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Testimony by

Alan Greenspan

Chairman

Board of Governors of the Federal Reserve System

before the

Subcommittee on Telecommunications and Finance and the

Subcommittee on Commerce, Trade, and Hazardous Materials

of the

Committee on Commerce

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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 bill before the subcommittees, Mr. Chairman, the "Financial Services Competitiveness Act of 1995," H.R. 1062, would authorize the affiliation of banks and securities firms, as well as permit banks to have affiliates engaged in most other financial activities.

This bill would reform outdated statutory prohibitions established for a financial system that no longer exists, continuing the modernization of our financial system begun with last year's passage of the landmark interstate banking legislation. It 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 and permit both banks and securities firms to operate more efficiently. The Board believes that modern global financial markets call for permitting financial organizations to operate over a wider range of activities. Distinctions among financial products and institutions have become increasingly difficult to make, undermining the statutory and regulatory structures established over three generations ago. The approach contained in the bill before you would be a major step, providing realistic reform, facilitating a wider range of activities for both securities firms and banking institutions, 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 products 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. The business of financial intermediation has always been the measurement, acceptance, and management of risk. In the past, commercial and investment banks performed these basic functions with quite different tools and strategies. Today, the tools and strategies increasingly overlap, blurring traditional distinctions between commercial and investment banks.

Examples abound. Securities firms have for some time offered checking-like accounts linked to mutual funds, and their affiliates routinely extend significant credit directly to business. On the bank side, the economics of a typical bank loan syndication do not differ essentially from the economics of a best-efforts securities underwriting. Indeed, investment banks are themselves becoming increasingly important in the syndicated loan market. With regard to derivatives instruments, the expertise required to manage prudently the writing of OTC derivatives, a business dominated by banks, is similar to that required for using exchange-traded futures and options, instruments used extensively by both commercial and investment banks. The list could go on. It is sufficient to say that a strong case can be made that the evolution of financial technology alone has changed forever our ability to place commercial and investment banking into neat separate boxes.

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 operations. 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. Similarly, foreign offices of securities firms have engaged in banking abroad.

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 authority to engage in 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, reviews such activities, but has not rejected an application to exercise any of these powers from adequately or well-capitalized banks. According to the most recent report of the Conference of State Bank Supervisors, 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 without mounting inefficiencies and dead-weight costs, and these forces will be supplemented by piecemeal revisions to federal regulation and sweeping changes in state laws. This was the pattern that we observed in the evolution of interstate banking and branching, a pattern that finally led the Congress to repeal artificial restrictions on the ability of banking organizations to expand geographically. And this is what we are here today to discuss—the need to remove outdated separations between commercial and investment banking and thereby take the next logical step in rationalizing our system for delivering financial services in a more efficient manner. I might note that in this regard the United States is, as it was with geographical restrictions, 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.

Let me be clear that the Board’s position in favor of expanding the permissible range of affiliations for banking and securities organizations is not a reflection of a concern for banks, securities firms, their management, or their stockholders. Managements of U.S. financial organizations have been quite creative—indeed have 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 for both banks and securities firms 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 both commercial and investment 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. As I noted, all are doing similar things now and are now in competition with each other, offering similar products. The Board believes that the focus should be on whether 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 safety net? Are buyers of securities—particularly retail buyers—continuing to be protected by clear and full disclosures and anti-fraud rules?

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. It is also clearly true that securities firms have built up a considerable information base on their investment and merchant banking customers. Accordingly, the financial innovations of recent years have facilitated investment banks’ development of commercial banking expertise through money market and other mutual funds, bridge loans, and loan syndications. And their expertise has been applied to affiliated financial firms in the United States and abroad.

An increasing number of customers of commercial banks and securities firms 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, the very entities that contribute so much to the growth of our economy. 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 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.
Some financial organizations in recent years have found that providing the full range of financial services is not compatible with either their management expertise or their market position. There are, as a result, frequent reports of divestitures and an increasing number of niche participants operating alongside wide-ranging financial supermarkets. The authorization to engage in broader activities does not necessarily mean that all banks will engage in securities activities or that all securities firms will engage in banking. But efficient markets providing better services should permit market participants to choose the best way for them to distribute financial services.

