities. We would not recommend that you address at this time the more generally comprehensive, but in some important ways more limited, approach taken in the very interesting proposals put forward in S. 1891 by Senators Wirth and Graham, about which I will comment in more detail at the conclusion of my testimony.

On the other hand, we very much prefer a full repeal of Glass-Steagall to a piecemeal removal of restrictions on underwriting and dealing in specific types of securities such as revenue bonds or commercial paper. This technique would artificially distort capital markets and prevent financial institutions from assuring benefits to customers by maximizing their competitive advantage in particular markets of their choice.

I. Reasons for Repeal of the Glass-Steagall Act

A very persuasive case has been made for adoption of the repeal proposal. It would allow lower costs and expanded services for consumers 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.

A. Evaluation Criteria

In reaching these conclusions, we have been 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 outline why we believe that changes in the Glass-Steagall Act should 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.

B. Public Benefits

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 obligation 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 should 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.

C. <u>Effect of Computer and Communication Technology</u>

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 these technological developments 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 has 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 securities. There are many others. Our concern is that these changes in the way that providers of credit utilize financial intermediaries have reduced the basic competitiveness of banks and that the trend toward direct investor-borrower linkages will continue.

D. Banks' Response to New Competitive Conditions at Home and Overseas

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 -- provided that the securities are issued abroad. In their home market, banks continue to be sharply limited by the Glass-Steagall Act in competing for the business of acting as intermediaries in the process of investors providing credit to corporations, just at the time that the new financial environment transformed by technological change has made such intermediation a natural extension of the banking business.

E. The Need for Reform

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 business credit. Society would lose the existing expertise and infrastructure of banking, and bear the cost of the redeployment of bank resources as personnel and capital move to nonbanking organizations. Instead, 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.

II. Evaluation of Possible Adverse Affects

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 include 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.

A. Effect of Stock Market Developments

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.

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.

B. Assessment of Risk

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 risk reduction, for banks being allowed increased securities powers.

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 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.

As I have stressed, such an insulating framework can be established. I would now like to turn to what we see as its major elements.

III. Need for Firewalls

Fundamental to our recommendation on repeal of Glass-Steagall, and to our assessment that potential adverse affects of securities activities are clearly manageable, is the view that securities activities can be conducted behind walls designed to separate, in so far as possible, the bank from the risks associated with the securities activities. We see two major elements to an approach toward 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.

At the same time, and without impairing the necessary separation, the structure should not be so rigid as to prevent affiliated organizations from providing the users of financial products with the improved service and reductions in cost that can come from the joint ownership of securities and banking organizations. We believe that it is both possible and desirable to accomplish both goals -- establishing fully adequate firewalls in a context that achieves the economic benefits of joint ownership.

It is here that we believe the Financial Modernization Act makes such a major contribution. Using the holding company framework as a focus, it establishes a system of firewalls that we believe is both workable and effective. Because of the importance of these provisions I would like to examine them with you in some detail.

A. Importance of the Holding Company Framework

S. 1886 would require that new securities activities made possible under this bill would have to take place in a subsidiary of a bank holding company, and not in a bank or a direct subsidiary of a bank. We believe that this is a sound decision because it provides the best separation that institutional arrangements can provide between a bank and a securities affiliate. In our judgment, this is the most effective structure for assuring that decisionmaking in securities firms is not affected by the benefits of the federal safety net, for minimizing the need for the regulatory framework that is a necessary consequence of maintaining the safety net, and, of course, for avoiding risks to the safety net itself. Achieving these goals is essential to any plans for permitting broader ownership of banks and wider powers for bank holding companies.

There has not been unanimous agreement on this point and I think it is important to examine the advantages of the holding company approach.

First, there is an important legal reason. The holding company mechanism takes maximum advantage of the doctrine of corporate separateness -- the legal rule that provides that 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. However, because of the direct ownership link between a bank and its subsidiary, any breach of insulating walls is much more likely to result in bank liability for the actions of its security subsidiary because the line of authority to direct operations runs from the bank parent to that subsidiary. The same breach in the wall between a bank holding company and a securities affiliate, on the other hand, is much less likely to involve the affiliated bank simply because of the fact that there is no direct ownership link between the bank and the securities affiliate.

