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Testimony by

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Board of Governors of the Federal Reserve System

before the

Committee on Banking and Financial Services

U S House of Representatives

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I am pleased to be here today to present the views of the Board of Governors of the Federal Reserve System on expanding permissible affiliations between banks and other financial services providers The bills being introduced in this Congress, such as the newly revised "Financial Services Competitiveness Act of 1995," introduced by Chairman Leach, would continue the modernization of our financial system begun with last year's passage of the landmark interstate banking legislation The Leach bill would authorize the affiliation of banks and securities firms, as well as permit banks to have affiliates engaged in most other financial activities

Before I present the Board's views, however, I first want to commend Chairman Leach for his leadership in recognizing the importance of congressional action in this area and for acting promptly to bring his bill before the Committee for its consideration The new Leach bill would reform outdated statutory prohibitions established for a financial system that no longer exists It thus provides Congress with the opportunity to make the financial system more competitive and more responsive to consumer needs, all within a framework that would maintain the safety and soundness of insured depository institutions The Board believes that modern global financial markets call for permitting financial organizations to operate over a wider range of activities The approach contained in the new Leach bill would be a major step, providing realistic reform, and thus has the strong support of the Board of Governors of the Federal Reserve System

There is, I think, general agreement on the forces shaping our evolving financial system—forces that require that we modernize our statutory framework for financial institutions and markets The most profound is, of course, technology the rapid growth of computers and telecommunications Their spread has lowered the cost and broadened the scope of financial services, making possible new product development that would have been inconceivable a short time ago, and, in the process, challenging the institutional and market boundaries that in an earlier day seemed so well defined Technological innovation has accelerated the second major trend, financial globalization, that has been in process for at least three decades Both developments have expanded cross–border asset holdings, trading, and credit flows and, in response, both securities firms and U S and foreign banks have increased their cross–border locations Foreign offices of U S banking organizations have for some time been permitted, within limits, to meet the competitive pressures of the local markets in which they operate by conducting activities not permitted to them at home In the evolving international environment, these off–shore activities have included global securities underwriting and dealing, through subsidiaries, an activity in which U S banking organizations have been among the world leaders, despite limitations on their authority to distribute securities in the United States

Such a response to competition abroad is an example of the third major trend reshaping financial markets—market innovation—which has been as much a reaction to technological change and globalization as an independent factor These developments make it virtually impossible to maintain some of the rules and regulations established for a different economic environment As a result, there is broad agreement that statutes governing the activities of banking organizations increasingly form an inconsistent patchwork

For example, under federal standards, banking organizations may act as agents in private placements of securities and, in fact, have done so quite successfully, accounting recently for one–third of all corporate bonds and one–seventh of all equity privately placed Banking organizations may also act as brokers of securities, and as investment advisers for individuals and mutual funds For many years, they have acted as major dealers in U S government and municipal general obligation bonds Banking organizations are also the leading innovators and dealers in derivatives, and banking organizations operate futures commission merchants as holding company subsidiaries As just noted, banking organizations underwrite and deal in securities abroad and, since 1987, banking organizations with the necessary infrastructure may apply for limited underwriting and dealing of securities through special bank holding company subsidiaries under a Federal Reserve Board interpretation of Section 20 of the Glass–Steagall Act

In a pattern that is reminiscent of interstate branching developments, the states for some time have been removing restrictions on the activities of state chartered banks The FDIC, as required by the Federal Deposit Insurance Corporation Improvement Act (FDICIA), reviews such activities, but has not rejected an application to exercise any of these powers from adequately or well–capitalized banks According to the Conference of State Bank Supervisors (CSBS), in 1993, seventeen states—including several large ones—had authorized banks to engage in securities underwriting and dealing, with about half requiring such activity in an affiliate At the federal level, the OCC has proposed a process to allow national bank subsidiaries to conduct activities not permitted for the bank

And so it goes on Technological change, globalization, and regulatory erosion will eventually make it impossible to sustain outdated restrictions, and these forces will be supplemented by piecemeal revisions to federal regulation and sweeping changes in state laws That is what we are here today to discuss—the need to remove outdated restrictions and to rationalize our system for delivering financial services I might note that in this regard the United States is behind the rest of the industrial world Virtually all the other G–10 nations now permit banking organizations to affiliate with securities firms and with insurance and other financial entities We are among the last who have not statutorily adjusted our system That might be acceptable, or even desirable, if there was a good reason to do so We do not think there is such a reason to retain the status quo

