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Testimony by

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Chairman, Board of Governors of the Federal Reserve System

before the

Subcommittee on Monopolies and Commercial Law

Committee on the Judiciary

U S House of Representatives

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Mr Chairman, members of the Committee, I am pleased to take this opportunity to present the Federal Reserve Board's views on the competitive and concentration of resources implications of H R 5094, the Depository Institutions Act of 1988 The promotion of competition in the financial services industry, and prevention of the undue concentration of resources, are important goals of Federal Reserve regulatory policy Indeed, we are required to pursue these objectives by the Bank Holding Company Act

For several years the Board has argued forcefully that our laws regarding financial structure need substantial revision in order to sustain and promote competitive financial institutions We have strongly supported repeal of the Glass-Steagall separations of commercial and investment banking, and are very much in favor of the Financial Modernization Act passed by the Senate, including its establishment of the bank holding company subsidiary framework for expanded securities powers We believe this framework, which is also the approach of the proposed Depository Institutions Act, is the best available, can be tested in the "real world" of financial institutions, and, if it proves as effective as we expect, should serve as a foundation on which to build more generally for the future I urge the Committee to support the establishment of this approach to expanded securities powers

Without denigrating the importance of encouraging competition and prevention of the undue concentration of resources, it must be remembered that there are other important goals of regulatory policy

Here also the Bank Holding Company Act includes principles that made good sense when they were first enacted and that make good sense today By these I mean that the Bank Holding Company Act also requires us to consider, in determining the appropriateness of new activities for bank holding companies, whether the activities will result in unsafe and unsound banking practices, decreased competition, or conflicts of interest 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

I am sure it will come as no surprise when I tell you that success in achieving these multiple objectives is neither easy nor assured, and that one goal can sometimes be in conflict with another For example, some proposed new powers are relatively risky, and it may be necessary to sacrifice some competitive benefits in order to insulate these new activities from an affiliated bank Here again, we believe that the bank holding company subsidiary framework that would be established by both the Senate's bill and the Depository Institutions Act of 1988 appropriately balances our complex goals

Since the Bank Holding Company Act provides the foundation of our current and hopefully our future approach to dealing with competition issues, I should like briefly to review how the Federal Reserve uses that act in this area I will argue that the existing provisions of the Bank Holding Company Act are fully adequate to address these concerns The final section of my testimony discusses in some detail why the Board feels that reform of the Glass-Steagall Act is procompetitive, identifies those provisions of the proposed Depository Institutions Act of 1988 that we feel go too far in restricting the expected benefits of increased competition, and explains why we feel the issue of the undue concentration of resources is not a major concern

I Board Supports the Bank Holding Company Act Approach to Competition

The Board is generally comfortable with and supports the provisions of H R 5094 aimed at maintaining competition The proposed bill's provisions on competition retain the principles set down in the Bank Holding Company Act as amended in 1970 These principles require that the Board not approve any acquisition or merger that would result in a monopoly, attempt to monopolize, or substantially lessen competition in any section of the nation, unless the anticompetitive effects are clearly outweighed by other public interest concerns We believe that these principles continue to make good sense Moreover, they have proven to be workable and effective in practice during almost two decades of experience Thus, the banking system has remained highly competitive and there has been no general tendency toward an undue concentration of financial resources during this period even as bank holding companies entered various nonbanking activities approved by the Board

In addition to the sensible principles and proven efficacy of the Bank Holding Company Act approach to competition, a relatively efficient administrative framework is already in place In particular, prior approval from the Federal Reserve is now required for acquisitions by bank holding companies of banks and nonbank firms Further, the Federal Reserve must assess, among other things, the competitive effects of all acquisitions This assessment begins with an analysis that focuses on the impact of an acquisition on traditional structural measures such as the concentration ratio and the Herfindahl index If a particular acquisition proposal raises substantive competitive issues based on purely structural measures, additional factors are taken into account Most notable among these are (1) the possible competitive influence of nonbank firms, especially thrift institutions and (2) the importance of potential competition, that is, the likely influence of firms outside the particular market on the pricing behavior of participants in that market This analytical approach applies to both bank and nonbank acquisitions

In short, I think that the competition principles that are contained in both the Bank Holding Company Act and the proposed bill have been and can continue to be efficiently and effectively applied with established administrative machinery and the application of established economic analysis There is a track record and it has worked

II Specific Comments on H.R 5094

A Expanded securities powers are procompetitive

Repeal of the Glass-Steagall Act would increase the number of actual and potential competitors in the investment banking industry Many of the major bank holding companies have made clear their intentions to quickly take advantage of expanded securities powers, should they be granted, and it is our expectation that more bank holding companies would follow if Glass-Steagall is repealed For example, many banks and bank holding companies that currently underwrite and deal in municipal general obligations would likely seek additional powers in at least the municipal revenue bond area, and possibly in corporate bonds as well With banks outside of money markets engaging in investment banking, the Board anticipates that local and regional firms would very possibly acquire direct 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