Second, there is a vital point of accounting and resulting market perceptions of the health of the bank. Any losses that may be incurred by the securities firm owned directly by a bank would be reflected in the balance sheets and income statements of the bank under normal accounting rules.

That would not be the case if the holding company owns the securities affiliate directly. Where a securities firm's losses are reflected directly on the financial statements of the bank, the markets' evaluation of the health of the bank will inevitably be adversely affected.

Third, 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.

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.

Thus, we believe the advantages of the holding company structure are both self evident and overwhelming. Larger banking companies that are most likely to be heavily involved in securities activities should have no serious organizational problems with implementing this approach.

For the smaller banking firms that do not have holding companies, the bill has two constructive solutions. First, to ease the regulatory and cost barriers to the establishment of holding companies, section 201 provides for expedited, almost automatic, Board approval of applications to form such holding companies, and section 202 allows such formations that are simply reorganizations without a change in ownership to be exempt from securities act registration. Second, the bill allows banks to continue to conduct presently authorized securities activities and also permits them to engage in underwriting municipal revenue bonds and brokerage of mutual funds. We understand the SEC's concerns about assuring that functional regulation prevails in this area, and we believe that consistent with appropriate exceptions for small banks, these problems are resolvable.

IV. Strengthening Holding Company Firewalls

The second major element of the separateness structure is to assure that the holding company firewalls are not impaired by transactions between a bank and an affiliated securities firm, with the consequence of the risks of securities activities being passed on to an affiliated bank. We believe that section 102 of S. 1886 is fully adequate to do this essential strengthening job. It clearly addresses the key issues of:

- -- interaffiliate credit transactions and guarantees,
- -- lending to support underwritten securities,
- -- officer and director interlocks, and
- -- adequacy of disclosure and other conflict of interest problems.

A. Prohibition on Lending by Bank to Securities Affiliate

In reviewing these firewall strengthening measures, we consider one of the most important and difficult to be the prohibition on a bank being able to lend to or purchase assets from its securities affiliate. There are strong arguments on both sides. In formulating our position on this issue we took into account the major advantages of a straightforward prohibition on lending to securities affiliates thus insulating the bank from the risks of securities activities, and weighed against it the benefits that could be achieved in terms of better service to customers.

We also considered that rules now exist limiting the amount of credit that a bank can provide to an affiliate and that require that this lending be at arms-length and adequately collateralized. Our experience indicates, however, 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, we came to the conclusion that 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. It would also 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 an affiliated bank. For these reasons, and because of the desirability of having a clear rule that is not subject to avoidance, we agree with the provisions of section 102 that prohibit banks from lending to, or purchasing assets from, their securities affiliates except for collateralized lending for intra-day government securities clearing.

We also agree, as allowed by S. 1886, that a securities affiliate should be free to borrow from its holding company parent. The holding company is not protected by the federal safety net and competitive fairness requires that the parent of a securities affiliate should be able to support its affiliate in the same manner as the corporate parents of investment firms that are unaffiliated with banks.

B. Other Transaction Limitations

For very similar reasons we agree, as provided in section 102, that a bank should not be able to guarantee, extend its letter of credit to, 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 transfer of the risks of securities activities to the federal safety net. This section would also prevent, during the underwriting period and for 30 days thereafter, loans from a bank affiliate to customers for the purpose of buying securities underwritten by a securities affiliate. Finally, it would stop loans from affiliated banks to companies whose securities have been underwritten by a securities affiliate for the purpose of repaying interest or principal due on such securities. We agree that these prohibitions are essential to establishing sound firewalls.

C. Preventing Conflicts of Interest -- Disclosure

Another major purpose of firewalls is to prevent conflicts of interest that can impair confidence in banking institutions. The disclosure requirements and other provisions of the securities laws already have made an effective contribution to dealing with this issue. Nevertheless, we welcome the strengthening of these already built-in protections by the provisions of section 102 which require, under rules established by the SEC, a securities affiliate to disclose its relationship to an affiliated bank and to state plainly that the securities it sells are not deposits and are not insured by a federal agency.