Let me be clear that the Board's position in favor of expanding the permissible range of affiliations for banking organizations is not a reflection of a concern for banks, their management, or their stockholders U S bank management has been quite creative—indeed has led others—in developing and using both technology and the globalization of financial markets for profitable innovations that have greatly benefitted their customers Rather, the Board's support for the expansion of permissible activities reflects the desirability of removing outdated restrictions that serve no useful purpose, that decrease economic efficiency, and that, as a result, limit choices and options for the consumer of financial services Such statutory prohibitions result in higher costs and lower quality services for the public and should be removed That their removal would permit banking organizations to compete more effectively in their natural markets is an important and desirable by–product, but not the major objective, which ought to be a more efficient financial system providing better services to the public Removal of such prohibitions moves us closer to such a system

Indeed, the Board urges that, as you consider the reforms before you, the focus not be on which set of financial institutions should be permitted to take on a new activity, or which would, as a result, get a new competitor All are doing similar things now and are now in competition with each other, offering similar products Securities firms have for some time offered checking–like accounts linked to mutual funds, their affiliates routinely extend significant credit directly to businesses, and they are becoming increasingly important in the syndicated loan market Banking organizations are already conducting a securities business While indicative of the need for reform, which institution has leaped some earlier restraint is not the issue The Board believes that the focus should be do the proposed bills promote a financial system that makes the maximum contribution to the growth and stability of the U S economy? Are existing restraints serving a useful purpose? Do they increase the compatibility of our laws and regulations with the changing technological and global market realities in order to ensure that these goals are achieved? Are they consistent with increased alternatives and convenience for the public at a manageable risk to the bank insurance fund?

Banking organizations are in a particularly good position to provide underwriting and other financial services to investors They are knowledgeable about the institutional structure of the market and skilled at evaluating risk Moreover, for centuries, banks' special expertise has been to accumulate borrower-specific information that they can use to make credit judgments that issue-specific lenders and investors cannot make Overcoming such information asymmetries has been the value added of banking on the credit side Indeed, it would appear that most companies want to deal with a full-service provider that can handle their entire range of financing needs This preference for "one-stop shopping" is easy to understand Starting a new financial relationship is costly for companies and, by extension, for the economy as a whole It takes considerable time and effort for a company to convey to an outsider a deep understanding of its financial situation This process, however, can be short-circuited by allowing the company to rely on a single organization for loans, strategic advice, the underwriting of its debt and equity securities, and other financial services As evidence that there are economies from this sharing of information, most of the Section 20 underwriting has been for companies that had a prior relationship with the banking organization

Our discussions with Section 20 officials suggest that the economic benefits of "one–stop shopping" are probably greatest for small and medium–sized firms These firms, as a rule, do not attract the interest of major investment banks, and regional brokerage houses do not provide the full range of financial services these companies require Rather, their primary financial relationship is with the commercial bank where they borrow and obtain their services Thus, from the firm's perspective, it makes sense to leverage this relationship when the time comes to access the capital markets for financing It is thus reasonable to anticipate that if securities activities are authorized for bank affiliates, banking organizations, especially regional and smaller banking organizations, would use their information base to facilitate securities offerings by smaller, regional firms, as well as local municipal revenue bond issues Many of these banking organizations cannot engage in such activities now because they do not have a sufficient base of eligible securities business revenue to take advantage of the Section 20 option that limits their ineligible revenues to 10 percent of the total Investment banking services are now available for some of these smaller issues, but at a relatively high cost Section 20 subsidiaries at regional banks indicate that they are eager to expand their investment banking services to small and moderate–sized companies These Section 20 subsidiaries view such firms as underserved in the current market environment and see an opportunity to provide a greater range of services at lower prices than those now prevailing

I should also note that almost all bank holding companies that have set up Section 20 subsidiaries believe that the diversification of revenues will result in lower risks for the organization While the empirical literature is inconclusive, and the Section 20's themselves have not been around very long, and have operated under significant restrictions, it seems likely that some bank holding companies could achieve risk reduction through diversification of their financial services