More generally, the major public benefit of Glass-Steagall repeal would be lower customer costs and increased availability of investment banking services, both resulting from increased actual and potential competition and from the realization of possible economies of scale and scope from the coordinated provision of commercial and investment banking services We believe that repeal of Glass-Steagall would reduce underwriting spreads and therefore lower financing costs to businesses large and small, as well as to state and local governments In addition, bank holding company participation in dealing currently ineligible securities is likely to provide the benefit of enhanced secondary market liquidity

Studies of the market structure of investment banking suggest that at least portions of this industry are fairly concentrated Evidence in this regard was provided in the September 1987 Report of the

House Committee on Government Operations, which presented data supporting its conclusion that corporate securities underwriting is highly concentrated In 1986, the five largest underwriters of commercial paper accounted for over 90 percent of the market, the five largest underwriters of all domestic corporate debt accounted for almost 70 percent of the market, and the five largest underwriters of public stock issues accounted for almost half of the market Data for 1987 and 1988 indicate that these numbers have remained essentially unchanged

I would emphasize that these data, while very suggestive, do not necessarily imply that concentration has led to higher consumer costs The possibility, or potential, that new firms will enter a market may be sufficient to achieve competitive prices However, it is precisely here that the Glass-Steagall Act is so troublesome Bank holding companies, with their existing expertise in many securities activities and their broad financial skills and industry networks, would be the most likely potential competitors of investment banks if not constrained by law

Repeal of the Glass-Steagall Act is also consistent with technological changes that are occurring in the financial services industry--changes that are inhibiting the ability of banking organizations to be effective competitors both now and in the future Unless there are compelling public policy reasons to continue the current Glass-Steagall restrictions--and we see none--society will incur unnecessary costs as bank holding companies' specialized resources are repositioned into other activities, not because of bank holding companies' unwillingness to compete or innovate, but simply because of an inflexible statutory and regulatory structure

The technological changes I am referring to--and that I and other members of the Board have discussed on many previous occasions--are developments in computer and communications technology that have enabled both borrowers and lenders to more easily and at lower cost obtain and use credit and market risk information. This strikes at the very heart of the value-added of financial intermediation More specifically, service organizations or investors' own 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 There are numerous examples of new financial products that have resulted from this technological revolution and that challenge traditional bank loans--the explosion in the use of commercial paper, the rapid growth of mortgage-backed securities, and the invention of consumer-receivable-related securities It seems reasonable to assume that the trend toward direct investor-borrower linkage, or more securitization, will continue

Bank holding companies, of course, have not ignored these vast changes and, indeed, have responded to the technological revolution by participating in it However, it is here once again that the Glass-Steagall Act is particularly constraining. The provision of investment banking services, particularly to corporate clients, is at the cutting edge of the information revolution The ability of banking organizations to hold their competitive position by continuing to operate on the margins of customer services is limited Unless the Glass-Steagall Act is repealed, the constraints it imposes, along with the continued undermining of the bank franchise by the new technology, are likely to limit the future ability of bank holding companies to contribute to and encourage a competitive and efficient economy

B Some provisions of the bill unnecessarily inhibit competition

As I noted in my introductory remarks, the encouragement of competition is not the only objective of Federal Reserve regulatory policy Other important objectives include a safe and sound banking system, prevention of conflicts of interest, and limiting the federal safety net to insured depositories These objectives have led us to support locating certain expanded nonbanking activities, including expanded securities powers, in a separate subsidiary of a bank holding company Successful implementation of this strategy requires the construction and maintenance of effective "firewalls" between a bank and an affiliated securities firm Thus, we support most of the firewall provisions of the Depository Institutions Act of 1988

However, two of the firewall and securities activities provisions of H R 5094 are, in our view, unnecessarily restrictive and would, if implemented, impose competitive costs that exceed any benefits The first such provision is the exclusion of underwriting and dealing corporate equities from the set of expanded securities activities In view of the extensive firewalls, particularly those limiting credit transactions and asset sales, insulating affiliate banks and thrifts from potential safety and soundness and conflict of interest concerns, we see no reason for an absolute firewall prohibiting equity activities

A second place where we believe the proposed bill would unnecessarily inhibit competition is its restrictions on the sharing of similar name, logo, premises, and joint advertising between the securities subsidiary and the affiliated bank or thrift Restrictions of this type would dilute and perhaps prevent some of the cost-saving synergies and economies of scope that are expected from the joint provision of these activities within a bank holding company The other extensive firewalls contained in the bill, and in the bill passed by the Senate, are sufficient to insulate the bank from risk, to warn investors of the nature of their risk, and to meet safety and soundness concerns is this area