D. <u>Officer and Director Interlocks</u>

The prohibition in section 102 on officers and directors of a securities affiliate serving at the same time as an officer or director of any affiliated bank is also important to maintaining the principle of corporate separateness and to avoiding conflicts of interest. For this reason we are somewhat concerned about the complete exemption in this section from this limitation for banks with total assets of $500 million or less. In order to permit the operating efficiencies that smaller banks may achieve from using common management officials without severely eroding the corporate separateness of the bank, we recommend that these banking organizations be permitted to have interlocking officials with a securities affiliate, but be required to maintain a majority of the board of directors of the securities affiliate that are not also directors of the banking organization.

E. <u>Other Conflict of Interest Safeguards</u>

In addition, S. 1886 reinforces the requirements of existing law by providing that a securities affiliate cannot sell securities from its portfolio to an affiliated bank at any time, or place securities with its trust accounts during an underwriting period or 30 days thereafter. S. 1886 also helps to assure objectivity where a securities affiliate underwrites securities originated by an affiliated bank by a requirement that those securities must be rated by an unaffiliated nationally recognized rating agency. Finally, we note with approval that under the bill neither banks nor their securities affiliates would 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.

F. Capital Adequacy

We believe that the firewalls that are established by S. 1886 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.

Accordingly, authority should be provided to assure that holding companies owning banks and securities companies should be adequately capitalized. Consequently, we fully support the provisions of section 102 which require that 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.

Moreover, to assure that a banking organization's securities affiliate is regulated as to capital adequacy in the same manner as other securities firms, section 102, in calculating the capital adequacy of a bank holding company that acquires a securities firm, excludes from the holding company's capital and assets any resources of the holding company that are invested in the capital of the securities affiliate. We agree that the investment of a holding company in its securities subsidiary may be deducted from the capital of the bank holding company in determining its capital adequacy. Such deductions should include any asset of the holding company that is considered capital in the securities subsidiary by its functional regulator.

However, in calculating the regulatory capital for the holding company, S. 1886 would deduct from the assets of the holding company all loans to the securities subsidiary, and thus the holding company would not be required to hold capital to support these assets. We feel that any holding company advances to a securities affiliate that are not considered capital by the functional regulator should not be deducted from the holding company's assets and capital. Rather, they should be supported by capital at the holding company, just as advances to other subsidiaries require capital support.

To do otherwise would be to promote unlimited leveraging in the holding company, thereby weakening or eliminating the ability of the holding company to act as a source of strength to its subsidiary banks. With this modification, section 102 would not only assure that the securities affiliate broker-dealer will be regulated as to capital adequacy by the SEC, but would also have the beneficial effect of requiring a bank holding company to maintain capital sufficient to absorb losses suffered by the securities affiliate without impairing the holding company's ability to serve as a source of strength to its bank subsidiaries. This result is consistent with the provisions of section 102 which provide that the Board can reject a notice to establish a securities affiliate if it would be inconsistent with a bank holding company's obligation to serve as a source of strength to its subsidiary banks.

G. Support for Functional Regulation

At this point I believe it would be appropriate to stress the full support of the Board for the concepts of functional regulation incorporated into S. 1886. We agree that a securities subsidiary of a bank holding company carrying out the functions of a broker-dealer should be subject to the net capital requirements of the SEC and should, indeed, be regulated by that body once it has been established.

As I have stressed, however, we do believe that there is a proper role for regulation of a company that owns a bank. As provided under current law, a company that owns a bank should have competent management, should be adequately capitalized, and should be open to review in as unobtrusive a manner as is possible consistent with achieving these goals.