Organizations that choose to offer new services may do so in part to diversify their risks. Indeed, 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 of expanded powers 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 of 1933 and 1934—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 bill before you. 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 ensure that risk can be managed and contained. As would be the case with H.R. 1062, 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 bill passed overwhelmingly by the House Banking Committee continues the holding company framework, which we believe is important in order to limit the direct risk of securities activities to banks and to 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 affiliates of the subsidy implicit in the federal safety net—deposit insurance, the discount window, and access to Fedwire—with the attendant moral hazard and risk of loss to the taxpayers. 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. While it is true that the profits of a
bank subsidiary would directly strengthen the bank, the profits of a holding company subsidiary can be rechanneled to the bank without exposing the bank to the risk of subsidiary losses.

An additional safeguard to protect the bank from any risk from wider financial activities is the adoption of prudential limitations through firewalls and rules that prohibit or limit certain bank and affiliate transactions. While firewalls may temporarily bend under stress, they nonetheless serve a useful purpose. It would be counterproductive, if not folly, if in order to avoid the risk of failure of firewalls, we sought to establish prohibitions and firewalls so rigid that they would eliminate the economic synergies between banks and their affiliates. Moreover, if we create such inflexible firewalls we run the risk of reducing the safety of the financial system by inhibiting its ability to respond to shocks. Clearly, there is a need for balance here.

The bill before you 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. H.R. 1062 also makes exceptions to firewalls and other prudential limitations if the bank affiliates are well-capitalized. Such banks can tolerate additional risk.

H.R. 1062 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 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 encompassing 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 are 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—the entity with access to the safety net—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. But the umbrella supervisor need not be so involved in the affairs of the nonbank affiliates and the parent that regulatory costs are excessive, or that the market perceives that the safety net has been expanded to the nonbank activities of the organization. Indeed, we applaud the continuation of functional regulators embodied in H.R. 1062.

In an effort to eliminate unnecessary regulatory constraints and burdens, the bill before you 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 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.

The bill would also require no consolidated capital supervision of the holding company, and minimal non-bank supervision so long as the uninsured bank subsidiaries have in total less than $15 billion of risk-weighted assets and the banks are less than 25 percent of consolidated risk-weighted assets. Similar treatment is available to holding companies if the insured bank subsidiaries have less than $5 billion in risk-weighted assets and are less than 10 percent of consolidated risk-weighted assets. More stringent consolidated supervision would be imposed if the banks increase to a size that raises systemic concerns, or if the Fed concludes that the holding company would not honor its guarantee of the insured bank subsidiaries, as required in H.R. 1062, or if the bank portion of the total organization is so large that the rest of the organization might have difficulty supporting the bank. That is to say, organizations that have bank subsidiaries with access to the safety net, which is
available in part even for the wholesale uninsured banks, are made subject to more supervision when their banks approach sizes that may pose systemic risk should they fail, or when there is concern that the overall organization might be unable to adequately support its banks. The bill approved by the Banking Committee also streamlines the process for evaluating the permissibility of new financial activities for holding companies with strong banks. In addition, organizations with uninsured bank subsidiaries are authorized a basket of investments in activities not permitted to those holding companies with insured bank subs.

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. It is worth underlining, however, that there is nothing in the bill that reduces the prudential supervision of the bank subsidiaries—whether insured or uninsured. Indeed, H.R. 1062 quite properly emphasizes the necessity for the parent holding company of insured or uninsured banks to maintain the strength of their banks if they wish to maintain their securities affiliate. If unable or unwilling to do so, they must exit either the banking or the securities business. Entities unwilling to accept the responsibility of maintaining strong bank subsidiaries are thus provided incentives to consider whether they should enter and/or maintain their banking business.

In conclusion, 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
The financial system should be of high priority in order better to serve the U.S. public. H.R. 1062 authorizes the next logical step in the modernization of our financial system, providing benefits to commercial and investment banking firms, but most importantly to the U.S. consumers of financial services. The Board believes its adoption would be a major step in the evolution and strengthening of our financial system, which sadly now operates under increasingly outdated restrictions and prohibitions.

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