To be sure, with the benefits comes some risk, but I read the evidence as saying that the risks in securities underwriting and dealing are manageable Underwriting is a deals oriented, purchase and rapid resale, mark–to–market business in which losses, if any, are quickly cut as the firm moves to the next deal Since the enactment of the Securities Acts—with their focus on investor protection—the broker/dealer regulator, the SEC, is quick to liquidate a firm with insufficient capital relative to the market value of its assets, constraining the size of any disturbance to the market or affiliates The SEC now applies such supervision to Section 20 affiliates, and it would do so to securities affiliates under the revised Leach bill and similar bills introduced so far in this Congress Section 20 affiliates have operated during a period in which sharp swings have occurred in world financial markets, but they still were able to manage their risk exposures well with no measurable risks to their parent or affiliated banks Indeed, in order to limit the exposure of the safety net, the supervisors have insisted that securities affiliates have risk management and control systems that assure that risk can be managed and contained As would the case with the new "Competitiveness Act," the Federal Reserve has required that such an infrastructure exist before individual Section 20 affiliates are authorized and that organizations engaging in these activities through nonbank affiliates have bank subsidiaries with strong capital positions

The Leach bill continues the holding company framework, which we believe is important in order to limit the direct risk of securities activities to banks and the safety net The Board is of the view that the risks from securities and most other financial activities are manageable using the holding company framework proposed in that bill But there is another risk the risk of transference to nonbank affiliates of the subsidy implicit in the federal safety net—deposit insurance, the discount window, and access to Fedwire—with the attendant moral hazard The Board believes that the holding company structure creates the best framework for limiting the transference of that subsidy We recognize that foreign subsidiaries of U S banks have managed such activities for years virtually without significant incident Nonetheless, we have concluded that the further the separation from the bank the better the insulation We are concerned that conducting these activities without limit in subsidiaries of U S banks does not create sufficient distance from the bank Moreover, even though the risks of underwriting and dealing are manageable, any losses in a securities subsidiary of a bank would—under generally accepted accounting principles—be consolidated into the bank's position, an entity protected by the safety net

An additional safeguard to protect the bank from any risk from wider financial activities, and to limit the transference of the safety net subsidy to such activities, is the adoption of prudential limitations through firewalls and rules that prohibit or limit certain bank and affiliate transactions However, it would be folly to establish prohibitions and firewalls that would eliminate the economic synergy between banks and their affiliates The revised Leach bill retains reasonable firewalls and other prudential limitations, but provides the Board with the authority to adjust them up or down Such flexibility is highly desirable because it permits the rules to adjust in reflection of both changing market realities and experience

The Leach bill attempts to accommodate the merchant banking business currently conducted by independent securities firms Both bank holding companies with Section 20 subsidiaries and independent securities firms engage in securities underwriting and dealing activities However, independent securities firms also directly provide equity capital to a wide variety of companies without any intention to manage or operate them The Leach bill would permit securities firms that acquire commercial banks, as well as securities firms acquired by bank holding companies, to engage in all of these activities—underwriting and dealing in securities, as well as merchant and investment banking through equity investment in any business without becoming involved in the day–to–day operations of that business These powers are crucial to permit securities firms to remain competitive domestically and internationally Under the bill, the Board could establish rules to ensure that these activities do not pose significant risks to banks affiliated with securities firms or serve as a "back door" to the commingling of banking and commerce

Some are concerned that an umbrella supervisor is incompatible with a financial services holding company with an increasing number of subsidiaries that would be unregulated if they were independent The Board too is concerned that, if bank–like regulation were applied to an expanded range of activities, the market would believe that the government is as responsible for their operations as it is for banks This subtle transference of the appearance of safety–net support to financial affiliates of banks creates a kind of moral hazard that is corrosive and potentially dangerous

Nonetheless, it is crucial to understand that both the public and management now think—and will continue to think—of bank holding companies (and financial services holding companies, if authorized) as one integrated unit, especially if they enjoy the economic synergies that is the purpose of the reform proposals Moreover, experience and the new computer technology are already adding centralized risk management to the existing centralized policy development for bank holding companies The purpose of the umbrella supervisor is to have an overview of the risks in the organization so that *the risks to the bank* can be evaluated and, if needed, addressed by supervisors The umbrella supervisor, it seems to us, becomes more crucial, not less, as the risk management and policy control moves from the bank to the parent