This position is consistent with our support for the provisions of section 102 which exempt a securities firm that owns a bank from normal holding company capital and examination requirements if at least 80 percent of its assets and revenues are derived from, or devoted to, securities activities. Even in this situation, S. 1886 does not ignore the importance of capital. If an exempt company's bank falls below minimum capital levels, the Board can require restoration of minimal capital levels within 30 days, and in the absence of compliance can order the termination of control within 180 days. In the context of the situation where a firm is overwhelmingly a securities firm, this framework has our full support. This is a unique provision that may, if it works successfully, provide a precedent for developing the complex of measures that are needed in order to allow broader ownership of banks and to protect the federal safety net.

We also support minimizing regulatory burdens wherever possible. Accordingly, we endorse the provisions of Title II generally on "Expedited Procedures" and, particularly, section 203 of the bill which speeds up the holding company applications procedure for approved holding company activities by changing it into a no objection arrangement and by eliminating the cumbersome requirements for formal hearings. We also endorse the provisions of the bill which allow the Board to take into account technological or other innovations in the provision of banking or banking related services in making judgments on whether an activity is so closely related to banking as to be a proper incident thereto. We believe that these provisions, which have had the Board's support for a number of years, will reduce regulatory burdens and introduce needed flexibility into the regulatory process.

VI. Coordinated Activities

With the strong system of firewalls that are contained in S. 1886 in place, we believe it is appropriate to allow the joint banking-securities enterprise the opportunity to realize the efficiencies that may be achieved by combining services that are functionally so closely linked. After all, one of the major purposes of allowing the affiliations that could be established by repealing Glass-Steagall is to permit, in a competitively neutral manner, the users of securities services to benefit from a higher level of competition. Thus, in our view, the approach taken in the bill of permitting use of similar names and coordinated marketing of products is appropriate. We believe that a prohibition on these activities would produce only small gains for bank insulation, but 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 earlier, 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 is proposed by S. 1886 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, and that have been adopted in S. 1886, should effectively deal with these problems.

VII. Concentration of Resources

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 does not oppose the limited provisions of section 102 of S. 1886 aimed at preventing the largest banking and securities organizations from consolidating.

VIII. Comments on S. 1891 --
The Financial Services Oversight Act

The Financial Modernization Act deals with the problems of our financial system by focusing on the specific question of securities powers, an area which is of great importance to the financial system. While it sets up a framework which could be used as a precedent for the consideration of other products and services, it does not deal with those issues at this time, leaving this question open for further consideration in the future. We believe this is the right way to proceed at this time.

A different approach has been taken by S. 1891, the proposed Financial Services Oversight Act introduced by Senators Wirth and Graham, which establishes a comprehensive framework for the conduct of the financial services business in the United States. As a first step toward this objective, the bill establishes a Financial Services Oversight Commission, with a membership drawn from the banking agencies, the SEC, the CFTC and the state insurance commissioners. This broadly based Commission would have three essential functions: (a) it would define the types of activities in which bank holding companies, financial holding companies, and commercial holding companies could engage; (b) it would be charged with enforcing compliance with the regulations defining new activities; and (c) it would establish minimum standards of capital adequacy for financial holding companies and their affiliates.

Fundamental to this approach is a broad expansion of the financial activities in which bank holding companies may engage, including an explicit repeal of the Glass-Steagall Act. The bill also provides for the extension of a limited degree of prudential regulation to financial holding companies, which are companies that include affiliates that offer uninsured transaction accounts, to include capital adequacy standards as well as reserve requirements. Also fundamental to this concept is the separation of banking and commerce by providing that a commercial holding company cannot own a bank that offers federally insured deposits.

The third major element of the bill is the establishment of a National Electronic Payments Corporation for the purpose of operating a mixed public/private corporation that would establish and operate a national electronic payment system to facilitate large dollar transactions, including book-entry transfers of U.S. government securities. The Corporation would also be responsible for the establishment of standards for utilization of this system and for improvements in the technological capability and reliability of the system as a whole. This enterprise, capitalized with funds from the Federal Reserve System and by the private shareholders, would provide for direct access to the system not only by banks, but also by other financial organizations which have transactions in funds and government securities of a magnitude sufficient to make their participation as shareholders in the new corporation appropriate.