In addition to the securities provisions I have just discussed, the Board believes that many of the insurance provisions of the proposed bill would unnecessarily restrict competition and thereby raise costs to consumers The one exception is that part of the bill that permits banks to provide financial guaranty insurance Since my colleague Governor Heller testified on the insurance provisions before another committee of this House last Friday, I will not dwell on this issue However, let me emphasize that of particular concern to the Board are the increased restrictions on the ability of banks to engage in insurance agency activities Insurance agency entails little risk, has been engaged in safely by many banks for many years, and its provision by banking organizations is clearly procompetitive Aside from deposit and loan activities, insurance is the one financial service that virtually all of our citizens use Generalized bank insurance agency services would reduce insurance costs to the public, and modernize the delivery of a valuable product

C Undue concentration provisions

Presumably because of the federal safety net and, therefore, a concern over the potential size of failed institutions, banking is the only industry to which laws explicitly restraining overall, or undue, concentration apply In addition, these restraints apply only to the acquisition of nonbank firms by bank holding companies, and do not appear in any of the nation's antitrust laws

The proposed bill contains specific numerical standards prohibiting the acquisition of a securities firm by a bank holding company These standards include prohibition of a merger if both parties are among the top 15 in their respective industries, or if the bank holding company and securities firm have total assets greater than $30 billion and $15 billion, respectively

While we recognize that the anxieties underlying inclusion of new undue concentration standards in H R 5094 have a lengthy historical tradition, there appears to be little foundation for such anxieties in today's environment This conclusion is supported by two observations First, the nonbank financial sector in general remains highly fragmented, in spite of the fact it is generally much less regulated than banking Second, the Board's experience in implementing section 4(c)(8) of the Bank Holding Company Act as amended in 1970, which allows bank holding companies to enter nonbanking activities approved by the Board, has not been marked with any general tendency toward increasing overall concentration in the approved activities Under section 4(c)(8), when considering expanded bank holding company powers the Board is required to account for possible adverse effects such as undue concentration of resources

Even a brief examination of the nonbank financial sector illustrates that much of it is highly fragmented For one thing, while recent years have seen significant blurring of distinctions between commercial and investment banking, the nonbank financial sector in general has tended to remain segmented. For example, different companies have operated in insurance, commercial and consumer finance, and mutual funds Furthermore, within most of the major nonbank financial services there are a large number of firms, including roughly 2,300 in life insurance underwriting, 3,500 in property and casualty insurance underwriting, 1,700 in commercial and consumer finance, and 650 in mutual funds Without any significant regulatory standards to inhibit them, market forces have not shown any notable tendency toward undue levels of aggregate concentration in the nonbank financial sector

Just as the nonbank financial sector in general has remained disaggregated, the activities approved since 1970 by the Board as permissible for bank holding companies have also generally remained unconcentrated Acquisitions by bank holding companies in most of the 25 nonbanking activities approved by the Board have been modest Indeed, most of the bank holding companies that entered activities such as underwriting credit life insurance, operating insurance agencies, providing financial advice, and engaging in data processing, have done so on a de novo basis Such entry is procompetitive and has extremely little effect on overall asset concentration

In a few activities, including mortgage banking, consumer finance, and factoring, bank holding companies have not only expanded de novo but have also expanded significantly by acquisitions subject, of course, to review by the Federal Reserve applying the competition and undue concentration standards of the Bank Holding Company Act In spite of entry by bank holding companies, mortgage banking and consumer finance remain relatively unconcentrated, bank holding companies have not dominated or taken over these industries, and overall financial sector concentration has not been appreciably increased because of the relatively small size of the acquired nonbank firms and their activities compared to banking While factoring has become dominated by bank holding companies, because of the small absolute size of factoring in the financial sector, the role of bank holding companies has not materially affected financial concentration in the United States

In short, based on the experience of bank holding companies in nonbanking activities, the experience of the nonbank financial sector in general, and the apparent effectiveness of current provisions of the Bank Holding Company Act, there seems to be little foundation for concern with the issue of undue concentration of resources However, we recognize that many people are concerned about this issue, and because we view the reform of Glass-Steagall as having the highest priority, we continue not to oppose the expanded concentration of resources provisions of the proposed bill

In closing, Mr Chairman, the Board believes that the Congress now has an historic opportunity to put the nation's financial system on a sounder footing--perhaps a unique opportunity to make it more competitive, more efficient, more responsive to consumer needs, and equally important, more stable It would be a major waste of Congress' and others' scarce resources if all the hard work on this subject of the last year were lost We urge you in the strongest terms to aid in the passage of 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 and our suggested revisions to the Depository Institutions Act