Balancing the supervisory needs of the bank regulators with concerns about the extension of bank–like supervision and regulation is not easy In an effort to eliminate unnecessary regulatory constraints and burdens, the Leach bill would require the banking agencies to rely on examination reports and other information collected by functional regulators In addition, it would require the banking agencies to defer to the SEC in interpretations and enforcement of the federal securities laws The revised bill goes further and eliminates the current application procedure for holding company acquisitions by well–capitalized and well–managed banking organizations whose proposed nonbank acquisitions or *de novo* entry are both authorized and pass some reasonable test of scale Your revised bill, Mr Chairman, also streamlines the process for evaluating the permissibility of new financial activities These are extremely important modifications both for existing bank holding companies and for securities firms that wish to affiliate with banks Such provisions would greatly enhance the "two–way street" provisions by eliminating unnecessary regulatory burden and red tape We believe that this concept could also quite usefully be extended to bank acquisition proposals

The Board is also committed to continuing to develop supervisory and examination policies that appropriately reduce unnecessary burdens on organizations with bank subsidiaries that are well capitalized and well managed But we must not lose sight, and the Leach bill does not, that the umbrella supervisor must still be permitted to monitor both the financial condition of the organization and the potential transfer of risks to the insured depository affiliates Moreover, we reiterate our concerns of last year that, however any restructuring is addressed, the Federal Reserve's capability to monitor large banking organizations in order to respond effectively to systemic crisis not be impaired

Mr Chairman, you asked for the Board's views on combining commerce and banking While the Board supports wider permissible affiliations between banks and other financial services companies, it does not believe that, at this time, banks should be affiliated with commercial and industrial firms The Board believes that in a free market economy there is a presumption of free entry into any business—including banking—although safeguards are required when public monies are at risk However, the Board believes it would be prudent to delay enacting the authority to link commerce and banking until we have gained some actual experience with wider financial ownership of, and wider activities for, banking organizations We should reflect carefully on such a basic change in our institutional framework because it is a step that would be difficult to reverse

Your invitation letter also asked about experience with banking and commerce abroad Our review of the industrial countries with internationally important banking sectors suggests that all seven (the non–U S G–7 plus Switzerland) permit limited ownership of banks by commercial firms and some ownership of commercial firms by banks In practice, despite the legal permissibility, banking–commerce ties are limited In none of the seven countries are any of the largest banks owned by commercial firms Banking and commerce affiliations are much more commonly in the form of banks' holding sizable equity stakes in commercial firms, rather than vice versa Only in Germany is bank control of commercial firms commonplace, and in that country a banking license is required to engage in any one of a number of credit services which are performed in the United States and in other countries by *nonbank* financial institutions In Japan, banks' equity holdings are substantial relative to bank capital, but, just as in the case of U S bank holding companies, a bank in Japan may not hold more than 5 percent of another company's shares

There are two main benefits from bank ownership of commercial firms One benefit is that such arrangements reduce the information costs associated with long–term projects, so that *ex ante* profitable long–term projects are more likely to be funded A second benefit is that adding equities to the mix of instruments in a bank's portfolio increases the potential for portfolio diversification However, foreign experience demonstrates that there are costs from bank ownership of commercial firms Banking–commerce ties may induce banks to continue to finance a project beyond the point at which it is prudent to do so In addition, equity holdings increase the sensitivity of bank capital to equity market volatility, as has been the case in Japan, thus exposing banks to additional risk A third cost, illustrated by Germany, is the tendency for capital markets—especially equity markets—to be less fully developed under a system of bank–dominated financing

Over the last three decades, deposit protection schemes have been established in all seven countries to avoid runs by depositors at small banks Financial problems at larger banks are normally dealt with by cooperative efforts of commercial banks and governments I should note that all these countries impose restrictions on banking–commerce ties in order to limit the risks resulting from such ties As I noted, the risks associated with commercial firm control of banks appear to be limited by permitting commercial firms to control only small banks In addition, all the countries except Japan limit the risks associated with bank ownership of commercial firms by limiting banks' total equity holdings to a fraction of bank capital Even with these limits, recent losses stemming from bank affiliations with commercial firms, most notably at

Metallgesellschaft in Germany and Credit Lyonnais in France, have sparked public debate in these countries about the advisability of banking--commerce ties

In the United States, the public debate continues to focus on wider affiliations between banks and other financial firms On more than one occasion, bills to permit at least securities affiliates were approved by the banking committees in both houses, as well as by the full Senate on several occasions In the meantime, technological change, globalization, and market innovations have continued In such a context, modernization of our financial system should be of high priority in order better to serve the U S public Consequently, the Board believes it is timely, desirable, and prudent to authorize wider affiliations between banks and other financial service providers, the approach contained in the revised Leach bill would be a major step in the modernization of our financial system, which sadly now operates under increasingly outdated restrictions and prohibitions