The Board finds this proposal to be a careful and very thoughtful approach to the difficult problems that this Committee is attempting to grapple with today. As Senator Wirth pointed out in introducing S. 1891, the bill incorporates a proposal made by Federal Reserve Bank of New York President Gerald Corrigan and thus the Board is fully familiar with both its structure and objectives.

A. Desirability of Coordinated Regulation

One of the proposals in the bill that we find to be particularly useful is the provision on establishing a Financial Services Oversight Commission to bring together the various regulatory interests that affect our highly integrated financial mechanism. The need for greater regulatory coordination could not have been brought out more clearly than in the recent stock market developments where we saw the complex interactions of securities, commodities, and banking markets.

Similarly, I have emphasized in my testimony today that securitized products are a natural extension of the market for banking activities, but at this point it is also important to stress that securities firms have undertaken many of the activities that have been traditionally thought of as unique to banking. Again, we have examples in the news, such as bridge lending, but there are many others as well, including foreign exchange transactions and the offering of transaction accounts.

These overlaps in functions suggest not only that rigid lines between providers of securities and banking services are impractical, but also that more coordination of regulatory activities is highly desirable. For example, as we seek to establish a worldwide risk based capital system for banking organizations that will apply capital standards to a considerable variety of now off-balance sheet activities, our ability to do so, and the stability of markets, will be adversely affected if almost identical activities of securities firms are not subject to the same type of capital adequacy requirements. Thus, a broadly representative financial regulatory body with adequate authority to coordinate financial regulation needs careful consideration as the Congress makes the essential changes necessary to adapt the financial system to the new realities of competition and technology. We urge that further thought should be given to how this approach could be integrated with S. 1886.

B. Concerns about the Authority of the FSOC

We are concerned, however, about taking the Financial Services Oversight Commission concept further at this time by establishing separate categories of bank, financial, and commercial holding companies, together with authority in the Commission to fix the activities of each type of institution. This format may be too rigid, and the bill does not give the Commission specific enough instructions as to the basis for its decisions, nor do we believe that it is possible now for the Congress to write the needed comprehensive instructions. For example, no guidance is provided on the firewalls to separate banking and nonbanking activities that the Board considers to be essential to an adequate framework for expanded activities of companies that own banks.

Rather, it seems to us that there are major advantages to proceeding on an incremental basis starting with securities powers where the rationale for change has been clearly established. In this way, we can have the benefits of change while gaining experience with the systems that are necessary to assure that this change is carried out in a responsible and effective manner. As conditions evolve over time, a more flexible structure will allow both the Congress and the regulators the opportunity to be more responsive to the needs of customers and less dependent on rigid formulas that may not be practical.

C. National Electronic Payments Corporation

Finally, we have given considerable thought to the concept of a National Electronic Payments Corporation. There is much to be said for its emphasis on spurring technological improvements, on arrangements for liquidity reserves to protect the integrity of that system, and on limiting intra-day overdrafts. However, we are not sure that the mechanism proposed in the bill is the most efficient and cost effective way of achieving its worthwhile goals. The issues that it raises warrant further study.

IX. Application of S. 1886 to Savings and Loans

Finally, I would like to note that S. 1886 does not apply to savings and loan institutions or their holding companies. However, it would seem appropriate that the framework that is being developed by this Committee for the proper conduct of securities activities to protect the federal safety net, to prevent conflicts of interest, and to assure competitive equality within a structure of functional regulation, should be equally applicable to these institutions. We understand, however, the concerns about the effect of these rules on the possible willingness of securities firms to put capital into troubled S&Ls at a time when the industry and its regulators are attempting to deal with large losses in a considerable number of institutions.

Thus, the Congress has to reconcile conflicting public policy objectives -- the need to deal with present losses in a constructive way, while at the same time to protect the future health of depository institutions when engaging in a new activity. I have no easy answers to this dilemma, except to suggest that it be kept under review so that this Committee can work, in close consultation with the FHLBB, on such ideas as transition periods, exceptions for capitalization of large troubled institutions, or other solutions that the legislative process is uniquely capable of working out.

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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 as provided in the Financial Modernization Act proposed by Chairman Proxmire and Senator Garn.

We also 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.